

# Beneficial holders beware: Insolvencies requiring action directly from beneficial holders of indenture-less debt securities

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**Several recent, high-profile US and non-US insolvencies have departed from the norm (radically so, perhaps) when it comes to what action and information is required of a beneficial holder of a publicly-traded bond issued by a debtor company. Holders of certain indenture-less programme debt securities in the Lehman Brothers Holdings Inc. US Chapter 11 case were required to file their own claims and provide significantly more information than is usually required regarding their position and the basis for their claims. Similarly, beneficial holders of indenture-less bonds issued by three major Icelandic banks in moratorium, Glitnir banki hf., Kaupthing banki hf. and Landsbanki Islands hf., were required to file their own proofs of claim. In both Lehman and the Icelandic Bank cases, beneficial holders were required to block their bond positions to establish ownership. Securities blocking is a tool used by central depositories to freeze the holder's bond position. Doing so has obvious implications on the holder's ability to trade its bond position. This article will review the situations in which beneficial holders faced increased claim-filing responsibilities and what they (and others) need to watch for as the global economy continues to undulate.**

## The downside to the indenture-less debt security

There was a time in US insolvencies, at least, that the beneficial holder of a publicly-traded debt security could take comfort in the fact that they needed to do very little, if anything, to protect their interests. This comfort stemmed in a large part from the fact that, ordinarily, the debt security purchased came tethered to an already-designated "Indenture Trustee." Appointed pursuant to the bond indenture, the Indenture Trustee, in addition to having other administrative responsibilities, is almost always the party authorised and responsible for pursuing a global claim for the bond issuance. In those cases where the bond issuance is the largest unsecured obligation of the debtor-company, which is quite often, the Indenture Trustee also takes a seat, if not the chairmanship, on the official committee of unsecured creditors appointed by the United States Trustee's Office and approved by the Bankruptcy Judge. In such cases, the Indenture Trustee is in the best possible position from the standpoint of access to information and negotiating leverage to ensure the interests of beneficial holders of the bond issuance are protected.

What could be better for the beneficial holder? Oh, yes, they can trade their security notwithstanding the commencement of the insolvency – assuming they can find a buyer. Again focusing on the US insolvency process, the fact that the Indenture Trustee is vested with contractual authority to file a claim on behalf of the entire issuance – regardless of who actually holds

the economic interests of the bond at any given time – trading in the bonds continues through the usual processes and platforms even after the Chapter 11 case is commenced. Such trading does not trigger the US Bankruptcy Rule 3001(e) requirements for trading in claims, which include filing a Notice of Proposed Transfer on the Bankruptcy Court docket and awaiting expiration of a 21-day period post-notice – during which period either party to the trade can object – before the trade is recognised under the US Bankruptcy Code.

So for all the downsides to finding oneself holding an unsecured bond of a Chapter 11 debtor, it could be much worse. The clout of a claim for the entire amount of the bond issuance, the existence of the Indenture Trustee to look out for their interests, a seat on the unsecured creditors committee; these facts alone put beneficial holders well ahead of many of their unsecured brethren. The virtually unimpeded ability of a beneficial holder to trade out of its position notwithstanding the commencement of an insolvency is but one more benefit. Now imagine a scenario where the Indenture Trustee is not around or is not recognised as the proper party to assert a global claim, and instead beneficial holders must pursue their own claims against the debtor-company. Add to this the requirement that beneficial holders must "block" their bond positions to properly establish their claim. While blocked, bond positions cannot be traded, and to trade their claim the beneficial holder must follow virtually the same procedures set forth in

US Bankruptcy Rule 3001(e). As farfetched as it may seem, some variation of the foregoing has occurred or is occurring in the Lehman Brothers Holdings Inc. US Chapter 11 case and the Icelandic Bank cases.

