

Client Alert

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Exit Consents

Summary

In an important judgment handed down on Friday 27 July 2012 (*Assénagon Asset Management S.A. and Irish Bank Resolution Corporation Limited (formerly Anglo Irish Bank Corporation Limited (Anglo Irish))*) Justice Briggs, sitting at the High Court, Chancery Division, upheld a challenge to the commonly used restructuring technique of "exit consents" used in English law governed bonds on the basis that this technique was an abuse of power by the majority and "at variance with the purposes for which majorities in a class are given power to bind minorities".

"This decision will for the foreseeable future create some uncertainty for restructurings implemented by way of a bond exchange or exit consent."

It is important to note that this case concerned English law governed bonds. United States courts interpreting New York law governed bonds have consistently held that the contractual relationship prevails in the case of creditors of a solvent company. As a result, we believe that exit consents will continue to be available as restructuring tools for New York law governed bonds.

Exit Consents

The *Anglo Irish* case focused on the restructuring technique known as "exit consents", which is commonly used in combination with an exchange or tender offer — a process which can be summarised as follows:

- The issuer wishes to persuade all the holders of a particular bond issue to accept an exchange of their bonds for replacement bonds on different (and typically less advantageous) terms.
- The holders are all invited to offer their bonds for exchange, but on terms that they are required to commit themselves irrevocably to vote at a bondholders' meeting in favour of a resolution amending the terms of the existing bonds so as to devalue the rights attaching to those existing bonds after the resolution has been passed.
- A holder who does not offer his bonds for exchange and either votes against the resolution or abstains takes the risk, if the resolution is passed, that his bonds will be devalued by the resolution.

Background

The bonds purchased by the claimant in the *Anglo Irish* case were subordinated and due to mature in 2017 (the 2017 Bonds). The 2017 Bonds were governed by English law and issued pursuant to a trust deed which provided that an Extraordinary Resolution for certain reserved matters could be passed at a meeting of bondholders representing two-thirds of the nominal amount of the 2017 Bonds, if 75 percent of bondholders voted in favour. The Extraordinary Resolution would then be binding on all bondholders.

The background to this case was the Irish financial crisis of 2008/09:

- By September 2008, Anglo Irish had become the third-largest bank in the Irish domestic market with €101 billion of gross assets on its balance sheet, representing about 50 percent of Irish GDP. It had a particular focus on commercial property lending and as a result of the 2008 financial crisis Anglo Irish faced a liquidity crisis which, unless it was rescued by the Irish Government, would have forced it into insolvent liquidation.
- On 21 January 2009, Anglo Irish was nationalised. On 30 September 2010, the Irish Minister of Finance made a statement on the banking system in Ireland which, while stating an intention to respect all senior debt obligations of Anglo Irish, continued:
"The principle of appropriate burden sharing by holders of subordinated debt, however, is one with which I agree...[I]t is right that the holders of Anglo's subordinated debt should share the costs which have arisen...I expect the subordinated debt holders to make a significant contribution towards meeting the costs of Anglo."
- On 21 October 2010, Anglo Irish proposed to bondholders an exchange of (*inter alia*) the 2017 Bonds for new notes (the New Notes) at a 20 percent exchange, giving exchanging bondholders 20 cents for every one euro of 2017 Bonds held. The proposal included the health warning that:
"By offering to exchange its Existing Notes, a holder will be deemed to...vote in favour of the relevant Extraordinary Resolution in respect of all Existing Notes of the relevant series offered for exchange by such holder and which are accepted by the Bank at the...2017 Notes Meeting...If an Extraordinary Resolution is passed in respect of any Series of Existing Notes...the amendments shall be binding on all Holders of Existing Notes of such Series, whether or not those Holders attended or were otherwise represented at the relevant Meeting and/or voted in favour of the relevant Proposal. If the Bank chooses to exercise such call right (which the Bank currently intends to do shortly after the relevant Settlement Date, although the Bank is under no obligation to do so), the redemption amounts payable to a Holder of Existing Notes (being €0.01 per €1000 in principle amount of Existing Notes) will be significantly less than the principal amount of the New Notes such Holder would have received had such Existing Notes been exchanged pursuant to the relevant Exchange Offer."
- The exchange offer was successful with 92 percent of holders voting in favour. Anglo Irish subsequently exercised its call right at the nominal price of €0.01 per €1,000 nominal value of bonds, meaning that the claimant received €170 for its €17 million nominal value of 2017 Bonds.

