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Rights of MBS bondholders against the company: privity of contract lost?



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The financial crisis of 2007-08 led to several failed securitization transactions and brought in a storm of litigations in structured products¹. Post the crisis, several bondholders sued the originators alleging misrepresentations on the quality of loans underlying the mortgage-backed securities that led to series of litigations and final settlements² in some cases as well. There have been several rulings, post the crisis where the rights of the bondholders to proceed against the originator-banks have been put to question, questioning the privity of contract between the bondholders and the originator companies. In this article we discuss one such ruling of DB Structured Products Inc and try and elucidate the privity of contract between the bondholders, trustees and the originator companies in case of structured instruments and the likes.

Rights of the beneficiary/ bondholders - in light of DB Structured Products ruling:

The right of the bondholders to bring suit against the originator company has been put to question and curtailed in the provisions of the agreement binding them, in a recent ruling of *ACE Corp vs. DB Structured Products Inc*³.

In the recent ruling, the plaintiff (ACE Securities Corp.) alleged that the defendant had breached the representations and the warranties in connection with the securitization of a pool of mortgage loans governed by a Mortgage Loan Purchase Agreement (MLPA) and a Pooling and Servicing Agreement (PSA). The clauses of the PSA indicated that the certificate holders did not have the authority to provide notices of default in connection with the sponsor's breach of representations and that the trustee could bring the suit against the defendant in such cases. The certificate holders commenced action on behalf of the trust. The New York Appellate Division held that the certificate holders' lacked standing to commence action on behalf of the trust and dismissed the complaint.

Bar on bondholders rights to 'putback': spate of rulings over the years

The court placed reliance on the ruling of *Walnut Place LLC vs. Countrywide Home Loans Inc.*⁴. In this case, Walnut (plaintiff) held mortgage-backed securities backed by the mortgage loans of Countrywide. The plaintiffs investigated into the portfolio of the loans sold by Countrywide and found that Countrywide had made false representations

¹ There have been a total of 927 credit crisis filings from January 2007 through the end of June 2013. http://www.nera.com/nera-files/PUB_Subprime_Series_Part_X_Credit_Crisis_Update_1113.pdf

² A lot of cases initiated during the crisis were settled in 2012-13. Of the cases brought by MBS and ABS investors 8 such cases were settled in 2012, and 17 in 2013 through October for a total value of \$6.6 billion. Fannie Mae and Freddie Mac have recovered more than \$18 billion from several financial institutions to resolve mortgage repurchase claims. There have been over \$34 billion of settlements between the US government and various financial institutions, related to foreclosure procedures and consumer finance issues such as fairness in mortgage lending. On January 7, 2013, the Office of the Comptroller of the Currency and the Federal Reserve Board announced an \$8.5 billion agreement with various banks such as Bank of America and Citibank regarding foreclosure practices and mortgage loan servicing deficiencies. http://www.nera.com/nera-files/PUB_Subprime_Series_Part_X_Credit_Crisis_Update_1113.pdf

³ <http://blogs.reuters.com/alison-frankel/files/2013/12/Document.pdf>

⁴ <http://www.leagle.com/decision/In%20NYCO%2020120406247>



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and warranties about in the pooling and servicing agreement (PSA) about the credit quality of the loans adversely affecting the interest of the plaintiffs. Bank of New York Mellon, the trustee vide a letter demanded Countrywide to repurchase those loans referring to the relevant clauses of the PSA and on the same date plaintiff send the letter to trustees for the breach of representation and warranties relating to the delinquent loans. The defendant failed to repurchase the loans within the stipulated time and the plaintiff directed the trustees to file a suit against the defendant. Since the trustee did not prefer the suit, the plaintiff commenced action on its own.

The defendants submitted that the requirements for bringing a derivative action by the plaintiffs were not met. Defendants rely on the case of *Velez v. Feinstein*⁵, where the Court held that:

[i]n an action brought by a beneficiary on behalf of a trust, the beneficiary must show why he has the right to exercise the power, which the law and the trust agreement in the first instance confide in the trustees, to bring a suit on behalf of the trust. This will normally require either a showing of a demand on the trustees to bring the suit, and of a refusal so unjustifiable as to constitute an abuse of the trustee's discretion, or a showing that suit should be brought and that because of the trustees' conflict of interest, or some other reason, it is futile to make such a demand.

