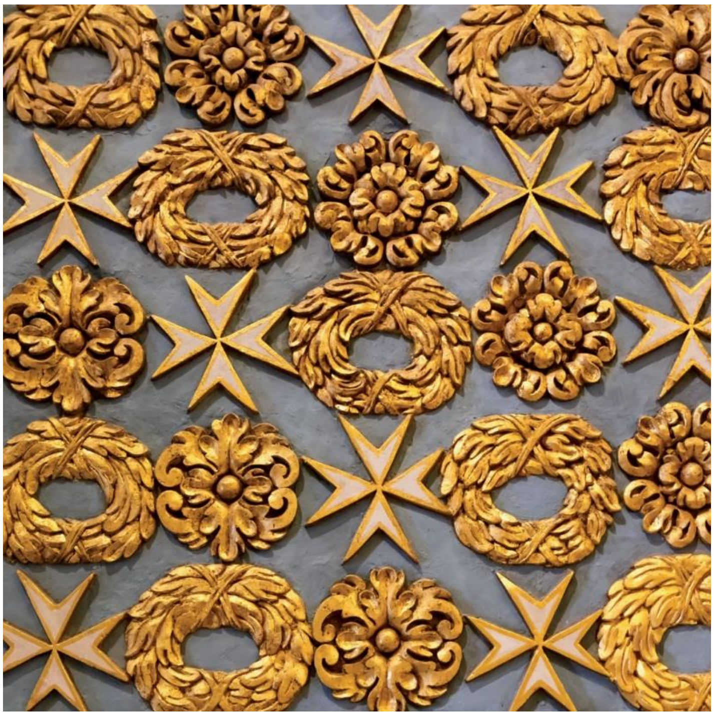
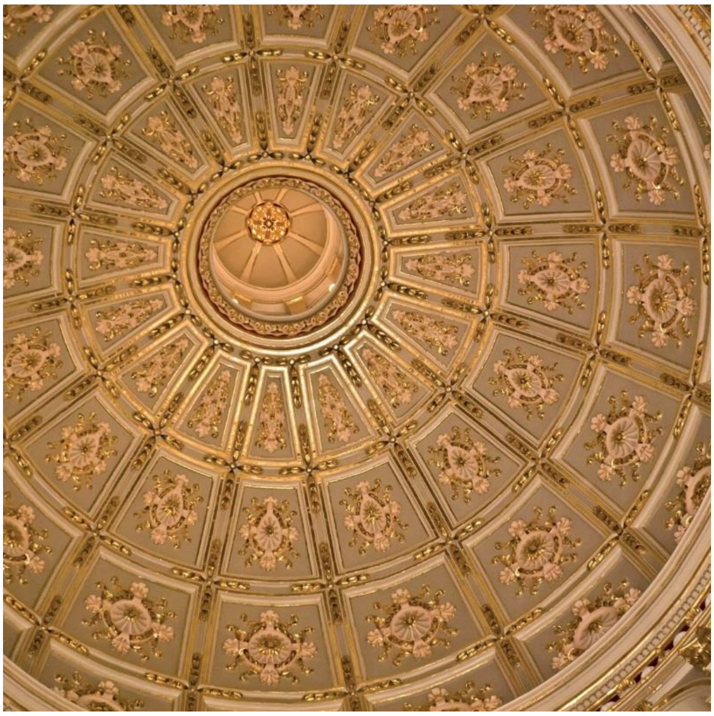
COMMERCIAL TRUSTS

A LITTLE NOTICED MAJORITY





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Over recent years media attention has almost exclusively highlighted the trust as a private family arrangement, indeed this is the origin of the trust.

In reality, family settlements account for significantly fewer trust arrangements. Today, the concept of trusts has extensively expanded into the commercial world particularly as a pre-requisite of every business transaction is the protection from the insolvency of a business partner. This is especially true in cross-border transactions as differing legal systems make it more difficult to obtain an enforceable security interest. A trust is often able to overcome this by building bridges between different legal systems.

The lack of rigid formal requirements for the creation and operation of trusts, offering, unlike companies or partnerships, a straightforward structure for joint ownership as well as tremendous flexibility, has enabled the trust to evolve into a versatile tool of commerce for raising capital throughout the world irrespective of tax advantages being available or not.

THE TRUST IN SIMPLE TERMS

In brief, a classic trust is relationship wherein a person (the settlor) transfers any type of property to another person (the trustee) so that this manages and controls the property for the benefit of a third person, known as the 'beneficiary'. Contrary to family trusts, where the asset is typically transferred into the trust for no consideration, the settlor of a commercial trust usually receives value for the transaction. Trust law works on the principle that more than one person can have rights over property at the same time.

