Testimony of Professor Steven Schwarcz
United Kingdom High Court of Justice, Chancery Division

(excerpted)

PROFESSOR STEVEN LANCE SCHWARCZ (sworn)

Examination-in-chief by MR MOSS

MR MOSS: Professor Schwarcz, you should have, I think, behind you a bundle that is marked "Core bundle". If you would care to turn to tab 7, divider 7 --

A. Tab 7?

Q. Please, you will see there what looks like your expert report and just to check, if you could turn to internal page 17, can I just get you to confirm that is your signature?

A. Yes, that is my signature.

Q. And therefore, if you could confirm this is your evidence in this case?

A. I confirm this is my evidence in this case.

MR MOSS: I am obliged. Wait there, please, my learned friend Mr Trower will ask you some questions.

MR JUSTICE FLOYD: I was going to ask somebody go and recover my core bundle from my room. But please carry on with your cross-examination in the meantime.

Cross-examination by MR TROWER

MR TROWER: Professor Schwarcz, I take it that you would accept that the starting point of the security trustee's

duties is the documentation under which he was appointed? That is what you start with.

A. Yes, I agree that is what you start with in the absence of a default. That's correct.

Q. The express terms of that documentation will influence the scope of any duties which the law will impose?

A. The express terms of documentation would influence the scope prior to a default. That is correct.

Q. Once one gets to the post-default context, your evidence is that the trustee must act prudently but only in the exercise of those rights and powers granted by the indenture; is that right?

A. My recollection from the cases -- certainly the trustee must act prudently in terms of the rights and powers that are granted in the indenture. My recollection of the case law is that the courts state that the obligation to act prudently may go beyond even what is explicitly stated in the indenture, certain cases.

Q. Yes. We will look at some of those cases in due course but as we say, as you accept, certainly pre-default, the security trustee's duties are in the documentation under which he is appointed, and pre-default it is the express terms which influence the scope?

A. Yes, I agree.

Q. Now, post-default, it remains the case that the scope of

the trustee's duties, albeit enlarged in accordance with your evidence, the scope of the trustee's duties are still influenced by the express terms of the indenture?

A. If you can repeat the question, because I am not sure what the word "influence" meant? Forgive me.

Q. It remains the case that post-default, the scope of the security trustee's duties are influenced by the terms of the indenture?

A. The scope of the trustee's duties are certainly influenced by the indenture, although again, I qualify it as I mentioned before, that there is case law saying that the prudent man obligation may go even beyond the specific terms of the indenture.

Q. Yes. We will come on to the context in which that may happen, but I just wanted to establish with you that the scope was influenced both pre- and post-default by the terms of the indenture?

A. Yes, that is correct.

Q. It is right too, isn't it, that it is commonplace for such discretions as an indenture trustee has to be subject to bondholder direction?

A. One certainly sees in many cases situations where an indenture does give the bondholders the ability to direct the trustee, in certain cases.

Q. One can put it a little higher than that, can't one?

That it is actually commonplace for the indenture to provide for direction to be given? It is standard form in most indentures, isn't it?

A. I have seen many indentures. Most have some types of provisions that will enable the bondholders to give directions to the trustee. The nature of those directions differs from indenture to indenture sometimes.

Q. I understand that. I don't want at the moment to focus in on the type of direction that the indenture might make provision for, but I just wanted to establish with you that it is commonplace for indentures to provide for bondholders to give direction to the security trustees?

A. Yes, I agree.

Q. Thank you. It is commonplace in the traditional way in which indenture trustees and security trustees operate for them to insulate themselves, insofar as they can, from liability by organising meetings to solicit direction where any unilateral action involving risk is something that they are going to be required to do?

A. That is commonplace but the commonplace nature that actually derives from statute, from the Trust Indenture Act of 1939 as amended which has a specific provision that says that upon a direction of a majority or supermajority, I forget, of the bondholder, they can

direct the trustee. So where the indenture is governed by the Trust Indenture Act, one often sees those meetings. As a factual matter, because there is a pattern to those meetings, one sometimes sees them where there is no Trust Indenture Act applicable.

Q. Yes, because what has actually happened is that a lot of the practice that was applicable in relation to the Trust Indenture Act indentures has carried over into indentures that are not actually governed by the Trust Indenture Act?

A. That is a question of fact as to which I believe the answer is probably that I may not be fully competent to say.

Q. Okay, we don't need to explore that any further.

Can I just focus for a moment on pre-default duties with you. Just a few questions on that. In Professor Thel's report with which I think you agreed, because broadly speaking you agreed with most of Professor Thel's report, isn't that right?

A. That is correct.

Q. He identified only two pre-default duties which were established by the authorities. The first of those was the avoidance of personal conflict of interest, correct?

A. That is correct.

Q. And the second is the duties imposed specifically on the

security trustee by the indenture itself?
A. That is correct.
Q. Those types of duty, that second type of duty, tended to be obligations to perform basic non-discretionary ministerial tasks?
A. That is typical, yes.
Q. And one of the reasons that the duties are limited in that way is that the security trustee must consider the interests of the issuer as well as the interests of the investors, the bondholders?
A. I am unsure about that. The trustee, of course, is a trustee for the beneficiaries, which in the case of an indenture or a security agreement would be the bondholders. So I am not sure there is as clear an obligation, if any, to the issuer as there would be to the beneficiaries.
Q. The reason I put it to you like that was because of what was said in the LNC case and I know you have been in court this morning, you have heard the cross-examination in relation to the LNC case. Perhaps we could turn it up for a moment. You have it in bundle 4, behind tab 53. You are reasonably familiar with the LNC case, I take it?
A. I have read the LNC case, that is correct.
Q. I do not think we need to spend time going through it,

because my Lord is familiar with it, having heard cross-examination on it this morning. Could I ask you to go to page 1347 of the report?

A. I am on that page.

Q. It is the passage beginning at the bottom of the left-hand column. I think that is taking it too shortly. It may be better if you just read from 1213, halfway up.

A. Okay.

Q. It is actually even higher than that. It is the bit:

"The role of an indenture trustee differs from that of an ordinary trustee because the indenture trustee must consider the interests of the issuer as well as the investors and because its obligations are defined primarily by the indenture rather than by the common law of trusts."

That would appear to support the proposition that an indenture trustee has to consider the interests of the issuer as well as the interests of the investors.

A. The way I read that is that the indenture trustee must consider the issuer to the extent the indenture states the indenture trustee must consider the issuer. I do not believe there is a common law obligation of the indenture trustee to regard the issuer beyond that.

Q. But it is likely to be inherent in the nature of the

situation prior to an event of default that there will be aspects of the indenture trustee's role which will affect the position of the issuer?

A. That may well be the case, yes.

Q. Yes. Then while we are on LNC, just before we leave it, could you just go down to the bottom of that column, bottom of the left-hand column on 1347:

"After an event of default, however, the loyalties of an indenture trustee no longer are divided between the issuer and the investors and, as a consequence, New York law reallocates the indenture trustee's fiduciary duties to reflect that change."

That would appear rather more clearly to set out the something which is no longer an issue is the division of loyalties as between the issuer and the investors?

A. I would agree that, to the extent there was a conflict before, it would cease to occur at that point.

Q. Can we now move to the position subsequent to an event of default, and can I ask you, please, to have in one hand your report; just keep that handy, because we will be looking at that from time to time.

A. Which bundle?

Q. You will find that in the core bundle behind tab 7. I want to ask you some questions about what you describe in your report as "the duty to preserve". If one can

pick that up in paragraph 14 of your report, where you say:

"A prudent man under New York law should preserve, by which I mean not waste, the trust assets to assure repayment of the underlying obligations."

And I think it is fair, is it not, that to say that, in support of that proposition, you discuss in different contexts three different cases. One is Magten, the other one is LNC and the third one is Beck.

A. I believe that is correct.

Q. And there aren't any other cases which you rely on to support what it is that constitutes the duty to preserve?

A. I believe that is correct.

Q. Can we look at the most recent one first, which is Magten, which you will find behind tab 69, which is in bundle 5. The word "preserve" so far as I could discover, only appears once in this case, which is on page 6 of the judgment in the passage several lines down by the three-asterisk 7 and it simply says:

"After a default, the trustee is under an enforceable obligation to act prudently to preserve the trust assets for the benefit of the investors."

And it appears on its face to be a statement by the judge in this case, Mr Justice Bernard Fried, of his

understanding of what Beck v Manufacturers Hanover Trust established. Do you agree with that?

A. I agree with that.

Q. So as a statement of principle, it may not add very much to what has already been decided in Beck, do you agree with that?

A. I agree with that. I also -- I do agree with that, yes.

Q. So let's just look at what was in issue in Magten for a moment so we can test what "preserve" might have been relevant to. The complaint seems to have been that collateral was lost because the trustee:

"... failed to move quickly enough after a disputed event of default to apply to set aside the transfers assets forming part of the collateral."

