KEY POINTS

- Extending the concept of beneficial ownership to include contractual rights of a non-proprietary nature would create a "*huge minefield of uncertainty*".
- There is certainty for draftsmen regarding the enforcement of commonly seen disenfranchisement provisions in securitisation documentation.
- *Assenagon* provides adequate protection to noteholders in circumstances where the majority has exercised its votes in an oppressive manner.
- The courts continue to take a business oriented approach to the resolution of disputes.

Feature

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Avoiding minefields: the concept of beneficial ownership in disenfranchisement provisions post-*Assenagon*

In *Citicorp Trustee Company Ltd v Barclays Bank PLC and Others* [2013] EWHC 2608 (Ch) (Citicorp) Peter Smith J was asked to rule on the enforcement of commonly seen disenfranchisement provisions in securitisation documentation for the purposes of voting on the restructuring of the underlying loans which were due to mature on 15 October 2013.In reaching his decision, the judge considered aspects of Briggs J's (as he then was) judgment in *Assenagon Asset Management SA v Irish Bank Resolution Corporation Ltd* [2012] EWHC 2090 (*Assenagon*). This article considers the reasoning behind *Citicorp* and draws conclusions from the two judgments for those practising in the securitisation markets.

SUMMARY OF THE FACTS IN CITICORP

On 2 August 2013, proceedings were issued by Citicorp Trustee Company Limited in its capacity as trustee for the noteholders of £660m worth of commercial mortgage backed floating rate notes issued pursuant to a European "CMBS" securitisation, for declarations regarding the interpretation of commonly seen disenfranchisement provisions.

In broad terms, the structure of the transaction was as follows:

- pursuant to a facility agreement dated 6 October 2006 Barclays and certain other financial institutions lent in aggregate £1.65bn to a group of borrowers comprising companies in the General Healthcare Group. The loans were split into senior and junior loans, the senior loans being referred to in the documentation as the "Whole Senior Loans".
- notes were issued by Theatre (Hospitals) No 1 Plc and Theatre (Hospitals) No 2 Plc in order to acquire the majority portion of the Whole Senior Loans from the "Sellers". Barclays was one of four Sellers in the case of Theatre 1 and the sole Seller in the case of Theatre 2. Each Issuer issued four classes of notes to pay for the acquisition: Class A, Class B, Class C and Class D.
- Barclays was the holder of the entirety of the Theatre 1 Class A and Class B notes. Ambac Credit Products LLC (the seventh defendant in the Proceedings) provided credit protection to Barclays by way of a credit default swap (CDS). Under the CDS, Ambac controlled the voting rights of the notes (by being able to direct Barclays' vote) since it was the party with the ultimate economic exposure to those notes. The fourth defendant, Cooperative Centrale Raiffeisen-Boerenleenbank B.A. (Rabobank), was the holder of the entirety of the Theatre 2 Class A notes which were the subject of a total return swap (TRS) between Rabobank and Barclays. Pursuant to the TRS Barclays was able to direct Rabobank's vote, although Ambac again stood as the ultimate credit protection seller in the package.
- Both sets of notes were issued at a time when there was appetite in the market for "negative basis trades" which were effectively packages consisting of bonds and credit default protection in respect of those bonds.

Due to concerns regarding the ability of the borrowers to repay the loans and the value of the underlying property, it was anticipated that there would be insufficient funds to pay all of the noteholders in full. Accordingly, negotiations began for the extension of the loan maturity date. During the course of these negotiations, a question arose as to which holders of notes could vote to approve the proposals in accordance with the trust deeds. The uncertainty was caused by the wording of a commonly seen disenfranchisement clause. As recognised by Briggs J in *Assenagon*, such clauses are inserted to:

> "prevent a vote designed to serve the interests of the noteholders from being undermined by the exercise of votes cast in the interests of the bank".

The clause in question prevented any noteholder from attending and voting at a meeting of noteholders if their notes were deemed not to remain outstanding, as were those notes

> "which are for the time being held by or on behalf of or for the benefit of the Issuer or each of the Sellers, any holding company of any of them or any other subsidiary of any such holding company, in each case as beneficial owner".

Having been alerted to the apparent concerns of an anonymous junior noteholder as to whether the notes held or controlled by Barclays were disenfranchised, the trustee sought clarification from the court.

THE RELEVANCE OF *ASSENAGON*

Assenagon involved the analysis of a similar, but not identical, disenfranchisement provision in the context of considering the lawfulness of a technique used by bond issuers known as "exit consents".

In that case, the noteholders had been asked to vote in favour of a proposal which involved the exchange of their notes for the issue of new notes. Those who did not vote in favour of the proposal had their notes cancelled for a nominal consideration. The deadline for exchange was set at a time before the meeting at which the relevant resolution would be proposed, so that the non-consenting noteholders did not have a second chance. As a result, they received just €170 for notes with a face value of €17m.

