

THE (UN)CHANGING ROLE OF THE TRUSTEE



PERPETUAL CORPORATE TRUST
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“Calm seas never made a good sailor,” as the old adage goes. The same could be said for trustees; their real value shines through when the financial storm clouds loom – in times of financial stress.

When times are good, volatility is low, credit is easy and payments are flowing, you might think less about a trustee’s size, experience and skills, and more about its cost. But when markets turn you realise the value of sticking with quality.

A trustee must be impartial and will be evaluated by its ability to make decisions that are legally correct and accurate, whilst allowing for the complexity of a given default scenario.

Every deal is different and so is every breach. When non-compliance is identified, there are legal obligations but there is also a whole range of difficult choices to make. This is when a trustee’s experience and knowledge will come to the forefront. The trustee will notify security holders, offer expert advice and dive into all the issues in search of a resolution that is both fair and legal.

“You want your trustee to have the confidence of the market – and whilst that means they may not necessarily give you the answers that you want, you have to be wise enough and strong enough to accept that. If they were to bow to any one stakeholder, then they lose their core competency, and that’s not helpful.”

DECISION TIME

Difficult decisions can be daunting, but they don't have to be. An experienced trustee team can help investors decide how to engage with issuers, to trigger events or pursue legal action. The trustee can meet with the servicer to negotiate options in the face of a potential default; in a worst-case scenario the trustee can replace the servicer.

Nuance and tact are important here. This is not a battle, it's more like a ship, and all parties are on-board together. Nobody wants to see the ship go down, and the trustee is best equipped to move everyone toward a safe harbour. While all situations are different, a trustee will always act in the interests of the secured creditors it represents.

A core element of keeping the ship afloat is understanding the varied motivations of the parties. The skillset here goes beyond administration of a trust; it requires commercial smarts to appreciate the goals of the other parties, as well as legal acumen and experience to foresee legal outcomes and complications. By design, the trustee will usually hold a stronger negotiating position than individual bondholders as it represents all the investors.

"A trustee is someone who is independent, who is fair, while also being someone who actually commercially understands the situation. They can balance the commercial and legal aspects."

Issuer Comment, Perpetual Trustee Research Study 2018

When it comes to making the bold decisions, a trustee needs to have a strong balance sheet and corporate support to ensure the ship makes it to the 'safe harbour'. Here is one example of how Perpetual navigated a specific storm.

THE MAHOGANY CASE

Roughly ten years ago, Mahogany Capital issued notes – the proceeds of which were used to invest in another series of credit linked notes. The issuer of these subsequent notes then purchased 'collateral' that was made up of debt securities from banks rated AA- or higher, while also entering a swap arrangement with the ill-fated Lehman Brothers. This arrangement required Lehman to make regular interest payments to the issuer, which in turn would flow to Mahogany noteholders. A 'flip clause' was included to protect the issuer from a Lehman default.

We don't need to go into the traumatic events of 2008 but suffice to say Lehman Brothers stopped making the interest payments.

Payments were due to noteholders, but Mahogany Capital was facing a challenge – as it was being argued that the flip clause (which would give it access to the collateral pool to support repayment to noteholders), was invalid under US law. Perpetual disagreed and acted on behalf of the noteholders by taking legal action in the High Court of England and Wales. The Court found in favour of the noteholders and confirmed the enforceability of the flip clause. Lehman appealed the case but lost.

The process continued with a US court deeming the flip clause unenforceable. More appeals, more decisions, until finally, Perpetual managed to reach an agreement with Lehman Brothers.

As a result of Perpetual's action, the noteholders including charities, local councils and more than 1,000 retail investors from Australia, New Zealand and Papua New Guinea received up to 85 cents in the dollar of principal invested on Mahogany Series 1 and 69 cents in the dollar of principal invested on Mahogany Series 2. This was a complex and lengthy legal battle in which Perpetual used its expertise and financial resources (over \$1 million) to cover the cost of litigation.

When the tide goes out

Your choice of trustee matters. A good trustee will be well resourced with experienced staff, a strong balance sheet, relevant industry expertise and a willingness to use its resources and financial muscle to support the interests of the secured investors.

On the anniversary of the global financial crisis, it (pays to remember) the value of having a quality trustee like Perpetual Corporate Trust by your side.

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