That seems to have been the complaint. Is that your understanding of the complaint or would you like just to refresh your memory as to the facts?

A. It has been a while since I read this case, and I -- in order to agree, I would have to re-read this case.

Q. Shall we just go then to the bits where I think one gets it most clearly from. Page 2, and if you go in the left-hand column to the penultimate paragraph:

"Magten asserts that, once NorthWestern made the purported admission [admission of insolvency] BNY should have started judicial proceedings to put aside the

transfer of the utility assets from NorthWestern Energy to NorthWestern or to impose a constructive trust on those assets. Either action would have preserved the assets for the QUIPS holders."

There is another use of the word "preserve" so I was quite wrong to say to you earlier, for which I apologise, that the word "preserve" came only at the end of the judgment.

And in the event what happened was the proceedings were struck out because the bondholders failed to establish an event of default and you may have heard that discussion between Mr Moss and Professor Eisenberg this morning.

A. Yes.

Q. So what this case seems to be dealing with is a situation in which the concept of preservation was relevant to the recovery of an asset which had been disposed of out of collateral. Is that right?

A. I believe that is correct.

Q. So to the extent that the trustee didn't take steps to recover, as quickly as he should have done, that which had been disposed of, that amounted to a breach of the duty to preserve or might have done?

A. Right, I was going to say the "might have". I would have to go back to the facts to see what was happening.

I am presuming here that this was a wasting asset of some sort.

Q. Perhaps we had just better look at it. It is not so much that it is a wasting asset; it was the fact that in failing to take certain steps, the value of the collateral was actually diminished by that failure. Do you recollect that or not? Or --

A. I would have to re-read the case.

Q. I see. Can I ask you this before, and see whether we do need to go back and read it. You do specifically refer to this case in your own report and you refer to it in footnote 12 which you will find on page 107 in the bundle numbering. By all means refresh your memory of the case insofar as you need to do so, but what I wanted to ask you before we do that is this: you appear to be citing Magten as authority for the proposition that, after default -- I am looking at where footnote 12 appears as against the text in your report -- the proposition that:

"After a default, an indenture trustee takes on a broader fiduciary responsibility to secure repayment for those beneficiaries' debt securities."

And the question I wanted to ask you was whether there is any language in Magten that you can point to which actually supports the proposition that there is

a broad fiduciary responsibility to secure repayment of those beneficiaries' debts securities as opposed simply to take reasonable steps to preserve the trust assets?

A. I would have to look through the Magten case to find it, which I can do. I do recall that if it is not in Magten, there is a case which in fact uses the -- or describes explicitly the fact that the duty is to the obligations of repayment.

Q. Yes, perhaps we can come and see where that might be in a moment, but the best I think we can do is, you refer in the footnote there to asterisk 7 which I think was the passage we have already looked at on page 6 of the print, which is the bit about preserving the trust assets for the benefit of the investors. (Pause). If that is what you meant by "takes on a broader fiduciary responsibility to secure repayment of those beneficiaries' debt securities", I will join issue with you as to whether that is a fair summary of what is said but we do at least know where that comes from.

A. The citation to Magten in footnote 12 I believe is simply for the quotation that reiterates in a general concept the duty.

Q. I see, so we shouldn't read Magten as of itself supporting the proposition in the text? You only rely on LNC for that, is that right?

A. The proposition in the text talks about the beneficiaries' debt securities. The Magten language talks about the investors. Of course, the concepts are related since the beneficiaries are -- the holders of debt securities are like investors basically. So I am not sure that the propositions are terribly different.

Q. I certainly accept that, in order to discharge liabilities to the bondholders, the assets will have to be preserved. To that extent one can see that there is a link. But I think your evidence is, as I understand it, that you are not citing anything other than the proposition that we've looked at under asterisk 7 on page 6 of the print for -- anyway out of Magten for the proposition that:

"After a default, an indenture trustee takes on a broader fiduciary responsibility to secure repayment for those beneficiaries' debt securities."

A. I believe that is correct, or let me restate it, and see if you agree, which is that the Magten case has language that states the general proposition. Of course, as you point out, it does quote it from Beck.

Q. Yes. Can we just then go and look at LNC. This is a case which you refer to in support of the proposition in paragraph 14 of your report and you will find it behind tab 57, which I am afraid is in the previous

bundle. So you can put away for the moment bundle 5.

This is another LNC case from the one that Mr Moss looked at with Professor Eisenberg this morning. There are two LNC cases. You cite this as authority for the proposition that:

"A prudent man under New York law should 'preserve', by which I mean essentially not waste, the trust assets to assure repayment of the underlying obligations: in this case, the obligations of repayment due to the senior and to the senior subordinated noteholders."

I think it is right, we weren't able to find in this judgment, although I hesitate in the light of what I said earlier on, the word "preserve" but what we were able to find in paragraph 18 of the judgment was the word "safeguard". Can I just invite you to go to paragraph 18 of the judgment.

Then the other paragraph I would like you to look at is paragraph 24.

A. Okay.

Q. Are you familiar with the facts -- it is obviously a case which is in your report so I imagine you read it at the time you prepared your report but have you recently refreshed your memory as to this case or do you remember the facts quite well?

A. I have not recently refreshed my memory.

Q. Let me remind you of this much: that the assets which were in issue in this case were security interests in aircraft. Do you recall that?
A. Yes, I do.
Q. The issue in the case was whether or not the trustee had actually safeguarded the trust interests in the aircraft and the question was whether -- and that, I think you will agree, is an asset which is not likely to appreciate in value?
A. As a question of fact, I really can't say whether an aircraft would or would not appreciate, it would depend upon the market, I imagine.
Q. Do you recall what the threat to the assets was in that case?
A. I would want to go back and read the case in order to respond specifically.
Q. Perhaps we could go to paragraph 8 from which one can see what it was. The threat to the asset was the failure of the trustee to take steps to apply to lift the bankruptcy statutory stage, do you remember that?
A. I do.
Q. If he had taken steps, one of two things would have happened: the stay would have been lifted, leading to a sale, or there would have been superpriority status which would have been granted as a condition of

maintaining the stay, do you recall that?
A. Yes, I do.
Q. So in either case, had that step been taken, the secured bondholder would not have suffered the consequences of the market value of the aircraft decreasing, do you accept that?
A. I accept that.
Q. So the failure to safeguard was a failure to move quickly to protect the value of the depreciating asset?
A. In the context of this case, that may well be true.
Q. Yes. There were, as it happens, do you recall this, three different series of bonds in this case. But all the bondholders had the same interests in ensuring an early lifting of the stay, would you accept that?
A. I would have to go back to read that, but I am happy to accept that for purposes of the discussion, if you wish.
Q. Perhaps I can put it in this way: if there were three separate series of bonds, which it is apparent from the face of the case there were, all of the bondholders would have had the same interest in ensuring an early lifting of the stay?
A. If the early lifting of the stay would maximise the value of the aircraft, then I would agree with that, yes.
Q. And it is pretty difficult to see that a timeous

application to lift the stay wouldn't have at least "preserved" in the sense of safeguarding what value there was?

A. If you could repeat that?

Q. It is pretty difficult to see that a timeous application to lift the stay wouldn't have preserved better whatever value in the aircraft there was?

A. Timeous?

Q. Timely.

A. Yes, I agree with that.

Q. So at the end of the day on the facts of LNC, the safeguarding is limited to preventing a deterioration in value from the time of the event of default?

A. In the context of the facts, that is what the safeguarding would be.

Q. Yes. And in the trust indenture context, what one can say or may be able to say, absent material in the trust indenture document itself, is that one of the primary duties of a trustee post-default is at least to try to preserve the amount that bondholders could recover at the time of the default from waste in the sense of a deterioration in value?

A. I do not agree with that necessarily. The words "at the time" I think qualifies that in a way that would not necessarily be true if, for example, the asset were to

appreciate significantly over time.

Q. So what you are saying is that a trustee may find himself with an enhanced duty as a result of the assets actually appreciating in value after the time of his original appointment?

A. What I am saying is that the nature of the prudent man duty will depend upon the facts and an application of judgment to the facts. It is what a prudent man would do in those circumstances when confronted with the specific facts.

Q. And in the context in which we are looking at it in LNC, it is a context in which all of the participants, all of the bondholders, had identical interests?

A. Again, I have not gone back to check that but we have assumed that for the purposes of this discussion.

Q. It is quite an important point. Is there anything about LNC that you recollect which might lead you to conclude that the participating bondholders/creditors had divergent interests that were relevant for these purposes?

