AN UNEVEN EXCHANGE? DEVELOPING A FAIR AND EFFICIENT APPROACH TO EXIT CONSENTS

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I. INTRODUCTION

A. Background

In 2008, Anglo-Irish Bank held €101 million in assets on its balance sheet, equal to half of the GDP of Ireland.[1] As the global economy deteriorated, the bank faced liquidity issues, to the point that the Irish Government was forced to guarantee liabilities of the bank for two years in September 2008[2] and then to nationalize the

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* Managing Editor, *Rutgers Law Review*. J.D., Rutgers School of Law–Newark, 2014; B.A., Economics, University of Virginia, 2007. This Note is dedicated to my wife, Joanna, whose sacrifices made this Note possible; my son, James, for inspiring me; my parents, Mary and Paul and in-laws, Don and Cassandra, and the rest of my family for their support; and finally, the 2013-2014 Editors and Staff of the *Rutgers Law Review* whose suggestions and edits were essential.

1. Assénagon Asset Mgmt., SA v. Irish Bank Resolution Corp., [2012] EWHC (Ch) 2090, [2012] W.L.R. 243.

2. John Murray Brown, *Ireland Extends Bank Guarantee,* FINANCIAL TIMES,

bank in 2009.[3] As the government guarantee expired in 2010, the Minister of Finance proposed a restructuring of the subordinated debt, including the notes at issue in *Assénagon Asset Management, S.A. v. Irish Bank Resolution Corporation Limited*.[4] The bank's exchange offer and corresponding exit consent gave bondholders every incentive to cooperate with the restructuring by setting up a Hobson's Choice: either bondholders could consent to the restructuring and receive twenty cents of new notes for every Euro of the old ones, or they could receive one cent of new notes for every thousand Euros worth of old bonds if they did not consent.[5] The restructuring effected this drastic consequence by tying it to the exit consent; any bondholder who agreed to accept the better deal would be consenting to vote on an "extraordinary resolution" to wipe out the remaining bondholders by leaving them with an exchange offer of one cent for every thousand Euros.[6]

While the above is an extreme example, this technique of exit consents has been pervasive in restructuring contracts worldwide for both corporate and sovereign debt.[7] The court in *Assénagon* deals with the adverse result to the bondholders by applying a new standard: any deal must benefit bondholders as a class (which includes minority bondholders).[8] This ruling was shocking and was considered an unexpected departure from what had become a rather routine solution to the problem of bondholder holdouts in an exchange offer.[9] It is a widespread technique that has been affirmed

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(Sept. 8, 2010, 2:31 AM), http://www.ft.com/cms/s/0/3aac1ede-baa8-11df-b73d-00144feab49a.html#axzz2sYgwlbtp.

3. Fergal O'Brien, *Anglo Irish Bank Nationalized Following Loan Scandal*, BLOOMBERG, (Jan. 16, 2009, 12:37 PM), http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a9uv0GkxuLys.

4. *Assénagon*, [2012] EWHC (Ch) 2090.

5. *Id.* [29], [30].

6. *Id.*

7. For a general discussion, especially regarding the pervasiveness of exit consents in restructuring sovereign bonds, see Lee C. Buchheit & Mitu Gulati, *Exit Consents in Sovereign Bond Exchanges,* 48 UCLA L. Rev. 59, 59-84 (2001). Gulati and Buchheit discuss how an exit consent may circumvent the problems of holdouts for sovereigns looking to restructure debt obligations. They trace the history of the exit consent including its origin in the 1980s world of high yield debt which was likely to face the problems exit consents address.

8. *Assénagon,* [2012] EWHC (Ch) 2090,[39], ("Even if ultra vires, the Resolution constituted an abuse of the power of the voting majority because: (i) It conferred no conceivable benefit or advantage upon the 2017 Noteholders as a class . . .").

9. *See* Anna Gelpern, *Exit Consents Killed in England?*, CREDITSLIPS (July 27, 2012, 2:22 PM), http://www.creditslips.org/creditslips/2012/07/exit-consents-killed-in-england.html#more. *See also,* Matt Levine, *'Everybody's Doing It' Legal Theory Does Not Protect English Bank Restructurings,* DEALBREAKER (July 27, 2012, 5:03 PM), http://dealbreaker.com/2012/07/everybodys-doing-it-legal-theory-does-not-protect-english-bank-restructurings ("This looks a little counterintuitive, but U.S. courts have allowed it for 25 years, so it's become standard. And like many U.S. financial

by courts in the U.S. again and again.[10]

Though the facts in *Assénagon* seems to illustrate an oppressive failure of the law for the minority bondholders, I explore the possibility that exit consents are necessary and conclude that the offered alternatives are a disruptive and impractical imposition by the courts on these contracts and on the world economy.[11] I then explore the possibility of using the *Concordance Principle*[12] to develop a new method of restructuring debt that better preserves the individual property rights of each bondholder while still offering a solution to the holdout problem among bondholders.

B. Roadmap

I will begin exploring these issues in Part II by providing a description of the settled American law regarding exit consents. Part III explores the changes to exit consents introduced by the *Assénagon* decision and concludes these changes are disruptive and introduce unnecessary risk. Part IV contains a general theory of the exit consent and any problems it raises, including my proposed solution using the *Concordance Principle*. Part V is prescriptive and will analyze how the *Concordance Principle* may provide guidance for courts and contract drafters in balancing the harms caused by the *Assénagon* rule and the prior rule and offers an intermediate solution. Part VI offers a conclusion.

II. LITERATURE REVIEW/ STATE OF THE LAW

In Part II, I will examine the current state of the legal rule for exit consents. I conclude that the current Anglo-American treatment lacks consistency and predictability and development of new law is important in balancing bondholder fairness (property rights) with the efficiency espoused in the current dominant law of exit consents.

There are three primary Legal Theories by which issuers/majority bondholders can be thought to have any legal duty to minority bondholders in setting the terms of restructuring.[13] They

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innovations that have been blessed and become standard here, it's standard worldwide.").

10. *See, e.g.*, Katz v. Oak Indus. Inc., 508 A.2d 873 (Del. Ch. 1986). *See also* Gradient OC Master, Ltd. v. NBC Universal, Inc., 930 A.2d 104 (Del. Ch. 2007).

11. *See infra* note 77 and accompanying text.

12. Scott Duke Kominers & E. Glen Weyl, *Concordance Among Holdouts*, HARV. INST. OF ECON. RES., April, 2010, at 1.

13. Andrew Laurance Bab, Note, *Debt Tender Offer Techniques and the Problem of Coercion,* 91 Colum. L. Rev. 846, 856-60 (1991). Bab offers a more in depth treatment of the different categories of legal challenges to exit consents and exchange offers that mirrors the history I have provided in this section. Bab categorizes his claims as "Fiduciary Claims" and "Contractual Claims." *Id.* at 856.

are (1) that issuers have a fiduciary duty to bondholders; [14](2) the implied covenant of good faith imports contractual terms that form the basis of the deal which preclude the majority of bondholders from imposing conditions on the minority;[15] (3) contractual remedies provided are the only remedies available[16] and (4) statutory limitations prohibit (certain types) of exit consents.[17]

A. Fiduciary Duty

Outside the context of bankruptcy, and, perhaps, the zone of insolvency, fiduciary duty of the issuer to bondholders is virtually unknown in American Law.[18] The management and directors may have a fiduciary duty to stockholders, but bondholders have generally been found to have arms-length contractual relationship.[19] The justification is the divergence between management's interests and those of bondholders.[20] Management is trying to maximize the value of the enterprise for shareholders whereas bondholders are trying to maximize the value of their holding which often conflicts with the health of the corporation.[21] Moreover, it would undermine contract law to impose fiduciary duty on contracting parties.[22] As one scholar

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14. *Id.* at 856. *Compare* Hackettstown Nat'l Bank v. D.G. Yuengling Brewing Co., 74 F. 110 (2d Cir. 1896) (holding majority owes a fiduciary duty to minority bondholders), *with* Harff v. Kerkorian, 324 A.2d 215 (Del. Ch. 1974) (holding absent fraud and other special situations, duty between parties is merely contractual).

15. *See, e.g.,* Metropolitan Life Ins. Co. v. RJR Nabisco Inc., 716 F. Supp. 1504 (S.D.N.Y 1989).

16. *Harff,* 347 A.2d at 134.

17. *See* Buchheit & Gulati, *supra* note 7, at 67.

18. Bab, *supra* note 13, at 857-58. *But see* Credit Lyonnais Bank Nederland N.V. v. Pathe Comm. Co. 1191 WL 277613 at *25 & n.55 ("[W]here a corporations is operating in the vicinity of insolvency, a board of directors is not merely the agent of the residue risk bearers, but owes its duty to the corporate enterprise."). Fiduciary duties may extend to the bondholders when the corporation is in distress, especially where the actions of the directors render the corporation insolvent. *See In re* Health Co. Int'l, 208 B.R. 288 (Bankr.D.Mass 1997). Despite there being a fiduciary duty to creditors during insolvency, bondholders of insolvent corporations may have difficulty showing the issuer did not act in good faith and without reasonable investigation, therefore overcoming the presumption of the business judgment rule. *See* Angelo, Gordon & Co. v. Allied Riser Commc'n Corp., 805 A.2d 221 (Del.Ch. 2002).

