Spotlight on Trustees: Adapting to "streamlined" documentation provisions

This briefing focuses on some of the prominent changes in approach and consequent effect for trustees in agreeing to amendments, waivers and consents and the changing landscape in which trustees operate in the capital markets.

Key issues

- Restricting or removing trustee discretion is an ongoing theme on which investors and trustees appear to agree
- Negative consent provisions are becoming more commonplace in structured finance documentation
- Issuers and investors are looking for more efficient ways of soliciting and providing consent and electronic voting goes some way to achieving this aim
- Third party advisers are performing roles traditionally within the remit of the monolines and trustees will be keen to ensure that the division of responsibilities between them and such advisers is clearly delineated

Introduction

In the current economic climate, and partly as a response to the global financial crisis, originators, arranging banks and issuers of structured finance transactions have sought to make transactions more readily 'fit for purpose' so as to meet the expectations of investors and other market participants, whilst still fulfilling their economic needs.

The desire to move away from repeat transactions and so-called 'cookie-cutter' documentation has necessarily meant that there have been more tailored transactions brought to market, but also that those structuring these transactions have had to look carefully at the way they mandate their advisers and service providers so as to maximise value and efficiency throughout the life of the transaction.

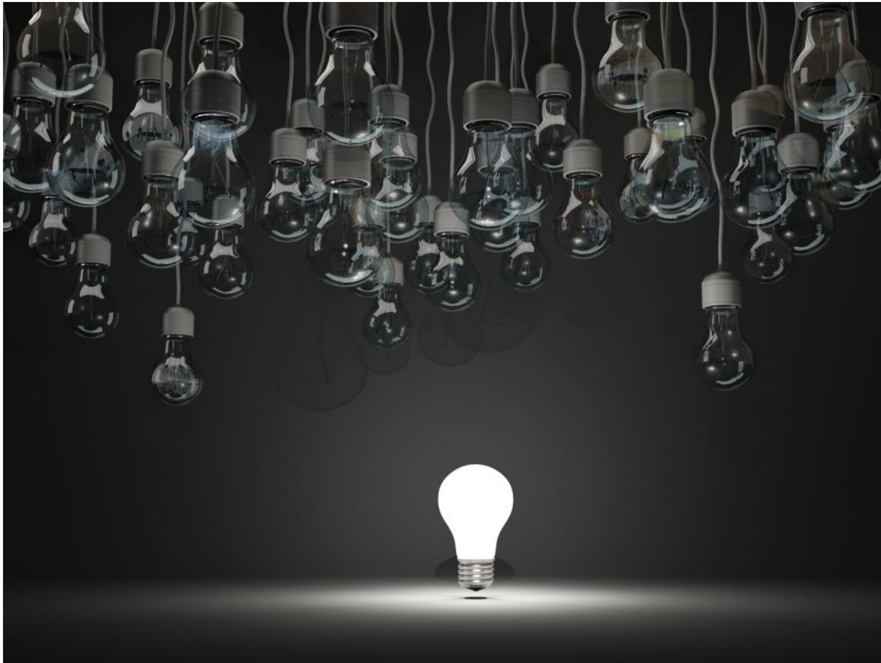
With renewed focus on efficiencies and difficult market conditions compounded by limited liquidity and often tight secondary market trading, trustees have had to adapt to stay competitive ahead of other rivals and service providers. As an independent entity with an active part to play in transactions post-closing, the role of the trustee has evolved in recent years.

Investors count

In November 2012, the CMBS 2.0 Committee established by the Commercial Real Estate Finance Council (CREFC) Europe published its best practice principles for CMBS transactions following consultation with a range of market participants, including investors, trustees, lawyers and other industry experts. The aim was to develop some consistency across CMBS transactions and limit the risks to which investors were exposed. The CREFC principles have been adopted to varying degrees but are considered best practice guidance for new CMBS.

As a consequence of the sharp increase in defaults and restructurings during and since the credit crunch, investors in CMBS transactions increasingly wanted to limit or even eliminate the discretion of trustees so that the role became more mechanical.

This seemed to accord with the spirit of what trustees had been seeking to achieve through their terms of appointment. However, the CREFC principles went further to provide guidance as to how this might be achieved, by proposing trustees place primary reliance on the use of expert advice when asked to exercise their discretion and rely on the veracity of



that advice (backed by professional indemnity insurance) rather than seeking additional indemnities from investors.