A. I do not recollect that they had divergent interests.

Q. Can we now turn to Beck which you will find behind tab 51, fortunately in the same bundle. It is relied on by you in paragraph 16 of your report. What you said was:

"In Beck, collateral being auctioned 'would be purchased, if at all' at an 'upset price' money lower than its fair value. The court ruled that, because the trustee, over and above its obligation specified in the trust agreement, 'owed its duty of loyalty ... to all the trust beneficiaries', it 'was absolutely crucial to the interests of the trust beneficiaries ... that the collateral be fairly valued'. The beck case thus stands for the proposition that, notwithstanding the contractual terms of the trust agreement, a trustee should take into account all trust beneficiaries."

What I want to do with you in looking at Beck is to examine the scope of that sentence, taking into account all trust beneficiaries and what exactly you are saying in relation to that.

First of all, just to remind you what was in issue in Beck, Beck was about the failure to obtain a competent independent valuation together with a series of other auction deficiencies and there was included within that, anyway at one level, collusion between the trustee and one beneficiary which resulted in an undervaluation of the auctioned assets. Is that fair?

A. Yes, that is fair.

Q. Perhaps I should have just confirmed with you, you are

familiar with Beck?

A. I am very familiar with Beck, yes.

Q. Against that background, the court at page 527, top of column 2 -- it is the bottom of column 1 and the top of column 2 -- had little difficulty in concluding that the trustee owed the fiduciary duty of undivided loyalty to the trust beneficiaries. Yes?

A. I see that.

Q. Then if we go to page 530, column 1, we can see there that -- and it starts about probably if you read from "while denominated" down to "the purchaser apparent", about twenty lines. (Pause)

A. Okay.

Q. So what one can see from that, I think you will agree, is that the duty of loyalty was owed to all beneficiaries and by "all", what was meant was the beneficiaries with whom the trustee had been negotiating a prospective purchase, there was just one of them, and the beneficiaries who were not. So everybody who was a beneficiary had an undivided duty of loyalty owed to them?

A. In this cases that is correct, because in this case I believe all the bonds were pari passu, that is correct.

Q. But the duty of loyalty was owed to them in their

capacity as creditors?

A. Yes, it was.

Q. And in their capacity as creditors, there was no conflict between them?

A. That is correct. Insofar as -- yes, in their capacity as creditors, all the bonds were pari passu, that is correct.

Q. And it was only in the capacity which one of them had as a prospective purchaser that there was a divergence of interest?

A. That is correct.

Q. And that was the divergence of interest which the court was focused on?

A. Yes, it was.

Q. Can we then consider the duty of prudence post-default, which is analysed in Beck and what it actually means, because it obviously has to be analysed, as I am sure you will agree, and in fact I think you told my Lord a short while ago, in the relevant factual context.

If we go back in the judgment to page 527, the duty of prudence at the bottom of the page is described as the duty to preserve and manage. Bottom of the page on the right-hand column.

A. Let me read this in context.

Q. Please do. Read it as carefully as you feel you need

to.

A. I should point out that we had talked before about where the duty is to the underlying -- to payment of the underlying obligations, and the language here is -- certainly sets that forth at the bottom of the right-hand side:

"The fundamental and highly salutary purpose of a bond indenture is to secure payment of the underlying obligation."

Q. Yes, they then go on, don't they and say:

"Duty to preserve and manage the trust assets in the event of default and so to provide some reasonable assurance that the bondholders eventually receive their due."

A. Let me just finish reading this. (Pause). Okay.

Q. Perhaps I could just ask you this: presumably what "the reasonable assurance that the bondholders eventually receive their due" is focusing on is what they are due in the context of the security agreement or the indenture in that case?

A. Ultimately what they are due would be repayment.

Q. Yes, but repayment in accordance with the terms of the governing documentation?

A. That gets into something that I think goes beyond what "due" means here. This situation involved a default and

already that there was not repayment in accordance with those documents. That goes to a different point about ultimate payment and time limits of payment, which is different.

Q. What they are due is what they are entitled to under the documentation under which the obligation arises, presumably?

A. That is a starting point to analyse that.

Q. Yes. So you do have to look at the terms of the documentation in order to see what they are due?

A. Clearly that is the starting point, yes.

Q. So what I suggest to you is that there is nothing in the concept which is being analysed or described in this passage other than a duty to safeguard the asset, and to manage it, to provide reasonable assurance in such a way that provides reasonable assurance that the creditors will receive what they are entitled to under the terms of the relevant documentation?

A. Insofar as that specific language is concerned, I would agree with that.

Q. In a case such as Beck, the concern was whether the creditors were getting the full value of the marketplace for the asset that was being transferred as part of the transaction which the trustee had committed that was under investigation?

A. Yes.
Q. I think I am right in saying, but please correct me if I am wrong, that there is nothing in the case that suggests that a sale must be timed at a particular moment to facilitate an increase in value, subsequent to the date of default? Nothing in this case?
A. This case did not necessarily involve that issue. One would not find that in a case unless you had a case where the facts raised such an issue.
Q. Yes. Can I move on to something that you have described in your report as "I think" a "duty to maximise". If you would go, please, to footnote 7, which we find at page 104.
A. Yes.
Q. What you there say is:

"This New York common law duty of a trustee to preserve trust assets for all beneficiaries also appears to be evolving, in practice, into a duty to maximise such value after default."

And you include some extracts from the Memorandum of the ABA Trust Indenture Committee. Just to clarify one point, there is no case law authority which suggests that a prudent trustee has a legal duty to maximise collateral after default, is there?
A. I am not aware of any such case law.

Q. So could we just look at the document that you produced in support of this which you will find at tab 78. I think, as far as I can tell, although it is not an easy document to make much sense of, but page 3 of the document is the relevant passage, as I understand it.

MR JUSTICE FLOYD: Can I ask why passages of this had been redacted?

MR TROWER: I think the witness may be able to help.

A. Your Lordship, this was a working memorandum commenting on a draft article that I was writing on what should be as a normative matter the obligation of an indenture trustee and what sort of immunity the indenture trustee should have from liability such as the business judgment rule and such. Some of the comments in the Memorandum were critical, some of the points I made, which on subsequent conversations, those comments turned out were -- I should say not really responsive to the draft of the article itself.

So the Memorandum on its face appears to be critical whereas in fact in retrospect it turned out that we had a great deal of agreement, and I simply did not want it to become a public record. But in fact, nothing in the remainder of this Memorandum had any bearing whatsoever on the case; unless this case were to involve the issue

of what should be the immunity of an indenture trustee, which I gather is not at issue.

MR JUSTICE FLOYD: Is this a private communication?

A. It is a private communication.

MR JUSTICE FLOYD: Yes, I see.

MR TROWER: My Lord we have dug out what I think is the article, which is coming up. (Handed). First of all, is this the article that you are referring to, Professor?

A. Yes, it is.

Q. We will come back to it in just a moment, but just looking at that passage in the report that you have put there at the moment, the most that "maximise" might mean is simply "obtain the best price", isn't it? It couldn't mean taking a risk with the collateral such that recoveries might ultimately be lower rather than higher?

A. It might mean that. The context of the article talked about the extent to which -- let me rephrase that. One of the questions was the extent to which indenture trustee ought to try to in fact take risk to maximise value of assets in a work-out, and the question is what the resulting liability might be in that case, and what might be needed to motivate the indenture trustee to take those risks. Recognising that, just like with a corporation engaging in business, what happens ex

ante, before the fact, does not guarantee what happens ex post, after the fact.

Q. Is this all part of the analysis which I think we will find when we have a brief look at your article about your view that it is appropriate for indenture trustees to take a more active role in relation to managing the asset which is under their control, making them more akin to corporate directors to whom the business judgment rule would apply, rather than traditional trustees?

A. No, this article has no bearing on my evidence today or previously. My evidence goes to what the law of New York is as a matter of positive law. This article is purely a normative article as to what the law should be, and I have kept them very strictly separated.

Q. Perhaps we can just look at one bit of this article in the context of what you've described as "the duty to maximise" which is pages 21 and 22, just to test the answer you have just given. You are here discussing traditional trust law concepts and it is fair, isn't it, that one of the themes of this article is that traditional trust law concepts shouldn't be applicable to the position of indenture trustees?

A. I am not sure I would state it that way. If you could kindly restate it for my consideration.

Q. Perhaps the sensible thing is to go to the bit we need to go to rather than getting into too much of a debate as to what the theme of the article is. If we go to page 21:

"Although trusts exist in many forms, traditional trust law is concerned with gratuitous trusts. Under a gratuitous trust, a settlor conveys the assets to a trustee to hold for the benefit of a beneficiary and the settlor receives no compensation for the conveyance. The standard of care applicable to a trustee under traditional trust law is the prudent man and the duty of a trustee under that standard is to use care and skill to preserve the trust property. This is primarily a negative duty, meaning the trustee should refrain from exposing trust beneficiaries to unreasonable risk. Thus the traditional trust law duty focuses more on preserving rather than increasing the value of the assets held in trust."

