

ASSESSING THE LEGALITY OF COERCIVE RESTRUCTURING TACTICS IN UK EXCHANGE OFFERS

*Robert Peel**

Abstract: This article discusses bondholder exchange offers, a useful private debt-restructuring technique. In a typical offer, an under-performing issuer will seek to exchange its old bonds for new bonds with economically less favourable terms to bondholders, thus deleveraging the issuer without the difficulties of a formal insolvency process. Some issuers seek to incentivise their bondholders to accept these new, less favourable bonds by using coercive tactics, such as ‘exit consents’ and ‘covenant strips’. While lawful in the US, the English courts have only recently considered them for the first time in relation to English Law bonds. The *Assénagon* case declared an egregious coercive tactic invalid on the basis of an old company law principle, casting doubt on the validity of other coercive tactics. This principle (the ‘abuse principle’) originally restricted the abuse of minority shareholders by the majority, but is now also applicable to debt security voting arrangements. This article examines the abuse principle through the cases and discusses its potential application to other forms of coercive tactics in exchange offers. The article argues that where a coercive tactic is used purely to compel bondholders to exchange their bonds, this will contravene the abuse principle. The use of coercive tactics may however still be consistent with the abuse principle and *Assénagon*. An issuer will need to show that ‘reasonable men’ could see the tactic as beneficial for the class of bondholders, even though its use might adversely affect non-exchanging bondholders. A potential permissible example is a covenant strip that removes a restriction on asset disposals in order to facilitate a disposal pursuant to a restructuring.

A. INTRODUCTION

The legal regimes of the United States and the United Kingdom cater for both statutory and consensual restructurings of financially distressed companies.¹ If a company in financial distress is worth saving, then ‘most well-informed practitioners think that a work-out is by far the best if it can be achieved’.² A private work-out permits the company to avoid the ‘trauma and taint of insolvency’, retain control of the process and thus maintain value and avoid the

* Associate, Business Finance and Restructuring, Weil, Gotshal & Manges LLP, London. This article is based on the dissertation I submitted during the 2013/2014 Masters of Law programme at UCL. I would like to thank Andrew Wilkinson, Partner at Weil, Gotshal & Manges LLP and Visiting Professor at the UCL Faculty of Laws, for drawing my attention to many of the cases discussed in this article in his postgraduate Financial Restructuring module. I would also like to thank Alfonso Nocilla, MPhil/PhD student at UCL, for his many helpful comments on an earlier draft of the article. Any mistakes are my own.

¹ The relevant procedure in the US is Chapter 11 of the United States Bankruptcy Code. In the UK, rescue procedures may be undertaken through a ‘panoply’ of procedures, including through a scheme of arrangement in terms of the Companies Act 2006, ss 895–899, or a company voluntary arrangement in terms of the Insolvency Act 1986, ss 1-7: Chris Howard and Bob Hedger, *Restructuring Law and Practice* (LexisNexis 2008) 2, 4.

² Philip R Wood, *Principles of International Insolvency* (2nd edn, Sweet & Maxwell 2007) 33. Whether a work-out is actually preferable depends, however, on the health of the company; if the company is utterly beyond redemption then a formal insolvency proceeding would be preferable to attempting a work-out: Howard and Hedger (n 1) 5.

transaction costs associated with a court procedure.³ A private work-out can also be faster, which is significant in the distressed context.⁴

Despite these substantial advantages, creditors of large insolvent firms achieve settlements in fewer than half of US cases; other private lawsuits by contrast have a settlement rate of over 90%.⁵ A significant obstacle to achieving a consensual bondholder restructuring in the US is section 316 of the US Trust Indenture Act of 1939, which requires unanimous consent for the amendment of terms affecting the rights of bondholders to receive payments of interest and principal.⁶ However, during the ‘deleveraging of corporate America’ in the 1980s, issuers explored other means of retiring tranches of their debt, notably the use of exchange and tender offers.⁷ An exchange offer generally entails the issuer offering holders of existing debt securities to tender those for an exchange of new securities, which might be securities with a lower interest rate or face value, or equity securities. A tender offer, by contrast, is an exchange of existing securities for cash.⁸

Section 316 of the Trust Indenture Act entails, however, that non-exchanging bondholders cannot be denied payments of interest or principal without their consent. These ‘hold-out creditors’ are a threat to a successful restructuring, because their refusal to exchange threatens to consume the savings created by the exchange offer.⁹ As such, US issuers have in the past introduced a variety of coercive tactics into their exchange offers in an attempt to make the alternative to the exchange offer – not exchanging – relatively less attractive. US courts have upheld the use of two of such tactics, namely exit consents and consent solicitation payments.¹⁰ Typically, an exit consent requires exchanging bondholders to consent to the removal of protective covenants in the indenture as a condition of the

³ Wood (n 2) 33.

⁴ Suniati Yap, ‘Investing in Chapter 11 Companies: Vultures or White Knights?’ (1995) 2 J L & Trade Am 153, 162.

⁵ Alan Schwartz, ‘Bankruptcy Workouts and Debt Contracts’ (1993) 36 J L & Econ 595.

⁶ As such, there have been calls for its repeal: Mark J Roe, ‘The Voting Prohibition in Bond Workouts’ (1987) 97 Yale L J 232, 235.

⁷ Andrew Bab, ‘Debt Tender Offer Techniques and the Problem of Coercion’ (1991) 91 Columbia L Rev 846.

⁸ Bab (n 7) 848-9. The distinction between exchange and tender offers is not significant in the present context and I will use the terms interchangeably. The offer will be at a discount to face value, but typically at a premium to trading value, in order to incentivise bondholders to participate in the exchange.

⁹ One of the common responses to the threat of transferring subsidies to hold-outs is to make the offer conditional on a high acceptance threshold, such as 85% to 95%: Roe (n 6) 236; John C Coffee, Jr and William A Klein, ‘Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations’ (1991) 58 U of Chicago LR 1207. For a recent UK example of an exchange offer that had a minimum acceptance rate of 75%, see The Co-operative Bank Plc, *Prospectus*, dated 4 November 2013 <<http://www.co-operativebank.co.uk/assets/pdf/bank/investorrelations/debtinvestors/lt2standalone2013/prospectus.pdf>> accessed 1 February 2015.

¹⁰ Respectively, *Katz v Oak Industries Inc* 508 A2d 873 (Del Ch 1986) and *Kass v Eastern Airlines Inc* [1986] WL 13008 (Del Ch).

exchange. Consent solicitation payments are payments that the issuer makes to bondholders who agree to vote in favour of an amendment effected to the indenture. The coercive effect of the tactics is in part premised on the ability to place bondholders into a prisoner's dilemma, where their dominant strategy is to opt for an outcome that, in their unconstrained choice, they would reject.¹¹

Both tactics have a history of use in England.¹² However, until the decisions of *Assénagon Asset Management SA v Irish Bank Corp'n Ltd*¹³ and *Azevedo v Imcopa Importação, Exportação e Indústria de Olêos Ltda*¹⁴ in 2012, the courts had not had an opportunity to consider their validity. The *Assénagon* case concerned a very unusual exit consent that expropriated the non-exchanging bondholders' bonds for nominal consideration. The court found that the resolution was invalid on the basis of an old company law principle that originally provided that shareholders must exercise their power to amend the articles of association of the company 'bona fide for the benefit of the company as a whole' (the 'abuse principle').¹⁵ On the other hand, the *Azevedo* case permitted consent solicitation payments.

In Part B of this article, I will discuss the use in practice of coercive restructuring tactics, such as exit consents in exchange offers. Since such tactics have a longer tradition of use in the US and because the US bond market dwarfs that of the UK, the analysis will concentrate on that market.¹⁶ I will argue that a variety of tactics other than exit consents have a potentially coercive effect. I will then examine whether there are good grounds to consider them as coercive as some commentators have argued and whether the prisoner's dilemma model of bondholder co-ordination is accurate. In Part C, I will discuss the application of the abuse principle, currently the most powerful defence against coercive restructuring tactics in English law, through the English cases and draw out the relevant legal propositions. In Part D, I will consider the application of the abuse principle in the *Redwood* and *Assénagon* cases, as well its potential application to the *Azevedo* case.¹⁷

¹¹ Coffee and Klein (n 9) 1231.

¹² James Cole, 'How to apply US-style exchange offers in Europe' (2002) 21 Int'l Fin L Rev 52.

¹³ [2012] EWHC 2090 (Ch).

¹⁴ [2012] EWHC 1849 (Comm); [aff'd] [2013] EWCA Civ 364.

¹⁵ *Allen v Gold Reefs of West Africa Ltd* [1900] 1 Ch 656, 671.