19. Katz v. Oak Indus. Inc., 508 A.2d 873, 879 (Del. Ch. 1986).

20. *See* American Bar Foundation's 1971 Commentaries on Model Debenture Indentures at 2 (1971); W. KNEPPER & D. BAILEY, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS 163 (6th ed. 1989); William W. Bratton, Jr., *The Economics and Jurisprudence of Convertible Bonds*, 1984 WIS. L. REV. 667, 731 ("the black letter proposition emerges that creditors have an inherently and exclusively contractual relationship with the corporation" and "no fiduciary duties . . . arise between the corporate entity and its creditors").

21. Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821, 1836-37 (1992).

22. "[B]y invading the law of contract with *corporate fiduciary principles,* the

opined*:*

> This argument relies on the economic justification that fiduciary relations are more efficient than contractual relations. All ex ante contracts, however, are "inefficient," for it is impossible to provide for an efficient resolution to every contingency. In this respect, there is no basis for distinguishing between bond contracts and any other type of contract. Does this mean that all contracting parties, in the interest of more efficient mutual protection, should owe fiduciary duties to one another? Such a suggestion would turn the economy on its head and make contracting an extremely burdensome affair.[23]

The case law overwhelmingly affirms this principle of excluding bondholders from fiduciary duty and defining the relationship as contractual.[24] Even if the law of fiduciary duty applied, for shareholders there have been high standards to find a violation of this duty. The standard for shareholders under this theory is that the exit consent must be "actionably coercive."[25] The Delaware Chancery Court has defined this standard:

> As a general matter, a tender offer is not actionably coercive unless the shareholders are being wrongfully induced to accept the offer for reasons unrelated to its merits. Thus, an offer that is economically "too good to resist" as compared to the alternative of not tendering, would not, for that reason alone, be actionably coercive.[26]

Therefore, fiduciary duty is an impractical imposition on an arms-length contractual relationship and courts are hesitant to interfere.[27] Any breakthrough in the law of exit consents would therefore be unlikely to use fiduciary duty under current American law.

B. *Implied Covenant of Good Faith*

The implied covenant of good faith makes good faith part of the

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courts were misinterpreting a basic tenet of contract law—contractual *good faith*, unlike fiduciary duties, *permits self-interested conduct*." Ann E. Conaway, *The Multi-Facets of Good Faith in Delaware: A Mistake in the Duty of Good Faith and Fair Dealing; A Different Partnership Duty of Care; Agency Good Faith and Damages; Good Faith and Trust Law*, 10 DEL. L. REV. 89, 90 (2008)

23. Bab, *supra* note 13, at 857-58 (citations omitted)

24. *See, e.g.*, Browning Debenture Holders' Comm. v. Dasa Corp., 560 F.2d 1078, 1084 (2d Cir. 1977) (applying federal law); Lorenz v. CSX Corp., 736 F. Supp. 650, 658-59 (W.D. Pa. 1990) (applying New York and Delaware law); Simons v. Cogan, 542 A.2d 785, 788-89 (Del. Ch. 1987) (applying Delaware law), aff'd, 549 A.2d 300 (Del. 1988).

25. Gradient OC Master, Ltd. v. NBC Universal, Inc., 930 A.2d 104, 127 (Del. Ch. 2007).

26. Lieb v. Clark, Civil Action No. 9012 1987 WL 11903 at *3 (Del. Ch. June 1, 1987) (emphasis added) (citations omitted).

27. Katz v. Oak Indus. Inc., 508 A.2d 873, 880 (Del. Ch. 1986).

basis of every deal.[28] Section 205 of the Restatement (Second) of Contracts states: "Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement."[29] In the law of exit consents, bondholders may make arguments such as the majority of bondholders cannot completely expropriate the notes of the minority.[30] Good faith is not implied to contradict any express provisions of the contract[31] nor does it introduce a benefit that has not been bargained for in the contract.[32] In *Katz*, the court used the following test to determine if the exit consent was in violation of good faith:

> [I]s it clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith—had they thought to negotiate with respect to that matter.[33]

The court in *Katz* declined to find a violation of good faith because there were no financial covenants in the contract restricting the ability to unilaterally alter the bonds.[34] *Katz* also did not find the exit consent particularly coercive.[35] *Katz* offers the high standard of coercion based on an inducement that does not offer the same terms to all bondholders.[36] Coercion is not offering someone two

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28. Kirke La Shelle Co. v. Paul Armstrong Co. 188 N.E. 163, 167 (N.Y. 1933).

29. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981).

30. *See* John C. Coffee, Jr., *Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations*, 58 U. Chi. L. Rev. 1207, 1216 (1991). "[T]he bondholder's problem is two-sided: The bondholder must fear both the issuer's threats and its fellow bondholders' opportunism."

31. *See, e.g.*, VTR, Inc. v. Goodyear Tire & Rubber Co., 303 F. Supp. 773, 778 (S.D.N.Y. 1969).

32. Metropolitan Life Ins. Co. v. RJR Nabisco, Inc., 716 F. Supp. 1504 (S.D.N.Y 1989) (court declined to find the acquisition of debt by RJR Nabisco in violation of the implied covenant of good faith because the contract expressly allowed for the acquisition of new debt).

33. Katz v. Oak Indus. Inc., 508 A.2d 873, 879 (Del. Ch. 1986).

34. *Id.*

35. *Katz* made it clear that not all coercive activity of bond issuers is wrongful or legally relevant: "to reach instances in which the claimed coercion arises from an act designed to affect the will of another party by offering inducements to the act sought to be encouraged or by arranging unpleasant consequences for an alternative sought to be discouraged, then—in order to make the term legally meaningful at all—we must acknowledge that some further refinement is essential. Clearly some 'coercion' of this kind is legally unproblematic . . . Thus, for purposes of legal analysis, the term 'coercion' itself—covering a multitude of situations—is not very meaningful. For the word to have much meaning for purposes of legal analysis, it is necessary in each case that a normative judgment be attached to the concept ('inappropriately coercive' or 'wrongfully coercive', etc.). But, it is then readily seen that what is legally relevant is not the conclusory term 'coercion' itself but rather the norm that leads to the adverb modifying it." *Id.* at 879-80 (Del. Ch. 1986).

36. *Id.*

alternatives, one of them unpleasant; "[C]oercion of this kind is legally unproblematic. Parents may 'coerce' a child to study with the threat of withholding an allowance; employers . . . 'coerce' regular attendance at work by either docking wages for time absent or by rewarding with a bonus such regular attendance."[37] This coercion does not always violate good faith; at times it simply gives another option to bondholders in order to engage them in negotiation.[38]

With such high standards for a violation of good faith, it is not likely for this contractual protection to overturn many exit consents.[39] The application has usually been limited to cases where the issuer has worked to eliminate a bargained-for benefit.[40]

C. Contractual Remedies

Some Courts have held that the only remedies for exit consents are those contractually provided.[41] Bondholders have sought favorable interpretations of the provisions of their contract.[42] Courts have the ability to supply omitted terms.[43] The exit consent may not be "reasonable in the circumstances" according to this theory, and the court should supply an interpretation of the contract that forbids the issuer from using it to indirectly coerce the bondholder into acceptance of the exchange offer.[44]

This legal theory has often worked against bondholders, rather than for them. [45] As the court in *Greylock Global Opportunity Master Fund Ltd. v. Province of Mendoza* noted, "[o]ne of the hallmarks of contract interpretation is that courts should interpret contracts to ensure that all terms of a contract are given meaning and, where

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37. *Id.*

38. *See id.*

39. Bab, *supra* note 13, at 889-90.

40. *See* Van Gemert v. Boeing Co., 520 F.2d 1373, 1393 (2d Cir. 1975).

41. *E.g.*, Harff v. Kekorian, 347 A.2d 133-34 (Del. 1975) (Bondholders are solely limited to contract remedies in "the absence of 'fraud, insolvency, or a violation of a statute'.").

42. Greylock Global Opportunity Master Fund Ltd. v. Province of Mendoza, No. 04 CIV.7643 (HB), 2005 WL 289723 at *5 (S.D.N.Y. Feb. 8, 2005) aff'd, 162 F. App'x 85 (2d Cir. 2006).

43. RESTATEMENT, *supra* note 29, §204 ("When the parties to a bargain sufficiently defined to be a contract have not agreed with respect to a term which is essential to a determination of their rights and duties, a term which is reasonable in the circumstances is supplied by the court.").

