

THE PASSIVE MONITORING ROLE OF THE INDENTURE TRUSTEE AND THE DEVELOPER'S MISBEHAVIOR RISK FOR FINANCIAL STANDBY ISSUING BANK IN PROJECTS FUNDED BY MUNICIPAL BONDS

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INTRODUCTION

A leading professor in commercial law commented that “financial standby letters of credit are among the most reliable and flexible assurances of payment and credit enhancements in the contemporary financial marketplace. They can assure payment and enhance credit in simple transactions such as single loans at fixed rates of interest and short terms of expiry. Or they can assure payment of loans extended by thousands of lenders (acting as buyers of bonds or other securities) to corporate or governmental borrowers at fixed or at variable rates of interest and with a daily, weekly, monthly or yearly term of expiration.”¹ The volume and proportion of financial standbys in comparison with other types of letters of credit (performance standby and commercial letters of credit) reflect its importance in the financial market. In the 2nd quarter of 2002, the net total of financial standbys issued by American banks was approximately \$213 billions while those of performance standbys and commercial letters of credit were approximately \$43.87 billions and \$24.80 billions respectively.²

In the United States, financial standbys (hereinafter “FS”) are widely used for backing the construction or development projects funded by municipal bonds. These projects are of a wide range from public or industrial facility to housing and normally of long or medium terms. Despite the complex nature of these projects and the huge amounts of outstanding liability of FS, many banks, for several reasons discussed later, still consider issuing FS backing up municipal bonds is a not-very-risk business.

This essay will discuss how the credit risks are transferred from the bondholders to the FS issuing bank (and from the FS issuing bank to other banks who issuing backup FS or being confirming bank) in development project funded by municipal bonds. Then we will discuss the weak and passive monitoring role of the indenture-trustee during the pre-default period. This weak and passive monitoring role, as discussed bellows, would put the FS issuing bank (or whoever is the final link in the chain of credit risk transferring and uses the project assets as collaterals) in risks of the project developer’s misbehavior. Misbehaviors of the not-closely-monitored developer could lead to some “incurable” consequences such as the project closure. The risk would be serious if the project assets have only some value if the project can operate and generate benefits (for example a nuclear power plant.) The conclusion of this essay is the FS issuing banks are unreasonably exposed to the risk which is the consequence of a flaw of the Indenture Trustee Act (and the Indenture Trustee Reform Act). The essay suggests that while the liquidity of financial standbys should be maintained, the Indenture Trustee Act should be amended not only for the safety of FS issuing banks but also for the benefit of the whole society.

¹ Boris Kozolchyk, *United States Law of Trade and Investment* ch.24 vol.3, 24-24 (2d ed., Fred B. Rothman Publications 2001) [hereinafter Kozolchyk, *Trade and Investment*].

² Letter of Credit Survey, Inc. *Statistics U.S. Banks*, 6 no.9 Documentary Credit World 23, 28, (Oct 2002) (available at <http://www.doccreditworld.com/>).

DESCRIPTION OF A PROJECT FUNDED BY MUNICIPAL BONDS AND BACKED BY A FINANCIAL STANDBY

The participants

A project in which a FS issued to backup municipal bonds be briefly described as follows. When a governmental body (hereinafter called the “bond issuer”)³ wishes to develop a project but lacks of financial source, it often chooses to borrow from the public by issuing project bonds. To attract the public, the offered municipal bonds are normally tax-exempted⁴. Depending on the nature of the project, the bonds may have different names and characteristics⁵. In most cases, the project for which the bonds issued is non-recourse or limited recourse⁶.

In order to deal with financial and procedural issues in relation to issuance of the bonds, the Bond issuer signs a *professional services agreement* (No.1 in Figure 1) with a financial advisor (usually the underwriter).⁷ A *loan agreement* (No.2) then will be signed between the Bond issuer with the project developer – who actually constructs and operates the project. The underwriter is the person who is responsible for issuing the bonds to the public (No.3). A financial institution which has experience and good reputation in monitoring development projects would be chosen as indenture-trustee. A *trust indenture* between the Bond issuer and the indenture trustee is executed (No.4)⁸. A *reimbursement and security agreement* is signed between the project developer (and/or

³ The governmental body can be the authority of a state or a county.

⁴ See Kozolchyk, *Trade and Investment*, *supra* n.1, at 24-27, 24-28. According to the author, by offering tax-exempted bonds, the bond issuer can reduce the cost of the federal registration which is obligatory to non-tax-exempted bonds and in combination with other credit enhancement such as the back up of a financial standby issued by a good bank the bonds normally generate more profit to the bond holder while keep the borrowing costs cheaper for the developer.

⁵ See generally *id.* at 24-27. According to Prof. Kozolchyk, the bond can be basically divided into two types: “(1) ‘general obligation’ securities backed by the taxing power or ‘full faith and credit’ of the governmental unit issuing the bonds and 2) ‘revenue’ securities backed solely by the revenues of a specific project such as housing rentals, airport, bridge, sewer or road fees and tolls.”

