Comments on behalf of
The Association of Corporate Treasurers
in response to Consultation Paper 171,

Trustee Exemptions

(The Law Commission, December 2002)

I Introduction

The Association

The Association of Corporate Treasurers was formed in 1979 to encourage and promote the study and practice of corporate finance and treasury management and to educate those involved in the field.

Today, it is an organisation of professionals in corporate finance, risk and cash management operating internationally.

A professional body and not a trade association, it has over 3,000 Fellows, Members and Associate Members. More information is available on our website, www.treasurers.co.uk.

With more than 1,200 students in more than 40 countries, its education and examination syllabuses are recognised as the global standard setters for treasury education.

Members of the Association work in many fields. The majority of Fellows work in large UK public companies, responsible for the treasury and corporate finance functions.

The ACT usually comments from the corporate and not the financial services sector standpoint.

This Consultation

The ACT welcomes the opportunity to submit views on this important topic and appreciates the Commission's willingness to receive comments after the closure of the formal consultation period.

We would be pleased to further expand any point made herein or to assist the Commission in any other way

July 2003

II Summary of principal points

Our comments deal only with the types of trustee appointments associated with corporate finance, including asset based and project finance (corporate finance trusteeships). These appointments are of a different kind from those associated with settlements and charities, the main concern of the Commission in its Paper. They are much more akin to contracts between competent, well advised parties.

- We believe that the current system works well and in the interests of all parties – those raising funding, those providing it and trustees.
- Existing protections for "beneficiaries" under CA 85, s. 192 (and similar provisions applied in corporate finance trusteeships to which CA 85 s, 192 does not apply) are satisfactory and are seen as such by the market.
- Changes would have substantial effects on practice and be materially damaging not only to the corporate sector in its funding arrangements but also to the position of London as a centre for corporate finance activity.
- Whatever changes to the law of trust regarding trustee exemptions should not apply to trusts in this corporate finance field.

III Comments

Background to corporate finance trusteeships

Development of the markets

The development of the markets in corporate finance since the growth of modern communications have generally been driven by companies raising finance seeking funding

- in the volumes they require
- with risk characteristics they find acceptable
- with appropriate maturities
- at lowest cost
- under arrangements flexible enough to deal with the requirements of both fund raisers and providers of funds and adaptable to whatever mechanism (which may be novel) for the funding.

Thus the growth of the Euromarkets followed US changes which disadvantaged funding in its domestic market. Equally, within the EU the absence of significant domestic funding markets in some countries reflects the rigid and inflexible regulations applicable to those markets.

Not all companies are in a position to have access to all markets and some markets do not provide all possible features (e.g. maturity ranges). But Euromarkets illustrate that substantial numbers of fund raisers and providers of funds are able to look internationally for their activity.

Eurobond market practice: use of trustee or fiscal agent?

From the earliest days of the Eurobond market, there was an important debate about whether bonds should be constituted by trust deed (with a trustee acting for the bondholders) or whether there should simply be a fiscal agent (who would have no brief for the bondholders). The latter was a continental concept, the former borrowed from many decades of UK domestic practice.

Of course use of any particular structure requires the agreement of both fund raiser *and* provider of funds.

The continental issuers were slow to accept the trustee structure but did so because they saw the merits of being able to deal during the life of the bonds with one focal point rather than numerous, often anonymous, bondholders (e.g. to propose an amendment to the terms or to discuss a breach of covenant).

Similarly, bondholders came to like the trust concept because the muscle of all the bondholders could be brought to bear on the issuer (through the trustee), for example in the case of a workout[1]. (See also para 4, page 6.)

[1] Adela, the first rescheduling of a corporate Eurobond, 1981 was a case where the bondholders did well by having a trustee (See Anderson, "Adela: the Violation of the Bond Market", Euromoney, Sept. 1981, p. 10 and Watkins, "How to Reschedule a Bond Issue", Euromoney, Jan. 1983, p. 103.)

On the other hand, a major factor in considering whether the trust structure would suit the Eurobond market (or the UK domestic capital market) has always been cost.

The treasurer/finance director of a company going to the market for debt funding needs to know how much it will cost. This requires (a) that the cost be no greater - or not materially greater - than an issue without a trust structure, and (b) that there be no escalation during the life of the issue in trustee fees, except perhaps for indexation. (This is essential in securitisations, as everything (in terms of rating and pricing) hinges on the integrity of the cash flows.)

