CLEARY GOTTLIEB

Alert Memo

MAY 1, 2013

www.clearygottlieb.com

Exit Consents in Restructurings – Still a Viable Option?

Speed read

- In the *Asénagon*[1] case, the High Court considered the legality of 'coercive exit consents' under English law.

- The decision created significant uncertainty about the criteria that an exit consent needed to satisfy in order to be valid and binding, and even cast doubt on whether a coercive exit consent (or 'covenant strip' in market parlance) could ever be valid.

- The decision was appealed and it was widely expected that the Court of Appeal would provide further guidance. The appeal was withdrawn before judgment was given, so the High Court decision remains authoritative.

- Disgruntled creditors could seek to bring litigation to unpick prior restructurings that were implemented by way of an exit consent, and any future restructuring being implemented by way of exit consent may be subject to an increased risk of litigation.

Background

Exit consents are often used as a restructuring tool by issuers of bonds. Issuers invite bondholders to exchange their existing bonds for new bonds (usually with a lower principal amount). In order to participate in the exchange, bondholders must agree to vote in favour of a resolution that amends the terms of the existing bonds so as to negatively affect (or, in *Assénagon*, substantially destroy) their value. This is referred to as 'covenant-stripping'. If the issuer does not achieve the majority needed to pass the resolution, the covenant-strip and the exchange do not happen. But if the resolution is passed, each participating holder's bonds are exchanged for the new bonds, and the terms of the old bonds are amended to remove most of the protective covenants. This incentivises bondholders to participate in the exchange: accepting the new bonds (even though they will usually have a lower face amount than the existing bonds) may be preferable to being 'left behind' in the old bonds, which will cease to have any meaningful covenant protection.

Facts of the case

Anglo Irish Bank Corporation Limited (the "**Bank**") suffered severe financial difficulties as a result of the financial crisis, and was nationalised in January 2009. As part of its restructuring, the Bank proposed an exchange offer whereby:

- bondholders would receive €0.20 of new bonds for every €1 of their existing bonds (the "**Existing Bonds**") exchanged; and

---

[1] *Assénagon Asset Management SA v Irish Bank Resolution Corporation Limited (formerly Anglo Irish Bank Corporation Limited)* [2012] EWHC 2090 (Ch).

CLEARY GOTTLIEB

- participating bondholders would have to vote in favour of a resolution amending the terms of the Existing Bonds. One of those amendments was the inclusion of a provision allowing the Bank to redeem the Existing Bonds at a rate of €0.01 per €1,000 of face amount.

The exchange and amendments went ahead. One of the bondholders that did not accept the offer was a hedge fund called Assénagon Asset Management SA. Its €17 million of Existing Bonds were redeemed for €170.

High Court decision

Assénagon challenged the validity of the exit consent on a number of grounds, the two most important of which were as follows:

Ground 1: At the time of the bondholders' meeting, bondholders who voted in favour of the resolution held their bonds beneficially for, or for the account of, the Bank

Bond documentation generally includes disenfranchisement provisions, which prevent bonds beneficially held by the issuer from counting in a vote. In *Assénagon*, a quirk in the timing of the exchange meant that the Bank had notified acceptance of the Existing Bonds offered for exchange the day before the bondholders' meeting. Because the issuer had agreed to buy these Existing Bonds (and the holders had agreed to sell), the issuer had entered into a specifically enforceable contract to acquire the Existing Bonds, meaning that it had acquired a beneficial interest in the Existing Bonds. So the disenfranchisement provisions prevented them from voting at the meeting.[2]

Ground 2: The resolution constituted an abuse of the power of the majority

Although the judge's conclusion on the first ground was sufficient to determine the case, he addressed the second given its importance to the bond market. There are some relatively old general principles of English law that limit the power of majorities to bind minorities. In short, they require the power of a majority to bind a minority to be exercised in good faith and in the best interests of the group as a whole. Many of the cases establishing those principles concerned shareholders (i.e., where the majority shareholders are seeking to prejudice the minority). But they are broad enough to apply to bondholder decisions as well.

The application of these principles to debt products was significantly watered down by the High Court in the 2002 case of *Redwood Master Fund Ltd and others v TD Bank Europe Ltd and others*,[3] which concerned a syndicated loan. The judge in that case decided that the power to bind a minority must be exercised in good faith, but that does not mean that the majority is prevented from approving any change to the agreement that might be prejudicial to other lenders.

In *Assénagon*, the judge decided that the proposed resolution was designed in substance to destroy rather than enhance the value of the Existing Bonds and was, on its own, of no possible benefit to the bondholders as a class. This could be contrasted with a resolution postponing

---

2 The standard approach in such exchanges (where the acceptance of bonds for exchange is conditional on the passing of the resolutions, with results only announced after the relevant meeting is complete) would prevent any such issues arising in the future.