44. Bab, *supra* note 13, at 869-870.

45. *See, e.g.*, Ian Ayres & Robert Gertner, Filling Gaps in Incomplete *Contracts*: An Economic Theory of Default Rules, 99 YALE L.J. 87, 90 (1989) (quoting Frank Easterbrook and Daniel Fischel for the proposition that "corporate law should contain the [defaults] people would have negotiated, were the costs of negotiating at arms'-length for every contingency sufficiently low").

possible, that the meanings should mesh."[46] The unanimous consent provision in this case was in the contract but was not construed as applying to exit consents.[47] Such an interpretation was contractually inconsistent and would encourage holdouts.[48] As such, it appears courts are often willing to break with the express language of the contract, if it is inimical to the functioning of debt exchange offers.[49]

D. Statutory Issues

Both the U.S. and Great Britain have relevant statutes that may affect the scope of exit consents for securities within their jurisdiction.[50] In *Assénagon,* the court notes, "[t]here is in England and Wales the statutory remedy for unfairly prejudicial conduct now to be found in Part 30 of the Companies Act 2006."[51] Part 30 of the Companies Act of 2006 in Great Britain limits the use of exit consents by allowing the Secretary of State or any Company Member to petition the court to intervene because (a) "the company's affairs are being or have been conducted in a manner that is unfairly prejudicial to the interests of members generally or of some part of its members (including at least himself)" or (b) "an actual or proposed act or omission of the company (including an act or omission on its behalf) is or would be so prejudicial."[52] The statute continues to grant the courts powers of rulemaking under Section 411 of the Insolvency Act for the purposes of claim arising under this section. [53] Section 411 of the Insolvency Act addresses the power to make rules and regulations for insolvent companies.[54] "[M]embers of a company" are limited to owners, shareholders, and those who subscribe to memorandum.[55] Therefore, this Act applies only by analogy since bondholders do not fall under the class protected by the Statute.[56]

The US Trust Indenture Act of 1939 at section 316(b) prohibits the modification of payment terms without unanimous consent of all

46. *Greylock*, 2005 WL 289723, at *6.

47. *Id.* at *7.

48. *Id.* at *8.

49. *Id.*

50. The two most relevant statutes are cited in the *Assénagon* opinion. Assénagon Asset Mgmt. S.A. v. Irish Bank Resolution Corp., [2012] EWHC (Ch) 2090, [49] (Eng.): (1) Companies Act 2006, 2006, 46 §§994-99 (U.K.), *available at* http://www.legislation.gov.uk/ukpga/2006/46/part/30 (last visited Feb, 22, 2014); and (2) Trust Indenture Act of 1939, 15 U.S.C. § 77ppp(b) (2006).

51. *Assénagon*, EWHC (Ch) at [49].

52. Companies Act, 2006, c. 46 pt. 30 §§995-96 (U.K.), *available at* http://www.legislation.gov.uk/ukpga/2006/46/part/30 (last visited Apr. 9, 2014).

53. *Id.* §997.

54. *See* Insolvency Act, 1986, c. 45 pt. XV, §§411-12, *available at* http://www.legislation.gov.uk/ukpga/1986/45/section/411 (last visited Feb. 22, 2014).

55. Companies Act, 2006, c.46, pt. 30 § 112.

56. *See* Companies Act, 2006, c.46 pt.30.

the holders of securities issued and registered with the SEC under the US Securities Act of 1933.[57] This provision was designed to protect the payment of principal and interest to bondholders.[58] Virtually any other provision may be changed without implicating section 316.[59] Thus, even under this Act, the minority of bondholders may be left with no covenants and no right to sue for non-monetary defaults.[60] The exit consent developed as a way to effectively amend terms of the bond without a unanimous vote. The bond issuer, with the consent of a supermajority of the bondholders, has found a way to create new restructured debt that is less burdensome for the issuer than the previous bonds were by offering an exchange.[61]

III. ANALYSIS OF THE IMPACT OF THE NEW ENGLISH RULE UNDER ASSÉNAGON

In this section, I present the justification for adopting a new rule. Why was a new rule proposed and what would be wrong with adopting the rule in Assénagon? If *Assénagon* stands for the proposition that every exit consent must benefit bondholders as a class, it is likely to do more harm to the bond issuer and through secondary market effects than any good it does the bondholders. Still, any new suggestions for exit consent interpretation must be subject to sharp scrutiny since continuity and uniformity of law are especially important in bond markets, which are international in scope.[62] Therefore, I will explore the state of the law after *Assénagon* and determine why remediation is necessary.

A. *Interpreting the Assénagon Rule*

Assénagon Asset v. Irish Bank can be read solely as enforcing the contractual rights of the bondholders according the Trust Deed.

57. 15 U.S.C. § 77ppp(b) (2006).

58. *See, e.g.*, UPIC & Co. v. Kinder-Cara Learning Ctrs., Inc. 793 F. Supp. 448, 452 (S.D.N.Y. 1992).

59. George W. Shuster, Jr., *The Trust Indenture Act and International Debt Restructurings,* 14 AM. BANKR. INST. L. REV. 431, 435. (2006).

60. *Id.*

61. *See* Richard L. Epling, *Exchange Offers, Defaults, and Insolvency: A Short Primer,* 8 Bankr. Dev. J. 15, 33 (1991) ("T.I.A. Section 316(b) protects minority bondholders from any change in repayment of their principal or interest, or from a change in their agreed maturities, but it does not protect them against changes to financial covenants. Thus, the indenture can provide for covenant amendments upon the affirmative vote of a super majority of bondholders without violating the T.I.A. As should be apparent, covenant stripping lets the exchange offer proponent do indirectly what it could not do directly: eliminate the control which bondholders may exercise over the company's financial decision-making and business affairs.").

62. *See* Buchheit & Gulati, *supra* note 7, at 73, 83 ("Market participants, this theory contends, have a strong interest in seeing a uniform, predictable interpretation of standard provisions . . .").

Reading the ruling this narrowly obviates some of the legal problems associated with the unfairness of the exit consent. Paragraph 13 of the Trust Deed states: "Neither the Issuer nor any Subsidiary shall be entitled to vote at any meeting in respect of Notes beneficially held by it or for its account."[63] The court looked to the time of the meeting for a vote on the "extraordinary resolution" and concluded that all the consented votes under the exchange offer were held for the benefit of the bank.[64] Thus, in this interpretation, the provision fails by its own contractual terms and the rest of the opinion on the abuse of power by the bondholder majority may be read as dicta.[65]

In addition, Paragraph 18 of Schedule 3 to the Trust Deed held any "abrogation [or] modification" of rights must be sanctioned by three-fourths of Noteholders, but as an "Extraordinary Resolution."[66] According to another theory the court considered, because the exchange offer effectively abrogated the rights of noteholders without the three-fourths vote it was *ultra vires* the Bank's powers.[67] This interpretation also does not require reading beyond the language of the contract itself. The claimant pursued this argument, but the court ultimately rejected it, noting,

> I am persuaded, albeit by a narrow margin, that the express provisions. . . prevent a purposively narrow interpretation of the power to sanction an abrogation pursuant to paragraph 18(b) of Schedule 3, so that the power to abrogate is capable (in circumstances not otherwise amounting to an abuse) of extending

63. *Assénagon*, [2012] EWHC 2090 (Ch) [63].

64. *Id.* [17], [50].

65. "The final question under this part of the case is whether the beneficial interest which ordinarily arises in favour of the contracting purchaser of shares (where the contract is specifically enforceable) is an interest of the type contemplated by the prohibition in paragraph 13 of Schedule 3. . . . When it is borne in mind that the purpose of the prohibition in paragraph 13 is aimed precisely at the avoidance of the voting of Notes in the Bank's interests rather than in the interests of the Noteholders as a class, I consider that the particular beneficial interest conferred by the exchange contracts falls squarely within the contemplation of the prohibition." *Id.* [68]. *See also Steven* Friel & Louise Verrill, *Dramatic Development in Eurozone Bank Restructuring*, BROWNRUDNICK (July 27, 2012), *available at* http://brownrudnick.com/news-resources-detail/2012-07-dramatic-development-in-eurozone-bank-restructuring (last visited July 27, 2012).

66. *Assénagon*, [2012] EWHC 2090 (Ch) [15],[50],[54]. "Paragraph 5(b) identified 'reduction or cancellation of principal payable on the Notes or the exchange or conversion thereof' . . . as one of the seven types of Extraordinary Resolution calling for two-thirds quoroum." *Id.* [15]. Since the Notehoders had assented to such a provision in the contract, they clearly had contemplated the Bank having the power to abrogate "all rights of Noteholders as against the Bank." *Id.* [54], [55].

67. *Id.* [72] (citing Palmer's Company Law Volume 1 paragraph 12.068, British Am. Nickel Corp. Ltd v M.J. O'Brien Ltd, [1927] AC369, Goodfellow v. Nelson Line (Liverpool) Ltd [1912] 2 Ch 234, and very recently Sergio Barreiros Azevedo v. Imcopa Importacao, Exportaacao e Industria de Oleos Limitada [2012] EWHC 1849 (Comm)).

to all the rights of Noteholders as against the Bank.[68]

The *Assénagon* case may also be read as the Court imposing a new standard on any exchange offer and exit consent for future English restructurings: can it be characterized as beneficial to the entire class of bondholders?[69] This would be, as noted above, a significant departure from prior English decisions and prevailing American law.[70] Before *Assénagon,* such an objection would usually fail if the inducement was properly disclosed to all members of the bondholder class.[71]

If *Assénagon* is interpreted as a major departure from prior law, we are left with a split interpretation underpinning much of the world corporate and sovereign debt market which may have detrimental effects as noted in the next section.[72] Uniformity and certainty of law in the law of bond exchanges is especially essential because this area is especially prone to runs on credit and other ill effects.[73]

B. An Analysis of the Rule's Effect on Corporate and Sovereign Debt Markets

The split interpretation between the laissez faire U.S. approach and the new "abuse of power"[74] English approach could hinder the restructuring of debt in a crisis. Twenty-five percent of sovereign Eurobonds[75] are governed by English law according to a Deutsche Bank study. Introducing a rule change questioning the validity of exit consents for this fraction of bonds could have unsettling effects on the world market.[76] Any questions about the governing law could drastically change how a contract may be enforced, and such a situation encourages jurisdictional arbitrage/forum shopping to find a rule that benefits your party the most.[77] These considerations would hinder the efficiency of debt restructurings globally.