So at that stage it is fair to say that your view expressed on the face of the article, not what the law should be but what the law in fact is, is that there is a focus on preservation rather than increase in value?

A. Yes, that is a statement of positive law. That is correct.

Q. But it is also right, isn't it, and you say this

probably most clearly on page 5 of the article where you are looking at the standard of care for indenture trustees:

"Although a prudent man standard is widely used and well-developed in other legal contexts, it has received scant attention in the trust indenture context. Indenture trustees for defaulted bonds therefore face the conundrum that they are required to act prudently but lack real guidance on what prudence means. Even worse, this article argues the limited guidance that exists derives from misplaced judicial reliance on traditional trust law to inform the prudent man standard. A comparison of the role of indenture trustees in modern securities markets with that of traditional trustees reveals that any analogy between the two is fundamentally misplaced."

As I read what you are saying there, you are saying you wish it wasn't this way, but the way in which the prudent man standard has developed in US law, New York law, is by reference to misplaced judicial reliance on traditional trust law concepts; that is what you are saying there, isn't it?

A. Yes, it is.

Q. Extrapolating forward to the passage we were looking at on pages 21 and 22:

"The traditional trust law duty focuses more on preserving rather than increasing the value of the assets held in trust."

I took your position to be that, well, you wish it wasn't this way but, given that traditional trust law concepts apply to the position of trust indenture trustees, there is a duty which is focused more on preservation than increasing value?

A. Indeed, and that is why, for example, in the experts' statement that Professor Eisenberg and I agreed with, the last paragraph attempts to show what such a balance might mean when this rule is applied. That, if the value of the collateral in this case were significantly declining in value, were subject to a grave threat thereof, then foreclosure at this time may well be appropriate although if the present value of the expected payments would significantly exceed that amount, then perhaps the answer would be otherwise. So my focus has been on preserving, that is correct.

Q. Because the purpose of this line of questioning is to test the evidence that you gave in your report about the development into a duty to maximise, and by "maximise" you don't really mean anything more than "preserve" on the basis of this article, do you?

A. The only place in my report that I believe the word

"maximise" comes up, if I am not mistaken, is on page 6, footnote 7.

Q. Which we have just looked at?

A. Yes, I am only saying that the New York common law duty appears to be evolving -- I don't necessarily say that is what New York law is at the present time or not. I simply make the observation for what it is.

Q. Thank you. I do not think we need to take it any further then, if, as I understand your evidence to be, it is not actually New York law yet, although it may be evolving that way in due course.

A. That is correct.

Q. Can we move to the duty of impartiality as you describe it in paragraph 19 of your report. Paragraph 19, you start off by saying:

"That duty also accords with my prior academic writings on the duty of trustees to act impartially in respect of subordinated or other residual trust beneficiaries."

When you are referring to "that duty", as I understand it what you are referring to is the duty to preserve assets for all trust beneficiaries, which you refer to in paragraph 18 of your report. Do look back and check.

A. Yes.

Q. You then point to a trustee's duty to act impartially in respect of residual trust beneficiaries in order to support the proposition which you have advanced in the first sentence?
A. Yes.
Q. Are you there saying that a security trustee has such a duty to act impartially in respect of subordinated classes of debt?
A. The question of obviously what is -- how the duty applies in practice will depend upon the facts. I do not believe I have ever said anything more than one would need to balance a trust -- a trustee would need to balance the obligation with the facts before it and decide in a factual context what it would mean, when you have a senior and subordinate class. So this is a very general statement. This is not a statement that is applied to a fact scenario, but I would be happy to consider how to apply that, if you wish.
Q. Let's just break it down a little bit. You say -- and this citation is a citation from one of your articles on this area. It is an area you have written quite a lot on, isn't it?
A. Yes, it is.
Q. You have obviously got quite well-developed views over both what the law is and where the law ought to be?

A. Which I try to keep separate in my mind.
Q. You say:
"The trustee's fiduciary duty to senior trust claimants is subject to a duty of impartiality to residual trust claimants to preserve the value of the trust assets, in order to ensure that both classes of claimants - senior and residual - have a reasonable chance of being paid."
Do you accept that there will, in cases of a shortfall, for the junior debt, often be a situation in which the interests of the seniors and the interests of the juniors will part company?
A. I believe in questions of shortfall there always will be an inherent conflict, yes.
Q. So when you talk about a duty of impartiality, are you primarily focusing on the situation in which there is no obvious or apparent shortfall?
A. I am focusing on both scenarios, where there is or where there is not.
Q. Is the way in which you formulated the duty of impartiality here supported by any case law authority?
A. I do not believe it is. This was -- this language came from a footnote where I observed this. I believe this is the case, but I do not off the top of my head have any other authorities to support that.

Q. Yes, it is the footnote in the article that you wrote. Is that what you are referring to?
A. Yes.
Q. Yes. So do I take it as well that you would accept that the duty to act impartially such as it is has to operate within the confines and the context of the relevant trust document?
A. I think it has to operate within the confines and context both of the document and the facts. I think it is the entire factual scenario which would include both.
Q. But the terms of the documentation will inform the nature of the duty that you assert exists in this form?
A. It will certainly inform it, yes.
Q. And will surely be conclusive as well?
A. No, I do not follow why you say that, forgive me.
Q. Because the conflicting rights will arise and interests will arise out of that document, will they not?
A. Forgive me but I am not sure I follow what you are saying in that regard.
Q. Let me try it another way. You have a suite of transaction documentation which sets out the arrangements and relationship between the junior bondholders, the senior bondholders and issuer; doubtless there may be other parties as well but let's keep it simple. That suite of documentation is what

gives rise to the relationship, the three-way relationship, between those three persons, yes?

A. Well, of course, prior to default, that is correct, yes.

Q. But even subsequent to default, it is still the origin of the relationship, isn't it?

A. That plus the prudent man standard which goes beyond the document.

Q. Perhaps I should have asked you this a bit earlier. Is it your position that the prudent man standard will always be there and the parties can't contract out of it?

A. If your question is: is it possible to contract out of the prudent man standard, I think it would depend upon the facts. I do not believe that an indenture that said: notwithstanding New York law, the prudent man standard will not apply, I do not believe that language would be enforced.

Q. You may be right in relation to the Trust Indenture Act indentures, because there may be some provision in the Act which prohibits contracting out, but is it really your evidence that the parties to a private bond issue can't contract out of the prudent man standard in relation to the security trustee's post-default duties?

A. If there were an explicit waiver of that and the question came up, I would want to review the case law.

My recollection is that there is language, perhaps in the Beck case for example, that explicitly says that, notwithstanding exculpatory provisions, the prudent man standard will apply to the indenture.

Q. We can look at Beck and see whether that is right or not, but whether that is right or not, I think you do agree that the terms of the trust indenture document itself is a starting point for informing the tripartite relationship that we were discussing just now?

A. Well, what I said before is that it does help -- it informs it, of course, and you also have the prudent man standard; I think after default they both have to be considered in context.

Q. Just moving on from that, you have accepted, I think, that, where the duty of impartiality does apply, your duty, and there is a potential conflict between the interests of two classes, it may well operate to prevent the trustee from putting the assets at risk. That is one way in which it will operate?

A. No, I never said that. In fact, if we go back to -- what is the article that we had before that, I guess the bond indenture article.

Q. Which article are you referring to?

A. This is the one that you handed me "Bond Defaults and the Dilemma of the Indenture Trustee". It was language

where I quoted the existing law.

Q. Page ...

A. If you could help me with the page?

Q. Page 22?

A. Let me just check. Yes. There if you look at the bottom of page 21/top of 22 said:

"... meaning the trustee should refrain from exposing trust beneficiaries to unreasonable risks ..."

And it is the "unreasonable" nature of it that I think is the focus as opposed to no risk. I am not at all saying that indenture trustees should expose the party to no risk. That is why in paragraph 6 of our agreed expert statement, Professor Eisenberg and I pose these competing considerations in context of a significant decline in value weighed against what the present value of the expected payments are.

Q. But this duty can't require the trustee to have regard to the interests of the residual beneficiary if that thereby puts at risk in any material sense the rights of the senior beneficiary, can it?

A. The only question would be whether the risk to the senior beneficiary is unreasonable in the context; that is a question of fact.

Q. Is that the right way round though? Whether the risk is unreasonable in the context? Why should that be the

question? Surely the question is any putting at risk of the rights of the senior beneficiary has to be justified?

A. It is justified in the sense that the trustee has an obligation to all the beneficiaries and those beneficiaries include the subordinated claimants.

Q. But one of the aspects of this, Professor, is people's commercial expectations, is it not, in relation to the rights that they have as creditors?

