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Hinging on Trust

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# HINGING ON TRUST

By Daniel Wenne<sup>1</sup>

*It is common practice in corporate bond issues to appoint a bond trustee in respect of the bonds in order to act as “the representative of the bondholders”. As representative of the bondholders, the trustee is given discretionary powers such as the ability to declare or waive an event of default which has occurred on the bonds, to consent to matters of formal, minor or technical nature, or matters where the outcome will not be materially prejudicial to the interest of the bondholders. Traditionally, it has been assumed that trustees in bond transactions are merely a necessary adhesive for such transactions, but that they are not expected to take an active role. However, slowing global economic activity means that bond defaults are on the rise and that trustees may be flooded with requests to exercise their discretion on a wide range of modifications and waivers. This article considers how bond trustees exercise their discretion in a typical bond documentation and whether its role should be strengthening so that it can resist pressure from bondholders and the issuer.*

## I. BACKGROUND

Bond<sup>2</sup> issues represent a significant part of the way in which finance is raised in the world’s financial markets. A bond is a means of raising finance through the issuance of a debt instrument whereby the issuer promises to pay to the bondholders coupon and the principal amount of the bond at a fixed or determinable date.<sup>3</sup> Traditionally, only the best credit-rated companies have issued bonds, i.e. companies with “investment grade” rating.<sup>4</sup> However, in recent years there has been a rapid growth in high-yield bonds, colloquially known as “junk” bonds, to accentuate the higher yield they offer, rather than the poorer

1 Daniel Wenne is an associate at Ackordscentralen Stockholm AB. The author would like to thank Mikael Kubu, CEO of Ackordscentralen Group AB and Ackordscentralen Stockholm AB and Erik Saers, CEO of Nordic Trustee & Agency AB (publ). This article is not designed to provide legal advice. The opinions expressed herein reflect only the author’s own views.

2 The term “bonds” will be used throughout the text, unless the context demands otherwise. In practice, the term “bond” is used where the maturity is more than five years, whereas the term “note” refers to a maturity between one to seven years. In contrast, the term “commercial paper” is used when the maturity is less than one year, see Valdez, S., Molyneux, P., *An Introduction to Global Financial Markets*, (7th edn, Palgrave Macmillan 2013), 167.

3 Although this may be the most straightforward means by which a State, an institution, or commercial enterprise raises finance, bond issues may come in various shapes. For instance, a bond issue may be designed so as not to oblige repayment or the option to convert the bonds to shares, see McKnight, A., *The Law of International Finance* (Oxford University Press 2008), 489.

4 A bond is considered “investment grade” if its credit rating is BBB- or higher by Standard & Poor or Fitch, or Baa3 or higher by Moody’s, see Landeman, L. & Bergin, G., *Företagsobligationer – från AAA till konkurs* (Ekerlids 2014), 83.

investment grades they are awarded by rating agencies who perceive them as at higher risk of default.<sup>5</sup> As the economy has cooled, default rates on high-yield bonds have increased dramatically.

The Anglo-American practice for corporate bond issues is to appoint a trustee in respect of the bonds in order to act as “the representative of the bondholders”. If the bonds were simply a debt owed by the issuer to the bondholder, each bondholder would be required to bring action against the issuer in the event of default. Furthermore, a single bondholder could accelerate, i.e. call for immediate repayment of the bonds ahead of their original maturity date, spark off cross-defaults and effectively force the issuer into bankruptcy, which might result in less recovery for bondholders than an out-of-court restructuring.<sup>6</sup> Consequently, by appointing a trustee, the issuer is enabled to deal with one representative of all the bondholders, rather than the bondholders individually.

Traditionally, it has been assumed that trustees in bond transactions are merely a necessary adhesive for such transactions, but that they are not expected to take an active role. Also, the relatively low fees charged have reflected the fairly low level of involvement expected from trustees.<sup>7</sup> The trustee is usually given power to consent to minor modifications and to consider the seriousness of events of defaults. Thus, major decisions, such as restructuring payments where the issuer is unable to meet its obligations, are taken by the bondholders.

Internationally, an increasing amount of bonds is held by large activist investors such as hedge and private equity funds. These investors specialise in buying distressed debt and then seeking to put the issuer into administration with the view to making a profit if the value of the bonds rises as a result of restructuring. These investors have brought with them a different attitude from that of banks, which have often been willing to reach an accommodation in the event of a large company being unable to meet its obligations. Furthermore, these investors often have conflicts of interests with other bondholders.

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5 These bonds are rated below “investment grade”. Since these bonds involve greater risk of defaults, bondholders are offered higher yield, security, the right to convert to equity at some date in the future or the option to redeem the bonds early, Rawlings, P., *The changing role of the trustee in international bond issues* (2007) *Journal of Business Law* 43, 45.

6 Wood, P., *Law and Practice of International Finance* (Sweet & Maxwell 2008), 181.

7 The low fees may indicate, as argued by Schwarcz and Sergi, a fundamental market defect, as investors’ expectations that the bonds in which they will invest will not default, discounting any expected benefit of a highly skilled trustee, see Schwarcz, S., L. & Sergi, G., M., *Bond Defaults and the Dilemma of the Indenture Trustee* (2008), *Alabama Law Review* Vol. 59:4:1037, 1041.

Concerns have therefore been raised of the extent of the discretionary powers of the trustee and whether it would make sense to limit some or all of its discretionary powers.