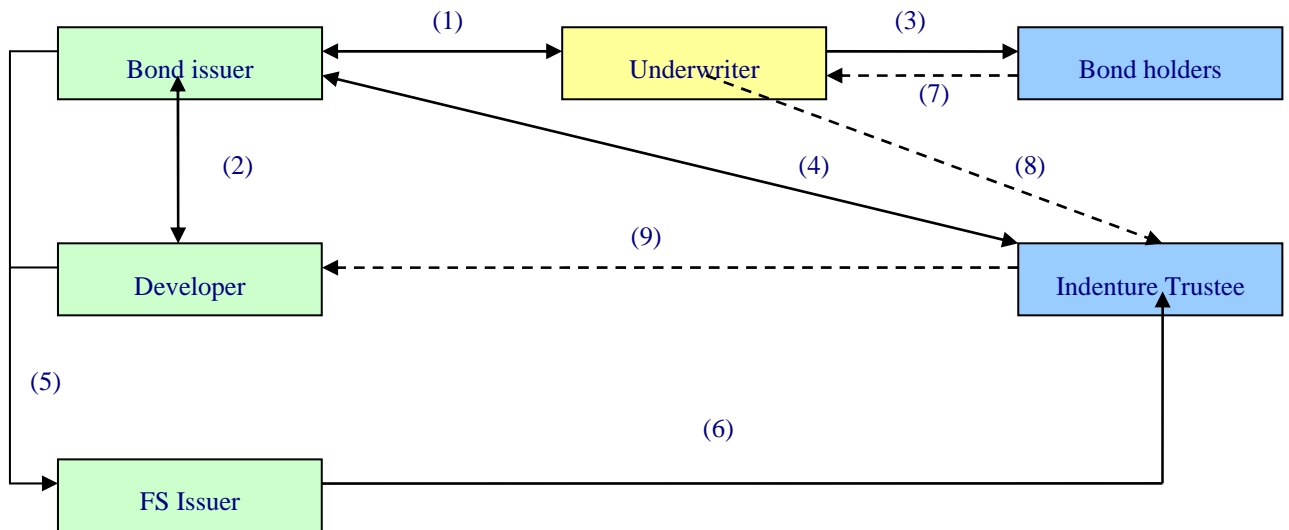
⁶ Scott L. Hoffman, *The Law and Business of International Project Finance* 4 (2d ed., Transnational Publisher and Kluwer Law International 2001) [hereinafter Hoffman, *The Law and Business*] , “The term ‘project finance’ is generally used to refer to non-recourse or limited recourse financing structure in which debt, equity, and credit enhancement are combined for construction and operation, or the refinancing of a particular facility in a capital-intensive industry, in which lenders base credit appraisals on the projected revenues from the operation of the facility, rather than the general assets or the credit of the sponsor of the facility, and rely on the assets of the facility, including any revenue-producing contracts and other cash flow generated by the facility, as collateral for the debt.”

⁷ Kozolchyk, *Trade and investment*, *supra* n.1, at 24-29.

⁸ *Id.* at 24-30. “One of the purposes of a trust indenture is to enable the bond issuer to assure the general public or the institutional investors that a respected fiduciary will distribute loan proceeds and facilitate the repayment of the borrowed funds. Another purpose is to restate in a publicly available document, the basic terms and conditions on which the bond issuer extends credit to the builder and restricts some of its own financial activities as long as the securities are outstanding. A third purpose is to convey a security interest in designated property, real as well as personal, to the *indenture-trustee*. Finally, together with the FS [financial standby] it provides the legal basis for the beneficiary’s drawing.”

the Bond issuer) and the FS issuing bank (No.5)⁹. The bank issues a FS with the indenture trustee is named as the beneficiary (No.6).

Figure 1: Relationships and participants



The disbursement of the bond sale proceeds to the developer is presented as the “dashed-arrows” numbers (7), (8), (9) in Figure 1. The fund transferred from the bondholders to the underwriter and then through the indenture trustee to the developer is called “conduit financing” meaning the indenture trustee and the bond issuer act as conduits of the funds.¹⁰

It is necessary to note that in many cases, another bank participates in with the role as the bank issuing a “backup standby letter of credit” with the beneficiary is the issuing bank of the primary standby¹¹. This backup standby serves as an assurance for the repayment of the Bond issuer or the developer to the primary issuing bank in case the first standby is drawn. Accordingly, the existence of the reimbursement between the primary issuing bank and the standby applicant will depend on whether the “backup standby” fully covers the primary standby. Normally, if the backup standby partly covers the primary standby, there would be two reimbursement agreements (the Bond issuer or developer with the primary issuing bank and the backing up bank.)

⁹ *Id.* at 24-31. “Prior to issuing its standby LOC [letter of credit] to the indenture-trustee, the issuing bank performs a credit analysis of the applicant-debtor (the bond issuer as well as the builder-developer) and evaluates the financial viability of the project and the quality of the proposed collateral or of other potential sources of repayment. This analysis must show that the revenues from the construction project and the liquid collateral in hand are enough to pay the trustee if the bond issuer default or, in the case of a “direct-pay” letter of credit, when the bonds or certificates mature. Once satisfied with the applicant’s ability to repay and with the source(s) of repayment, the issuing bank requests that the developer-applicant sign a reimbursement and security agreement pledging the necessary project and non project related assets.”

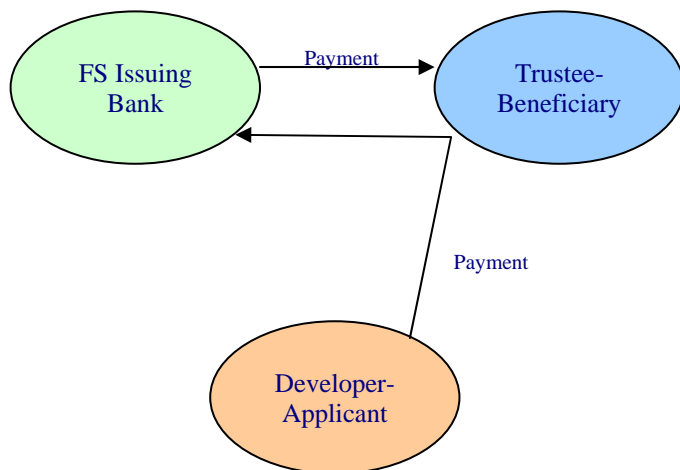
¹⁰ *Id.* at 24-30. “After deducting its customary commission, the underwriter pays the remainder of the proceeds to the trustee. The trustee, in turn, disburses funds provided by the underwriter to the developer and the latter commences the construction described by the loan agreement.” [footnote is omitted.]

¹¹ Boris Kozolchyk, *The Financial Standby: A Summary Description of Practice and Related Legal Problems*, 28 UCC L.J. 327, 341 (1996) [hereinafter Kozolchyk, *The Financial Standby*].

