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The Cross-Border Trustee: From Behind the Scenes to Center Stage

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Introduction

Investors of debt globally typically have a mere cursory awareness of the existence of the corporate/commercial trustee administering their debt investment. When times are good and corporate default rates are low, the trustee quietly goes about the business of coordinating payments and redemptions, monitoring compliance items under the trust documents and generally working behind the scenes to assure the peaceful administration of the securities on behalf of their bondholders.

In less happy times, when things begin to sour for a company, investors of all shapes and sizes rapidly turn their attention to all parties relevant to their securities who might potentially provide information as to the performance of the company and the prospects of future debt service on their securities. At this point, the trustee's profile on the transaction begins to elevate rapidly. By the time a material event of default occurs under the trust documents, bondholders have placed the trustee center stage as a source of information and a repository for complaints, suggestions, concerns or grievances. Often, the trustee represents the only prospective party to whom bondholders may turn for a measure of hope for some recovery on their investment.

Although sophisticated investors generally have vast resources to implement measures for the recovery of their investment, in many markets there remains a large investor community of retail-based holders and their brokers who turn to the trustee as their sole source of information and, more importantly, representation in any forthcoming workout negotiations or insolvency proceedings.

The role of the trustee in global insolvencies is underscored by these expectations of their investors. The trustee's duties and responsibilities are enumerated in the documents governing the debt issuance and governed by the laws of the jurisdictions involved, but the reality is that the trustee must navigate the same complex global insolvency environment as investors while at all times fully maintaining its fiduciary responsibilities to them.

Global reach

Many of the banks and trust companies focused on developing a global corporate trust business maintain multiple trust offices throughout the international markets from which they derive significant volumes of new trust appointments. Although this type of globally focused trust business may have a single management structure, invariably many trust offices evolve into self-contained trust businesses focused primarily on the legal and practical concerns of doing business locally.

Although these local trust departments may naturally evolve to reflect the character and nature of the specific market they serve for their non-distressed issuers, whether it is the US, UK, Asia or other, in a potential insolvency by a client who is a debt issuer with global debt or global businesses, the trustee is shaken from their insular environment and forcefully returned to their original purpose of serving as a true global trustee.

Many trustees do not have the capabilities, staffing or risk appetite to provide local or global trustee services for distressed or insolvent companies. These trustees will often choose to implement their delegation or resignation rights under the governing trust documents and seek the appointment of either a 'delegated' or 'successor trustee'. A delegated trustee is more common under trust deeds in the UK and Asia, whereas a successor trustee is more common in the United States. The Trust Indenture Act of 1939 (the 'TIA'), as revised, compels the resignation of a US trustee under certain conditions, including the existence of a lending or other conflict or serving as trustee for multiple levels of non-pari-passu debt.

However, a few hardy, specialized trustees, particularly in the US and UK, actively seek appointments as

Notes

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successor trustees or delegated trustees, or may choose to retain defaulted or insolvent deals that arise in their own portfolios. These trustees rapidly discovered over the past few years of peak corporate insolvencies that in order to successfully administer these transactions, the insular environment and limited scope of representation offered by their local trust offices are not adequate. The challenges for these trustees are to assess a trust appointment for a debt issuer in distress and anticipate what jurisdictions may be involved globally. The experienced trustee assembles a team, internally and externally, to administer the distressed transaction efficiently and effectively. For example, the trustee may proceed with administering distressed issues or insolvencies without any indication of whether the transaction will ultimately become subject to an administrative proceeding in UK courts or a Chapter 11 bankruptcy proceeding in the US.

Trustees operating in the US and UK are now well aware of the possibility of their trust issue requiring the involvement of their colleagues 'across the pond.' An understanding of similarities and differences in how they operate becomes critical in understanding how to effectively transition a global insolvency between global trust offices, if necessary.