¹⁶ In 2011, US firms issued US \$1trillion worth of corporate debt; by comparison, the UK had issuance of only £38bn: Securities Industry and Financial Markets Association, 'US Bond Market Issuance and Outstanding' <www.sifma.org/WorkArea/DownloadAsset.aspx?id=8589942781> accessed 1 February 2015; Aashish Pattani, Giuseppe Vera and James Wackett, 'Going Public: UK Companies' Use of Capital Markets' (2011) 4 Bank of England Quarterly Bulletin 319, 320, 325.

¹⁷ *Redwood Master Fund Ltd v TD Bank Europe Ltd* [2002] EWHC 2073 (Ch); *Assénagon* (n 13); *Azevedo* (n 14).

A paradox that I seek to answer in this article is the difference in verdicts in the *Assénagon* and *Azevedo* cases.¹⁸ Commentators have noted that ‘it is not intuitively obvious why one of these techniques should be lawful and the other not’.¹⁹ I aim to explain this apparent anomaly on the basis of the abuse principle. An important consideration is how the abuse principle interacts with coercive restructuring techniques. On this point, I will argue that the prisoner’s dilemma model of bondholder co-ordination does not always accurately reflect marketplace interactions. This provides reason to regard the alleged coercive effect of these restructuring tactics with a measure of scepticism. It also suggests that the abuse principle’s relatively deferential assessment is appropriate. The thesis of this article is that the invalidation of the expropriatory exit consent in *Assénagon* does not entail that all restructuring tactics that impose adverse consequences on a minority are necessarily invalid: it is consistent with the abuse principle to impose prejudicial consequences on a minority, unless ‘no reasonable men’ could consider it beneficial for the class.²⁰ If one views the decisions in *Azevedo* and *Assénagon* in this light, the two can be successfully distinguished. The distinction lies in the fact that the *Assénagon* exit consent could not rationally be said to benefit the class, whereas the *Azevedo* case could (or, at least, its putative benefit was not demonstrably irrational).

B. EXCHANGE OFFERS: A US LAW PERSPECTIVE

In the US, section 316(b) of the Trust Indenture Act of 1939 provides that issuers require the unanimous consent of bondholders to amend ‘the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture’.²¹ The difficulties of obtaining unanimous consent mean that bond exchange and tender offers are an important mechanism for US firms to quickly ‘relieve long-term financial pressure and avoid short-term liquidity squeezes’, without the expense – regarding both time and money – of going into bankruptcy.²²

¹⁸ *Assénagon* (n 13); *Azevedo* (n 14).

¹⁹ Stephen Moverly Smith and Harry Sharpe, ‘An Offer You Can’t Refuse: When Does Coercion of a Group to Accept a Proposal Constitute Oppression of the Minority’ (2014) JIBFL 288, 289.

²⁰ *Shuttleworth v Cox Bros and Co (Maidenhead)* [1927] 2 KB 9, 18.

²¹ This is subject to a carve-out that the indenture may provide that the holders of 75% of outstanding securities may consent to a postponement of interest for a period of not more than three years: s 316(a)(2).

²² Lewis S Peterson, ‘Who’s Being Greedy? A Theoretical and Empirical Examination of Holdouts and Coercion in Debt Tender and Exchange Offers’ (1993) 103 Yale L J 505.

1. Hold-out creditors and other obstacles to successful exchange offers

The primary disadvantage of a work-out such as an exchange offer is the need for ‘unanimity or near unanimity amongst the participating creditors – the problem of the ‘hold-out creditor’’.²³ In the context of a bondholder exchange offer, hold-out creditors are bondholders who do not exchange their bonds. If the exchange is completed, the issuer’s financial health improves, making it better able to pay the non-exchanging bondholders in full.²⁴ Thus, provided the restructuring is successful, the non-exchanging hold-outs are ‘enriched at the expense’ of those who do exchange.²⁵ The hope of a payout of 100% of the face value of a bond, particularly where the bond may have been acquired in a distressed scenario at a fraction of that price, potentially provides a powerful motivation for creditors to hold out.

In a completed exchange offer with an excessive amount of hold-outs, the exchanging bondholders will in effect be subsidising the gains of the hold-outs and making their debt more valuable (ie ‘buoying up the debt’).²⁶ If the subsidy to the non-exchanging bondholders is greater than the costs saved by avoiding a court reorganisation procedure or bankruptcy, then the bondholders should refuse the exchange.²⁷ Even if the subsidy to the hold-outs is less than the cost of bankruptcy, bondholders may balk at the idea of violating the principle of ‘equality of sacrifice’, which advisers stress should govern a restructuring.²⁸ The risk, therefore, of holding out is that other bondholders will also vote strategically and hold out, thus preventing a consensual work-out and forcing the issuer into a formal court-based proceeding or insolvency, with the attendant, Pareto-inefficient, risks and costs (including the risk that the bondholders would receive less in an insolvency proceeding than in the exchange offer).²⁹

In addition to the problem of the hold-out creditor, there are a number of other obstacles to completing successful exchange offers. One important issue for bondholders is the difficulty of ascertaining whether the exchange offer is fair. The US distressed debt trading markets are arguably less efficient than the equity trading markets, because there is less information available regarding distressed securities and the trading is relatively illiquid.³⁰ In particular, securities analysts do not devote the same level of research to the

²³ Wood (n 2) 34.

²⁴ Roe (n 6) 236; Bab (n 7) 849.

²⁵ Roe (n 6) 236.

²⁶ *ibid* 234.

²⁷ *ibid* 236.

²⁸ *ibid* 237.

²⁹ Bab (n 7) 849; Schwartz (n 5) 595.

³⁰ Coffee and Klein (n 9) 1217.

distressed debt market, because of the reduced appetite for information about the market.³¹ In Europe, this inefficiency is exacerbated by ‘a lack of experienced players as well as different legal regimes across European Union countries’, while in the UK, there is simply ‘no proper market for distressed debt’.³² These factors suggest that it will be difficult to objectively verify that an exchange offer is fair. Creditors may also be wary about trusting the issuer, based on previous defaults or bad dealings.³³ This might be exacerbated by a ‘perverse incentive’ of issuers contemplating an exchange offer ‘to withhold positive information from the market, in order to increase the discount by which the bonds trade below their face amount’.³⁴ The lack of a means to objectively verify information, as well as the information asymmetry between the issuer and its bondholders, tend to lessen the chance of a successful consensual work-out.³⁵ Lastly, Kahneman and Tversky’s work on prospect theory suggests a further aggravating factor. Their studies have shown that the loss aversion exhibited by decision-makers bargaining under risk translates into risk-seeking behaviour when confronting losses.³⁶ Bondholders are thus more likely to reject ‘fair’ settlements that impose certain losses on them in favour of riskier strategies that might result in no losses, or gains, but which ultimately have a lower expected value and are sub-optimal. Their studies therefore suggest that work-out negotiations, where bondholders are bargaining over uncertain losses, will be amongst the most difficult to obtain consensus.

2. Coercive restructuring techniques

The obstacles to a successful exchange offer alluded to above suggest that if an issuer is able to alter the incentives of its bondholders in assessing the exchange offer, thus making the exchange offer more likely to succeed, then it should. Issuers do in fact have a variety of tactics at their disposal to achieve this end. Three tactics are of particular relevance for present purposes: the exit consent, the consent solicitation payment and the early consent

³¹ Coffee and Klein (n 9) 1219.

³² Anousha Sakoui, ‘Big returns lure investors to distressed debt’ (*Financial Times*, 6 July 2010) <<http://www.ft.com/cms/s/0/e703da28-892a-11df-8ecd-00144feab49a.html#axzz39Wtkanae>> accessed 26 January 2015; John Board and others, ‘The Impact of the Credit Crunch on the Sterling Corporate Bond Market’ (2009) Investment Management Association 29.

³³ Yap (n 4) 158.

³⁴ Coffee and Klein (n 9) 1220. Of course, were such actions undertaken in the UK they could potentially attract liability under other areas of law, such as the market abuse regime in terms of the Financial Services and Markets Act 2000, but this is beyond the scope of this article.

³⁵ Roe (n 6) 238.