The complaint was dismissed by the court on the grounds that the PSA limited the rights of the certificate holders to sue for the breach of servicers obligations (event of default) further the section barred the certificate holders from initiating any suit except where an event of default had occurred. The rights to initiate suit for repurchase of the loans was with the trustees under the PSA and not the certificate holders.

In *Feldbaum vs. McCrory Corporation*, the Court upheld a no-action clause providing that security holders must give notice of an event of default, on the grounds that "*if the trustee is capable of satisfying its obligations, then any claim that can be enforced by the trustee on behalf of all bonds ... is subject to the terms of a no-action clause.*"

In a similar case of *Greenwich Financial Services Distressed Mortgage Fund 3, LLC vs. Countrywide Financial Corp.*⁶, Greenwich the plaintiff brought a class action against Countrywide, the defendant, requiring the defendant to repurchase the mortgage loans on which defendant has agreed to reduce the payments. The defendants submitted that the suit was not maintainable on the grounds that the procedural requirements under the pooling and servicing agreement (PSA) were not met and that there was a limitation on the rights of the certificate holders under the PSA which were not complied with. The relevant clause of the PSA read as below:

No Certificateholder shall have any right by virtue or by availing itself of any provisions of this Agreement to institute any suit, action or proceeding in equity

⁵ 87 A.D.2d 309, 315 (1st Dep't 1982)

⁶ Index No. 650474/2008 (Sup Ct, NY Co, Oct. 7, 2010), <http://statecasefiles.justia.com/documents/new-york/other-courts/2010-ny-slip-op-33803-u.pdf?ts=1373469690>



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or at law upon or under or with respect to this Agreement, unless such Holder previously shall have given to the Trustee a written notice of an Event of Default and of the continuance thereof, as provided in this Agreement, and unless the Holders of Certificates evidencing not less than 25% of the Voting Rights evidenced by the Certificates shall also have made written request to the Trustee to institute such action, suit or proceeding in its own name as Trustee hereunder and shall have offered to the Trustee such reasonable indemnity as it may require against the costs, expenses, and liabilities to be incurred therein or thereby, and the Trustee, for 60 days after its receipt of such notice, request and offer of indemnity shall have neglected or refused to institute any such action, suit or proceeding; it being understood and intended, and being expressly covenanted by each Certificateholder with every other Certificateholder and the Trustee, that no one or more Holders of Certificates shall have any right in any manner whatever by virtue or by availing itself or themselves of any provisions of this Agreement to affect, disturb or prejudice the rights of the Holders of any other of the Certificates, or to obtain or seek to obtain priority over or preference to any other such Holder or to enforce any right under this Agreement, except in the manner provided in this Agreement and for the common benefit of all Certificateholders.

The court held that the clause prevented the certificate holders from bringing any suit, proceeding or action in equity or in law under the PSA unless the procedural requirements are complied with. The court held that the plaintiff's allegation that the trustee failed to bring the suit against the defendant and that there was conflict of interest in terms of reduction in fee if the defendant was required to repurchase did not stand. Further the plaintiff's plea that the trustee's response of evaluating the position before bringing the suit could not be construed to be denial by the trustee and was premature under the circumstances. Since the plaintiff had not complied with the procedural requirements the suit was not maintainable.

Analogy drawn in context of Debentures:

Closer home, in the case of *Narotamdas Trikamdass Toprani vs. Bombay Dyeing And Manufacturing Co. Ltd. And Others*⁷, the maintainability of a suit initiated by the debenture holders against the issuer company was challenged on the grounds that the agreement permitted the trustees to bring suit against the company and not the debenture holders. However the Bombay High Court did not dismiss interim relief to the plaintiff on the grounds of non-maintainability of the suit.

The plaintiff debenture holder proceeded to file a suit with Bombay High Court demanding a declaration that the company was not entitled to issue the proposed debentures ranking *pari passu* with the existing debentures and is not entitled to secure the said issue by a first mortgage on the fixed assets of the first defendant company.

