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Legal Analysis

Schemes of arrangement – 12 month lookback

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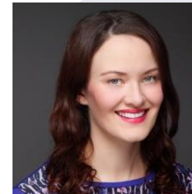

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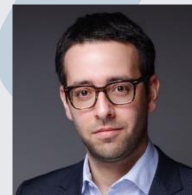

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OVERVIEW

The UK scheme of arrangement has continued to be a popular tool for large-scale debt restructurings over the past year, being deployed by struggling UK retailers **New Look** and **House of Fraser** and used in a somewhat novel context in the long-running **Lehman** saga. It retains its international appeal, with Croatian debtor **Agrokor** and Bermudan company **Noble also** using schemes to effect their restructurings.

In this special report, *Debtwire*'s Legal Analyst and Court teams highlight takeaways from the last 12 months of schemes with Polina Lyadnova and Jim Ho, Partners at **Cleary Gottlieb Steen & Hamilton LLP**, who worked on the recent FESCO scheme.

CVA THEN SCHEME – RISE OF THE 'DUAL TRACK' RESTRUCTURING

Recent months have seen a couple of retail debtors (**New Look** and **House of Fraser**) use company voluntary arrangements (CVAs) before ultimately resorting to schemes. With high street casualties in the retail and casual dining sectors continuing to turn to CVAs, we may see more of these 'dual-track' workouts to achieve thorough financial and operational restructurings.

So, what makes CVAs so appealing as a first attempt at saving a struggling company?

"CVAs bind unsecured creditors and there are no costly court hearings as there would be under a scheme. Although they require the supervision of an insolvency practitioner, CVAs are often seen as a less formal restructuring process. This may play into their growing popularity as a 'first step' in what may end up as a dual-track restructuring," observes Lyadnova.

The scheme, however, is a more comprehensive restructuring tool. Their flexibility means it is possible to use the process for many types of restructuring, including amend-and-extends, debt-for-equity swaps and full-blown workouts, plus secured creditors can be bound.

"Schemes can also be used to target financial debt as opposed to operational indebtedness like rental obligations. As such, schemes may be well-suited as a second attempt at restructuring. We may also see schemes replacing CVAs if a more comprehensive restructuring is required – especially given the most recent examples of combining trade and finance creditors into a single class in a scheme," explains Ho, alluding to the **Noble** scheme.

Neither CVAs nor schemes offer a complete panacea: they cannot fix a fundamentally flawed business. Ho points to **BHS**, **JJB Sports** and, more recently, **Jamie's Italian**, which used a CVA in 2018 but ultimately landed in administration as the CVA was not enough to save the ailing restaurant chain.

"While we may see an increased number of dual-track restructurings in the coming years, this does not guarantee a corresponding increase in companies avoiding insolvency," concludes Lyadnova.

CLASS ISSUES: JUST AN ILLUSION?

In **Noble**, the scheme creditors comprised substantially all the company's creditors, e.g. finance creditors but *also* certain other persons who had made claims against the company (the 'other scheme creditors').

At the convening hearing, Mr Justice Snowden had to decide whether it was appropriate to place all scheme creditors (other than **Deutsche Bank**, which would emerge from the scheme with senior notes) in the same class. One argument he had to consider was that the other scheme creditors would not be able – or indeed want – to advance new money (a requirement to obtain priority debt under the scheme) and were therefore in reality being offered a separate deal by the company.

Snowden J agreed with counsel that any inability or reluctance on the part of some of the other scheme creditors to advance new money was the

result of their individual situations and commercial interests rather than any difference in *rights* (a difference in rights being necessary to fracture the class). He found that the opportunity to elect to 'risk participate' in return for the priority debt was a right offered to all scheme creditors and that the reasons why some of the other scheme creditors might not be able to, or want to, risk participate ultimately related to their individual circumstances and commercial interests.

"The more important element of the scheme was that both categories of creditors were offered to participate in the risk, rather than whether they were interested in doing so," notes Lyadnova.

Snowden J's remaining concern lay in ensuring that the right, however, was not merely 'illusory', i.e. was the opportunity to risk participate genuine in respect of the other scheme creditors?

"The essential details of the proposals had been discussed with the ad hoc group but not with the other scheme creditors and, due to timetabling, the other scheme creditors were given a very limited amount of time in which to review the explanatory statement," explains Ho, adding that Snowden J noted that sufficient time to consider the essential information relating to the offer and to make arrangements pertaining to participation in the offer was critical in order for the offer to be "real".

