

“Noteholder or Not a Holder?”

Actions taken to seize control of a securitisation structure and the underlying loan portfolio declared void and of no effect.

Summary

Two recent High Court cases, *Business Mortgage Finance 6 Plc v Greencoat Investments Limited and others* [2019] EWHC 2128 (Ch) (the **Greencoat Case**) and *Business Mortgage Finance 6 Plc v Roundstone Technologies Ltd* [2019] EWHC 2917 (Ch) (the **Roundstone Case**) (together, the **Business Mortgage Cases**), have affirmed a number of principles relating to securities held through the clearing systems and the powers of receivers, including the following:

- The ability of noteholders to direct the trustee to act is set out in the terms of the transaction documents.
- The question of who has the ability to direct the trustee should be construed by reference to the specific terms of the transaction documents and how the notes are held within the clearing systems.
- Where noteholders wish to instruct the trustee, they must establish their entitlement to do so by delivering proof of holding satisfactory to the trustee. A trustee is not bound to act until it has received satisfactory proof of holding (and indemnification, if required).
- Typically the powers of a receiver are restricted to dealing with the assets over which the issuer has granted security to the trustee and do not extend to control over specific corporate matters, such as the ability to appoint and remove directors of the issuer.

The Business Mortgage Cases follow a number of recent cases which have concerned the validity of actions taken by parties purporting to be noteholders, who have sought to take control of securitisation transactions. The Business Mortgage Cases will be of interest to trustees, issuers and investors in providing greater clarity on the ability (or otherwise) of investors to direct a trustee. They also provide useful guidance as to the construction of “protection of third party” clauses in security documents and provisions governing the appointment of new trustees in trust deeds.

Facts and background

The Greencoat Case

In 2007, Business Mortgage Finance 6 PLC (**BMF6**) issued six classes of notes backed by a portfolio of commercial mortgages relating to property in the UK. BNY Mellon Corporate Trustee Services Limited (**BNY Mellon**) was appointed as trustee. In January 2019, Greencoat Investments Limited (**GIL**) launched a tender offer to purchase notes with an initial settlement date of February 28 2019 (subsequently postponed to July 10 2019). On March 18 2019, GIL announced it would make an initial cash payment to each of the holders of the notes equal to 1% of the purchase price in return for the immediate transfer of their rights under the notes. Although there was no evidence that such payment had been made or that any noteholders had transferred any of their rights in the notes prior to the proposed settlement date (or since), GIL purported to take certain steps to seize control of the securitisation. These purported steps included (i) appointing a trustee, (ii) directing BNY Mellon to declare an event of default, accelerate the notes and declare that the security was enforceable, (iii) appointing a receiver, (iv) removing BNY Mellon as note trustee, (v) replacing the directors of BMF6, and (vi) directing the sale of the underlying loan portfolio.

BMF6 sought declaratory relief against GIL and a number of other parties in relation to these arrangements. Judge Zacaroli held that there was no evidence that GIL was a noteholder within the meaning of the transaction documents when it purported to take the steps described above. The judge decided that the steps taken by the defendants to take control of the securitisation structure were invalid and of no effect.

Debt issues in global form

Where notes are issued in global form, the entirety of the debt issuance is represented by the global note. That global note is deposited with a “common depository” who holds it on behalf of the clearing systems. The clearing systems record the dematerialized positions held in the notes by their participants. The holders of the economic interest in the debt will not themselves hold a note; instead the holders of the economic interest will either be direct participants in the clearing system or will hold their interest in the notes through a custodian or broker.



The Roundstone Case

The Roundstone Case concerned declaratory relief sought by BMF6 against Roundstone Technologies Ltd (**Roundstone**), the purported purchaser of the underlying loan portfolio. Roundstone asserted that it was a *bona fide* purchaser without notice when it acquired the rights to the receivables comprising BMF6's loan portfolio and the cash standing to the credit of BMF6's bank accounts. The sale and purchase agreement was executed by a receiver (appointed by GIL when it claimed to be the noteholder) in favour of Roundstone. Judge Nugee supported the judgment in the Greencoat Case that GIL was not a noteholder and that the receiver appointed by GIL had not been validly appointed. As a result, Judge Nugee decided that the purported receiver had no actual or ostensible authority to execute the sale. The court held that the sale was invalid and that Roundstone was not a *bona fide* purchaser without notice.

The issues

The meaning of a "Noteholder" and the importance of proof of holdings

The key issue in the Business Mortgage Cases was whether GIL was a 'noteholder' and therefore able to instruct the trustee. As the notes were in global form, the holder of legal title to the notes was the holder of the global note, i.e. the common depositary. In order to instruct the trustee by a written resolution, it was necessary for GIL to be a holder of the beneficial interest in the notes which it had sought to acquire through the tender offer. Judge Zacaroli held that a holder of the beneficial interests in the notes meant "*only those persons in whose name the Notes are held in the records of the clearing systems*".

He supported this conclusion with reference to the definition of "*Instrumentholder*".