Trust deeds for structured debt transactions in any case typically contain a senior ranking indemnity in favour of the trustee from the primary obligor and entitle trustees to rely on expert advice without liability and to refuse to act unless they have been indemnified to their satisfaction. Some might query whether the CREFC guidelines really improve the situation? If an expert is willing to provide an indemnity to the trustee, the trustee would have to be satisfied the indemnity were 'satisfactory', which it may not be, and the extra risk to the expert would probably be reflected in its own fee (which might increase as a consequence of the expert needing to pay for its own enhanced indemnity cover, if it were available). This extra fee would itself be passed back by the trustee to be paid out of the transaction. If the expert refused to provide an indemnity or capped it, the trustee might then require a back-up indemnity from the investors. In short, someone has to take the risk in these situations and it is not clear that the guidelines have cleanly solved how this can be achieved.

In theory, there ought to be few areas in which the interests of trustees and investors diverge. Issues surrounding indemnification, instructions and reliance, however, have seen rifts develop between trustees and their beneficiaries. In addition, despite their apparent common interest, a significant hurdle in implementing investors' views has proved to be the divergence in views amongst the investor base itself, which leads to the trustee being at risk of adverse claims from one investor group if it follows the views of another.

In many cases where investors are given the opportunity to tailor their own transactions, trustees have had to navigate a common position while seeking to maintain their own fundamental protections and exculpations.

Market acceptance of 'negative consent'

Issuers and originators are increasingly looking to circumvent the need for trustees to exercise their discretion in agreeing to amendments, waivers and consents. In the past, notification to investors that the trustee intended to exercise a discretion unless, within a specified period of time, investors notified the trustee of an objection (often termed 'negative consent') was used sparingly and was generally considered to be a measure of last resort since the use of negative consent was not an express term of the trustee's appointment.

During the wave of counterparty downgrades by the rating agencies in the last few years, negative consent was seen by some as a practical solution where existing service providers no longer met the rating criteria provided for in the transaction documentation and there were no suitably qualified alternative providers available.

The CREFC principles reflected investor feedback that a negative consent process should be an option in relation to technical or administrative matters or where rapid investor input is required with respect to a difficult issue; however, it should not go so far as to become the principal or only method

for obtaining investor consent. The issue trustees are left with is that they would ultimately be called upon to be arbiter of what is in fact technical, administrative or a 'difficult issue' and could be exposed to challenge for allowing the proposal to be put to investors by means of negative consent, instead of the more standardised discretionary options or seeking investor consent in the normal way.

More recently, members of AFME (the Association for Financial Markets in Europe) have championed a model form of negative consent wording (as part of their "Modifications Without Direct Noteholder Consent: Wording for inclusion in Terms and Conditions") pursuant to which a trustee would be required, subject to the satisfaction of various conditions, to agree to certain categories of transaction document amendments (including those driven by changes to rating agency criteria and, for instance, in respect of recent regulation such as EMIR (European Market Infrastructure Regulation)).

Trustees and their advisers have been active participants in the dialogue which resulted in the AFME model wording. In contrast to the historic use of negative consent, the model wording would be disclosed to investors in their offering document and provide that the trustee is **obliged** to agree to the relevant changes assuming, inter alia:

- the proposer provides a company certificate confirming that the changes are necessary to cover the scenario envisaged and that those changes achieve only the specified effect;
- the trustee retains a veto to refuse to agree to any modifications which would have the effect of exposing the trustee to liabilities or increasing its obligations or decreasing its rights and protections; and
- reserved matters (i.e. changes to fundamental commercial terms, such as maturity dates or priorities of payment) would be carved out of the application of the power on the basis that investors expected to retain the ability to determine such important commercial matters themselves.

Whilst the approach to agreeing the model wording was collaborative, the precise scope of the wording to be agreed on a given transaction is still likely to require careful consideration by trustees, particularly where the impact on investors of certain categories of modification might be said to be unclear at present.

It is evident for example, that in respect of the rating agency related changes, the wording which is encapsulated in the model drafting is far more detailed than that proposed in respect of some of the other potential categories of mandatory change and could be said to result from the evolution of language and practice in numerous transactions since the issues related to rating criteria changes and downgrades became commonplace.

Some of the most challenging exercises of discretion for trustees are where they are asked to agree to amendments "necessary to comply with changes in law or regulation" (as it is sometimes referred to in the transaction documents). This is because it is not always straightforward for trustees to determine if the amendments are in fact necessary and that there are no other viable alternatives. With the model wording, it will be for the requesting party to certify which "limb" of the mandatory modifications clause the proposed amendment falls within and whether the proposed drafting specifically achieves that amendment.

To the purist, negative consent wording effectively denies investors a forum for discussion regarding the relevant change, but this has to be balanced against the fact that under the model wording investors are deemed to have agreed to such provisions by investing in the debt instrument. They also have 30 days in which to object to the modification and a relatively low percentage of noteholders would be required to object. If there is such an objection, the modification cannot be made by means of a negative consent, but must instead be agreed through the traditional noteholders' extraordinary resolution.