The Claim

The claimant asset management fund did not attend, or vote by proxy at, the 2017 bondholders' meeting on 23 November 2010. It first complained about what had occurred on 30 November 2010 and issued a claim on 15 April 2011. It would appear that the bondholder had been "asleep at the wheel" and, having missed the opportunity to participate in the exchange, subsequently sought a declaration that

the resolution passed at the meeting was invalid on three independent but related grounds:

1. *Wrongful expropriation/Ultra Vires*: The resolution constituted, in substance, the conferral of a power on Anglo Irish to expropriate the 2017 Bonds for no more than a nominal consideration. It was therefore ultra vires the power of the majority under the trust deed to pass a resolution to this effect
2. *Issuer cannot vote on a resolution*: This was a technical objection arising from a provision included in most trust deeds that prohibits the issuer from voting on a resolution. As a result of the way in which this exchange offer was constructed, at the time of the bondholders' meeting on 23 November all the consenting bondholders' 2017 Bonds were held beneficially by Anglo Irish and, accordingly, all those votes were to be disregarded pursuant to the provision in the trust deed that prohibited the issuer from voting in a resolution.
3. *Oppression of the minority*: Even if ultra vires, the resolution constituted an abuse of the power of the voting majority because:
 - i. It conferred no conceivable benefit or advantage upon the 2017 bondholders as a class; and
 - ii. It was both oppressive and unfair as against that minority who had not agreed to participate in the exchange offer and vote in favour of the resolution.

Justice Briggs found against the claimant on the first ground (ultra vires), but found in favour of the claimant on the second ground (issuer cannot vote on a resolution) and the third ground (oppression of the minority). In short, the exchange offer and exit consent process carried out by Anglo Irish was unlawful and oppressive.

Oppression of the Minority

It is the third ground that is perhaps the most significant for the bond market and future restructurings of bond issues.

Having characterised the resolution as a "negative inducement" to deter bondholders from refusing the exchange, Justice Briggs concluded that it was not lawful for the majority to aid the coercion of a minority by voting for a resolution which expropriates the minority's rights under their bonds for nominal consideration.

In so holding, Justice Briggs declined to follow a long line of US cases involving New York law governed bonds, most notably, *Katz v Oak Industries Inc.*, which the Delaware Courts of Chancery concluded that voting of securities by majority noteholders pursuant to exit consents do not conflict with provisions that prohibit the issuer from voting treasury securities and that, emphasizing the strictly commercial nature of the relationship between the corporation and the bondholders, exit consents are not an abuse of power or unduly coercive. Other Delaware courts have similarly concluded that a creditor's rights are fixed by contract with the corporation and that creditors are usually better able to protect themselves than dispersed stockholders.

It should be noted in this context that New York law governed bonds which are registered in the US are subject to the US Trust Indenture Act, which provides that certain fundamental terms cannot be amended without the consent of each holder. Even if bonds are not registered in the US, if they are nonetheless sold primarily to US investors, this 100 percent consent requirement has become expected by investors. For New York law governed bonds sold primarily to European investors, a 90 percent threshold for amendments to such terms is market standard. In English law governed bonds, the threshold for amendments to fundamental terms has historically been a 75 percent quorum (or, as in the *Anglo Irish* case, two-thirds) of which 75 percent must vote in favour.

The Issuer Cannot Vote on Resolutions

Ordinarily it should be possible to structure exchange and tender offers coupled with exit consents in such a way as to avoid this technical issue. English law governed trust deeds typically provide that bonds held by an issuer and its subsidiaries cannot be voted in a resolution of bondholders.

