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## Successor note trustee roles (opportunities and pitfalls)

The exponential growth of the debt capital markets before the Lehman crisis, and increasingly complex issues and conflicts arising on highly structured transactions, have resulted in note trustees finding themselves in situations where they are unable or unwilling to continue acting. It is certainly more common now than it was a decade ago to see note trustee roles being transferred to successors.

In turn, this has led to the emergence of a new breed of independent trustee - the so-called "challengers".

This article explores the potential opportunities and pitfalls which a successor trustee role can present for both the incumbent trustee and the successor trustee.

### Delegation or replacement?

#### Delegation

A key issue for all relevant parties to consider is whether any hand over of the trustee role should be by delegation, or via the trustee's complete replacement.

Delegation involves the delegation by the trustee of all or part of its role via a delegation agreement, with the incumbent trustee remaining the "trustee of record". Delegation will need to be permitted by the terms of the note trust deed (which will ordinarily be the case).

The note trust deed will commonly enable a delegating trustee to exclude certain liability for the acts of its delegate. However, the incumbent trustee remains in the picture - even if in name only. Therefore, from a reputational perspective, the identity of the delegate will be highly relevant to the incumbent trustee.

Also, because the incumbent trustee remains the trustee of record, it will continue to benefit from the indemnity in its favour. However, the delegation agreement will almost certainly include an indemnity in favour of the delegate, which would need to be taken into account by the existing trustee when assessing the ongoing value of its own indemnity.

#### Replacement

Where the trustee is being replaced, the incumbent trustee will step out of the picture completely and the new trustee will take on its role and become the trustee of record. Replacement will usually be the route used when the incumbent trustee is stepping aside, or is being forced to step aside, because it is not comfortable with action being suggested by a group of activist noteholders.

The trust deed will dictate the procedure to be followed to effect the replacement. For example, when the investments are listed, the replacement will likely require approval by an extraordinary resolution of the noteholders.

Once the existing trustee is out of the picture, it will not benefit from an ongoing indemnity unless it has been able to negotiate one as part of the exit strategy.

#### The reason underlying the change

An incoming trustee will inevitably wish to investigate who, or what, is driving the proposed change of trustee as this can drive not only the manner in which the role is transferred, but will affect issues such as the fee and the due diligence to be carried out.

The transfer of a note trustee role to a successor can be mutually beneficial to both the incumbent and the successor trustee. There could be any number of legitimate reasons why an incumbent trustee may want, or need, to step aside.

- The trustee may be fulfilling other roles in a transaction. If a conflict arises, the organisation may wish to prioritise its other (potentially more remunerative or relationship-enhancing) roles.
- The risk appetite of the existing trustee may change as the deal evolves. Perhaps the organisation has made a strategic decision to cease being involved with transactions in certain jurisdictions, or the transaction in question has started heading towards litigation and the existing trustee does not have the appetite for that.
- The existing trustee may simply cease to meet certain eligibility criteria required on the particular transaction.

However, an incoming trustee is likely to be more cautious where the driver for change is an activist noteholder group. There is an increasing trend for "ad hoc" groups to seek the transfer of the note trustee role to a new trustee organisation, perceiving (rightly or wrongly) that it will be easier to force through the ad hoc group's preferred course of action with a "tame" trustee in situ. Or perhaps the existing trustee is itself stepping down because an activist group of noteholders is pressuring it to act in a way it is not comfortable with.

While the ad hoc group is now an established part of the furniture in most distressed capital markets transactions, dealing with "ad hoc" groups is always challenging for note trustees.

Crucially, the protective provisions in most trust deeds are drafted to protect trustees acting on the instructions of a steering committee appointed by extraordinary resolution of noteholders. In the absence of a formally appointed steering committee the trustee's duty must always be to the class.

However, most ad hoc groups have no desire to form a formal steering committee as the constituent members will wish to preserve their ability to continue trading in the relevant notes (which membership of a steering committee will ordinarily curtail). Consequently, membership of an ad hoc group can change rapidly and it can often be difficult for a trustee to know who it is dealing with at any given time.

Furthermore, ad hoc groups commonly have commercial agendas, and not all members of the ad hoc group will necessarily have the same agenda. Ad hoc groups can also take (sometimes seemingly

illogical) positions as noteholders to arbitrage other creditor positions held in the deal. This clearly increases the likelihood of conflict with the trustee's duties/obligations to noteholders as a class – as well as raising the spectre of market abuse issues.

