Issues to consider when using security trustees

Angelique Thiele of Boekel De Nerée discusses the issues that arise when using a collective security arrangement involving Dutch law security, how these issues are resolved in practice and the risks that remain

Under Dutch law, arrangements whereby a security trustee is authorized to deal with security for a group of lenders under a collective security arrangement are common creatures, found in a wide range of habitats ranging from leveraged acquisition finance and project or property finance transactions, where a security trustee is appointed to hold security for the benefit of a syndicate of lenders, to commercial mortgage-backed securitizations, where a security trustee is appointed to hold security for the benefit of varying groups of bondholders.

However, things might not be what they seem. As is now the case with most financial jargon, Dutch finance practice uses the same terminology on collective security arrangements that is traditionally used in English finance practice and has now become international standard. Accordingly, a person acting under a collective security arrangement for a group of bondholders, for example, will normally be referred to as the security trustee. However, this need not, and in this particular case does not, say anything about the legal arrangements actually made. In particular, the use of the term *security trustee* could wrongly give the impression that Dutch law acknowledges a concept of trust. Consequently, it could lead parties to believe that the interests of the lenders will be protected under Dutch law in a similar way as, for example, under a security trustee arrangement governed by English law. This is, unfortunately, not the case.

> **"If it walks like an elephant and looks like an elephant, it does not necessarily have to be an elephant"**

A degree of creativity is required to accommodate finance practice, which seems to have developed a stubborn appetite for this species, while the Dutch legislator seems determined to ignore the animal altogether (perhaps hoping that it might eventually go away).

Two kinds of collective security arrangement

Under Dutch law, a collective security arrangement can be based either on agency or on ownership. The crucial distinction is that, under an agency type of arrangement, the lenders will become entitled to the security, whereas under an arrangement based on ownership, title to the security is vested in the person chosen to manage the security for their benefit.

Below, the term *security agent* is reserved for a person who merely manages security on behalf of a group of lenders. Where title to the security is vested in the person chosen to manage the security, that person is referred to as a *fiduciary* (*fiduciair gerechtigde*). This term is not ideal, in that it is not often used in practice. It might also give the impression that the lenders in whose interest the security is held somehow have a special right in respect of the security. This is not so. However, unlike *trustee*, the term *fiduciary* is familiar to Dutch law and has traditionally been used to describe arrangements whereby title to an asset is transferred to a person to allow them to manage the asset in the interest of others.

The use of security agent under Dutch law (not an elephant at all...)

In practice, the use of a security agent gives rise to a number of complications. If the security takes the form of an all-monies mortgage or pledge rather than securing a fixed-term loan, it is uncertain whether the security can pass to successor lenders if loans are transferred. Serious difficulties arise if loans are transferred by novation. This has now become quite common because syndicated loans to Dutch borrowers are increasingly made subject to English law, which often uses novation to transfer loan participations. Novation results in the release of the debt the borrower owes to the selling bank and creating a new debt to the buying bank in the same amount. The buying bank cannot be regarded as a legal successor of the selling bank. So Dutch law security created in favour of the selling bank cannot secure the new debt owed to the buying bank. For similar reasons, security obtained by lenders under a collective security arrangement based on agency cannot cover new loans made by new lenders. Creating new security is cumbersome and costly. The new security will be weaker in priority. It might also run an increased risk of being avoided under insolvency laws, because it was created at a later date. Priorities could be re-arranged through an inter-creditor agreement, but such an arrangement does not have effect against third parties. With respect to the security agent's authority to act on behalf of the lenders, it is unsure whether Dutch law rules on common property would allow a security agent to enforce the security without the consent of all secured lenders. Accordingly, an arrangement whereby the security may be enforced on the instructions of majority of the lenders might not be effective.

It is therefore unsurprising that collective security arrangements based on agency are rarely used in Dutch finance practice. Transactions where this type of arrangement is still applied are typically limited to loans, which involve a small syndicate of the borrower's relationship banks that do not expect to transfer their loans.

The use of a Dutch law fiduciary or security trustee (something like an elephant)

The problems discussed above in relation to security agents do not occur if security is granted to a fiduciary. Like a security

Author biography

Angelique Thiele
Boekel De Nerée

Angelique Thiele specializes in acquisition finance, property finance and structured finance and has wide experience in acting for listed companies and other large and medium-sized borrowers, equity houses and banks in different kinds of domestic and cross-border finance transactions, with an emphasis on cross-border secured finance.

