Lending transactions: To trust or to trustee – The interests to balance are delicate

Published: December 20, 2018 12:10 AM

The requirement of having a security trustee in transactions involving a single lender is not that straight-jacketed and requires various factors to be considered.

To trust or to trustee

By Karan Kalra, Abhinav Harlalka & Deepa Rai

Secured lending transactions require borrowers to create security interest in favour of lenders. In consortium arrangements, considering there are a number of lenders involved, security interest is often created in favour of a trustee (referred to as the 'security trustee'), on behalf of, and for the benefit of the various lenders. The requirement of having a security trustee in transactions involving a single lender is not that straight-jacketed and requires various factors to be considered. Historically, trustees were appointed for administrative convenience, but in recent times the dynamic regulatory landscape has also played quite a crucial role in such appointments. While secured bond issuances in India require a trustee (known as debenture trustee) to be appointed mandatorily, such is not the case in unsecured bond issuances or any non-bond lending transactions (whether secured or unsecured). We try to lay down some considerations on both sides of the equation that become relevant in making this decision.

Under banking regulations, banks are restricted from having a pledge of more than 30% shares of a company. In cases where there are multiple lenders, while each lender may take pledge of up to 30% shares of the borrower, the individual pledge disturbs the nature of the consortium arrangement, where each lender is expected to act uniformly and, more importantly, be treated at par with each other. However, this restriction does not apply to security trustees, thereby enabling pledges exceeding 30% of the shares of a company to be created in favour of a trustee. Not only does this settle potential disconcerting situation between lenders, but also enables lenders to increase their pledge cover (especially in consortium with less than four lenders).

Pertinently, in lending transactions (including issuance of masala/rupee-denominated bonds, where the appointment of a debenture trustee is not mandatory), while there is no requirement to appoint a security trustee either, the appointment of a security trustee is extremely beneficial for facilitating sell downs and transfers by original lenders/bondholders or even subsequent ones. Where security interest is created directly in favour of lenders, the same needs to be specifically assigned/recreated in favour of the incoming lenders, which is often costly, time-consuming and also increases the dependency on the borrower. On the other hand, if security interest is created in favour of a trustee, the trustee can merely acknowledge the transfer between the outgoing and incoming lenders of the lender, and recognise the new lender as the person for the benefit of whom the security interest has been created.

A somewhat limited but very interesting benefit of having a debenture trustee is available for bond issuances where the bonds are listed on the wholesale debt market segment of one of the two key Indian exchanges. In such situations, the debenture trustee should enjoy the privilege of being considered as a 'secured creditor' for the purposes of the Sarfaesi Act, thereby enabling enforcement of security interest without the intervention of courts, a benefit that would have otherwise not been available in such situations, unless the holder of the bond itself had Sarfaesi benefits available to it.

Another recent but interesting implication is related to the Insolvency and Bankruptcy Code, 2016, where consortium lenders have the right to appoint a trustee to act for all financial creditors in meetings of the Committee of Creditors (COC), in proportion to their respective voting shares. This avoids the problem that the lenders may face if they were to select a single representative on their behalf, while ensuring that the decisions in the COC are taken in accordance with pre-agreed process and procedure. A trustee is generally a regulated entity registered with SEBI as a debenture trustee and SEBI dictates requirements to ensure appropriate governance standards, monitoring of the underlying assets, certifications and timely disclosures. Accordingly, the appointment of a security trustee would reduce the compliance requirements of lenders.

A security trustee also eases the enforcement mechanism for lenders. For instance, a borrower creates a first charge on its assets in favour of a lender (say, lender A). The borrower then raises further funds from another lender (say, lender B), and offers a second charge on the same assets to lender B. However, the security interest has already been created in favour of lender A. While the borrower can include lender B as a second charge holder, the right to enforce security interest remains with lender A. This typically may not make commercial sense for lender B and, accordingly, in such situations, having security interest created in favour of a security trustee, who shall act as the trustee for both lender A and lender B, can potentially take care of the concerns of both lenders and the borrower. Needless to say, the manner in which the security trustee operates/enforces security interest would need to be commercially agreed between the parties.

However, on the flip side, the appointment of a security trustee also deprives lenders of benefits under certain extant laws. For instance, under the SEBI Takeover Code, enforcement of pledge by lenders is an exempt transaction not requiring lenders to make an open offer (assuming the relevant thresholds are breached), but the same exemption is not provided to security trustees. As per two separate but similar informal guidances issued by SEBI to IL&FS Trust Company Limited and IDBI Trusteeship Services Limited in 2012, SEBI clarified that 'debenture trustees' acting as custodians/agent for pledged shares on behalf of the lenders are not exempted from the obligations of an open offer under SEBI's Takeover Code. SEBI had opined that the exemption granted to banks and public financial institutions (PFIs) under the Takeover Code cannot be extended to a trustee even if the trustee was acting on behalf of such exempted banks and PFIs.

There are certain other benefits which are available to lenders directly, but which are not extended to trustees acting on behalf of such lenders. Under exchange control regulations, a person resident outside India holding shares of an Indian company is permitted to pledge such shares to secure loans raised by the Indian company only in favour of lenders, but not in favour of trustees appointed on behalf of such lenders. Also, creation of security interest over the Indian party's assets in a wholly-owned subsidiary or joint venture is also permitted only in favour of overseas lenders and not trustees appointed on behalf of such lenders. Prior approval of RBI would be required for security creation in favour of trustees.

Another limiting factor that plays an important role is cost implications and the administrative burden of appointing a trustee as against not having one. Obviously, borrowers deter and resist this, since they have a more convenient option and, more importantly, the fact that the benefits of appointing a trustee favour only the lenders.
Having analysed the factors on both sides, it is fairly apparent that the interests to balance are delicate and the debate continues to remain interesting.

Kalra is head, Harlalka and Rai are members, Banking Practice, Nishith Desai Associates