Some jurisdictions, like Malta, offer the additional attraction of permitting the establishment of charitable purpose trusts as an alternative to traditional beneficiary trusts. In a purpose trust, the beneficiaries are replaced by a purpose specified by the settlor(s). The obligation of the trustee to maintain and apply the trust assets to the specified purpose in accordance with the
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established rules is the most prominent feature of the purpose trust. The precise terms of the purpose and the mode of its execution are specified in the trust instrument and can be varied within the parameters established by the settlor.

Trustees, by law, have to act purely for the benefit of the beneficiaries or purpose, avoiding all conflicts of interest and exercising a high duty of care. Trusts are therefore an amazingly useful structure in the commercial world, combining a high degree of flexibility with strong protections and certainty as to interpretation and execution.

Trusts can be used for almost any commercial transaction and in any country. Below is an overview of some of the main areas where trusts are commonly used in a commercial context.

PRIVATE INVESTMENT FUND TRUST

Private Investment (Purpose) Fund Trusts can be used as an alternative to unit trusts or investment fund companies. Instead of holding units or investment shares the investors may receive participation notes that merely grant contractual rights as set out in the in the terms of the notes. This may have tax advantages in some circumstances and offers more flexibility with regard to distributions of income and gains, the maintenance of capital adequacy requirements and restrictions of return of capital prior to liquidation.

SECURITISATION OF ASSETS

Securitisation is a structured finance process by which a bankruptcy remote Special Purpose Vehicle (SPV, e.g. a trust or company) is established to raise funds from investors by issuing debt securities (typically bonds) in order to acquire a single asset or a pool of assets. The assets are thereby transferred from the balance sheet of the seller (originator) to the balance sheet of the SPE (buyer), in return for payment. The SPE's obligations to the investors are limited to and secured by a security interest created over the assets. When amounts payable are received by the SPE they are used to fund the payment obligations of the SPE towards the investors and to meet the costs of the structure.

Typical reasons for doing a securitisation transaction are:

- Cheaper borrowing and credit arbitrage as the issued debt securities are collateralized with the asset and completely segregated from the credit risk of the financed company.
- Balance sheet benefits as liquidity is raised without increasing the liabilities.
- Capital adequacy optimisation as less liquid assets are immediately transformed into liquidity.
- In the context of investment funds securitisation can also be used in order to invest in asset classes that would otherwise not be available due to applicable investment restrictions or guidelines. In place of a direct investment, for example into private equity or mezzanine lending, the investment fund acquires debt securities from the SPE, which in turn does the private equity investment or mezzanine lending.

In contrast to securitisation transactions that are structured as a purely contractually segregated compartment of a multi-transaction securitisation company, the use of a dedicated trust provides complete segregation of the assets from other securitisation transactions.

EMPLOYMENT BENEFIT TRUST

Employment benefit trusts exist in various forms and with numerous purposes. One of the benefits of using a trust is that the assets are segregated and therefore protected against the employer's bankruptcy.

- Pension Scheme Trusts: many international pension schemes are set up as trusts to which the employer and the employees contribute pursuant to the contract of employment. As the trust fund is separate from the assets of the employer, the employee-beneficiaries are protected in the event of the insolvency of the employer.
- Bonus Benefit Trusts: this type of trust is extremely useful in situations where payment of a bonus is deferred until a certain future event occurs.
- Share Plan Trusts: this type of trust is used in the context of employee option or share plans, where the trust holds the options or shares until these, or the corresponding cash value, are transferred to the employee, usually when a certain future event occurs. Often, this is also chosen as a solution in order to enable the employees to participate in a company's success, without however having direct ownership title and therefore the controlling rights typically associated to shares (see also Voting Trusts).
- Medical Benefit Trusts may be an alternative to conventional health insurance.

COMPANY RESERVE OR FUNDING TRUSTS

In certain circumstances assets of a company may be allocated to the trustee of a purpose trust on the proviso that these can only be used in accordance with the specified purpose of the trust. The company may possibly even declare itself the (co-)trustee and, if clearly identifiable from the other assets of the company, such assets are segregated from those of the company whilst remaining on the balance sheet. They become a 'ring-fenced' reserve protected from the insolvency risks of the company. Such arrangement may be used to fund contributions to a directors' pension scheme or, in cases where an independent trustee is appointed, can be utilised to remove assets or cash from the balance sheet of a company. This can be useful to set aside funds so that these are available over time to meet the costs of a particular project, e.g. major repairs to a building, replacement or installation of infrastructure etc.