A. Certainly commercial expectations is part of this, yes.

Q. And people's commercial expectations will primarily be governed by the terms of the documentation? That is right too, isn't it?

A. Well, people's expectations will be governed by the terms of the documentation, but also by how they believe things will happen in the default scenario.

For example, there is a wonderful article by Douglas Baird in the EL Law Journal called "Bankruptcies' disputed axioms", where he talks about the fact that expectations in the bankruptcy context are not only determined according to contracts, but also according to the bankruptcy rules that apply in override contracts, and what that means, and it is the same thing here.

Q. When you are talking about people's commercial

expectations, you are looking at people's commercial expectations at the time they invest, that is what one is concerned with in this context, isn't it?

A. Yes, it is.

Q. It is not a commercial expectation that arises subsequent to the date of default?

A. There always must be an expectation of the possibility of default and so that has to be --

Q. Certainly, but it is an expectation which they will have at the time of investment that one is concerned about?

A. But that expectation will include -- I think any investment will always include a possibility that down the road there could be a default.

Q. Yes, yes, I do not think we are apart on that. I think you have said elsewhere in your report that New York law strongly favours an interpretation that supports financial market expectations?

A. Yes.

Q. What one has to look at at the time of the investment is the financial or market expectations that the creditors, in this case the bondholders, will have had in the light of the documentation. Yes?

A. Again, informed by the possibility of a later default.

Q. Of a default?

A. And that might have occurred, yes.

Q. In the present case, those financial market expectations, there are two factors which are relevant for expectations at the default stage. The first is that there is a subordination of rights as between the senior subs and senior notes in this case and that goes into informing financial market expectations?
A. Yes, it does.
Q. And if it were to be the case -- and I quite appreciate that it is in issue in this matter -- if it were to be the case that my clients had a right to direct, that also would go to inform the financial market expectations?
A. If it were to be such a right, and if that right was clear enough so that the inspections were developed based on it and if those expectations were in accordance with the case law, then I would agree, but in order to completely agree, one would have to examine those two conditions I put on my --
Q. Yes, I understand that. There will also be financial market expectations to preserve in the sense of safeguarding the assets post-default? That would be another financial market expectation people will have?
A. Yes.
Q. Now, if you go to paragraph 18 of your report, and just remind yourself of what you say in paragraph 18.

A. Okay, I have looked that over, thank you.
Q. What you seem to be saying there is -- but maybe you are not. Are you saying there that financial market expectations of the subs extend to the expectation that they will be entitled to wait until a distressed market recovers?
A. I am simply making a general statement here, and if you wish me to apply it to the scenario you have described, I am happy to do so.
Q. I just want to know what you are saying there. Maybe I put words into your mouth that you are not saying.
A. What I am simply saying is that subordinated investors expect to be paid too.
Q. Yes. So it doesn't go any further than that?
A. It might. I am simply making a general statement. Again, how far it goes will depend upon the context. You have used the example of a distressed market, and I am not sure that the example that Professor Eisenberg and I used in the experts' statement goes beyond mere distress. In fact we talk about that in a weak market and I would have to get that document before me.
Q. You have mentioned this a couple of times now, perhaps we had better turn it up. I think it is behind tab 12 of the core bundle. Perhaps you could tell me which bit you are referring to here.

A. I was referring on page 221 in B5. It says:

"A secured creditor who otherwise has a right to foreclose does not act in a commercially unreasonable manner under the UCC solely because foreclosure occurs when there is weakness in the market."

And your use of the term distressed" reminded me of the concept of weakness, and we'll compare that, for example, with paragraph B4, which talks about what happens if the market has collapsed.

Q. I was going to ask you some questions about market collapse in a moment anyway, because you use that concept in your report, and we can examine that in a moment, but I am still not sure I quite understand why we are here in the context of financial market expectations.

A. I was simply referring to your hypothetical question about whether my language would -- how it would refer to a distressed market, and I was simply -- by "distressed" I was thinking you were talking about "weak", and therefore B5 discusses a weak market.

Q. Perhaps we are not making much progress on this point so I think perhaps we will move on from it, but before we leave financial market expectations altogether, there are two further questions I want to ask you. Presumably you would accept that the seniors will at least have

an expectation that their security should not be put at risk post-default?

A. I don't know if that is a reasonable expectation on the part of the seniors. I think a reasonable expectation would be that, if there was a default, there is always a great deal of risk --

Q. I am sorry, you may have misunderstood my question. Should not be put at risk.

A. No, I wouldn't agree with that. Again I think, as I mentioned in the article on bond defaults and the dilemma of the indenture trustee, that collateral should not be put at unreasonable risk but I am not sure that "at risk" alone is the standard. I think the main expectation in my experience and reading and study of a senior creditor is that a senior creditor will get paid before the subordinated creditor gets paid, but the process by which that happens is a very complex one.

Q. But if you are correct in relation to this approach to financial market expectations in relation to the subordinated or the residual claimants, what legal test is applicable to the question of how long, for example, the security trustee may have to wait before selling? How does he identify a legal test to guide him?

A. There are two determinations, there are two bodies of law that inform that. One body of course is the UCC,

and that has been discussed at length, and paragraph B4 talks about that and discusses in the context of a market collapse, and there is even an official comment that says that, where there is a collapse, it may be commercially reasonable for the secured party to wait.

The second body of law of course is trust law after default, which supplements the responsibility of the trustee in the case of a default, trustee acting as a prudent person, and there it is a question of fact. In our case it is a question of fact as to which there is not a lot of case law.

Q. So you are not able to say very much more than one looks at the UCC and one looks at trust law, and one sort of slightly throws it up in the air and looks at the facts and then reaches a decision?

A. No, what I am saying is that the trustee would need to comply both with the UCC commercial reasonableness standard and the supplemental duties that adhere under trust law. As to what it would mean in a factual context will depend upon the context. Ultimately, I think it is going to be a balancing that the trustee will need to examine the facts and try as best it can to balance its responsibility to both parties; recognising the seniors are contractually senior.

Q. Perhaps we can come back and look at how that balance

might work in a moment when we have looked at market collapse because I think it might help inform where we are, which is an aspect of your evidence that you deal with in paragraph 22 of your report.

Just to start off on this, what you there do is, you refer to the Henderson report as having shown that the market has collapsed; is that what you are doing?

A. In this paragraph here, I do indicate that, without having done research on what "collapse" means. I have done subsequent research on that and would be happy to inform you and the court, your Lordship, if you wish.

Q. We will come to that in a moment. I just want to focus on the factual question first, which is you assert, although it seems that you asserted this without having done research as to what the word "collapse" means, that the Henderson report demonstrates that the market for underlying collateral assets has collapsed. That is what I read paragraph 22 to say. Is that right?

A. I believe in a colloquial fashion, or as -- the Henderson report on its face does suggest, if not -- I am not sure I use it as a term but it clearly indicates a market collapse in a general sense. That is correct.

Q. But you used the word "collapse" for a rather special reason, didn't you? Why did you use the word

"collapse"?

A. I used the word "collapse" because it keys into the official comment of the UCC.

Q. I thought so. So what you were doing was you identified a word in the comment to the UCC and you used it to describe what the position was in relation to the Henderson report, is that right?

A. The UCC does not define the word "collapse" and in the UCC, where words are not defined, they take their colloquial meaning in general so I was using it in a colloquial sense.

Q. Yes, but you were using --

A. I set it in quotes to show that.

Q. Yes, but you were using it because you wanted then to be able to relate it back to the comment in the UCC?

A. I was certainly making that analogy, yes.

Q. But there is no other evidence you rely on, apart from the Henderson report, that the market has collapsed, whatever one means by "collapsed"?

A. Subsequent to this report, I have had research done and have examined what "collapsed" means --

Q. I am not asking you this. I am asking you whether there is any other evidence apart from the Henderson report as to the market for the underlying collateral assets having collapsed?

MR JUSTICE FLOYD: Is there any you are aware of?
A. Yes, there is a great deal, your Lordship. A great deal of my work is on the subprime crisis and the possibility of systemic risk in the international financial system, and I have three major articles coming out. They are all on the social science research network, and there are quotations throughout about market collapse; the newspapers use the term "collapse" throughout.
MR TROWER: The only thing we are concerned about in this case is the underlying collateral assets which are in issue in these proceedings and the evidence in this case. Is there anything apart from the Henderson report which shows collapse?
A. The underlying assets in this case are all asset- and mortgage-backed securities, and those are assets specifically that I have written about extensively in, for example, an article called "Protecting financial markets, lessons from the subprime financial crisis" --
Q. Have you analysed the make-up of the underlying book in this case?
A. I have examined them from the Henderson report description and from some other descriptions.
Q. Have you established what has happened as a result of that analysis to their value?
A. I have examined that as to the market value, yes.

