Feature

KEY POINTS

- Debt write-downs may be implemented under certain debt instruments without unanimous creditor approval or resorting to the courts through Schemes of Arrangement.
- However reductions which discriminate against the minority will be scrutinised.
- The picture can be complicated where consent solicitation fees or exchange consent tactics are adopted.

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Carrots and sticks: limits on majority creditors' rights to bind a minority

This article looks at the circumstances in which a majority of creditors may be limited in its powers to bind a minority in a restructuring – we consider the tactics corporate debt issuers commonly use to persuade creditors to vote in favour of a restructuring proposal and some of the challenges that often arise in practice.

INTRODUCTION

It would be unusual for a company, in financial distress and with a diverse creditor group to contend with, to propose a restructuring that attracts unanimous creditor approval. Invariably there will often be one or more dissenting creditors, who either dislike what is tabled or hold out for a better offer. This problem can be particularly acute where a company has issued publicly traded debt such as bonds which have been purchased in the secondary markets by those with "ulterior" motives.

Against this backdrop, there is always a balance to be drawn between pushing creditors to accept a restructuring that achieves its purpose whilst conceding as little as possible. The option of attempting to cram down dissenting creditors by forcing a restructuring on them through a scheme of arrangement may not always be viable, especially since schemes can be time-consuming, expensive and require court sanction.

This article considers some alternative tactics that corporate borrowers may employ when promoting a restructuring which involves a debt write-down. As a debtor, a key consideration is whether to offer a carrot to tempt creditors who might otherwise say no, or threaten those who refuse to play ball with some kind of stick. We will consider the limits as to what debtors can and cannot do in such scenarios.

DETERMINING THE REQUISITE MAJORITY

The first hurdle to cross when devising a restructuring proposal is to assess what mandate of creditor consent is required to implement the relevant waivers or amendments. A request to reduce the debt payable typically requires all lender consent under standard Loan Market Association documentation; however such requirements for unanimous creditor consent for debt write-downs are not universal. In the case of bonds or loan note instruments, a relevant majority alone, whether by an extraordinary resolution or otherwise, might be sufficient to reduce the value of outstanding bonds or notes. Even in the loan context, a sponsor-friendly credit agreement may feature "snooze you lose" or "yank the bank" provisions, which may help to dilute the blocking ability of any potential minority. However even where a reduced constituency of creditor support is sufficient to approve a debt write-down or other restructuring proposal, care must still be taken to ensure the majority do not abuse their power by discriminating against the minority.

RESTRICTIONS ON THE EXERCISE OF MAJORITY POWER

Having established the requisite voting threshold, it is equally important to consider the extent to which creditors' discretion is restricted when deciding whether to approve a restructuring.

In *British America Nickel Corporation, Limited and Others v MJ O'Brien, Limited* [1927] AC 369, Viscount Haldane compared the position of debenture holders with voting powers to amend the debenture to the position of shareholders voting to amend articles of association.

> "There is, however, a restriction of such powers when conferred on a majority of a special class in order to enable that majority to bind the minority … the power given must be exercised for the purpose of benefiting the class as a whole and not merely individual members only."

The *British America* passage was cited with approval in *Redwood Master Funds Ltd v TD Bank Europe Ltd* [2002] EWCH 2703 (Ch), in which the borrowing company, having hit financial trouble, sought to restructure its syndicated facility agreement by proposing a waiver involving a relaxation of covenants in return for a reduction in the facilities, a consent fee and a margin increase. Crucially the prepayments involved a drawing under the revolving facility to prepay outstanding loans under one of the term facilities, so that some lenders (including the claimants) were net contributors as a result of the facility reduction exercise.

In *Redwood*, analogous company law cases were cited, including *Greenhalgh v Arderne Cinemas Ltd and others* [1951] Ch 286, where Evershed MR stated that a special resolution might be impeached if its effect were to discriminate between majority and minority shareholders, so as to give the former an advantage of which the latter were deprived.

Rimer J in *Redwood* considered that the *Greenhalgh* principle is equally capable of applying to the manner in which a class of lenders conducts itself in relation to matters affecting the whole class. However, Rimer J determined that the *Greenhalgh* principle did not in fact apply – it would need to be a term implied into the contract and would cause paralysis if every amendment was unable to discriminate against any lender, given the diversity of net financial positions of the lenders across

the facilities. The parties could not have intended to imply such a term.

The famous case of *Allen v Gold Reefs of West Africa Limited* [1900] 1 Ch 656 was also considered in *Redwood*, with its well-known dictum that a majority must exercise its power *bona fide* for the benefit of the company as whole. Analysing that case and others, Rimer J concluded that the purpose of majority voting powers could be restricted where such powers are used by a majority to confer special benefits on the majority alone, or to maliciously damage or oppress the minority.

