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## *New Guidance from the High Court on the Ability of Trustees to Pay Noteholder Expenses*

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On 13 July 2017, Mr Justice Blair handed down the long-awaited decision in *UBS AG, London Branch v GLAS Trust Corporation Limited and Fairhold Securitisation Limited*. In these proceedings, UBS AG, London Branch ("UBS"), one of the swap counterparties for the ground rent-backed securitisation issued by Fairhold Securitisation Limited (the "Issuer"), brought a claim against GLAS Trust Corporation Limited (the "Note Trustee") in respect of the Note Trustee's attempt to pay certain legal and financial expenses of the ad-hoc group of noteholders as an element of its own expenses pursuant to the Issuer's priority of payments in the sum of £2,447,859.09 (the "AHG Expenses").

### **Background**

In 2006 and 2007, the Issuer issued secured floating rate notes due in October 2017 in a total amount of £443,500,000 (the "Notes"). The Notes are secured against cashflows deriving from ground rents and other related amounts payable in respect of a portfolio of sheltered housing located throughout England and Wales. In connection with the securitisation, the Issuer entered into a series of long-dated interest rate and inflation swap transactions (the "Swaps") with HBoS Treasury Services plc (as it then was) and UBS (the "Swap Providers") to hedge its obligations under the Notes.

Recent events relating to this transaction which are relevant to the matters discussed in the abovementioned case are as follows:

- In March 2015, an ad-hoc group of noteholders was formed (the "AHG").
- In October 2015, UBS notified the Issuer of the exercise of its optional early termination rights in respect of the Swaps.
- Pursuant to an extraordinary resolution of the noteholders passed on 5 October 2015, GLAS Trust Corporation Limited was appointed as the Note Trustee replacing Deutsche Trustee Company Limited.
- On 15 October 2015, a potential Event of Default in respect of the Notes occurred as a result of the Issuer failing to pay interest due on the Notes.
- On 21 October 2015, the Cash Manager informed UBS that the Note Trustee had directed it not to make any payments under the Swaps and to hold back amounts otherwise payable to the Swap Providers on the basis that alleged fraudulent misrepresentations had been made by the Swap Providers (the "Swap Allegations") which allegedly entitled the Issuer to rescind the Swaps.



- In August 2016, the Issuer purported to rescind the Swaps on the basis of the Swap Allegations.
- In March 2016, pursuant to an extraordinary resolution of the noteholders, the Note Trustee was directed to agree and pay (in accordance with the Issuer's priority of payments) the AHG Expenses in respect of work which was stated to be for the benefit of the noteholders as a whole (the "Extraordinary Resolution").

## **The Proceedings and the Arguments of the Parties**

Following these events, UBS sought declaratory relief against the Note Trustee and the Issuer in the form of an order for the AHG Expenses not to be paid by the Note Trustee pursuant to the securitisation waterfall.

The Note Trustee initially argued for the opposite result but during the course of the hearing changed its approach from a total rejection of the UBS argument to a request to the Court to consider a draft order tendered by it setting forth a procedure to be followed by it in considering which of the AHG Expenses could be approved by it and paid pursuant to the securitisation waterfall. The Court noted that the request by the Note Trustee to consider this draft order amounted to the Note Trustee seeking directions from the Court as to what it should do. UBS chose not to respond to the draft order in its submissions to the Court and so the Court did not hear full arguments on this.

This change in approach by the Note Trustee led to the decision of the Court being divided into two parts: first a consideration of whether the Note Trustee could agree to pay all of the AHG Expenses, a point which was partly conceded by the Note Trustee in changing its approach, and secondly a consideration of the draft order proposed by the Note Trustee, on which (possibly as a result of the absence of a response on the same from UBS) the Court felt it could only give preliminary guidance.

The case must also be considered in its wider commercial context, being the purported rescission by the Issuer of the Swaps, a matter which, depending on the final result, will result in either the Noteholders or the Swap Providers recovering almost all of their claims or almost none, each amounting to several hundred million pounds.

