

## Trustee and Paying Agent FAQs : Should the Principal Paying Agent Hold Bond Payments On Trust for Bondholders?

A principal paying agent acting in a bond transaction is sometimes asked to hold in trust for bondholders amounts paid by the bond issuer through the paying agent to the bondholders. This request is perhaps prompted by the fact that, in US bond transactions, the principal paying agent normally holds such funds in trust for the bondholders. In the context of bond transactions outside the US, however, this request is generally ill conceived. This alert tells you why.

In US bond trust indentures, where the bond issuer appoints a paying agent, it is usual to find provisions requiring the paying agent to hold bond payments in trust for the bondholders. Where the paying agent is not also the bond trustee, the paying agent would need to agree, in an indenture to the bond trustee, to hold such sums in trust for the bondholders and to notify the bond trustee upon any payment default by the bond issuer and the paying agent would often agree to pay the bond trustee amounts held in trust by the paying agent during the period of default by the bond issuer. The paying agent would be discharged from the trust by paying over the amounts held in trust to the bond trustee. It is important to note that this indenture is necessary as the paying agent is the agent of the bond issuer and, in the absence of an indenture, the agent owes no fiduciary duty to the bondholders.

However, it is generally inappropriate to ask principal paying agents acting in international bond transactions to hold monies in trust for bondholders for the following reasons:

- **US trust account is driven by US regulations** : The US experience is driven by section 317(b) of the US Trust Indenture Act which requires all sums held by any paying agent for payment of principal or interest on the bonds to be held in trust for bondholders or the trustee and that notice shall be given to the trustee of default in making such payment. In the context of listed bonds, paragraph 602.01 of the Listed Company Manual of the New York Stock Exchange also requires that funds deposited with a paying agent for the purpose of paying principal or redemption price of debt securities must be impressed with a trust for the bondholders and that if the depository is not a qualified bank or trust company, the funds must be segregated and held by the depository as a separate trust fund for the benefit of those persons entitled to receive payment of the funds. These

provisions do not apply in the context of non-US bond transactions, and are driven by policy concerns for the protection of public bondholders in the US.

- **Bondholders should not bear paying agent's insolvency risk :** As agent of the bond issuer, the insolvency risk of the paying agent properly rests with the bond issuer. If the bond issuer were to make bond related payments to the paying agent and the paying agent were to become insolvent, since the paying agent received the monies in its capacity as agent of the bond issuer and not of the bondholders, the bondholders have not received the payments and the bond issuer is not discharged from its payment obligations. If the paying agent were purportedly to act as trustee for the bondholders, the bond issuer would be discharged upon paying the paying agent notwithstanding that the bondholders may not receive full payment due to the insolvency of the paying agent. This would be unacceptable in the market as bondholders are not equipped to assess and to bear paying agent's insolvency risk. There would also be an impact on the rating of the bonds and appropriate additional risk disclosure.
- **Inconsistency with agency role :** As noted above, a paying agent normally owes no fiduciary duty to the bondholders. A paying agent is not set up to discharge such duties. For example, at the operational level, staff would not be trained to discharge such higher duties and funds received are generally comingled in an omnibus account and not segregated so as to adequately identify the subject matter of the trust. The operational and cost implications would be significant. This is also at odds with the standard payment provisions in an agency agreement under which the agent acts as paying bank for, and agent of, the bond issuer and payments are made on behalf of the bond issuer. The bond issuer normally indemnifies the paying agent against losses arising from discharging its agency functions. If the agent acts for the bondholders, its effect on the indemnity provision should also be considered. The standard agency agreement also provides that an agent has no obligation towards or relationship of agency or trust with any bondholder. This would obviously need to be amended if the paying agent holds bond payments in trust for the bondholders.
- **Building the trust framework :** If the principal paying agent were to hold monies in trust for the bondholders, then the agency agreement would require a number of detailed provisions to support the agent's trust-related obligations. For example, the agency agreement would need to provide for the identification of the beneficiaries of the trust, how the principal paying agent is to obtain discharge of its trust obligations, and how the principal paying agent is to deal with the trust monies such as reinvestment and accounting for interest.

In practice, paying agents are sometimes asked, within the existing paying agency framework, to include general language to the effect that the bond payment received from the bond issuer are to be held in trust for the

bondholders. As this change fundamentally alters the rights and obligations of the parties to the bond transaction, it would be unwise to include such general language without detailed consideration of the issues raised by the points above to avoid potentially serious and unintended consequences.

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