The concept of trusteeship has, until recently, given common law jurisdictions a significant legal edge over civil law rivals when it comes to bonds and capital markets.<sup>8</sup> In Sweden, the concept of trustees in bonds is fairly new, with the introduction of Intertrust Sweden AB (former CorpNordic Sweden AB), in 2003 and Nordic Trustee & Agency AB (former Swedish Trustee AB), in 2012.<sup>9</sup> The role of the Swedish trustee is governed by a non-binding standard agreement drafted by the Swedish Securities Dealers Association.<sup>10</sup> However, the Swedish modelled trustees are not trustees in the common law sense since they do not hold property on trust which is owned by the beneficiaries and immune from the private creditors of the trustee. Although the Swedish standard agreement includes a “no-action” clause, it is not crystal clear whether the trustee have the authority to sue on behalf of the bondholders as titleholders and creditors.<sup>11</sup> Yet, in spite of its significance, the role of trustees in relation to an issue of bonds has received comparatively little attention in the Swedish scholarly literature. This neglect may be attributable to the scarcity of cases involving such trustees in Sweden.

The purpose of this article is to consider how bond trustees exercise their discretion in a typical bond documentation. The article proceeds by first explaining the concept of trusts and capital markets. The article then addresses the purpose of the bond trustee. Further, it examines the duties and discretions of the trustee and the protections afforded to it. Finally, it considers whether its role should be strengthening so that it can resist pressure from bondholders and the issuer.

## 2. TRUSTS AND CAPITAL MARKETS

In the Anglo-American common law jurisdictions, a trust is a separation of legal title to an asset from beneficial ownership or equitable interest in it.

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8 See Rawlings, *Supra* n 5, 43.

9 Landeman & Bergin, *Supra* n 4, 141.

10 The Swedish Securities Dealers Association’s standard agreement is available at <http://www.fondhandlarna.se/regler-mm/obligationsvillkor/> accessed September 1, 2015. According to Erik Saers, CEO of Nordic Trustee & Agency AB (publ), the standard agreement, which is similar to a loan agreement, is rarely used as the issuer and the trustee normally draft their own agreement, interview with Erik Saers on July 2, 2015.

11 See Wieslander, M., *Om avtal om talerätt och talförbud på företagsobligationsmarknaden i Sverige*, JP 2012, 263–287.

The trust is not an entity, but a relationship. The characteristic form of the trust is the family trust, in which property such as land, goods or funds, is transferred by a parent, the settlor, to a trustee to be held for a child, the beneficiary. According to the Hague Convention on the Law Applicable to Trusts and on their Recognition, concluded 1 July 1985, a trust has the following characteristics:<sup>12</sup> (a) the assets constitute a separate fund and are not part of the trustee's own estate; (b) title to the trust assets stands in the name of the trustee or in the name of another person on behalf of the trustee; and (c) the trustee has the power and the duty, in respect of which he is accountable, to manage, employ or dispose of the assets in accordance with the terms of the trust and the special duties imposed upon him by law. However, the use of the trust for wills and family settlements is minor compared to its commercial use, and in particular its use in international finance. Examples of use of trusts in financial law, other than bondholder trustees, are custodianship of investments, whereby a bank holds investment securities for the benefit of clients, or in mutual funds where the fund trustees hold the investment for the benefit of the investors who each have a pro rata interest in the pooled investments.<sup>13</sup> Similarly, it is common to use a trustee as a component of a structured finance transaction, under which a special purpose vehicle transfers security over all of its assets, normally a portfolio of debt or debt instruments, and the capital amount held on deposit to a trustee to be held for the benefit of the bondholders.

The main advantage of having a trust is that, since the title to the asset is held by the trustee, the assets are immune from the trustee's private creditors. Consequently, if the trustee becomes insolvent, the beneficiary can claim the trust assets, which are not available to the trustee's creditors.<sup>14</sup> Moreover, it is essential to have a device whereby experienced and skilled title-holders can act as active managers or passive custodians, e.g. bondholder trustees.<sup>15</sup> It has therefore been said that the trust is an "immensely powerful and flexible instrument in modern finance"<sup>16</sup>. Similarly, it has been stated that the trust has given common law jurisdictions a significant legal edge over civil law rivals when it comes to the construction of financing deals, since it is a key feature in securitisations, project finance, mutual funds and bonds.<sup>17</sup> As a result,

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12 Chapter 1, Article 2 of the Convention. Sweden has not ratified the Convention.

13 Wood, *Supra* n 6, 305.

14 *Ibid*, 302.

15 *Ibid*, 304.

16 Goode, R., *Commercial Law* (LexisNexis Butterworths 2004), 165.

17 Rawlings, *Supra* n 5, 43. It should be noted that there are substantial differences between the bond trustee in modern securities market with that of traditional trustees. Hence, an analogy between the two is fundamentally misplaced, see Schwarcz & Sergi, *Supra* n 7, 1040–41.

the Anglo-American practice for corporate bond issues is to appoint a trustee in respect of the bonds in order to act as “the representative of the bondholders”.

Unlike the traditional trust, where assets are held by a trustee for the benefit of a beneficiary, the bondholder trustee does not hold property.<sup>18</sup> Instead, the bondholder trustee holds an irrevocable authority granted by the bondholders to exercise their powers under the trust deed on behalf of the bondholders.<sup>19</sup> It may seem somewhat remarkable that the characteristics of the trust in this context, in contrast to the ordinary trust, are that it does not involve the holding of any trust property. Yet, what the trustee holds is a collective delegation of authority from the bondholders.<sup>20</sup>

### 3. WHAT IS THE PURPOSE OF THE BOND TRUSTEE?

When a bond issue is being planned, the issuer and the lead manager<sup>21</sup> will decide whether to appoint a trustee or a fiscal agent. The advantage of appointing a trustee or a fiscal agent is that the problem of there being multiple lenders to deal with in a bond issue is minimised. The main difference between a trustee and a fiscal agent is that the trustee acts on behalf of the bondholders, while the fiscal agent acts on behalf of the issuer. The role of the fiscal agent is to conduit payments on the bonds to the bondholders. As representative of the bondholders, the trustee will have to monitor the issuer’s compliance with the covenants, terms and conditions of the bonds.<sup>22</sup> Further, the trustee is given more discretionary powers, such as the ability to declare or waive an event of default which has occurred on the bonds, to consent to matters of a formal, minor, or technical nature, or matters where the outcome will not be materially prejudicial<sup>23</sup>

18 In a secured bond, the subject matter of the trust is the security interest granted to secure the issuer’s obligation, see Gullifer, L. & Payne, J., *Corporate Finance Law – Principles and Policy* (Hart Publishing 2011), 334.