Operation of a FS

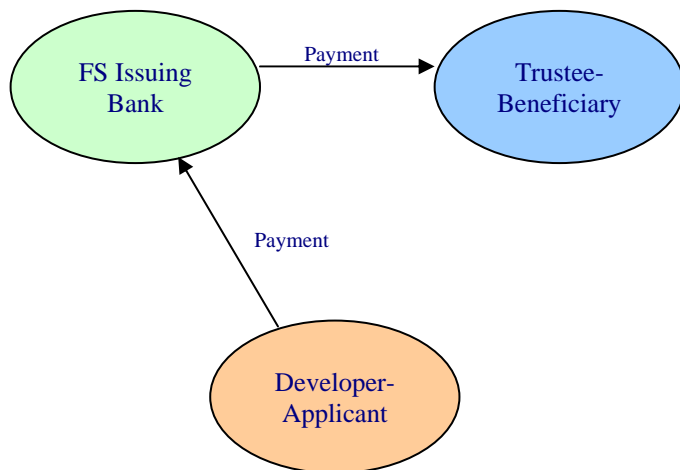
This section briefly describes the operation of the two types of FS, the normal FS and its “direct-pay” derivative.

Figure 2: Direct-pay Financial Standby



drawn of the FS¹³. The diagram in Figure 2 represents the flows of money in a direct-pay financial transaction.

Figure 3: Normal Financial Standby



In the case of direct-pay FS: on a certain day each month (or quarter depending on each case), the indenture trustee would draw upon the FS an amount that has been provided in the loan agreement¹² and distribute it to the bondholders. The developer-applicant is obligated pursuant to both the loan agreement and a reimbursement agreement to deposit an equal amount with the indenture trustee on the same day, and the trustee would immediately reimburse issuing bank for the amount

In the case of normal FS, the issuing bank pays upon a draft submitted by the indenture trustee with a statement of the developer-applicant's failure to fulfill his obligations according to the loan agreement. The developer-applicant is obliged under the reimbursement agreement to reimburse the issuing bank an amount equal to the sum drawn down against the standby¹⁴.

¹² The loan agreement between the bond issuer and the developer providing the due date and amount of principals and interests.

¹³ See generally, *Mellon Bank, N.A. v. Midwest Bank & Trust Co.*, 1993 Ill. App. LEXIS 620 (Ill. App., 1993).

¹⁴ For more details about the difference between normal financial standbys, direct-pay financial standbys and commercial letters of credit, see generally Boris Kozolchyk, *The Emerging Law of Standby Letters of Credit and Bank Guarantees*, 24 ARIZ L. REV. 319 (1982) [hereinafter Kozolchyk, *The Emerging Law*].

Strict compliance in examining FS

One of the most concerns that a bank document checker in dealing with a demand for drawing under a commercial letter of credit is the compliance of the documents tendered by the beneficiary with the terms and conditions of the letter of credit. Failure to find out the incompliance of tendered documents could expose the bank to the risk that it could be charged with contractual or negligence liability and not get reimbursed from the letter of credit applicant or other bank in case of negotiating or confirming¹⁵. This risk (compliance risk) has a root in the ambiguity of the court in determining the strict compliance principle. This principle, as commented by professor Kozolchyk, “requires that the documents tendered by the beneficiary comply strictly with the terms and conditions of the LOC, but it does not say how strict is strict.”¹⁶

Facing the fact that discrepancies are very popularly found in tendered documents¹⁷, and bearing in their mind of the compliance risk, commercial letter of credit bankers has to adopt highly defensive practices to protect them¹⁸. If the bank does not resort to relatively radical practices as mentioned, the document checkers then face a difficult task due to the numerous types of discrepancies involving in many types of documents in transactions between the applicants and beneficiary¹⁹.

Unlike his colleague dealing with commercial letter of credit, a FS document checker is much more relaxed in his job. The picture of compliance risk is totally changed as most of the elements which make the compliance risk potential in the case of commercial letter of credit do not exist in the case of financial standbys. In the case of commercial letter of credit, there are three major elements that cause the compliance risk very potential. The first element is the ambiguity of the law on the strict compliance principle. The second is the un-acquaintance and in many cases, the distrust between the banks involved in the transactions²⁰. The third is the unavoidable of discrepancies in paper documents²¹.

¹⁵ See generally, Boris Kozolchyk, *Strict Compliance and The Reasonable Document Checker*, 56 Brooklyn L. Rev. 45, 47 (1990) [hereinafter Kozolchyk, *Strict Compliance*].

¹⁶ Kozolchyk, *Trade and investment*, *supra* n.1 at 24-59.

¹⁷ Kozolchyk, *Strict Compliance*, *supra* n.15 at 47. “In July 1987, Letter of Credit Update published the result of a survey of documentary compliance practices of letter of credit bankers in the United States. Bankers were asked what percentage of documents presented by the beneficiaries or beneficiaries' banks contained discrepancies. The majority of the respondents indicated that 90% of the documents initially tendered contained discrepancies. A similar survey conducted by this writer in the early 1970s among representative bankers of major financial centers produced estimates in the same range.” [footnotes removed].

¹⁸ The most popular defensive practices are: (i) refusing to confirm foreign irrevocable letter of credit, (ii) being the beneficiary's collection agent than negotiating beneficiary's draft without recourse, (iii) rejecting questionable tenders and listing as many discrepancies as possible for submission to the applicant's approval or waiver, and (iv) inserting in the application for letter of credit a clause to authorize the bank to make payment and get reimbursement regardless of discrepancies. See *Id.* at 47.

¹⁹ Most of the discrepancies can fall under four distinct groups: (i) minor discrepancies which can be corrected by the remitting bank, (ii) discrepancies which can be corrected by the exporter, (iii) discrepancies which must be corrected and (iv) discrepancies which cannot be corrected. Kozolchyk, *Strict Compliance*, *supra* n.15 at 61, n.56. For the role of the bank in “determining whether a documentary discrepancy is significant” See *Id.* at 61.