## Lehman Brothers Holdings Inc.

Lehman Brothers International (Europe) ("LBIE") and certain other non-US Lehman affiliates arranged the Euro Medium Term Note Programme, under which they issued "Structured Notes." The Structured Notes ranged from "relatively simple fixed or floating rate securities" to those that were "highly complex and uniquely tailored to the interests of specific investors." In most cases, "the principal amount as well as the amount and payment of interest [under the Structured Notes] is linked to some underlying security, foreign exchange rate, commodity price, index or basket of securities or indices."<sup>1</sup> Among other features, many of the Structured Notes were not issued pursuant to an indenture, and therefore without an Indenture Trustee. This fact may have been viewed as a benefit to investors when purchased, as the lack of an indenture would allow for more flexibility for each investor.<sup>2</sup>

As Lehman Brothers Holdings Inc. was a potential guarantor of the Structured Notes obligations, procedures were established for the filing of guarantee claims relating to the Structured Notes. Foremost among these was that beneficial holders or their account holders (i.e. banks and brokers who hold and trade securities for beneficial holders at the relevant depositories) would be required to file a proof of claim to establish the potential guarantee claim. Adding to the work, the holder was required to "block" their Structured Note position from the time of filing the claim until expiration of the deadline to file claims. This process would provide LBHI and its advisers sufficient time to properly identify the holders of Structured Notes via the blocking reference numbers assigned to them by the relevant securities depository, in this case Euroclear and Clearstream.

The procedures defined by LBHI were unpopular among holders of the Structured Notes, leading many to object formally in the United States Bankruptcy Court. Many argued that LBHI should be required to list the entire obligation of the Structured Notes as part of its Schedules of Liabilities. Doing so would have potentially obviated the need for beneficial or account holders to file individual proofs of claims. LBHI resisted this suggestion and argued forcefully that holders of the Structured Notes should be afforded no special treatment:

- Unless the Debtors agree to treat the parties to the EMTN Programme differently from other creditors, these objecting parties complain that they will incur significant burdens and expense in preparing their

proofs of claim. At the very least, however, the Account holders – who are generally large financial institutions – knew, or should have known that the benefits of flexibility without an indenture trustee are counterbalanced by the burdens that may arise in the event of a bankruptcy. At the very least, the Account holders should have considered how they would need to respond. If they did not begin thinking about this when they bargained for the terms of the Structured Notes, they should have begun to do so nearly 10 months ago, when the Debtors' commenced these Chapter 11 cases. The time to begin raising these issues is not on the eve of a hearing on the Debtors' Motion to establish a bar date in these cases.

- The parties to the EMTN Programme should not be permitted to derail the process and extract concessions from the Debtors that would afford special treatment to investors in the Structured Notes. Neither the Debtors nor even the Issuers are responsible for the way in which the Account holders marketed the economic interest in each Series to their customers, either the Intermediaries or the Ultimate Beneficial Owners. Only the Account holders, and the parties that follow down this chain of ownership, can take responsibility for organising themselves in order to assert their claims as required by the Bankruptcy Code and Bankruptcy Rules. These parties should be required to undertake the same obligations as all of the Debtors' other similarly situated creditors, and should be afforded no better treatment solely because they now wish they had bargained for notes under an indenture rather than a fiscal or paying agent.<sup>3</sup>

The lesson from LBHI is that sympathy from the debtor and/or the Bankruptcy Court for the administrative burden of beneficial holders of an indenture-less debt security may be in very short supply. Vigilance in understanding what may be required to protect their interests, therefore, is a requirement for beneficial holders of indenture-less debt securities in US cases.

## Icelandic Banks

Glitnir banki hf., Kaupthing banki hf. and Landsbanki Islands hf. (collectively, the "Icelandic Banks") also issued indenture-less programme securities<sup>4</sup> similar to the Structured Notes programme in Lehman. To best establish ownership of a bond position, beneficial holders were instructed to block their bond positions and provide the blocking reference information as part of the proof of claim. For example, information provided in a "Frequently Asked Questions" section available on the website maintained by the Winding Up

Board of Glitnir banki hf. provides:

- For claims related to Glitnir Bonds held through Euroclear, Clearstream and DTC, it is mandatory that you request a blocking number (or its equivalent) for each bond and security position. Failure to receive and include a blocking number for claims related to these types of Glitnir Bonds will cause your claim to be deficient and as such will be rejected by the Winding-Up Board.<sup>5</sup>

The Glitnir FAQ also describes the primary role of the beneficial holder in the blocking process:

- *Beneficial holders* (which includes most individuals) must direct their accountholder (the bank, broker or other entity that holds the bonds on behalf of the beneficial holder) to contact the relevant depository to obtain a blocking number.<sup>6</sup>

In contrast to Lehman, where beneficial holders objected to the proposed claim-filing procedures, arguing, in part, that LBHI should schedule the Structured Notes thereby potentially excusing beneficial holders from having to file an individual claim, applicable Icelandic bankruptcy laws do not appear to have an obvious equivalent to a US debtor's "Schedules of Assets and Liabilities" rendering this possibility effectively moot. Nor was there an obvious forum for such a suggestion to be made, as the insolvency process in Iceland is conducted largely outside the court system, at least initially. To the extent objections to the procedures employed by the Icelandic Banks were made, the Icelandic Bank Winding-Up Boards and Committee were not swayed.

Another important difference from Lehman is the fact that Icelandic Bank bonds are required to maintain their blocked bond positions indefinitely. The obvious consequence of this requirement is that beneficial holders are prohibited from trading their bonds, which is a significant change from other insolvency situations. Moreover, in order to trade the filed-claim associated with the blocked position, beneficial holders must adhere to claim transfer procedures set out by the relevant Winding-Up Board or Committee. These procedures – as set forth on each of the Icelandic Bank websites – are akin to the process established under US Bankruptcy Rule 3001(e), including a 21-day waiting period before the transfer is recognised by the Winding-Up Board/Committee. This, too, represents a significant departure in what beneficial holders are used to.

The lesson from the Icelandic Banks is that beneficial holders must understand the domestic insolvency laws of the debtor-company issuing the bonds in order to understand what heightened information or action may be required of them should the company become insolvent. This holds true for indenture-less debt securities and even, potentially, those bonds issued under an indenture.

## Conclusion

The claim-filing procedures employed in Lehman and the Icelandic Bank cases may very well be a "red flag" to the bondholder community. Absent renewed interest in the US for the debtor to schedule an indenture-less bond, the use of securities blocking will likely continue. This signals the need for beneficial holders of indenture-less bonds to familiarise themselves with and clearly understand the rules and domestic laws applying to their bonds. Failure to comply with the relevant processes may ultimately result in loss of any recovery rights related to the bond claim. Final words of advice and wisdom – caveat emptor – know your rights and what is required of you in case the company in which you are investing takes a turn towards insolvency.

## Notes:

<sup>1</sup> Debtors' Reply to Objections for Establishment of the Deadline for Filing Proofs of Claim in Connection With the EMTN Programme, dated June 29, 2009 ("LBHI Reply"), p. 2, ¶ 1.

<sup>2</sup> LBHI Reply, p.7, ¶ 14: "The Debtors are not at fault because the Accountholders and their customers bargained for and purchased Structured Notes that do not have an indenture trustee to represent them in the event of a default or a bankruptcy. On the contrary, the Structured Notes could only be issued in jurisdictions outside of the United States because the investors preferred the flexibility that the Structured Notes offered by, among other things, not requiring an indenture. Indeed, the absence of an indenture was often embedded in the pricing of the Structured Notes, so that ultimately those who invested in them made a greater return on their investment because of this feature, at the cost of the Issuers."

<sup>3</sup> LBHI Reply, p.8, ¶¶ 16 and 17.

<sup>4</sup> It bears noting that at least one of the Iceland Banks issued bonds pursuant to an indenture. Yet, the claim-filing instructions did not distinguish between bonds issued under an indenture or otherwise.

<sup>5</sup> See "How to file a claim – FAQ" ("Glitnir FAQ") available at [www.glitnirbank.com](http://www.glitnirbank.com), Question 1.4.

<sup>6</sup> See FAQ, Question 4.2.

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