19 Goode, *Supra* n 16, 166.

20 *Ibid.*

21 A bond issue involves three groups of financial intermediaries: managers, underwriters and a selling group. The managers manage the issue and usually delegate the negotiation and the preparation of documents to a lead manager. The underwriters take up any bonds not sold by the selling group. Finally, the selling group is responsible for selling the bonds to investors by using their well-developed list of customers.

22 For a glossary giving brief definitions of many terms used in bonds and bond trading, see, for example, J.P. Morgan Asset Management’s prospectus, available at <https://www.jpmorgan-funds.com/cm/Satellite?UserFriendlyURL=Fund+Documents&pagename=jpmfVanityWrapper> accessed August 6, 2015.

23 The drafters of the Swedish standard agreement have used the wording “not detrimental to the interest” of the bondholders, see the Swedish Securities Dealers Association’s standard agreement, available at <http://www.fondhandlarna.se/regler-mm/obligationsvillkor/> accessed July 2, 2015.

to the interests of the bondholders, and to take enforcement action on behalf of the bondholders against the issuer.

The issuance of a bond may not *per se* require the appointment of a trustee if the amount involved is relatively small and the bonds are not traded on an exchange.<sup>24</sup> Where there is no trustee, it is common for a fiscal agent to have similar but more limited powers. Since the structure of the fiscal agent is cheaper, it is a common feature in short-term securities, such as commercial paper, and plain “vanilla” issues, (i.e. the most basic or standard version of a bond). If the issuer defaults, each bondholder would be able to pursue its right as a creditor of the issuer.

However, there are a number of advantages in using the trustee structure, both from the perspective of the bondholders as well as for the issuer. For the bondholders, the main advantage is to have a specialist who can monitor the issuer’s compliance with the covenants, terms and conditions of the bonds. If the trustee recognises that the issuer does not comply with the covenants, terms and conditions, it shall initiate action in a timely fashion to protect the interest of the bondholders. It shall be noted, though, that the monitoring role of the trustee, as regards the issuer’s compliance with the terms, is greatly limited by provisions in the trust deed.<sup>25</sup> Nevertheless, the presence of a trustee means that the issuer is more likely to agree to disclose confidential information, which might not be possible to divulge to all the bondholders.<sup>26</sup> Thus, the trustee is more likely to be aware of financial difficulties or a default at an earlier stage and therefore able to negotiate with the issuer on behalf of the bondholders, and agree to minor modifications to the terms of the issue. Further, where there is a secured bond, the trustee will have the power to hold the security and, in the event of default, to enforce the security and to distribute the proceeds.<sup>27</sup>

For the issuer it is necessary to be able to make modifications to the terms of the issue. Normally, bondholders are largely anonymous and it could therefore be difficult for the issuer to obtain the consent from the bondholders to minor

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24 In the US, the Trust Indenture Act of 1939 (TIA) mandates that a trustee must be appointed for each public bond issue over \$10 million, as a representative of bondholders to help enforce their rights, see 15 U.S.C. § 777ddd(a)(9).

25 The limited monitoring role is justified by the mere fact that trustees are not investigating accountants or financial analysts, see Financial Markets Law Committee, *Issue 62 – Trustee Exemption Clauses* (Financial Markets Law Committee 2004), 25–26.

26 Gullifer & Payne, *Supra* n 18, 331.

27 Rawlings, *Supra* n 5, 47.

changes. Similarly, it is more convenient if the issuer has one person to deal with rather than a large number in the event of rescheduling. Suppose, for example, that there is a SEK 100 million bond issue, the bonds being available in denominations of SEK 10,000. At any time there could be literally thousands of bondholders. If the bonds were simply a debt owed by the issuer to the bondholder, each bondholder would be required to bring action against the issuer in the event of default. Indeed, it would result in chaos if the issuer had to negotiate separately with each bondholder. Moreover, the action of a single bondholder could result in severe consequences for the issuer. Firstly, other loan contracts, which the issuer may have entered into, will most likely include cross-default clauses, which mean that the enforcement action on the bond will entitle creditors under those loan agreements to insist on repayment. In effect, the enforcement action by a single bondholder could force the issuer into formal insolvency proceedings even where the infringement is relatively trivial.<sup>28</sup> Secondly, a single bondholder, who is also an unscrupulous competitor of a distressed issuer could, in a restructuring, force the issuer to convert the bonds into equity. Thereby the competitor, as a stakeholder, could threaten the business of the issuer. Finally, a single bondholder who has made small investments in a distressed issuer's bonds might refuse to engage in negotiations to restructure the debt and threaten an enforcement action in the hope of being able to sell the bonds at a profit to other bondholders whose greater level of exposure leads them to favour restructuring, as demonstrated by some hedge funds.<sup>29</sup> Thus, the appointment of a trustee means that the issuer is protected from one or two "mad bondholders".

Although the appointment of a trustee can be seen as a way to balance the interests of the issuer and the bondholders, there are a few drawbacks with the trustee structure. Firstly, there is a general loss of control, since the trustee will have the discretion to act on behalf of the bondholders. More significantly, some bondholders, in particular, large activist investors such as hedge and private equity funds that specialise in buying distressed debt, may be unwilling to agree to modifications in the terms of the issue. Secondly, the trustee can impede payments in default situations, as an issuer is not afraid of the "mad bondholder". Thirdly, some jurisdictions will not recognise mortgage security holding by trustees.<sup>30</sup>

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28 Wood, *Supra* n 6, 181.