VOTING, JOINT VENTURE AND PARTNERSHIP TRUSTS

Trusts are a proven tool to ensure the continuity of a business venture.
Voting trusts are used in commercial situations where the voting rights of the shares of a company should be segregated from the rights to the profits and capital of a company. Distributions by the company of both income and capital are allocated to one group of beneficiaries whilst the voting shares are controlled by the trustee either at its discretion or for the benefit of another group of beneficiaries. A voting trust may also be used in the context of a joint venture company to avoid a deadlock between the parties whereby the trust owns a minority holding in a company and is entitled only to the 'voting share' and not dividends or capital. Voting trust can further be set up in order to protect from a hostile takeover when a sufficient number of shares are put in a trust.
Partnership or joint venture agreements usually contain clauses dealing with the withdrawal or death of a partner. In the case of death of a partner an insurance may be contracted that enables the surviving partner to buy the interest of the deceased partner and thereby avoiding a forced sale of the partnership or joint venture.

ESCROW OR SECURITY TRUSTS

The escrow trustee holds property in trust for third parties, while a transaction is finalized or a disagreement is resolved. The trustee thereby has a fiduciary responsibility to all parties to the escrow agreement, essentially serving as a neutral middleman. The escrow trustee holds the funds until it receives the appropriate instructions or until predetermined obligations have been fulfilled. Money, securities, funds, titles to real estate, personal security interests such as mortgages, hypothecs, privileges, pledges and guarantees can all be held in escrow. The funding of the trust in respect of its exposure can be full or partial from the outset, e.g. with the retained profits serving to reach the full amount over time or with insurance coverage bought to bridge any gaps.
Escrow transactions are typically made where protection is needed against one party going insolvent or refusing to deliver, e.g.:

- when lender needs protection that the money provided to the borrower is effectively used by this for the agreed purpose;
- when a party should collect money before this is due to be paid on to sub-contractors (e.g. in the construction industry);
- when goods or services need to be paid before delivery, so that the money received could be returned if the company was not able to fulfil the orders.
- when there is dispute or potential dispute, for example where security is being taken in major litigation.
- when a company experiences financial difficulties and may be heading for insolvency in order for that company to continue to trade so long as new money taken from customers is held on trust.

DEBENTURE TRUSTS

This kind of trust enables a company to raise capital in the form of a loan rather than share capital by creating transferable securities issued to lenders. The trustee takes an intermediary position between the bondholders and the debtor, securing the collective interest of the bondholders and simplifying the administration for the bondholders and the debtor as the borrower does not have to deal with multiple lenders. The access to confidential financial information is thereby often granted exclusively to the trustee, who has the responsibility to monitor the borrower's covenant and pay-back obligations and react immediately whenever required. In case of default the trustee can enforce a decision on behalf of the bondholders avoiding huge expenses and communication problems in cases where the bondholders would act themselves. Debenture Trusts are also established as a collateral arrangement under which the trust will hold the collateral for the benefit of the bondholders.
This type of trust can also be used when a company has issued debt instruments and wishes to redeem these, e.g. in order to improve its balance sheet structure, even though the debt instruments prevent any early redemption. The Debenture Trust is properly funded by the company and assumes the obligations of the company under the debt instruments.
Finally, a trust is also an appropriate vehicle to structure syndicated loan agreements.

UNIT TRUSTS

The Unit Trust is a type of collective investment scheme (i.e. investment funds). In practise, the Unit Trust is established by a fund manager, the so-called sponsor/fund promoter, entering into a written trust deed with the trustee. The number of issued shares (units), which are held by the investors, divides the net asset value of the trust. The investors therefore have a right over the trust assets according to their number of units and may demand the redemption of units, which may also be structured as tradeable. Unit trusts can apply for an ISIN.
All Collective Investments Schemes structured as Unit Trusts must be licenced by the Malta Financial Services Authority under the Investment Services Act with the exception of those falling within the scope of the newly launched Notified Alternative Investment Fund (NAIF) framework. Unit Trusts established under the NAIF regime are exempt from licencing (in Malta). Instead their creation is simply notified to the Malta Financial Services Authority. A Unit Trust set up under the NAIF process must be managed by an authorized EU AIFM and the Trustee must be based in Malta and also be authorised as a depository by the MFSA.
Usually, Unit Trusts are tax-transparent, which can produce favourable results for certain investors, depending on their residence.

Mandaris operates trustees in several jurisdictions and is specialised in the area of trusts and other asset structuring solutions. Our multi-lingual professionals have particular knowledge and experience with regard to legal, tax and administrative questions surrounding the structuring of assets in an international environment.

Please do not hesitate to contact us if you have any questions or queries.

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