

# Security Trustees: the in-betweeners?

When looking at a distressed credit, determining creditor priority becomes key. The focus is not just on realising value, but on who has control of that realisation process. In a recent case (*Saltri III Ltd v MD Mezzanine SA Sicar & Ors* [2012] EWHC 3025) the High Court in London was asked to consider whether action taken by a group of Senior Lenders to enforce their rights under a typical intercreditor agreement with a sale to an SPV and a release of the underwater Mezzanine debt was valid. The challenges to the enforcement by the Mezzanine Lenders were levelled not at the Senior Lenders themselves, but at the Security Trustee. As matters transpired these challenges were unsuccessful.

Mark Campbell, partner in our finance practice comments: *"Whilst the case doesn't contain any surprises, it is a useful reminder of the importance that intercreditor arrangements play in the context of a restructuring. It also provides a helpful insight into the role, duties and obligations of a Security Trustee and the potential conflicts of interest that may arise where they are also a Senior Lender"*.

By way of background, Stabilus is a leading manufacturer based in Germany supplying parts primarily to the automobile industry. It owed approximately €409 million to its Senior Lenders and approximately €83 million to its Mezzanine Lenders. The relationship between the Senior and Mezzanine Lenders was regulated in terms set out in an intercreditor agreement, which were typical (as far as the release on enforcement provisions were concerned) of those in use on Senior-Mezzanine deals at the time.

Stabilus experienced severe financial difficulties and, despite a number of waivers from its Lenders, it became

apparent in 2010 that the Mezzanine debt was "underwater" and the Senior Lenders would have to take action to avoid the directors becoming obliged to follow the mandatory filing requirements for insolvency in Germany. The Security Trustee was instructed by the Senior Lenders (as provided for in the intercreditor agreement) to enforce the security as part of a wider restructuring proposal. As part of the restructuring the Mezzanine debt was transferred to an SPV set up for the purpose of the restructuring, and then released. The Senior Lenders took what the Mezzanine Lenders alleged was a 36% "haircut" on their debt which was reconstituted as a combination of debt and quasi equity/debt instruments.

## Challenges

The Mezzanine Lenders challenged the restructuring on the grounds that it was effected without authority or was for an improper purpose and therefore should be considered void. The Mezzanine Lenders also advanced claims against the Security Trustee claiming breaches of duty and

## Key issues

- Importance of intercreditor arrangements
- Role of the Security Trustee on enforcement
- Power of sale
- Valuations – no absolute obligation to carry out sale or market testing
- Non-cash nominal consideration on disposal
- Importance of establishing and adhering to "Chinese walls" to avoid conflicts

requesting equitable compensation or damages. There were no allegations of bad faith or dishonesty on the part of the Security Trustee.

## Improper use of the intercreditor for a restructuring?

The Mezzanine Lenders were subordinated to the Senior Lenders in all respects by the intercreditor agreement. They argued that the

Senior Lenders were using the intercreditor agreement to effectively force through, and implement, a non-consensual restructuring which was not the purpose of the intercreditor agreement. This argument was dismissed by the Judge. The Security Trustee's compliance with the provisions of the intercreditor agreement (by following the instructions of the Senior Lenders to implement the restructuring) was not an improper use of the intercreditor agreement.

#### **Non cash/nominal consideration – commercially acceptable in non liquid market**

The case also looked at the validity of accepting nominal consideration or non-cash consideration when a realisation was made under the intercreditor agreement. This had not been expressly considered by an English court before, although it did form the basis of the European Directories restructuring. The intercreditor agreement, in this case, did not contain any express requirement that the Security Trustee must make all sales or disposals in exchange for cash, nor did it expressly preclude the acceptance of nominal consideration or non-cash consideration. The Judge observed that if the parties had intended for such a "significant fetter" to apply to the Security Trustee's powers, it would have been expressly stated in the intercreditor agreement. He further noted that such a restriction may be considered uncommercial with respect to the Senior Lenders' ability to make a recovery on their claims, especially in a market which is short on liquidity.

