

Liability Management: Exit Consents and Oppression of the Minority

In a significant recent judgment, the English Court has analysed the legal basis for the "exit consent" technique that has formed an important part of recent liability management exercises and provided a timely reminder that the English courts will not uphold structures that seek to impose unfair or punitive outcomes on dissenting or non-participating Noteholders.

The judgment of the High Court in *Assenagon Asset Management S.A. and Irish Bank Resolution Corporation Limited (Formerly Anglo Irish Bank Corporation Limited)* which was handed down on 27 July has for the first time analysed the legality of the exit consent under English law. Although the judgment should be seen as sounding a cautionary note, it nevertheless offers welcome guidance on what the courts will regard as permissible.

Background

The term "Exit Consent" describes a liability management technique whereby Noteholders are invited to participate in a tender offer or an exchange offer, and as part of their tender or exchange instruction are required to deliver a vote in favour of an extraordinary resolution proposing amendments to the terms of the Notes. It has been used in a number of liability management exercises, particularly where an issuer wishes to retire all or part of a class of Notes and therefore seeks to rely on the majority rule provisions commonly found in English law bonds, by inviting holders to sanction the early redemption of one or more classes of Notes in conjunction with a voluntary exchange offer or tender offer. Exit consents are also, on

occasion, used in the context of sovereign debt restructuring transactions.

In the present case, the Court focussed heavily on the fact that the Notes in question were redeemed for a nominal or punitive price, as compared to the substantive value that was available to those holders who elected to participate in the accompanying exchange offer. It is important to bear in mind however that most exit consents are not structured in this way, and there are many examples of transactions where this significant disparity in value has not been a feature.

Facts of the Case

The present case related to a series of subordinated floating rate notes (the "Notes") issued by Anglo Irish Bank Corporation (the "Bank") and maturing in 2017. As part of the recapitalisation of the Irish banking sector from 2008 onwards, the Irish Government announced in May 2009 that it intended to make substantial additional capital available to the Bank, and that the Bank was also planning a liability management exercise in order to increase its Core Tier 1 Capital.

Key issues

- **Modifications which are *prima facie* detrimental to Noteholders may still be within the modification powers forming part of the security.**
- **Notes that have been acquired by an issuer prior to a meeting may be effectively disenfranchised if the terms of the Notes so provide.**
- **Resolutions that impose an unfair price or outcome on holders who do not participate in the tender or exchange may be overturned by the courts.**
- **Open disclosure of the terms of the proposal will not save a resolution that is inherently unfair or oppressive.**

The claimant acquired its holding in the Notes at prices of approximately 41 to 42 per cent of their par value in the period between September 2009 and April 2010. The exchange offer was launched on 21 October 2010, after the Minister of Finance of Ireland had made a further public statement on 30 September 2010 in which he indicated his intention that "*subordinated debt*

holders should make a significant contribution towards meeting the costs of Anglo".

The terms of the exchange offer were that an exchanging holder would be offered 20 Euro cents in nominal value of new notes for every one Euro in nominal value of Notes so exchanged, i.e. an exchange ratio of 0.2. The new notes would have a coupon of 3.75 per cent. above three month EURIBOR, mature in December 2011 and have the benefit of a guarantee from the Irish government.

In connection with the exchange offer the Bank also proposed an extraordinary resolution, to be sanctioned at a meeting of the holders of the Notes, which would modify the conditions of the Notes to give the Bank the right to redeem the Notes outstanding following completion of the exchange offer at an amount equal to Euro 0.01 per Euro 1,000 in principal amount of the Notes. It was a condition of a holder's ability to participate in the exchange offer that they should also vote in favour of the extraordinary resolution.

One unusual feature of the transaction was that the Bank announced the results of the exchange offer, and the principal amount of Notes that it was accepting for exchange, on the day prior to the meeting. As is typical in most English law bond issues, the meeting provisions set out in the trust deed constituting the Notes provided that: "*Neither the Issuer nor any Subsidiary shall be entitled to vote at any meeting in respect of Notes beneficially held by it or for its account*" (the "Voting Restriction").

