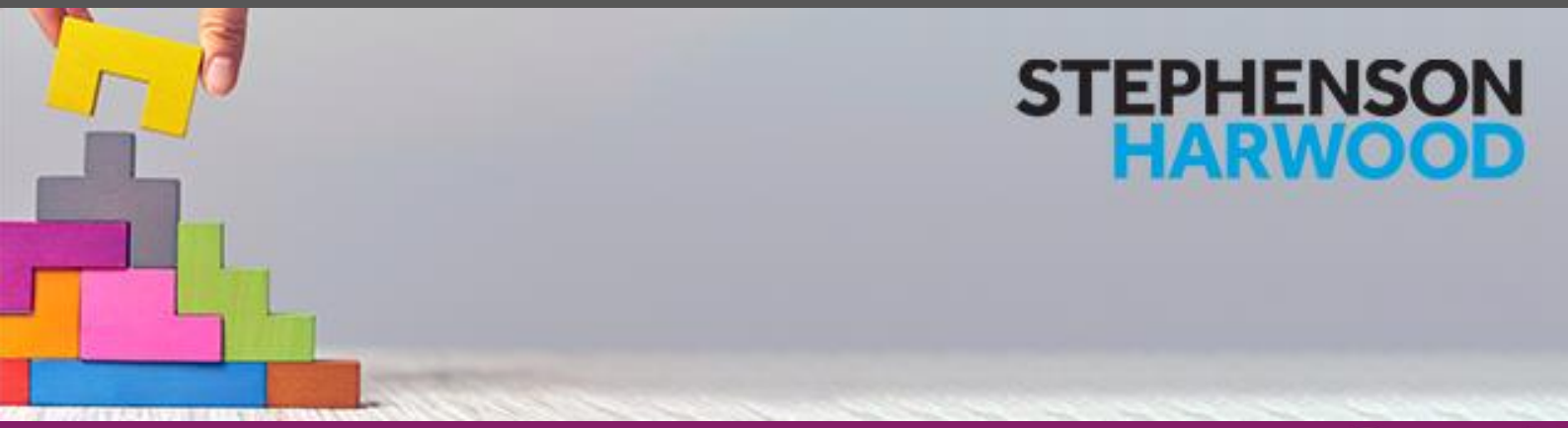

Trustee Basics: Edition 4

Events of default

The issue

As we noted in our previous article on the "no action" clause, in a note issue with a note trustee, it is the note trustee who has the right to take enforcement action against the issuer. The noteholders only have direct enforcement rights if the trustee, having become bound to do so, fails to take action within a reasonable time.

This limitation on the ability of noteholders to enforce their rights directly against the issuer is key to the way a note issue constituted by a trust deed works. This is seen particularly clearly in the events of default and acceleration provisions, where the note trustee retains key discretions and remains responsible for making key determinations.

For example:

- Only the trustee can call an event of default under the relevant condition of the notes and accelerate (i.e. require the issuer to pay back the principal outstanding and any accrued but unpaid interest).
- A number of events of default other than failure to pay and the winding-up or dissolution of the issuer (and any guarantor) often do not even arise under the conditions unless and until the trustee has certified that, in its opinion, the relevant event is materially prejudicial to the interests of the noteholders.
- Certain events of default may be expressed in the conditions to be subject to grace periods, unless the trustee determines that a particular event of default is "*incapable of remedy*".

These determinations are rarely straightforward for the note trustee to navigate. The trustee often finds itself having to make them at the very point when a transaction is in, or approaching, distress, which serves to add additional pressure.

Once an event of default has occurred, there are certain steps a note trustee would be prudent to take so as to ensure it is communicating with and preserving the rights of its beneficiaries, as well as protecting its own position.

The current law

The trustee will usually have no active duty to monitor breaches

Most note trust deeds will include a provision to the effect that the note trustee can assume that the issuer is performing and that no event of default or potential event of default has occurred unless it has received notice (or, sometimes, has actual knowledge) to the contrary.

This clause aims to ensure that the trustee is not required to monitor the issuer's performance proactively.

The case of *Infiniteland Ltd v. Artisan Contracting Limited*[1] confirms that actual knowledge, where relevant, is a person's own knowledge, rather than knowledge attributed to that person (either because the person ought to have it ("constructive knowledge"), or because it is knowledge of the person's agent ("imputed knowledge")). Therefore, the knowledge of an agent appointed by a corporate

[1] [2005] EWCA Civ 758

trustee (including its advisor) would not constitute the trustee's own actual knowledge. Whether the knowledge of a particular officer within a company will always be attributed to the corporate is more difficult to address in general terms[2]. However, due to the nature of the corporate trustee's business and the role played by the trust officers who work for it, the safe assumption would be that it is likely to be.

Determining whether an event is "materially prejudicial to the interests of the noteholders"

As noted above, many events of default will not be deemed to have arisen unless and until the trustee certifies that, in its opinion, the relevant event is materially prejudicial to the interests of noteholders.