²⁰ Kozolchyk, *Strict Compliance*, *supra* n.15 at 49: “Some banks in the world's financial centers plainly refuse to confirm foreign irrevocable credits for fear of being denied reimbursement by a hyper-technical issuing bank.”

In the case of financial standbys, the ambiguity of the law on the strict compliance principle remains. However, the un-acquaintance and distrust between the banks are quite rarely. As a measure to enhance the credibility of the municipal bonds, normally reputable banks are chosen as the indenture trustee and the financial standby issuer²². Actually, these banks “create” a close community that they know well each others²³. Knowing each other well and greatly trusting each other, these banks actually develop a practice that the time for checking and making a payment under a financial standby is counted by hours not by days as in the case of commercial letter of credit²⁴.

In addition to the trust among the parties in public finance, format of the documents to be represented in financial standbys also helps to reduce discrepancies. In the case of commercial letter of credit, the beneficiary can be an individual, a company, a governmental agency, or financial institutions. Of course, the letter of credit-related knowledge of such wide range beneficiary is very different from that of banks involving in public finance, and therefore, mistakes or discrepancies are popular²⁵. However, in the case of financial standby, the beneficiary is usually the indenture trustee bank who, unlike the beneficiary of commercial letters of credit, has expertise in dealing with financial standbys. For that reason, mistakes and discrepancies by the beneficiary are less likely. Second, the required language of each document to be submitted by the beneficiary is incorporated into the financial standbys as annexes and certificates. These pre-printed exhibits are easily to be filled out and require little time of the document checker to examine²⁶.

In brief, while the compliance risk in commercial letter of credit is a head ache for document checkers²⁷, it is not something that financial standby document checkers need to worry about due to (i) the trust and honorable behaviors between the involved parties²⁸, (ii) the beneficiary’s expertise in preparing to-be-tendered documents, and (iii) the pre-printed forms of documents and the easiness to fill in.

²¹ *Id.* at 61: “...discrepancies are the rule and perfect tenders are the exception” [footnote omitted].

²² Good credit enhancement would keep the loan cost low while still keep the bond attractive to the buyers. See Kozolchik, *Trade and Investment*, *supra* n.1 at 24-24.

²³ Interviewed by Boris Kozolchik, Prof. L., with Neal S. Millard, Atty. of the Los Angeles offices of White and Case LLP (Nov. 23, 1998) [hereafter Millard, *Interview*]: “Please note also that those who work in this line of business have to work together for long periods of time. This process leads to close working relationships... The municipal debt securities professionals are members of a closely knit community, at least in California. For example, in the greater Los Angeles area only eight banks among dozens get involved in the indenture-trustee business.... as I stated earlier, only a few banks act as indenture-trustees. The same is true with issuers of financial standbys, and bond or bank counsel.” [emphasized by the author].

²⁴ Millard, *Interview*, *Id.*: “Unlike commercial letters of credit where examination and payment can take up to 7 days, the payment of financial standbys is often within hours of the receipt of the documents.”

²⁵ *Supra*, n.17.

²⁶ Kozolchik, *Trade and Investment*, *supra* n.1 at 24-32.

²⁷ Prof. Kozolchik commented that the intervention of courts into daily banking operations (which increases the compliance risks to banks) “...seriously threatens the viability of the letter of credit as an inexpensive means of financing, securing, and effecting payment.” See Kozolchik, *Strict Compliance*, *supra* n.15 at 47.

²⁸ Professor Kozolchik called it is a “brotherly standard”. See Maria del Pilar Perales Viscasillas and Boris Kozolchik, *El Derecho Comercial ante el Libre Comercio y el Desarrollo Economico*, 10 Pace Int’l L.Rev. 197, 201, 202 (1998).

RISKS TRANSFERRED FROM LENDERS TO THE STANDBY ISSUER: A FINANCIAL STANDBY IS LIKE A LOAN

Unlike guarantees, the FS issuing bank cannot invoke an underlying transaction or causal defense, such as a waiver, release, or setoff between the applicant and the beneficiary, except in case the beneficiary is “egregious” fraud²⁹. Unlike commercial letters of credit, the process of drawing under a FS are fast and simple because, and as mentioned above, most of the required exhibits are technically easy to fill out. The FS, therefore, is so liquid and flexible (especially in the case of direct-pay FS) that it could be considered as once the bank issues a FS, it promises “unconditionally” to replace the lender whenever the lender requires. Thus, by promising unconditionally to step in and replace the lender, the issuing bank, therefore, takes credit risk from the lender. The Comptroller of the Currency considers “advance funds under a standby letter of credit”³⁰ as “contractual commitment to advance funds”³¹. The “contractual commitment to advance funds”, in its turn, constitutes “loans and extensions of credit” which are subject to the lending limit (15 percent of the bank’s capital and surplus) to one borrower.³²

The Federal Reserve, in one supervisory letter, also asserted that the FSs were very similar to “credit default swaps”, a type of credit derivatives that were increasingly used by banking organizations³³. Credit derivatives were described by the Federal Reserve as “off-balance sheet arrangements that allow one party (the ‘beneficiary’) to transfer the credit risk of a ‘reference asset,’ which it often actually owns, to another party (the ‘guarantor’)”³⁴.

In next parts, we discuss the measures to deal with credit risks and which of these measures available to the FS issuing bank when it takes credit risks from the bondholders. However, before discussing the case of the FS issuing bank, it would be necessary to discuss about such measures in the case of (i) a lender in a normal loan transaction, and (ii) in the case of the indenture trustee in a project backed by a FS.

²⁹ See Kozolchik, *The Financial Standby*, *supra* n.11 at 331.

³⁰ See 12 C.F.R § 32.2(f)(iv) (2004).

³¹ *Id.* at (k).

³² See 12 CFR § 32.3 (a).

³³ Fed. Res. Super. Ltrs. SR-96-17(GEN), 2 (Aug. 12, 1996) (available at <http://www.federalreserve.gov/boarddocs/SRLETTERS/1996/sr9617.htm>).