The exchange offer achieved a high participation rate (92 per cent.) and the acceptance of the Notes for exchange was confirmed by the Bank on 22 November 2010. On 23 November 2010 the resolution was duly passed at the Noteholders' meeting and the exchange offer was settled on 24 November. On 30 November the Bank exercised the new call option and redeemed the Notes, paying the claimant Euro 170 for

its Euro 17 million principal amount of Notes.

Issues

The claimant raised three main arguments before the Court as to why the extraordinary resolution should be overturned:

1. The resolution was not within the powers of the majority as set out in the trust deed constituting the Notes.
2. At the time of the Noteholders' meeting all those Noteholders who had elected to participate in the exchange and whose votes were counted as being in favour of the extraordinary resolution were effectively holding those Notes for the account of the Bank and that the Bank should therefore be disenfranchised as a result of the Voting Restriction.
3. The Extraordinary Resolution constituted an abuse of the majority's voting powers because it conferred no conceivable benefit on the Noteholders as a class, and it could only have affected those Noteholders who had not agreed to participate in the exchange offer, and should therefore be regarded as both unfair and oppressive of the minority.

The Court's Decision

Ultra Vires

The powers of the trust deed permitted the appropriate majority of Noteholders to "*sanction any abrogation...in respect of the rights of Noteholders against the Issuer.*" Mr Justice Briggs noted that, in the absence of this wording, he would have had significant doubts that the resolution fell within the other powers provided by the trust deed. He felt that the substance of the extraordinary

resolution did more than merely modify or compromise the rights of Noteholders, but in fact proposed that they should be entirely extinguished. The Judge also expressed some sympathy for the claimant's argument that the power of abrogation should be construed in similar vein to the other powers created by the trust deed, which all represented a modification, rather than a complete extinction, of Noteholders' rights.

Nevertheless in light of the fact that the quorum provisions also specifically referred to a reduction or cancellation of the principal or interest payable on the Notes, the Judge concluded on balance that the complete extinction of Noteholders' rights as against the Bank was in fact within the powers conferred by the trust deed.

Notes held by or for the account of the Bank

The claimant's argument that the Notes were disenfranchised from voting by virtue of the Voting Restriction was contested on two principal grounds: firstly the defendant argued that the date at which the prohibition should be assessed was the date that the relevant voting instruction was given and not the date of the meeting, and secondly that the contract of exchange was not specifically enforceable at the date of the meeting, and therefore the Bank could not properly be said to have a beneficial interest in the Notes as at the time of the meeting.

The Judge was not persuaded by the defendant's arguments on either point. On a proper construction of the trust deed, the Judge felt that the reference to the Notes being voted "at any meeting" within the text of the Voting Restriction made it clear that it was the date and time of the meeting at which the Voting Restriction applied. Moreover, the Judge also felt that determining exactly when the voting decision was made in the manner suggested by the defendant would give rise to significant practical difficulties in light of the electronic proxy

arrangements commonly used in modern bondholder meetings.

Having determined the question of timing, the Court then went on to consider whether the Bank did in fact have a beneficial interest in the Notes that had been accepted for exchange prior to the date of the meeting.

The Court rejected a broad argument put forward by the claimant's counsel that the disenfranchisement should apply in any circumstances where an issuer had obtained a contractual commitment to vote in a particular way, even if wholly unconnected with an agreement to exchange or purchase the Notes. The Court confirmed that the prohibition on voting would only apply in circumstances where the Noteholder was obliged to either transfer a proprietary interest, or transfer the whole of the economic risks and rewards relating to the Notes, to the Bank as at the relevant meeting date.

In the present case the Judge was satisfied that all of the Notes were "held under contracts for sale between the relevant majority Noteholders and the Bank". The only question for determination therefore was whether the contract was capable of specific enforcement, and whether the Bank had therefore acquired a beneficial interest in the Notes on the date on which it had accepted the Noteholders' offer to exchange.

The Judge had little difficulty in concluding that the contract to exchange the Notes was capable of specific enforcement. Although contracts for the sale and purchase of securities are not specifically enforceable where equivalent securities are readily available in a liquid market, in these circumstances because the purposes of the liability management exercise was to put an end to the market for, and the existence of, the relevant Notes, in connection with a politically significant restructuring of the Bank, the Judge had little difficulty in concluding that

damages would not be an adequate remedy for the Bank.