Thiele has a PhD in Dutch, English and German financial law and has recently published a book on cross-border collective security arrangements for syndicated loans, securitizations and other capital market transactions (Kluwer Legal Publishers, Amsterdam/London 2003).

She is a graduate of the University of Nijmegen (1989 to 1995) and the University of Essex, UK (1993/1994). She was admitted to practise in 1995.

agent, a fiduciary can monitor security for a group of lenders in accordance with a prior arrangement. But an agent must be authorized by each of its principals, while a fiduciary simply accepts the security in its own name and agrees to deal with the security in accordance with a contractual arrangement made between it and the lenders from time to time. Provided that the definition of secured debt is wide enough, any new lender can benefit from the security by acceding to this arrangement. Security need not be transferred if lenders trade their loans and need not be recreated in favour of new lenders if loan participations are transferred through novation. If the borrower intends to obtain new loans from other lenders in the future, these lenders will be able to benefit from the same security.

The fiduciary may be a third party or one of the lenders concerned. The contractual arrangement between the fiduciary and the lenders could provide that the third party must deal with the security in accordance with instructions of a defined majority of the lenders.

Under Dutch law a collective security arrangement will normally be structured so that the fiduciary becomes entitled to the secured debt in its own right. Where this is done, the fiduciary can transfer the security to a replacement fiduciary by transferring the secured debt. Provided the fiduciary transfers all of its rights and obligations vis-à-vis the borrower under the transaction, difficulties with respect to transferability of all-monies security do not arise. Arguably, this is different if the security also secures other credit relations between the fiduciary and the borrower than the one transferred.

Despite their practicality, Dutch law collective security arrangements that make use of a fiduciary still have a few shortcomings when compared, for example, with an English law security trustee.

Complications when using a fiduciary

No recognition of a trust concept

The main shortcoming of providing security to a fiduciary follows from the fact that Dutch law does not recognize a trust concept.

This imposes additional risk on the lenders for whose benefit the security is being held. The existence of a separate fund (*afgescheiden vermogen*) is not recognized. Accordingly, the security and any proceeds of the security held by the fiduciary become part of the fiduciary's private estate and are exposed to recourse by the fiduciary's private creditors. If the fiduciary is declared bankrupt, security and proceeds will fall into the fiduciary's bankrupt estate. The lenders for whose benefit the security has been given do not have a special right in respect of the security or proceeds held by the fiduciary. If the fiduciary acts in breach of its obligations towards the lenders, the lenders' remedies do not go beyond those available to an ordinary contracting party for breach of contract.

Various methods can be used to minimize the risk that a fiduciary becomes insolvent. In practice, the most common method is to use a special vehicle, a legal entity that, according to its objects clause in its articles of association, only has the authority to perform the specific acts necessary for the particular task to which it is appointed, as fiduciary.

A Dutch law special purpose vehicle usually takes the form of a Dutch law foundation (*stichting*) or private limited company (*besloten vennootschap met beperkte aansprakelijkheid*).

The fact that restrictions on the acts a special purpose vehicle may be perform are laid down in its objects clause gives additional protection to those that have an interest in the tasks performed by the vehicle.

Under Dutch statutory law, an act that has been performed by a legal entity in violation of its corporate objects (*ultra vires*) can be annulled. Violation of the corporate objects of a legal entity may further result in personal liability of the entity's management. Only the entity or its bankruptcy trustee may instigate these actions, but parties that are to benefit from the tasks the entity performs will be able to require that the entity initiate these actions, if they have ultimate control over the entity (for example, as shareholders). The risk of personal liability should normally act as a strong incentive for the management of a special purpose vehicle to ensure that it acts in accordance with its objects. The risk that a special purpose vehicle does not meet its obligations towards the parties concerned can further be minimized by ensuring that a professional institution manages the vehicle independently.

