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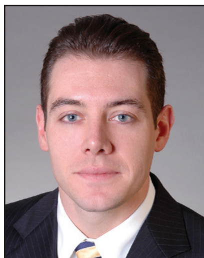
Feature

By Richard J. Corbi and Oscar N. Pinkas[1]

The (In)validity of Exit Consents

Majority Bondholders Cannot Oppress Minority Bondholders



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The English High Court of Justice, Chancery Division, recently upheld a challenge by minority bondholders to exit consents under a trust deed governed by English law as oppressive and at odds with the purposes for which majority bondholders may bind minority bondholders in *Assenagon Asset Management SA v. Irish Bank Resolution Corp. Ltd. (Formerly Anglo Irish Bank Corp. Ltd.)*.[2] When sifted to its essence, *Irish Bank* is simply an application of settled principles—namely that any power granted to a majority to bind a minority is constrained under English law by good faith and exercise for the benefit of the noteholders as a class—to curb use of a highly unusual exit consent involving the "expropriation" of minority notes.

What Is an "Exit Consent"?

The court summarized an "exit consent" as when "[t]he issuer wishes to persuade all the holders of a particular bond issue to accept an exchange of their bonds for replacement bonds on different 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 for a resolution amending the terms of the existing bonds so as seriously to damage or, as in the present case substantially destroy, the value of the rights arising from those existing bonds."[3] The purpose of such an exit consent is to permit a restructuring of bonds on terms not permitted in the original issuance.

An exit consent has no adverse effect on a holder who offers bonds for exchange and votes for the resolution. If the resolution fails to muster requisite bondholder approval, the exchange does not take place. If the exchange goes forward, the holder's notes are exchanged, precluding potential harm caused by a subsequent decrease in their value by virtue of the resolution. However, "a holder who fails to 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 either devalued by the resolution or, as in [Irish Bank], destroyed by being redeemed for a nominal consideration."[4]

Facts of the Case

The facts of the *Irish Bank* case arise out of the 2008 credit crunch and, in particular, the subordinated notes issued by a company then known as Anglo Irish Bank Corp. Ltd. (the bank). The claimant, Assenagon Asset Management SA, had acquired subordinated floating rate notes due in 2017 (the "2017 notes") issued by the bank under a trust deed (as amended, the "trust deed") with a face value of €17 million.[5] The 2017 notes were redeemable at par, whether at maturity or prior thereto.[6]

The trust deed was governed by English law and contained a consent to jurisdiction in English courts regarding the dispute *sub judice*.[7] By "Extraordinary Resolution," the noteholders could "assent to any modification of the provisions contained in [the trust deed] which shall be proposed by the Issuer or the Trustee."[8] For an "Extraordinary Resolution" to pass, it had to be accepted by three-fourths of "persons voting" at a noteholders' meeting in which there was a two-thirds quorum.[9]

By September 2008, the bank had become the third-largest bank in Ireland and had gross assets

1 Nothing in this article constitutes an opinion or view of the authors, Lowenstein Sandler PC, SNR Denton or any of their clients.
2 *Assenagon Asset Management SA v. Irish Bank Resolution Corp. Ltd. (Formerly Anglo Irish Bank Corp. Ltd.)*, 2012 WL 2923062 (Eng. Ch. July 27, 2012). Citation is to the decision reported on Westlaw and the corresponding numbered paragraphs of the official transcript.
3 *Id.* at *1.
4 *Id.* at *2.
5 *Id.* at *6.
6 *Id.*
7 *Id.* at *13.
8 *Id.* at *17.
9 *Id.* at *18.

on its balance sheet representing approximately 50 percent of the Irish GDP. Because its focus was on commercial real property lending, the 2008 financial crisis and declining commercial property values caused the bank to suffer a liquidity crunch to such a degree that unless the bank was rescued, it would have been forced into insolvency proceedings.[10] The Irish government rescued the bank by guaranteeing certain liabilities that included some—but not all—of the 2017 notes.[11] During the Irish government rescue, Assenagon purchased its holdings of 2017 notes at 42 percent of face value.[12]

The bank was then nationalized "because of its systemic importance to the maintenance of the stability of the Irish financial system."[13] After the bank was nationalized, Ireland's Minister of Finance announced that the bank's subordinated debtholders would share in the bank's losses, either through a voluntary restructuring of the bank's debt or, if necessary, legislation.[14]

To effectuate the restructuring, the bank announced an exchange offer in October 2010 in which subordinated noteholders, including the holders of 2017 notes, were invited to exchange their notes for new *senior* notes.[15] For every euro of 2017 notes exchanged, the noteholders would receive 20 cents on the euro in new senior notes issued by the bank.[16] As a condition to the exchange, consenting holders were required to vote in favor of a resolution to amend the terms of the 2017 notes to grant a call option on unexchanged notes for a nominal cash payment—€0.01 per €1,000 in face value.[17] The exchange offer was held in November 2010 and was successful, with 92 percent of the holders of the 2017 notes by value voting in favor.[18] The bank then redeemed the remaining 2017 notes. Assenagon chose not to exchange its €17 million of 2017 notes, which were redeemed for €170.[19]

Assenagon's Claims

Assenagon sought a declaration that the exchange offer was invalid for three reasons. First, the resolution that conferred power on the bank to "expropriate" the 2017 notes for nominal consideration constituted an *ultra vires* act.[20] Second, majority noteholders who voted in favor of the exchange offer held their notes beneficially for and on account of the bank, and therefore, those votes should have been disregarded pursuant to the terms of the trust deed.[21] Third, the resolution was oppressive and unfair, as the exercise of power by the majority noteholders was not in good faith and conferred no benefit to the noteholders as a class.[22]

The Court's Analysis

A theme of the Court's analysis was the "well recognised constraint upon the exercise of [power to bind the minority] by a majority, namely that it must be exercised *bona fide* in the best interests of the class of bondholders as a class, and not in a manner which is oppressive or otherwise unfair to the minority sought to be bound."[23] Keeping this theme in mind, the court then addressed Assenagon's claims.