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68. *Id.* [55].

69. *See id.* [17], [50].

70. *See* Gelpern, *supra* note 9, at 1.

71. *See Assénagon*, [2012] EWHC 2090 (ch) [72].

72. *See infra* Part III.B.

73. Buchheit & Gulati, *supra* note 7, at 62. ("[I]f such changes erode the confidence of the well-intentioned investors in the efficacy of their legal remedies, the private market may simply withdraw from unsecured lending . . . .").

74. *See Assénagon*, [2012] EWHC (Ch) 2090 [84] ("The exit consent is, quite simply, a coercive threat which the issuer invites the majority to levy against the minority, nothing more or less. Its 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 (or it) will be left out in the cold.").

75. *See* Gulati & Buchheit, *supra* note 7.

76. *See id.*

77. *See* Christopher A. Whytock, *The Evolving Forum Shopping System,* 96 CORNELL LAW. REV. 481, 495-97 (2011).

Even if courts took a consistent view of exit consents and adopted the approach in *Assénagon,* it is likely to have unintended adverse effects. If the rule rejecting any exit consent that did not benefit bondholders as a class were adopted universally, it could increase the incidence of bankruptcy, both sovereign and corporate, which could result in financial crisis and contagion.[78] Global credit markets are set up in such a way as to propagate the effects of a major bankruptcy and encourage a run on financial institutions.[79] The "safe harbor" from Chapter 11 given derivative and repo contract holders in the U.S., for example, allow these creditors to quickly sell off their collateral or demand greater collateral, often facilitating contagion through counterparties.[80] Without the benefit of restructuring corporate debt through an exchange when the firm is at its most vulnerable—and therefore must impose the harshest discount for new bonds in an exchange—many bond issuers would be left with their hands tied.[81]

How does the inability to restructure through an exchange lead to bankruptcy? An exchange may often be the last resort and last chance at restructuring before a firm or sovereign faces demands for more collateral and runs by creditors.[82] The bankruptcy code revisions from the early 90s through the 2005 Bankruptcy Abuse Prevention and Consumer Protection Act allow derivative counterparties to demand collateral and liquidate it immediately

78. *See generally* Mark J. Roe, *The Derivatives Market's Payment Priorities as Financial Crisis Accelerator*, 63 STAN. L. REV. 539 (2011). Further discussion of this paper is beyond the scope of this article, but it is immensely important to understanding how one default may easily be propagated and creates contagion under the current Bankruptcy Code.

79. *Id.* at 541.

80. *See id.* at 546-49.

81. *See* Bab, *supra* note 13, at 886 ("One of the benefits of restructuring outside of bankruptcy is avoiding the costs in time and fees involved in litigating about valuation; indeed, such litigation may prevent an issuer from effectuating a transaction in time to avoid bankruptcy.").

82. *Cf.* George G. Triantis & Ronald J. Daniels, *The Role of Debt in Interactive Corporate Governance*, 83 Cal. L. Rev. 1073, 1094-95 (1995) ("The conventional explanation for preference law is that it deters asset-grabbing on the eve of bankruptcy. However, this theory does not explain why the debtor must be insolvent at the time of the payment to the creditor. The interactive theory supplies a more complete explanation. The voidable preference rule encourages timely monitoring and pre-insolvency action by threatening to reverse any attempt to exit after the debtor has become insolvent. Although the rule tends to underdeter preferences by insolvent debtors, it provides some incentive to a lender to observe early warning signs and to blow the whistle *before* the debtor becomes insolvent. This incentive is important because the signal from a bank is of little value after the onset of insolvency since other creditors are often already aware of the insolvency through their respective interactions with the debtor."). Recent changes in the bankruptcy code tend to operate against this. *See* Roe, *supra* note 78, at 571 n.80.

ahead of other creditors.[83] Because of the super-priorities given to derivative contracts in bankruptcy, anyone who is a creditor would want to structure their contract as a derivative (or repo, or other exempted contract) if they could, which led to an explosion in the derivatives market and the repo market.[84] It undermines the purpose of reorganization if most of the creditors are allowed to use an exemption to wipe out the potentially bankrupt debtor and basically liquidate the estate anyway.[85] This situation leaves creditors trigger-happy to collect on their collateral and close out their deals with the *ipso facto* clause at the first hint of trouble.[86] Dodd-Frank (which introduces uncertainty as to whether or not the counterparty would fall under the new proceedings because it could have less than 85% financial business[87] or because the government may use the receivership option or not[88]) may only serve to accelerate the liquidation of derivative and repo positions and is not a complete solution.[89] Therefore, exemption from the bankruptcy code of derivatives and repos actually aggravates systemic risk. To state otherwise is a fallacy of composition: while each individual counterparty may have greater stability/more liquidity if it is able to accelerate payments from a bankrupt debtor and close out

83. An exception to the automatic stay in bankruptcy is granted to derivative counterparties. "The filing of a petition under section 301, 302, or 303 of this title, or of an application under section 5(a)(3) of the Securities Investor Protection Act of 1970, does not operate as a stay . . . under subsection (a) of this section, of the exercise by a swap participant or financial participant of any contractual right (as defined in section 560) under any security agreement or arrangement or other credit enhancement forming a part of or related to any swap agreement, or of any contractual right (as defined in section 560) to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more such agreements, including any master agreement for such agreements. . . " 11 U.S.C.A. § 362 (2006). *See also* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. 109-8, 119 Stat. 23. "The exercise of rights not subject to the stay arising under section 362(a) pursuant to paragraph (6), (7), (17), or (27) of section 362(b) or pursuant to section 362(n) shall not be stayed by any order of a court or administrative agency in any proceeding under this chapter."

84. Roe, *supra* note 78, at 555-56.

85. *Id.* at 568-69.

86. *Id. at 573.* "The de facto priority problem is in how much further the Code goes. During the financial crisis, strong parties demanded more margin when they saw a weak counterparty. . . . These transfers were conceptually preferential, but were safe from attack due to the superpriorities. Such eve-of-bankruptcy collateral calls in derivatives and repo markets should be reclassified as nonexempt, voidable preferences." *Id.* (emphasis omitted).

87. "Dodd-Frank also creates uncertainty by the use of a bright-line 85% rule." Stephen J. Lubben, *Financial Institutions in Bankruptcy*, 34 Seattle U. L. Rev. 1259, 1274 (2011).

88. *See id.* at 1269.

89. *Id.* at 1274. For a discussion of the shortcomings of the derivatives clearinghouse set up by Dodd Frank, see Roe, *supra* note 78, at 587.

derivative/repo positions, if every counterparty does this, firms will summarily be wiped out by these "super" creditors all at once, spreading risk across the financial markets.[90]

Most entities offering bond exchanges with exit consents are troubled institutions. If an exchange offer were announced with any question as to its enforceability, there could be a sharp contraction of the offering firm's credit on the commercial paper market, which would exacerbate any problems.[91] Alternatively, if the troubled entity attempted restructuring without the flexibility of exit consents, many bond issuers may either be forced to pay holdout creditors more than they can handle[92] or the troubled entity may not be able to convince the last holdouts to sell at a price that would give the entity any advantage in restructuring over the current debt structure.[93]

Further complicating matters, the jurisdiction clause itself is frequently a subject of exchange offers and exit consents. Differences in the legal treatment of exit consents between jurisdictions therefore may introduce uncertainty about how and where the contracts will be enforced.[94] If an exit consent includes submission to the jurisdiction of a particular court, it is important for the parties to have settled expectations that this provision will be upheld by the courts.[95] As

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90. *See* Roe, *supra* note 77, at 573. For a definition of the fallacy of composition see WILLIAM A. MCEACHERN, ECONOMICS: A CONTEMPORARY INTRODUCTION 13 (5th ed. 2000) (defining fallacy of composition as "an erroneous belief that what is true for the individual or the part is also true for the group or the whole.").

91. Super-creditors secured by swaps or derivatives may accelerate payments and demand greater collateral, which would tend to signal other creditors to do so. *See* Roe, *supra* note 78, at 587-88. *See also, e.g.*, 80 N.Y. Jur. 2d Negotiable Instruments, Etc. § 110, "Acceleration clauses, which appear in many and varied forms in the commercial paper or in the written agreements collaterally securing such paper, are usually used for protection if the credit risk changes prior to maturity." (citation omitted).

92. *See* Lewis S. Peterson, *Who's Being Greedy? A Theoretical and Empirical Examination of Holdouts and Coercion in Debt Tender and Exchange Offers*, 103 YALE L.J. 505, 513-14 (1993).