As a result of this analysis the Judge therefore concluded that the Notes were held for the benefit or account of the Bank at the time of the meeting, and that the Bank was prohibited from voting the Notes as result of the Voting Restriction.

Oppression of the Minority

The Judge acknowledged that, although his conclusions on the second issue were enough to determine the case in favour of the claimant, the third issue was one of significant wider importance to the bond market and one which could "*prima facie apply to any form of exit consent which imposed less favourable consequences upon those who declined to participate in the associated exchange offer*".

Counsel for the defendant argued strongly that the test of whether the extraordinary resolution was an abuse of power should be construed by reference to the value offered by the resolution combined with the exchange offer. The exchange offer was openly disclosed and available to all Noteholders in a manner consistent with the principles set out in *Goodfellow v Nelson Line (Liverpool) Ltd* and *British American Nickel Corp Ltd v MJ O'Brien Ltd*, and the recent decision of Mr Justice Hamblen in *Sergio Barrios Azevedo v Imcopa Importacao, Exportacao e Industria de Oleos Limitada* which we discussed in our earlier briefing of 31 May 2012 (*Noteholder Meetings: Paying the Price for Change?*)

Mr Justice Briggs rejected those submissions however, on the basis that in each of those previous cases "*it was not irrational to conclude that the proposal, ignoring the benefit of the inducement, was nonetheless itself capable of being regarded as beneficial to the class*".

Clifford Chance Contacts:

Stewart Dunlop

Partner, London

stewart.dunlop@cliffordchance.com

T: +44 207 006 2787

Simon Sinclair

Partner, London

simon.sinclair@cliffordchance.com

T: +44 207 006 2977

Deborah Zandstra

Partner, London

deborah.zandstra@cliffordchance.com

T: +44 207 006 8234

Paul Deakins

Senior Associate, London

paul.deakins@cliffordchance.com

T: +44 207 006 2099

The Judge endorsed a distinction between a situation where a "drag-along" scheme resulted in the dissenting Noteholders receiving the same, or substantially the same, consideration as those voluntarily participating in the liability management exercise and the facts of the present case where the minority was subject to a destruction of value that did not affect the majority.

The Judge confirmed that the key issue was "*whether it can be lawful for the majority to lend its aid to the coercion of a minority by voting for a resolution which expropriates the minority's rights*".

under their bonds for a nominal consideration". The Judge was firmly of the view that this type of resolution could not be considered to be lawful.

Counsel for the claimant also acknowledged (after questioning from the Court) that had the dissenting holders been given the opportunity, after the passing of the resolution, to revise their decision and elect to participate in the exchange, it would have been difficult to sustain a challenge to the arrangements simply because the majority of the value was attributable to the exchange offer rather than the resolution.

Comment

On the first issue, that of the powers of the Noteholders to sanction the complete extinction of Noteholders' rights, the Judge ultimately concluded this was within the scope of the broad power of abrogation found in the trust deed. Nevertheless this is an important reminder that the powers of compromise will be strictly construed by the courts, and that any ambiguity as to the width of these powers are likely to be construed in favour of the affected party. As such it is therefore important when drafting meeting provisions to ensure that the exchange of securities and/or the extinction of Noteholders rights, are within the list of powers exercisable by resolution. As will be evident from the Court's decision on the oppression issue however, the existence of a power alone will not be enough to ensure that a resolution is upheld; those powers must also be exercised *bona fide* in the interests of Noteholders as a class.

On the second issue it is interesting to note the Court's implicit endorsement of the view that the contract between the Bank and the exchanging Noteholders was formed at the point that the Bank publicly announced its acceptance of the Notes offered for exchange. This has long been the view of most practitioners in this field, and it is helpful that this position seems to have been endorsed by the Court. A consequence of this

position however, is that care needs to be taken as to when that contract is in fact concluded.