³⁶ Daniel Kahneman and Amos Tversky, ‘Rational Choice and the Framing of Decisions’ (1986) 59 *Journal of Business* 251. In another study, the authors conducted an experiment where respondents were asked to choose between a sure loss of \$750 or a 75% chance to lose \$1000. The equivalence in expected value implied that a rational actor would be neutral as to which choice it took, but 87% of the respondents preferred the gamble (ie they exhibited an irrational preference for risk-seeking behaviour when confronting potential losses): Kahneman and Tversky, ‘The Framing of Decisions and the Psychology of Choice’ (1981) 211 *Science* 453, 454.

deadline.³⁷ When a US-style exit consent accompanies an exchange offer, an exchanging bondholder is only permitted to tender its old bonds for exchange if at the same time it consents to the removal of protective covenants in the old bonds via the exit consent. The coercive force of the exit consent arises out of the individual bondholder's concern that without the protective covenants and with the drop in liquidity in the bonds post-exchange, its old bonds 'will be worth substantially less than even its low market price prior to the exchange'.³⁸ It is often said that a central aspect of the coercive effect is the dispersion and anonymity of bondholders, which prevents them from co-ordinating with each other and thus overcoming the prisoner's dilemma scenario that is imposed on them.³⁹ For some US issuers, a key purpose of the exit consent is to reduce the attractiveness of the old bonds, compared to the new bonds, and encourage their exchange where the bondholders might otherwise have refused.⁴⁰ However, there may also be arguably valid commercial reasons for an exit consent, such as the removal of a negative pledge in order to grant new security pursuant to the wider restructuring plan.⁴¹

A similarly coercive technique is for the issuer to include a consent payment with a consent solicitation requesting the amendment or waiver of bondholder rights in the indenture.⁴² If a bondholder votes in favour of the proposed amendment and the amendment is successfully instituted, the bondholder receives the consent payment. If the bondholder does not vote in favour of the restructuring, it receives the 'punishment' of foregoing the consent payment.⁴³ This punishment is a form of coercion.

Lastly, there is the 'early consent deadline'.⁴⁴ Rule 14e-1 of the US Securities Exchange Act of 1934 requires all US tender offers to remain open for at least 20 business days, but issuers commonly set early consent deadlines, which provide that bondholders who tender their bonds prior to that date receive a greater total consideration than those that do

³⁷ Examples of other tactics with coercive effects include: imposing a high hurdle rate of acceptance on the transaction, which decreases the liquidity and thus the value of non-exchanged bonds (Bab (n 7) 850; Roe (n 6) 247, 249), and emphasising the threat of insolvency. This latter approach was evident in the Co-operative Bank's exchange offer (n 9) 46.

³⁸ Peterson (n 22) 513.

³⁹ Moverly Smith and Sharp (n 19) 288.

⁴⁰ Coffee and Klein (n 9) 1212.

⁴¹ Cole (n 12) 52.

⁴² Marcel Kahan, 'Rethinking Corporate Bonds: The Trade-Off between Individual and Collective Rights' (2002) NYU L Rev 1040, 1058; Kass (n 10) 1-2, which involved an offering of cash or airline tickets to bondholders who voted in favour of removing two restrictive covenants.

⁴³ Zohar Goshen, 'Voting (Insincerely) in Corporate Law' (2001) 2 Theoretical Inquiry in Law 815, 823.

⁴⁴ Rodrigo Olivares-Caminal and others, *Debt Restructuring* (Nick Segal and Look Chan Ho eds, OUP 2011) 92.

not.⁴⁵ Inherent in this tactic is a potentially powerful element of coercion. Bondholders might be numerous and widely dispersed. An accelerated timeframe compounds the difficulties they face in organising themselves so that they may negotiate with the issuer. However, the early consent deadline also has a variety of justifiable benefits. Issuers are given ‘an early view of the certainty of the outcome, which may aid the completion of other transactions conditioned on completion of the exchange offer’.⁴⁶ Issuers that have an idea of preliminary uptake are also empowered to consider whether it will be necessary to extend the offer.⁴⁷

3. The role of the prisoner’s dilemma in coercive tactics

Bondholder co-ordination (or rather the lack thereof) is a key element in the coercive effect of these techniques, which is frequently described as imposing a prisoner’s dilemma situation on bondholders.⁴⁸ Coffee and Klein provide an example of an exchange where a bondholder is invited to exchange and provide an exit consent for a bond that it believes to be worth \$500, for \$450 (currently it cannot find a buyer for \$500).⁴⁹ If the exchange is completed and the exit consents denude the old bonds of their protection, they will be worth only \$400. The decision matrix is as follows:

Sufficient Others’ Choice	Bondholder’s Choice	
	Don’t Tender	Tender
Don’t Tender	\$500	\$500
Tender	\$400	\$450

On the author’s version, an exit consent confronts bondholders with a scenario where, if they do not tender their bonds, but sufficient others do, they will be left holding a bond without protective covenants and diminished liquidity in trading, which will significantly erode its value. If they do tender their bonds, but sufficient others do not, they will be unaffected. They do not know whether others will tender their bonds and cannot co-ordinate their actions. Whatever sufficient others choose to do, the individual bondholder is better off tendering, meaning that this is its dominant strategy. All of the bondholders are faced with

⁴⁵ US Code of Federal Regulations § 240.14e-1; Olivares-Caminal and others (n 44) 92. A recent UK exchange offer made significant use of this technique, albeit modified so that no bondholders would receive the extra premium, to the extent that the early deadline was not met: The Co-Operative Bank (n 9) 36.

⁴⁶ Olivares-Caminal and others (n 44) 93.

⁴⁷ Cole (n 12) 52.

⁴⁸ Coffee and Klein (n 9) 1229; *Assénagon* (n 13) [4].

⁴⁹ While this example uses an exit consent, the same co-ordination problems (if real) apply to consent payments and early consent deadlines, which are on these premises also capable of coercing bondholders into amendments that in their unconstrained choice they would have rejected: Coffee and Klein (n 9) 1231.

the same dilemma and therefore they too tender their bonds. The exchange thus succeeds and each bondholder receives \$450, even though it would have been preferable for each individual bondholder not to tender and retain \$500.

As to whether exit consents succeed in coercing bondholders in practice, there is anecdotal and empirical evidence to argue either side.⁵⁰ After reviewing a sample of 25 transactions, Bab found that tender offers with coercive devices attached to them were far more likely to fail than non-coercive ones and thus concluded that exit consents were not coercive.⁵¹ However, Peterson's study of a larger sample of 118 tender offers led him to the conclusion that 'coercive elements probably do have some [positive] effect on the success of an offer'.⁵² The same study also showed that in 27 successful exchange offers (where coercive tactics were not used), bondholders who held out (and did not exchange) benefited from an increase of 27% in the price of their unexchanged bonds over pre-offer prices. This 'strongly supports' the prediction that incentives to hold out will cause problems for non-coercive US exchange offers and suggests that coercive tactics do have a legitimate and useful role to play in US exchange offers.⁵³

Other authors have attacked the notion that bondholders cannot co-ordinate, a central premise of the coercive force imposed by the prisoner's dilemma:

The assumptions underlying this story of creditor vulnerability have come into question. Institutions have replaced individuals as the leading bondholders. In the corporate distress context, they have been shown to be capable of surmounting collective action problems and saying 'no' to an unsatisfactory offer from a distressed debtor.⁵⁴

Studies have shown that bondholders are able in certain instances to overcome the co-ordination problems and resist tender offers. For instance, in one study in the early 1990s, bondholders established formal co-ordination committees in 12 out of 58 tender offers.⁵⁵

⁵⁰ For authors suggesting anecdotally that exit consents are coercive, see: Nick P Saggese and others, 'US and UK Tender Offers, Exchange Offers, and other Out-of-Court Restructurings' in Chris Mallon and Shai Waisman (eds), *The Law and Practice of Restructuring in the UK and US* (OUP 2011) 82; Jill E Fisch and Caroline M Gentile, 'Vultures or Vanguard?: The Role of Litigation in Sovereign Debt Restructuring' (2004) 53 *Emory L J* 1043, 1092. For those suggesting they are not, see Bab (n 7) 879.

⁵¹ Bab (n 7) 880.

⁵² Peterson (n 22) 527.

⁵³ Peterson (n 22) 529.

⁵⁴ William W Bratton and G Mitu Gulati, 'Sovereign Debt Reform and the Best Interest of Creditors' (2004) 57 *Vand L Rev* 1, 39.

⁵⁵ Marcel Kahan and Bruce Tuckman, 'Do Bondholders Lose from Junk Bond Covenant Changes?' (1993) 66 *J Bus* 499, 512. The true number might have been higher, to the extent that the press releases did not mention every bondholder committee. Furthermore, in 42% of the 44 cases in which bondholders were required to

While a relatively small minority, it goes towards establishing that the prisoner's dilemma model of bondholder co-ordination does not always apply. Furthermore, it is common practice in the US for bondholders to 'preemptively contact significant other bondholders to organize an ad hoc bondholder committee in anticipation of a debt restructuring'.⁵⁶ The fact that institutional investors hold 86% of the US corporate bond market provides further grounds for rejecting the prisoner's dilemma theory.⁵⁷ It should be noted that the same characteristics define the UK corporate bond market, where 'trading in value terms is almost exclusively institutional/professional' and large lot sizes, out of the reach of most individual investors, are commonly used to bring issuances within the exemptions of the Prospectus Directive.⁵⁸

Thus, while these restructuring tactics can have coercive effect, there are many circumstances where it is reasonable to believe that bondholders could overcome the co-ordination difficulties and refuse the offer, if it is unfavourable to them. As Peterson points out, successful coercive offers are often good offers too.⁵⁹ Since much of the coercive effect of these tactics is premised on the alleged prisoner's dilemma imposed on bondholders, and because of the inherent difficulties of negotiations in the distressed debt market, the US courts' non-interventionist approach to exit consents and consent solicitations is arguably appropriate in the US context.

