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Who is the noteholder?

Confusion between the law and practice

The documents constituting a note issue will usually provide that a requisite percentage by value of noteholders can vote on resolutions or direct the trustee to take action under the trust deed. Therefore, all participants in a note issue will be concerned to identify the person with the standing to cast the votes and to give instructions. If instructions are taken from the wrong person, there is a risk that any resolution passed or direction given, and subsequent actions taken in reliance on it, will be invalid.

An investor would (quite rightly) see this as a simple matter. Common sense dictates that when an investor purchases debt securities in the debt capital markets, the investor – being the person with the economic interest and bearing the investment risk – should always be the person whose voice counts when considering any proposals relating to, or actions to be taken in connection with, those notes.

However, the question of who is a noteholder can become a far more confused issue than logic would dictate. Much of this confusion is caused by the various attempts in bond documentation to reconcile the practical operation of the clearing systems with the "pure" legal characteristics of a listed bond. As we discuss in this article, this can present particular problems for a note trustee.

It therefore seems to be good news that the Law Commission, in August, published a call for evidence seeking consultees' views about, and experiences of, the current intermediated securities system. One of the projected outputs from the call to evidence is stated to be a scoping study which, among other things, will apparently provide *an accessible statement of the current law, including a clear explanation of how shares and bonds are "owned" and held*. The call to evidence seeks views on a range of issues relevant to intermediated securities, including whether and to what extent the current law limits the ultimate investor's ability to sue anyone in the intermediated securities chain beyond their immediate intermediary (the so-called "no look through principle").

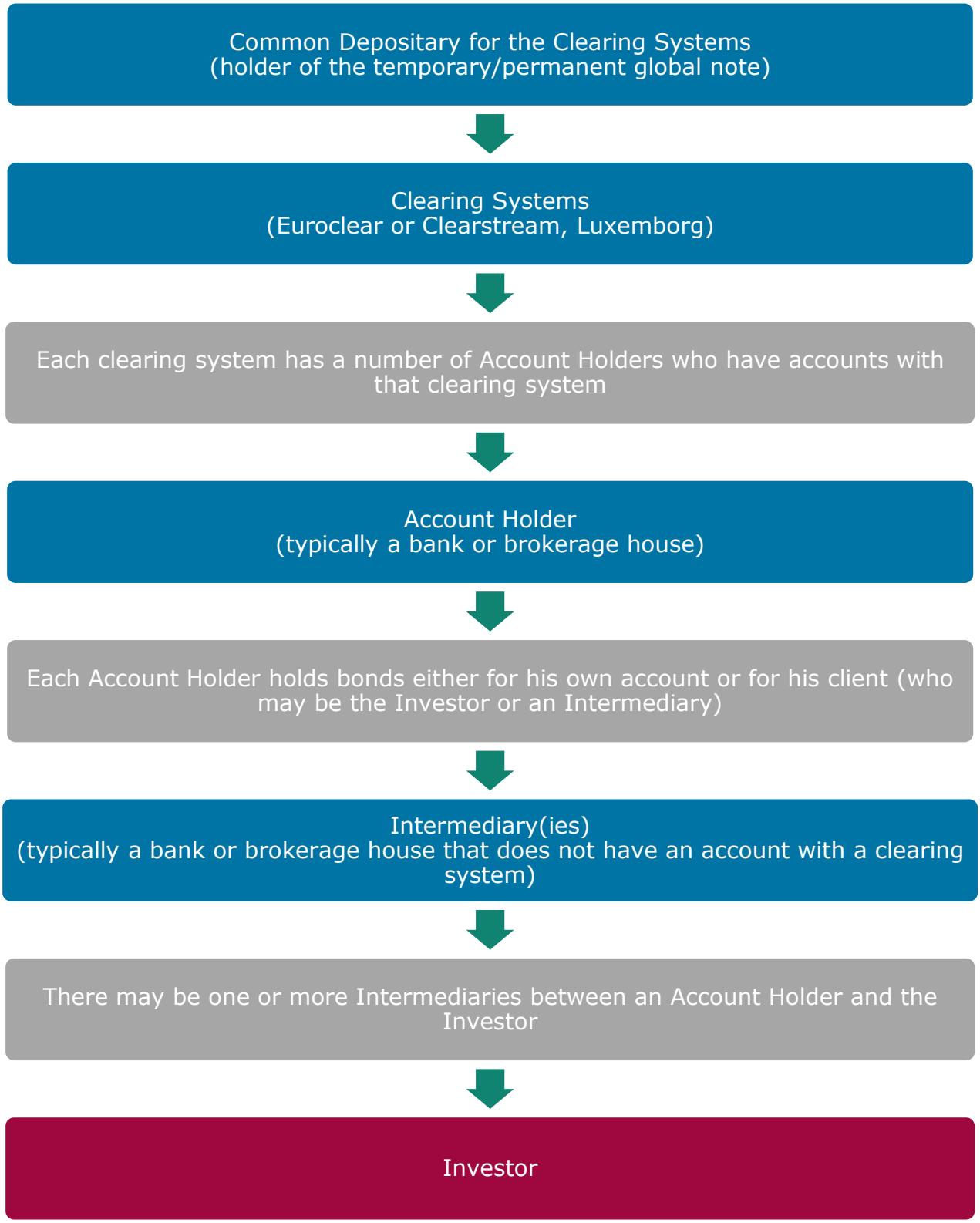
Why is there confusion?