On the facts of *Redwood*, no such purpose could be imputed. The waiver letter was the product of protracted negotiations and there were some benefits for all lenders, including the survival of the borrowing group, payment of a waiver fee and an increased interest rate. The fact that one class of lenders was proportionally more disadvantaged than another was not fatal. The decision to reduce the facilities by drawing under the revolving facility was informed by the cashflow requirements of the group rather than any attempt to discriminate against the minority. What might have tipped the outcome in a different direction may have been evidence that, in Rimer J's words, the majority's exercise of power was so manifestly disadvantageous, discriminatory or oppressive towards the minority

> "[T]hat the only conclusion that can be drawn is that it must have been motivated by dishonest considerations inconsistent with a proper exercise of the power."

Making out a case of minority oppression is a difficult hurdle to overcome then. However *Redwood* illustrates that challenges to majority lender decisions under syndicated loan transactions are possible, albeit (given the requirement to demonstrate discrimination) an uphill struggle. A mere difference of opinion alone is not, it seems, sufficient, but nor is the fact that lenders are not split by classes necessarily a bar to any potential discrimination claim.

OFFERING A CARROT: CONSENT SOLICITATION FEES

Consent solicitation fees are a common feature in many restructuring proposals. They typically act as a sweetener, providing for a fee payable to bondholders who consent to an issuer's proposed amendments to a bond's terms.

Such a fee was offered to the holders of the Imcopa Group's bonds in *Azevedo v Imcopa Importacao* [2012] EWHC 1849 (Comm). Imcopa, a Brazilian soybean processor, refinanced its business in 2006 through issuing loan notes. During 2009 and 2010 the Imcopa group sought the consent of loan note holders to a restructuring proposal on four occasions, with each consent solicitation involving a postponement of interest payable under the notes and three of them offering a consent payment to those noteholders voting in favour of the relevant extraordinary resolution. The claimants voted for the first three consent solicitations (receiving consent payments in respect of two of those) but rejected the fourth and missed out on any consent payment in respect of that last consent solicitation. The claimants asserted that the consent payments represented a bribe and the extraordinary resolutions passed in respect of the last consent solicitation were invalid.

The High Court rejected the claimant's claim, Hamblen J concluding that consent payments are not bribes if made openly and noteholders are not incapacitated from voting. The consent payments in question had been openly and repeatedly disclosed to all noteholders, were payable to all consenting noteholders and each noteholder was free to vote as they determined.

The court considered the *British America* case (cited above) and also *Goodfellow v Nelson Line (Liverpool) Limited* [1912] 2 Ch 324. In *British America*, a bondholder was induced to vote in favour of an amendment by an issue of ordinary stock to him, not disclosed in the resolution. The resolution was not allowed to stand. By contrast in *Goodfellow*, guaranteed notes were replaced with unguaranteed notes at a slightly higher coupon, with the decision reliant upon the guarantor to be passed. The special interest of the guarantor was openly disclosed and the court upheld the resolution, acknowledging however that the fairness of such schemes would be prone to greater scrutiny where diverse interests were involved.

The *Azevedo* decision has been warmly received since it endorses a common practice of largescale corporates and financial institutions offering bondholders a small inducement, or so called "early bird" or "success fee", as an incentive to vote in favour of a consent solicitation. The case demonstrates that consent solicitation fees can work provided they stay on the right line of persuasion and do not cross the threshold so that they represent an illegal bribe or threat.

A different outcome would it seems have been possible if the incentive had been available to some (but not all) noteholders, or if inducements had been made in secret.

WIELDING A STICK: MINORITY OPPRESSION AND EXIT CONSENTS

The use of exit consents in bond restructurings has found favour in the US in the face of minority creditor challenge but remains a controversial tactic on this side of the Atlantic. The employment of such tactics was at issue in *Assenagon Asset Management v Irish Bank Resolution Corporation Ltd* [2012] EWHC 2090 (Ch), which again (like *Azevedo*) involved an issuer attempting to persuade its bondholders to accept a restructuring although on this occasion without paying them.

The tactic involves an invitation to bondholders to offer their existing bonds in exchange for new ones with less favourable terms, with the added proviso that if bondholders accept the offer they irrevocably commit to vote at a bondholder meeting in favour of a resolution that amends the existing bond terms so as to materially damage or reduce their value. Those who decline the exchange and who either vote against such resolution or otherwise abstain, entertain the risk that

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they will be left with bonds which are materially devalued or destroyed altogether by being redeemed for nominal value.