C. THE IMPLICATIONS OF THE ABUSE PRINCIPLE

English law has long provided that the vote attached to a share is a proprietary right that a shareholder may exercise in its 'own selfish interests'.⁶⁰ However, voting rights permit a shareholder to 'control not only his own property but also that of others'.⁶¹ Accordingly, the courts have thought fit to impose the limitation of the abuse principle on this power,

provide a consent or exit consent, issuers were required to modify the terms of the tender offer after the first tender offer failed: at 513.

⁵⁶ Olivares-Caminal and others (n 44) 93-94; Michael Dakin and others, 'Getting into Bed with Bondholders' (2012) 4 CRI 120, 121 emphasise the importance of forming ad hoc bondholder committees for restructurings, but note the problems in ascertaining whether such committees are representative of the holders.

⁵⁷ Hao Jiang, 'The Role of Institutional Investors in Corporate Financing' 4 <<http://www.financepractitioner.com/contentFiles/QF02/gjbk9a0/17/0/the-role-of-institutional-investors-in-corporate-financing.pdf>> accessed 1 February 2015.

⁵⁸ 50,000 is typical: Board and others (n 32) 12, 55; Directive 2003/71/EC.

⁵⁹ Peterson (n 22) 508.

⁶⁰ *North-West Transportation Co Ltd v Beatty* (1887) 12 App Cas 589 (PC); Paul Davies and Sarah Worthington, *Gower and Davies' Principles of Modern Company Law* (9th edn, Sweet & Maxwell 2012) 691.

⁶¹ Dan Prentice, 'Restraints on the Exercise of Majority Shareholder Power' (1976) 92 LQR 502 at 506.

notwithstanding its proprietary nature.⁶² The most widely-cited formulation of the abuse principle appears in the *Allen* case, from Lindley MR:

The power thus conferred on companies to alter the regulations (...) [must] be exercised subject to those general principles of law and equity which are applicable to all powers conferred on majorities and enabling them to bind minorities. It must be exercised, not only in the manner required by law, but also bona fide for the benefit of the company as a whole, and it must not be exceeded. These conditions are always implied, and are seldom, if ever, expressed.⁶³

The reasoning for limiting a shareholder's right to vote is equally applicable to collective action clauses, a key organising principle in modern English corporate credit agreements. In the early 20th century, English courts accordingly saw fit to apply the abuse principle to decisions that lenders had taken in terms of such provisions.⁶⁴ The abuse principle thus acts as a constraint on the decision of majorities to bind minorities, both in the context of shareholder and lending decisions.⁶⁵ While it is true that the meaning of 'bona fide in the best interest of the company' has 'beguiled and confused the Courts', a number of propositions can be discerned from the shareholder cases, starting with the point that the burden of proof is on the party who challenges the amendment.⁶⁶ The other propositions, as far as they are relevant, are set out below.

1. The requirement of honesty and bona fides

A pivotal question that the abuse principle asks is whether the members honestly believed that the exercise of the power was for the benefit of the company as a whole.⁶⁷ This requirement of honesty or good faith 'is simply a reflection of the traditional equitable constraints on the ability of a majority to bind a minority ... It protects the minority by ensuring that alterations motivated by malice, fraud and personal benefit cannot stand'.⁶⁸ The

⁶² 'The chief reason for denying an unlimited effect to widely expressed powers such as that of altering a company's articles is the fear or knowledge that an apparently regular exercise of the power may in truth be but a means of securing some personal or particular gain, whether pecuniary or otherwise, which does not fairly arise out of the subjects dealt with by the power and is outside and even inconsistent with the contemplated objects of the power': *Peters' American Delicacy Co Ltd v Heath* (1939) 61 CLR 457, 511 (Dixon J).

⁶³ *Allen* (n 15) 671. The court did not cite any authority for this proposition; Lindley MR's words have, however, 'through repetition ... tended to become almost a formula': *Peters' American Delicacy Co Ltd* (n 62) 509 (Dixon J).

⁶⁴ *Goodfellow v Nelson Line Liverpool Ltd* [1912] 2 Ch 324; *British America Nickel Corporation Ltd v MJ O'Brien Ltd* [1927] AC 369.

⁶⁵ *Goodfellow* (n 64) 333; *British America Nickel Corp Ltd* (n 64) 371; *Redwood* (n 17) [84].

⁶⁶ *Gambotto v WCP Ltd* (1993) 11 ACLC 457, 460; *Citico Banking Corp NV v Pusser's Ltd* [2007] UKPC 13, [18].

⁶⁷ *Shuttleworth* (n 20) 18 (Banks LJ), 23 (Scrutton LJ).

⁶⁸ Brenda Hannigan, 'Altering the Articles to Allow for Compulsory Transfer – Dragging Minority Shareholders to a Reluctant Exit' (2007) JBL 471, 478.

case of *Brown v British Abrasive Wheel Co Ltd* can be seen as an example of amendment that was made in bad faith.⁶⁹ In *Sidebottom v Kershaw, Leese & Co Ltd*, Sterndale MR reviewed the decision in *Brown*'s case and explained the ruling forbidding the amendment on the basis that what was done 'was not bona fide; it was not done for the benefit of the company, but for the benefit of [the majority]'.⁷⁰

The fact that an amendment only has a practical effect on certain identifiable shareholders does not necessarily mean that the amendment was made in bad faith. In *Allen*'s case, the plaintiffs charged the company with bad faith for amending its articles in a way that specifically targeted a particular deceased shareholder, whose estate owed the company a substantial amount of money.⁷¹ The amendment provided that the company would have a lien on the shares of all members who owed debts to the company. Although the court said the amendment 'excite[d] suspicion as to the bona fides of the company', it was not in bad faith.⁷² The only reason the deceased shareholder was affected was that he 'was the only holder of paid-up shares who at the time was in arrear of calls'.⁷³

2. Drawing an inference as to bona fides

The fact that the majority passed the resolution honestly and in good faith is not, however, the end of the enquiry. Bowing completely to the subjective views of shareholders leaves the problem of the 'amiable lunatic'.⁷⁴ Furthermore, it is difficult enough to assess the state of mind of one person, but in this area, one is required to assess the 'state of mind' of a body of persons.⁷⁵ In the *Shuttleworth* case, the Court of Appeal sought to curb this problem by approving a subjective approach, tested against objective circumstances. The test is whether the alteration of the articles was in the opinion of the shareholders for the benefit of the company. By what criterion is the court to ascertain the opinion of the shareholders upon this question? The alteration may be so oppressive as to cast suspicion on the honesty of the persons responsible for it, or so extravagant that no reasonable men could really consider it for the benefit of the company: '[T]he alteration of a company's articles shall not stand if it is

⁶⁹ [1919] 1 Ch 290.

⁷⁰ [1920] 1 Ch 154 (CA) 167; *Brown* (n 69).

⁷¹ *Allen* (n 15) 666.

⁷² *ibid* 675.

⁷³ *ibid* 675.

⁷⁴ *Hannigan* (n 68) 478. As Bowen LJ stated in *Hutton v West Cork Railway Co* (1993) 23 Ch D 654, 671: 'Bona fides cannot be the sole test, otherwise you might have a lunatic conducting the affairs of the company, and paying away its money with both hands in a manner perfectly bona fide yet perfectly irrational'.

⁷⁵ FG Rixon, 'Competing Interests and Conflicting Principles: An Examination of the Power of Alteration of Articles of Association' (1986) 49 MLR 446, 457.

such that no reasonable men could consider it for the benefit of the company...'⁷⁶ The Court of Appeal sensibly rejected the purely objective test espoused in previous cases because 'to adopt that view would be to make the Court the manager of the affairs of innumerable companies instead of the shareholders themselves'.⁷⁷

3. Conflicts of interest and 'the company as a whole'

While the *Shuttleworth* case may appear to provide a reasonable basis for assessing whether a decision was made 'bona fide for the benefit of the company', it is of little utility when the decision adjusts the rights of the shareholders between each other.⁷⁸ In exercising their votes, which are proprietary rights, shareholders do not characteristically exemplify 'inhuman altruism'; they will simply be considering what is best for themselves.⁷⁹ Accordingly, it is somewhat artificial to base the test on whether a decision was bona fide for the benefit of the company, when it is in fact unlikely that those voting on it considered that question at all.