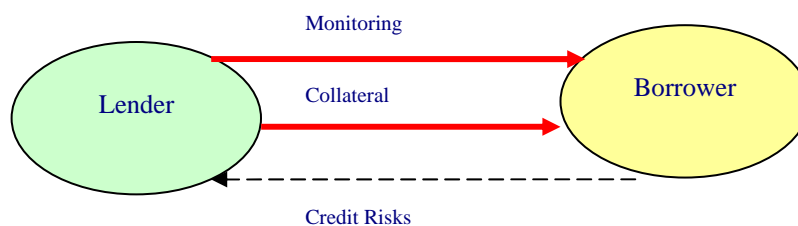
³⁴ In this letter the “reference asset” is referred to the loan that granted by the bank who is the “beneficiary” to a borrower. See *Id.*

THE PASSIVE MONITORING ROLE OF THE INDENTURE TRUSTEE IN PRE-DEFAULT PERIOD

Measures available to the lender to deal with credit risks in a normal loan transaction

In a normal lender-borrower transaction, the ultimate concern of the lender is to ensure the repayment of the principals and interests. In order to ensure the repayment, the lender should consider at least three major risks before granting a loan. The first is the revenue that the project can yield may not enough to repay the loan and interests, or in other words, the project is not feasible. The second risk is the good faith of the borrower in using the loan proceeds to invest in the project and its ability to efficiently manage the project³⁵. The third is liquidity and value of collaterals.

Figure 4: Lender and Measures Against Risks



Corresponding to those risks, there are several measures available to the lender. Before granting the loan, the lender could carry out a careful study on the feasibility of the project as well as

the available credit enhancements. During the implementation of the project, monitoring activities could be conducted by the lender to ensure that the loan proceeds and the project are properly used and managed in accordance with terms and conditions of the loan agreement. The feasibility study and monitoring activities can be called as “pre-default measures” to prevent or at least to reduce the chance that defaults can occur. The acquisition of collateral assets and third party’s guarantee can be called as “post-default measures” as the lender resorts to these after a default has occurred. Figure 4 describes the measures available to the Lender to deal with risks after granting a loan.

³⁵ Theodore J.Sawicki, *Comment: The Washington Public Power Supply System Bond Default: Expanding The Preventive Role of The Indenture Trustee*, 34 Emory L. J. 157, 159 (1985). Sawicki summarized Jackson & Kronman’s discussion on how the borrower could benefit from misbehavior as follows: “The price of extending credit, which is the interest rate that a creditor charges a debtor for a loan, increases as the perceived risk of the loan increases. Once a loan agreement is made, the interest rate normally remains fixed for the period of the loan. Thus, after the loan agreement is finalized, the debtor may improve his position economically by increasing the loan risk to the creditor. This may be done by assuming additional loans or otherwise further encumbering assets, or by following a course of business that is more risky than had been anticipated originally by the creditor at the time of the loan agreement. By behaving in this way, the debtor in effect obtains a higher-risk loan for a discounted price because the interest rate is set to reflect the lower risk level calculated by the creditor. The debtor “gets something for nothing.” Jackson and Kronman call the possibility of such debtor conduct the ‘threat of debtor misbehavior.’”

In the case of project funded by municipal bonds, the bond issuer, however, does not deal directly with the bondholders, but with the indenture-trustee who acts on behalf and for the benefits of the bondholders. The following section discusses the indenture trustee's role in the pre-default period and examines if the indenture trustee could use act to protect the bondholders as a lender could act to protect himself.

Measures available to the Indenture-Trustee to deal with credit risks

"Although municipal bond issuances are exempt from application of TIA, courts deciding on FS trustee's duties are likely to turn to TIA-inspired case law when attempting to evaluate the trustee's performance."³⁶

The rights and obligations of the indenture-trustee are provided in the trust indenture and governed by the Trust Indenture Act of 1939 (as amended by the Trust Indenture Reform Act in 1990) ("TIA"). Most commentators believe that an indenture trustee under TIA basically acts in a ministerial role before default has occurred³⁷. In addition to the ministerial tasks of a normal indenture-trustee, a trustee in a project funded by municipal bonds has other functions which specifically designed for its role in the particular type of projects³⁸. Although the FS's trustee may have more special functions and tasks than other normal indenture trustees, like the former, its discretion is quite limited until the event of default. As discussed bellows, this limitation will lead to the passive role of the indenture trustee in using pre-default measures, particularly the monitoring activities, to discover or prevent impending defaults.

There are three reasons for the limited discretion of the indenture trustee: (i) the standard of care of the indenture trustee provided in the TIA, (ii) the bad affect to credit enhancement of the municipal bonds in case the indenture-trustee has a broad discretion, and (iii) the monitoring costs of the indenture trustee itself.

TIA: The Standard of Care of the Indenture Trustee

The TIA provided that a trustee can be found liable for actions it conducted and omissions to act only if it was negligent.³⁹ However, as set forth in the TIA, the indenture trustee is

³⁶ Kozolchyk, *The Financial Standby*, *supra* n. 11 at 349.

³⁷ Efrat Lev, *The Indenture Trustee: Does It Really Protect Bondholders?* 8 U. Miami Bus. L.Rev. 47, 74 (1999).

³⁸ Kozolchyk, *The Financial Standby*, *supra* n.11 at 351: "[I]t must be remembered that the trustee-beneficiary of a FS usually wears more hats than an indenture trustee. Under the loan agreement between the municipality and the developer, the trustee has the rights of collection of monies from the bondholders and the disbursement of funds to the developer. Under the indenture he draws on the issuer of the bonds, his payment agent or the FS, and tenders of bonds for payment or reissuance. Hence, the trustee-beneficiary represents the bondholders both as a collecting agent during the financing stage and as a disbursing agent during the repayment stage. As a manager of the trust funds, he is not only responsible for proper disbursements, but also for the preservation of the value of the security pledged for the issuance by the developer-applicant. The trustee-beneficiary is also charged with preserving the documents and properties pledged as security, which may include money, collateral, deeds of trust, and lease agreement. Finally, as a manager of the rebate fund, the trustee is also responsible for payments due to the appropriate state or federal governments."

