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Trustees in the New World Conference

On Wednesday 27 January 2010, Clifford Chance hosted The Association of Corporate Trustees in a conference which we called Trustees in the New World. There were around 90 attendees at four sessions and we are delighted to be able to provide you with brief summaries of the proceedings.

Opening Session - Current Trends of Islamic Finance

Debashis Dey, Partner, Clifford Chance Dubai
Claudio Medeossi, Consultant, Clifford Chance London

The speakers told the delegates that, although sukuk tend to replicate fixed rate instruments, this financial product is not necessarily easy to understand. Though functionally akin to a conventional bond, its structure is very different and also its terminology can sometimes be confusing; this is compounded by the absence of standardisation in sukuk documentation.

Structured as a trust rather than debt relationship, the sukuk revolves around a special purpose vehicle (SPV) set up as a trustee, which we will call the "Issuer/Trustee", which buys an underlying asset from the obligor using funds from the investors (the beneficiaries), who during the life of the sukuk share among themselves the income generated by such asset (for example, the rental paid by the obligor for the use of the asset). On maturity, the SPV sells the asset back to the obligor and the price is distributed to the investors who can so recover the initial capital invested in the transaction.

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Current Trends of Islamic Finance

In a sukuk the role played by the corporate trustee, usually described as the Delegate or Transaction Administrator, is modelled to replicate what a trustee typically undertakes in a conventional bond; however, though the powers given to them may look familiar, the similarities may be misleading, particularly in a distressed scenario.

If a default occurs, the investors can only try to recoup their investment by forcing the Issuer/Trustee to sell the asset to the obligor and suing the obligor if the price is not paid. Because of its structure, the role of the Issuer of the sukuk is instrumental to the enforcement of the investors' interests.

"The Issuer/Trustee is the only party that has rights to enforce payment," said the speakers. "It's the Issuer/Trustee who is the creditor [of the obligor]. That way of thinking is important. The party that needs to go into administration is the obligor. That's a party one step removed from you: a party that unless you have some sort of security arrangement over, you can't directly control.

"Cooperation between directors of the SPV and you as Delegate becomes fundamental. It's essential to make this cooperation work."

Difficulties can arise because it can be problematic selling the assets back to the obligor when the default was triggered by problems of the obligor or the asset. Normal options for recourse do not apply and the professional trustee may find itself with uncomfortable decisions to make.

As for restructuring a sukuk, this is a very new area and doesn't follow the same fundamental rules as bond restructuring. Simply amending the trust certificates may fall foul of the Islamic scholars and the Issuer/Trustee typically isn't typically set up to issue a new instrument which can be used as part of a restructuring.

One solution for the obligor is to create a parallel sukuk using a new Issuer/Trustee with a new set of assets, and to swap new for old and release the old assets. "This is cumbersome but seems the only way to restructure a sukuk short of unwinding it, dissolving it and releasing assets."

With the coming into force of the Financial Services and Markets Act 2000 Order 2010, sukuk transactions, until now considered 'exotic', are likely to become more mainstream in the UK financial market. Under the new legislation, most of the sukuk structures that have been developed in the last few years in the Gulf region can be used in the UK domestic market under the regime set out for alternative finance investment bonds (AFIBs). However, "we need to look at sukuk in a different way in the domestic markets," a speaker said. Further, the financial situation in the Gulf is in effect "testing the structures": every time something new comes up and new lessons are learned. In such a steep learning curve, all parties – investors, trustees, counsel – must make it their business to learn how these investment instruments and the relevant documentation work.

Panel Discussion 1 – Defaults and litigation risk in the New World

Ian Moulding, Partner, Clifford Chance London
Bruce Kahl, Senior Associate, Clifford Chance London
Sam Dundas, Associate, Clifford Chance London
Leigh Cobb, Associate Director, Deutsche Trustee Company Limited
Elizabeth Taraila, Senior Counsel and Managing Director, Corporate Trust (EMEA), BNY Mellon

The last 18 months since the collapse of Lehman Brothers has been a steep learning curve for many market participants. An increase in defaults and litigation has forced investors and trustees to deal with issues that many, particularly investors, have never faced before.

Ironically, defaulting transactions have given trustees an opportunity to demonstrate where they can add value through their knowledge of documentation and the market, and because most trustee houses have a breadth of experience of default situations.

At the outset, correctly determining whether there has been an event of default is crucial: miscalling an event of default can have serious consequences for various participants in a deal. Noteholders do not always appreciate that the trustee must carry out its own detailed investigation before acting. Trustees should be equipped under the transaction documents with adequate tools to allow them to perform their role in these situations.

The trustee's role can be particularly beneficial where there is a less sophisticated investor base, becoming a communication hub between investors and making sure everyone knows the status of the deal. The role of the trustee "is not to formulate investor strategy but in many cases they can help facilitate discussion between investors to decide how they want to deal with the issues."

Alongside the communication role, the trustee often has to "think outside the box" when dealing with defaults, especially when the documentation doesn't cover the situations they are facing.