He also relied on provisions of the trust deed and the global note to the effect that the trustee was entitled to rely on information provided by the clearing systems as to whether a particular person has an interest in the global note. The judge commented that, when ascertaining the beneficial owner of the notes, wherever the transaction documents envisage looking beyond the actual bearer of the global note, "*it goes no further than someone recorded as the holder... in the books of Euroclear or Clearstream.*" As there was no evidence from the clearing systems that the positions had been transferred to GIL, GIL was not a holder of beneficial interests in the notes and did not have standing to instruct the trustee.

The judgment confirms that the meaning of 'noteholder' is a matter of contractual interpretation, properly informed by an understanding of how interests in global notes are recorded by the clearing systems. The judgment supports the view that any language which "cuts-through" to beneficial holders (i.e. the persons shown in the records of the clearing systems as the holder of a particular amount of the debt) is a practical matter. The court recognized that, as the ultimate beneficial interest in the notes can subsist through a chain of intermediaries, it is possible that "*neither the clearing systems themselves, nor their account holders, would have knowledge of the ultimate beneficiary.*"

Most bond documents provide that investors are able to give instructions relating to the notes through a ‘written resolution’. This takes effect as an extraordinary resolution if it is signed by holders of a sufficiently high threshold of the total bonds outstanding (usually 75% or 90%) and avoids the need for a formal investor meeting to obtain instructions. The Greencoat Case is a helpful reminder that the written resolution is valid if signed by the beneficial holders of the debt (provided the documents have ‘cut-through’ language) and that the written resolution does not need to be signed by the common depository. The case also supports the conclusion that a trustee is not obliged to act unless it is satisfied that it is being instructed by the beneficiaries of the trust. This means that trustees will have the “*task of determining whether anyone other than the bearer of a global or definitive Note is a beneficial holder entitled to take action such as participating in a Written Resolution.*” Where an investor claims to hold an interest under a global note, the investor must provide documentary proof in a form which can be reconciled to a holding of a direct participant in the clearing systems.

In his judgment, Judge Zacaroli referred to certain forms of evidence which may be provided by an investor to prove its entitlement in the notes. These include a “*current position statement taken from a recognised clearing system record keeping system.*” Alternatively, the beneficial holder can ask the direct participant to procure that the clearing systems themselves deliver a SWIFT disclosure message to the trustee. If the investor is not itself a direct participant at the clearing systems, any position statement or SWIFT disclosure message will need to be accompanied by custody statements showing the note holding structure so that the trustee can reconcile the holding to the ownership claims of the purported holder. Judge Zacaroli summarized the verification process: “*the person beneficially entitled to notes held for it by an account holder at the clearing systems will provide evidence of that interest by instructing its account holder to provide such evidence via the clearing system directly to BNY [Mellon]*”.

Validity of Actions

Aside from the fact that GIL was unable to prove that it was a noteholder at the time it purported to make the appointment by written resolution, the court also found other grounds to question the validity of actions taken.

Appointment of New Trustees: the court held that this power was vested in BMF6 as issuer of the notes. Although there was a requirement for the appointment to be ratified by an extraordinary resolution of the most senior class of notes then outstanding, the noteholders did not have the power themselves to appoint a new trustee.

Appointment of co-trustee: the court found that (i) only the trustee had the power to appoint a co-trustee and (ii) the noteholders’ power to direct the trustee did not extend to directing the trustee to conclude that something was in the interests of the noteholders (which was relevant because the trust deed only allowed the trustee appoint a co-trustee if it considered “*such appointment to be in the interests of the Instrumentholders*”).

The court’s commentary demonstrates that noteholders cannot expect to direct trustees to take actions or make determinations that the transaction documents expressly reserve to the trustee.

Trust Corporation: the trust deed provided that whenever there were more than two trustees, the majority of such trustees would be competent to exercise the rights and powers vested in the original trustee provided that a “Trust Corporation” was always included in such a majority. In this case, the entities purported to be appointed as co-trustees had not established that they met the criteria of being a Trust Corporation, and therefore could not exercise the trustee’s powers on their own.

Removal of Trustee: the trust deed provided that where the only trustee in place is a Trust Corporation, the removal would not become effective until such time as a Trust Corporation was appointed as replacement trustee. As neither of the proposed replacements were a Trust Corporation, BNY Mellon’s purported removal was invalid.

Powers of a receiver and protection of third parties: the steps taken by the purported receiver to remove the directors and company secretary of BMF6 were invalid primarily because the co-trustees had not themselves been validly appointed. However, the court noted that even if a receiver had been properly appointed, it would have no power to appoint and remove directors of BMF6. The judge highlighted that a receiver's power to act was limited to dealing with the charged property granted by BMF6 to the trustee. In an effort to delineate the extent of the receiver's powers, the court held that *"while the appointment of receivers will supersede the powers of the company (and thus the board of directors) to act in relation to the charged assets, it does not vest the receivers with any power to interfere in the shareholders' control over the appointment and removal of directors."*

Protection of Purchasers: Roundstone argued that it was a bona fide purchaser of the charged property for value without notice. It relied on the clause titled *"Protection of third parties"* to argue that it should enjoy protection in dealing with purported trustees and purported receivers. The court held that that clause only offered protection to purchasers dealing with validly appointed trustees and receivers *"in relation to the purported exercise of their powers even if events have not in fact occurred to make those powers exercisable."*

Final thoughts

These cases provide useful clarification for market participants on how important provisions relating to the exercise of investor rights and powers should be construed.

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