The court rejected Assenagon's first argument, explaining that "taking the provisions of the Trust Deed as a whole, the Noteholders must be taken to have assented to the exercise of a power in the majority to bind the minority both to a cancellation of the principal payable on the Notes and to a cancellation of the minimum interest payable thereon."[24]

> **The decision clearly casts doubt, however, on the use of "oppressive and unfair" exit consents under English law.**

The court, however, agreed with Assenagon's second argument, explaining that "Notes by then offered and accepted for exchange were held for the benefit of the Bank by the time of the [noteholders'] meeting…. All [of] those Notes were by that time held under contracts for sale between the relevant majority Noteholders and the Bank.… [T]hey thereby conferred a beneficial interest in the Notes on the Bank from the moment of the Bank's acceptance of the offered exchange on the day before the [Noteholders'] meeting."[25] The 2017 notes therefore fell within the prohibition in the trust deed of voting 2017 notes in the bank's interest rather than in the interest of the noteholders as a class.

Despite the fact that the court's holding on the second argument was dispositive, it also considered and agreed with Assenagon's third argument regarding the majority's "abuse of power" because it raised a "question of wide importance within the bond market," as the court understood that exit consents have "been put into significant, if not yet widespread, use within the context of bonds structured under English law."[26] The court explained that "there was not a single Noteholder who can be said to have accepted [the exchange] unaffected by the coercive effect of the exit consent."[27] The exchange offer was (1) "no more than a negative inducement to deter Noteholders from refusing the proffered exchange"; (2) the majority noteholders, rather than the issuer, "wield[ed] the negative inducement"; and (3) the exchange offer was "designed in substance to destroy rather than to enhance the value of the Notes and was, on its own, of no conceivable benefit to the Noteholders."[28] As a result, the court held that it was not "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."[29]

Implications

As is always the case in judicial opinions, how one views *Irish Bank* depends on one's position. At its core, *Irish Bank*

10 *Id.* at *19.
11 *Id.*
12 *Id.* at *26.
13 *Id.* at *21.
14 *Id.* at *27-28.
15 *Id.* at *30.
16 *Id.*
17 *Id.*
18 *Id.* at *36.
19 *Id.* at *37.
20 *Id.* at *39.
21 *Id.*
22 *Id.*

23 *Id.* at *6.
24 *Id.* at *54.
25 *Id.* at *64.
26 *Id.* at *6, 69.
27 *Id.* at *77.
28 *Id.* at *82-83.
29 *Id.* at *84.

is an example of the settled principles that any power granted to a majority to bind a minority is constrained by the requirements that the power must be exercised in good faith and for the benefit of the noteholders as a class under English law (which principles apply equally to resolutions under English law trust deeds). The decision clearly casts doubt, however, on the use of "oppressive and unfair" exit consents under English law, such as in the unusual circumstances seen in *Irish Bank*—namely the "expropriation" of minority notes. In this context, it may therefore impede the use of a corporate and debt-restructuring tool for issuers and majority noteholders. The ripple effect of this impediment carries to shareholders, as the inability to utilize similar exit consents also stalls increases in equity value that attend exchange offers. Minority noteholders benefit from the decision, however, insofar as it impedes use of "oppressive and unfair" exit consents that devalue the notes of nonconsenting bondholders.

To permit the use of these types of exit consents going forward, issuers, agents and large bondholders may request the application of U.S. law and a consent to jurisdiction in U.S. courts for issuances: (1) not governed by § 316 of the Trust Indenture Act, and (2) not involving an English law trust deed. Under those limited circumstances, and assuming the application of U.S. law, *Irish Bank* may constitute a Pyrrhic victory, but since *Irish Bank* involved an oppressive exit consent under which nonconsenting notes were cancelled for minimal payment, the decision may have no material ramification for exchanges conferring value to nonconsenting noteholders—for example, those including resolutions whereby notes held by nonconsenting holders are exchanged for new notes or payment at a premium over market trading values.

Conclusion

The decision is significant for several reasons. First, it "test[ed], for the first time, the legality under English law" of exit consents and will therefore constitute a marker in decisions regarding the validity of exit consents going forward.[30] Second, as the court recognized, its holding is contrary to decisions under U.S. law in which "[e]xit consents… have survived judicial scrutiny…in the face of challenge by minority bondholders" alleging a coercive exchange offer, though not involving squarely analogous facts.[31] Third, the decision may cause issuers, trustees and large bondholders to request the application of U.S. law and a consent to jurisdiction in U.S. courts in limited circumstances so as to permit the use of such exit consents going forward in order to facilitate corporate and debt restructurings. This assumes that the bonds are not constituted by English law trust deeds because resolutions under such deeds are similarly limited by the principles of good faith and exercise for the benefit of the noteholders as a class. One exception to this practical effect to apply U.S. law is that indentures issued in the U.S. are typically subject to the Trust Indenture Act, which requires each bondholder's consent to impair a right to payment of the principal amount of debt for bonds issued and registered with the Securities and Exchange Commission under the Securities Act of 1933. abi

30 *Id.* at *1.
31 *Id.* at *5 (citing *Katz v. Oak Indus. Inc.*, 508 A.2d 873 (Del. Ch. 1986)).

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