An approach that is more sensitive to this consideration can be found in the High Court of Australia's decision of *Peters' American Delicacy Co Ltd v Heath*, where the directors of the company sought to amend an article to effect a profit capitalisation on what they considered to be a more equitable basis.⁸⁰ The amendment reduced the potential profit capitalisation for certain shareholders, who then challenged it on the basis that the proposed change was not for the benefit of the company or the body of shareholders, but for the majority. The court found that the amendment was not invalid. Latham CJ stated '[I]n cases where the question which arises is simply a question as to the relative rights of different classes of shareholders the problem cannot be solved by regarding merely the benefit of the corporation'.⁸¹ In a similar vein, Dixon J stated that '[T]o say that the shareholders forming the majority must consider the advantage of the company as a whole in relation to such a question seems inappropriate, if not meaningless, and at all events starts an impossible inquiry'.⁸² Thus even if a member is prejudiced by an amendment to the articles, the amendment will not be invalid unless the member is able to show bad faith, fraud, oppression or that the amendment is 'so extravagant that no reasonable person could believe that it was for the benefit of the company'.⁸³

⁷⁶ *Shuttleworth* (n 20) 18 (Banks LJ) (emphasis added).

⁷⁷ *ibid* 22 (Scrutton LJ).

⁷⁸ Hannigan (n 68) 476; Davies and Worthington (n 60) 700; Dan Prentice, 'Alteration of Articles of Association – Expropriation of Shares' (1996) LQR 194, 195.

⁷⁹ *North-West Transportation Co Ltd* (n 60); *Peters' American Delicacy Co Ltd* (n 61) 512 (Dixon J).

⁸⁰ *Peters' American Delicacy Co Ltd* (n 62).

⁸¹ *ibid* 481 (Latham CJ).

⁸² *ibid* 512 (Dixon J).

⁸³ *ibid* 483.

D. THE APPLICATION OF THE ABUSE PRINCIPLE TO COERCIVE RESTRUCTURING TECHNIQUES

Like the articles of a company, a modern credit agreement will usually institute a collective action mechanism in terms of which the majority lenders are able to make democratic decisions and amendments to the agreement by voting. Until the *Redwood* case, however, the courts had not had an opportunity to consider the interaction of the abuse principle and these collective action clauses for a period of seventy years.⁸⁴

1. *The Redwood case*

In the *Redwood* case, the claimants challenged a variation to the terms of a €4 billion syndicated loan facility agreement, arguing that the majority had ‘abused their position as a majority and breached their duty to act bona fide in the interests of the lenders as a whole’ in acceding to the terms of a waiver letter.⁸⁵ So far as is relevant, the facility agreement comprised Facility A (a revolving credit facility) and Facility B (a term loan facility). Facility A was wholly undrawn while Facility B was almost completely (97.5%) drawn.⁸⁶ At the inception of the facility agreement, each lender held a commitment of Facility B that was 3.66 times greater than its commitment under Facility A.⁸⁷ Importantly, many of the original lenders had traded their Facility A commitments on the secondary market, with the result that certain new lenders (including the claimants) held only (or predominantly) Facility A commitments.⁸⁸

The facility agreement provided that in the event of default, the borrower would not be entitled to draw down on any of the facilities.⁸⁹ In due course, the borrower anticipated a default and sought to obtain the relevant waiver from the lenders under the facility agreement. Without this waiver, the borrower would have been unable to draw down on the facility agreement to fund its working capital.⁹⁰ As part of an overall restructuring plan and as a condition of any waiver granted to the borrower, the lenders required an overall reduction of their commitments under the facility agreement.⁹¹ The lenders initially assumed that this reduction would come from Facility A, the undrawn facility, but the borrower insisted (in negotiations that were ‘not easy’) on a reduction and prepayment of Facility B, using Facility

⁸⁴ *Redwood* (n 17).

⁸⁵ *ibid* [3].

⁸⁶ *ibid* [21].

⁸⁷ *ibid* [7], [9].

⁸⁸ *ibid* [32].

⁸⁹ *ibid* [13].

⁹⁰ *ibid* [23].

⁹¹ *ibid* [26].

A, because this would improve its repayment profile.⁹² Until the claimants raised their objections, this proposal was not considered to be problematic, because it had been assumed that all lenders held their Facility A commitments in proportion to their Facility B commitments.⁹³ A prepayment using a Facility A drawdown under those circumstances would only have had a ‘cash positive or, at worst, a neutral effect’.⁹⁴ However, for those who held predominantly Facility A commitments, the prepayment proposal ‘required them to take over from the B lenders a real and measurable exposure at a time when [the borrower’s] future solvency was in question’.⁹⁵

Nonetheless, the majority lenders, acting in terms of a provision entitling lenders holding two-thirds in value to amend the facility agreement, waived certain covenants and relaxed the draw-stop. This allowed the borrower to drawdown on Facility A to repay Facility B. The claimants argued that the waiver letter was a violation of the abuse principle and that the Facility B lenders were enriching themselves at the expense of the minority, Facility A, lenders.⁹⁶ Rimer J upheld the terms of the waiver letter. Although the fact that a small proportion of the Facility A lenders were adversely affected might, in the words of Lindley MR, ‘excite suspicion’ as to the bona fides of the majority, the facts indicated that the majority did not dictate the amendment to the borrower.⁹⁷ The borrower had negotiated forcefully for the reduction to come from the B facility because that improved its repayment profile in the optimal way. The majority were not even aware that certain lenders could be prejudiced until a relatively advanced point in negotiations and, as Rimer J indicated, they had no duty to educate themselves as to the percentage holdings of the various lenders.⁹⁸ It was thus not the B lenders’ intention that a minority of A lenders become net payers.⁹⁹ In any event, only 14 of 29 B lenders benefited from the amendment.¹⁰⁰

Rimer J noted that it was inherent in a facility agreement such as this one that conflicts of interest could arise between the various classes of lenders and that ‘it would or could in practice often be impossible for the majority to exercise their [majority voting] powers in a manner which, viewed objectively, could be said to be for the benefit of each

⁹² *ibid* [35], [44], [108]. The outstanding commitment on Facility B as at 31 December 2003 determined the amount to be repaid from June 2004 onwards in biannual tranches. Since Facility A only fell to be repaid in 2008, using Facility A to prepay Facility B offered an improved short-term repayment profile.

⁹³ *ibid* [50], [53].

⁹⁴ *ibid* [52].

⁹⁵ *ibid* [79].

⁹⁶ *ibid* [92].

⁹⁷ *Allen* (n 15) 675; *Redwood* (n 17) [116].

⁹⁸ *Redwood* (n 17) [112].

⁹⁹ *ibid* [116].

¹⁰⁰ *ibid* [110].

hypothetical member of each class'.¹⁰¹ The claimants' position was that if such impossibility were to arise, then the majority voting power would be paralysed. Rimer J could not accept this proposition as it would work against the purpose of the majority voting provision, which was to bind dissentient parties on difficult decisions: '[T]he point is that the facility agreement is one under which all three lending classes are part of the long term lending package, and no class is entitled to say that it has had enough and wants to call a halt to its commitments'.¹⁰² Furthermore, the amendment placed the borrower in a stronger financial position, which was to the benefit of all lenders. For these reasons, the amendment was upheld.

Most commentators have remarked favourably on the judgment.¹⁰³ The judgment is to be welcomed because it applies the abuse principle consistently with authority in a way that is sensitive to the commercial importance of majority lending provisions.¹⁰⁴ Rimer J, accepting that there was no bad faith on the part of the majority lenders, was appropriately deferential to the commercial benefits of the transaction extolled by the issuer. In particular, the fact that the resolution adversely affected a particular minority did not entail that the resolution was in bad faith, which is consistent with earlier decisions.¹⁰⁵ Rimer J was also in principle prepared to draw inferences of subjective bad faith on the basis of objective circumstances, which is consistent with the Court of Appeal's approach in *Shuttleworth*.¹⁰⁶ Lastly, his reliance on the *Peters' American Delicacy* case is also appropriate because, as Prentice has commented, '[i]n any situation where there is internal disharmony within a company, it is fatuous to talk in terms of 'the interests of the company' when in actual fact the company is Balkanised into different factions'.¹⁰⁷

One deficiency in the judgment is that Rimer J considered that the abuse principle to be an implied term of the facility agreement, either on the basis of 'obvious inference' or 'to give effect to the reasonable expectations of the parties'.¹⁰⁸ In the *Assénagon* case, Briggs J expressed doubt as to whether this approach was correct, preferring to regard the abuse

¹⁰¹ *ibid* [94].