Yet, extra time, effort and costs will be involved in incorporating or finding a suitable special purpose vehicle and a degree of residual risk remains. Firstly there is always a possibility, although a remote one, that the special purpose vehicle will become insolvent or otherwise not comply with its obligations. Pursuant to the Dutch statutory law, an act performed by the special purpose vehicle that is outside its corporate objects cannot be annulled if the party with whom the vehicle was dealing was not and need not have been aware of this. Furthermore, a special purpose vehicle will inevitably incur some liability vis-à-vis third parties (such as management fees, registration fees and legal costs), even if it does not act in accordance with the restrictions contained in its articles of association.

Despite these drawbacks, the use of a special purpose vehicle as fiduciary is the most straightforward way to minimize the risk of a fiduciary's insolvency under Dutch law. For this reason, security provided for the benefit of bondholders in connection with a securitization or

other type of secured bond issue is conventionally vested in a special purpose vehicle.

However, a special purpose vehicle as fiduciary will often not be practical in other types of finance transactions. In the case of a secured syndicated loan facility, for example, it will normally be considered too much hassle and the borrower will not usually be willing to carry the costs involved. Lenders under a syndicated loan facility might also be reluctant to propose a special purpose vehicle, because they would have to openly question the solvency of the bank that would otherwise be put in charge of monitoring the security. This reluctance becomes more understandable if one bears in mind that this bank will usually also be the arranger of the facility. In practice, lenders usually take comfort in the fact that the bank acting as fiduciary is of good standing, but this is not ideal.

Must security and secured debt be in the same hands?

Uncertainty exists under Dutch law as to whether a mortgage or pledge can be given to a person who is not the creditor of the secured debt. This poses a problem because the fiduciary will generally either not be a lender at all (for example, in a secured bond issue) or just one of the lenders (for example, in a syndicated loan).

Supporters of the view that security and secured debt must be in the same hands argue that a person can only obtain a valid mortgage or pledge if, and to the extent that, they are also entitled to the debt it secures. A mere power of attorney to collect the secured debt is not considered sufficient for this purpose.

The main argument is that the Dutch Civil Code does not seem to recognize the position where a mortgage or pledge, and the debt it secures, belong to different persons. Wherever the mortgagee or pledgee is mentioned in relation to the debt secured, the Dutch Civil Code assumes that the person entitled to the mortgage or pledge is also entitled to the secured claim. Section 3:248 of the Civil Code, for example, reads:

"Where the debtor is in default of paying that for which the pledge serves as security, the pledgee is entitled to sell the pledged property and to take recourse against the proceeds *for what is owed to him* [italics added]."

Another possible impediment that has been put forward follows from the accessory nature of Dutch law security. It could be questioned how a structure under which security remains with a fiduciary while the claims secured are transferred, can be reconciled with the principle that a Dutch law mortgage or pledge automatically follows the claim that it secures into the hands of a transferee. It is further argued that it is doubtful whether the accessory nature of mortgages and pledges would allow the fiduciary to transfer the security to a successor without the secured debt.

These arguments can be dismissed with good reasons. It is true that the Civil Code assumes in several places that the mortgagee or pledgee and the person entitled to the debt secured by the mortgage or pledge are one and the same. But this assumption can simply be explained by the fact that this is usually the case. Further examination of the Dutch Civil Code shows that the dependent nature of mortgages and pledges must not be interpreted too strictly. The Dutch law position on the transfer of all-monies security illustrates clearly that a mortgage or pledge does not necessarily follow the secured claims around.

Also, the secured debt need not even exist at the time the security is created. The rationale of the principle that mortgages and pledges are connected to the debt secured should be kept in mind. The reason behind the rule that Dutch security is accessory (besides facilitating the transfer of security) is to make clear that a mortgage or pledge cannot secure debts other than those that were properly defined between the parties as secured debt. As long as clear language is used to describe the secured debt, the fact that security is granted to a fiduciary that is not a creditor does not lead to any ambiguity. The security that is vested in the fiduciary will still benefit the lenders that are entitled to the secured debt, although indirectly.

The main shortcoming of providing security to a fiduciary follows from the fact that Dutch law does not recognize a trust concept

However, in the absence of clear authority, practice simply does not wish to take the risk. A number of techniques have been developed to ensure that a fiduciary that obtains security for the benefit of a group of lenders becomes creditor of all secured claims. This is most commonly achieved by including a *parallel debt clause* in the finance documentation.