Discussion turned to last year's **Lehman** scheme, where a broad range of creditors was included in the same class. Again, emphasis was placed on the legal *rights* scheme creditors have against the company rather than the individual *interests* and motives of such creditors.

"There has been an extensive discussion of whether the right attributed to one of the creditors, ***Wentworth****, in the determination process had a class splitting effect with the ultimate result of Wentworth's veto being downgraded to consultation only",* remarks Lyadnova. *"Hildyard J also made an interesting observation on cross-holdings, concluding that close association of the entities in different classes with potentially competing interests in the scheme outcome does not fracture the class composition, while the conclusion may have been different if those entities were each alter egos of the other,"* she adds.

Both Noble and Lehman involved insolvent schemes. There is a distinction between situations in which the alternative to the scheme is insolvency and situations in which a solvent run-off is more likely. *"While, in Noble, Snowden J drew no distinction between the existing rights of creditors with claims in contract and those of creditors with claims in equity or tort, he specifically noted that his approach to the question of class would have been different in the context of a solvent scheme,"* Lyadnova observes.

Ho points to **Stronghold** by way of comparison. *"The creditors with contingent claims were placed into a class of their own, separately from those with accrued claims. Since the insurance company was likely to remain solvent, the IBNR [incurred but not reported] creditors may have benefited from its continuance in such a way that the scheme would offer them virtually no advantage. Expecting them to discuss the scheme with the other creditors (who stood to benefit significantly from it) would be unrealistic."*

Notably, both Snowden J and Hildyard J left the motivation of various creditors and their special interests for examination as part of the fairness analysis and further elaborated on those in the respective sanctioning hearings.

LET'S TALK ABOUT THE MONEY

It has been said that the convening judgment in Noble might well become the leading case on backstop and consent fees and their impact on classes.

While the level of fees in Noble was fairly substantial, no separate class was convened for the creditors receiving them. However, Snowden J made a number of observations in his analysis that could provide valuable guidance, dismissing the idea that fees do not give rise to a class issue because they are *de minimis*.

"A distinction was made on the basis of whether or not the fee payments were part of the scheme proposal. As long as fees are paid for legitimate reasons and are genuinely independent of the scheme, e.g. ad hoc group work fees, Snowden J concluded they did not come into the class composition equation," notes Ho.

Certain aspects of the evidence caused Snowden J concern – e.g. the dramatic increase in the RCF waiver fee when the ad hoc group became involved and the introduction of a work fee around the same time. *"But they were not offered in exchange for the express support of the ad hoc group via the execution of the restructuring support agreement. Further, evidence was provided to confirm that they were payable even if the restructuring was not implemented, and that they were paid as a percentage of holdings solely for practical reasons. As such, Snowden J concluded that they were not a disguised part of the consideration for the scheme,"* explains Lyadnova.

But what about fees such as the backstop fees, which were dependent, and conditional upon, the scheme becoming effective?

"The materiality of fees was looked at from the perspective of the impact of them on the fee-receiving creditor's decision as to whether or not to support the scheme," explains Ho. *"If the fees are material to the decision, the creditors receiving fees probably can't consult together with those who will not receive fees. Here, it's important to look at the level of the fees and how they relate to the anticipated returns offered to all creditors under the scheme or in a liquidation. Snowden J built upon the comments of David Richards J in* ***Privatbank*** *when he explained that one shouldn't just look at the percentage the fee represents of the face value of the debt held by potential recipients,"* explains Ho.

"Since the risk participation was an option offered to all creditors and there would be a large disparity in the likely returns to participating and non-participating creditors anyway, Snowden J considered that the existence of the backstop fees was not a material concern," Lyadnova adds.

Finally, it is worth noting that the discussion of the fees in Noble was still guided by the main principles in class composition, mainly, the need to avoid an unworkable number of classes as well as giving a small minority a disproportionate right of veto.

SCHEME APPLICANTS: DO YOUR HOMEWORK

As has been the case at other hearings he has presided over, Snowden J was *"not wholly convinced"* by the evidence initially provided in Noble, and his two detailed judgments provide guidance for companies proposing schemes regarding provision of information, especially as to fees.

"Companies should be aware that any fee arrangements agreed with creditors will need to be properly disclosed to the court and be prepared to justify their proposed class composition in light of these arrangements. At many points throughout Snowden J's judgment it is clear that he was frustrated with the level of disclosure provided and indeed pushed the company for more information," cautions Ho.

