

# International Corporate Rescue



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## UK Court Deals with US SIV Dispute: *Bank of New York v Montana Board of Investments* [2008] EWHC 1594 (Ch)

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Recently in the High Court, Mr Justice Floyd was called on to make an urgent decision on whether the senior creditors of an insolvent structured investment vehicle (SIV) were entitled to give directions to the security trustee as to the time, manner and place of sale of the SIV's assets. A SIV is a specialist fund that raises cash by issuing short term debt to investors and profits from the difference between the short term borrowing rate and the returns it makes on higher yielding longer term assets.

The case arose out of a dispute between the senior creditors who wanted the security trustee to sell the assets of the SIV quickly and another class of creditors who wanted to wait for the market to improve before any such assets were sold. The court examined the discretion afforded the security trustee in such circumstances.

### The facts

Orion Finance Corporation ('Orion') was incorporated on 1 June 1995 under the laws of the Cayman Islands. The claimant bank (the 'Security Trustee') was appointed trustee by way of a security agreement dated 27 June 2006 ('Security Agreement'). The first defendant was a holder of senior notes issued by Orion ('Senior Creditors'). The second and third defendants were the only holders of senior subordinated notes issued by Orion ('Senior Subordinated Creditors').

The classes of debt security issued by Orion included senior notes, senior subordinated notes, and capital subordinated notes. Under the Security Agreement, the Senior Subordinated Creditors agreed their right to payment would be fully subordinated to the debts of the Senior Creditors. All of Orion's assets ('Collateral') were charged to the Security Trustee for the benefit of Orion's secured obligations.

### The event

Due to concerns surrounding the US sub-prime mortgage market the valuation of SIV assets declined significantly in 2007 on a global basis.

A downgrade by Moody's rating agency on 30 November 2007 of medium-term notes issued by Orion constituted an 'Automatic Enforcement Event' under the Security Agreement. Prior to the occurrence of an enforcement event, Orion had the right to arrange, purchase or dispose of the investment security and was responsible for making the decisions on the investments and dispositions of the Collateral. Upon the occurrence of this event the Security Trustee became entitled to enforce security in accordance with the provisions of the Security Agreement.

On 4 December 2007, the Security Trustee issued an enforcement notice and took exclusive control of the Collateral. Orion did not meet senior obligations due for payment on 14 January 2008 which constituted an 'Insolvency Event' which in turn triggered a 'Mandatory Acceleration Event' under the Security Agreement. This resulted in all Senior Notes becoming immediately due and payable.

The Security Trustee liaised with the Senior Creditors and the Senior Subordinated Creditors as to the preferred course to be taken in order to realise the Collateral. This process revealed that the Senior Creditors and the Senior Subordinated Creditors had differing views as to the duties of the Security Trustee and the timing within which the Collateral should be realised. The Senior Creditors wanted the Security Trustee to commence the liquidation of the Collateral immediately, whereas, the Senior Subordinated Creditors essentially wanted to wait for the market to improve before any assets were sold.

### The issues before the court

The court was asked to give directions as to the following:

1. Whether the Security Agreement provided the Senior Creditors with the right to direct the Security Trustee as to the time, place and manner of sale of Orion's assets;
2. Whether if the Senior Creditors had such a right the Security Trustee's obligation to comply with the above direction was subject to the discretionary

powers and general fiduciary duties of the Security Trustee; and

3. Whether the Security Agreement mandated any specific timing for the liquidation of the Collateral where insufficient funds were available to redeem in full all of the then outstanding Senior Notes.

## New York law

While the courts in England and New York had exclusive jurisdiction over the Security Agreement the applicable law of the Security Agreement was New York law. The judge identified the following two elements of the case to which he felt New York law would be of relevance:

- i) The general principles of law governing the interpretation of written contracts; and
- ii) The obligations and duties of a security trustee under New York law.

The judge highlighted Article 9-610 of the Uniform Commercial Code (UCC) which provides that where there is a disposition of collateral by a secured party after a default, every aspect of such a disposition including the method, manner, time, place and other terms, must be 'commercially reasonable'. The judge also referred to notes added by the UCC draftsmen, which he considered highly persuasive but not formally binding, to the effect that Article 9-610 of the UCC does not specify a period within which a secured party must dispose of collateral.

The judge referred to the fact that after there has been a default New York law imposes an 'enhanced' duty on a security trustee '[T]o act as prudent men of intelligence and discretion employ in their own affairs. The prudent security trustee would preserve trust assets, not waste them.'

To conclude his analysis of New York law Floyd J summarised his thoughts as follows:

'What I derive from the general New York law pertaining to security trustees is that they are required to exercise prudence, or to put it another way, judgment in the way in which they deal with trust assets.'