Bonds can be issued in registered or bearer form. However, most bonds traded in the international debt capital markets are, conceptually, bearer instruments in denominations of $US50,000 to $100,000, title to which passes on delivery. It is easy to lose sight of this fundamental legal truth because bond documentation has, over time, adapted and evolved to take account of the practical trading and settlement procedures of clearing systems.

Nowadays bonds are almost never issued to investors as "definitive" notes. Definitive notes are physical pieces of security printed paper with coupons attached for the payment of interest. Transfers of definitive notes are effected by the seller handing over the relevant pieces of paper to the buyer against payment.

Instead, a permanent "global note" (a single document representing the entire bond issue with the terms and conditions of the bonds attached) will be issued, which is deposited with a financial institution (the "common depositary" for the clearing systems) for safekeeping during the lifetime of the bond issue. Trading in bonds occurs through the crediting and debiting of securities and cash accounts held with clearing systems (being Euroclear and Clearstream in the eurobond market) and investors in bonds often hold their investment through complex chains of contractual relationships with custodians ("intermediaries"), culminating with an "accountholder" – a financial institution which holds a securities and cash account with the clearing system.

The diagram below shows an intermediated chain.



However, even where a permanent global note represents the note issue, the terms and conditions of the global note will provide that if a clearing system closes for business for a period of time (usually 14 days), or ceases business, the Issuer will be obliged to ensure the delivery of an equal aggregate principal amount of definitive notes in exchange for the global note.

Crucially, therefore, the fact that a note is at its core a definitive instrument (rather than a book entry in a clearing system) will enable the investor to claim payment from the issuer – even where there is a complete failure of the current market through which it can be traded.

The definition of noteholder in bond documentation

The uneasy relationship between the practical way in which bonds are held in intermediated chains and the fact that they are, at their heart, definitive instruments has led to inconsistency over the way in which "Noteholder" is defined in bond documentation.

Historically, trust deeds would define the noteholder as "*the bearer of a Note*" – reflecting the fact that notes are, conceptually, definitive bearer instruments. Trust Deeds issued by a number of law firms with considerable expertise in the capital markets arena still use this drafting.

Tweaks and enhancements to the operative provisions of trust deeds sometimes attempt to reflect clearing systems procedures and the way in which the notes are held in intermediated securities chains.

It is also now common to see trust deeds in which the definition of Noteholder has been extended. For example, the definition can be construed to include, for certain purposes, "*a holder of beneficial interests in the Notes*". However, while investors might assume they would be covered by a Noteholder definition which includes within its scope the holder of "*beneficial interests*" in the notes, recent case law suggests that this is not the case.

Case law on noteholders and the holders of beneficial interests in notes

In 2017 in *Secure Capital SA v Credit Suisse AG* the Court of Appeal looked at whether an investor with an interest in notes issued in bearer form and held through the Clearstream system had a direct claim for breach of contract against the issuer of the notes in respect of an alleged breach of the misleading statements term.

The Secure Capital note issue involved a fiscal agency structure, rather than involving a note trustee holding the benefit of the issuer covenants on trust and through whom enforcement action would usually be taken.