In this case, the Court noted that the Noteholders would be potential beneficiaries of any rescission of the Swaps and that efforts by the Noteholders to divert part of their entitlements to interest on the Notes to fund possible litigation in relation to the rescission came to nothing. The advisers to the AHG stated that they had not advised the Issuer on the dispute relating to the Swaps. UBS did not challenge this but pointed to line items in certain invoices for liaising with the Issuer's solicitors in relation to the Swaps dispute and suggested that the line between the two may be difficult to draw. Given this, it is not clear whether the matter at issue in this case may have been a tactical point in the wider context of the Swaps dispute.

## **The Arguments of UBS**

UBS claimed that the AHG Expenses did not relate to the Note Trustee's powers, authorities and discretions under clause 10.5 of the Note Trustee Deed which provides:

### 10.5 Note Trustee's Expenses

The Issuer shall also pay or discharge all legal fees and other costs, charges, liabilities, damages and expenses properly incurred by the Note Trustee in relation to the preparation and execution of, and the exercise of its powers, authorities, rights and discretions and the performance of its duties under, and in any other



manner in relation to, this Deed or the other Transaction Documents, (including, but not limited to legal and travelling expenses and any stamp and other taxes or duties paid by the Note Trustee) and in connection with any legal proceedings brought by the Note Trustee in respect of the enforcement of the Issuer Security constituted by the Transaction Documents or against the Issuer for enforcing any obligations under this Deed, the Notes or the other Transaction Documents.

UBS also raised, amongst others, the following arguments:

- The Note Trustee had no power and was not authorised to pay the AHG Expenses out of the Issuer's priority of payments as it would be using funds that would otherwise be allocated to the Issuer for payment to those parties who were entitled to be paid pursuant to the Issuer's priority of payments.
- The AHG Expenses were incurred by the AHG and not the Note Trustee.
- The Note Trustee did not demonstrate that the AHG Expenses were properly incurred in accordance with its contractual right of indemnity under the Issuer Deed of Charge and the Note Trust Deed.
- The Noteholders had no power to pass the Extraordinary Resolution (which directed the Note Trustee to pay future advisory fees incurred by the AHG on an on-going basis) and the Extraordinary Resolution was not validly passed under the provisions of the transaction documents.
- The advice given to the AHG was not capable of being relied on by the Note Trustee and the advice was partisan advice provided for the benefit of the AHG only.

## **The Initial Arguments of the Note Trustee**

The Note Trustee initially submitted that it was entitled to adopt the AHG Expenses since these expenses related to advice for the benefit of the noteholders and if the AHG had not instructed the advisers, it would have been necessary for the Note Trustee to engage its own advisers to provide substantially the same advice at additional cost.

## **The Note Trustee's Revised Arguments and Draft Order**

Shortly before the hearing, the Note Trustee revised its arguments as follows:

- The draftsman of the Note Trust Deed was concerned to ensure that the Note Trustee had the broadest power to incur expenses.
- It was appropriate for the Note Trustee to incur the AHG Expenses as a matter of principle but having done so, the Note Trustee would then have to conduct an exercise to scrutinise each element of the AHG Expenses in order to determine whether they could properly be paid in accordance with the terms of the Note Trust Deed.
- As part of this exercise, if the Note Trustee considered that any specific items charged by way of the AHG Expenses did not relate to its powers and duties under the Transaction Documents in accordance with clause 10.5 of the Note Trust Deed, the Note Trustee would have to query those expenses and, if appropriate, not pay such items.
- The services provided by the advisers to the AHG were beneficial to the Note Trustee and the wider class of secured creditors under the Issuer Deed of Charge, in particular due to the fee letters providing that the advisers would *"update the Note Trustee and its legal*



*advisers on a regular basis on the strategies to achieve a financial restructuring as they are developed in the best interests of the Noteholders as a whole and the Issuer Secured Creditors on a basis agreed with the Note Trustee.”*

In response to questions from the Court as to these arguments, on the second (and last) day of the hearing the Note Trustee tendered a draft order setting out the orders which it suggested the Court should make in relation to this matter. The full text of this order is not available but parts of it were considered in some detail by the Court, as to which, see below.

