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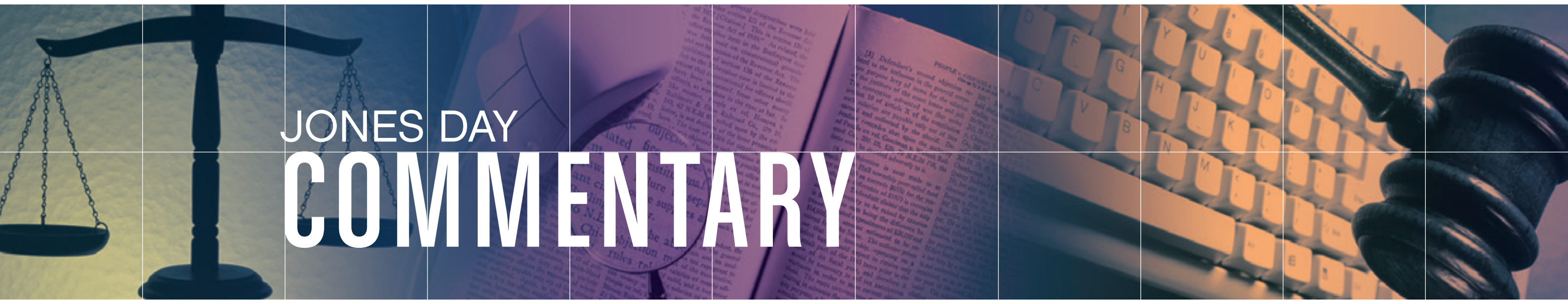

TWO RECENT CASES TEST LEGALITY OF CONSENT PAYMENTS AND EXIT CONSENTS UNDER ENGLISH LAW

The ongoing global financial crisis has resulted in a number of debt restructuring transactions as a result of companies being unable to meet with their debt obligations. In distressed situations, issuers typically seek investor consent to amend existing terms and conditions, often to relax covenants, reschedule payments, limit events of default and remove restrictions on raising further capital.

In two recent High Court cases, noteholder resolutions were challenged by minority investors whose rights were affected by the majority's binding decisions. For the first time, the English courts have attempted to establish the limits of acceptable practice in the context of consent solicitations through the judgments in *Azevedo v Imcopa* [2012] EWHC 1849 (Comm) and *Assénagon Asset Management S.A. v Irish Bank Resolution Corporation Limited (formerly Anglo Irish Bank Corporation Limited)* [2012] EWHC 2090 (Ch).

MONETARY INDUCEMENT—THE CONSENT PAYMENT

One strategy frequently employed by issuers to incentivise noteholders to give their consent to proposed changes is known as the "consent payment".

A consent payment is a payment of cash or other consideration by the issuer to noteholders in exchange for noteholder consent to amend the existing terms and conditions of the notes. Consent payments have survived judicial scrutiny in the US, where it has been held that such payments are generally permissible. However, prior to the decision in *Azevedo*, no English court had directly considered the validity of consent payments under English law.

The Court's decision reaffirmed the general understanding that consent payments would be valid if openly disclosed and offered to all noteholders on an equal basis prior to any noteholder meeting.

The Facts in the *Azevedo* Case. In 2006, the Imcopa Group of companies issued US$100 million 10.375 per cent. guaranteed notes due 2009. The group subsequently implemented a restructuring plan in order for it to service its existing debt. This gave rise to three successive resolutions amending the terms and conditions of the notes and postponing certain interest payments. Consent payments were offered to all noteholders who voted in favour of the proposed resolutions, and the resolutions were subsequently passed.

The Claims Made in the *Azevedo* Case. The claimants, two individual investors, subsequently sought declarations for repudiation and breach of contract, on two main grounds.

- First, it was argued that the consent payments were in essence a bribe and the noteholder resolutions were therefore invalid under English law.
- Second, it was argued that as payments were made only to certain noteholders, the different treatment of consenting and nonconsenting noteholders violated the fundamental requirement for all noteholders as a class to be treated *pari passu* and without preference among themselves.

The High Court Judgment in the *Azevedo* Case. The Court held that the consent payments were not fraudulent or illegal as they had the following characteristics: (i) they were openly disclosed to all noteholders before the noteholder meeting and vote took place; (ii) they were payable on an equal basis to all those noteholders voting in favour of the relevant consent solicitation; and (iii) each noteholder was entitled and free to vote in favour of or against the consent solicitation as it saw fit.

Further, the consent payments constituted separate consideration paid by the solicitation agent to investors, in return for acceptance of the issuer's offer. The payments were not paid pursuant to any obligations owed to noteholders under the notes, nor were they made by the trustee under the terms of the trust deed. As such, the payments fell outside the scope of the applicable *pari passu* contractual provisions. The claim against the issuer was dismissed.

NEGATIVE INDUCEMENT–THE EXIT CONSENT

Another strategy employed by issuers to incentivise noteholders to give their consent to such proposed changes is described as the "exit consent". Using this structure, the issuer offers noteholders the opportunity to exchange their existing notes for replacement notes which contain the amendments it is seeking.