⁷ <http://www.indiankanoon.org/doc/603115/>



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The company challenged that the suit itself was not maintainable and that the plaintiff had no *locus standi* to maintain the suit and such a suit was maintainable by the trustees under the covenants of the debenture trust deed entered into by the trustees with the company.

Under clause 55 of the debenture trust deed, "the debenture-holders shall in general meeting have", inter alia, "the powers to sanction any modification of the rights of the debenture-holders against the company or against its property whether such rights shall arise under these presents or otherwise". Under clause 56, the trustees may, from time to time, and at any time whenever they think fit or expedient in the interest of the debenture-holders, waive, on such terms and conditions as shall deem expedient to them, any breach by the company of any of the covenants contained in the said trust deed.

The defendant company contended that the covenants of the debenture trust deeds conferred obligations on the company towards trustees and not on the debenture holders and thus the debenture holders' class action cannot seek action for enforcement of the covenants of the debenture trust deed. In the present case, the trustees are also made party-defendants to the suit along with the first defendant company. The Bombay High Court did not dismiss the suit on grounds of maintainability.

In case of *Gramercy Emerging Market Fund vs. Essar Steel Limited*⁸, the Gujarat High Court held that the debenture holders were the creditors of the company and held that the petition for winding up by the debenture holders was maintainable as the debenture trustees were party to such petition. However the court held that the trustees were necessary party to the winding up petition in the absence of trustee being party to the petition, the petition could be dismissed.

Does a trust put complete cloak over the identity of beneficiaries?

In the several rulings discussed above the privity of contract between the bondholders / debenture holders has been put to question. The rights of the debenture holders and the obligations of the company have been determined in terms of the agreement to the tee and not on the basis of equity or law. Before we delve into the question in details we need to understand the need for a trustee and the role conferred on such trustees in issuance of such instruments.

A debenture is a capital market instrument and it is commonplace for the beneficiary debenture holders put their trust in the appointed trustee to protect the interest of the debenture holders at all times. A debenture trust deed creates an express trust and the property is vested in the trustees and the trustee holds such property in trust for the benefit of the beneficiary. The arrangement renders logistical convenience to the issuer and the debenture holders as each time the debentures would change hands the security interest will have to be modified accordingly affecting the transferability of the instrument. If security interest is held by the trustee, the trustee can act expeditiously and

⁸ <http://www.indiankanooon.org/doc/1898011/> judgement dated 20th March, 2002



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effectively in safeguarding the interests of the debenture-holders; and enforcing the security on their behalf.

In some cases, the *locus standi* of the debenture holders has been questioned, on the ground that the company enters into covenants with the debenture trustees, and not with the debenture holders.

Thus, in Uruguay Central and Hygueritas Railway Co. of Monte Video, In re [1879] 11 Ch 372, the company had issued bonds or debentures and had created a debenture stock. There was no direct covenant between the company and the debenture stock-holders for payment of any amount to the stock-holders. The covenant was between the company and the trustees for payment of the amounts. The court held that in view of the terms of the deed, the holders of bonds were not creditors of the company; they were merely cestui que trust of a charge, having a right, no doubt, to put their trustees in motion to compel payment under the covenant, but not having any independent right to sue the company either at law or in equity.

Similarly, in Dunderland Iron Ore Co. Ltd., In re [1909] 1 Ch 446, a trust deed for securing debenture stock made between the company and the trustees for the stock-holders, provided that the company would pay the interest to the stock-holders. But the certificate delivered to each stock-holder did not contain any direct covenant with the stock-holder to pay him interest. It was held that stock-holders whose interest was in arrears were not entitled to present a winding-up petition as creditors under section 82 of the English Companies Act, 1862.

In both these cases, a debenture holder was held not to be a creditor of the company on the basis of covenants contained in the debenture certificate which was issued to him by the company. There are a number of cases, however, where English courts have construed the debenture holder as a creditor of the company wherever there has been such a direct covenant between the company and the debenture-holder.

In Olathe Silver Mining Co., In re [1884] 27 Ch 278, the earlier decision in Uruguay Central and Hygueritas Railway of Monte Video, In re [1879] 11 Ch 372 was distinguished. Looking to the covenants contained in the debenture certificate, the holder of the debenture in that case to whom interest was overdue was held entitled to petition for the winding-up of the company.