In the *Anglo Irish* case the exchange offer was structured so that the issuer accepted the bonds proffered for exchange prior to the bondholders' meeting. Settlement of these bonds took place after the bondholders' meeting at which the resolution was passed. This meant that a contract for sale by exchange was deemed to have taken effect prior to the bondholders' meeting such that the bonds voted in favour of the resolution were held for the benefit of the issuer at such time and, accordingly, could not be voted in the resolution.

By structuring the exchange so that the acceptance falls after the bondholders' meeting, this issue should be avoidable.

Consent Fees

Also relevant to bond restructurings is another recent judgment by the English High Court on 4 July 2012 in *Azevedo v Imcopatwo*. This case established for the first time the legality of fees paid to consenting bondholders in a consent solicitation process. Here a fee was offered to consenting noteholders only and the company was sued by two noteholders claiming the consent payment amounted to bribery and rendered the resolution passed invalid.

The court ruled that the consent fees were legal on the basis that the offer is made publicly to all voters on the same terms that bondholders are free to accept or reject. The judge noted that "the same could not perhaps be said if the offer of consideration in exchange for a bondholder's vote was not made to all bondholders on the same terms". It accordingly remains essential to ensure that any restructuring is implemented so as to treat all bondholders equally and that fees and other benefits are open to acceptance by all.

In the *Anglo Irish* case, Justice Briggs considered the *Azevedo* case in detail, and distinguished it on several counts, including that:

- The resolutions in *Azevedo* to postpone interest payments were the substance of what the issuer wished to achieve, whereas in the *Anglo Irish* case the substance of the plan was to substitute the New Notes for the 2017 Bonds by way of a contractual exchange.
- The postponement of interest payments in *Azevedo* was capable of being beneficial to bondholders, since it was designed to facilitate a reconstruction of the issuer which was beneficial to all stakeholder, whereas in the *Anglo Irish* case the resolution "was designed in substance to destroy rather than to enhance the value of the 2017 Bonds and was, on its own, of no conceivable benefit to bondholders".

Conclusion

An appeal may be lodged by Anglo Irish but it is clear that this decision will for the foreseeable future create some uncertainty for restructurings implemented by way of an exchange offer and/or exit consents. There is a risk that the structures and techniques that the restructuring community have been using historically may no longer work, unless it is possible to distinguish the preferred implementation route in some significant way from the proposals put to bondholders in the *Anglo Irish* case.

In particular:

- It would seem important to look for some substantial benefit to bondholders (per *Azevedo*) or no substantial disparity between exchanging and non-exchanging bondholders. Binding all holders to the same result would seem to enable a structure to be more easily distinguished from the *Anglo Irish* case.
- The *Anglo Irish* case appeared to focus on the expropriation of the minority's rights *for nominal consideration*.
- It is possible that the call option inserted by the resolution in the *Anglo Irish* case, which permitted Notes to be called by the Issuer so far below their principal value, might distinguish this from other structures.
- Issuers will need to consider whether other forms of exit consents (whether or not combined with an exchange or tender offer) to the extent they can be said to be "coercive" or unfair in some way will be caught by the judgment in the *Anglo Irish* case as oppressive of the minority, even if they fall short of a complete expropriation of the bonds.

In the context of securities that are typically held by sophisticated investors who are not only familiar with the restructuring techniques employed but who frequently buy and trade securities for the very purpose of positioning themselves to put pressure on issuers in a restructuring scenario, it is perhaps surprising that the court should have come down so hard on these commonly employed restructuring techniques. An appeal would be welcome to ensure that this important area is finally adjudicated by the highest courts in England and, one would hope, in a judgment that gives more definitive guidance on what is acceptable going forward.

Given the history of case law in the United States, where exit consents have long survived judicial challenge by minority bondholders, issuers might wish to consider using New York as the exclusive governing law for debt instruments and submitting to exclusive United States jurisdiction to provide more certainty if a restructuring is needed in the future.

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