United States

US trustees are not only subject to federal law for management of conflicts of interests, as required by the TIA; often the business they conduct is subject to their own evolving credit and/or operating policies and procedures. US trustees, in the wake of Enron and WorldCom, are acutely aware of even the mere appearance of a conflict or potential for conflict. Corporate governance concerns have prompted trustees in the US to closely examine their portfolios and resign any such trust appointments to their colleague trustees, even before an event of default or other TIA provision may trigger the actual requirement of a resignation. Large US money center banks usually have extensive lending activities as well as corporate trust departments and, as corporate trustee, they are often appointed to provide trust services for multiple debt issues for a single client. As the number of distressed issuers accumulated rapidly in the last few years of activity, many trustees started to develop an early detection system or a 'watch list' for early identification of potential conflicts of interest for their corporate trust clients. Some of these large corporate trust departments have also shied away from providing new trustee services to high yield issuers to avoid the potential for default or bankruptcy altogether and to clearly send the message to clients and investors that they are managing their corporate governance concerns. When the choice is narrowed to pursuing lending activities or corporate trust appointments, economics usually make the decision an easy one for money center banks: lending is more lucrative and desirable a business to pursue.

Some trust businesses, particularly those financial institutions for whom corporate trust is a more of a key business overall, have created specialized business lines focused on accepting successor trustee appointments for the purposes of guiding transactions through default and/or Chapter 11 or Chapter 7 bankruptcy proceedings. For these trust businesses, developing the expertise to successfully handle these distressed situations results in a higher profile for the institution within the banking industry and assists in generating strong trust relationships with investors, law firms, financial advisors and other industry professionals. This network of professionals with an appreciation for this specialized trust work strengthens the potential yield of opportunities for their general trust business of new or 'healthy' trust appointments.

To be successful as a trustee for distressed debt, however, the trustee must develop a careful and considered approach for handling newly defaulted issues and working with issuers facing imminent workout negotiations or bankruptcy in the US. The 'bells and whistles' inherent in trust indentures for setting forth the trustees' actions in default or bankruptcy scenarios may include such activities as giving formal notice of a cure period and/or notice of default to holders, accelerating or de-accelerating the debt, marshalling assets, as necessary for fully or partially secured bond issues, and other clearly defined steps toward remedies for the bondholders. However, the experienced trustee in these scenarios is wise to engage counsel early, along with whatever other professionals it may deem immediately necessary to assess the status of creditor position for their holders' securities in the overall context of the distressed situation. Accordingly, the trustee may or may not seek inclusion on any ad hoc bondholder committees, seek out third or foreign parties for additional relevant information, review the possible jurisdictional effects, and generally take all appropriate steps to prepare to represent the bondholders through workout or forbearance negotiations, default on the debt, consensual restructuring and/or through the filing for Chapter 11 protection and the resultant judicial proceeding in US Bankruptcy Court. In short, the trustee starts to chart a course of action on the uncertain, unpredictable road of domestic or global insolvency.

For example, in order to successfully administer defaults and bankruptcies in the US for debt issues, the corporate trustee must be prepared, if necessary, to represent its bondholders from the start of any proceedings brought before US Bankruptcy Courts. In addition to drawing upon internal resources, a seasoned US trustee will usually have engaged outside counsel, with preferably an experienced corporate

bankruptcy practice as well as experience in representing the interest of the corporate trustees themselves. The engagement may take place at any point but is usually teed up at the occurrence of a material event of default and certainly no later than the filing date of a petition for bankruptcy court protection by the company issuing the debt. The danger for a corporate trustee that adheres strictly to the most basic of requirements of a trustee in the indenture's default provisions is finding itself woefully unprepared for the complexities of a restructuring or insolvency/bankruptcy proceedings in both the US and other jurisdictions.

A pro-active approach by an experienced corporate trustee is essential in the US for a company that seeks Chapter 11 bankruptcy protection. The trustee in many cases will determine that the best chance for representing their holders' interests in recovering their investment will be to seek appointment to the bankruptcy case's Official Committee of Unsecured Creditors as appointed by the US Trustee in place on the case on behalf of the US Department of Justice. Typically, the US Trustee selects the indenture trustees as members of the committee for the largest unsecured debt issues outstanding for the petitioning debtor company. As the trustee ostensibly represents all of the outstanding bondholders for a debt issue and is not, potential TIA conflicts aside, beholden to any special interest or sub-group of bondholders, it is the ideal representative of that unsecured class of holders in the overall creditor base of the company. If appointed to the Committee, the trustee will have the responsibility of performing its fiduciary duty to all of the general unsecured creditors of the debt issuer while continuing its representation of the bondholders with the goal of achieving the highest recovery possible for their investment.

