Developments in English Law: Chancery Division of High Court Overturns Exit Consent

August 3, 2012

The recent judgment of the Chancery Division of the English High Court in *Assénagon Asset Management S.A. v. Irish Bank Resolution Corporation Limited* (*formerly Anglo Irish Bank Corporation Limited*), issued on July 27, 2012, struck down an exit consent in a transaction governed by English law. The *Anglo Irish* judgment is the first time that the legality of exit consents has been tested under English law. While the judgment is subject to appeal, it calls into question the continued efficacy of established restructuring techniques that have used exit consents as a core mechanic and introduces significant uncertainty into the English law governed bond market.

THE ANGLO IRISH JUDGMENT

The claimant, Assénagon, held €17 million worth of Anglo Irish's subordinated floating rate notes due 2017. Following the nationalization of Anglo Irish in 2009, as part of its debt restructuring, in October 2010 Anglo Irish announced an exchange offer for its various notes, including the 2017 notes. Noteholders were invited to offer to exchange their 2017 notes for new senior notes at an exchange ratio of 0.20 (i.e. an offer of 20 cents of new notes for each Euro of 2017 notes). In connection with the exchange offer, Anglo Irish proposed to convene meetings of relevant classes of noteholders to amend certain terms and conditions of each series of existing notes, including an amendment which if approved by an affirmative vote of three-fourths majority of persons voting, would give Anglo Irish the right to redeem all of the unexchanged existing notes for a nominal sum of €0.01 per €1000 principal amount. Under the terms of the exchange offer, by offering to exchange its existing notes, a noteholder would automatically be deemed to have appointed a proxy to vote in favor of the amendments proposed by Anglo Irish. It was not possible for noteholders to validly offer to exchange their existing notes without at the same time appointing such a proxy.

At the conclusion of the exchange offer in November 2010, 92.03% of noteholders had offered their 2017 notes for exchange and Anglo Irish had accepted all such offers. The amendments proposed by Anglo Irish to the terms and conditions of the existing notes were duly passed by a resolution of noteholders. Shortly thereafter, Anglo Irish exercised its new right to redeem the remaining 2017 notes for the nominal amount stated and Assénagon, which had not participated in the exchange offer, received €170 for its €17 million face value of 2017 notes.

In its claim issued on April 15, 2011, Assénagon sought a declaration that the noteholders' resolution amending the terms and conditions of the 2017 notes was invalid on three grounds: (1) the resolution constituted, in substance, the conferral of a power on Anglo Irish to expropriate the 2017 notes for a nominal consideration and exceeded the power of a majority under the trust deed governing the 2017 notes; (2) at the time of the noteholders' meeting, all those noteholders who voted in favor of the resolution held their notes, beneficially, or for the account of, Anglo Irish and those notes should have been disregarded pursuant to the provisions in the trust deed that prohibited the issuer from voting in respect of notes beneficially held by it or for its account; and (3) the resolution constituted an abuse of the voting power of the majority because it conferred no conceivable benefit or advantage upon the noteholders as a class and was both oppressive and unfair against the minority who had not participated in the exchange offer.

The court found against Assénagon on the first ground but found in favor of Assénagon on the second and third grounds. In particular, the court concluded in broadly phrased language that it would be unlawful for majority noteholders to extend their aid to the coercion of a minority by expropriating the minority for nominal consideration.

COMMENTS

Exit consents have long been upheld in the United States. In the 1986 case, *Katz v. Oak Industries Inc.*, the Delaware Chancery Court upheld the legality of an exit consent that was constructed to remove significant negotiated protections of the noteholders, including all the financial covenants. The court held that the challenged exit consent did not, despite its coercive effect, amount to a breach of the indenture or an implied obligation of good faith and fair dealing between the issuer and the noteholders in what was an ordinary commercial arms-length contract. Similarly, in *Greylock v. Province of Mendoza*, an exit consent was upheld in New York and generally New York courts will not imply prohibitions that are not expressly set out in the contract.

The court in *Anglo Irish* at the outset took note of the *Katz* judgment but declined to apply it in this case. The court pointed out that the unsuccessful challenge in the *Katz* judgment was based on the notes issuer's obligations towards noteholders. In contrast, the challenge in *Anglo Irish* was based on an abuse of the power of the majority noteholders to bind a minority and on well established English law principles governing the duty of the majority to act bona fide in the interests of the class of bondholders as a whole.

While noting the established use of exit consents in the United States, as a caveat, it is important to keep in mind that although exit consents are used to strip notes of a wide variety of rights, the Trust Indenture Act, which applies to many U.S. indentures either directly or through incorporation, protects noteholders' fundamental rights to principal and interest. Pursuant to a "principal and interest exception", under the Trust Indenture Act, the consent of each affected holder is required to effect amendments to rights relating to payment of principal and interest, the timing of such payment and the right to sue for such payment. Consequently some courts, for instance in *Federated Strategic Income Fund v. Mechala Group Jamaica*, have struck down particularly aggressive exit consents as violating this "principal and interest exception". Even in cases where the Trust Indenture Act does not apply, typically a U.S. indenture would require the consent of each affected holder on certain fundamental matters such as those falling under the "principal and interest exception".

CONCLUSION

The *Anglo Irish* judgment could potentially apply to any form of exit consent which imposes less favorable consequences upon those who decline to participate in an associated exchange offer, even if such consequences do not amount as they did in the *Anglo Irish* case to a complete expropriation of the relevant securities from the dissenting minority. It therefore throws into doubt the option of using an exit consent mechanic in English law debt restructurings. Given the more settled position under New York law, unless the *Anglo Irish* judgment is overruled on appeal, issuers should consider applying New York law as the governing law in debt documentation.

The judgment also illustrates the pitfalls of changing the governing law clauses in instruments such as high yield bonds where New York law is the established governing law with an established body of well-understood precedent. As parties experiment with introducing different laws in the high yield bond market, they should be aware that local law rulings might cause a significant departure from market expectations.

This memorandum is for general information purposes and should not be regarded as legal advice. Please contact your relationship partner if we can be of assistance regarding these important developments. The names and office locations of all of our partners, as well as our recent memoranda, can be obtained from our website, www.simpsonthacher.com.

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
2 Houston Center
909 Fannin Street
Houston, TX 77010
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2550 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3919 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Tokyo
Ark Mori Building
12-32, Akasaka 1-Chome
Minato-Ku, Tokyo 107-6037
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000