The position in the Anglo Irish exchange offer, whereby the Notes were accepted for exchange prior to the holding of the meeting, is not typical of the majority of exit consents. Rather the more conventional approach is for the results of the voluntary process to be announced after the conclusion of the relevant meeting, and the acceptance of Notes for purchase or exchange is also often conditional upon the passing of the relevant resolution. In light of the detailed analysis that the Court conducted as to the time at which the Voting Restriction applied, and whether or not the contract for exchange was capable of specific enforcement, it would seem that the simple step of accepting the Notes for exchange after the Noteholder meeting, in accordance with conventional market practice, would have avoided the issues presented in this case.

Notwithstanding the above it also remains to be seen whether or not the defendant will seek to appeal the Judge's decision that the exchange contract was capable of specific enforcement. The Judge took a very narrow approach to determining whether or not the Bank could have been adequately compensated in damages, analysing the question solely in terms of the trading market for the Notes as opposed to considering the broader effects of the transaction on the financial position of the Bank.

The Judge also left open the broader question as to whether the same analysis might apply to all exit consents, (on the basis that they aim to extinguish the entire series of Notes), or whether he only reached that conclusion in this case because of the particular economic and political circumstances affecting the Bank. Pending an appeal or any further clarification of these issues, it would seem that this decision falls short of

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providing any broader comfort to issuers that these sorts of contracts may be specifically enforced against Noteholders.

On the final issue, it is evident from the judgment that Mr Justice Briggs was strongly opposed to the way in which the minority Noteholders were treated. The Judge even went so far as suggesting that the whole purpose of an exit consent was *"seriously to damage, or, as in the present case substantially destroy, the value of the rights arising from those existing bonds"*.

"The exit consent is, quite simply, a coercive threat which the issuer invites the majority to levy against the minority, nothing more or less. Its only function is the intimidation of a potential minority, based upon the fear of any individual member of the class that, by rejecting the exchange and voting against the resolution, he (or it) will be left out in the cold."

Although the Judge's comments cited above seem to be fairly critical of exit consents as a whole, it is clear from the rest of the judgment that it is the disparity in value between those who accept the exchange and those who are "left out in the cold" that formed the real basis for his decision. The Judge himself acknowledged the important distinction between the facts of the present case and those where the resolutions were (ignoring the effects of any inducement) nevertheless something for which a rational and economically motivated bondholder could legitimately have voted.

When used properly, the purpose of the exit consent is not to inflict a destruction of value upon minority holders, but to ensure that an issuer can implement modifications to existing contractual arrangements without requiring the specific consent of each individual bondholder.

It is clear that Mr Justice Briggs's fundamental objection to the Anglo Irish exchange offer was the fact that the minority holders were given no value for the redemption of their securities, and that this also acted as a form of coercion, threatening all holders with a choice between accepting the exchange and taking the risk of having their securities redeemed for zero consideration.

In circumstances where the resolution is, by its terms, unfair or oppressive, it is also important to note that the problem is not cured merely by giving open disclosure of the proposal. Mr Justice Briggs explicitly rejected this argument, although he acknowledged that it is a common misapprehension amongst some practitioners and commentators.

In his obiter remarks, the Judge also gave informal approval of arrangements whereby Noteholders are given the opportunity to participate in the liability management exercise after the meeting date, and therefore have a second chance to realise the value available to all holders. In those circumstances the

Judge felt that the proposal would not be liable to challenge just because the value lay in the exchange as opposed to the resolution.

However, whilst alluding to the question of open participation, the Judge did not unfortunately consider the question of jurisdictional restrictions on participation which are often imposed by issuers who do not want to comply with the more draconian requirements of particular securities laws. Moreover his comments did not suggest what an appropriate time frame would be for this second opportunity to participate, or address the fact that this would add yet further delay to a what may already be a lengthy bondholder meeting process.

Provided however that substantially equivalent value is made available to the minority holders who do not participate in the exchange or tender offer, it should still be possible to structure an exit consent that does not fall foul of the principles set out in this case, without needing to extend the opportunity to participate in the offer after the date of the relevant meeting. Problems arise when structures are created which impose a penal or unfair outcome on one group of holders as compared to another, not simply where the purpose of the structure is to bind all holders into the same outcome.

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Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

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