As the Chapter 11 bankruptcy case proceeds, the trustee as committee member must continually and responsibly balance its role as a fiduciary on the committee with its fiduciary responsibility to its bondholders. Often, a large institutional holder of the securities is also appointed to the committee by the US Trustee. That bondholder, however, may hold multiple levels of debt that are of unequal creditor status (i.e. non-pari-passu debt) of the company and the trustee must remain aware of its representation of all of the holders of just the particular debt issue for which they serve as trustee and not solely the largest holder taking a seat on the committee. The trustee may also find itself the sole representative of the bondholders on the committee in the case where the bondholder members divest their holdings during the course of the case and resign their seats as committee members. Further, the influence and/or prior activities of ad hoc bondholder groups are a factor that the trustee must be aware of and consider, again with its focus squarely on ascertaining the best recovery for the whole of its bondholders.

Hedge funds and other distressed investors may also acquire a significant block of the securities or a majority of a holders may want to direct the trustee to take certain legal actions in the case, such as initiating litigation against other parties to the case for a multitude of possible reasons, quite frequently including a challenge to the bondholders' creditor status. In consultation with its counsel, the indenture trustee may or may not determine that the particular course of action meets the standard of care for a reasonable and prudent trustee. Thus, the trustee undertaking default and/or bankruptcy representation must bear a degree of risk for the potential of dissatisfied holders or other parties initiating further litigation challenging the trustee's actions.

Most importantly to the interest of all of its bondholders, the trustee may also be the sole party capable of advancing a critical legal issue to be determined by the courts; for example, when distressed investors buy or sell their positions during the course of bankruptcy proceedings. The trustee, therefore, may be deemed to be the only party with the required legal 'standing' before the court to pursue litigation on behalf of the securities and their holders because the trustee represents the entire base of holders and the securities since their date of original issuance.

Therefore, in addition to playing an often crucial and integral part in Chapter 11 proceedings, the trustee must manage cross-border concerns that frequently arise when the US debt securities the trustee represents were issued by a non-US company. A debtor company's restructuring and/or administrative proceedings for a plan of reorganization may occur in another global jurisdiction, requiring the trustee to actively pursue representation on behalf of their holders in a non-US jurisdiction.

Conversely, the US indenture trustee may become involved in Chapter 11 proceedings on behalf of their internal counterparts on global debt issuances that become voluntarily or involuntarily subject to US courts. As significantly as US investors are invested in global debt and equity, so are US indenture trustees involved in global corporate trust appointments. Thus, the effect of title 11 of the US Bankruptcy Code is to create as many uncertainties for US and global trustees as it does for global investors.

As distressed investors are well aware from many recent cases, the provisions of title 11 of the US Bankruptcy Code may result in either a full-scale or parallel case in US Bankruptcy Courts for global companies or the initiation of a competing proceeding to one in another international jurisdiction as may be forced upon the debtor by a third-party dissatisfied with the debtor company's restructuring plan or the actions of the debtor's proceeding. A judgment in a non-US jurisdiction for the restructuring plan of an

international company may also result in a US proceeding for recognition of the judgment pursuant to Section 304 of the US Bankruptcy Code. In all of these potential proceedings, the indenture trustee in the US is either subject to involvement by other parties or acts as an active and willing participant on behalf of the holders; and, frequently, the trustee becomes the sole representative of bondholders in legal proceedings.

Although these cases and the activities of the US-based trustee often dovetail with the activities of their UK trust colleagues, the legal and customary roles of a trustee in the US and UK are paradoxically the same in function yet quite different in form. Though the tasks and duties may appear to be the same, the manner of executing them is quite different.

United Kingdom

As there is a growing trend for companies operating in Europe to raise capital through corporate bonds rather than through traditional bank debt or equity, a secondary market for trading debt has rapidly developed. In order to attract US investors into this market, bond indentures governed by New York law have been introduced alongside the traditional trust deed governed by English law for the structuring of these corporate bond issues in the UK.

Although there are similarities in the basic duties and responsibilities of both a UK and US trustee, there are also considerable differences in how the duties and responsibilities are performed. Under traditional trust deeds in the UK, there is usually a higher degree of interpretation and judgment required of the trustee in executing its duties and responsibilities on behalf of bondholders, particularly in the event of a default under its terms or in the event of the insolvency of an issuer.

In general terms, a US indenture contains more explicit provisions setting out the role of the trustee and the rights of bondholders, whereas English law trust deeds have wider and less stringent provisions. Furthermore, the voting thresholds to amend the documentation or impact the material terms of the transaction are very different for trust deeds under English law.

