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Who is the noteholder? (A reprise)

The recent decision of *Re Shinsun Holdings (Group) Co., Ltd*[1], handed down by the Grand Court of the Cayman Islands, is likely to cause ripples throughout the international debt capital markets.

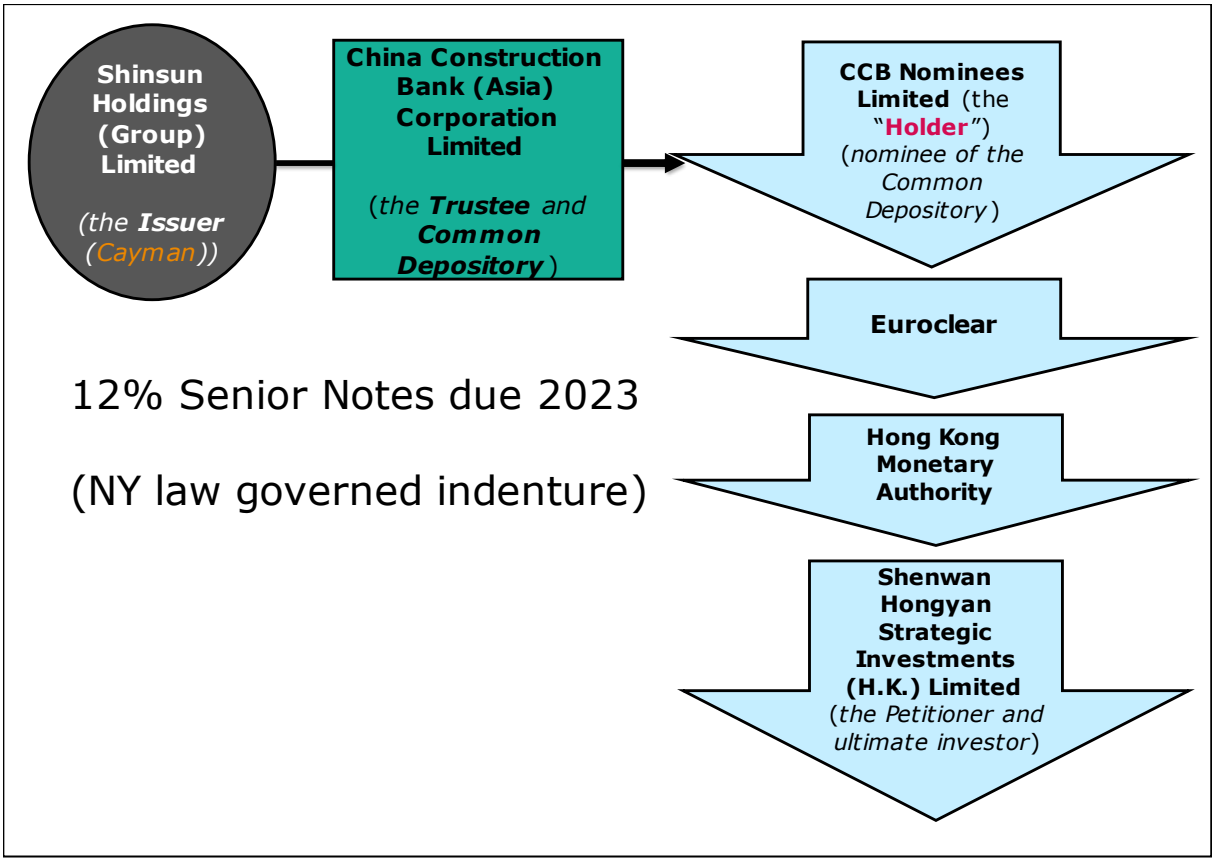
It follows a previous judgment of the English courts which applied the "*no look through*" principle strictly, even where doing so had the effect of preventing ultimate investors from progressing action against the issuer following a default.

The case explores a number of issues we have discussed previously in our articles "Who is the Noteholder? Confusion between the law and practice" and "Identifying a "Noteholder"".

Background

The registered note issue in *Re Shinsun Holdings* was constituted by a New York law Indenture and traded through Euroclear.

The diagram below shows how the notes were held through an intermediated chain:



[1] FSD 192 of 2022 (DDJ)

The Issuer defaulted in making its payment of interest on the notes. In reliance on the non-payment event of default the Petitioner (an ultimate investor whose holding represented at least 25% of the aggregate outstanding principal, but who was not the "Holder" as defined in the Indenture) directed the Trustee to issue a notice of acceleration, which the Trustee duly did.

When the Issuer failed to pay, the Petitioner sought to commence winding-up proceedings against the Issuer. On the evidence, the Petitioner was not willing to put the Trustee in the funds, which the Trustee considered it would require to progress the winding-up. Instead, the Petitioner itself sought to progress the winding up proceedings against the Issuer.

The Issuer challenged the winding up proceedings, on the basis that the Petitioner had no legal standing to bring them.

The Issuer also disputed that the Trustee had had the right to accelerate the notes on the directions of the Petitioner.