Q. So have you got those workings?
A. Sorry?
Q. Have you got the computations that you have made to justify this conclusion that the market has collapsed?
A. The issue of collapse, the entire mortgage- and asset-backed securities market has in fact collapsed. I have looked in detail at CDOs, collateralised debt obligations, and MBS, mortgage-backed securities, APS, CDOs and the whole -- every type of asset class which is in this sieve is within the asset classes that I have examined in my writings. My writings extensively cover structured finance and securitisation in these types of assets.
Q. Can I just repeat the question: have you analysed the underlying book of assets which constitute the collateral in this case, and carried out that exercise?
A. I have not done that other than to note that they are all within the types of assets as to which I am aware of a general market collapse.
Q. If I were to say that the word "collapse" normally means complete breakdown in the market, would you agree with that as a description?
A. As I mentioned, I have had research done subsequent to this report, and my recollection of that research -- I do not have a copy here but my recollection is that

the word "collapse" is a question of what judges will take judicial notice of and that judicial notice can come from newspapers for example, and there are extensive newspaper reports referring to what has happened in these markets as a "collapse".

Q. Can we just go and look at how the word is used or the context in which the word is used in the note in 9-610, which you will find at tab 8 in bundle 3. The footnote is on page 2, note 3, and this is one of the comments to the UCC which I think both you and Professor Eisenberg agree are to be referred to but aren't actually part of the statute?

A. In my expert report, I actually do not agree with Professor Eisenberg as to the paragraph of his report that characterises the official comments of the UCC. I make a specific exception for that, and I would be happy to discuss how I believe official comments of the UCC are reviewed, if I may.

Q. Yes, you had better, as you have raised the point. I hadn't appreciated it was contentious; perhaps you can tell my Lord what you think the correct approach to the UCC comments is.

A. The UCC comments, I agree, are not technically part of the statute. The UCC itself is promulgated to each state's legislature and the legislature will decide to

enact or not or make changes. The official comments -- and the word "official" is a little bit (inaudible) because they are written by the directors of the UCC and I have an article on the Georgia Law Report that goes through the details of that process, if you wish --

Q. I don't want to cut through what you are describing but I think all we probably need is the proposition as to what it is or how it is that one should read the comments.

A. The comments are regarded as highly authoritative and, in the absence of authorities, even where there are authorities contradicting them, one often sees the official comments override the authorities. Let me give you two examples, if I may. There is a very famous case which I teach my students each year, Mobil Oil, and I do not have the cite on me, but I could get it if you wish, where there is several centuries of a rule that says, where there is a loss, that you get profits and the official comments that came out and said that where you have a loss, you do not get comments that that rule is basically revoked. The court simply respects the official comments and overrides the centuries of state law.

Another case --

Q. Just before you go any further, can I ask you just to

turn up what Professor Eisenberg says in paragraph 16 of his report, tab 5. I don't want to get too distracted on this. By the same token, I don't want you to feel that --

A. Tab 5?

Q. Tab 5, paragraph 12.

A. Of which book?

Q. The core bundle. Do you have that? The one with all the witness statements and reports in it. Tab 5, paragraph 12. I will just ask you to read paragraph 12 and just identify the sentence or sentences you disagree with and then we can just explore whether it matters that you do. (Pause)

A. I think that in many cases, certainly where there are not authorities on point, courts generally review the comments as authoritative and dispositive and, as I mentioned in the Mobil Oil case, even in other situations, some courts refer them as dispositive. There is a famous UCC Professor, James White at Michigan, who has stated that the official comments are law in that what they say is what courts generally do.

I don't go that far but I simply cite and he is very famous, he is part of the White and Summers UCC Hornbook. I would go beyond what Professor Eisenberg says and say that they are more authoritative than he

states. I also would -- I will stop there.

Q. Just so there can be no misunderstanding about this, the reason, I am afraid, we hadn't picked up there was an issue here, if you go to paragraph 10 of your report, the same bundle, tab 7, page 102, you say:

"I generally agree with Professor Eisenberg's description of the UCC set out in paragraphs 10 to 12 of his report."

I know this is qualified as "except otherwise provided herein" but I have not identified that there was another area, but maybe you have had a description of the force of the comments elsewhere. Do you recall engaging in a dissertation on that?

A. I am sorry, I was -- if you could just repeat that.

Q. Do you recall whether there was anywhere else in your report where you engage in a dissertation on the weight to be given to UCC comments? (Pause). Perhaps if there is anywhere, Mr Moss can ask you a question in re-examination, rather than spending a lot of time looking for it now?

A. It may be that -- originally, my recollection it said 10 to 11, and it may be that somehow someone thought there was a typo and changed it. I apologise.

Q. I am sure not an awful lot turns on this because the important point is to get to the note itself which is

behind tab 8 and it is note 3 on page 2:

"The article doesn't specify a period within which a secured party must dispose of collateral. This is consistent with the article's policy to encourage private disposition through regular commercial channels. It may for example be prudent not to dispose of goods when the market has collapsed."

Two points there, of course. That is an "it may be"?

A. Yes.

Q. And it doesn't of course say that it will be -- or even may be imprudent to dispose on collapse?

A. I agree with that and my report in fact is not inconsistent with that in any way.

Q. Taking that on to the next stage, it is fair to say, isn't it, there is no case authority in which a challenge to the sale was successful on the basis that the sale was conducted too quickly? That is the first point?

A. I am unaware of any such case authority.

Q. Nor is there any case in which there was a challenge to the sale where the sale was conducted at a time when the market was depressed?

A. I have not seen any cases -- I have not seen any cases where a sale was conducted at a time when the market was

so depressed or anything close to collapse, so the cases I have seen are cases of weak markets.

Q. What about the cases when there were foreclosure sales during the Great Depression?

A. That was prior to the UCC.

Q. Yes. But those cases are supportive of the proposition that the mere fact that the Great Depression was in play was not a reason why a timely foreclosure sale would not go ahead?

A. I recall seeing a case referring to that, but again the law we are stating here, we are discussing, is a law that was enacted decades after that time and based on other principles.

Q. I understand that, but insofar as one can identify what was probably the most dramatic economic collapse in the United States in recent decades -- not so recent decades -- there was no case in which the sale was subject to a successful challenge because it was effected during that time of depression?

A. I did not exhaustively research those cases because they weren't UCC cases so I don't know for sure.

Q. Do you know of any case in which a court has found that a market has collapsed since the enactment of the UCC?

A. I -- I am not sure if I do or do not. I know I have had research done. I have looked at the summary memo,

I haven't had the time to look beyond the cases -- the summary memo talks about what constitutes a market collapse, and for that reason, those cases may have dealt with markets that collapsed so I can't say for sure.

Q. But anyway, you can't say for sure but you haven't been able to find anything within the confines of your research capabilities which supports that?

A. I haven't had the chance to look back through the cases. It may be that some of those cases do involve market collapse.

Q. Yes, but as I say, you haven't found them.

MR JUSTICE FLOYD: Mr Trower, how are you getting on?

MR TROWER: I am nearly any there.

MR JUSTICE FLOYD: I was going to give the shorthand writers a break at some point in the afternoon.

MR TROWER: I should think I have probably not much more than another twenty minutes/half an hour.

MR JUSTICE FLOYD: I will break for five minutes to give the witness and shorthand writers a break.

(3.30 pm)

(A short break)

(3.35 pm)

MR TROWER: Professor Schwarcz, can you turn to paragraph 25 of your report, please, behind tab 7.

A. Okay.

Q. In the last sentence there you say:

"The collateral assets in the present case are not depreciating and, to the extent they are not declining in value, the cases cited by Professor Eisenberg would not apply."

And you say that in the context of a proposition of Professor Eisenberg's that:

"Commercial reasonableness does not prevent a secured party from selling collateral in a depressed market that was, or was subject to, a grave threat of declining in value."

The first question I have is simply this: you've explained to his Lordship the work that you have been doing in recent months in relation to the collapse in the mortgage market and the credit crunch and so on. Is it based on that that you have reached the conclusion that the collateral assets in the present case are not depreciating or is it based on something else?

A. The word "depreciating", it is based upon looking up the word "depreciating" in a business dictionary. The word itself has a meaning regarding -- at least according to the dictionaries I have seen, where you have physical goods. These are not -- these are securities. It's simply the term --

Q. I see, so you say they are not depreciating because they are not a type of asset that is capable of depreciation?
A. Yes, that is correct.
MR JUSTICE FLOYD: Like bananas, they are not like bananas.
A. Your Lordship said?
MR JUSTICE FLOYD: Bananas.
MR TROWER: I am slightly surprised by that answer because you then go on to say:

"And to the extent they are not declining in value."