Whilst there is no court precedent specifically dealing with the concept of deemed investor consent in lieu of a trustee exercise of discretion, the position is akin in some regards to the concept of estoppel. In other words, the investors know or should know the contents of the documents that contain the terms of their investments. Thus it is argued that investors are on notice (or are deemed to have notice) of the contractual provisions governing their rights (which are expressed to be binding on them) and if the trustee receives certification that the modification proposal falls squarely

within the relevant category, the trustee ought to be able rely on certification, including as to the outcome of the negative consent process, without liability which might otherwise attach to the trustee under the general law and principles of equity. In the absence of binding precedent, the possibility that a court might impose certain fiduciary duties on the trustee even where these are excluded by the terms of the trust deed seems highly remote, but cannot be discounted completely.

Modernising consent solicitations

Issuers can be reluctant to approach investors directly to agree consensual modifications or waivers because of the time and costs involved in holding noteholder meetings. Transaction document provisions governing the meeting process do not truly reflect the process by which noteholders vote for resolutions and such procedures are (where the notes are held in global form), subject to the procedures and deadlines imposed by the clearing systems.

Noteholder meetings typically require 21 clear days' notice be provided to noteholders and if the initial meeting is not quorate, issuers must then wait for at least another 14 days to call an adjourned meeting for another chance to pass their resolution. The process is also reliant upon notices being sent through the clearing systems which, due to the chain of participants and account holders, might mean that noteholders are left with less time to decide on the proposal(s) once they actually receive a notice of meeting.

As a result of perceived difficulties with the formal meeting process it is becoming increasingly common to include provisions in transaction documents providing for electronic voting. In such cases, noteholders deliver voting instructions through the clearing systems with respect to their notes, and no physical meetings are held in respect of the vote. If the notes are held through the clearing systems, noteholders holding a requisite percentage of notes may approve a resolution within a certain (reduced) timeframe by communicating their electronic instructions through the clearing systems and thereby short circuiting the more formal time and cost restraints of a traditional noteholder meeting.

If the voting procedures and mechanics are clear and the resolution confirms that the trustee is authorised, directed and exonerated to effect the relevant modification or waiver, trustees are unlikely to feel uncomfortable by this move to modernise the archaic workings of the meeting provisions within the trust deed.

Members of the ICMSA (International Capital Market Services Association) have actively endorsed a pro forma set of standardised provisions for meetings and voting for use on capital markets transactions with the aim at streamlining and simplifying bondholder voting procedures. One of the features of the pro forma provisions was electronic voting, and this, more than any other endorsed feature, has been readily used in the market.

Quasi-monoline advisers

The infrastructure market has seen new "advisory" entrants which have replaced certain services that were previously in the domain of the monolines. These providers are not necessarily triple A-rated, as the monolines were historically, they do not guarantee principal or interest

payments for investors and, most significantly for the trustee, do not provide an indemnity to the trustee when the trustee acts on its instructions. In other respects, though, they fulfil many of the duties that a monoline would provide, in particular, evaluating project risks, conducting due diligence and modelling and providing structuring input, ongoing monitoring and investor recommendations.

Whilst these providers are not seeking to capitalise on the traditional duties of a corporate trustee (indeed a trustee would typically exculpate itself from any liability to monitor the transaction covenants or advise on creditor recommendations), they inevitably affect the landscape within which a trustee would operate on a transaction.

For investors, these advisers provide a valuable 'insiders' view' regarding creditor issues and decisions during the life of a transaction. Separately, trustees will be keen to ensure that their role *vis a vis* the investors, the adviser and other secured creditors is clearly defined and that the division of responsibility between the trustee and the adviser does not leave rights or obligations unattributed.

As the infrastructure bond market continues to develop, it will be interesting to see how the role of such advisers will evolve alongside changes to consent solicitations and negative consent provisions.

Conclusion

Trustees have to adapt their role to accommodate market changes, from new-deal cycle to requests for amendments or waivers and then defaults and restructurings. Recent 'streamlined' documentation provisions have provided some concerns for trustees, but broadly speaking, trustees have reacted favourably to these changes as a part of the general evolution in their role and duties.

Trustees are acutely aware of the reputational risk and commercial pressures that their business might be faced with, but additionally, need to be beyond reproach in the pursuance of their duties on a transaction. Trustees have generally welcomed the ability to rely on the mandatory consent clauses, but inevitably realise that there is not a 'one size fits all' solution and that they will need to consider any potential risks in agreeing such provisions, at the relevant time and in light of the particular features of a transaction.

The continued focus of industry bodies, such as ICMSA, on matters affecting trustees is pivotal in establishing common concerns and helping to find solutions which assist the capital markets. With the current wave of regulatory change and potential unintended consequences for trustees, there are likely to be many more interesting challenges ahead.

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