## Transaction dynamics

### Credit profile

When taking over a role, understanding the overall credit profile of the transaction will be critical for an incoming trustee – not least so that it can work out how to structure and calculate its fee.

- Is the transaction already in default, or is there a risk of imminent default? If the answer is yes, what is the nature of the default and what will the likely creditor response be?
- Is the insolvency of the issuer likely or possible, and what would the potential effect on creditor outcomes be? It can be important for a trustee to understand where the value breaks in an insolvency situation.
- Is there sufficient cash flow in the structure to fund fees and advisors' costs? If not, is a noteholder indemnity available?
- Might there be a need to enforce in problematic or politically sensitive jurisdictions? If there is, this will usually protract the enforcement process and make it much more expensive.

All of the above issues could present good reasons for a trustee to want to exit a transaction. However, equally, so far as a successor is concerned, the credit profile of the transaction will be absolutely critical to understand.

### Relationship between key players

An incoming trustee must evaluate not only the dynamics between the transaction parties, but also the position and attitude of relevant creditors.

Crucially, could the trustee risk being caught in the cross-fire between different creditor groups with different concerns and motivations? The position of different classes of noteholders or swap counterparties could need to be considered, for example.

Also, how does the role of a note trustee interact with the role of a security trustee on a structured financing? In structured transactions a single institution will commonly take all the "trustee" roles at the outset. That institution may hold bank accounts and therefore wish to retain the role of security trustee - even if it wants to divest itself of the role of note trustee.

In this situation how will the dynamic between the two trustee roles work on an ongoing basis? It seems likely, for example, that the security trustee may require an indemnity to take enforcement action, even if it is protected by acting on the instructions of the note trustee.

### Beneficiaries

The need for a trustee to know who its beneficiaries are seems a very obvious point to raise. However, definitions used in trust deeds can sometimes be unhelpfully drafted, so it only becomes clear from delving into the documentation that the trustee is not just the "note trustee", but is also acting as trustee for various other creditors. This clearly complicates the trustee's position as it has to take into account the needs of those other beneficiaries.

Also, if the trustee is trustee for swap counterparties, whether or not the liabilities have crystallised via close-out of the swap positions will be key. In an enforcement scenario the beneficiaries set to recover could in fact principally or solely be the swap counterparties (rather than the noteholders). But equally, that position can change.

Therefore, knowing where the value breaks on an ongoing basis in an insolvency situation can be very important to enable a trustee to discharge its trust obligations.

### Fees and due diligence

There will inevitably be a reason why an existing trustee will be standing aside on a deal. If that reason involves additional risk for any successor, this will commonly justify the charging of additional fees.

Renegotiating a fee to reflect the current deal dynamics therefore commonly represents a key opportunity (and driver) for an incoming trustee.

It is important that none of the parties involved underestimate the due diligence required on the transaction. The due diligence may also be critical in setting the quantum of the ongoing fee.

An incoming trustee may well be urged not to reinvent the wheel, facing arguments that a lot of due diligence and advice has already been provided at a cost to the overall transaction.

However, an incoming trustee may not have been told the full story (particularly if telling the whole story could be a disincentive to taking the role). Furthermore, issues may have been previously (albeit inadvertently) overlooked.

As part of the whole due diligence and pricing exercise it will, of course, be essential to consider carefully the scope of the reliance provisions in the trust deed and the position of successors.

### Reputational considerations

As part of any decision to take on an existing role the incoming trustee will need to consider its reputation. How might a trustee's competitors view a decision to take on a role? Other trustees are, of course, a source of referrals.

Is the fee being offered (and the arrangements and timing for payment of that fee) so attractive that it outweighs any potential reputational risk considerations?

Probably more relevant to a trustee than the reaction of its competitors is the likelihood of an incoming trustee's conduct being subject to judicial and market scrutiny.

Finally, if it did become necessary to enforce, could the underlying assets in the transaction be potentially toxic? The press (and potentially the judiciary) can take a rather different attitude when there are vulnerable classes of people involved with the underlying assets.

*Based on a talk delivered by [Charlotte Drake](#) at the 2019 Annual TACT Conference (22 May 2019)*

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