29 For example, see *Re Colt Telecom Group plc* [2002] EWHC 2815 (Ch).

30 A mortgage involves the transfer of ownership of an asset by way of security. The ownership will be retransferred to the debtor on discharge of the obligation secured by the mortgage, see Smith, M., *Security*, in Prentice, D., Reisberg, A., (eds), *Corporate Finance Law in the UK and EU* (Oxford University Press 2011), 240.



Finally, the appointment of a trustee means that there are some extra costs and documentation.

#### 4. THE TRUSTEE'S DISCRETION

The issuer and originators can ask the trustee to make decisions affecting the rights of the bondholders without involving the bondholders on the basis of discretionary powers conferred on the trustee in the trust deed and in the terms and conditions of the bonds. The rationale for conferring discretionary powers on the trustee is because of the difficulties of convening a bondholder meeting or of gathering sufficient support in a short period of time from a largely anonymous bondholder community. Furthermore, the trustee may be better placed to assess the technicality of a proposed amendment as it usually has the ability under the terms of the trust deed to seek professional advice from lawyers and accountants to analyse the issuer in hand.

The trust deed will usually set out that the trustee can agree to certain matters or waive minor breaches of a covenant without the consent of the bondholders, as long as the trustee is satisfied that the interest of the bondholders will not be materially prejudiced. In a similar way, the trustee can consent to modifications in the terms of the issue, if such modifications are, in the sole opinion of the trustee: (i) formal, minor or technical; or (ii) to correct a manifest error; or (iii) not materially prejudicial to the interest of the bondholders.<sup>31</sup> However, the exercise of determining material prejudice by the trustee is far from straightforward. Firstly, although the provisions “formal, minor or technical nature” has narrowly-defined legal meanings as it refers to “manifest errors”, it may not always be crystal clear whether an error falls within the ambit of the trustee’s discretion.<sup>32</sup> Suppose, for example, that the terms include an incorrect coupon rate. For the drafters and the issuer the error may be obvious, but the trustee may be risk adverse and therefore unsure whether the proposed modification falls within the narrowly-defined scope of its discretionary powers. Similarly, suppose that the issuer breaches a financial covenant such as holding less capital than the stipulated minimum amount of capital in the terms and conditions. Should the trustee waive the breach if it knows that the issuer is preparing a capital injection, or should it declare an event of default? Considering that the trustee is normally approached to

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31 These are the classic concepts under which a trustee could agree to modifications without the consent of the bondholders in a Eurobond or securities transaction. In other transactions, such as a collateral debt obligation, CDO, the list of concepts could be much more extensive, Regan, P., Ganguly, N., *How corporate trustees exercise discretion (Pt 1)* (2014) *Journal of International Banking and Finance Law* 105, 106.

32 *Ibid.*

exercise its discretion in the 11<sup>th</sup> hour, the short-term deadline can put a lot of pressure on the trustee to agree to modifications, especially if it concludes that a proposed modification, or waiver, should be considered at a bondholder meeting. Secondly, the determination of whether a proposed modification or waiver will not be materially prejudicial to the interest of the bondholders is by no means an easy undertaking for the trustee, as it involves the trustee making a decision that would bind the bondholders and which could potentially leave the trustee open to criticism and even legal action.

In the matter of *Law Debenture Trust Corp PLC v. Acciona SA*<sup>33</sup>, (one of the first decisions in a long line of cases relating to the same bond issue. The case will be discussed further below), Peter Smith J explained that by “the interest of the bond-holders” was meant “merely the bond-holders’ legal or contractual rights or the economic interest of the bond-holders”. By way of further amplification, his Lordship said that the interest of the bondholders related to their contractual entitlements under the bond to the payment of interest and the repayment of the capital on the redemption date, as well as any ancillary rights which the bondholders might have to protect the entitlement to payment of interest and redemption.<sup>34</sup> Such rights would extend to security rights and the right of the bondholders in that case to appoint a director to the board of the issuer.

Matters for voted decisions by the bondholders include changes in payment schedule, merger of the issuer, conversion of the bonds into equity, waiver of event of default or covenant, and the appointment of a committee to represent bondholders in insolvency proceedings.<sup>35</sup> Such decisions may require unanimous consent or the approval of a very high percentage of noteholders, which is calculated according to the principal outstanding amount.<sup>36</sup> Normally, larger holders of bonds will form an ad hoc committee who negotiates with the issuer and its various stakeholders when the issuer is reporting financial difficulties.<sup>37</sup> Still, the

33 *Law Debenture Trust Corp Plc v. Acciona SA* [2004] EWHC 270 (Ch).

34 *Ibid*, at [42].

35 Bondholders are permitted to vote according to their own particular interest. However, there must be no oppression or secret advantages to individual bondholders, see in the matter of *Goodfellow v. Nelson Line (Liverpool), Limited*, [1912] 2 (Ch) 324. Still, the majority decision must be strictly within the power granted by the trust deed, *Mercantile Investment v. Int'l Co. of Mexico* [1893] 1 (Ch) 484.

36 Terms and conditions under US law will provide for unanimity for amendments to such provisions as the maturity date, the principal sum and coupon rate. By contrast, Eurobond terms often provides for amendments by a majority of three-quarters or two-thirds of the principal outstanding amount, see Norley, L., Sprayregen, J., H., M., *High Yield Bond Restructuring – Comfort or Caution From the Use Of the US Model in Europe* (2002) *The Tact Review* No 21, 1.