#### **Duties of the Security Trustee and power of sale**

The intercreditor agreement in this case dealt expressly with the duty of

the Security Trustee towards the Mezzanine Lenders, in relation to its power of sale, essentially providing that the duty owed was equivalent to that of a mortgagee to a mortgagor. In particular, the Security Trustee was entitled to remain passive and had no duty to exercise his powers. Further it had unfettered discretion as to when and how to sell and was not bound to postpone a sale in the hope of obtaining a better price. The Security Trustee was however under a general duty to take reasonable care to obtain the best price reasonably obtainable at the time and in the prevailing circumstances; but it would not breach its duty if it exercised its judgment reasonably and its assessment fell within an acceptable "margin of error".

In this respect, the Court rejected the Mezzanine Lenders' argument that the Security Trustee was under an absolute obligation to carry out a marketing and sales process. It held that the correct test for the Security Trustee in relation to the method, type and timing of enforcement was: (a) to take reasonable care to obtain the true market value of and/or the best price reasonably obtainable for the security at the time of the sale or disposal; and (b) to exercise the power of sale bona fide and for its proper purpose. The Court emphasised the importance of considering the reality of the situation. In this case, Stabilus was trying to avoid insolvency as well as trying to put itself on a proper commercial footing with its customers and suppliers. Undertaking a proper sales and marketing process would have been impracticable, if not impossible, and would potentially have damaged Stabilus' ability to recover its commercial position.

In this case, the Security Trustee did in some respects owe a fiduciary duty of care to the Mezzanine Lenders, but not in relation to its power of sale which was expressly governed by the terms of the intercreditor agreement. It was also recognised that, as in many distressed situations where the value breaks in the Senior debt, the interests of the Senior Lenders and Mezzanine Lenders were inherently in conflict. Their interests were, however, governed by the intercreditor agreement in this case, and the Senior Lenders had the ability to validly instruct the Security Trustee to take steps which were adverse to the interests of the Mezzanine Lenders.

#### **Contracting parties' autonomy respected**

Iain White, partner in our Restructuring and Insolvency group comments: *"It is encouraging that the Court took a commercial and common sense approach to the interpretation of the intercreditor agreement. It was noted that this was a case where there was a relationship between sophisticated market parties where those parties had chosen to govern their relationship through an arms-length commercial contract, which was shaped by the language and terms used in that contract. In such cases the English Courts will assume that the parties meant to be bound by their express words and will not usually seek to re-write the agreement"*.

#### **Where the value breaks?**

A number of valuation reports from 2009 onwards were produced in relation to the business. The Mezzanine Lenders asserted that the Security Trustee breached its duty by ignoring a particular report from 2009 which suggested that a sales process

might have yielded more successful results than an enforcement and as such that value may have broken in the Mezzanine debt. This argument failed on the basis that the report in question had been commissioned for Stabilus and not the Security Trustee who had ultimately decided not to pursue a sales route. Doubts were expressed as to whether a sales process could in fact have been followed given the short time frame and the risk of further depressing the value of the business. The Security Trustee did rely on a desktop valuation which the Mezzanine Lenders claimed was "patently flawed and unreliable" but clearly showing value breaking in the Senior debt. The Judge considered the Security Trustee's reliance on the desktop valuation and concluded that it was reasonable in the circumstances to rely on the report which was detailed and, at the relevant time, contained up to date information.

#### **Security Trustee and conflicts of interest**

The Security Trustee was also a Senior Lender in this transaction and the Mezzanine Lenders advanced arguments that the Security Trustee was under a duty to avoid conflicts. While the Judge did not decide this point, he did accept that the Security Trustee had failed to put in place proper 'Chinese walls' and protocols to prevent information from being leaked between the Senior Lenders and the Security Trustee. Mark Campbell notes "*This aspect of the decision serves as a useful reminder to Security Trustees to ensure that any potential conflicts are dealt with practically by ensuring internal procedures and protocols are respected*".

The Court granted the declaratory relief requested by the Senior Lenders in relation to the enforcement being valid. We understand that the Mezzanine Lenders are continuing to pursue proceedings against Stabilus in the German courts claiming repayment of the original loan.

#### **A sign of the times?**

In the current market, litigation is on the increase and parties will inevitably continue to seek to gain whatever leverage they can in order to protect their own position. The importance of the finance documents correctly reflecting the respective rights of the parties comes into sharp focus on enforcement and in a restructuring scenario. From the Security Trustee's perspective, the importance of having clear instructions from those it represents, and guidance from its advisers to avoid being stuck in the middle, is essential. Whilst this will not prevent strategic plays, it should assist in bringing such challenges to a satisfactory conclusion.

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