¹⁰² *ibid* [98].

¹⁰³ Philip R Wood, 'Syndicated Credit Agreement: Majority Voting' (2003) 62 Cambridge LJ 261, 263; Howard and Hedger (n 1) 28.

¹⁰⁴ Howard and Hedger (n 1) 28 comment that had the ruling gone in favour of the claimants, the syndicated lending market 'would have effectively been paralysed'.

¹⁰⁵ *Allen* (n 15); *Shuttleworth* (n 20).

¹⁰⁶ *Shuttleworth* (n 20); *Redwood* (n 17) [105].

¹⁰⁷ Dan Prentice, 'Winding up on the Just and Equitable Ground: the Partnership Analogy' (1973) 89 LQR 107, 116.

¹⁰⁸ *Redwood* (n 17) [92].

principle as a term implied by law.¹⁰⁹ Briggs J's approach is arguably preferable, being more consistent with authority, in particular Lindley MR's statement in the *Allen* case that the abuse principle derives from 'general principles of law and equity ... applicable to all powers conferred on majorities' and that it is 'always implied'.¹¹⁰

2. The Azevedo case

The *Azevedo* case concerned the validity of consent payments made exclusively to bondholders who voted in favour of consent solicitations made pursuant to the issuer's restructuring plan, a novel point under English law.¹¹¹ Towards the end of 2008, the issuer and its group experienced difficulties with the issuer's debt burden in the wake of that year's financial crisis. Its financial advisers developed a restructuring plan to mitigate these problems.¹¹² The restructuring plan required various modifications to the terms of certain notes, some of which could only be obtained through a 'special quorum' resolution, which, in addition to the consent of 75% in value of those voting on it, also required a quorum of 75% in value.¹¹³

The proposed modifications involved, among other aspects, amendments to the economic terms of the notes, including postponement of interest and principal.¹¹⁴ In conjunction with these consent solicitations, the documentation openly provided for a consent payment to be made exclusively to all noteholders voting in favour of the extraordinary resolution.¹¹⁵ The first three of such resolutions were passed with close to unanimous majorities, with the claimants voting in favour.¹¹⁶ The fourth and final resolution was the one the claimants (who had voted in favour of the preceding three resolutions) voted against and subjected to challenge. The resolution provided that each noteholder who provided valid voting instructions in favour of the resolution, which cancelled an interest payment, and who did not revoke them would receive a consent payment of \$25.94 for every \$1,000 of the face value of the notes that the noteholder held.¹¹⁷ This amount was half the amount of the interest payment due and owing.¹¹⁸

¹⁰⁹ *Assénagon* (n 13) [46].

¹¹⁰ *Allen* (n 15) 671.

¹¹¹ *Azevedo* (n 14) [55].

¹¹² *ibid* [15].

¹¹³ *ibid* [8].

¹¹⁴ *ibid* [16].

¹¹⁵ *ibid* [13].

¹¹⁶ *ibid* [16].

¹¹⁷ *ibid* [17].

¹¹⁸ *ibid*.

The claimants argued that these consent payments violated the *pari passu* principle, in that they treated consenting and non-consenting noteholders differently; secondly, they argued that the consent payments constituted a bribe and therefore rendered the consent solicitations and resultant resolutions illegal and invalid.¹¹⁹ The court rejected the claimants' arguments and upheld the validity of the consent payments.¹²⁰ While the claimants did not seek to argue that the consent payments violated the abuse principle, their bribery argument cited important cases in its history, namely the *Goodfellow* case and the *British America Nickel Corporation Ltd* case.¹²¹ These cases support the application of the abuse principle to decisions taken pursuant to majority lending provisions. However, neither case advanced the claimants' argument.

In *Goodfellow*, the scheme documents openly provided certain benefits to a party whose consent was vital for approval of the scheme. The scheme was held to be valid. In the *British America Nickel Corporation Ltd* case, certain benefits were also offered to a party whose consent was vital for approval of the scheme. These offers were, however, made in secret. The scheme was therefore invalid, confirming the converse of the principle in *Goodfellow*. Hamblen J concluded that together the cases showed that 'payments offered in exchange for votes do not constitute bribery where the relevant scheme has openly provided for the separate treatment of persons with a different interest'.¹²² Since the resolutions and accompanying documentation had repeatedly made transparent disclosures surrounding the consent payments, the consent payments did not amount to bribery. Furthermore, two other features of the consent payments were inconsistent with bribery: first, the consent payments each noteholder received were made on an equal basis and second, each noteholder was freely entitled to vote on the resolution as it saw fit.¹²³

Hamblen J noted that it had not been argued that the consent payments were oppressive to those who did not receive them.¹²⁴ In this context, it should be borne in mind

¹¹⁹ The *pari passu* argument was dismissed on the basis that the *pari passu* treatment of creditors was only contractually required in respect of funds received by the trustee. Since the funds used for the consent payments were never held by the trustee, that provision did not apply. Furthermore, the broader principle of *pari passu* treatment of creditors in insolvency did not apply either, since the issuer was not insolvent: *Azevedo* (n 14) [39]-[50], [66].

¹²⁰ Affirmed by the Court of Appeal: *Azevedo* (n 14).

¹²¹ *Goodfellow* (n 64) 333; *British America Nickel Corporation Ltd* (n 64) 371. The omission of the abuse principle is discussed further at (n 124) below.

¹²² *Azevedo* (n 14) [53].

¹²³ *ibid* [54].

¹²⁴ Moverly Smith and Sharpe (n 19) 289-290 argue that the abuse principle 'was not even capable of being alleged in *Azevedo*' because 'the coercion is applied outside the resolution [and so] there is no transaction between the noteholders inter se on which that principle can bite'. This is arguably an inappropriately narrow approach in relation to the abuse principle, the reason being that it is implied by law to all majority noteholder

that, as noted in Part B, offering a consent payment to those who vote in favour alters the incentives of the participants, punishing those who do not support the resolution. Those who do not support the resolution but who believe it will be passed anyway have an incentive to vote in favour and at least collect the consent payment. To the extent that bondholders are exposed to a prisoner's dilemma through co-ordination problems, a consent payment could conceivably be attacked on grounds of oppression and the abuse principle.¹²⁵

While Hamblen J did not need to decide the point, he made some remarks that indicated that he did not believe that the notes were unduly oppressive. First, he noted that the claimants had accepted previous consent payments and waived their right to test their validity. That only shows that previously they accepted them, not that they were fair. His second point was that an 'overwhelming' majority voted in favour of the resolutions. However, respect for the democratic principle does not go towards establishing the fairness of a decision towards a dissenting minority. Lastly, he noted that the consent payments formed part of a comprehensive reorganisation that was formally confirmed as a matter of Brazilian law.¹²⁶

This point also does not establish that the consent payments were not oppressive as a matter of English law. The Court of Appeal also failed to offer a suitable explanation. It emphasised that the special quorum requirement of 75% provided the issuer with a 'special reason' to offer the consent payment to vote on the resolution.¹²⁷ It is true that establishing such a quorum of dispersed bondholders might prove difficult; however, that is an argument for paying the consent payment for assisting to establish the quorum, not for voting in favour of the resolution. Neither the High Court nor the Court of Appeal addressed the fundamental point that a consent payment can alter the incentives of bondholders in a potentially coercive way.

Thus, while no one was accused of dishonesty or malice, it could be argued that the coercive element inherent in a consent payment renders the payment an abuse against the minority who did not receive it. However, it is suggested that this argument would be incorrect and that the decision in *Azevedo* is consistent with the abuse principle. The coercive effect of a consent payment is premised on the inability of the bondholders to co-ordinate with each other to overcome the prisoner's dilemma. However, empirical research

decisions (*Assénagon* (n 13) [46]). Briggs J furthermore noted, in relation to the facts of the *Assénagon* case, that the mere fact that the 'relevant quid pro quo' was offered 'outside the four corners of the resolution could not be relevant to its bona fides' (at [75]).

¹²⁵ The Court of Appeal noted this possibility: *Azevedo* (n 14) [32].

¹²⁶ *Azevedo* (n 14) [68].

¹²⁷ *ibid* [35].

demonstrates that bondholders are at least on occasion able to organise themselves into committees to present a united front to issuers.¹²⁸ The concentration of sophisticated institutional investors in the UK bond market and the inference that as ‘repeat players’, they know whom to contact, adds weight to this argument.¹²⁹ These considerations entail that a court should exercise caution before concluding that a coercive prisoner’s dilemma arose in a particular restructuring.