In order to ensure that as many noteholders take up the opportunity to exchange their notes as possible, while minimising the number of existing notes which are left in issue, the issue of replacement notes to the exchanging noteholders is made subject to a requirement that they are also deemed to vote in favour of a resolution in relation to the existing notes, which strips out much of their value. The meetings at which such resolutions are approved are typically held almost contemporaneously with the acceptance of the tender by the noteholders of their notes.

Any noteholders who do not exercise the opportunity to exchange are therefore potentially left with notes which are greatly devalued or, in the worst case, almost worthless.

In a landmark decision, the High Court held in *Anglo Irish* that an exit consent approved by an extraordinary resolution of noteholders was oppressive on and unfair to minority noteholders.

The Facts in the *Anglo Irish* Case. In 2008, faced with a liquidity crisis and rapidly declining commercial property values, Anglo Irish Bank was rescued by the Irish Government and was nationalised in January 2009. In 2010, the Minister of Finance announced a voluntary restructuring of the bank's debt, which would be completed by legislative intervention if necessary. The statement made clear that the subordinated debt holders were expected to meet a substantial share of the costs involved.

Subsequently, the bank offered to exchange €0.20 of new notes for each €1 of its existing 2017 subordinated notes. Noteholders wishing to tender their holdings were also required to vote in favour of the bank's proposed extraordinary resolution. Upon being passed, this extraordinary resolution would give the bank a call right to redeem the notes at a later date at a redemption amount of €0.01 per €1000 of notes—significantly less than the €0.20 offered pursuant to the exchange offer.

The exchange offer was structured so that each noteholder, in offering notes for exchange, was deemed to have instructed the relevant agent to proxy vote in favour of the proposed resolution. In this matter, 92 percent of investors offered their notes for exchange, and the extraordinary resolution was passed.

The Claims Made in the *Anglo Irish* Case. The claimant did not attend the noteholder meeting, nor did it vote by proxy in respect of the exit consent. A week after the exchange offer was completed and the resolution passed, the bank exercised its right of redemption. The claimant received €170 in payment for a face value holding of €17 million of notes.

The claimant sought a declaration that the noteholder resolution was invalid on a number of grounds:

- First, it was argued that the resolution was *ultra vires*, as under the terms and conditions of the notes, noteholders could not legally sanction what amounted to a complete abandonment of their rights.
- Second, that at the time of the noteholder meeting, the notes were beneficially held by the bank (or for its account) and under the terms of the notes, the corresponding votes should have been disregarded.
- Third, the claimant stated that the resolution was an abuse of power by the voting majority, because it conferred no benefit on the noteholders as a class and that it was oppressive and unfair on the minority as by that point, it could only affect that minority that had chosen not to participate in the exchange offer.

The High Court Judgment in the *Anglo Irish* Case. In relation to the first claim, the Court considered whether the resolution constituted a complete abrogation of noteholders' rights. While lawyers representing both sides agreed that it was within the powers of the meeting to sanction any "abrogation of the rights of noteholders against the issuer", the claimants argued that the exit consent went beyond this and constituted a complete abandonment of noteholders' rights. The Court found (although "by a narrow margin") that because the noteholder meeting schedule specifically contemplated that a noteholder meeting might approve a reduction of principal and interest payable on the notes, the sanction of the proposed amendments to the notes could not in themselves be described as a complete abandonment of their rights.

In relation to the second argument, the Court held that at the time of the resolution, the tendered notes were in fact beneficially held by the bank. Under the terms of the trust deed, the bank was prohibited from voting in respect of such notes. The noteholder resolution was therefore invalid. In reaching this judgment, the Court carefully considered the timing of the exchange offer and consent solicitation. Noteholder offers for exchange were accepted by the bank a day before the noteholder meeting. At that point in time, the investors and the bank became bound by a contract for sale. It followed that, at the time of the meeting, the notes were beneficially held for the benefit of the bank. The judge rejected the argument that, on a purposive interpretation, the ownership should be tested on the date that noteholders decided to offer their notes for exchange. Accordingly only those noteholders who had not tendered their notes for exchange would have been eligible to vote and the votes of the exchanging noteholders should have been disregarded.

Although the judge's conclusion in favour of the claimants was based on the exclusion of exchanging noteholders from the voting process, in recognition of the impact of the *Anglo Irish* case on the wider note market, the Court went on to consider the arguments relating to the alleged abuse of majority voting power. The Court took the view that the exit consent was a "coercive threat", wielded by the issuer and exercised by majority investors. As such, the Court held that it was unlawful for the majority to vote in favour of a resolution which effectively expropriated the minority's rights for nominal consideration. Despite the wider context of government intervention and possibility of further losses for noteholders, it could not be said that the majority voters were acting in the best interests of the noteholders as a class.

THE IMPACT OF THE DECISION IN ANGLO IRISH

Because the Court held in favour of claimants in relation to the second and third claims, it is sufficient to note in relation to the first *ultra vires* claim that the judgment indicates that where an express power is given to noteholders to abrogate some of their rights, only complete abandonment of those rights is potentially outside of the powers of such meetings.