The challenges start with dealing appropriately and in the best interests of all noteholders in releasing information. Specific requests for information compound the problems of balancing confidentiality with disclosure, while the slowness of some channels has led to consideration of alternatives.

The trustee must be mindful of unexpected or jurisdiction-specific regulatory requirements. In some cross-border enforcement situations, for

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Default and litigation risk in the New World

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example, government approval is required for non-residents to effectively enforce share security. "This highlights the need to take advice and carefully consider your strategy before you embark on it," said one contributor.

Acceleration or enforcement may be options, but before taking any action, trustees should obtain clear and valid instructions from the noteholder group, a comprehensive indemnity and cash on account for a fighting fund. Unfortunately, trust documents are often "woefully lacking" in these areas, said another contributor.

Noteholders often need convincing of the benefits provided by the trustee and why there is a need for the trustee to be indemnified. "They like the trustee to think outside the box but don't like paying for it. We have to be robust in this area."

So many issues arise which are not specifically covered in the documentation that the trustee needs to consult legal and financial advisors frequently. "There is rarely a clear path to resolution in a distressed situation."

Competing creditor claims cast the trustee as 'piggy in the middle' when what the trustee seeks is clarity on the actions it should or can take and on distribution of assets. In collateralised structured transactions, providing an agreed framework for the sale of the underlying collateral would be "hugely beneficial on the back end of a distressed deal". So too would pre-funding arrangements for the trustee.

"It's impossible to address all eventualities. Providing issuers and trustees with a more substantial framework to address practical issues in a default situation would benefit all of us."

Panel Discussion 2 – Is there a role for a "super trustee" in the New World?

Esther Cavett, Partner, Clifford Chance London
Lydia Brookes, Associate, Clifford Chance London
Peter Knust, Senior Associate, Clifford Chance London
Julie Fort, Deputy Head of Transaction Management CTLC Europe, HSBC Bank plc
Natalia Pasynok, Senior Vice President and Head of Trustee Business GSS, Bank of America Merrill Lynch

A discussion of the super trustee role is bound to produce as many questions as answers because it is not a 'one size fits all' scenario. The super trustee is likely to be a bespoke role, crafted jointly by market participants around an asset class rather than written into every trust deed as standard.

Without doubt, one area of difficulty is communication between trustee or issuer and noteholder and, if this can be improved, it may mean that we do not need a super trustee. Notices sent through the clearing system can take a long time to reach the ultimate beneficial holder of a note, as they often need first to pass through several other parties such as custodians and subcustodians. Bloomberg is a more direct method, but not always practicable given that the information can be seen by anyone and not just the note-holders. Another problem is the lack of a standard format for notices, which can mean that content is sometimes cut or summarised so that it can be sent electronically.

The International Capital Markets Services Association (ICMSA) has been considering possible improvements with parties in the market. Suggested solutions include a secure website, or the creation of a template similar to a pricing supplement that would enable the clearing systems to pick up and relay essential information on proposed documentary amendments quickly. "This would standardise notices, which would be a vast improvement on what we see at the moment," said an expert.

Communication is one thing; getting results is another matter. Negative consent

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"I think there will be a role for a super trustee in the new world, however it will take the cooperation of everyone involved to achieve this goal and not just the trustee industry alone."

Super/Trustee in the New World

is an option being explored for new transactions going forward as a means of giving more responsibility for decision-making to noteholders rather than needing a super trustee. The concept could be useful in emergencies, when there is no time to call a note-holder meeting or when it is not practicable to obtain a written resolution. Negative consent has been used on some existing transactions, but as it is not set out in the contractual documentation it is not a "cast-iron" legal position for the trustee. "If it is not a term of the trust, you can't rely on it in the same way as an extraordinary resolution. It must be treated with caution," said a speaker.

Although negative consent puts more onus on noteholders to be alert and responsive, if the concept were to be used in new transactions going forward it might also be seen as taking away the key protection for noteholders of having a trustee acting on their behalf. "In many situations, professional trustees could be better placed to deal with decisions which would otherwise require a vote of a wide-ranging group of investors to reach a consensus in a short time-frame."

A reasonable middle way for new transactions may be to combine negative consent with other decision-making mechanisms in the documentation, rather than to replace the concept of noteholder meetings and trustee discretion altogether.

Some would argue that trustees already have to take the super trustee approach when asked, as they often are, to exercise discretion in agreeing proposed amendments on the basis that no material prejudice to noteholders will occur. Responsibility for such a decision ultimately rests with the trustee, although expert opinion may help inform it.

Current trust deeds typically allow a noteholder committee to be set up to make decisions on behalf of the rest of the noteholder group. A noteholder committee has the advantage of being able to make decisions more quickly as it can sidestep the full meeting process in the short term, but a formal meeting of noteholders will still be required at the outset in order to approve the formation of the committee. Informal noteholder committees, common in the restructuring world, don't have any power to bind the whole noteholder population but they can help build a consensus prior to a full formal meeting. "As a practical matter, if proposals have been 'blessed' by certain noteholders, others are more likely to vote in favour of them," said a speaker.