3 [2002] EWHC 2703 (Ch).

CLEARY GOTTLIEB

interest payments,[4] which was capable of being beneficial to the bondholders as a class since it aimed to facilitate a restructuring of the issuer for the benefit of all its stakeholders.

Towards the end of the judgment, it looked like the Court was going to draw a distinction between exit consents that seek to expropriate rights and those that seek to amend them (with only the latter being acceptable). But the judge ended up making statements that cast doubt on whether any form of exit consent could be valid. In doing so, he observed that:

> "*…oppression of a minority is of the essence of exit consents of this kind, and it is precisely that at which the principles restraining the abusive exercise of powers to bind minorities are aimed…*".

Implications

As English law currently stands, in a collective contract like a bond or syndicated credit agreement, the majority creditors must exercise their power to amend the terms of that contract:

- in good faith; and
- for the benefit of the group as a whole.

It is unclear what level of 'coercion' (if any) is permissible before an exit consent will be held unenforceable by virtue of being an abuse of an amendment power. However, some comfort is to be derived from apparent approval in *Assénagon* of both:

- "drag along" schemes, where dissenting holders receive the same consideration as those participating in the exchange; and
- arrangements where holders are given a second chance to participate in the exchange after the meeting date.

The overall effect of the decision is to increase the risk that a disgruntled creditor could disrupt a restructuring being implemented by way of an exchange offer and exit consent, or use the uncertainty around the process as leverage to negotiate a better deal.

*   *   *

If you have any questions, please feel free to contact David Billington at +44 20 7614 2263 or dbillington@cgsh.com, or any of your regular contacts at the firm listed on our website at http://www.clearygottlieb.com.

[4] See, for example, *Azevedo v Imcopa Importação and others* [2013] EWCA Civ 364, which involved the postponement of a payment of interest.

CLEARY GOTTLIEB

Office Locations

NEW YORK
One Liberty Plaza
New York, NY 10006-1470
T: +1 212 225 2000
F: +1 212 225 3999

WASHINGTON
2000 Pennsylvania Avenue, NW
Washington, DC 20006-1801
T: +1 202 974 1500
F: +1 202 974 1999

PARIS
12, rue de Tilsitt
75008 Paris, France
T: +33 1 40 74 68 00
F: +33 1 40 74 68 88

BRUSSELS
Rue de la Loi 57
1040 Brussels, Belgium
T: +32 2 287 2000
F: +32 2 231 1661

LONDON
City Place House
55 Basinghall Street
London EC2V 5EH, England
T: +44 20 7614 2200
F: +44 20 7600 1698

MOSCOW
Cleary Gottlieb Steen & Hamilton LLC
Paveletskaya Square 2/3
Moscow, Russia 115054
T: +7 495 660 8500
F: +7 495 660 8505

FRANKFURT
Main Tower
Neue Mainzer Strasse 52
60311 Frankfurt am Main, Germany
T: +49 69 97103 0
F: +49 69 97103 199

COLOGNE
Theodor-Heuss-Ring 9
50688 Cologne, Germany
T: +49 221 80040 0
F: +49 221 80040 199

ROME
Piazza di Spagna 15
00187 Rome, Italy
T: +39 06 69 52 21
F: +39 06 69 20 06 65

MILAN
Via San Paolo 7
20121 Milan, Italy
T: +39 02 72 60 81
F: +39 02 86 98 44 40

HONG KONG
Cleary Gottlieb Steen & Hamilton (Hong Kong)
Bank of China Tower, 39th Floor
One Garden Road
Hong Kong
T: +852 2521 4122
F: +852 2845 9026

BEIJING
Twin Towers – West (23rd Floor)
12 B Jianguomen Wai Da Jie
Chaoyang District
Beijing 100022, China
T: +86 10 5920 1000
F: +86 10 5879 3902

BUENOS AIRES
CGSH International Legal Services, LLP-
Sucursal Argentina
Avda. Quintana 529, 4to piso
1129 Ciudad Autonoma de Buenos Aires
Argentina
T: +54 11 5556 8900
F: +54 11 5556 8999

SÃO PAULO
Cleary Gottlieb Steen & Hamilton
Consultores em Direito Estrangeiro
Rua Funchal, 418, 13 Andar
São Paulo, SP Brazil 04551-060
T: +55 11 2196 7200
F: +55 11 2196 7299

ABU DHABI
Al Sila Tower, 27th Floor
Sowwah Square, PO Box 29920
Abu Dhabi, United Arab Emirates
T: +971 2 412 1700
F: +971 2 412 1899

SEOUL
Cleary Gottlieb Steen & Hamilton LLP
Foreign Legal Consultant Office
19F, Ferrum Tower
19, Eulji-ro 5-gil, Jung-gu
Seoul 100-210, Korea
T:+82 2 6353 8000
F:+82 2 6353 8099