93. *See id.* at 505-06 ("Such private restructurings are a relatively quick means of providing a firm with the financial flexibility needed to adjust to changes in market conditions, and are widely held to be an efficient and relatively inexpensive method by which firms can privately negotiate. . . .

. . .

This high rate of failure is alarming because failed private offers generally result in weaker firms and, in the worst cases, costly bankruptcies. One crucial aspect that contributes to this problem is the holdout—the bondholder who refuses to accept an offer in hopes of profiting . . . .").

94. *See* Stephen J. Choi & G. Mitu Gulati, *Innovation in Boilerplate Contracts: An Empirical Examination of Sovereign Bonds*, 53 EMORY L.J. 929, 958 (2004).

95. This is especially true of sovereign debt restructuring. "Debt restructuring for a sovereign state is fundamentally different from corporate restructuring. With corporate debt, the parties are relatively easy to identify and governing laws are clearly defined. Unlike other debtors, sovereigns do not have access to a formal bankruptcy process, and therefore are dependent upon the consent and cooperation of

noted in a recent journal article, "the following clauses could be candidates for an exit amendment: . . . Submission to Jurisdiction. The sovereign issuer's express submission to the jurisdiction of foreign courts (including the appointment of agents to receive service of process in those jurisdictions) could be revised."[96]

Additionally, the problem of holdouts resurfacing after a restructuring becomes an issue under a standard where minority bond-holders cannot be made worse-off under the exchange offer.[97] "Even a rumor that [the issuer] intends to continue paying holdouts in full after the exchange will obviously scupper the chances for a successful exchange."[98] There is a "high failure rate of out-of-court restructurings" due to bondholder holdouts.[99] For this reason, the problem of minority bondholders who took a risk purchasing the notes of a distressed issuer is preferable to the market problem of forcing default on large institutions and sovereign.

There are some other legitimate reasons for courts to tread lightly when rejecting exit consents. Above all, the exit consent forces efficient restructuring out of court in situations with few better alternative outcomes.[100] As scholars have recently noted,

> Seen as a parable in the context of the bondholder complaint in *Katz*, Chancellor Allen's invocation of a majoritarian default analysis in denying the preliminary injunction may simply be a method of encouraging voluntary workouts where there is little palpable harm to bondholders facing the alternative to bankruptcy. This, of course, adds little to the normative inquiry concerning suboptimality in the indenture. But it may explain the apparent insensitivity of the court to the insolvent state of Oak Industries as merely a statement of the court to the Delaware legal community: offers to bondholders on equal terms are permitted absent a showing of some specific harm when the continued viability of the entire enterprise is at stake.[101]

An exit consent rule which forces bondholders to bargain and restructure the debt they hold may be preferable even if it is not for their benefit. After all, the aggregate loss from failure to restructure debt and default is often greater than the loss suffered by holdouts in

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their creditors.[3] Unfortunately, the process of seeking this consent and cooperation to restructure sovereign debt remains unpredictable and disorderly." Elizabeth Broomfield, Note, *Subduing the Vultures: Assessing Government Caps on Recovery in Sovereign Debt Litigation*, 2010 COLUM. BUS. L. REV. 473, 474-75. *See also* Michael M. Chamberlin, *At the Frontier of Exit Consents*, 7 J. EMERGING MARKETS, 50, 50-52 (2001).

96. Buchheit & Gulati, *supra* note 7, at 81.

97. Assénagon Asset Mgmt., SA v. Irish Bank Resolution Corp., [2012] EWHC (Ch) 2090 [39] (Eng.). *See also* Peterson, *supra* note 92, at 513-14; Bab, *supra* note 13, at 849.

98. Buchheit & Gulati, *supra* note 7, at 64.

99. Peterson, *supra* note 92, at 534.

100. *See id.* at 534-35.

101. Frederick W. Lambert, *Path Dependent Inefficiency in the Corporate Contract: The Uncertain Case with Less Certain Implications*, 23 DEL. J. CORP. L. 1077, 1153 (1998).

an exchange.[102] There is a clear market failure here, which cannot simply be addressed by granting minority bondholders unyielding property rights when exit consents are subject to a fairness standard.[103] Therefore, I conclude courts must reject the temptation to entirely refuse enforcement of one-sided exit consents. A perhaps better development may be the ex post facto redistribution of "taxes" after restructuring.[104] I will elaborate on this approach in Part V.

IV. PROBLEMS WITH EXIT CONSENTS

Assénagon developed out of frustration with some one-sided and often unfair consequences of exit consents.[105] The exit consents themselves, however, are legal instruments that were developed as solutions to problems that arise in restructuring agreements between bond issuers and bond holders.[106] Many of the drawbacks of exit consents may be necessary because they are a consequence of their ability to facilitate restructuring.[107]

First, the alleged injury to minority bondholders is not always discernable.[108] Sure, covenants in the bonds are adjusted by majority vote, but in the U.S., by statute, the issuer is generally not permitted to change payment terms when using an exit consent as part of its exchange offer.[109] Yet, in practice, an exit consent often reduces the value of the bonds when it amends covenants other than payment terms.[110] It is not clear, however, that even minority bondholders are worse off under the restructuring based on bond values after the exchange.[111] Bondholders are often sophisticated financial

102. *See* Peterson, *supra* note 92, at 522 ("The critical distinction between helpful and harmful coercion can be found in the relationship between the offer price (E) and the value of the debt after the offer fails (F_c or F_h). All else being equal, 'good' coercion occurs when the offer price is greater than the price of debt after the offer fails ($E > F_h$). 'Bad' coercion occurs when the price offered is less than the price of debt after the failed offer ($E < F_c$).").

103. *See* Assénagon Asset Mgmt., SA v. Irish Bank Resolution Corp., [2012] EWHC (Ch) 2090,[39] W.L.R. 243 (Eng.).

104. *See infra* Part V.

105. *See Assénagon*, [2012] EWHC (Ch) 2090, [41]-[45].

106. Buchheit and Gulati, *supra* note 7, at 67-68 ("As a technique to facilitate the restructuring of corporate bonds, exit consents gained some notoriety in the 1980s. This was an era of sizable high-yield ('junk') bond offerings by American corporations. Inevitably, some of these bonds could not be serviced on their original terms and the issuers were faced with the need to restructure the instruments . . . A few corporate bond issuers in the 1980s therefore sought to replicate the attractive feature of a formal bankruptcy (the ability to force changes on a dissident minority), without actually putting the company into Chapter 11.").

107. *See id.* at 69.

108. *See* Bab, *supra* note 13, at 879.

109. *See* 15 U.S.C. § 77ppp(b) (2006).

110. Broomfield, *supra* note 95, at 497; *see also* Bab, *supra* note 13, at 853.

111. *See* Peterson, *supra* note 92, at 531-32 (discussing data which showed price

institutions and systemically important themselves.[112] The exchange offer should be available equally to all bondholders and is often at market rate or above.[113]

Second, there are many issues that often make exit consents necessary in an exchange offer with current bondholders. The issuer is the only party offering the exchange and the current bondholders are the only other party participating.[114] This presents the widely recognized problem in the field of economics of a bilateral monopoly.[115] Let us consider one extreme alternative to restructuring by majority vote: a requirement of the unanimous consent of bondholders in order to restructure the bonds.[116] This is not an unrealistic assumption; when each bondholder is allowed to retain all their rights and covenants in the original bonds in the absence of exit consents, there is a strong individual incentive to retain these rights and reject the exchange offer.[117] Faced with the proposition of a restructuring, the minority bondholder will attempt to hold out for a better deal than the initial bondholders who accepted the exchange offer by attempting to redeem their bonds for full value after the exchange causes the issuer to become more solvent or by seeking better terms on their restructured bonds.[118] It will be difficult for the issuer to come up with a plurality of the votes in the face of this incentive. "A holdout problem arises when a disparately-owned good is desired by a prospective buyer only in its entirety. . . ."[119] In this case, the good would be a restructuring of the debt and the collective

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increases after an exchange offer with an exit consent and which "contradicts what has become common wisdom regarding the effects of exit consents on non-tendered debt.").

112. Mark E. Van Der Weide, *Against Fiduciary Duties to Corporate Stakeholders*, 21 DEL. J. CORP. L. 27, 47 (1996) ("The vast majority of holders of corporate bonds are sophisticated institutional investors."); *see also* RICHARD S. WILSON, CORPORATE SENIOR SECURITIES 5-7 (1987) (comparing the aggregate value of U.S. corporate bonds held by institutional investors and households). For current data, see BOARD OF GOVERNORS OF THE FED. RESERVE, FINANCIAL ACCOUNTS OF THE UNITED STATES 99 (2014), *available at* http://www.federalreserve.gov/releases/z1/Current/z1r-4.pdf.

113. *See* Peterson, *supra* note 92, at 514.

114. *See, e.g.,* West's Cal. Code Forms, Corp. § 1200 Form 8 (3d ed.).

115. *See generally* James N. Morgan, *Bilateral Monopoly and the Competitive Output*, 63 Q.J. OF ECON. 371, 371-77 (1949) for a description of the problem of bilateral monopoly ("where a monopolistic seller faces a monopolistic buyer"). In other words, this applies where there is only one seller and one buyer for a particular good.