If bondholder co-ordination were practically impossible – because, for example, the investor was an individual with a small holding – then the possibility of coercion remains. That said, even though a coercive element is present, the offer might still be one that is beneficial to bondholders. In the absence of malice, the court is required to draw an inference as to bad faith from the facts before it is able to intervene on the basis of the abuse principle. It is only able to do this if ‘no reasonable men could consider it for the benefit of the company’ or ‘it is so manifestly disadvantageous, discriminatory or oppressive towards them that the only conclusion that can be drawn is that it must have been motivated by dishonest considerations’.¹³⁰ This is a high threshold to cross and arguably it was not satisfied in the *Azevedo* case.

As Briggs J noted in the *Assénagon* case, the *Azevedo* resolutions were ‘plainly capable of being beneficial to noteholders, since they were designed to facilitate a reconstruction of the issuer, beneficial to all its stakeholders’.¹³¹ Arguably, a consent payment was a rational option given some of the difficulties of work-outs in the distressed debt market alluded to in Part B, including the problem of the hold-out creditor, the opacity of the distressed debt market and the psychological barriers of decision-makers to loss-taking settlements. It seems fair to conclude that it would on these facts be very difficult for the claimants to discharge their onus of showing bad faith on the part of the issuer. If however a consent payment were substantially larger than is customary, it might ‘excite suspicion’ as to its bona fides. The traditional approach of lawyers to drafting might deter such an aggressive course of action, but if such a case were brought to the courts, it could well infringe the abuse principle.¹³² It would however be very difficult ‘to say where the line should be drawn’.¹³³

¹²⁸ *Kahan and Tuckman* (n 55) 512; *Olivares-Caminal and others* (n 44) 93-94.

¹²⁹ *Board and others* (n 32) 12.

¹³⁰ *Shuttleworth* (n 20) 18; *Redwood* (n 17) [105].

¹³¹ *Assénagon* (n 13) [83].

¹³² *Bratton and Gulati* (n 53) 50.

¹³³ *Citco Banking* (n 66) [12] (Lord Hoffman).

3. *The Assénagon case*

The *Assénagon* case was the first decision to consider the validity of exit consents under English law.¹³⁴ On the basis of the abuse principle, Briggs J found that an exit consent in an exchange that stripped any notes that were not exchanged of virtually all of their value was invalid. The dispute arose out of a restructuring of the issuer necessitated by its significant exposure to commercial property lending at the time of the 2008 financial crisis. As the issuer was deemed to be of systemic national importance, various steps were taken by the Irish Government to shore up the issuer's finances. These included an initial two-year guarantee of various of the issuer's liabilities, including the notes that were the subject of the exchange, nationalisation of the issuer and various equity injections.¹³⁵ The issuer sustained enormous losses over the following months: by December 2009, losses stood at €12.7bn. By 30 September 2010, the Irish Government had provided €22.88bn in capital while a newly formed government agency had acquired €6.5bn worth of distressed loans from the issuer.¹³⁶ While the Irish Government was seeking to salvage the issuer, the claimant acquired its notes at a discount to face value of between 0.418 and 0.420 per nominal euro, the discount reflecting the fact that the notes were subordinated and the Irish Government was not expected to extend its guarantee of the notes at the possible expense of retail deposit holders.¹³⁷

This expectation proved to be accurate when the Irish Government announced its restructuring plan on 30 September 2010, which anticipated that 'subordinated debt holders [would] make a significant contribution' towards meeting the liabilities of the issuer.¹³⁸ The most relevant aspect of the restructuring plan to the notes was an exchange offer, in terms of which bondholders were invited to tender their notes for exchange for new notes at an exchange ratio of 0.2, meaning that for every €1 of face value of old notes, the exchanging bondholder would only receive €0.2 of new notes. The new notes were however unsubordinated and guaranteed by the Irish Government.¹³⁹ In order to tender their bonds, it would also be necessary for the bondholder to appoint a proxy to vote in its stead at a meeting in favour of an extraordinary resolution. The relevant resolution provided for the insertion of a right of the issuer to redeem the notes upon payment of €0.01 per €1,000, a payment ratio

¹³⁴ *Assénagon* (n 13).

¹³⁵ *ibid* [19], [21], [24].

¹³⁶ *ibid* [24]-[25].

¹³⁷ *ibid* [26].

¹³⁸ *ibid* [27].

¹³⁹ *ibid* [30].

of 0.00001 (which contrasted with a payment ratio of 0.2 under the exchange).¹⁴⁰ The effect of the exchange therefore was that if a bondholder chose not to exchange its bonds, it ran the risk that, if the resolution were nonetheless passed, its notes could be redeemed for practically nothing. Indeed, that is the risk that the claimant chose to take. Shortly after the extraordinary resolution was passed, the issuer then purported to exercise its newly acquired right to redeem the claimant's notes, which had a face value of €17m, for only €170.

The claimant challenged the resolution purportedly passed at the meeting on three grounds. The first challenge, which failed, was that the resolution was ultra vires the power to amend the note. As a matter of contractual interpretation, the court found that the issuer had the necessary power.¹⁴¹ The second challenge, which succeeded, was on the basis that at the time of the meeting, the issuer was beneficially entitled to the notes on which the noteholders were purporting to vote. This meant that in terms of a standard 'sterilisation' clause included in the notes, the issuer was disenfranchised from voting on notes beneficially held by it.¹⁴² However, because of the possibility of appeal on the second point as well as the abuse principle's wider importance to the restructuring community in this context, Briggs J also gave judgment on the third challenge.¹⁴³ The substance of the complaint was that the exit consent infringed the abuse principle because it permitted the expropriation of the notes of a defined minority in circumstances where the majority could exchange their old notes for new notes of 'substantial value'.¹⁴⁴ It was contended that this was of no possible benefit to noteholders and thus 'oppressive and unfairly prejudicial'. Briggs J agreed, finding the exit consent to be invalid on the facts of the case.

The issuer sought to argue that the exit consent had to be seen in the wider context of the role of the exchange offer, which offered 'real value' for the notes, in the rescue of a deeply distressed bank. In such light, it was contended, the exchange offer and exit consent, which the noteholders could 'freely' accept, were clearly for the benefit of the noteholders as a class.¹⁴⁵ Furthermore, there was ample authority for the proposition that where an inducement to support a scheme is properly disclosed to all members of the class, a challenge

¹⁴⁰ *ibid* [32], [33].

¹⁴¹ *ibid* [54]-[55].

¹⁴² *ibid* [64]-[67].

¹⁴³ *ibid* [69]. '[T]he 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': Paul Deakins, 'Exit Consents and Oppression of the Minority' (2012) 5 *Corporate Rescue and Insolvency* 172, 174.

¹⁴⁴ *Assénagon* (n 13) [70].

¹⁴⁵ *ibid* [71].

on the basis of the abuse principle will usually fail.¹⁴⁶ The issuer thus pointed towards the wider context of its efforts to effect a comprehensive restructuring.

In contrast, the claimant focused on the prejudicial effect of the resolution on the minority. Briggs J noted that he was essentially required to choose between two different analytical approaches. Rejecting the issuer's approach, Briggs J distinguished the authority cited by the issuer on the basis that those cases represented instances where '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'.¹⁴⁷ By implication, in this instance, it would be irrational to conclude that the expropriatory exit consent could be for the benefit of the class. The exit consent's '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 ... will be left out in the cold'.¹⁴⁸ Further, those voting in favour of the exit consent had no common interest with the non-exchanging bondholders. Briggs J concluded that the coercive nature of the exit consent was 'entirely at variance with the purposes for which majorities in a class are given power to bind minorities' and that 'oppression of a minority is of the essence of exit consents of this kind'.¹⁴⁹ Furthermore, the noteholders' 'relative inability' to co-ordinate between each other 'aggravated' the purely coercive nature of the exit consent.¹⁵⁰

On the facts, *Assénagon* represents a correct application of the abuse principle. Briggs J's use of the language of 'irrationality' is similar to the language used in the *Shuttleworth* case, where the court found that a resolution would be impugned if 'no reasonable men could consider it for the benefit of the company'.¹⁵¹ It seems fair to conclude that there is no rational justification for such an over-reaching and confiscatory exit consent. One was left with the conclusion that its only purpose was to coerce the minority into accepting the restructuring. By contrast, the court noted it would have been difficult to criticise a 'drag-along' exit consent that permitted those who did not vote in favour of the resolution to nonetheless exchange their bonds for a 'potentially beneficial' substitute if the resolution were successfully passed.¹⁵²

¹⁴⁶ *ibid* [72].

¹⁴⁷ *ibid*.

¹⁴⁸ *ibid* [84].

¹⁴⁹ *ibid* [84], [86].