In relation to the second claim, the impact of the judgment is limited in that it is possible to structure an exchange combined with an exit consent so that the resolution is passed prior to acceptance of the exchange offer taking place, thus allowing exchanging holders to vote on the exit resolutions.

The most significant issue arising from the judgment lay in the discussion of the third claim, that the exit consent constituted an abuse of power by the majority. Although both sets of lawyers agreed that the noteholders were under an obligation to act for the benefit of the noteholders as a whole, they differed in how this rule was applied to the facts. Counsel for *Anglo Irish* focused upon the entirety of the bank's proposal, and primarily upon the exchange offer to which the exit consent (in the form of the commitment to vote for the resolution) was attached. In this context, it was argued that the exchange offer represented "real value" being offered to noteholders. By contrast, the claimant's lawyers viewed the effects of the resolution in isolation from the exchange offer and questioned whether it can be lawful for the majority to level its aid to coerce the minority by voting for a resolution which expropriates the minority's rights under their bonds. It was this argument that the judge found more persuasive, in forming his conclusion that "the exit consent is, quite simply, a coercive threat which the issuer invites the majority to levy against the minority, nothing more nothing less". On this basis, the sole purpose of the resolution was not to restructure the notes, but rather to destroy their value, as a way of intimidating holders into accepting the exchange offer.

COMMENT–USE THE CARROT, NOT THE STICK

At first glance, it is difficult to reconcile the decisions in *Anglo Irish* and *Azevedo*. In *Anglo Irish*, the judge distinguished the cases on the basis that the incentive fee offered in *Azevedo* constituted a financial inducement to vote in favour of the resolution. By contrast, the exit consent in *Anglo Irish* concerned a negative inducement for noteholders not to reject the exchange offer.

In light of these cases, it seems that under English law, in order to secure noteholder consent, the carrot is acceptable, but the stick is not.

According to *Azevedo*, consent payments are not necessarily to be construed as resulting in any differentiation of treatment amongst noteholders, and so are acceptable. This is the case even though the consenting majority receives a fee in return for its consent and, in effect, is therefore less adversely impacted than the nonconsenting minority which receives no payment. By contrast, as stated in *Anglo Irish*, the exit consent approach functions in practice by way of intimidation of a potential minority to act in a certain way in order to protect their rights. It is precisely this abuse of power which the law aims to prevent. A further interesting aspect of the *Anglo Irish* judgment was the judge's willingness to imply equitable principles relating to the protection of shareholders into the context of a debt security restructuring.

In both cases, it is obvious that emphasis must be placed on noteholder equality when invoking collective action clauses. Such equality must be maintained both in the consent solicitation process and afterwards in the implementation of the ensuing amendments. If the proposal in *Anglo Irish* had been structured to bind the dissenting minority into the same exchange as was accepted by the majority, then this would "deprive the exit consent of its coercive effect". In practice, this would have provided an incentive to noteholders to accept a payment of €0.20 of new notes for each €1 of existing notes held, or else face the risk of all the issuer's notes being rendered substantially worthless as a result of any subsequent legislative intervention or restructuring.

Furthermore, in order to avoid the necessity for an exit consent, a specific provision can also be incorporated in the powers given to meetings of noteholders, allowing noteholders the ability to approve by extraordinary resolution a scheme for the exchange of existing notes for new notes or other securities. In this way, all of the noteholders receive new notes having the same terms, regardless of whether or not they have voted for the scheme, meaning that equality of treatment is ensured while there is no need to impose punitive amendments on holders who retain their notes.

Irish Bank Resolution Corporation Limited has been granted leave to appeal the decision in *Anglo Irish*, so it may be that the courts have yet to provide their final position on the exit consent method. As such, these recent cases have by no means tested the limitations of consent solicitations in practice. With binding majority noteholder decisions now under scrutiny, issuers are likely to face ever greater obstacles to implementing change.

FURTHER CONSIDERATIONS

- For existing issuances, issuers should carefully consider the means by which noteholders are incentivised to co-operate with consent solicitations to ensure that these do not constitute a negative inducement falling within the scope of *Anglo Irish*.
- Issuers may continue to offer payments to consenting noteholders to vote in favour of proposed changes, even where such changes relate to interest payable under the notes.
- In structuring any exchange offer, issuers should consider the timing to ensure that the acceptance of the notes is conditional on the passing of the resolution. This way, notes are accepted for exchange only after the noteholders have voted in favour of any applicable resolution.
- When negotiating deal terms, issuers should be aware that these should explicitly include appropriate issuer call rights, as well as the power for noteholders to (i) vote on resolutions abrogating their rights and (ii) approve by extraordinary resolution a scheme for the exchange of existing notes for new notes or other securities.
- In practice, issuers may also wish to consider the use of New York law as governing law for new issuances, as the established practice of using exit consents has been upheld in the courts in the United States.

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