The phrase "*materially prejudicial to the interests of the bondholders*" was given judicial consideration in the case of the *Law Debenture Trust Corporation p.l.c. v Acciona SA*[3].

In this case the phrase "*interests of the bondholders*" was held to mean not only the contractual entitlements of holders under the bonds to be paid on time, but also contractual entitlements under the bonds designed to protect that entitlement to receive timely payment. In *Law Debenture v Acciona*, this included the right to appoint a representative to the issuer's board to control expenditure by the issuer.

When making its determination the trustee must also be satisfied that the event has caused actual (rather than potential) material prejudice. This contrasts with the note trustee determining that a modification is not materially prejudicial to the interests of noteholders, where (as we explained in edition 1 of our trustee basics series (A Note Trustee's discretion to agree modifications)) a note trustee is likely to need to consider potential (as well as actual) material prejudice.

Determining whether an event is materially prejudicial to the interests of holders will often be a balanced judgement, involving an investigation of the breach, its circumstances and its consequences.

In line with the case law on the trustee's exercise of discretions, the trustee does have an active duty to consider whether or not to exercise its discretions. This would likely include a duty to consider whether or not to certify material prejudice.

Determining whether a breach is capable of remedy

Determining whether a breach is capable of remedy is often no less straightforward than making a determination of whether an event of default is materially prejudicial to the interests of bondholders.

The courts have made it clear that it is possible to remedy many breaches, even breaches of a negative covenant[4]. The key appears to be whether the mischief resulting from the breach can be addressed.

Reserving rights

Most trust deeds will provide that, following the event of default, the trustee may accelerate the notes at its discretion, but will be obliged to do so if it is directed by the holders of a certain percentage of the notes, or by extraordinary resolution, and is indemnified to its satisfaction. However, in most situations the trustee will not wish to exercise its discretion to accelerate and will prefer to wait until it gets instructions to do so from the relevant noteholders, and is satisfied that it will not incur any unindemnified liability.

It can take time to coordinate the necessary noteholder directions and to get in place an indemnity which may be necessary to satisfy the note trustee. Consequently, to avoid any risk of the issuer trying to argue that the relevant event of default has been waived, a sensible course of action is likely to be for the note trustee to send a reservation of rights letter to the issuer. As its name suggests, in a reservation of rights letter, the trustee would make it clear that, while it may not enforce immediately (often because it is awaiting noteholder instructions or a satisfactory indemnity) it reserves its right to do so in the future.

Once the trustee has issued a reservation of rights letter, it is also important to ensure that any subsequent action taken by the trustee is consistent with the reservation of rights letter to ensure that it does not inadvertently waive the event of default in question. It is clear from recent case law that reserving rights is not effective in all scenarios and a party's conduct can override a reservation of rights.[5]

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[2] The leading case on attribution of acts or knowledge to a corporate is Meridian Global Funds Management Asia Limited v Securities Commission [1995] 2 AC 500, more recently followed and applied by the UK Supreme Court in Bilta (UK) Ltd v Nazir (No 2) [2015] UKSC 23.

[3] [2004] EWHC 270 (Ch)

[4] The Supreme Court's decision in Telchadder v Wickland [2014] UKSC 57 discusses when a breach of contract is capable of remedy and how you can remedy breach of a negative obligation.

[5] For example, SK Shipping Europe Plc v Capital VLCC 3 Corp [2022] EWCA Civ 231 and Lombard North Central plc v European Skyjets Ltd (in liquidation) [2022] EWHC 728 (QB).

Practical Tips

If a trustee is unclear whether a breach has occurred, it can request a certificate from the issuer

The trust deed will often make it clear that the trustee can assume that the issuer is performing and no event of default or potential event of default has occurred unless it has actual knowledge or express notice to the contrary. While the note trustee is under no obligation to take any active steps to monitor breaches, a trustee can of course find itself being put on notice (or receiving "actual notice") of actual or suspected breaches.

If a note trustee is unsure whether an event of default has occurred, but has reason to believe one may have occurred, it can request a certificate to this effect from the issuer. Most trust deeds will include a provision obliging the issuer to provide the note trustee with a directors' certificate confirming that, as at a date close to the date of the certificate, no event of default, potential event of default or other breach has occurred since any previous certification date (or, if none, the date of the trust deed).

If such an event has occurred, the certificate should provide details.

It is the trustee's opinion which matters

It is the note trustee who needs to form its own view on whether a breach is incapable of remedy, or whether an event is materially prejudicial to the interests of noteholders, based on an objective consideration of the relevant facts.

As a determination of material prejudice requires an objective determination by the note trustee and also requires an assessment of material prejudice to the holders as a class, it would not be appropriate for the trustee to seek to rely on a direction from the holders in this context. Similarly, it would not be appropriate for the trustee to act under the influence of, or to be pressured by, particular holders.