³⁹ Lev, *supra* n.37 at 76.

still relatively well protected from charges of negligence. First, the TIA provides that the indenture trustee is exempted from performance which is not set out in the indenture⁴⁰. Second, the trustee may conclusively rely on the bond issuer's statements as long as the trustee acts in a good faith.⁴¹ Third, the indenture trustee is protected from "any error of judgment made in good faith by a responsible officer or officers of such trustee, unless it shall be proved that such trustee was negligent in ascertaining the pertinent facts".⁴² A commentator has commented on this issue as "the standard of care required from the trustee prior to default is actually less than negligence. It seems that only acts or failures-to-act conducted in bad faith could lead to trustee liability".⁴³ This commentator also asserted that "a trustee is not encouraged by either the TIA or the indenture to do anything that could lead to such early discovery of a possible default."⁴⁴

The bad affect to credit enhancement of the municipal bonds

As the attractiveness of the municipal bonds is based on the liquidity and reliability of the FS, the bond issuer and the indenture trustee normally try to minimize the factors which could provide the standby issuer reasons to deny payments. A broad discretion of the indenture trustee could provide a good ground for the standby issuer to dishonor its promise claiming that the trustee has not taken all possible steps to protect the bondholders.⁴⁵ Hence, the trustee's discretion, in practices, is intentionally limited. This limitation is acceptable to the bondholders because it increase the liquidity and reliability of the FS.

The monitoring of the indenture trustee

After granting the loan and depending on the agreement and the nature of each loan transaction, the lender could choose one of the three courses of action in response to the future anticipated misbehavior of the borrower: (i) increase the price for credit, or (ii) increase monitoring activities, or (iii) demand and rely on a more reliable guarantee from a third party⁴⁶.

⁴⁰ 15 U.S.C.S § 77000(a) 1990 (LEXIS 2004).

⁴¹ *Id.*

⁴² 15 U.S.C.S § 77000(d) 1990 (LEXIS 2004)

⁴³ Lev, *supra* n. 37 at 79.

⁴⁴ *Id.*

⁴⁵ Kozolchyk, *The Financial Standby*, *supra* n. 11 at 340: "If the trustee is given broad discretion with respect to the determination of whether acts or event of default took place and no clear documentary requirements are set forth in the FS for acts or events of default, the issuing bank unwittingly become involved in the underlying transaction(s). For example, some underlying agreements require that in the event of default 'the trustee... act as a reasonable and prudent man would, and take all steps necessary to protect the bondholders.' Bond rating agencies dislike such discretionary language because they may delay and complicate payment of the FS. In fact, according to a California municipal bond expert, if the rating agency determines that the trustee does have significant discretionary powers, there will be no rating for that bond, or the municipal bond will be rated as if no credit enhancing letter of credit had been issued."

⁴⁶ Sawicki mentioned only two courses of action available to the lender: (i) increase the price for credit, (ii) increase monitoring activities. See Sawicki, *supra* n. 35 at 159.

In the case of municipal bonds, the bondholders (or the indenture trustee) cannot increase the interest for the reason that they anticipate some misconducts of the bond issuer in future. Increase monitoring activities are not a simple issue either. The complexity of monitoring activities varies from project to project depending on the purpose and nature of the project. For example, if the project is a nuclear power plant which is subject to very strict requirements in terms of environment, safety, the monitoring activities would be costly to the trustee as it would require special technical knowledge that the trustee's staff do not possess. As the service payment for the indenture-trustee is usually preset in the indenture and based on the services rendered regardless of the value of the securities outstanding⁴⁷, the indenture-trustee, for the benefit purpose, would limit the monitoring activity to an extent enough to prove their "good faith"⁴⁸. And sometimes "good faith" is a concept not clear enough to clarify what the indenture-trustee should do to protect the bondholders.⁴⁹ However, this manner of the indenture trustee would be acceptable to the bondholders if they have a very liquid and reliable assurance as a FS.

Sub-conclusion

As discussed above, the indenture trustee in project backed by FS play a passive role in pre-default period notwithstanding if it is due to the provision of the TIA, or for the purpose of credit enhancing, or for cutting monitoring costs. The monitoring, an important element of pre-default measures, therefore, would not be used as aggressively as in the case of a lender in a normal loan transaction.

Figure 5: FS Indenture Trustee and Measures Against Risks

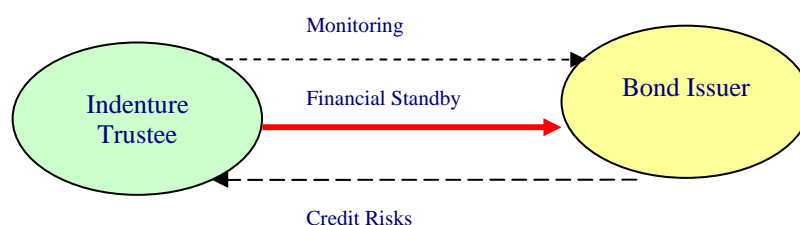


Figure 5 describes the measures available to Indenture Trustee after the bond issuance. The dashed arrow represents the passive role of the indenture trustee in monitoring the developer.

Measures available to the FS Issuing Bank

Pre-default measures to the FS issuing bank

Similarly to other participants in the project, the financial issuing bank conducts a credit analysis on the project (especially the loan repayment ability or other potential sources of

⁴⁷ Boris Kozolchik, _____ ch.2, 71 (forthcoming 2004) (copy on file with Author).

⁴⁸ As discussed above, the TIA allows the indenture trustee to rely on the bond issuer's statements and exempts it from liabilities if the trustee acts in a good faith.