Providers of funds

Investors in Eurobonds, loan stock, debenture stock or other forms of security constituted by trust deed ("debenture trust deed") are normally sophisticated. They all see listing particulars, which inform them of the trustee's powers and exculpations, before deciding to invest. In the case of private placements with one or a small number of providers of funds or in project finance where there are no listing particulars, the initial investors actively negotiate the deed and later holders see the deed itself. In other words, the type of trust we are concerned about here is worlds away from the normal settlor/beneficiary, or charitable, trust that the Commission is mainly concerned with in its paper.

Liability exemption for corporate finance trustees – current practice

The trustees of debenture trust deeds do not have the type of sweeping liability exemption that the Consultation Paper generally speaks of. Indeed, they cannot, because of CA 85, s.192. There is therefore no question of a debenture trust deed trying to absolve the trustees of liability (or indemnifying them) for breach of trust arising from the failure to show the degree of care and diligence required of them.

Exemptions in corporate finance trusteeships not governed by CA 85, s. 192 generally are comparable in effect with the section.

Comments on the current arrangements

CA 85, s. 192 and comparable provisions

We believe that s.192 is well drafted and fits well-worn and recognised debenture issue practice.

It recognises that, in deciding whether the trustees have committed a breach of trust by failing to show the degree of care and diligence required of them as trustees, the court must have regard to the powers, authorities and discretions conferred on the trustees by the trust deed. These always include a number of matters which the market views as standard and acceptable, such as the ability to assume that the issuer is not in breach of its covenants, etc. (unless the trustees are put on express notice that such is not the case).

Thus the trustee is able to avoid doing voluminous audit-type work just to satisfy itself that the issuer is in compliance. This substantially reduces cost. However, usually the trustee will, under the deed, be in receipt of an annual certificate of compliance from the obligor to the effect that the obligor is in compliance with the various covenants under the trust deed and that there are no outstanding events of default. To the extent that the certificate is not satisfactory, the trustee will make further enquiries. Without the trust deed in place it would be very difficult for this type of comfort to be obtained on behalf of all bondholders.

Another standard power is the right not to take action against the issuer without the sanction of a vote at a meeting of, or the consent of a minimum level of, bondholders and without receiving from bondholders an indemnity against the litigation costs (bearing in mind that the trust property normally contains no funds that the trustees can access[2]). Obviously, no trustee would take on the trusteeship without this power.

Insurance?

It is suggested that perhaps the alternative to present exemption practice would be insurance.

In fact, it would not be possible to arrange special PI cover on an issue by issue basis - even if the insurance market (a) was willing to operate in this way (it has not been) and (b) had the capacity.

Insurers would have to agree a fixed premium (possibly with indexation) to cover the many years of the transaction. This would be contrary to the normal practice of the insurance market, where insurers assess their appetite for risk (capacity) on an annual basis and are capitalised accordingly. Furthermore, the typical issue timetable would simply not permit this procedure. The time insurers would take to understand the particular transaction is orders of magnitude greater than the time available.

Also, the cost would depend on the market at the time and would thus be variable from issue to issue. This rules out the ability for the arrangers of the issue to quote a reliable trustee cost to the issuer to enable the decision to be made in principle to go ahead with the issue on the basis of a UK-based corporate finance trusteeship. The costs in any case would make the structure using UK corporate finance trusteeships unviable. This would force the issuer to use the much less satisfactory fiscal agency structure or non-UK-based trusteeship. There would be an even more serious structural problem if the (non-UK-based) trustee was to hold security, as would be the case for all UK securitisations, debenture (and mortgage debenture) stock issues and project financings.

The capital sums involved in the markets concerned are vast. Capacity for insurance of corporate finance trustees on the current basis is already very restricted. It is unlikely capacity could be developed to serve the new market.

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[2] In some cash-flow trusts funds may flow via the trustee but the trustee's claims are generally subordinated to those of beneficiaries.

Comments on proposed changes

Impact on fund-raising companies and London as a financial centre

London's success as a global centre for corporate finance activity is often said by economists to reflect among other factors the effect of the "cluster" of support activities.