The documentation stated that it was only the "holder" of the notes who had locus to sue the issuer for breaches of covenant. The Court of Appeal concluded that the "holder" of the Notes for this purpose was the common depositary as holder of the permanent global note. The effect of the judgment was to remove from the investors contractual recourse against the issuer, as the common depositary will never take action on their behalf.

However, if the definition of Noteholder had been extended to encompass those with *beneficial interests* in the Notes, would an investor be in a stronger position? Not according to *Business Mortgage Finance 6 v Greencoat & others*, a case involving the latest attempt by an SPV associated with Rizwan Hussain to wrest control of a securitisation structure[1] . In this case, the judge recently stated, on an obiter (i.e. non-binding) basis, that the "*holder of the beneficial interests*" in the relevant notes, for the purposes of the definition of instrumentholder, meant only those persons in whose name the notes are held in the records of the clearing systems (i.e. the account holders at Euroclear and Clearstream).

This decision is in line with the so-called "*no look through principle*" which limits an ultimate investor's ability to sue anyone in an intermediated securities chain beyond their immediate intermediary. In *Re Lehman Brothers International (Europe) (in administration)* the court categorised the legal nature of an intermediated securities chain as a series of trusts and sub-trusts.

The Law Commission's call to evidence on intermediated securities flags that the no look through principle has been described as "controversial" - noting that Richard Salter QC points out that the ultimate investors are the ones who have paid for the securities and taken the economic

[1] Please also see our article "Stepping in or over-stepping" relating to issues arising from the attempts of Mr Hussain and his SPV, Clifden, to take control of the Fairhold securitisation structure.

risk, yet they get "*the downside of the advantages that this principle confers on others*".[2] We have sympathy with this concern given that a bond is, at its legal core, a definitive bearer instrument and the trading and settlement mechanics are procedural matters which can be dispensed with where necessary.

The position of a note trustee

The stark way in which the courts have applied the no look through analysis presents a note trustee with particular challenges. For a note trustee (whose fiduciary duties are owed to the noteholders as a class) matters are rarely as simple as looking to the holding of the clearing system accountholder, but not beyond. A trustee will see itself as owing its duties to those with any ultimate right to call for definitive notes, rather than to the financial institutions fulfilling mechanistic roles in an intermediary chain.

Processes and procedures have developed to enable the ultimate investor in notes held through the clearing systems to cast votes on extraordinary resolutions at noteholders' meetings. The Law Commission's call to evidence raises the fact that these processes do not always work well, in part due to the sheer length of certain intermediary chains. However, in general there should (in theory at least) be a well-trodden route, supported by mechanisms set out in the meetings schedule of the trust deed, which ensure that it is the ultimate investor (or its authorised agent) who will ultimately dictate how votes will be cast. However, the position can be rather different where the note trustee receives, for example, directions to accelerate following an event of default. Many trust deeds provide that if an event of default occurs the trustee may, and, if so requested in writing by holders of at least one quarter of the aggregate principal amount of the outstanding Notes, shall, accelerate the bonds (subject to the trustee's right to be indemnified to its satisfaction).

The trustee will therefore always need to satisfy itself that any person or persons from whom it receives a direction to accelerate represents at least the requisite percentage of holders entitled to serve such a notice. We would argue that best practice continues to be for the trustee to look beyond the clearing system accountholder to satisfy itself that the clearing system accountholder is acting in accordance with the wishes of the ultimate investor. This is likely to mean seeking proof of holding and authority from each intermediary at each level of the intermediary chain, until it is possible to identify the ultimate investor of the notes attributable to the relevant direction.

Conclusion

Hopefully note trustees will actively engage with the Law Commission's call to evidence process to explain the particular challenges that they encounter.

Whether or not change will follow as a result of the resulting scoping study will remain to be seen. At this stage the Law Commission has not been asked to produce a full report with detailed recommendations for reform. The purpose of the scoping study is stated to be to inform public debate, develop a broad understanding of potential options for reform and develop a consensus about issues to be addressed in the future.

In the meantime, note trustees and their lawyers will need to continue to navigate the issues prudently.

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[2] Paragraph 2.35 of the Law Commission's call to evidence on intermediated securities, citing R Salter, Intermediation and Beyond (2019) p 139.

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