I had not appreciated you were giving the word "depreciating" a particularly technical meaning. So your evidence is, is it, that the reason they are not depreciating is simply because they are not capable of depreciating as assets?
A. Yes, that is what I intended here.
Q. So you are not intending to say there that there is not a threat that they might decline in value?
A. That would be a factual question as to which I do not have competence to answer.
Q. Yes. But in the event that there is a risk that the assets might be depreciating or declining in value, there is no case, I think you have agreed, that says that it would be commercially unreasonable to sell at this time?
A. Bear with me. There is no coffee downstairs and my mind

is still jet-lagged. If you could repeat that.

Q. I shall not call it the "Eisenberg problem" but you know what I mean. In the event there is a risk that the assets might be depreciating or declining in value, there is no case that says it would be commercially unreasonable to sell at this time?

A. I believe that is correct.

Q. Just --

A. May I simply clarify that, if I may? Again, I just want to point out that the commercial reasonableness standard is a UCC standard but it is a necessary but not a sufficient standard; one still has the trustee/prudent man overlay on top of that.

Q. So it might be commercially reasonable to sell under the UCC, but imprudent to sell under some trust concept?

A. That could be a fact scenario. I am not saying that is absolutely the case, I am simply saying it could be the case.

Q. Is there any case which discusses that?

A. I do not recall any such case.

Q. Can I just ask you to turn, please, to tab 10 of bundle 3? Would you like to tidy up your desk. Tab 10 of bundle 3. This is article 9-627 of the UCC, with which I think you are familiar?

A. Yes, I am familiar.

Q. This sets out, doesn't it, a legal test in relation to commercial reasonableness?
A. It sets out certain safe harbours but it is not exclusive for all types of assets.
Q. But there is no issue that it is capable of relating to the assets that we are looking at in this case, is there?
A. It depends what section you are referring to.
I certainly agree that 9627A is applicable.
Q. Thank you. Can I just ask you to read to the end of A. Perhaps you are familiar with it?
A. Okay.
Q. That does support the proposition that, as a matter of UCC law, the fact that you might have obtained a greater amount by sale at a different time is not of itself sufficient to preclude a party from establishing that the enforcement was not made in a commercially reasonable manner?
A. Yes, that is what it says.
Q. Then --
A. Let me just clarify. It says:
"... could have been obtained by a collection, enforcement, disposition or acceptance."
What occurred to me and this is a factual question that one might need to look at and I guess it is partly

reflected in the joint expert statement, the assets we have here, the securities underlying the SIVs, are all referred to as "financial assets"; that is that they collect over time. So the question as to whether there is a collection over time falls within the phrase "collection" there, I would have to think about. In other words, there could be an argument that in fact there are two types of ways in which the asset price could be determined. One is by how much you could sell at now, and the other going back to the final paragraph of the joint expert report is looking at the present value of the expected cashflows.

Q. Yes, I am not sure I quite followed that. Because you have agreed that this provision applies to the assets that we are dealing with in this case?

A. Yes, I do.

Q. And this deals with, amongst other things, the timing of an enforcement activity, does it not?

A. Right, but it is really the phrase "collection at a different time". One issue here is, if you are looking at the present value of the expected cashflows, that is deemed to be a collection at this time. Let me give a concrete example and again I just refer this by looking at the words you referred me to. Let's assume that you are trying to make a decision now whether to

sell assets in the market or whether their collection in fact will yield a higher amount. All this says is -- all this subsection A, I think, is intended to mean is whether you should sell the assets now or whether you should sell the assets later.

I am raising a question -- I do not think in looking at this that this does address the issue of self-liquidating assets where the present value of the expected payments over time would now yield a higher amount.

Q. I am obviously being rather stupid, but I thought that all this was saying was that, if you chose a particular time to collect, enforce, dispose or accept and it subsequently transpires that you would have received a greater amount, had you chosen another time to collect, enforce, dispose or accept, that fact will not of itself be sufficient to preclude you from saying you acted in a commercially reasonable manner?

A. Yes, in and of itself, so given the example, if one were to sell the assets -- and again this only goes to the UCC commercial reasonableness -- if one were to sell the assets now, and then one were to sell them, compared to one would sell them, let's say, six months from now, the mere fact that one sold them now, if in fact you got more six months from now would not make today's sale

commercially reasonable, that in and of itself.

But that doesn't address two things, I guess. It doesn't address, of course, you are still subject to the official comment about market collapse which modifies this, and it doesn't address the example I just gave, which is, what if you don't in fact sell it six months from now? What if you are comparing selling it today with how much the assets would yield if simply held because the present value of the expected cashflows might be higher than the sale value today? It does not cover that scenario.

Q. I will return to that second point in a moment. I was going to ask you about that anyway. You made some point about the interplay, I think, between the comment that we looked at before the short break we had just now and 9627A. I am right in thinking, am I not, if there were to be any conflict between the comment and a provision of the Code itself, the Code would prevail?

A. I think they would both be interpreted to the extent and weighed in context. I think in theory what you are saying is correct, but how that would apply in context, I would have to consider.

Q. I think we can probably leave that. Can I go to the second point that you made, which I think is a point you also touch on in paragraph 24 of your report.

It is the last two sentences of that report that I wanted to ask you about:

"Because of the well-publicised collapse of liquidity in the mortgage-backed securities market, it is the logical inference that the market valuation of the collateral assets does not presently reflect the expected cashflows on those assets. If so, foreclosing now would 'waste' the value of those cashflows."

I was slightly puzzled by that because it wasn't clear to me why it was that the market value wouldn't reflect all aspects of the expected cashflows, including the possibility that there may be defaults or other matters which would mean that cashflow from particular assets was not as secure as might otherwise be the case?

A. The reason is, and I actually have an article that discusses this, in the article again "Protecting Financial Markets; Lessons from the Subprime Market Meltdown", I examine behavioural psychology and reasons why in fact markets are imperfect and the way investors look at them and examine what are called "bubble behaviour". Why, for example, market prices might exceed what the real value is, and the obverse which is panic, where in fact the market value is lower than what the real value is and I believe that what we are seeing is a species of panic present.

Q. So we have to inject into the logical inference that you have put in there the fact that you have been able to examine behaviour of the market and panic activity, which is all part of why one reaches the logical conclusion that you've explained in that sentence, is that right?

A. Part of that is also based upon the sentence before it, which is that:

"These are income generating assets which based upon the ratings indicated in the Henderson report I assume are continuing to pay."

I do understand that subsequent to my report I saw in the skeleton argument that three of the -- three of the underlying securities may be close to default, but that is -- something like 5 per cent or so, but it doesn't change the underlying overall view I express here.

Q. But anyway the bottom line of your view is that the market is imperfect and doesn't reflect, or is unable to reflect, for whatever reason, the expected cashflows on those assets?

A. That may well be the case, yes.

Q. So it is not as sophisticated a market as we might all have assumed it was?

A. Not as thick a market, and it may be sophisticated but

even in sophisticated markets bubbles and panics happen.

Q. The whole thing as well is based on the assumption that everything is continuing to pay, which may or may not be right and probably isn't right in relation to some 5 per cent in any event?

A. Yes, it is based on the assumption that certainly many of these, if not most of these assets, were continuing to pay.

Q. Can you go back one paragraph in your report, where you refer to two cases, one called Hinrichs and one called Fletcher v Cobuzzi, is it fair to say, without turning those two cases up, that what they stand for is the proposition that it may be commercially reasonable to wait. In other words, a challenge on the grounds of delay by a secured party in realising wouldn't succeed. They don't support the proposition that it was then commercially unreasonable to sell?

A. I agree with you, yes.

Q. Yes. Can we then go on to paragraph 27. In this paragraph you say that the NY UCC law would appear to allow, if not require, the security trustee to delay foreclosure.

A. Yes.

Q. I think it is right, isn't it, there is no case in which the NY UCC has been held to require foreclosure to be

delayed? I think we have established that already?

A. That is my understanding, yes.

Q. But what you have managed to dig out is something called "Barclay Clark. The Law of Secured Transactions under the Uniform Commercial Code", which you have footnoted to that proposition. Can we just look at that, please. It is behind tab 77.

A. In which file?

Q. Sorry, it is in bundle 5, I think. It is a passage that begins at comment 6 in the last paragraph on -- paragraph 4-211:

"Comment 6 to old UCC 9-504 suggests that timing of the foreclosure sale may have to be adjusted to meet unusual external conditions: 'It may, for example, be wise not to dispose of goods when the market has collapsed or to sell a large inventory in parcels over a period of time instead of in bulk'."

Do you happen to know, is old UCC 9-504 the same as the comment we have already looked at, or don't you know the answer to that? Don't worry if you don't.

A. I believe it is certainly similar in terms of collapse but I think the language is slightly different.

Q. Then it goes on:

"This warning by the drafters should be taken to heart by the prudent creditor. Although prescience

concerning market conditions cannot be expected, the facts in a given case may impose a duty on the foreclosing creditor to time the sale in order to set the best price."

