Insight: Financial Restructuring & Insolvency

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The Cooperative Bank's Restructuring – will this be a case of lessons learned?

The UK's bank regulatory and insolvency law structures were unprepared for the global financial crisis. As a result, the UK government's response to intense bank stress in the immediate aftermath of the crunch led to a number of somewhat unsatisfactory ad hoc solutions ranging from nationalisations to encouraging otherwise healthy institutions to take over weaker banks. Generally speaking, there was a criticism, fairly made perhaps, that profits were privatised and losses had been socialised. In common with other European nations, the UK has striven hard to improve its insolvency laws so that a bank requiring a restructuring is able to contemplate a 'bail in' (a debt haircut in old parlance) of its subordinated bondholders to contribute to the restructuring. In recent days the Co-operative Bank (the "**Bank**") has announced that it requires additional capital to satisfy regulatory requirements. The Bank needs additional aggregate Common Equity Tier 1 capital of £1.5 billion by 2015, comprising:

- £1 billion to be contributed in 2013; and
- £500 million to be contributed in 2014.

The Bank announced that it expects at least £1 billion will be generated in 2013 from an exchange offer with its subordinated bonds into shares and an unspecified fixed income instrument. Much of the crucial detail remains unclear; in particular the exchange ratio, the nature of the new fixed income instrument and how the new securities will be divided up between the different tranches of the subordinated bonds. The Bank currently expects that the launch of the Exchange Offer will be in October 2013. The Bank announced that it expects the remaining balance to be sourced from proceeds of the disposals of insurance assets owned by the group, savings on coupon payments tendered in the exchange offer and certain planned management actions.

The restructuring is bound to be controversial. Although this has been reported as being the first UK bank restructuring which involves a contribution by the subordinated bonds, in 2009, the West Bromwich Building Society's fixed rate subordinated bonds were exchanged into a new type of equity called "profit participating deferred shares" or "PPDS" to increase its tier one capital. The Bank stated that "[t]he Exchange Offer is designed to ensure the Group and investors in the Bank's subordinated capital securities make a joint contribution to the recapitalisation of Co-operative Bank and share in the upside of the Bank's transformation under the strengthened management team."
We discuss below the experience of other bail-ins, particularly in Ireland where we see close parallels. We also review how the Bank's restructuring is likely to be implemented and focus on what inducements, negative and positive, there will be for the holders to participate in the proposed exchange offer.

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The Irish Experience

The regulators and the management of the Bank are likely to draw upon the Irish experience of bondholder bail-ins, particularly as the Irish banks had considerable success 'bailing in' their bonds, many of which were English law governed. A number of Irish banks launched similar offers to noteholders inviting them to tender their notes for new securities or cash at a discount to face value. Holders were asked to appoint a proxy to vote in favour of an extraordinary resolution to include in the notes a call option allowing the bank to redeem for nominal consideration all notes which had not been tendered for exchange.

In at least one case, involving Anglo Irish Bank, after a successful offer, the bank purported to redeem the remaining notes as it believed it had obtained the requisite noteholder approval. However, in respect of some English law governed bonds, the High Court subsequently held that the resolution was not validly passed as the terms of the notes prevented Anglo Irish from voting notes in which it held a beneficial interest. In *Assenagon Asset Management S.A. v Irish Bank Resolution Corporation (formerly Anglo Irish Bank Corporation Ltd)* [2012] EWHC 2090 (Ch), Briggs J held that Anglo had acquired a beneficial interest in notes when they were tendered for exchange. Briggs J also considered the requirement for the "exit consent" from participating noteholders to be an unlawful "coercive threat". He held that "this form of coercion is in my judgement entirely at variance with the purpose for which majorities in a class are given power to bind minorities" and added that "oppression of a minority is of the essence of exit consent of this kind, and it is precisely that at which the principles restraining the abusive exercise of powers to bind minorities are aimed". Following *Assenagon*, it seems highly unlikely that the Bank will launch an offer on a similarly aggressive basis.

Inducements

It is, however, likely that the Bank will consider another recent consent solicitation case which showed issuers how to incentivise a consent solicitation without falling into the same trap as Anglo Irish. In *Azevedo and Another v Importacao, Exportaacao E Industria De Oleos Ltda and others* [2012] EWHC 1849 (Comm), Hamblen J found that it is lawful for a company to offer the 'carrot' of an additional payment to bondholders who vote in favour of an amendment where that additional payment is not made to those that do not vote or vote against the proposal. The claimants argued that (i) a class of noteholders must be treated on a pari passu basis; and (ii) consent payments made only to those noteholders who vote in favour of an amendment should be characterised as an unlawful "bribe". These arguments were rejected.

Accordingly, experience suggests that the Bank may offer a small additional payment, perhaps for responding early – a so called 'early bird fee' for voting for the proposal by a certain deadline and it is unlikely this will be challenged.