37 Frauman, D., *The bust boom* (2012) *The Lawyer* 27, 27.

trustee may provide an important channel for both the bondholders and the issuer and can, in its role as a specialist, recommend a course of action for both parties.<sup>38</sup>

Further, it is the trustee that determines if there is an event of default, and the course of action to be taken. An event of default will have the effect of accelerating the issuer's obligations, thereby rendering principal and accrued coupon repayable immediately.<sup>39</sup> In order for the trustee to declare an event of default, it may be required to certify that the event of default is materially prejudicial to the interest of the bondholders. The terms and conditions of a bond will specify particular breaches as event of defaults, such as late payments or a downgraded credit rating. Still, since the trustee is under no obligation to monitor the issuer's circumstances, it will not always be immediately obvious that an event of default has occurred. The trust deed normally provides that the trustee is entitled to assume that no event of default has occurred unless it has express notice of the same. In addition, the trust deed commonly provides that the trustee may rely upon certificates provided by the issuer as to due compliance by the issuer with its obligations under the trust deed and the terms and conditions of the bonds.<sup>40</sup> Yet, the trustee is not left to its own devices as the trust deed commonly provides that the trustee may seek professional advice, and that it may rely on any such advice that it receives.

When the trustee becomes aware of an event of default, it will normally wait for bondholder instructions before taking action to accelerate the bonds. An acceleration of the bonds is a matter that affects the bondholders' commercial interests and thus something over which the bondholders would expect to have control.<sup>41</sup> Bondholders may give instructions to the trustee either by way of resolution passed by a specified percentage of bondholders at an extraordinary bondholders meeting or by written request by holders of, typically, one-fifth of the principal amount of the outstanding bonds.<sup>42</sup> Clearly, if a bondholder does

38 Rawlings, *Supra* n 5, 48.

39 Rawlings, P., *Reinforcing collectivity: the liability of the trustee and the power of investors in finance transactions* (2009) *Trust Law International* 14, 17.

40 McKnight, *Supra* n 3, 540.

41 Cavett, E., Walker, J., *New issues for trustees in the credit crunch* (2009) *Journal of International Banking and Finance Law* 215, 215.

42 Wood, *Supra* n 6, 184. In the matter of SMP Trustees Ltd [2012] EWHC 1728 (Ch), SMP Trustees Ltd (SMP) was the trustee in relation to bonds issued under a bond programme which made 25 separate bonds. Each of the 25 bond issues had its own separate trust deed (though they were in substantially the same form). The Luxembourg bond issuer, Lifemark SA, went into liquidation. Under the terms of the trust deeds, one instance in which SMP could enforce the security it held on behalf of the bondholders was if it was so directed by a "Holder Request". The term was defined in the trust deeds by reference to a percentage of the "Bonds" outstanding.

not hold the stipulated percentage of bonds to direct the trustee, it will have to identify the other bondholders in order to reach the required threshold. Though, ascertaining who the other bondholders are can be very cumbersome, depending on whether the bonds are bearer bonds or held through a clearing system.<sup>43</sup> Internationally, larger investors are likely to be very active in forming ad hoc committees in order to gather a sufficient percentage for them to be able to direct the trustee to take action without the need for an extraordinary resolution of a bondholder meeting.<sup>44</sup>

Under the terms of the trust deed, the trustee is usually not required to take any action against the issuer unless it has been indemnified or secured to its satisfaction in respect of all liabilities and costs it may incur in connection with any enforcement action it takes against the issuer.<sup>45</sup> Typically the trustee will receive indemnity from the instructing bondholders, and it is also common that the trustee will insist that the indemnity is given by the instructing bondholders on a joint and several basis.<sup>46</sup> The rationale for the indemnity is that the trustee is not, and never has been, a commercial party in the transaction and therefore should not be required to expend or risk its own funds.

## 5. THE “NO-ACTION” CLAUSE

Bolstering up the trustee’s position in relation to acceleration and enforcement is the “no-action” clause which will be found in either, or both, the terms and conditions of the bonds or the trust deed. This clause, which is impractical without a trustee, prohibits actions by noteholders, except if certain conditions are met. Although there are many variations of the “no-action” clause, the following is a fairly typical example:

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The central issue for consideration was whether the requirements of a “Holder Request” could be satisfied by reference to the wishes of all the bondholders collectively, or whether they had to be satisfied separately in respect of each of the 25 issues. The judge held that the definition of “Bonds” and thus of “Holder Request” should be interpreted as including any existing bonds as well as any further bonds, with the result that a holder request was global and not an issue specific, concept. Moreover, the bondholders formed a single class at any rate in relation to matters which affected the bondholders as a class. Consequently, only a single bondholders’ meeting was needed. For a summary of the case, see Hiller, K., *Interpretation of bond trust deeds* (2012) *Journal of International Banking and Finance Law* 413, 413.

43 Where bonds are held by custodians such as Euroclear, the market practice is for the trust deed to state that voting power vests with the person named in the custodian account book.

44 Rawlings, *Supra* n 5, 65.

45 The indemnity shall cover day-to-day legal costs, including court fees, any costs the trustee incurs in defending itself in proceedings against it, and the costs of the issuer or other parties to the proceedings where the trustee loses the court proceedings, see Cavett & Walker, *Supra* n 41, 215.

