Bondholders, fight back

Asian trustees are increasingly powerful, which can lead to delays when bonds default. Their influence needs to be reduced

Recent bond defaults by Asian issuers have highlighted problems with trustees. In a number of cases, certain trustees have been reluctant, uncooperative or even obstructive when the bond investors – even a supermajority of bondholders – have tried to instruct a trustee to accelerate or otherwise take action in respect of their investment.

In some cases there were delays of up to three to five weeks before any action was taken by the trustee. This has raised a number of concerns among bondholders as to how their investments are structured at the outset, and whether some changes to traditional market practice are now warranted to address these concerns.

In a bond issuance, a company issues bonds to investors, either directly or through a special purpose company. If bonds are issued through a special purpose company, they will usually be guaranteed by the corporate parent. Bondholders appoint a trustee to, among other things, record the rightful owners of the bonds and represent them in their dealings with the issuer. The terms and conditions that govern the bonds are set out in an indenture in US-style transactions or (in abbreviated form) in a trust deed for English style transactions.

If the issuer then encounters financial difficulties or can't perform its obligations under the indenture, the bondholders must act through the trustee to enforce their rights under the indenture. In many Asian bond transactions, the terms of the indenture usually provide for the trustee to require an indemnity from the bondholders to protect its position as being top of the payments waterfall (ie, not only to cover its costs in performing its duties under the indenture and any instructions from the bondholders, but also to cover any trustee fees that the issuer has likely also defaulted upon). Bondholders may then be required to issue instructions to the trustee in order to require it to take any action the bondholders require.

"Provisions that require the issuer's consent to replace the trustee should be removed"

The errant trustee

Uncooperative trustee behaviour can manifest itself in various ways.

First, trustees can demand broad indemnities before taking action: the trustee may demand a very broad indemnity (rejecting any reasonableness qualifiers and asking for the indemnity to cover other investors that are not party to the indemnity) before any steps are taken to accelerate. These indemnities may have little relation to the original form of indemnity given by the issuer to the trustee and will typically be much broader, including joint and several liability and potentially onerous provisions on termination and release.

Second, a trustee is paid a relatively modest fee for its administrative role, and is therefore incentivised not to take any action that could increase its risk. Trustees do not always disclose what their fees and expenses are to the bondholders, especially hourly rates. It can be frustrating for bondholders that a good deal of the time and cost incurred by the trustee is focused on negotiating the indemnity and taking actions primarily to protect the trustee's legal and business position.

Some trustees have demanded a significant payment to cover their legal fees and internal time costs and asked for the financial statements of bondholders to back the indemnity. For bondholders, this can be difficult to rationalise, especially as in a default situation a bondholder is already out of the money. In some cases, a trustee's fees (excluding their legal fees) have ended up being higher than the bondholders' legal fees. Unless fee arrangements change, which involve a certain element of risk taking, this appears unlikely to change.

In litigation proceedings against issuers, those actions are typically initiated through the trustee. The trustee usually selects its own counsel without consulting the bondholder group, and while ad hoc groups of bondholders may retain counsel, they must do so at their own expense. A trustee will often not agree to retain counsel jointly or otherwise, the cost of which is paid from the top of the waterfall as a trustee's expense, for the benefit of the bondholders (other than derivatively through the trust role of the trustee). Because of this the role of trustee's counsel has been focused mostly on protecting the trustee's interests, with the bondholders' interests being secondary.

The bondholders are the ones that are focused on maximising recovery from the issuer and arguably it should be bondholders' counsel that lead any litigation proceedings. However, some trustees have insisted that trustee's counsel be appointed to lead the litigation and bondholders' counsel play an advisory, backseat role only. In these situations one would expect a bondholder committee to be the more creative and resourceful of the creditor side participants in seeking a negotiated solution, so arguably it should take the lead in the process.

In terms of instruction notices, the trustee can sometimes demand, on short notice, instructions from a majority of the bondholders on all aspects of the litigation process, however minor. This can be an inefficient process, especially given that the situation was created by the trustee insisting on its counsel taking the lead in the litigation and because the two sets of counsel have differing and possibly conflicting objectives. Where there are diverse bondholder groups located in multiple jurisdictions on different continents, this can automatically lead to at least a one day delay in simply coordinating signatures to an instruction notice.

Those conflicting objectives would not necessarily be resolved by selecting those trustees whose parent banks were also bondholders – in a similar manner to how in a syndicated financing a facility agent may also have a lending commitment.