We believe that the London "cluster" would be greatly weakened if a change in our law of trusts led to a reduction or discontinuation of the kind of structure for corporate financing which we have discussed above, or to the export of the trustee role to other common law jurisdictions. The former would mean that fund raisers (and providers of funds) would not have available structures of choice. The latter would bring attendant tax and other issue risks and complexity – including greater legal costs.

Securitisations - of which London has a very important share - and other forms of structured finance (e.g. project financing), to say nothing of secured sterling issues such as mortgage debenture stocks for UK property companies, would be impossible without the trustee structure. Nothing should be done to prejudice this.

Where a UK type trustee arrangement is adopted, its effectiveness in some cases depends on the resolve of the trustee to stand up to a section of beneficiaries – such as incoming "vulture funds" – and seek to represent the interests of beneficiaries as a whole. The changes proposed in the Consultation Paper would be unhelpful in this context.

Recommendations

We strongly urge the Commission to consider the approach set out below in considering the impact of any proposed changes to the law concerning trustee exemptions as applied to what we have called corporate finance trusteeships generally.

1. Whatever changes to the law of trust are thought fit to be made, to curb the tendency of settlement trustees to seek unreasonably to exclude liability for breach of trust not involving fraud, those changes should be expressed not to apply to trusts constituted by debenture trust deeds (or other commercial arrangements, such as voting arrangements or the holding of security for debts or other obligations, done by means of trust).

   The existing protection of the "beneficiaries" – e.g. the holders of the securities, in the case of a debenture trust deed – under CA 85, s. 192 works very satisfactorily and is seen by the market to do so. It may be appropriate for corporate finance trusteeships not already subject to CA 85, s. 192 to be subject to similar provisions (which is currently often achieved by provisions in the deed itself).

2. It follows that, for debenture trusts (or such other arrangements as discussed above):

(a) there should be no reasonableness test for the trustees' exemption clause (see paras 4.52 and 4.86 of Law Commission Paper 171). To incorporate such a provision would introduce too much uncertainty for the trustees and increase the likelihood of litigation against them – all of which would increase the cost of issues and/or result in trustees being unwilling to provide their existing service, which is extremely useful to both fund raisers and providers of funds;

(b) similarly, there should not be a prohibition on exemption clauses, even if combined with a judicial discretion to exculpate – see para 4.66. This, again, would be too uncertain and encourage litigation;

(c) the standard discussed in para 4.85 – that trustees should not be able to rely on an exclusion of liability for breach of trust arising from negligence – is broadly correct, but is unnecessary given the existence of s.192 (no reliance on exclusion of liability for, or indemnity against, breach of trust arising from failure to show the degree of care and diligence required of them as trustees). If the wording of s.192 was changed to refer instead to negligence, it would be essential to perpetuate the existing qualification in s.192, i.e. in deciding what amounted to negligence, one would have to have regard to the powers, authorities and discretions contained in the trust deed; and there should be no restriction on what those powers, authorities and discretions could be, given the constant evolution of the markets and the London tradition (key to its international competitiveness) for innovation in financial structuring, which can give rise to the need for additional powers, etc. for the trustees;

(d) the gross negligence standard discussed in para 4.78 is inappropriate.

3. Whilst 2(c) above suggests that it might be acceptable for the wording of s.192 to be changed to refer to negligence (instead of the failure to show the required degree of care and diligence), this would be undesirable.

The existing system and wording work well and are recognised by the debt markets as doing so, and to make a change, even if only intended as cosmetic or for consistency with other types of trustee, could be misconstrued and thus harm the London market. Worse, it might be thought by a court to import a more substantive change, which would be unfair on trustees and potentially also issuers (if costs increase as a result). Thus, the optimum position for issuers, as well as debenture trustees, is the status quo, i.e. the recommendation in 1 above.

4. In any case, given the finely priced fees involved, to make any changes retrospective for arrangements previously made and which may have extremely long duration would be a major injustice and lead to significant market dislocation.

Contacts:

Richard Raeburn, Chief Executive
(020 7213 0734; rraeburn@treasurers.co.uk)

John Grout, Technical Director
(020 7213 0712; jgrout@treasurers.co.uk)

The Association of Corporate Treasurers
Ocean House
10/12 Little Trinity Lane
London EC4V 2DJ

Telephone: 020 7213 0728
Fax: 020 7248 2591
Website: http://www.treasurers.org