116. Such a unanimous consent requirement does, in fact, apply to certain amendments. "[U]nanimous consent generally is required to reduce or postpone the payment of principal or interest on the bonds, reduce the redemption premium, or make the bonds payable other than in cash." Marcel Kahan, *Rethinking Corporate Bonds: The Trade-Off Between Individual and Collective Rights*, 77 N.Y.U. L. Rev. 1040, 1047-48 (2002).

117. *Id.* at 1055-56.

118. *See* Buchheit & Gulati, *supra* note 7, at 64-66.

119. Kominers & Weyl, *supra* note 12, at 1 (emphasis omitted).

owners are the bondholders.

This problem has also been referred to as the "paradox of collective action" by economist Mancur Olson.[120] Though collectively a debt restructuring may be best for the bondholders as a class, individually, the bondholders rational self-interest impels them to avoid the restructuring or "demand []an arbitrarily high price" for cooperating in order to obtain a better deal for themselves.[121] Additionally, in order to obtain unanimous consent, the bond issuer must present an offer which would have the highest value that any bondholder requires, which makes it extremely unlikely to structure an effective exchange offer.[122]

Unfortunately, as illustrated in *Assénagon*, the solution can often be as bad as the initial holdout problem. The exit consent uses a voting scheme that "poorly protect[s] property rights" and is "highly inefficient."[123] The bondholders as individuals are stripped of their ability to influence the restructuring, because the exit consent is used to weight the voting process in favor of collective action.[124] This solution to the holdout problem is known in economic literature as an "X-plurality" system.[125] As long as "x" is large, few individual property rights will be violated, but there is an inverse effect on efficiency, because fewer restructuring deals are ever completed.[126] Exchange offers usually settle for a supermajority of bondholders as a requirement to approve the transaction.[127] This approach, at first glance, seems to be a good balance between efficiency (number of exchanges approved) and property rights violations (those who are unable to influence the outcome of the exchange). However, on an individual level, there are still great inefficiencies, since a simple exchange offer ignores the valuation holdouts attach to their bonds.[128]

There are also deadweight loss inefficiencies that result from the

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120. *See id.* at 6 n.4.; MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION 86 (1971).

121. *See* Kominers & Weyl, *supra* note 12, at 3.

122. *See id.*

123. *Id.*

124. "The collective action problem with respect to the enforcement of collective bondholder rights has two aspects. First, the need to form a group holding the requisite percentage of bonds to take the enforcement action increases information costs because several bondholders must collect and analyze information before action can be taken. Second, it imposes coordination costs resulting from the need for bondholders to communicate and agree with each other to take an action." Kahan, *supra* note 116, at 1057 (emphasis omitted).

125. Kominers & Weyl, *supra* note 12, at 25.

126. *See id.* at 29.

127. For a discussion of the historical development of the supermajority requirement for amending bonds, see Lee C. Buchheit & G. Mitu Gulati, *Sovereign Bonds and the Collective Will*, 51 EMORY L.J. 1317, 1321 (2002).

128. *See* Peterson, *supra* note 92, at 518.

bondholder holdout problem, when no exit consent solution is used. Deadweight loss is particularly large in bilateral monopolies because the deadweight loss of both the monopolist and the monopsonist are aggregated.[129] The monopolist- or single seller- in the transaction is the bondholder; by design, bondholders are the only possible sellers of their rights in an exchange offer.[130] The monopsonist- or single buyer- in the transaction is the bond issuer; the original bonds may only be exchanged with the issuer for new bonds in an exchange offer.[131] The price in the exchange is the relative value of the offered bonds compared with the current bonds.[132] For any restructuring deal offered, there will be X bondholders who value their bonds at less than the exchange offer price.[133] Any disruption to the market by holdouts which stops the exchange causes these bondholders to forever lose any surplus they would have gained from the deal and thus, is inefficient. [134] Likewise, the bond issuer in the restructuring has an optimal value of their offer they would like to target, any difference between this value and the value it would take to get the last bondholder standing to agree is deadweight loss.[135]

One proposed solution to holdouts stems from theory developed

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129. *See* Michael E. Bradley, *Profit Maximization*, *in* 1 21ST CENTURY ECONOMICS: A REFERENCE HANDBOOK 111, 123 (Rhona C. Free ed., 2010) ("The deadweight efficiency loss in a bilateral monopoly combines the deadweight loss from monopoly in the product and from monopsony in the labor market.").

130. *See* Coffee & Klein, *supra* note 30, at 1239-41.

131. *See* ROGER D. BLAIR & JEFFREY L. HARRISON, MONOPSONY IN LAW AND ECONOMICS 3-6 (2010). The book provides a detailed discussion of how a bond auction is a type of monopsony that is susceptible to collusion. *Id.*

132. *See, e.g.,* Assénagon Asset Mgmt., SA v. Irish Bank Resolution Corp., [2012] EWHC (Ch) 2090, [2012] W.L.R. 243 [36]-[37](Eng.).

133. Peterson, *supra* note 92, at 514 ("[B]ondholders may reject an offer either to gain an advantage over their fellow bondholders (the holdout problem) or because the offer would indeed harm all bondholders by offering an extremely low exchange price (the inadequate offer). The failure of an offer is only inefficient when its success would have benefitted the bondholders as a class as well as the future viability of the firm—that is, where the offer increases firm value. More specifically, holdouts create an inefficient outcome when the value of the debt after a failed exchange remains below the offer price, but the value of non-tendered debt after a successful exchange is higher than the offer price.").

134. *See* JOHN B. TAYLOR & ALIKA WEERAPANA, PRINCIPLES OF MICROECONOMICS 173 (2012). "Deadweight loss is not simply a theoretical curiosity with a morbid name; it is used by economists to measure the size of the waste to society of deviations from the competitive equilibrium." *Id.*

135. For an interesting discussion of the economic theory of deadweight loss in holdouts see Flavio Menezes & Rohan Pitchford, *A Model of Seller Holdout*, 24 ECON. THEORY 231, 231-33 (2004). The authors stressed the role of complementarity, the value of the aggregate being greater than the individual value of the parts. They observed that as complementarity increases, so does the deadweight loss associated with the holdout problem.

by renowned nineteenth century economist Cournot.[136] When different parties to a transaction monopolize the inputs, production is stopped after each party tries to mark up the price of their piece the deal.[137] An assumption of this theory is that each party's piece is perfectly complementary because the buyer must obtain every piece. [138] That is, the issuer must restructure the terms of all the bonds to be successful.[139] This is very close to the actual case when any bondholder can reject the restructuring and retain his or her own bonds under the original conditions, when there are no exit consents. Cournot's main observation was that holdouts could be avoided if the externalities the holdouts impose on the transaction can be internalized by merging their interests.[140] In Cournot's example many firms were upstream in the production process and provided a product to one buyer.[141] His suggestion was that these firms merge and share equally in each other's profits.[142] From this basic idea, Kominers and Weyl have recently extrapolated a concordance principle with two basic parts: (1) Sellers should split any proceeds from the transaction according to a pre-defined formula and (2) sellers' incentives must be realigned to share information through internalization of the costs associated with influencing the group's decision according to his or her preferences. [143]

V. A BALANCED APPROACH TO EXIT CONSENTS

The *Concordance Principle* offers guidance for a more balanced solution to the problem exit consents were developed to address. The *Concordance Principle* attempts to navigate the competing pressures of dealing with holdouts and respecting property rights by applying a Pigouvian tax to make the result more efficient.[144] Applying this principle to the holdout problem requires designing a mechanism that allows each participant to receive her share in full if they do not influence the offer but must pay a tax if they decide to influence the

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136. Kominers & Weyl, *supra* note 12, at 2.

137. *Id.* at 6.

138. George J. Mailath & Andrew Postelwaite, *Asymmetric Information Bargaining Problems with Many Agents*, 57 REV. OF ECON. STUD. 351, 351-53 (1990). As the number of perfectly complementary sellers increases, trade will not occur, thus requiring a coercive mechanism (such as an exit consent). *Id.*

139. *See id.* at 351.

140. Kominers & Weyl, *supra* note 12, at 9.

141. A. AUGUSTIN COURNOT, RECHERCHES SUR LES PRINCIPES MATHEMATIQUES DE LA THEORIE DES RICHESSES 110 (Chez L. Hachette, 1838).

142. Kominers & Weyl, *supra* note 12, at 6.

143. *See id.* at 14-15. The authors specifically mention "debt renegotiation" as a potential application of this principle and encourage further research on the implementation of the principle developed in their paper. *Id.* at 17, 35.

144. *Id.* at 3-4. *See also* DAVID D. FRIEDMAN, LAW'S ORDER: WHAT ECONOMICS HAS TO DO WITH LAW AND WHY IT MATTERS 40-41 (2001).

offer. [145]

One option in implementing this solution is to refund the tax share-weighted to each seller.[146] These solutions are developed from auction theory and are called Vickrey-Clarke-Groves (VCG) mechanisms.[147] In this market mechanism, each seller pays their expected externality on the group and receives a refund of the surplus.[148] The following mechanism for exit consents will be a modified VCG auction.