46 *Ibid.*

A Holder may not pursue any remedy with respect to this Indenture or the Notes unless: (a) the Holder gives the Trustee written notice of a continuing Event of Default; (b) the Holder of at least 25% in aggregate principal amount at maturity of Outstanding Notes make a written request to the Trustee to pursue the remedy; (c) such Holder or Holders offer the Trustee indemnity to satisfactory to the Trustee against any costs, liability or expense (including reasonable fees and expenses to its counsel); (d) the Trustee does not comply with the request within 60-days after the receipt of the request and the offer of indemnity; (e) during such 60-day period, the Holders of a majority in principal amount at maturity of the Outstanding Notes do not give the Trustee a direction that is inconsistent with the request. A Holder may not use this Indenture to prejudice the rights of another Holder or to obtain a preference or priority over such Holder.<sup>47</sup>

The “no-action” clause prevents individual holders from taking enforcement action against the issuer, when the rights of the bondholders are meant to be protected and pursued on a collective basis by the trustee in whom their rights are vested.<sup>48</sup> As such, the clause promotes the pro rata treatment of bondholders as it prevents the race to the court of the most diligent bondholder, with consequent risk of preferential payments to that bondholder. Further, it prevents multiplicity of suits, and action by a single bondholder, that could jeopardise the common interest of the bondholders.<sup>49</sup> The restriction in the clause will usually cease to bind individual bondholders where the trustee has become obliged by a vote of the bondholders to take action but fails to do so within a given period.

An example of where the “no-action” clause could be effective was given in *Re Colt Telecom Group plc*<sup>50</sup> where one hedge fund acquired seven percent of the bonds at a discount and sought to put the issuer into administration with the view to making a profit if the value of the bonds rose as a result of restructuring. The terms stated that insolvency of the issuer constituted an event of default. The hedge fund argued that the company was or was likely to become insolvent notwithstanding, inter alia, that the company’s latest balance sheet

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47 *Colt Telecom Group plc* [2002] EWHC 2815 (Ch), at [28].

48 It should be noted that the “no-action” clause does not prevent an action based on a misrepresentation by the issuer in the prospectus that induced the bondholder to purchase the bonds, or against other parties, see Rawlings, *Supra* n 39, 22.

49 See *Elektrim SA v. Vivendi Holdings I Corp* [2008] EWACA Civ 1178, at [91]. See also Wood, *Supra* n 6, 184.

50 *Colt Telecom Group plc* [2002] EWHC 2815 (Ch).

showed that the various series of bonds issued by the company were not in default and did not fall due for payment until a couple of years later. Against that, the hedge fund sought to rely on the dramatic fall in the company's share price and on its substantial losses and negative cash flows. None of the other bondholders supported the hedge fund's petition. The court held that the "no-action" clause prevented action being taken by bondholders before an event had occurred, despite in its literally wording it only referred to the pursuit of a remedy if an event of default had occurred.

It can be argued that it would be inconsistent with the intention of the clause if bondholders could commence insolvency proceedings when they were precluded from suing for recovery of their debts. In the *Re Colt Telecom Group plc*, the issuer accused the hedge fund of buying the bonds at a discount in order to make a speculative profit by forcing an "unjustified transfer of value from shareholders to noteholders" that a debt-for-equity-swap would bring.<sup>51</sup> Indeed, had the hedge fund been successful in persuading the court that the issuer was heading for insolvency, it would have opened the way for similar proceedings against highly indebted issuers. However, if the "no-action" clause is interpreted as preventing all enforcement, including "non-contractual claims", and enforcement where there has been no event of default, this could lead to situations where no one can enforce, not even the trustee.<sup>52</sup> Thus, careful consideration needs to be taken when drafting the clause.

In addition, the drawback with the "no-action" clause is that the individual bondholder faces substantial barriers when it comes to bringing a suit against the issuer if his or her rights are violated. Furthermore, suppose for example, that an event of default has occurred and that the trustee does not on its own take enforcement action against the issuer. Instead, a group of bondholders holding 50 percent in aggregate principal amount of bonds request the trustee to pursue a remedy, and offer to the trustee indemnity against loss, liability or expense. Even if this is done, the remaining holders of 50 percent in aggregate principal amount of bonds may direct the trustee not to pursue the claim. If so, how should the trustee act?

## 6. THE ELEKTRIM LITIGATION

There is a substantial body of case law in England concerning the interpretation of events of default and the trustee's powers and duties to bondholders in

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51 *Ibid*, at [15].

52 See Kahan, M., *Rethinking Corporate Bonds: The Trade-off Between Individual and Collective Rights* (2002) N.Y.U.L. Rev. 1040, 1040–1089.

such circumstances. The Elektrim litigation is interesting as it involves a long line of cases relating to the same bond issue. In the first case in the Elektrim litigation, in the matter of *Law Debenture Trust Corp PLC v. Acciona SA*, the trustee sought directions as to the construction of the expression “materially prejudicial to the interest of the bondholders”. The case involved bonds issued by Elektrim Finance BV (hereinafter Elektrim Finance), which were guaranteed by Elektrim SA (hereinafter Elektrim). Although the bonds matured in December 2003, the bondholders had an option to redeem in 2001. By December 2001 it became clear to the bondholders that Elektrim Finance and Elektrim would default on their respective obligations upon the exercise of the optional redemption. Accordingly, almost all bondholders exercised their redemption option in December 2001 and Elektrim filed an application for composition. Following the December default and the commencement of the composition proceedings, negotiations ensued between the bondholders through a negotiating committee and Elektrim. During those negotiations it became obvious for the bondholders that a cash payment would not be available to them in the near future. The bondholders were therefore keen to ensure that they obtained maximum security for their lending and, in particular, ensure that future monies would be applied to payments due under the bonds. Moreover, the bonds were amended to include a term giving the bondholders the power to appoint a member to Elektrim’s management board. In order to provide considerable protection to the bondholders, the nominated director’s consent was required in respect of all transactions exceeding €25,000. The bondholder appointed a director, but shortly afterwards, Elektrim suspended the director after he had vetoed a questionable corporate transaction and Elektrim began to dispose of assets in transactions exceeding €25,000. The bondholders contended that the suspension was materially prejudicial, whereas the issuer suggested to the trustee that, in financial terms, it was not. The case came before Justice Peter Smith in the English High Court who held that the suspension of the director had been a breach which was materially prejudicial to the interest of the bondholders and the trustee could certify to that effect without the need for any further investigation. As a result, the trustee notified an event of default to Elektrim.