The exit consent strategy should not be confused with the concept of turkeys voting for Christmas, since those who vote in favour of the exit consent resolution do so having taken the informed (if reluctant) view that it is better to be left with bonds of some value (albeit less attractive than the existing bonds) than none at all. In *Assenagon*, for example, the new bonds were issued at 20% of the par value of the old bonds but benefitted from a government guarantee. Those who gamble and reject an exit consent face a real risk of not just suffering a haircut but a complete scalping.

The success or failure of the exit consent technique depends largely on how quickly bondholders can organise themselves to align their interests before the exchange acceptance deadline in order to stifle the exchange by subsequently voting against the exit consent resolution. Bondholders are described in this context as being confronted with the prisoners' dilemma, ie their interests are best served by acting in unison to reject the offer but they cannot be sure that others will do likewise, and so any bondholder voting against risks being wholly disenfranchised. The claimant in *Assenagon* acquired subordinated loan notes issued by Anglo Irish Bank Corporation Limited for an aggregate value of just over €17m. The notes were purchased in the secondary markets between 2009 and 2010 at a deep discount owing to the troubles experienced by the then nationalised bank following the financial crisis. The implications of rejecting the exchange offer (including the issuer's entitlement to redeem existing bonds (if not exchanged) for 0.00001 of their face value) prompted 92.03% of relevant bondholders by value to offer their bonds for exchange and bind themselves to accept the exchange offer.

Briggs J in the High Court considered the previous authorities cited above, and distinguished those cases where resolutions were approved because it was not irrational to conclude that the relevant proposals were beneficial to the class. He cited with approval the dictum of Evershed MR in *Greenhalgh* (cited above).

He distinguished *Assenagon* from *Azevedo* on four grounds. First, the resolution in *Azevedo* was what the issuer wanted to achieve. In *Assenagon* it was merely a negative inducement and the exchange of old bonds for new was contractual. Second, in *Azevedo* the issuer offered an incentive to all noteholders who voted in favour of the resolutions for restructuring. In *Assenagon*, by contrast, it was a majority of the bondholders who (albeit at the issuer's request) issued a threat with the aim of encouraging all bondholders to accede to the exit consent. Third, in *Azevedo*, the resolution was capable of benefitting the class whereas in *Assenagon* the resolution proposed was designed to destroy, rather than enhance, the value of existing bonds. Fourth, no case of oppression or unfairness was sustained in *Azevedo*, only an allegation of bribery whereas *Assenagon* concerned alleged oppression.

Briggs J concluded that the exit consent strategy was unlawful, representing an invitation by an issuer to the majority to threaten the minority with the prospect of being left out in the cold with worthless bonds. In his words,

> "oppression of a minority is of the essence of exit consents of this kind."

It should not necessarily be assumed that the exit consent strategy is dead in the water. An appeal was lodged in *Assenagon* but never heard. The exit consent involved in *Assenagon* was an extreme illustration of coercive tactics which left non-exchanging bondholders with virtually nothing, such that it was an easier task for the court to find in the claimant's favour. Some have argued that less controversial exit consents could gain court approval (for example, a covenant strip that facilitates an asset disposal).

For the time being the exit consent tactic is likely to see little use as issuers prefer instead to pursue more formal restructuring tools such as schemes of arrangement or alternatively less draconian approaches such as "drag-along" schemes of the kind used in the Co-operative Bank restructuring. Under the latter approach, dissenting bondholders typically receive the same consideration as those participating in the exchange or effectively get a second bite at the cherry – ie, an opportunity to sign up to the exchange offer after bondholders have resolved to approve the exchange. In *Assenagon*, Briggs J distinguished "drag-along" schemes of this kind from the harsher exit consent strategy employed in that case and indicated that the former are acceptable. They do of course lack the coercive effect of exit consent schemes because a dissenting bondholder does not lose out.

CONCLUDING THOUGHTS

A review of the case law in this interesting area, with particular analysis of the *Redwood*, *Azevedo* and *Assenagon* cases, illustrates that there is a delicate path to be taken between the Scylla of bribery and the Charybdis of oppression and unfairness. These cases demonstrate that inducements made by a company to all creditors of a particular class in an effort to persuade them to accept the terms of a restructuring can work. However if there is any question of a majority of those creditors threatening a non-compliant minority with the devaluation or expropriation of their investment, or where a majority are motivated by an undisclosed benefit or ulterior or malicious motive, they run the risk of the arrangement being set aside. In summary, persuasion and openness will likely succeed whereas force or subterfuge will likely fail. ■

Further Reading:

- An offer you can't refuse: when does coercion of a group to accept a proposal constitute oppression of the minority? [2014] 5 JIBFL 288.
- Minorities, modifications and the demise of good faith? [2015] 7 JIBFL 398.
- LexisNexis RANDI blog: What to do when creditors fail to participate in an administration (*Parmeko* case).