Essentially, the English law for trust deeds is derived from legislation and convention; in the US, the TIA explicitly establishes the parameters for the trust role and trust indentures are derived from standardized model forms that adhere to the requirements of the TIA, such as the model form of indenture recommended by the American Bankers Association. The basic difference between the two documents is that a UK trust deed can be thought of as an enabling document that allows the trustee to use its experience and discretion to run the trust, whereas the US trust indenture is a self-contained document and any action taken outside of its terms must be approved by a court. In effect, the distinction between UK and US trustees, particularly with regard to global insolvency situations, is akin to a distinction between discretion and process.

For example, under English law, the trustee acts for holders as a class whereas, under US indentures, individual holders retain the right to sue for principal and interest. However, under English law, this right only applies if the trustee has failed to act. The trust deed sets out the standard of care required of a trustee, who will be liable to bondholders for a range of 'failings' including negligence, default and breach of trust. There is also substantial case law to indicate the degree to which a trustee ought to be held liable under English law with all of the remedies that may available to the beneficiaries of the trust. In the US, the standards of care in an indenture are typically established in accordance with section 315 of the TIA which sets forth a prudent man standard and typically results in a review of the reasonableness of a trustee's actions. Therefore, it is arguable that the standard of care under an English law trust deed is higher, or more subject to interpretation under case law, than that of a US trust indenture. Accordingly, with regard to global insolvencies, a UK trustee may bear a correspondingly greater risk of liability in representing its bondholders in either restructuring negotiations or administrative proceedings in the courts than a US trustee.

The Cross-Border Trustee

US and UK trustees are not only forced to manage their trust role performance risks based on different standards of care and custom in each other's judicial realms, but many are forced into other jurisdictions globally, most notably Latin America and Asia. Insolvency or bankruptcy proceedings taking place in more unpredictable or unstable jurisdictions globally can severely complicate and/or thwart a trustee's ability to pursue potential remedies for their bondholders.

Yet another wrinkle in understanding the role of the cross-border trustee in globally insolvency situations, as well as a source of investor confusion and misunderstanding, is the belief that the trustee role alone is able to effectuate any of the many processing roles necessary to fully administer debt issues. Many trustees serve in ancillary capacities on the debt issues to which they are appointed as trustee, by also serving as a collateral agent (a.k.a. a security trustee in some jurisdictions), paying agent, registrar, tender agent, distribution and/or exchange agent, among many other types of related agency services for debt issues. These are non-fiduciary roles through which the trustee actually facilitates and handles the processing of payments and the securities themselves. However,

in a cross-border insolvency or bankruptcy, the trustee role can be complicated by a single trustee performing all these roles, and finding conflict between them in multiple jurisdictions, or complicated by the necessity of working through other banks or trust companies serving in one or more of these capacities. These various roles can greatly increase the risk of liability or prospects of litigation whether with regard to the actual performance of the roles or the legal complexities of the jurisdictions in which these services are being provided.

Conclusion

Although the international corporate default rates are currently at the lowest levels in years, the situations that arise grow exceedingly complex in nature and demand greater administrative skill by a corporate trustee. Global insolvencies of the future are likely to involve ever-increasing levels of cross-border activity with correspondingly difficult jurisdictional questions in order for international restructurings and corporate rescues to be successfully coordinated by a trustee. Investors, from sophisticated hedge funds to the more modest retail or 'moms and pops' investors, have all gained unfortunate experience in the past few years of frenetic corporate insolvencies. The challenge for corporate trustees, and for all the various parties to these global insolvencies, is to learn the painful lessons derived from these experiences and take the necessary steps to both mitigate risk and evolve their services and skills accordingly.

The increasing skill and service requirements necessary for successfully providing cross-border corporate trustee services, however, will likely winnow the field of true global trustees to a few key players. The surviving global trustee must be truly capable of, as well as committed to, maintaining the comprehensive services and the global reach essential to offering genuine value-added services. Global and/or distressed investors will benefit from a measure of due diligence of the trustees involved when the stage is set for a global insolvency and the players are assuming their roles. The right trustee will have stepped out from behind the scenes to present the proven insolvency or bankruptcy experience necessary to keep the show on the road towards a successful conclusion for its global debt investors.