## **The Issue to be Decided by the Court**

As a preliminary matter the Court addressed its own role in connection with trustee powers. Mr Justice Blair referred to the analysis of Mr Justice Robert Walker (as he then was) in an unreported judgement cited in *Public Trustee v Copper*<sup>1</sup> in which a distinction was drawn as to the Court's role in connection with trustees' powers in four situations or categories, as follows:

1. where the issue is whether some proposed action is within the trustees' powers, which is a question of construction of the trust instrument or a statute or both;
2. where the issue is whether the proposed course of action is a proper exercise of the trustees' powers where there is no real doubt as to the nature of such powers and the trustees have decided how they want to exercise them but the trustees wish to obtain the blessing of the Court;
3. in the case of a surrender of discretion properly so called, which the Court will only accept for a good reason, as to what may constitute good reason; and
4. where the trustees have actually taken action and that action is attacked as being either outside their powers or an improper exercise of their powers.

In the case at hand, the relevant category was noted to be whether the proposed action, i.e., payment of the AHG Expenses, fell within the Note Trustee's powers in accordance with the Note Trust Deed and the Issuer Deed of Charge (i.e., the first category). The Court noted that there could have been a cross over with the fourth category as to whether the Note Trustee has taken an action which was outside its powers or which was an improper exercise of its powers. However, the Court noted that the AHG Expenses were not paid and that the fee letters specifically provided that such payment would only be made if it could lawfully be made from the Issuer's priority of payments. As such, the Note Trustee had actually taken no action to pay the AHG Expenses and so the fourth category was not relevant.

## **Construction of the Trustee's Expenses Clause**

The Court considered clause 10.5 of the Note Trust Deed and noted that in deciding whether particular expenses fell within the trustee's expenses clause, it should be kept in mind that such clauses are typically widely drafted and, in the context of a financial transaction, should be given a commercial meaning rather than an artificial restricted meaning.

The Court then broke down its analysis of the Note Trustee's entitlement to be reimbursed for its costs and expenses pursuant to clause 10.5 of the Note Trust Deed as follows:

1. the right extends to all legal fees and other costs, charges, liabilities, damages and expenses which have been incurred by the Note Trustee;
2. such payment must have been properly incurred;



3. such payment must have been incurred under one of the following heads:
  - (a) in relation to the preparation and execution of the Issuer Deed of Charge, the Note Trust Deed and the other Transaction Documents;
  - (b) in relation to the exercise of the Note Trustee's powers, authorities, rights and discretion under and in any manner in relation to the Issuer Deed of Charge, the Note Trust Deed and the other Transaction Documents;
  - (c) in relation to the performance of the Note Trustee's duties under and in any other manner in relation to the Issuer Deed of Charge, the Note Trust Deed and the other Transaction Documents; and
  - (d) in connection with any legal proceedings brought by the Note Trustee in respect of the enforcement of the Issuer's security or against the Issuer for enforcing any obligation under the Issuer Deed of Charge, the Note Trust Deed and the other Transaction Documents.

## Decision of the Court

The Court noted that in changing its arguments as described above, the Note Trustee had implicitly accepted that adopting all of the AHG Expenses without review would not comply with the provisions of the relevant transaction documents. The Court said that the Note Trustee was "*clearly right*" to accept this and that the arrangements made in March 2016 could not be legally sustained as they amounted to a surrender by the Note Trustee of its duty to form an independent view as to whether the expenses were ones it could properly incur. The Court noted a lack of transparency as to the AHG Expenses, which parts of the advice had actually be seen by the Note Trustee and whether it was appropriate for the Note Trustee to pay for advice on which it could not rely. The Court also noted the context of the dispute as to the Swaps between the AHG and the Swap Providers.

The Court further noted that the presentation by the Note Trustee of a draft order was not supported by the evidence the Court would need to enable it to give actual directions and that UBS did not respond in any detail to the drafting of the order in its submissions. Despite this the Court decided to give its preliminary views on the draft order to assist the parties to resolve the matter without further recourse to the Court. In doing this, the Court was influenced, in particular, by the fact that UBS accepted in principle that the Note Trustee could adopt expenses incurred by third parties, including the noteholders.

