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TRUSTEES – ALWAYS USE PROTECTION

By David Allen and Julie Bowring

In the past, when people thought of trusts, they thought of the private family trust (parents holding property for the benefit of their children). Nowadays, trusts are recognised as vital to modern international finance. They are an essential component in many different types of financial structures, including securitisations, bond issues and pension schemes. As Philip Rawlings, a Professor of the Law of Finance at University College London, has said “*the trust has given common law jurisdictions [of which the English legal system is one] a significant legal edge over their civil law rivals when it comes to the construction of financing deals*”. Indeed, the success of the trust has led some civil law jurisdictions (such as, France since 2007) to incorporate trusts into their civil codes.

In a typical securitisation structure (as illustrated in the diagram below), a trustee’s primary duty is to administer the trust that holds those securities in the best interests of the investors (that is, the beneficiaries) who have purchased the securities pursuant to the securitisation.

The subprime crisis and credit market collapse, with their huge investment losses to investors, have catapulted trustees into uncharted territory, not contemplated by securitisation transactions or properly addressed in the documents. Trustees now

find themselves embroiled in a rising number of complex and costly disputes as aggrieved investors are eager to recover their losses from transaction participants or third parties.

The English courts categorise such disputes involving trustees as “third party disputes”. They are disputes between trustees (acting on behalf of the beneficiaries) and third parties with whom trustees, in their capacity as trustees, have legal relations (such as, the cash manager or the liquidity facility provider in a securitisation). With third party disputes, trustees face two principal risks:

1. Trustees may choose not to litigate, leaving them with the risk of a future claim by investors that they committed a breach of trust.
2. Alternatively, trustees may choose to litigate but may lose, resulting in liability for costs.

There is a presumption that where trustees engage in litigation for the benefit or protection of the trust fund, they are entitled as of right to be fully indemnified by the trust fund against all costs, charges and expenses properly incurred while performing these duties. However, in reality, trustees who decide to pursue or defend claims which later turn out to be unsuccessful might have their right to their indemnity challenged by



David Allen is a partner and **Julie Bowring** is a senior associate in the Litigation & Dispute Resolution group at Mayer Brown International LLP.

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disgruntled beneficiaries. This is particularly the case where the disgruntled beneficiaries are investors who have already suffered huge losses on their investments. To avoid finding themselves personally liable for costs which are likely to be substantial, trustees must know how to effectively manage third party disputes and take all the necessary measures to protect themselves.

What to think and what to do

Trustees should be clear about their duties

Trustees' fundamental duties are to preserve and protect the trust fund which may include enforcing causes of action for damages or defending the trust against adverse claims. These duties are owed to the beneficiaries. They are not absolute duties but require the trustees to exercise reasonable care and prudence when deciding how to act.

Seek legal advice

Trustees must seek legal advice on all aspects of the claim, including the merits of the case, settlement prospects and likelihood of recovery as well as how to avoid being in the firing line for breach of trust claims or adverse costs orders.

Consult with the beneficiaries

Communicating with the beneficiaries to establish their views is essential. If nothing else, this will considerably reduce the risk of a claim against the trustees being brought by the beneficiaries down the line.

Check the provisions in the trust document

There may be a clause in the trust document which provides that the trustee is entitled to be reimbursed out of the trust fund for all litigation costs properly incurred unless it is proved that such costs were incurred dishonestly or a clause excluding the trustee for breach of trust in the absence of a dishonest intention of the trustee. There may also be a clause that the trustee need not take any

action unless it is first indemnified and/or provided with security to its satisfaction.

Do the beneficiaries have the rights of action in respect of any claims?

Statute or the transaction documents may provide that the beneficiaries can pursue or defend proceedings in their own right, at their own costs and risks. For example, under the Trust Indenture Act 1939, if a US bondholder's right to receive payment is impaired or affected without his consent, that bondholder has the right to take direct action against the third party responsible. The US bond trustee (unlike its English equivalent) is not given a wide discretion to act on the bondholders' behalf.

Court action and the costs involved

Trustees need to know the merits of their case and familiarise themselves with the costs regime of the jurisdiction in which the court action will be conducted. In many jurisdictions (such as England and Wales and many offshore jurisdictions), costs follow the event which means an award of costs will generally flow with the result of litigation; the successful party being entitled to an order for costs against the unsuccessful party. However, in other jurisdictions, this is not the case. In the United States, court practice regarding costs operates on the general principle of no fee shifting (i.e. each party to civil litigation is responsible for its own legal costs regardless of which party prevails, otherwise known as the "American Rule").