⁴⁹ See generally Sawicki, *supra* n. 35.

repayment such as third-party guarantees or collateral unrelated to the project). The analysis must show that the project revenue will generate enough funds to repay the developer-applicant's financial obligations to the bondholders. The terms and conditions of the FS will be written in accordance with the findings of credit analysis and the risks that the issuing bank could foresee⁵⁰.

The need for a speedy and reliable payment for the FS beneficiary requires that (i) the drawing procedures should be excluded from elements which would take time and create unpredictability for the payment such as the examination of fact or law, and (ii) the assurance for the reimbursement to the issuing bank after it has honored the standby. Both customary and statutory laws have provisions to assure these requirements. On the one hand, the customary and statutory laws require the issuing bank to honor the standby based on a documentary principle (which means only to base on the presentation of documents and an examination of required documents on their face.)⁵¹ On the other hand, the law provides the applicant's obligation to reimburse the issuing bank when it has honored the standby in accordance with the documentary principle.⁵² Considering the above mentioned provisions of law, the issuing bank naturally avoids the possibility that it has to get involved in the underlying transaction (which also means to avoid any activities monitoring the developer-applicant's project).

Figure 6: FS Issuing Bank and Measures Against Risks

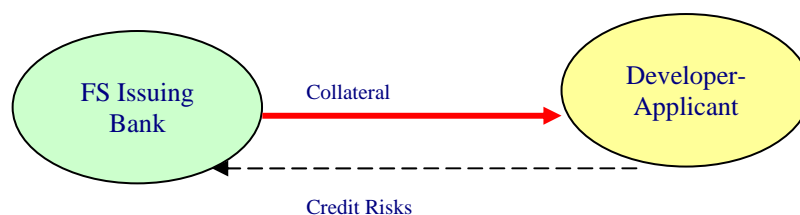


Figure 6 describes the measures available to the FS issuing bank. As mentioned above, the very high liquidity of the FS means that the issuing bank commit to step in and unconditionally lend the developer-applicant the amount

drawn by the trustee-beneficiary. By doing that, the issuing bank takes the credit risks from the bondholders but as provided by the law on letter of credit, it cannot rely on monitoring activities to minimize the risks. The only measure to deal with risks available to the issuing bank is the post-default measure: collaterals.

Post-default measures available to the FS issuing bank

The FS issuing bank is normally very careful in examining the feasibility of the project as well as the guarantee of its reimbursement. Two measures are often to be used to assure the reimbursement: (i) the collaterals of the project assets, and/or (ii) the guarantee from a third party which may be under the form of another backup FS or, in the case of limited recourse, a guarantee from the special fund or authority created to help obtain financing of

⁵⁰ See Kozolchyk, *The Financial Standby*, *supra* n. 11 at 340.

⁵¹ Institute of International Banking Law & Practice, Inc, *International Standby Practice*, Rules 1.06. d and 4.01. b [hereinafter *ISP 98*]. See also U.C.C § 5-108 (a).

⁵² *ISP 98*, Rule 8.01 and UCC § 5-108 (i).(1).

the project, or (iii) having another more creditworthy bank acts as a confirming bank while the issuing bank “assumes the obligation of prepayment or reimbursement of the confirming bank.”⁵³

The risks related to reimbursement for the issuing bank can be very different depending on the measures used by the issuing bank to fence off the risks. If the reimbursement is assured by the collaterals of the project assets, the liquidity of the collaterals would be the most important thing to the issuing bank.⁵⁴ The collateral would be much more liquid if it is a FS of other bank or having other bank acting as the confirming bank. However, in this case, while the issuing bank can transfer all the credit risks to the backup issuing bank or the confirming bank, the later still face a risk of weak pre-default monitoring activities. It is also noteworthy that in some project, the assets are valuable only if the project could operate (for example, the assets of water treatment or power plants). The risk to the banks when it takes collaterals of these projects will be discussed in the next section.

PROBLEM

As discussed above, FS is increasingly used in project funded by municipal bonds in order to provide the bondholders a most speedy and reliable assurance for their principals and interests. To limit the ground on which the FS issuing bank could base to deny payment, the pre-default discretion of the indenture trustee is rather limited. This limitation is supported by (i) the law on the indenture trustee, (ii) the bad effect to credit enhancement of the bonds, and (iii) the matter of monitoring costs. The issuing bank, in its turn, tries to avoid its involvement in the underlying contract and restrain itself in only dealing with documents – the area in which it has expertise. If the issuing bank goes outside the “protection umbrella” set by the dealing-only-with-document-principle, it would expose itself to non-reimbursement risks.

Hence, it is interesting to see that, in order to have good credit enhancement for the municipal bonds, monitoring activities are sacrificed for the liquidity of the FS. Although having limited monitor on the project, the indenture-trustee still be safe by transferring the credit risks to the FS issuing bank by obtaining a very highly liquid assurance from this bank. The issuing bank, in its turn, could transfer the credit risks to another bank who acts as the confirming bank or issuing backup FS bank. No matter how many times the credit risks transferred to other participants, the emerging problem is if the limitation of the lender’s monitor could result in any unacceptable risks.

So, one can ask the question: “is monitoring the developer-applicant important?” The answer is “yes”. As the projects funded by municipal bonds are commonly for development purposes so it is often of long or medium terms, complex in construction and operation, and has the involvement of many parties with different interests. Due to the complex and long term nature of the project, several issues require the lender monitor.

⁵³ Kozolchyk, *The Financial Standby*, *supra* n. 11 at 341.

⁵⁴ Interviewed by Boris Kozolchyk, Prof. L., with Andrew Ball, Senior Lending Officer (Nov. 23, 1998): “Some of [the] bonds were secured by apartments or condominiums and it is not that hard to foreclose on that collateral. The same is not true if the collateral is a bond issuer’s sewage or water system. Obviously, you cannot repossess those systems, although you can continue to collect their revenues”.