Which was the bit, I think -- that sentence was what you quoted in your footnote and it then goes on --

MR JUSTICE FLOYD: I do not have any more.

MR TROWER: I am so sorry, I had to ask for the next page. I got it and I am it terribly sorry it hasn't made it into the bundles. Can I read you what it says?

My Lord, I am sorry we will get a page into the bundles:

"For example, if the creditor is in possession of stock that is terribly depressed because of litigation against the issuer and the creditor is reasonably certain that the litigation is groundless, and the depressed price temporary, it might be commercially unreasonable to proceed headlong with a foreclosure sale."

So that is the kind of context in which this comment is being made, isn't it?

A. Yes, I believe so.

Q. And there isn't any work of authority or any legal text which gives as an example anything short of that kind of context with those kind of considerations in play?

A. Again, in the current version of the UCC, the equivalent

comment is broader, because it doesn't give a limiting -- an example that might be regarded as limiting.

Q. It depends of course what one means by the word "collapse" doesn't it?

A. Yes, it does.

Q. And the one thing you don't contend in your report is that any principle of New York law extends to requiring delay in foreclosure if the security agreement permits the seniors to direct foreclosure sale to take place.

A. That is correct. I do not look at that, although I have researched and examined that in connection with the joint expert report, and have concluded that -- well, I can go through that if you wish, but as you can see the experts disagree on that point.

Q. But there is no New York law principle which extends to requiring delay in foreclosure if the security agreement permits seniors to direct? That is clear, isn't it?

A. I am sorry, could you just repeat that last ...

Q. There is no New York law which extends to requiring a delay in foreclosure if the security agreement permits the seniors to direct foreclosure?

A. The way you stated it, I would agree, but there are two New York cases quite on point that state that even where you otherwise would have -- where a beneficiary would

otherwise have the contractual right to direct, that the trustee may well -- it will depend upon the facts -- be subject to a fiduciary duty that overrides that direction. And I would be happy to discuss those cases, if you wish.

Q. Are they in your report?

A. They are not -- one of them -- the Beck case, is --

Q. One of them is Beck?

A. One of them is the Beck case.

Q. We have been through Beck. I am not sure we need to go back to Beck on that.

A. The other case, and Beck did involve, as we know, Mexico and Beck had the contractual right to direct, which it exercised, so that is a case quite on point. The other case is 5th Avenue bank.

Q. Is that in your report?

A. It is not but I have it in my materials which I was going to bring up. What that case says is, under New York law, it is a New York law case, and it deals with gratuitous trusts as opposed to commercial trusts but it looks at the issue of what obligation there is, when you have a gratuitous trust with a right to direct, and it says that in order for a right to direct to override the trustee's fiduciary duty, that right to direct must be "express and unambiguous".

Q. Yes.
A. In this case here, even if contractually one might conclude -- which I do not believe should be the case but it is again neither here nor there, even if one contractually were to conclude that there might be, or there were, a right to direct, I do not believe that right to direct is "express and unambiguous".
Q. This is a case that has emerged from your researching since the time you prepared your report?
A. Yes, it is subsequent to the report. That is correct.
MR TROWER: My Lord, I think we probably ought to have a look at it.
MR JUSTICE FLOYD: Yes. Nobody can be expected to absorb it on the trot.
MR TROWER: No. The evidence is what it is at the moment on this. I am slightly reluctant to leave it there.
MR JUSTICE FLOYD: Is Professor Schwarcz getting on a plane tonight?
A. No, tomorrow morning. I would be happy to -- as long as we need to ...
MR JUSTICE FLOYD: What time is your flight?
A. It is early morning, 10.40 am from Gatwick.
MR TROWER: My Lord I am happy just to have five minutes with it now and if I can deal with it straightaway I will. If I can't we will have to see where we go.

A. It is a very short case, your Lordship.

MR JUSTICE FLOYD: I will rise for ten minutes.

(4.05 pm)

(A short break)

(4.10 pm)

MR TROWER: I am grateful, I am afraid we have only one copy, which is the professor's copy which has been scribbled on, but which I have been kindly provided with. I think I can ask what I need to ask on the back of that.

I will hand it up to you if I need to, Professor Schwarcz, but I do not think I probably do. This was a case of a gratuitous trust I think in a private context?

A. Yes, it was.

Q. It was a case in which the power to direct was retained by the settlor, is that right?

A. I believe that is correct.

Q. Yes. And the words which I think you rely on are: "To be exercisable for the sole benefit of the settlor the power must be express and unambiguous, it cannot be implied."

Yes?

A. I believe that is correct.

Q. So two distinguishing characteristics. One is, this is

in the context of the settlor retaining a power to direct, notwithstanding the transfer of the interest to the trustee, correct?

A. I believe that is correct.

Q. And the power must be expressed and unambiguous, is something which is contrasted to the power not being capable of being implied because what they say is: "The power must be express and unambiguous, it cannot be implied."

Correct?

A. Yes.

Q. Thank you.

MR MOSS: My Lord, could we get copies?

MR TROWER: We will get copies.

MR JUSTICE FLOYD: And circulate it, thank you very much.

MR TROWER: You have obviously told my Lord about Beck and those are the two cases which you have been able to identify which go to the point on which I was asking you questions before we rose.

A. Yes, those are the two cases.

MR TROWER: My Lord I have no further questions for Professor Schwarcz.

Re-examination by MR MOSS

MR MOSS: Just brief re-examination on a couple of points, if I may. Professor Schwarcz, do you still have tab 77

there?

A. Tab 7?

Q. 77. This is in bundle 5. I assume you still have that, which is why I started there. Because that was the last thing we looked at.

A. We will find it. Yes, I have it before me.

Q. The problem here is that most people have got the last page missing but I have begged, borrowed and stolen two last pages for present purposes. Perhaps I can hand one to my learned friend and one to the witness?

MR TROWER: I have it.

MR MOSS: Perhaps your Lordship --

MR JUSTICE FLOYD: Maybe I can have one then. (Handed).

MR MOSS: Don't give the witness the one with the writing on it. I have tried to blank out the writing, it doesn't actually say very much. (Handed).

Mr Trower took you to the top of this last page and I was just wondering if either read to yourself or remind yourself, if you have read it before, the final -- not quite the final paragraph, the penultimate paragraph, that deals with Bank One Texas v Montle.

A. Yes, I do recall reading that. That is correct.

Q. That was a situation where the creditor -- I think probably unlike any other case we have looked at, did get some financial advice as to the best method of

getting the best possible price?
A. That is correct.
Q. And for his pains, he was then criticised both for not selling early enough and also for selling too late?
A. I believe that is correct as well.
Q. And he was vindicated by the court?
A. Yes he was.
Q. And that is why the author here says that puts a strong stamp of approval on flexibility for the creditor in the way that he sells if he has proper advice?
A. Yes.
Q. We can put that away for the moment. You were asked about the Great Depression in the United States. Do you happen to recall how long that lasted?
A. It lasted from 1929 until, one can debate, almost a decade.
Q. If we can go back to Magten for a moment. That is still in 5, at tab 69. My learned friend Mr Trower I think counted one "preserve", we then found another one. Can I just draw your attention to the bottom of page 2 on the right-hand side. A little bit of teasing of Mr Trower I am afraid, but you will see there five lines up there is another "preserve"?
A. Right, yes.
Q. Quite a good passage. If you just go to Beck for

a moment.

A. To Beck?

Q. Yes. That is volume 4, I think, at 51. During your evidence you mentioned that there was a passage about the ability or non-ability to exculpate by means of language in the security document --

A. Sorry, could you repeat that, the background noise ...

Q. You mentioned I believe in your cross-examination that you recalled that there may have been some language about exculpatory provisions and their non-admissibility?

A. Yes.

Q. I just want to see whether I can identify what you are referring to. If you go to page 527, right-hand column in the bottom half of the page. Do you see anything that might have been what you are referring to?

A. Yes, the language:

"It simply does not accord with sound public policy or the ostensible purposes for which an indenture is made and relied upon by its beneficiaries, to allow indenture trustees the benefit of broad exculpatory provisions to excuse their failure to exercise those powers they possess pursuant to the indenture prudently in order to mitigate or obviate the consequences of default. The fundamental and highly salutary purpose of

a bond indenture is to secure payment of the underlying obligation."

Q. Was that the passage that you were thinking about?

A. Yes, it was.

MR MOSS: Would you wait just one moment, I wonder if your Lordship will excuse me just one second, I want to check one point. I have no further re-examination. Does your Lordship have any questions?

MR JUSTICE FLOYD: No, thank you.

MR MOSS: I wonder if Professor Schwarcz might be released?

MR JUSTICE FLOYD: Yes.

(The witness withdrew)