Ultimately, the super trustee role will develop if the market needs it, and if trustees can find the right balance between the risk they take and the reward they achieve for doing so.

Factors to be considered include whether some of the trustee's technical decision-making should be separated from its fiduciary role, whether sufficient resources can be allocated internally or externally to do the job, and whether in fact the sheer size and complexity of some modern transactions makes such a role untenable.

"I think there will be a role for a super trustee in the new world," said a panellist; "however it will take the cooperation of everyone involved to achieve this goal and not just the trustee industry alone."

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Panel Discussion 3 – A New World for trustees in Structured Finance?

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Raman Subberwal, Associate Director, Deutsche Trustee Company Limited
David Mares, Director, Citicorp Trustee Company Limited
Helena Giles, Manager, Corporate Trust, Capita Trust Company

The past 15 months has been an "interesting time" for trustees in structured finance. Despite the unprecedented nature of the events, the transaction documentation generally appears to have stood up quite well.

The need to replace downgraded counterparties was one of the biggest problems during this time. This was further compounded by the sheer number of banks being downgraded simultaneously and difficulties with replacing counterparties on cross-border transactions. The lack of choice for replacement entities led to an unrealistic expectation that trustees would be able to exercise their discretionary powers in order to find a suitable replacement. The "main issue, as always," is the market's mistaken belief that the trustee's permissive right to consent to changes is often conceived as an implication that the trustee "will" give its consent. That said, refusing consent "often has relationship implications", a contributor said.

What is agreed is that increasingly trustees are being asked to make commercial decisions when they are not in a position to do so; either because the documentation does not allocate responsibility for sourcing replacements and/or provide any detailed guidance on how that should be achieved. In many instances, this has lead to the "time-consuming process" of a noteholder meeting being the only option.

Counterparties falling below minimum ratings required by the terms of existing transactions (but not, however, below the level required by more recent revised rating agency criteria published after the closing date of transactions) was one of the issues which had been a major "headache" for trustees. Most experts agree that flexibility should be built into all required rating definitions to enable counterparties to comply with ratings that are consistent with the then published criteria of the relevant rating agency as the minimum rating required.

Rating Agency attitudes post-credit crunch have also added to the "burden" on trustees. One contributor noted that rating agency confirmation or affirmation ("RAC") has long been just one of the factors that a trustee will consider in determining whether an amendment, consent or waiver is materially prejudicial; but what is now clear is that some of the rating agencies are refusing to provide any comfort or any formal comfort in this regard. Improved communication with the rating agencies would benefit trustees, "so if an amendment comes through the door we can actually pick up the phone and discuss the implications with them; there are obvious sensitivities, but it seems the only way, going forward," said a contributor.

Further, this communication has to be two-way. Trustees "need to be more accessible to rating agencies so they can approach us before they put out their pronouncements, downgrade action etc".

If RACs are hard to obtain in future, trustees will need to consider new tools or seek to bolster those already built into the documentation to assist them in the exercise of their discretionary powers. An important consideration is the trustee's neutrality in a deal, but given the current environment and difficulty in obtaining RAC or RAC-like comfort, "we do need to consider whether certain circumstances might necessitate our being more proactive so we're in a better position to exercise our discretion, and I don't think that's stepping beyond our remit as a trustee", said a contributor.

Given the number of times trustees have been asked to exercise their discretion recently, there are some important changes that could be made in order to make the use of discretion more streamlined – in particular, towards pre-packaging amendment requests or "hardwiring" the use of discretion within the documentation and seeking to engage SPV issuers within the process. An important issue for trustees personally, is that remuneration for work of an "exceptional" nature is expressly catered for in the transaction documentation.

From recent experience, it appears an explanation of what constitutes 'exceptional' should be built into the documentation to avoid trustees facing requests to consent to, amend or waive certain matters for "free". This may also be the time to reopen discussions on fee caps in distressed situations. "It may also be worth looking at reserves and whether we can build in a slush fund to deal with exercise of discretion scenarios," said one speaker. "It's not

going to be popular with arrangers, but it's worth raising the issue".

The experiences of the last year have revealed a lack of consistency in noteholder meeting documentation. Said one: "My concern is holding a meeting incorrectly that could then be challenged". Inconsistency within the documents themselves, particularly around timeframes, voting thresholds, whose interests ought to be considered and when multiple meetings are required can be unhelpful, especially when the noteholder meeting schedule doesn't reflect provisions set out in the Conditions and the Trust Deed. Panellists agreed that some kind of standardisation would be helpful and that TACT might be an appropriate forum to consider such changes.

Lawyers often have a big part to play in ensuring consistency across documentation and that the circumstances in which trustees are required to exercise their discretion are clearly set out. There are some obvious changes that could be made to the documentation, but only if it is not solely trustees but also arrangers, originators, raters and SPVs which are engaged in thinking through and promoting the issues will there be any significant changes to structured finance documentation.

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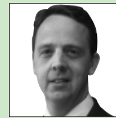

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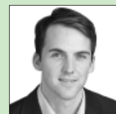

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