Careful consideration should be given to how to calculate and present fees to the court. *"The ad hoc group was to be paid a 'work fee', ostensibly to incentivise cooperation between the group, and to compensate for the time spent in participating in the negotiations. However, the fee appeared to have been calculated on the basis of holdings of debt rather than by reference to the actual amount of work done. Further, the letter agreements outlining the Work Fee did not contain any provisions obliging the ad hoc group to do actual work. Snowden J made clear that he found this evidence unconvincing,"* warns Lyadnova.

Particularly where fee arrangements are complex as in Noble, it may be helpful to outline what each creditor stands to gain from the scheme / restructuring. As in previous schemes, Snowden J requested such a statement showing cumulatively what any particular creditor or group of creditors stood to get out of the scheme or wider restructuring that was distinct from the general body of creditors.

The source of the evidence presented was also subject to scrutiny.

"Snowden J noted that evidence from creditors not receiving the fees as to how the fee arrangements may or may not affect the ability of the scheme creditors to vote together is likely to be considered as more convincing than 'self-serving assertions' of creditors who have negotiated to receive the fees," reasons Lyadnova.

Snowden J noted that creditors who raise legitimate points at the convening hearing can expect to receive their reasonable costs for doing so regardless of outcome.

Interestingly, Snowden J observed a reluctance to identify members of the ad hoc group.

THIRD PARTY RELEASES

Noble's scheme contemplated – as is commonplace – that claims against the advisers and representatives of the company, management and the ad hoc group, among others, would be released.

"It is well established that such mechanisms could be sanctioned by the court where releases were necessary in order to give effect to the scheme," explains Lyadnova. *"In the **FESCO** scheme, which we worked on, Snowden J supported the view that the release of certain claims could be justified due to the need to avoid scheme creditors undermining the scheme itself. However, in Noble, Snowden J noted that class composition issues may arise where some but not all scheme creditors have more tangential claims against third parties or where such claims could be pursued by some scheme creditors against other scheme creditors."*

SPECIAL INTERESTS

A further point to note, which both Noble and Lehman highlight, is the consideration of 'special interests' issues in the fairness context in the sanctioning hearing.

"In Lehman, in particular, a number of points came up as part of the assessment of whether each class was fairly represented – we have in fact raised some of these issues with the administrators," explains Lyadnova.

The key questions Hildyard J considered were whether a majority of creditors had special interests that were different from and contrary to those of the other creditors in the class, whether their voting was affected by such interests (the 'but for' link), whether their votes should therefore be disregarded or discounted and how this should affect the court's decision as to whether to sanction the scheme.

"On special interests of a majority, Hildyard J emphasised that the key element is whether such interests clash with those of the minority. The mere existence of such special interests does not in itself mean that the class was not fairly represented," explains Ho. *"Additionally, the requirement for the 'but for' link essentially requires it to be clear that a member of the class not in possession of the special interests would not have been able to vote in the way that the majority member voted. Hildyard J proposed two questions in this respect: first, whether the scheme has been approved by the other creditors as being in the interests of the class; and second, whether compared to a situation in which there was no scheme, there is more to unite the members of the class than to divide them."*

If a vote at a class meeting was unrepresentative of the class, the court has the option to either discount the weight given to the majority vote or disregard the special interest votes altogether. If the result of disregarding such votes is that the requisite majority is not obtained, the scheme will fail. *"Hildyard J didn't express a view as to whether discounting or disregarding is preferable. Rather, in his view, it is a matter requiring consideration of all the relevant circumstances,"* concludes Lyadnova.

ARTICLE 8: A NUMBERS GAME?

In past schemes there has been a debate as to how many creditors must be UK domiciled to satisfy the 'expediency' test and enable a debtor to rely on Article 8 of the EU Judgments Regulation (e.g. Snowden J in **GGP** and **VGG**). The prevailing

view seems to be that just one UK domiciled creditor is sufficient.

However, Snowden J still seems to have his reservations about this approach, stating in Noble *"... I have taken the view that if, for example, one scheme creditor owed US$1 was domiciled here, and, say, 200 creditors owed US $100 million were domiciled in Germany, the framers of the Recast Judgments Regulation might not regard it as 'expedient' for the purposes of avoiding irreconcilable judgments that the 200 German creditors should be subjected to a scheme in England."* Will we see more debate on this issue in future schemes?

"Our feeling is that the debate over whether one creditor being based in England and Wales is sufficient to satisfy the expediency test is not over yet," says Ho.

The position has not, however, really been tested in recent schemes.

"Just because the debate has subsided for a while, doesn't mean it is settled," asserts Lyadnova, pointing out that, in her view, Snowden J is clearly leaving open the possibility that the value – not just the number – of the English-based debt holdings could determine whether Article 8(1) is engaged. "While one doesn't generally like to sit on the fence on an issue, it is hard to see how if a situation such as that hypothesised by Snowden J arose the debate wouldn't be reopened and real consideration given to the value of the English-domiciled holdings by the judge," she concludes.