Accordingly, the Court gave the following preliminary views on the draft order submitted by the Note Trustee:

- The Court rejected the submission made by UBS that the Note Trustee could not adopt the AHG Expenses on the basis that reliance on the advice did not extend to the Note Trustee. It noted that although reliance is an important consideration, the Note Trustee can still incur the AHG Expenses even if the advice may not be relied on by the Note Trustee. The Court further noted that it cannot be excluded that in limited circumstances, it would be sensible and legitimate for the Note Trustee to adopt expenses which may require for the advice to be readdressed to the Note Trustee at a later stage.
- As set out by the Note Trustee in the draft order, the costs should relate to advice in respect of enforcement. In this respect, the draft order identified the following categories of work:



- (a) advice on the different possible ways in which the Issuer's security may be enforced;
  - (b) advice as to whether enforcement is appropriate;
  - (c) advice on the valuation of any assets subject to the Issuer's security; and
  - (d) participating in negotiations with any interested commercial parties (or advisers thereof) in relation to (a), (b) and (c).
- The advice on restructuring should not necessarily be excluded. Although the role of the Note Trustee in enforcement is largely mechanical, it does not exclude advice comparing the option of enforcement versus the option of restructuring.
  - The Note Trustee should identify and propose the AHG Expenses that it intends to pay through the Issuer's priority of payments. It should obtain a letter from the relevant adviser setting out certain details (on the work, the expense, the period) and if UBS considers that the Note Trustee cannot incur such expenses, UBS will have to serve on the Note Trustee written particulars of its objections. At that stage, the parties will have to decide whether to apply to the Court for further directions.
  - UBS objected to the mechanism proposed by the Note Trustee in the draft order on the basis that this process would leave the responsibility of identifying which AHG Expense constitutes a "properly incurred" expense with the advisers. Although the Court recognised force in this objection, it relied on the Note Trustee's proposal to exercise its independent discretion in making this assessment. Ultimately, the debate will remain between the noteholders and UBS and it was recognised that the parties may have to seek directions from the Court.

## Comment

Unusually, the Note Trustee appears to have changed its position during the course of the hearing for this case from an initial position that it was entitled to adopt all of the AHG Expenses to proposing a draft order for the court to consider. The draft order proposed by the Note Trustee implicitly accepts that not all of the AHG Expenses can be so adopted and the Court made it clear in expressing its preliminary views on the draft order that this is indeed the case.

Although the Court did not explicitly rule on this point (due to the Note Trustee changing its initial argument the Court did not have to reach a decision based on the initial issue submitted in the proceedings), it is clear that the Court felt that the Note Trustee cannot adopt the expenses of noteholders as a whole without further scrutiny. The Court was clear that in considering whether to adopt the expenses, the Note Trustee would be required to exercise a certain level of discretion.

Trustees in complex transactions such as securitisations seek to avoid having discretions due to their fiduciary obligations and their lack of the level of commercial expertise needed to exercise such discretions. However, given the wide powers of trustees, which the Court noted "*may contain a substantial measure of judgment, may be controversial, and may have to be carried out speedily to enable resolution of the transaction,*" at least some level of discretion is unavoidable. In this case, the Court was clear that where a trustee has to exercise discretion, it must do so properly and carefully.

It is notable that the decision of the Court in this regard echoes another recent decision also involving a securitisation transaction; *US Bank Trustees Limited v Titan Europe 2007-1 (NHP) Limited*.<sup>2</sup> In this case, the Court held that a condition to the replacement of the special servicer for



the securitisation requiring the trustee to approve the replacement required the trustee to make its own decision and to do so in a proper manner.

This case can also be contrasted with other cases such as *Torre Asset Funding v RBS*,<sup>3</sup> where the Court gave a narrow interpretation to the scope of the duties of a loan facility agent and declined to imply additional duties. It would seem that the Courts will construe the duties of agents and trustees exclusively on the basis of the terms of the relevant documents but where these documents give an agent or trustee discretion, that discretion must be exercised properly.

These cases could be seen as the first steps in developing a clear statement of the duties owed by trustees and agents in making decisions on financing transactions.

The views of the Court on the draft order are also helpful in confirming that, subject to the terms of the securitisation documents, note trustees can be authorised to incur and pay certain costs incurred by noteholders. In the future, note trustees may feel greater confidence in their ability to follow the process suggested by Mr Justice Blair, and agree to pay certain costs and expenses of the noteholders through the securitisation waterfall. This process could potentially allow noteholders to engage more actively in CMBS and other securitisation transactions, in particular legacy deals approaching or having reached the deal maturity without achieving a full resolution on the underlying assets.



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<sup>1</sup> [2001] WTLR 901.

<sup>2</sup> [2014] EWHC 1189 (Ch).

<sup>3</sup> [2013] EWHC 2670 (Ch).