

Corporate Trustees And Defaulted Bonds: Protecting A Client's Investments

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You are counsel to a company that has a significant investment in a secured corporate bond that is in default for obligor's failure to make debt service payments among other reasons. Your client is seeking your advice on possible next steps regarding the default. Your client's management decides to hold the bonds and ride out the default with the hope that the value of the bonds and the collateral that secures the bonds will increase. In this article, I review the steps you may consider in protecting your client's investments.

Step 1: Review Applicable Financing Documents

The first step is to review the applicable trust indenture¹ and other related

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agreements. The trust indenture is a contract between an obligor and a trustee in which an obligor borrows money from investors.² The obligor in turn issues debt securities or bonds to evidence the debt. In the trust indenture, the obligor appoints a trustee to perform administrative functions and to protect the investor's interests in the event of a default. If the debt securities are secured, the trust indenture will also describe the collateral.

When a default occurs, the trust indenture will provide guidance on (i) the definition of defaults, (ii) remedies available to the trustee, (iii) the trustee's obligations, (iv) who can direct the trustee to exercise remedies, (v) when the trustee will be obligated to follow such direction and (vi) what collateral secures the oblig-

ations and how can it be realized.³

Each trust indenture has its own nuances. If governed by the Trust Indenture Act,⁴ however, the indenture should contain certain provisions mandated by the TIA. It may also contain many of the provisions found in the *Commentaries on the Model Debenture Indenture Provisions* ("MDI").⁵ A review of the TIA and MDI will assist you in understanding a trustee's responsibilities.

A. Trustee's Responsibilities In A Default Case

1. Notice to Investors.

Most trust indentures require the trustee, upon notice of a default, to issue a default notice to the investors.⁶ In a payment default, the trustee will be on notice of the default if the obligor is required to make the payment directly to the trustee. The default notice should advise the investors of the nature of the default and how to contact the trustee.

2. Standard of Conduct.

The standards of conduct imposed upon the trustee depend upon whether an event of default has occurred.⁷ If no default exists, the trustee is required to perform only those duties specifically set forth in the indenture.⁸ If a default exists, indenture sections such as MDI Section 601(b) become the operative standard by which a trustee must be guided: "the Trustee shall exercise each of the rights and powers vested in it by this Indenture, and use that same degree of care and skill in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs."⁹ The MDI comments recognize that the applicability

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of the “prudent man” standard is an expression of the need for the trustee to be proactive in protecting the investors.¹⁰

The trustee, after a default, is vested with fiduciary duties requiring the trustee to take any action authorized by the trust indenture to protect the investors.¹¹ Courts have noted that the trustee is “able to act swiftly and effectively” to assure the rights of the investors to recover what they are owed.¹² A trustee’s actions in following the prudent standard of conduct will be judged by the facts as they existed at the time of the action.

3. Trustee Taking Direction from the Investors.

The trustee should, where appropriate, look to the investors for direction before it takes action. For example, in TIA section 315(d)(3) a trustee will be protected against a negligence claim if the action was taken in good faith and at the direction of the investors of not less than a majority in principal amount relating to the “time, method, and place of conducting any remedy available to such trustee, or exercising any trust or power conferred upon such trustee under such indenture.”¹³

The trustee is also protected from negligence in the MDI provision 601(c)(4) by providing that the trustee shall not be required to “expend or risk its own funds or otherwise incur any financial liability in the performance of any of its duties hereunder, or in the exercise of any of its rights or powers, if it shall have reasonable grounds for believing that repayment of such funds or adequate indemnity against such a risk is not reasonably assured to it.” This section reflects the reality that the trustee is not a stakeholder in the matter and as such does not have an investment at risk. In light of the prudent man standard, however, a trustee should not ignore its responsibilities to protect and secure collateral if the trustee does not receive assurance of payment.