¹⁵⁰ *ibid* [4], [85].

¹⁵¹ *Shuttleworth* (n 20).

¹⁵² *Assénagon* (n 13) [75]-[76].

Using this structure would permit an issuer to achieve its goal of retiring an entire tranche of debt by only obtaining the levels of consent required in the indenture for the prescribed supermajority, which will usually be two-thirds or 75%.¹⁵³ If such an exchange offer is completed, there is no possibility, as in the US, of non-exchanging bondholders consuming the savings generated by the exchange offer with their unaffected economic rights: they would be compelled to exchange their bonds at the same price as the majority. A drag-along scheme is therefore a viable alternative to achieve the same restructuring as that which the exit consent sought to bring about. The fact that another means that was not coercive could arguably have been used provides good reason to suggest that a rational bondholder would not consider the expropriatory exit consent to be in the interests of the class.¹⁵⁴

One relatively unsatisfactory element of the *Assénagon* judgment is Briggs J's attempt to distinguish *Assénagon* from *Azevedo* by characterising the consent solicitation payment as a positive financial inducement (permissible) and the exit consent as a 'negative' inducement (impermissible).¹⁵⁵ As argued above, consent payments, early consent fees, and exit consents all have the potential to exercise coercion on bondholders. The difference is a question of degree, not whether it is a negative inducement or not. If one were to imagine an issuer launching a cash tender offer with a consent payment that was half the price offered for the tendered securities, it is hard to imagine the court permitting this purely on the basis of its not being a negative inducement. The court would, in those circumstances, need to consider whether a rational bondholder voting in the class could consider the consent payment beneficial to the class.

The decision has also introduced doubt as to whether exit consents that merely strip covenants are valid, because some of Briggs J's statements, taken in isolation, imply a complete ban on them. For instance, he notes that the claimant's 'original submissions' could, if correct, 'prima facie apply to any form of exit consent which imposed less favourable consequences upon those who declined to participate'.¹⁵⁶ He also used very harsh language when describing the exit consent, particularly in the conclusion of his judgment where he stated that 'oppression of the minority is of the essence of exit consents'.¹⁵⁷

¹⁵³ Cole (n 12) 53.

¹⁵⁴ A version of a drag-along exit consent was used in the Co-operative Bank restructuring. Exchanging bondholders consented to an amendment entitling the issuer to 'mandatorily' acquire the non-exchanging bondholders' holdings 'on the same economic terms' as the other exchange offers: Co-operative Bank (n 9) 33.

¹⁵⁵ *Assénagon* (n 13) [82].

¹⁵⁶ *ibid* [69].

¹⁵⁷ *ibid* [86].

Arguably, this condemnation specifically applied to the expropriatory species of exit consent under consideration, which was designed ‘to destroy rather than to enhance the value of the notes and [which] was, on its own, of no conceivable benefit to noteholders’.¹⁵⁸ It is true that this statement encompasses any exit consent that, while not completely confiscatory, has only the intention of dampening bondholder enthusiasm for retaining their old bonds in the face of a proffered exchange by damaging their value. It could thus include covenant-stripping exit consents. However, some exit consents have different and arguably legitimate purposes. For instance, an exit consent could remove a negative pledge covenant to allow the taking of further security for new money, a restriction on disposals covenant in order to allow for an asset sale, or amend a leverage ratio covenant in order to allow the issuer to take on further debt, without putting the issuer into default. If the removal of covenants is, in the honest view of the issuer, necessary for an aspect of a restructuring, which would be beneficial for the non-exchanging bondholders, and there is a rational basis for such view, then arguably such exit consents would be acceptable, notwithstanding the adverse effect upon the non-exchanging bondholders.

The courts have a long tradition of respecting business judgment, provided the decision is not in bad faith.¹⁵⁹ Therefore, if the court is satisfied that the proposal passes the minimum threshold of rationality set out in the *Shuttleworth* and *Redwood* cases, then it should permit the exit consent.¹⁶⁰ In contradistinction, it is unlikely that the courts would permit wholesale covenant-stripping, where such removal is not justifiable in light of the proposed restructuring. This reasoning also suggests that it would not be possible to provide for non-exchanging bondholders to receive a less valuable exchange than the exchanging bondholders, since such a threat would be purely punitive.

E. CONCLUSION

Exchange offers can be a useful mechanism for financially restructuring over-leveraged companies in an efficient and flexible manner. However, restructuring negotiations are notoriously difficult and hold-out creditors pose a particular threat to efficient exchange offers by threatening to consume the savings generated by the exchange offer. This suggests that coercive tactics in exchange offers can have a legitimate role to play in an economy that prefers efficient restructurings to more expensive alternatives, such as formal insolvency

¹⁵⁸ *Assénagon* (n 13) [83].

¹⁵⁹ In *Carlen v Drury* (1812) 1 V & B 154 at 158, Lord Eldon LC stated: ‘[t]his court is not to be required on every Occasion to take the Management of every Playhouse and Brewhouse in the Kingdom’.

¹⁶⁰ *Shuttleworth* (n 20); *Redwood* (n 17).

processes. As such, whether the abuse principle has ‘killed’ exit consents and other kinds of coercive restructuring tactics in England is an important question for issuers and the restructuring community.¹⁶¹ The answer to this question is negative. It is highly unlikely that the unusual exit consent in the *Assénagon* judgment will ever be resurrected. However, there are persuasive grounds to believe that the judgment does not as a matter of logic entail that all other ‘covenant-stripping’ exit consents or, indeed, other potentially coercive restructuring tactics, are unlawful.

Shuttleworth, *Redwood* and *Assénagon* show that to successfully invoke the abuse principle, disgruntled bondholders must discharge their onus in showing that it is irrational to conclude that the proposals were beneficial for the class.¹⁶² However, issuers may well be able to show some benefit for the class, notwithstanding the use of a tactic that prejudices non-exchanging bondholders (in the case of an exit consent combined with a covenant strip, or a consent solicitation payment), or late exchanging bondholders (in the case of an early consent payment). Issuers and their majority bondholders would be able to point to the benefit of a broader restructuring as evidence of the rationality of the proposed scheme for non-exchanging bondholders, provided the prejudice to them is not too severe, as in the *Assénagon* case. Litigious minority bondholders would have to go further and cross the high threshold, before courts that respect the business judgment of honest persons, of showing that the coercive tactic manifestly exceeds the commercial necessities of the restructuring to such an extent that it is irrational for bondholders to conclude that it is in the interests of the class.¹⁶³

This relatively deferential approach is consistent with the English courts’ attitude towards the business decisions of honest persons. While there is some empirical evidence that coercive tactics have in the past proved to be a useful tool in corporate restructurings, fears of coercing bondholders into a prisoner’s dilemma-type scenario do appear to be exaggerated, given the possibility of bondholder co-ordination. A measure of deference, and scepticism, in assessing the true coercive effect of these techniques is therefore appropriate. Moreover, even if a tactic introduces a measure of coercion, it is appropriate that the coercion should be considered in light of the difficulties of negotiating with hold-out creditors and achieving consent in consensual restructurings. Finally, it should also be weighed against the efficient

¹⁶¹ Anna Gelpern, ‘Exit Consents Killed in England?’ (*Credit Slips* 22 July 2012) <<http://www.creditslips.org/creditslips/2012/07/exit-consents-killed-in-england.html>> accessed 1 February 2015.

¹⁶² *Shuttleworth* (n 20); *Redwood* (n 17); *Assénagon* (n 13).

¹⁶³ *Shuttleworth* (n 20) 18; *Redwood* (n 17) [105].

economic benefits of a successful exchange offer to the non-exchanging bondholders. These factors indicate that some degree of coercion is acceptable and even appropriate.

Seen in this light, the ruling that the early consent payment in *Azevedo* was lawful is not inconsistent with the ruling that the exit consent in *Assénagon* was unlawful. In the circumstances, the former represents an acceptable degree of coercion because the offer as a whole was, in the eyes of a rational person, still capable of being beneficial to the non-exchanging bondholders. *Assénagon*'s exit consent, on the other hand, is an extreme example of the use of coercive tactics, offering no benefit to non-exchanging bondholders. It was therefore understandably intolerable to the court.

It has been argued that some exit consents could withstand the scrutiny of the abuse principle (eg a covenant strip that facilitates an asset disposal). That said, it is likely that *Assénagon* will curb issuer enthusiasm for exit consents, at least until a higher court has an opportunity to consider the matter. Until that time, the market is likely to see an increased use of the 'drag-along' schemes that received Briggs J's blessing and which have already been used in the recent Co-operative Bank restructuring.¹⁶⁴

¹⁶⁴ *Assénagon* [75]-[76]; Co-operative Bank (n 9) 33.