The Insolvency Infrastructure for Banks in the UK

The Bank will be discussing a Plan B with its advisers in case an insufficient amount of capital is raised to fill the regulatory gap. One key aspect of the bonds is that they include collective action clauses, which means they can be compromised if an Extraordinary Resolution is passed and accordingly minority holders can be subject to a 'haircut' against their will. We assume that the threshold for an Extraordinary Resolution is 75%, but this information is contained in the bond trust deeds rather than the public debt documentation and is therefore not currently available to us. As discussed above in the Anglo Irish Bank restructuring, the exchange offer was accompanied by a form of resolution which we now think the court would find unlawful if replicated and so the Bank may decide not to accompany its exchange offer with a vote, or if it does, it will need to think very carefully about the impact of the *Assenagon* decision. We suspect that holders will be sufficiently wary not to rely solely on the case law, however, and no doubt some holders may see the need to obtain stakes in relevant tranches to block a resolution in case the deal offered is not sufficiently attractive to them. Assuming the take up on the exchange offer is insufficient to fill the regulatory gap, and that the Bank does not find a way to cram down the holders using the collective action clauses, the Bank and the authorities will need another way to 'close the gap'. Accordingly, in the exchange offer documents we would expect that the Bank will make reference to the powers of the Bank of England in respect of failing banks. The Banking Act 2009 (the "**Act**") brought in the 'Special Resolution Regime' (the "**SRR**") for deposit-taking institutions. The SRR gives the UK authorities the power to transfer parts of a bank to another institution, or to a publicly-owned "bridge bank" (these types of transfers being referred to as partial property transfers, or "**PPTs**") until a private purchaser is found, or place a failing bank in temporary public ownership. The stabilisation options are exercised through the stabilisation powers, which are the powers to effect the transfer of shares and other securities or property, rights and liabilities, by operation of law. There is a relatively high threshold test for the use of these powers. Broadly, the power to effect a PPT can only be exercised where necessary to protect the public interest, having regard to the stability of UK financial systems, public confidence in UK banks and the aim depositor protection. A transfer to temporary public ownership will only be possible where necessary to resolve or reduce serious threats the stability of the UK financial systems, or where the Treasury has already provided financial assistance to the same end.

There are a number of creditor safeguards in place in the case of use of the SRR/PPTs, including that:

a) secured creditors' claims cannot be separated from the assets securing the liabilities in a PPT;

b) the normal priority ranking of creditors is not altered; and

c) creditors left behind upon transfer pursuant to a PPT will be compensated so that they are no worse off than they would have been in an insolvency of the whole bank.

It is obvious that the Bank's management and the UK authorities will want the Bank to be restructured privately without the use of any of the powers granted under the SRR. Leaving aside the dire public relations, cost and damage to the business which would result from the use of such powers, it is quite likely that holders will seek to use the protections inherent in the Act to challenge any such intervention. The nationalisation of Northern Rock saw several hedge funds contest the lack of compensation for shareholders and it is likely that any use of the Act would lead to a number of legal challenges.

Bondholders' Reactions

Many bondholders are customers of the Bank and there will be a large number of retail holders who are unlikely to welcome the loss of the attractive coupon attached to the subordinated debt instruments. It is reported that 5,000 investors hold Co-op preference shares, many of whom are likely to have bought these instruments at their local branches. If recent experience is anything to go by, we may see the emergence of a campaign which mimics the small investor group which faced losses in Bank of Ireland's attempted coercive exchange of its permanent interest bearing shares ("**PIBS**"), which had been issued by the Bristol & West prior to a takeover. Holders of £75 million in PIBS managed to avoid an exchange by a combination of a vigorous PR campaign and legal threats. A larger institutional base also held out and did not take part in the distressed exchange offer.

Over the past few months a number of hedge fund investors have purchased subordinated bonds at distressed prices, hoping to take advantage of the current uncertainty. A large amount of debt is likely to be in their hands. Such investors may not necessarily reject an exchange as they may well have bought the subordinated debt at a level where they may see an upside in owning shares or an instrument the pay out of which may be based on the future profits of the Bank, rather than a fixed interest rate. Ultimately their decision will be driven by the ratio of new equity to debt at which the exchange is offered.

Of some concern for the Bank's management is an editorial in the Financial Times on 17 June 2013 which suggested "[i]t is, however, a mystery how the Prudential Regulation Authority could sign off on a restructuring that seems to upend the established ranking of investors". As a shareholder, the Bank's parent (the mutual Co-operative Group) would be the last to see a return on its investment in an insolvency, but the proposed restructuring would have it retain almost complete control at the expense of the junior bondholders. The Bank's argument might be that by virtue of selling certain assets the shareholder is 'buying back' its stake in the Bank. Bondholders may be looking for some certainty of commitment that, if they agree to the exchange, the further capital need to plug the regulatory hole will be made available by the shareholder. The next few months will prove fascinating and may involve brinkmanship on both sides before an agreement is reached. The Bank will soon need to decide whether to engage constructively with the holders in a negotiation, or simply launch an offer and see how many accept. Whether, in the absence of agreement, the UK authorities is prepared (and indeed, empowered) to step in to use any of its powers under the Act is an interesting question.