Under a parallel debt clause the fiduciary obtains a parallel claim on the borrower equalling the total amount of the debts the borrower owes to the lenders under the loans that are to be secured. It is further agreed between the parties that the parallel debt becomes due and payable and will be considered paid and discharged at the same time and to the same extent as the underlying loans, so that the borrower cannot be forced to pay the same debt twice.

Parties might wonder whether a parallel debt of this kind is valid. There is something unnerving about a claim that has no apparent cause. The old Dutch Civil Code contained an expression provision to the effect that each contract must have a proper cause (*geoorloofde zaak*) to be valid. Opinions were divided as to whether this provision should be explained merely as a prohibition against contracts that are unlawful or contrary to good morals, or whether it also imposed a positive requirement that a contract must have a cause to be valid and enforceable. In this context, the requirement of a cause was generally considered to imply that the party undertaking the contractual obligation must have some purpose or interest in doing so. The first requirement is now included in the new Dutch Civil Code. The second requirement was intentionally not included, because it was considered that the interests that would be served by such a requirement were already protected by other legal concepts, such as abuse of circumstances (*misbruik van omstandigheden*), mistake (*dwaling*) and the principle of reasonableness and fairness (*redelijkheid en billijkheid*). For this reason, it is generally accepted that a general positive requirement that a contract must have a cause no longer exists under Dutch law. Even if such a

requirement existed, a cause, although perhaps not directly apparent, could be construed on the basis that the parallel debt clause enables parties to make a more efficient collective security arrangement, which saves time and costs that would otherwise have been for the account of the borrower.

The use of a foreign law security trustee (why not use somebody else's elephant?)

The complications and residual risks that arise when using a Dutch law security agent or fiduciary prompt the question whether it might be easier to use a foreign law security trustee instead. The Netherlands is party to the Hague Trusts Convention of 1985. This convention was implemented in the Netherlands by the Act on Conflict Rules on Trusts (Wet conflictenrecht trusts) and came into force on February 1 1996. On the basis of The Hague Trusts Convention, a foreign law trust will in principle be recognized in the Netherlands.

Uncertainty stems from article 13 of the Hague Trusts Convention. On the basis of this provision no contracting state is bound to recognize a trust whose significant elements are more closely connected to a non-trust state. In assessing whether this is the case, the place of domicile and administration of the trust, and the law applicable to the trust are not taken into consideration.

It is unclear what elements should be regarded as significant in the context of article 13 and how each of these elements should be weighted. From the negotiations on the text of article 13, it appears that these include the nationality of the parties involved and where the assets that are held in trust are situated. However, other factors might be relevant. It is also unsure at what point an accumulation of relevant factors could result in application of article 13. Is this only the case where it is clear that the parties have only chosen the laws of a jurisdiction that recognize the trust so they could evade national laws that would otherwise have led to non-recognition of the trust? Or could a court also refuse to recognize a trust on the basis of article 13, if that trust is part of a transaction that is, to a considerable degree but arguably not primarily, connected to a jurisdiction that does not recognize the trust? So far there is no decisive authority on this point.

The safe approach is to use a Dutch law option where Dutch law security is concerned. This applies not only in domestic transactions, but also in international transactions that could be considered to have a significant connection to the Netherlands or to another jurisdiction that does not recognize the trust.

Outlook

The Dutch legislator must step in to resolve these issues. Finance practice has so far not been successful in convincing the Dutch legislator that the complications with collective security arrangements involving Dutch law security are unnecessary and could be easily resolved by a statutory provision that would enable parties to create trust for this purpose. But it is hoped that the European committee's plans to create a *Euromortgage*, which are expected to include provisions that facilitate the creation of mortgages in favour of a security trustee, will provide an incentive to the Dutch legislator to revisit this issue.

The author has based this article on her book Collective Security Arrangements *(Kluwer International, 2003).*

Boekel De Nerée
Gustav Mahlerplein 2
1082 MA Amsterdam
P.O. Box 75510
1070 AM Amsterdam
The Netherlands

Tel : (31.20) 795 39 53
Fax : (31.20) 795 39 00
E-mail : boekel.de.neree@bdn.nl
Web: www.boekeldeneree.nl