Current exit consents provide a negative incentive to holdouts (similar to the tax structure above), but lack the incentives to merge interests as sellers and do not encourage truthful reporting of sellers' valuations.[149] If each seller/bondholder were required to submit a reserve value in an exchange offer, the determination of whether or not the exchange is made could be determined simply by aggregating the bondholder's reserves.[150] The deal is accepted when the issuer's offer exceeds the sum of the reserves.[151] This mechanism preserves each bondholder's property rights while discouraging inefficiency resulting from strategic overvaluations pursued by holdout

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145. Kominers & Weyl, *supra* note 12, at 14.

146. *Id.* at 19.

147. *See* Jonathan Levin, *Vickrey-Clark-Groves Mechanisms,* http://www.stanford.edu/~jdlevin/Econ%20285/Vickrey%20Auction.pdf (last visited Apr. 10, 2014) for a description of the system of transfer payments developed so each market participant "pays his expected 'externality'" to others.

148. *See generally*, William Vickrey, *Counterspeculation, Auctions, and Competitive Sealed Tenders*, 16 J. OF FIN. 8, 21-23 (1961) (discussing how implementing such an auction would make the dominant strategy truthful reporting of values).

149. *See* Kominers & Weyl, *supra* note 12, at 7, 16.

150. Steven A. Matthews, *A Technical Primer on Auction Theory I: Independent Private Values* 5 (Northwestern Univ. Ctr. for Mathematical Studies in Econ. & Mgmt. Sci., Discussion Paper No. 1096, 1995), *available at* http://www.kellogg.northwestern.edu/research/math/papers/1096.pdf (last visited Apr. 10, 2014) ("A *reserve price*, denoted by *r*, is one parameter of each auction. This is a number which determines the lower bound on acceptable bids. In the first and second price auctions, all submitted bids must be greater than or equal to *r*; no sale occurs if no such bids are submitted. In the second price auction the reserve price will be the price the winning bidder pays if he is the only one to submit a bid (*r* is then, in a sense, the second highest 'bid'). In the English auction the auctioneer starts the bidding at *r*, and no sale occurs if no bidder is willing to bid at least that much. In the Dutch auction, no sale occurs if no bidder stops the wheel before the price drops to *r*. In each auction we assume the reserve price is announced before the bidding starts, so that all bidders know it before they bid.").

151. *See* Levin, *supra* note 147; *see also* Matthews, *supra* note 150. The example developed in this section is like a VCG auction combined with a traditional U.S. Treasury auction where each competitive bid is accepted in ascending order of price up to the price which satisfies the offering amount issued. *See How Treasury Auctions Work*, TREASURYDIRECT, U.S. DEPT. OF THE TREASURY, http://www.treasurydirect.gov/instit/auctfund/work/work.htm (last visited Apr. 10, 2014).

bondholders. [152]

One option in implementing this mechanism is an exchange offer/exit consent with the following conditions: [153] (1) every bondholder must submit their valuation of the debt being exchanged;[154] (2) a supermajority vote consents to apply the conditions outlined on the entire class of bondholders; (3) any holdouts must pay a tax (in terms of a reduction in the value of their bonds—similar to a current exit consent);[155] and (4) after, a bondholder receives a share weighted refund of any taxes imposed[156].

What advantages would such a mechanism offer over ordinary exit consents? Deadweight loss would be minimized in such a situation.[157] Those who hold out do so because they feel their bond is more valuable than the offer. Therefore, there is no consumer surplus

152. *See* Kominers & Weyl, *supra* note 12, at 22-24.

153. These conditions are designed to replicate a VCG auction mechanism and to redistribute payments from market participants in order to compensate for any negative externalities created by holdouts. Since the equitable powers granted courts may be limited in this area of the law such that wholly redrafting an exit consent to create transfer payments is unlikely, this approach may be best used by contract drafters creating exit consents that are likely to comply with both prevailing American Law and the rule under *Assénagon (*the exit consent must benefit bondholders as a class). *See supra* note 8 and accompanying text.

154. This mechanism would only likely work for debt securities. Straight-debt exchange offers are not subject to the requirements of Rule 13e-4. *See* 17 C.F.R. § 240.13e-4(a)(2)(2009). Issuers pursing exchange offers subject to 13e-4 are substantially limited in their ability to set prices by a Dutch auction by the "best price" rule (requiring the highest price paid to any security holder be paid to all bond holders). *See* Amendments to Tender Offer Rules All-Holders and Best-Price, Securities Act Release No. 6653, Exchange Act Release No. 23421, Investment Company Act Release No. 15199, 51 Fed. Reg. 25873 (Jul. 11, 1986). Release No. 34-23421. Nor are issuers required to include "withdrawal rights" for offers submitted by bondholders. *Compare* 17 C.F.R. § 240.13e-4(f)(2) (requiring issuers to permit an offer to be withdrawn) *with* 17 C.F.R. § 240.14e-1 (containing no such requirement). Solicitation of bondholders by issuers would still have to comply with the new "general solicitation" requirements of Regulation D and other applicable law (unless otherwise exempt). *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Securities Act Release 9415, Exchange Act Release, 69959, Investment Company Act Release 3624 (Jul. 10, 2013).

155. This may be accomplished by offering to redeem the holdouts with consideration valued by a published formula—the clearing price in the auction reduced for the holdout's "overvaluation" (submitted price – auction clearing price). Thus, regardless of the reduction in the market value of the old bonds after the exit consent, holdouts are assured of being offered, at a minimum, the clearing price reduced by the externalties they have imposed as holdouts.

156. These share-weighted refunds may take the form of a "consent payment" – payments of greater consideration in new bonds in exchange for consent in amending the terms of the bond. *See* Sergio Barreiros Azevedo v. Imcopa Importacao, Exportaacao e Industria de Oleos Limitada [2012] EWHC 1849 (Comm).

157. *See* Bradley, *surpa* note 130, at 123.

lost if they opt not to receive the offer.[158] The holdouts then pay a transfer tax to the participants who have reserve values less than the clearing price.[159] These participants are able to make a deal with the bond issuer and are not held up by the holdouts angling for a higher price. This holds an advantage over situations where holdouts scuttle the deal and consumer surplus for the potential participants in the exchange is lost.[160] Additionally, the value of a tax the holdouts would pay would be equal to the difference between their reserve value and the maximum accepted value.[161] Therefore, they are made no better off than the participants in the exchange and, importantly, their property rights are respected.[162]

The key difference between earlier exit consents and this new design is the fact that minority bondholders are still left worse off by not accepting the terms of the exchange offer (according to their reserve value they got less than they hoped for), but they received the same amount nominally as the others for their new bonds. This provides a disincentive to holdouts to overstate their valuation, without fear of functionally being given nothing after the exchange, and likely, without later court intervention stopping the exchange.[163] The bond issuer who opts for this method in drafting an exchange might (but not necessarily) have to agree to better terms for current bondholders when restructuring, but can be sure that reserve values in bid valuations would approximate the fair market value of the bond because of the aforementioned disincentive to overstate valuations (because of the transfer tax).[164] Bondholders in an

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158. *Id.*

159. *See* Kominers & Weyl, *supra* note 12, app. at 55 ("transfer occurs in BNC if and only if $o \geq R$ [bid is greater than or equal to maximum accepted reserve value] . . . and all tax revenues collected in BNC are shared amongst the sellers.").

160. *See supra* note 138 and accompanying text.

161. *See supra* note 153 and accompanying text.

162. After paying their VCG externality tax, holdouts are left with bonds with the maximum accepted value under the offer. *See supra* note 153 and accompanying text.

163. The justification for the court's holding that there was an abuse of power in *Assénagon* was that the exit consent in that case was a "coercive threat which the issuer invites the majority to levy against the minority, nothing more or less. Its 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 (or it) will be left out in the cold." Here, though there is a transfer tax, it is paying for externalities imposed by the minority and the holdouts receive the same price as the others (after paying for their externalities). This would not likely constitute an abuse of power. *Cf.* Assénagon Asset Mgmt., SA v. Irish Bank Resolution Corp., [2012] EWHC (Ch) [84](Eng.).

164. One example of an auction of bondholders submitting their reserve values not approximating fair market value of the bonds would be if all bondholders could collude to offer an elevated price. If adequate privacy is maintained in the bidding process, or if other safeguards are in place, such as a maximum offer of fair market value + X offered in exchange, this exception should not be much of a concern.

exchange often get a deal that is at least as good as fair market value.[165] If property rights are more or less preserved for all bondholders and the value exchanged approximates fair market value of the bonds, even a court like the one in *Assénagon* would likely find the exchange was fair and to the benefit of all bondholders. Thus, in certain situations, the bond issuer who drafts such an exchange offer has made each party better off: bond issuer, majority bondholder, and minority bondholder.