It should be noted that the only parties in the proceedings before Peter Smith J were the trustee and the bondholders. Elektrim, therefore, was not bound by the decision, and was free to challenge the trustee’s action in seeking to accelerate payment. In the subsequent litigation, in the matter of *Concord Trust v. The Law Debenture Trust Corporation plc*<sup>53</sup>, two issues arose: (i) whether the trustee was

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53 *Concord Trust v. The Law Debenture Trust Corporation plc* [2005] UKHL 27.

obliged (subject to its indemnity rights) to give notice of acceleration to Elektrim and Elektrim Finance; and (ii) whether the trustee was entitled to insist on an indemnity to cover its possible exposure to action by Elektrim and Elektrim Finance for damages. Under the terms and conditions of the bond issue, on the occurrence of a defined “event of default” the trustee might, and had to if so required by 30 percent in value of the bondholders, give notice to the issuer and the guarantor of the acceleration. Following the judgement by Peter Smith J, the bondholders instructed the trustee by way of a written request from over 30 percent of the bondholders to accelerate payment. The trustee requested an indemnity for the costs of any action Elektrim and Elektrim Finance might take to challenge the decision, as well as for any damages which it might sustain if Elektrim and Elektrim Finance successfully claimed that there was no event of default. The indemnity was offered by one of the bondholders, with a guarantee from its affiliate. The trustee refused to accept the indemnity offered, suggesting instead that the indemnity should cover liability up to €1bn for a period of 12 years, and that the indemnity should be offered by way of a letter of credit from an English clearing bank. The House of Lords held that the first issue, i.e. whether a materially event of default had occurred, had been settled as between the trustee and the bondholders (i.e. the conclusions reached by Peter Smith J) and since the bondholders had made the requisite written request, the trustee, subject to the indemnity, came under a mandatory obligation to give notice of acceleration. Regarding the indemnity, the court held that the trustee was not entitled to an indemnity to cover its possible exposure to an action by Elektrim and Elektrim Finance for damages. It was not reasonably arguable that the unjustified assertion by the trustee of an event of default or the giving by the trustee of an invalid notice of acceleration exposed the trustee to the risk of being found liable in damages for breach of contract or negligence. Similarly, the argument that the trustee could be found liable in damages for conspiring with the bondholders to cause the two companies injury by unlawful means or interfering by unlawful means with the companies’ business was described as fanciful.

These proceedings demonstrate the difficulties that may arise in a bond issue and some of the issues facing trustees. Nevertheless, not a huge amount can be taken away by way of general principles from the two proceedings as they are very much borne out of their facts. If a trustee already has a decision in which it is concluded that the issuer has defaulted and that it is materially prejudicial to the interest of the bondholders, the trustee may feel confident in issuing an acceleration notice. Moreover, following the Concord Trust litigation, the trustee will rely on an indemnity for the costs of any action challenging the acceleration. However, there is a risk that trustees are becoming more cautious



and more likely to seek directions from the court, thereby adding complexity and delaying matters when time is of the essence. It shall be noted that the ruling in *Concord Trust v. The Law Debenture Trust Corporation plc* came nearly two years after the suspension of the nominated director.

## 7. THE DILEMMA OF THE TRUSTEE

There is an ongoing debate whether the role of the trustee should be mainly ministerial or whether it should be strengthening.<sup>54</sup> It has been argued that the main problem is that the trustee's powers and obligations are laid down in the trust deed, which is executed by the issuer and negotiated with the trustee, but not necessarily with the original bondholders, and certainly not with the bondholders who acquire the bonds in the secondary market.<sup>55</sup> However, the main problem with the current structure of the trusteeship is that it creates few incentives for the trustee to act as an effective representative of the bondholders. Firstly, the trustee has no direct monetary stake in preserving the value of the bonds. Secondly, the trustee's remuneration structure does not create any incentives for the trustee to take any optional action to represent the bondholder interest. Consequently, the trustee will favour the least risky approach when considering potential courses of action when the issuer gets into financial difficulties.

Traditionally, trustees have not been expected to be particularly active. Similarly, bondholders have played a passive role in their relationship with the issuer as long as the issuer has reported healthy financial performance and paid the coupon. However, the rapid rise in bonds rated below "investment grade" and bonds without any credit rating have attracted a different type of investors – distressed debt investors. As has been demonstrated in the last major round of restructurings, these types of bondholders are likely to take an active role at the negotiation table. These investors tend to buy bonds at a discount in order to make a speculative profit by forcing the issuer to convert debt for equity in the event of default or restructuring. It has, therefore, been argued that distressed debt investors do not have the same relationship with a company as the original bondholders had and that they will be more likely to push for liquidation.<sup>56</sup> Although this is not necessarily the case, it is true that distressed investors are looking for the best possible return on their investment. As a result, the pressure under which the trustee may be placed by the parties is likely

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<sup>54</sup> Kahan argues that the role of the trustee should be mainly ministerial as it has limited incentive to enforce bondholder rights, Kahan, *Supra* n 52, 1069.

<sup>55</sup> See Gullifer & Payne, *Supra* n 18, 343.

<sup>56</sup> See Frauman, *Supra* n 37, 27. See also the example of Nobina Sverige AB in Landeman & Bergin, *Supra* n 4, 123.

to increase as one group of bondholders may wish to renegotiate the debt, whereas a sufficient minority favours acceleration. Not only must the trustee consider the interest of the instructing bondholders as a whole (who might as between themselves have different views of steps to be taken), but the trustee is also vulnerable to the claims of other bondholders who could challenge the trustee's action. Although the Elektrim litigation referred to above refers to English law concerning the interpretation of events of default and the trustee's powers and duties to the bondholders in such circumstances, it is relevant as it is rife with such examples.