This is primarily due to potential conflicts of interest that may arise within the parent banks themselves and the multiple levels in which those banks may be participating in the transaction – for example the same bank's trustee group could be extracting

> "Small fees lead to small risk tolerance"

trustee fees, its investment banking group could be extracting advisory fees and its proprietary trading desk could potentially be involved as an investor.

Restrictions on distressed sales

Once the situation deteriorates to the point where bondholders need to take enforcement action in respect of the bonds, the trustee is incentivised to focus its energies on protecting its interests in negotiating an indemnity. As a result, trustees can be stubborn in accepting any revisions of the standard form indemnities they use.

So before they release bondholders from an indemnity, the trustee will generally not only require that any new purchaser agree to an indemnity similar to the bondholders' indemnity but may also insist on unilateral approval rights over the potential purchaser's acceptability to it. (It may not be expressed in such explicit terms, but could be a combination of trustee rights that results in the same effect).

If the trustee refuses to release an indemnifier, this may make it impossible to sell the bonds without having some residual liability under the indemnity, which clearly impacts the attractiveness of a distressed sale to the bondholders.

Even worse, where the bonds are actively traded sellers who have signed the indemnity remain liable even after they have sold the bonds.

For bondholders who are institutional investors, this can also lead to internal policy and compliance considerations where a bondholder may be restricted from assuming residual liabilities in respect of assets it no longer owns or controls.

As mentioned, trustees sometimes require payment on account from the bondholders. They may also require this of a new purchaser, and can even demand a sum more than originally posted by the bondholders. All of these can serve to alienate potential purchasers of the debt.

Proposed solutions

A number of possibilities exist for bondholders to limit the ability of their trustee from frustrating their actions. First, they can agree the form of indemnity at the outset and attach this as an annexure to the indenture or, as a separate arrangement between the trustee and bondholders. The bondholders will have more scope to resist overkill protections than by waiting for a default scenario where the negotiating power is with the trustee.

They can also broaden the bondholder provisions on decision-making to ensure the manner in which the trustee takes instructions and in what situations the trustee should exercise its discretion to act for the benefit of the bondholders (for example, appearances in court).

Trustees' fees and expenses (including hourly rates and estimates on certain actions, such as commencing litigation proceedings in various jurisdictions) should also be disclosed up front and in default situations. It should also be the first thing disclosed to bondholders.

Provisions that require the issuer's consent in order to replace the trustee should be removed. These provisions only serve the interest of the issuer, especially if the bondholders are faced with an uncooperative trustee. A supermajority of bondholders should be allowed to replace the trustee without the consent of the issuer.

The role of counsel should be agreed before litigation arises. Parties should consider whether the majority bondholders should be entitled to retain counsel that is paid out of the top of the waterfall in connection with enforcement. At the very least, trustees should agree to jointly appoint bondholders' counsel in litigation matters.

Trustees may be entitled to have their own counsel review the proceedings to ensure the trustee's interests are protected but otherwise they do not need to be involved in the litigation process. In situations where there is security involved, it should be made clear what processes will be taken for enforcement or foreclosure on security by the trustee or security agent.

The trustee should be required to accept an indemnity from a potential purchaser and allow the current indemnity to be terminated if the potential purchaser agrees to an indemnity similar to what the current bondholders have already agreed.

In addition, if the trustee still has concerns about the creditworthiness of the potential purchaser, certain benchmarks and other objective criteria may be used to alleviate these fears.

However, if these benchmarks and objective criteria are met, the trustee should be required to allow the release of the bondholders under the indemnity and accept the indemnity from the new purchaser.

The problem of how bondholders deal with a uncooperative trustee will not be resolved without the concerted action of hedge funds and investment banks' proprietary trading desks. Changes to the established structure would appear to require changes to the incentives of trustees, which is a fairly simple economic proposition: small fees lead to small risk tolerance.

An additional problem arises from the fact that most major law firms are reluctant or unable to file lawsuits against trustees due to conflicts with the parent bank or for fear of alienating major clients. And given the increasing reliance of trustees' parent banks on fee income following the financial crisis, any ambiguity is likely to result in further opportunity for increased trustee time costs and consequently fees. However, certain changes may be possible without the need to radically alter trustees' fee structures.

While it is an accepted principle that a trustee should not be at risk for its participation in the transaction, more consideration should also be given to the principle that a bondholder should be free to sell out of a position. A more concerted effort may be required to ensure that these two principles do not collide.

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