The trustee should not just sit on its hands

As noted above, the trustee cannot just sit on its hands and opt not to consider the issue at all. It has an active duty to consider whether to exercise a discretion or make a determination.

In *Law Debenture v Acciona*[6], Mr Justice Peter Smith explained how he viewed the obligation of the trustee in connection with the determination of material prejudice. Whilst he described it as "relatively straightforward", it is equally clear from what he said that there will never be a "cookie cutter" approach to this issue:

"…the obligation of the Trustee in my opinion, is relatively straightforward. It has to ascertain that there is a breach. It then has to ascertain the consequences of the breach. If the consequences of the breach are that the interests of the Bondholders … are materially prejudiced then, and only then can it issue a certificate. In most cases that will require an examination of the circumstances. However, that examination might be short, it might be long, depending on the nature of the breach and the acts complained of. It will also be dependent on the nature of the obligation that is broken."

When making its determination the trustee can take (and rely on) expert advice

As making its determination is likely to involve an assessment of commercial and financial matters, the trustee is unlikely to feel comfortable making the determination without the benefit of specialist advice.

Under the terms of well-drafted trust deeds the trustee will have the right to instruct and rely on expert advice (often including the right to take advice from an independent financial adviser). The trust deed will usually provide that the issuer needs to meet the cost of this advice and also that the trustee can rely on the advice without liability.

Therefore, a trustee should be protected if it relies on the advice of a suitably qualified financial adviser (or other expert) as to whether a particular event is materially prejudicial to the interests of holders.

However, in practice, it has become increasingly difficult to find financial advisers who are willing to take on mandates where there is a risk of disputes. As noted above, the trustee can't however just sit on its hands: it has an active duty to consider whether or not to issue a material prejudice certificate and it will obviously wish to do this as soon as reasonably practicable to avoid criticism by holders. Therefore, if the trustee is unable to secure appropriate expert advice, this could leave it exposed.

Consequently, when a trustee has the ability to input into the drafting of the events of default, it could consider bolstering its own position by building in some additional provisions to assist. For example,

[6] Para 48.

additional drafting could be added to the event of default condition to do the following:

- set out clearly exactly what the trustee needs to consider when determining whether an event is materially prejudicial to the interests of holders. For example, the trust deed could provide that, when assessing whether an event was materially prejudicial to the interests of holders, the trustee is required only to consider the direct effect on the ability of the issuer to pay interest and repay principal on the notes. This would reduce the scope of what the trustee would need to consider, which could also assist it to secure appropriate independent financial advice;
- confirm that the trustee is not liable for delay in determining material prejudice or whether a breach is capable of remedy; and
- provide that the trustee is not liable for any loss suffered by the issuer, the noteholders or any other person as a result of delivering a certificate of material prejudice.

Once an event of default has occurred, a trustee should take certain steps

Notice to noteholders

Once an event of default has occurred (either because it is objectively certain that the relevant event has happened and no determination of material prejudice is necessary, or because the trustee has (where required) determined material prejudice), the trustee may wish to give notice of the occurrence of the relevant event of default to the noteholders.

Most trust deeds will include an obligation on the issuer to notify the noteholders of the occurrence of an event of default. As such, why might a trustee serve the notice, rather than relying on the issuer doing it? There are a few reasons for this:

- The trustee serving the notice itself would be in line with the general principle that a trustee should communicate with its beneficiaries about issues affecting trust assets.
- The issuer may not itself be complying with its obligations to disclose the occurrence of the event of default.
- As noted above, most trust deeds will provide that, following the event of default, the trustee may accelerate at its discretion, but will be obliged to do so if it is directed by the holders of a certain percentage of the notes, or by extraordinary resolution, and is indemnified to its satisfaction. The trustee can use the notice it sends to confirm to its beneficiaries that it is not planning to exercise its discretion and will only take action to accelerate if it receives instructions from the relevant noteholders in line with the provisions of the trust deed and (if necessary) receives an indemnity satisfactory to it. It can also let the beneficiaries know how to get in touch with the trustee if (for example) they do wish to coordinate acceleration instructions and/or provision of an indemnity.

Send a reservation of rights letter to the issuer

As noted above, the safest course to avoid suggestions that an event of default has been waived or a breach affirmed is for the trustee to send a reservation of rights letter to the issuer and, subsequently, to ensure that it takes no action which would be inconsistent with the reservation of rights letter.

Consider what other rights could have been triggered by the event of default, which the trustee may wish to exercise

The rights which could arise will vary depending on the drafting of the relevant trust deed and transaction documents. However, for example, the occurrence of an event of default will often:

- entitle the trustee to request and receive enhanced information; and
- trigger the right for the trustee to direct the principal paying agent to act as an agent of the trustee (rather than the issuer) and to hold all moneys it has received under the bonds on behalf of the trustee, and to promptly pay such moneys to the trustee.

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