In the case of Bachharaj Factories Ltd. v. Hirjee Mills Ltd. [1955] 25 Comp Cas 227, a Division Bench of this court distinguished the case of Dunderland Iron Ore Co. Ltd., In re [1909] 1 Ch 446 and held that in the case before the Division Bench, there were debentures and not stock certificates. The debentures contained a personal covenant by the mills to pay to the debenture-holders. Hence the circumstances which prevailed upon the court in Dunderland Iron Ore Co. Ltd., In re [1909] 1 Ch 446 were not present in the case before them and the debenture-holder was entitled to present a winding-up petition as a creditor of the company.



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In a later case of Sholapur Spg. and Wvg. Co. Ltd.⁹, the court had held that a winding-up petition by a debenture-holder was maintainable in view of the direct covenant contained in the debenture certificates between the company and the debenture-holder to pay the amount to the debenture-holder, although in that case one of the relevant conditions was to the effect that the debenture was issued subject to the provisions of the trust deed whereby all remedies for the recovery of the principal money and interest secured by the debenture were vested in the trustees on behalf of the shareholders.

In the eyes of equity:

The intent of the covenants of the trust deed irrespective of the provisions spelt out is to confer certain rights on the trustees for the benefit of the debenture holders not to refrain those rights from the debenture holders which originally would have vested in them in absence of the trustee acting on behalf of the debenture holders. Although certain rights may be conferred on the trustees and the debenture holders may not be direct party to such rights but as beneficiaries their entitlement to such rights cannot be denied in equity.

Similarly in the above judicial pronouncements the purpose of the bar on the debenture holders/ bondholders was to ensure that an individual bondholder did not jeopardise the benefit of all the bondholders and that a single trustee may act on behalf of the wider and common interest of all bondholders.

In the case of *M. C. Chacko vs. State Bank of Travancore*¹⁰, the Supreme Court has observed as follows (at page 508):

"... It has, however, been recognised that where a trust is created by a contract, a beneficiary may enforce the rights which the trust so created has given him. The basis of that rule is that though he is not a party to the contract, his rights are equitable and not contractual. The Judicial Committee applied that rule to an Indian case Khwaja Muhammad Khan v. Husaini Begum [1910] 37 IA 152; [1910] ILR 31 All 410. ... It must, therefore, be taken as well settled that except in the case of a beneficiary under a trust created by a contract or in the case of a family arrangement, no right may be enforce by a person who is not a party to the contract."

The right of the bondholder may be barred for logistical convenience but not in equity.

Can the beneficiaries proceed against the trustee?

The Indian Trust Act, 1882 explicitly lays down the rights of the beneficiary. The trustee is bound to fulfil the purpose of the trust and he must deal with the trust property as a man of ordinary prudence would deal with such property as if it were his own. The trustee is also bound to maintain and defend all such suits and take such other steps as

⁹ [1965] 35 Comp Cas 165

¹⁰ AIR 1970 SC 504



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may be reasonably requisite to preserve the trust property and assert or protect the title thereto (section 13 of the Act).

Under section 61 of the Trust Act the beneficiary has the right to compel the trustee to perform any particular act of his duty and restrained from committing any contemplated or probable breach of trust. Where there is a breach of trust the trustee shall be required to make good such loss which the trust property or the beneficiary has sustained (section 23 of the Act).

In light of the above, the debenture holders surely have the right to proceed against the trustees where it can be established that the trustees have acted in a manner jeopardizing the interest of the beneficiary or the trust property.

Future of such capital market instruments:

The age old rule of substance over form must be relied upon for determining the rights of the bondholders.

The very essence of capital market instruments is free transferability of the securities. If the judicial pronouncements bar the rights of the bondholders based on the form, merely because the logistic convenience is acting as a hindrance for the bondholders to exercise their equitable rights surely does make a dent on their acceptability amongst investor classes. The more the complex instruments, the more such issues act as a hindrance on their acceptability. The judiciary may require the trustees to join any suit filed against the originator and/ or require other bondholders to join the class action, however merely on the pretext that the agreement explicitly rests this right on the trustee cannot deny the right of the bondholders on the equitable grounds. Hence the judiciary should remove the cloak and look at the substance of the transactions to render justice.

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