B. Identification Of Investors

Investors may not find it the most desirable course of action to allow the trustee to act to secure and protect the collateral or take action under the indenture without direction or guidance.¹⁴ How do investors find out who owns the securities for the purpose of providing the trustee direction or guidance? In the case of indentures qualified under the TIA, they should contain a procedure that

allows for either the trustee to share the investor list or mail a communication from investors provided that three or more investors apply to the trustee stating that they desire to communicate with other investors regarding their rights under the indenture. The application should be accompanied by a proposed communication along with proof of ownership for a period of six months preceding the date of application.¹⁵

For securities that are not registered, the trustee may act as the registrar and, therefore, a list of investors should be readily available. A difficult situation arises in identifying investors when the securities are freely tradable in public markets. A trustee may, with the assistance of a service that identifies investors, attempt to identify the investors.¹⁶

Step 2: Contact Your Trustee

Once familiar with your security documents, you should contact the corporate trust officer at the trustee that has been assigned to this default to find out preliminary information about the trustee’s intentions regarding the default. How does the trustee intend to protect the collateral? Does the trustee have counsel with whom you can speak? If the obligor filed for bankruptcy protection, does the trustee intend to serve on the creditors committee? Request a copy of all notices that the trustee may have issued in connection with the default. You should find out if a list of other investors is available in case you want to communicate with those investors. In discussing possible actions with the trustee, you should also keep in mind that the trustee may be seeking indemnity from investors before it takes action that will require it to expend its own funds.

Step 3: Contact Other Investors

If your client does not hold the majority of the outstanding principal amount of the securities, you may want to seek out other investors to form an ad hoc committee to direct or provide guidance to the trustee. Many times these ad hoc groups will retain counsel who help to organize the group and communicate with the trustee and its counsel regarding investors’ rights.

The ad hoc committees can be effective since they should provide a unified voice to the trustee regarding action to be taken by the trustee. If disparate groups

of investors do not share the same opinion as to the direction the trustee should take to protect the collateral or enforce the rights, the trustee may be left with using its own discretion to exercise remedies.

Conclusion

Each default situation is different and will require close attention to the details of your situation. As investor’s counsel, you will be best served by fully understanding the governing documents, and communicating with the trustee and other investors.

¹ Although trust indentures generally contain similar provisions, a close review of the pertinent provisions is required. The Trust Indenture Act of 1939 (“TIA”), 15 U.S.C. § 77aaa, et seq. provides for certain mandatory and permissive requirements for trust indentures that are “qualified” under the TIA.

² For the purpose of this article, I use the term “investor” to mean a holder of securities or bond holder.

³ The nature of the collateral is of critical importance. If the collateral is perishable or subject to market fluctuation, the trustee may need to act fast to protect the investment.

⁴ See 15 U.S.C. § 77aaa, et seq.

⁵ American Bar Foundation, Commentaries on the Model Debenture Indenture Provisions (1986).

⁶ Under Section 315(a) of the TIA, 15 U.S.C. § 7700(b), the trustee is required to give notice to the security holders of all “known defaults” within 90 days of the occurrence of the default. Except for certain payment defaults, however, the trustee may be protected in withholding a notice if the trustee in good faith determines that withholding the notice is in the interest of the investors. This exception relates to non serious defaults, such as an obligor’s failure to provide routine reports or information to the trustee that can be easily cured. See MDI at 254. This exception is directed to publicly traded companies or debt where a notice of default may “disturb” the market in which the securities are traded. Id.

⁷ See MDI § 601 at 248; see also LNC Investments, Inc. v. First Fidelity Bank, Nat’l Ass’n., 935 F. Supp. 1333, 1347 (S.D.N.Y. 1996).

⁸ MDI at 248 and LNC Investments, 935 F. Supp. at 1347; see also Jeffrey J. Powell and Harold L. Kaplan, A Primer on Indenture Trustee Duties, ABA Trusts & Investments (Nov./Dec. 2004), 52.

⁹ The MDI conforms to the Section 315(c) of the TIA that mandates the prudent man standard being applied to a trustee’s conduct during an event of default.

¹⁰ MDI at 250.

¹¹ See LNC Investments, 935 F. Supp. at 1948.

¹² Id. at 1347 (quoting Beck v. Manufacturers Hanover Trust Co., 632 N.Y.S.2d 520, 527 (1st Dept. 1995)).

¹³ See TIA § 315 (2)(3), 15 U.S.C. § 77000 (d)(3).

¹⁴ Individual investors are not permitted to take remedial action unless they meet the following conditions: (i) 25% of the investors (ii) request the trustee to act on the default, (iii) offered reasonable indemnity (iv) and the trustee does not act on the request for 60 days (v) and the request is consistent, to the extent applicable, with direction of the majority of investors. MDI § 507 at 232.

¹⁵ TIA Section 312, 15 U.S.C. § 77III; see also MDI at 282-284.

¹⁶ See Robert C. Apfel, How to Identify Bondholders and Communicate with Them, ABA Trusts & Investments (Sept./Oct. 2004), 26.