The first is the developer's misbehavior in project management. Although, both the indenture trustee and the issuing bank, in their credit analysis, consider the developer's experience and reputation in managing project, they should be aware that a history of good management or a good reputation name does not guarantee that no misbehavior would occur in future. As the big name, the developer often belongs to a larger group or carries out several projects at a same time. So misbehavior could occur if the developer re-prioritizes its resources when it has problems with other projects or when the group, for some reasons, puts the developer into risks by taking away its human, technological or capital resources. The case of Enron and its subsidiary National Energy Production Company (NEPCO) is the most recent outstanding example. Just before Enron's bankruptcy, hundred of millions of dollars has been swept upstream to Enron leaving NEPCO without sufficient funds to complete many of its ongoing projects. As a result, after Enron's bankruptcy, many letters of credit issued to guarantee NEPCO's obligations were drawn upon.⁵⁵ Although, not all misbehaviors of the developer would lead to a total disaster as the case of Enron, but in a long term, these misbehaviors could cause fundamental risks for the project. For example, a low quality bridge built with an estimated life of thirty years may be alright in the first ten years but it would be closed after that due to the downgrade of its safety. One can argue that, the developer is the one that should care most about the operation of the project because it is the ultimate person responsible for all of the risks. However, as discussed above, if let the developer at his own, sometimes, the short-term vision prevails the long-term.

The second issue is the non-recourse nature of the project may encourage "potentially unacceptable risk taking" of the bond issuer. A leading lawyer in project finance commented as follows: "[p]roject finance is, in the final analysis, risk allocation. Risk allocation is required by the non-recourse (or limited recourse) characteristics of project finance. Consequently, it might be argued that a project sponsor, having no recourse liability, is more likely to aggressively accept risks."⁵⁶

Weak monitoring activity would not be a threat to the bondholders or the FS issuing bank when they are still able to transfer the credit risks to other participant (i.e. obtaining a highly liquid assurance such as an FS.) However, to the last participant in the chain of transferring credit risks, whose the reimbursement would be guaranteed by the collaterals of the project assets, the weak monitoring activity means that they are exposed to the risk of misbehavior of the developer without any measures to minimize it. This risk becomes greater if the collateral assets are not liquid (i.e. in the case of the project for public utility purposes such as power plant or water treatment).

It is necessary to understand that when the developer defaults due to the bad management, it does not always means that the project is not feasible. This is the reason that banks issuing FS accept the risk. On the one hand, the most concern of the bondholders is the repayment of their principals and interest. And on the other hand, the bondholders do not possess the expertise for a proper credit analysis. Therefore, the common reaction of bondholders is to require the indenture trustee to draw upon the FS once there is a default. The FS issuing bank, with his financial capacity and its credit analysis of the project

⁵⁵ Carter H. Klein, *The Effects on Letters of Credit of Enron*, Annual Survey of Letter of Credit Law & Practice 94,96 (2004).

⁵⁶ Hoffman, *The Law and Business*, *supra* n.6 at 20.

would not be panic as easily as the bondholders, and therefore, it could have some solutions better than foreclosing the collaterals. Normally, having a “breath space” given by the FS issuing bank and with proper improvement of its management, the project could run well and generate profit again, and the municipal bonds can be resold to the public. However, this is the case where the consequences of the bad management are “curable”. If the consequences are “incurable”, such as a downgraded bridge should be abandoned due to safety, the collaterals would be unpleasant gift to the FS issuing bank as the project assets itself, in this case, could be valuable only if it could operate. The incurable consequences could be caused by the bad management during the construction (i.e. using low quality materials lead to a shorter life of the construction) or during the operation of the project (i.e. an environmental accident caused by negligence of the management of a nuclear power plant would lead to the closure of the plant forever.) However, to prevent this type of bad management, no measure available to the FS issuing bank.

CONCLUSION

In a summary, while FS is the fastest and most reliable assurance for the bondholders in projects funded by municipal bonds, it is necessary to ascertain that to ensure the speedy and reliability of the standby, the pre-default monitoring activity of the indenture-trustee is limited. There are three reasons for this limitation: (i) the standard of care of the indenture trustee provided in the TIA, (ii) the bad affect to credit enhancement of the municipal bonds in case the indenture-trustee has a broad discretion, and (iii) the monitoring costs of indenture trustee itself. The not-being-closely-monitored-developer could have misbehavior which could lead to “incurable” consequences to the future of the project. The FS issuing bank or the banks issuing backup FS or being confirming bank, therefore, is exposed to the risks of misbehavior of the developer-applicant. This risk would become serious in the case of projects of public utility purposes where the project assets are not liquid and valuable only if the projects operate.

It is true that in the banking world, risks and benefits exist together. And if a banker sees profits in a transaction, he automatically knows that there should be some risks associated with those profits. And even if he could not see it right away, he will bear in his mind that the risks are somewhere or may be just around the corner. However, the matter is if the risk is reasonable, and if not, it could be cured or not. The developer’s misbehavior risk that FS issuing banks are exposed to is unreasonable because, in particular, it could cause loss to the bank, but in general, it could cause much more for the whole society due to the failure of the development project. Whether this problem can be solved, the answer is “yes”.

As mentioned above, although municipal bond issuances are exempt from application of TIA, courts deciding on FS trustee's duties are likely to turn to TIA-inspired case law when attempting to evaluate the trustee's performance. While it is unlikely that a special law on the indenture trustee of the projects funded by municipal bonds is enacted in the future, an amendment of the TIA is more feasible. Nevertheless, the TIA, which was commented by a commentator as “[it] does not serve the purpose for which it was enacted

or the economic interest of the bondholders”⁵⁷, should be amended to put the indenture-trustee in a more active and responsible role in monitoring the developer’s behavior in pre-default period⁵⁸. The liquidity of the financial standbys, for the benefits of the development market, should be maintained.

⁵⁷ Lev, *supra* n. 37 at 120.

⁵⁸ *Id.* at 120: “...the trustee should be activated in the pre-default situation and judged according to the same standard of care that governs the trustee in the post-default situation – the prudent person in the conduct of his own affairs.”

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