TIMING IT RIGHT

In Noble the court was asked to impose a very tight timetable. One particular concern for Snowden J was the short time within which the 'other scheme creditors' were originally given to assess the merits of risk participation and find the money to do so.

"An offer which does not give the offeree the essential information with sufficient time to consider it and make the necessary arrangements to participate is not a real offer", Snowden J said. Regarding giving the court time to prepare, Snowden J warned that *"the parties involved in restructuring discussions must understand that they cannot run things down to the wire for their own benefit.....The position should not be reached in which the court is presented with a metaphorical 'gun to the head' and the judge is in effect told that if he does not comply with the company's application immediately, he will be responsible for the collapse of the company."*

"The timing of the Noble scheme was tantamount," explains Ho. "Due to a condition imposed by the Singaporean Securities Council, the restructuring had to be completed by 27 November 2018. The company indicated that it would make the explanatory statement available on 16 October and hold the scheme meeting and sanction hearing within a month. However, Snowden J noted that, although the terms of the rights to risk participate had been discussed for some time, certain scheme creditors would depend on receipt of the explanatory statement to make their decision. A revised timeline was provided by the company but, in the convening judgment, Snowden J seemed to prime creditors to object to the timeline on unfairness grounds. Whilst in the end no creditor took this course, Noble demonstrates the willingness of the courts to interfere in the proposed timeline of the scheme. Companies should think carefully about any proposed scheme timeline, and whether it could be challenged on unfairness grounds," advises Ho.

Snowden J also reiterated that the court does not act simply as a "rubber stamp" for schemes and that restructuring steps should not be arranged on a timeline that assumes the court will give a decision immediately. *"After being given a very short time to familiarise himself with the extensive bundles – which he did express his concern about in only a way Snowden J can – he reinforced that the Court Listing Office should be kept informed regarding the extent of pre-reading required of the judge and hearing bundles be filed well in advance of the hearing,"* cautions Lyadnova.

"So, although not always possible, the overall advice is to plan the scheme timetable to give both creditors and the courts as much time as possible to consider the scheme. The rescheduling of a hearing on the grounds that the timetable was inadequate could be fatal to a company facing severe financial distress if the scheme is not sanctioned," she concludes.

COMMENT

The scheme's popularity continues, and, despite Brexit throwing a cat among the pigeons, we are confident many more debtors – from England and beyond – will follow the well-trodden path to the Rolls Building to take advantage of the process.

As the high street bloodshed continues in the retail and casual dining sectors, we may see more companies use the two-pronged CVA then scheme approach.

Scheme jurisprudence will continue to evolve – with Mr Justice Snowden at the helm no doubt – with hot topics to watch in forthcoming schemes including class composition, fees and jurisdiction.

You can follow *Debtwire*'s scheme coverage with our 2019 Scheme Tracker HERE.

*This interview took place prior to the sanction of **Nyrstar**'s scheme on 26 July (Debtwire coverage HERE) and the convening hearing for Syncreon's scheme on 25 July (Debtwire coverage HERE).*

SCHEMES OF ARRANGEMENT SINCE LAST SUMMER	
Lehman Brothers	Convening hearing: 9-10 May 2018 (Mr Justice Hildyard) Sanction hearing: 13, 15 & 18 June 2018 (Mr Justice Hildyard)
House of Fraser	Convening hearing: 4 July 2018 (Mr Justice Birss) Sanction hearing: 25 July 2018 (Mr Justice Carr)
Noble	Convening hearing: 12, 15 & 16 October 2018 (Mr Justice Snowden) Sanction hearing: 12 November 2018 (Mr Justice Snowden)
Steinhoff	Convening hearing: 24 October 2018 (Mr Justice Zacaroli) Sanction hearing: 12 November 2018 (Mr Justice Marcus Smith)
Agrokor	Convening hearing: 14 February 2019 (Mr Justice Fancourt) Sanction hearing: 28 February 2019 (Mr Justice Fancourt)
New Look	Convening hearing: 2 April 2019 (Mr Justice Marcus Smith) Sanction hearing: 30 April 2019 (Mr Justice Morgan)
Nyrstar	Convening hearing: 4 July 2019 (Mr Justice Norris) Sanction hearing: 26 July 2019 (Mr Justice Norris)
Syncreon	Convening hearing: 25 July 2019 (Mrs Justice Falk)

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