## Issue one and issue two

The Security Agreement contained a general provision '[N]ot to bring any action or proceedings or otherwise attempt to enforce any remedies or direct the Security Trustee to take any actions' in relation to the Collateral. The Senior Creditors' argument centred around an exception to this prohibition which allowed the Security Trustee and the Senior Creditors to '[T]ake such action to the extent and in the manner provided for by the

Security Agreement'. They argued that 'such action' included the right to direct the Security Trustee as to the time, place and manner of sale of Orion's assets. In dismissing this line of reasoning the judge relied on four observations set out below.

First, the judge considered that the Security Agreement expressly left it to the Security Trustee to decide how it would enforce the Collateral. Citing section 5.6.1 of the Security Agreement, the judge pointed to the fact that the Security Trustee had 'exclusive control' and the 'exclusive right' to exercise rights in relation to it, involving the preservation or selling of the Collateral '[A]t such place or places as the Security Trustee deems best'. It also must do it in a 'commercially reasonable manner'.

The judge felt that these provisions were not consistent with the suggestion that the Senior Creditors could direct the time, place and manner of the sale. The judge considered that had it been intended to give the Senior Creditors the power to 'trump' section 5.6.1 of the Security Agreement then this would have been expressly provided for in the Security Agreement.

Secondly, the judge pointed out that there was no express provision in the Security Agreement which gave directions to the Security Trustee as to the time place and manner of sale of Orion's assets. The court highlighted the fact that the Security Agreement mandated that the Collateral was to be held for the benefit of all of the secured parties and not to the exclusive benefit of one particular class of creditors.

Thirdly, the judge adverted to the fact that the position of the Security Trustee generally under New York law makes it clear that the Security Trustee is not a 'mere agent' of the creditors but is required to exercise its powers in a discretionary way. The judge held that the Security Trustee '[C]annot surrender discretion or any part of it to any individual class or creditor'.

Fourthly, the judge considered from his reading of Articles 9-610 and 9-627 of the UCC that the time, place and manner of sale are aspects of the sale which are required to be commercially reasonable. Giving specific direction as to these aspects of sale could have had the effect of preventing the Security Trustee from conducting a sale in a commercially reasonable manner which Floyd J felt would not have been envisaged by the Security Agreement.

On the basis of the above reasoning the judge answered the first question in the negative.

The judge, however, tempered his commentary by saying the Security Trustee did not enjoy an 'unfettered discretion' as to how to enforce against the Collateral. The judge set out the framework within which the Security Trustee must exercise his discretion. He said that the Security Trustee must:

1. Enforce in a manner consistent with the full subordination of the subordinated creditors' rights;

2. Bear in mind the purpose of the security interest which is to ensure prompt payment of the notes when due; and
3. Keep in mind that all the senior creditors have resolved that it should enforce the security.

The second question before court therefore did not have to be addressed.

### Issue three

The third issue concerned the issue of whether the Security Agreement directed any specific timing for the liquidation of the Collateral following the occurrence of a so-called mandatory acceleration event. The clause in the Security Agreement which dealt with mandatory acceleration events did not lay down any specific timing for the liquidation of the Collateral. The judge however said that this particular provision should be construed on the basis that the security is there to ensure the prompt payment of obligations when due.

The judge concluded that the Collateral should be sold in a commercially reasonable manner. He felt that it would be wrong to imply into the Security Agreement, as suggested by the Senior Creditors, that the Security Trustee should sell 'as soon as reasonably practicable'. The judge stated that '[T]he phrase 'as soon as reasonable practicable' is not the same thing as 'commercially reasonable'.

In answer to question 3, the judge held that no specific timing of a sale was mandated following the

happening of a mandatory acceleration event when insufficient funds are available. Rather, any sale should take place in a commercially reasonable manner as provided for under the Security Agreement.

### Conclusion

In this case the court adopted a commercial approach to its construction of the discretion afforded a security trustee. The Security Agreement contained wording to support the court's finding that the Security Trustee had discretionary power to deal with the assets under its management. The contention that the Senior Creditors could dictate the time, manner and place of sale was simply not supported by the drafting of the Security Agreement or by general principles of New York law and therefore the task before the court was quite a straightforward one.

This decision is a further illustration of the appeal of the English legal system when it comes to settling complex disputes arising out collapsed SIVs. The fact the English High Court was the preferred forum to give guidance on the duties of a US security trustee under documents governed by New York law adds further weight to this proposition. A speedy resolution to such complex issues is particularly attractive to claimants in the SIV arena where judicial delay can lead to further devaluation of asset classes. The efficacy of the English courts in this area may be attributed, at least in part, to the positive effects which have trickled through the legal system due to the Woolf reforms.<sup>1</sup>

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### Notes

- 1 The Woolf reforms are embodied in the Civil Procedure Rules introduced on 26 April 1999. These CPR rules are based on 'Access to Justice Final Report' by The Right Honourable Lord Woolf, Master of the Rolls, July 1996. The rules aim to simplify and speed up the process of taking cases through the courts.

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