The judgment

The Cayman Islands court (having taken expert evidence on matters of New York law) determined:

- The Petitioner did not have legal standing to progress the winding-up petition because it was not a creditor or contingent creditor of the Issuer.
- The Petitioner had not been furnished with requisite authority to progress the winding-up proceedings by the Holder (i.e., the registered holder of the global note, CCB Nominees Limited).
- The court also determined that the acceleration notice which had been issued by the Trustee was invalid because the request to issue it had come from the Petitioner, rather than the registered holder.

Discussion of issues explored in the judgment

- **The "no look through" principle applies to intermediated securities**

  The "no look through" principle was famously applied by the Court of Appeal in the English law case of *Secure Capital SA v Credit Suisse AG*[2]. It is a principle of English law which limits an ultimate investor's ability to sue anyone in an intermediated securities chain beyond their immediate intermediary.

  While the principle creates legal certainty, it is recognised to be controversial because it means that those who bear all the economic risk of owning the intermediated securities are unable to enforce their rights directly against the issuer.

  Unlike *Secure Capital*, the bonds in *Re Shinsun Holdings* were constituted by a New York law indenture. It was also a registered bond issue.

  However, while the Indenture was governed by New York law (with the parties providing expert evidence to the Cayman Islands court on New York law issues) the judge considered that the New York principle of privity of contract would have the same result as the English law "no look through" principle. Consequently, as in *Secure Capital*, the judge concluded there was no contractual relationship between the Petitioner (the ultimate investor) and the Issuer.

  The consequence in *Re Shinsun Holdings* was that the Petitioner had no standing to launch proceedings to wind-up the Issuer following a non-payment event of default. The judge said "*The principle of privity of contract and what English judges, lawyers and academics would describe as the "no look through" principle are in play*"[3].

  The judge also considered the investor's complaint that this meant there was no party with an economic interest to bring enforcement proceedings to be misplaced. He said, "*The Petitioner appears to have fundamentally misunderstood the legal position in respect of its investment and the terms of the Indenture* "[4].

- **The Petitioner did not have standing as a "contingent creditor" and the English authorities on schemes of arrangement did not apply**

  The Petitioner pointed to its right, under the Indenture, to require the delivery of certificated notes as evidencing that it had standing to bring the winding-up proceedings as a "contingent creditor". However, the judge considered the Petitioner to have incorrectly conflated the concept of contingent creditor with contingent standing.

[2] [2017] EWCA Civ 1486
[3] Para 143.
[4] Para 143.

He stated, "*The Petitioner has not received the Certificated Notes and does not appear to have taken any proper steps to obtain them and to obtain legal standing. I agree with the Company that unless or until the Petitioner obtains Certificated Notes in its name it cannot establish it is a creditor, either actual or contingent. It is its standing which is contingent, in the first place, upon its succeeding in bringing itself into a direct contractual relationship with the Company and this is regardless of whether the debt is also properly to be treated as contingent. It is insufficient in law to have "contingent standing" in respect of winding up petitions in this context*"[5].

Ultimately, as a result of the "no look through" principle, there was no contractual relationship between the Issuer and the Petitioner. The judge said "*The evidence before me establishes no obligation, upon the Company to the Petitioner, whether in contract, tort, equity or otherwise. In such circumstances and put simply, the Petitioner is not a contingent creditor of the Company*"[6].

As we have previously explored in our article "Who is the creditor in a bond restructuring"[7], in the context of English law schemes of arrangement the English courts have enabled beneficial owners of notes to be treated as contingent creditors and therefore entitled to vote directly at relevant scheme meetings. The Petitioner cited these English scheme of arrangement cases as providing authority for its argument that it had standing as a "contingent creditor".

However, the judge disagreed. He described the English scheme of arrangement decisions as "*commercially pragmatic decisions*" which "*need, I would respectfully suggest, to be treated with caution and confined to their context*"[8].

- **For intermediated securities, complete chains of authority must be in place**

  The Petitioner argued that it had authority to pursue the winding-up action pursuant to the Euroclear operating procedures.

  The Euroclear operating procedures authorise the underlying beneficial owners of securities to maintain proceedings against issuers, guarantors and any other parties (to the extent that Euroclear, its nominee, a depositary or their nominee acts as registered owner of any security held in the Euroclear system, or in any other relevant situation).

  The Petitioner presented to the court a statement of account from Euroclear, referencing the operating procedure described above and which confirmed that the relevant notes had been blocked in Hong Kong Monetary Authority's account. The Euroclear statement of account went on to note that Euroclear had been informed that the holding was allocated in Hong Kong Monetary Authority's books to the Petitioner.

  The judge did not accept the Petitioner's argument.

  Under terms of the Indenture, only the Holder (CCB Nominees Limited) and not Euroclear was permitted to authorise a person to take actions which the Holder was permitted to take. Furthermore, the judge confirmed that the Indenture could not be modified by provisions of the Euroclear operating procedures that were not expressly incorporated into the Indenture.