What are the chances of implementation of such an exchange? Any exchange must comply with applicable securities laws.[166] Morever, since developments in the law of exit consents are so new, many bond issuers are likely to wait and see whether a new standard is adopted before adjusting their approach because the current exit consent offers firms many advantages.[167] Surely, the current type of exit consent leaves bond issuers and majority bondholders better off in many exchanges. Bond issuers are able to restructure easily, while giving minority bondholders practically nothing.[168] Before *Assénagon,* bond issuers had little incentive to change the status quo when drafting exchange offers. Now, there is new uncertainty and risk around a court such as the one in *Assénagon* rejecting exit consents, and this should work to impel bond issuers to look for a solution that may be fairer to minority bondholders.[169] However, courts are highly unlikely to completely rewrite the bargained-for contract between the bond issuer and bondholders and substitute an exchange offer using an auction as described above.[170] It is a principle of contract law that

165. *See* Peterson, *supra* note 92, at 524-29. *See also* Bab, *supra* note 13, at 849 & n.20.

166. Exchange offers must be registered under the Securities Act of 1933 absent one of the following exemptions from registration: (1) Section 3(a)(9): "any security exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange" or (2) Section 4(a)(2): private placement—where general solicitation of the current bondholders would be limited to "accredited investors." *See* Securities Act of 1933 §§ 3(a)(9), 4(a)(2), 15 U.S.C. §§ 77c(a)(9), 77d(a)(2); *see also* Rule 506, 17 C.F.R. §§ 230.506(c) (2013). Without the exemptions above, the regulations under Regulation 14E would apply to the exchange. 17 C.F.R. 240.14d-1(a)(2013).

167. *See* Michael Doran & Sylvana Lee, *Bond Exit Consents: No Way Out?,* WHITE & CASE (Sept. 2012), http://www.whitecase.com/files/Publication/b82c0001-6c4b-4f36-bf19-8b44aae6a19c/Presentation/PublicationAttachment/f33270d1-638e-44bd-8064-94aea09dffee/article-Bond-exit-consents.pdf.

168. *See, e.g.*, *Assénagon*, [2012] EWHC (Ch) 2090 [36].

169. Doran & Lee, *supra* note 167, at 2.

170. Courts are reluctant to rewrite these bond contracts. *See* VTR, Inc. v. Goodyear Tire & Rubber Co., 303 F. Supp. 773, 778 (S.D.N.Y. 1969) ("an implication should not be made when the contrary is indicated in clear and express words."); *see also* Emigrant Indus. Sav. Bank v. One Hundred Eight W. Forty Ninth St. Corp., 8 N.Y.S.2d 354 (App. Div. 1938) *aff'd* 21 N.E.2d 620 (1939) ("The rule is that where there is an express covenant in regard to any subject, no covenants are to be implied as to

courts must not substitute their judgment and create contract terms where the parties to the contract never intended them.[171] Therefore, any change in this arena must be effected through bond issuers proactively adopting an auction mechanism in proposing an exit consent. Bond issuers may not be likely to attempt such an exchange until minority bondholders' rights as defined in *Assénagon* become a bigger problem if the ruling in that case becomes more widely adopted by other courts.

Finally, there are a few disadvantages to using a new approach to exit consents. There is a tradeoff between the added efficiency and the success of the exit consent.[172] If there is a maximum reserve value that the bond issuer will accept in an exchange, there may still be instances where the bids from most bondholders exceed this value and therefore no exchange will be completed.[173] Bond issuers definitely have an incentive to set maximum values they will accept, otherwise bondholders could easily collude and drive up the price in the exchange by agreeing to all submit higher bids.[174] Having to maintain the privacy of each bid during the auction is also an inconvenient mechanism and lacks the simplicity of a take-it-or-leave-it offer.[175] The bids must be submitted blindly in order for the transfer tax and auction mechanism to work.[176] Otherwise, if each participant in the exchange were able to share their reserve price with other participants, the participants with the highest bids would convince the other bondholders to adopt their price in order to drive up the clearing price.[177] This would cost the bond issuer dearly in restructuring.[178] Therefore, these exit consents would likely require

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the same subject.").

171. "[I]n interpreting a contract 'an implication . . . should not be made when the contrary is indicated in clear and express words.'" Third Story Music, Inc. v. Waits, 48 Cal. Rptr. 2d. 747, 750 (citing ARTHUR LINTON CORBIN, CORBIN ON CONTRACTS: A COMPREHENSIVE TREATISE ON THE WORKING RULES OF CONTRACT LAW, § 564, (1960)).

172. *See* Kominers & Weyl, *supra* note 12, at 29-31 (surveying the tradeoffs involved in implementing solutions to the holdout problem).

173. *See supra* note 151 and accompanying text.

174. Kominers & Weyl, *supra* note 12, at 21 ("In one form of collusion effective against [this type of auction], groups can avoid tax payments by share-weighted averaging their values and each reporting their share of this average. . . . Since we are concerned with achieving efficiency and protecting property rights, rather than raising revenue, collusion in this fashion actually *improves* outcomes" (italics in original). In contrast, the bond issuer will be highly concerned with how much revenue is raised (in this case in the form of lower values of the exchanged bonds).

175. *See id*. *See also* Levin, *supra* note 147. Each participant is assumed to have private information and not to share it with other bidders, or else they can collude on price.

176. *See* Kominers & Weyl, *supra* note 12, at 9. Assumptions include a "private-information . . . valuation." *Id.*

177. *See supra* note 170 and accompanying text.

178. "Even more important than the financial windfall conferred upon holdouts,

more complicated procedures, greater susceptibility to manipulation by bondholders, and they would also fail at a higher rate than the current system.

On balance, the auction mechanism described in this paper provides a viable alternative to traditional exit consents. The popularity of the idea behind this method demonstrates its practical utility in dealing with holdouts. Using taxes and penalties to redistribute losses due to the externalities of holdouts is a prevalent solution in other areas of law.[179] For example, in order to deal with holdouts during capital calls, investor members have employed penalty dilution, in which investor members who agree to contribute money get accorded points or percentage in the equity greater than what their original investments secured.[180] This is paid out of the penalty applied on holdouts.[181] In another example, a "merger divides stock in the conglomerate among the shareholders of the merging firms."[182] Through giving each seller a stake in the new firm, each has an incentive to avoid pushing too hard and to collaborate.[183] Importing an analogous mechanism to deal with holdouts in exit consents might be beneficial for all parties to the exchange. The key for future courts and drafters will be to develop a mechanism that eliminates the incentive to holdout while giving adequate protection to the property rights of those who attempt to holdout and do not agree with the terms of the exit consent. This is a tricky balance to strike; an exit consent mechanism which gives consideration to

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however, is the vulnerability of exchange offers to opportunistic behavior by minority holders. An exchange offer seeking significant financial concessions will typically be conditioned upon a high level of acceptance, usually eighty-five to ninety-five percent. While a financially troubled issuer often needs substantial participation in the exchange in order to obtain the overall financial relief it seeks, the primary impetus for such high acceptance levels comes directly from the bondholders, who will object to the windfall conferred upon fellow bondholders that refuse to participate."

Bryant B. Edwards, Jeffrey A. Herbst & Selina K. Hewitt, *Mandatory Class Action Lawsuits as a Restructuring Techinique*, 19 PEPP. L. REV. 875, 886 (1992).

179. *See* FRIEDMAN, *supra* note 144, at 30-40 (describing several examples of Pigouvian taxes, including tort liability and environmental fines).

180. Kate Litvak, *Governance Through Exit: Default Penalties and Walkaway Options in Venture Capital Partnership Agreements*, 40 WILLAMETTE L. REV. 771, 785 (2004). ("[F]und agreements must specify the penalty for the investor's failure to contribute capital on time. Penalty clauses are often written as long laundry lists of various punishments, ranging from relatively mild (such as charging interest on delayed contributions) to severe (such as forfeiture of the defaulter's entire stake in the fund).").

181. "This default penalty can be collected without litigation by providing for an automatic transfer of a defaulter's interest in the fund to non-defaulting investors." *Id.* at 773.

182. Kominers & Weyl, *supra* note 12, at 13.

183. *Id.*

individual valuations of the bonds,[184] and looks for the most efficient solution leaving the fewest bondholders with less than their valuation,[185] such as the auction mechanism proposed in this paper, is probably the best course.

VI. Conclusion

Exit consents, though appearing to be often unfair to minority bondholders, are essential to the success of debt restructuring outside bankruptcy. Adopting a new standard to protect the rights of minority bondholders by rejecting the use of exit consents will have the unintended consequences of empowering these investors to stop any restructuring and add needless inflexibility to the world economy.[186] Yet, the current treatment of the bondholder class by the issuers is unsatisfactory. Exit consents do not adequately protect the property rights of all bondholders by allowing the supermajority to eliminate any value in the bonds of those who do not agree to accept the exchange offer.[187] Therefore, in this paper I proposed that bond issuers look to developing a better mechanism which courts will be more likely to accept: the tax is applied to holdouts and the deal meets bondholders reserve value and is therefore neither coercive nor violative of bondholder property rights.[188] The use of exit consents is essential to the proper functioning of the debt markets, and therefore must be developed and embraced by the court by employing a clear and consistent standard. Additionally, bond issuers, using a better mechanism in exchange offers, can adopt future exit consents that respect property rights of all bondholders and maintain both fairness and efficiency in the debt markets.

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184. *Id.* at 4, 12.
185. *Id.* at 11-12.
186. *See* Roe, *supra* note 78, at 548-49.
187. *See supra* pp. 26-28.
188. *See supra* Part V.