Alternatives to court action

The Civil Procedure Rules 1998 and Practice Directions in England and Wales specifically state that starting proceedings should usually be a step of last resort and proceedings should not normally be started when a settlement is still actively being explored. Although alternative dispute resolution (such as mediation or facilitation) is not compulsory, the parties should consider whether

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some form of alternative dispute procedure might enable them to settle the matter without starting proceedings and the court may require evidence that the parties considered some form of alternative dispute resolution.

Weigh up the options

Trustees need to weigh up all the options before adopting the course of action which in their view is in the best long-term interests of the trust.

How to protect against the costs of any court action

Apply to the court for directions, otherwise known as a Beddoe application

Under English law, trustees can apply to the court for directions (otherwise known as a Beddoe application) as to whether or not proceedings should be conducted on behalf of the trust fund. Similar relief to that provided by the English courts is likely to be available in other jurisdictions where trusts are recognised and available.

The principles of Beddoe proceedings were first laid out in the 19th century English case of *Re Beddoe, Downes v Cottam* [1893] 1 CH 547. However, trustees of present-day trusts under the jurisdiction of England and Wales will find that the principles are still applicable today. In 2003, the principles in *Re Beddoe* were incorporated into the Civil Procedure Rules 1998 and Practice Directions at Part 64B.

Beddoe applications take the form of a separate action and are heard by a different judge from the action against the third party. They must be supported by evidence including the advice of an appropriately qualified lawyer as to the prospects of success (full disclosure of the strengths and weaknesses of the case must be given to the court), the beneficiaries' views, the value of the trust assets, the significance of the proposed litigation or other course of action for the trust, and why the

court's directions are needed. The evidence should also state whether the trustees have proposed or undertaken, or intend to propose, mediation by alternative dispute resolution, and (in each case) if not why not. Lord Justice Jackson in his final report of his review of civil litigation costs published on 14 January 2010 made the recommendation that, save in exceptional circumstances, all Beddoe applications should be dealt with on paper.

Beddoe applications should be made as soon as possible and ideally before taking any steps in instigating or defending the third party litigation. The English courts are not keen on granting an indemnity retrospectively for costs already incurred.

Beddoe proceedings offer trustees a means of complete protection from any future claims by the beneficiaries that they should or should not have litigated. Further, if litigation is pursued with the court's approval, the trustees' costs incurred in the litigation will be recoverable against the trust fund whatever the eventual outcome of the litigation. It is a myth to think that trustees are safe by simply following the advice of their counsel as to whether or not to sue or defend.

By agreement and/or obtaining an indemnity from the beneficiaries

Trustees should consider obtaining a written agreement from all the beneficiaries that any litigation costs would be met out of the trust fund. The written agreement must be properly constituted to include all material information. In relation to securitisations, where there are numerous investors and trustees do not know who or where they all are, this approach is not feasible.

As an alternative, the trustees could seek to obtain an indemnity for the litigation costs from one or more of the beneficiaries, provided that they are not aware that other beneficiaries are against the litigation being conducted.

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Prospective costs order

Under English law, trustees may apply for a prospective costs order (formerly known as a “pre-emptive costs order”). The English courts will order that one side will pay the other side’s costs whatever the result of the litigation. An application for a prospective costs order is an application in the existing litigation. Prospective costs orders are generally only sought in administrative proceedings and are only made in very strong cases where the judge hearing the application is satisfied that the trial judge would make the same costs order.

Insurance

Trustees may be able to get indemnity or “after the event” insurance for the costs of pursuing or defending litigation which later turns out to be unsuccessful.

Final thoughts

If trustees have to conduct expensive third party litigation the outcome of which is not clear, trustees should always use protection. Under English law, the best protection afforded is by making a Beddoe application and obtaining the court’s approval in the form of directions for a proposed course of action. Ultimately, this gives trustees their most valuable benefit - protection against becoming personally liable for any costs incurred in pursuing or defending the litigation. As Lord Justice Lindley advocated in *Re Beddoe, Downes v Cottam*:

“A trustee who, without the sanction of the court, commences an action or defends an action unsuccessfully, does so at his own risks as regards the costs, even if he acts on counsel’s opinion”.