It has been held that Eurobond documentation for new transactions is reflecting the Elektrim litigation as well as other lessons learnt from the 2007–09 financial crisis, as the provisions are more detailed when it comes to indemnification, instructions and reliance.<sup>57</sup> Indeed, it is perfectly possible to enhance the traditional role of the trustee if the market is prepared to pay for the trustee to assume greater risks and responsibilities. For example, the trustee could be given wider discretionary powers in relation to certain matters or particular assets over which it holds security. There are a few ways by which the role of the trustee can become more flexible and add value by circumventing the need to ask bondholders to vote on almost every proposed modification or waiver.

Firstly, in order to minimise the burden of the trustee to gather all relevant factual information and other information before it exercise its discretion, the trustee consent letters have evolved as a convenient vehicle. A trustee consent letter is a certificate given by a bondholder requesting the exercise of discretion, which the trustee can rely on, pursuant to the typical provision of a trust deed that provides that the trustee is entitled to rely on a certificate by a bondholder in relation to facts within their knowledge.<sup>58</sup> The trustee consent letter provides the trustee with facts which demonstrate the background of the request and why the bondholder believes that the trustee should exercise its discretion. It is then for the trustee to evaluate whether it should exercise its discretion.<sup>59</sup> Although the trustee consent letter is a useful tool to help the trustee, the trustee cannot rely on it without further consideration. Thus, the trustee must form its opinion and be satisfied that it has considered all the relevant facts,

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57 See Cavett, E., *When the music starts again: how should trustees conduct themselves in the new world* (2010) *Journal of International Banking and Finance Law* 469, 470.

58 Regan, P., Mason, S., *How corporate trustees exercise discretion (Pt 2)* (2014) *Journal of International Banking and Finance Law* 172, 173–174.

59 Usually the trust deed will allow the trustee to seek professional advice from lawyers or auditors.

that it has sought the necessary expert advice, and that it is reasonable for it to exercise its discretion in relation to a given request.

Secondly, the introduction of “negative consent” provisions as a means of amending transaction documentation is an alternative aimed at enabling more decisions to be made by the bondholders themselves. The idea is that the trustee sends a notification to the bondholders that it intends to exercise its discretion unless, within a specified period of time, the bondholders notify that they object. As a means to obtain bondholders approval to consent to amendments or waiver, the “negative consent” provision can be very useful. The drawback is that it more or less removes the need for a trustee. Furthermore, it is not crystal clear whether it is possible to bind bondholders and other transaction parties without a formal meeting thereafter to ratify the action taken by the trustee.<sup>60</sup> Consequently, it might be that Eurobond documentation needs to be amended so that it is specifying that if the trustee does not receive objections, it would be entitled to proceed with the amendment or waiver without liability to the bondholders. Conversely, if it receives any objection, the amendment or waiver would be put to the bondholders via the traditional bondholder meeting route.<sup>61</sup> The “negative consent” provision would undoubtedly require bondholders to play a more active role in monitoring the issuer and be more responsive to proposed amendments in a short time frame. Yet, there may still be situations where it would not be appropriate to use such a mechanism. For example, it would not be suitable to use the provision where the trustee requires an indemnity from noteholders before taking a certain course of action. Similarly, it would not work in a restructuring where the issuer proposes to convert debt for equity, as the bondholders are not actively engaged unless they object.

Finally, by including a provision in the trust deed by which a bondholder committee can be set up to make decisions on behalf of the other bondholders, the trustee would be given some breathing space in matters which it feels it would be inappropriate for it to make. A bondholder committee could make decisions more quickly on behalf of the bondholders, without the need for an extraordinary resolution of a bondholder meeting, and then direct the trustee on how it should act. For the issuer this is more convenient as bondholder meetings normally require 21 days’ notice to be provided to bondholders and if the meeting is not quorate, the issuer must then wait for at least another 14 days to call an adjourned meeting for another chance to pass a resolution. Also, the process is reliant upon notices being sent through the clearing


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60 See Cavett, *Supra* n 57, 470.

61 *Ibid.*

systems which, due to the chain of participants and account holders, might mean that bondholders are left with less time to decide the proposal(s) once they have actually received the notice.<sup>62</sup> Also, the bondholder committee could be a useful tool in the context of restructuring as it is a powerful lobby group representing the interest of a disparate group of bondholders. The drawback with bondholder committees is that they may feel unwilling to direct the trustee unless indemnified or because its action could be challenged by other bondholders or parties. Further, there is the risk that the committee is formed by the major bondholders or by distressed investors which might not seek to save the distressed issuer and rather push for liquidation.

## 8. CONCLUSIONS

A trustee's discretionary powers may include the ability to declare or waive an event of default which has occurred on the bonds and to take enforcement action on behalf of the bondholder against the issuer. The 2007–09 financial crisis resulted in reduced liquidity, pressure on financial covenants and, in many cases, the prospect of default. Consequently, trustees have been flooded with requests to exercise their discretion on a wide range of modifications and waivers. Internationally, distressed debt investors have been major purchasers of all types of claims and are often the largest holders of bonds issued by distressed issuers. These investors are clearly looking for the best possible return on their investment, which may come from a break-up of the issuer. As a result, a trustee may be put under a lot of pressure, as one group of bondholders may wish to renegotiate the debt, whereas a sufficient minority favours acceleration. Concerns have therefore been raised of the extent of the discretionary powers of the trustee and whether it would make sense to limit some or all of its discretionary powers. It is argued that there are a few ways by which the role of the trustee can become more flexible and add value by circumventing the need to ask bondholders to vote on almost every proposed modification or waiver. 

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62 Keary, L., Lovett, J., *Spotlight on trustees: how have they adapted to recent “streamlined” documentation provisions?* (2014) *Journal of International Banking and Finance Law* 672A, 672C.