  In *Re Shinsun Holdings* the judge saw there to be a clear "gap" in the chain of authority between the Holder (CCB Nominees Limited, the nominee for the common depository) and Euroclear. The judge explained, "*Euroclear is not the registered holder of the relevant Global Note. It is beyond reasonable doubt that CCB Nominees Limited is the Holder under the terms of the Indenture and it has given no proxies or authority to the Petitioner…*"[9].

- **Acceleration and enforcement mechanisms must be followed to the letter**

  The New York law governed Indenture in *Re Shinsun Holdings* provided that, following the occurrence of a relevant default which was continuing, the Trustee would be obliged to send an acceleration notice upon the directions of "the Holders" of at least 25 per cent of the aggregate principal amount outstanding.

  Holder was defined in the Indenture as being the nominee of the common depository. Following

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[5] Para 153.
[6] Para 143.
[7] We have previously expressed a view in our article, "Who is the creditor in a bond restructuring?" that the solution of enabling investors to vote directly on a scheme as contingent creditors has been arrived at "*in the interests of pragmatism and policy, rather than being a solution which strictly adheres to legal principles*".
[8] Para 98.
[9] Para 163.

the occurrence of a non-payment event of default under the notes, the Trustee received directions from the ultimate investor to accelerate and proceeded to serve an acceleration notice on the Issuer.

The judge stated: "*The request to the Trustee appears to have wrongly come from the Petitioner rather than the Holder. In such circumstances the acceleration is not valid*"[10].

- **Trustee discretions should be retained – they may help to navigate some problematic issues**

In his judgment, the judge in *Re Shinsun Holdings* set out in full various relevant provisions from the Indenture. It is clear from the acceleration clause that, as well as being obliged to act on the directions of the requisite percentage of "the Holders", the Trustee had a discretion to accelerate the bonds (as is typically the way).

While not discussed in the case, it is also clear that a subsequent clause in the Indenture cut across this discretion by going on to state: "*During the continuance of an Event of Default, the Trustee shall act only upon the written direction of the Holders of at least 25% of the aggregate principal amount then outstanding, subject to its receiving indemnity and/or security to its satisfaction*".

We are now more frequently encountering provisions in trust deeds which cut across or water down a trustee's discretion. It is understandable why advisers to a trustee might seek to limit the trustee's discretion as much as possible. However, the trustee's discretion serves a key purpose and can even offer an alternative way forward, where others are unintentionally unavailable. Consequently, additional provisions watering down or removing the trustee's discretion may be unhelpful.

Key takeaway points for trustees

- **Defined terms matter:**
  - The "no look through" principle will apply to intermediated securities constituted by English (and likely New York) law trust instruments. If the transaction documents define key terms such as "Holder" unhelpfully, judges are unlikely to look beyond the words on the page.
  - Trustees need to pay close attention to the defined terms used in bond documentation, particularly when taking directions from holders or enforcement action outside the ambit of a bondholder resolution (where the meetings schedule will often set out a well-trodden path to ensure that instructions flow up and down the intermediated securities chain). While it may not have made commercial sense for the Trustee in *Re Shinsun Holdings* to take its directions from the nominee of the common depository, it was the nominee of the common depository which was defined as "Holder" in the acceleration clause.
- **Interrogating evidence of authority all the way up the intermediated chain is key:** Interrogating chains of authority is an issue which trustees have to grapple with frequently (and which we addressed in our article "Identifying a "Noteholder""). *Re Shinsun Holdings* only serves to underline the importance of ensuring there is clear evidence of authority at every relevant step of an intermediated chain.
- **Trustee discretions should not be watered down or cancelled out without good reason**: Including provisions watering down or removing the trustee's discretion may be unhelpful as the trustee's discretion can sometimes assist to unlock routes forward. The "traditional" formulation (whereby discretions remain available to the trustee, but with no obligation upon it ever to exercise them) is, in our opinion, preferable.
- **The contingent creditor analysis in English law scheme of arrangement cases is context-specific:** The judge in *Re Shinsun Holdings* did not accept that the line of English scheme of arrangement cases (in which beneficial owners of bonds were entitled to vote directly on the schemes as contingent creditors) were analogous. It seems unlikely that this Cayman Islands decision will be viewed as casting any doubt on the existing line of English cases on schemes of arrangement. The judge in *Re Shinsun Holdings* was careful to make it clear that context is everything and he would not find it surprising if words such as creditor and contingent creditor would mean one thing in one context and another thing in another context.

[10] Para 168.

Looking forward

While there were some obvious holes and problems in the drafting used in the Indenture in *Re Shinsun Holdings*, the case seems likely to focus the minds of investors. In turn, this seems likely to prompt parties and their advisers to pay greater attention on ensuring that bond documentation is drafted correctly at the outset of a transaction. In particular, bond documentation should include the mechanisms required to mitigate the effect of the "no look through" principle and enable underlying investors to enforce their rights against the issuer (albeit, necessarily, indirectly).

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