The non-consenting noteholders put forward three arguments in support of their case, one of which turned on the disenfranchisement provisions of the trust deed which stated that:

> "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".

Briggs J held that the arrangements between the issuer and the consenting noteholders amounted to a specifically enforceable contract for sale of the notes to the issuer, and on that basis held that the issuer was disenfranchised because it was the beneficial owner of the notes[1].

In *Citicorp*, the trustee argued (on behalf of the junior noteholders) that Barclays' interests in the notes held by Rabobank pursuant to the TRS caused such notes to be disenfranchised. The basis of this argument was that the court should construe the disenfranchisement provisions widely, so as to include within the class of person contemplated by the phrase "*as beneficial owner*" not just beneficial owners, but also those who have "*in real commercial terms, a sufficient economic interest in [the] notes*", such as Barclays. The trustee relied on para 63 of *Assenagon* in which Briggs J stated:

> "I consider that the prohibition must be construed as it stands, so as to relate to the beneficial holding of notes, either in a proprietary sense or, perhaps, in an economic sense where, without conferring a proprietary interest, the noteholder is obliged to confer upon or transfer to the bank the whole of the economic risks and rewards arising from the notes as at the date of the meeting." (emphasis added)

The trustee contended that unless the words "*for the benefit of the Seller*" in the disenfranchisement clause were otiose, they must be intended to catch notes in which the Seller has a real economic interest albeit not necessarily a proprietary one. The trustee further contended that the ability to control the notes under the TRS would give rise to precisely the sort of mischief that the disenfranchisement clause intended to address, namely, Barclays exercising voting rights in its own interests as "Seller" of the loans rather than noteholder.

In addition, the trustee argued in respect of the Theatre 1 notes that Barclays' position as hedge counterparty under certain "in the money" super-senior interest swap agreements entered into with the Borrowers placed it in a position of conflict, as it stood to receive a windfall if the loan defaulted, which would be contrary to the interests of the noteholders.

Barclays disputed the trustee's arguments on the following grounds:

- Briggs J's observations were *obiter*, as he had already decided the case on alternative grounds;
- Moreover, they were only tentatively expressed, prefaced as they were by "*perhaps*";
- Briggs J expressly rejected counsel for the noteholders' purposive construction that the disenfranchisement provision should apply "*in any case where the bank had obtained a mere contractual commitment from a noteholder to vote its notes in a particular way*".

On this basis, Barclays contended that Assenagon did not provide any basis for departing from the plain meaning of beneficial ownership.

THE JUDGE'S FINDINGS

Beneficial ownership

Peter Smith J rejected the trustee's argument that beneficial ownership should be stretched beyond a proprietary nature to include those with a simple economic interest, holding that para 63 of *Assenagon* had no impact on the construction of the trust deed.

The expression "*economic interest*" was too vague "*and will give great hostages to fortune and lead to uncertainty*". Peter Smith J highlighted the difficulties that would result from introducing a broader definition of beneficial interest in situations such as this where Barclays occupied an intermediate position in the package between the noteholder (Rabobank) and the ultimate credit protection seller (Ambac), as it would create uncertainty as to who holds the economic interest and who should therefore be disenfranchised. He stated that:

> "departing from the traditional meaning of the words 'beneficial owner' makes a potentially huge minefield of uncertainty".

Conflict of interest

- There was no commercial reason not to give effect to the plain meaning of the words "*in its capacity as Seller*" found in the disenfranchisement clause (notwithstanding that Barclays could never have held the notes in its capacity as Seller).
- Barclays was entitled to act in its own commercial interests, which may, should it so choose, include blocking the restructuring proposal in order to receive a windfall under the swap as a

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result of the default.

- Affirming the *Assenagon* decision, Peter Smith J stated that minority noteholders would always have a remedy where votes taken by senior noteholders were oppressive.

CONCLUSIONS

- The concept of beneficial ownership should not be stretched to include those with merely an economic interest or contractual rights in the underlying asset. As Peter Smith J observed, *"the idea that the concepts are determined by the phrase 'economic interest' would create nightmares"*.
- There is certainty for trustees, issuers and servicers in determining which party is entitled to vote and/or may be subject to disenfranchisement.
- Commonly seen provisions disenfranchising notes held by the Issuer and the Seller work as intended.
- Courts will take a business oriented approach to the resolution of disputes. Senior noteholders enjoy control by virtue of their investing in lower-yielding but less risky notes: they should not readily be found to have surrendered such control or subordinated their interests to junior noteholders.
- Occupying more than one role within a transaction structure (such as hedge counterparty) will not necessarily constitute a conflict of interest and parties are entitled to pursue their own commercial objectives.
- If, however, a noteholder can show that the majority has exercised its votes in an oppressive manner then *Assenagon* (and the authorities referred to therein) provide it with adequate protection.

1 The other arguments were: (i) that the powers of the majority noteholders were *ultra vires* the trust deed; and (ii) the resolution was both oppressive and unfair as against the minority. See (2012) 8 JIBFL 516-518.