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ARTICLE

When the Waterfalls Dried Up: The Lehman Scheme

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Synopsis

In his judgment sanctioning the scheme of arrangement proposed by LBIE to, among other things, bring an end to the long-running Lehman waterfall litigation and enable the payment of statutory interest, Hildyard J provided an excellent and thoughtful summary of the key legal issues and tests to be considered at both convening and sanctioning stages of a scheme.

Introduction

On 15 June 2018 the High Court sanctioned a scheme of arrangement proposed by Lehman Brothers International (Europe) ('LBIE') (in administration).[1] The scheme was designed to bring to an end the outstanding 'waterfall' and other surplus fund litigation in relation to LBIE that had been running since 2015, provide a mechanism for the payment of statutory interest to creditors and facilitate the wind down of an administration that has now been running for over 10 years. Without the scheme, statutory interest could not have been paid for a number of years due to the ongoing litigation preventing the administrators from distributing the surplus.

Hildyard J handed down a detailed judgment following his sanctioning of the scheme, addressing a number of issues relevant at both the convening and sanction hearing stages.

Schemes of arrangement – a brief refresher

A scheme of arrangement is a statutory procedure under Part 26 of the Companies Act 2006. A scheme allows a company to enter into a compromise or arrangement with some or all of its members or creditors.

Importantly, schemes can be used to 'cram down' dissenting members or creditors (as applicable) within a class. Provided the requisite majority have approved the scheme and it has been sanctioned by the court, it will be binding on all affected members or creditors, whether or not they voted in favour. This means schemes can be used by companies seeking an arrangement which would otherwise require a higher level of consent.

While schemes are not formally insolvency proceedings themselves, creditor schemes are often used where a company is in financial distress or is insolvent, with a view to implementing a restructuring.[2]

While the LBIE scheme is not a classic restructuring scheme, a number of issues that arose at the convening and sanction stages will be relevant for future restructurings, and the judgment provides a helpful recap of some of the key law in this area.

Background to the LBIE scheme

The administrators issued the first waterfall directions application in 2013. This commenced over five years of litigation, leading to uncertainty which prevented the administrators from paying statutory interest to creditors even after payment in full of all proved debts. With appeals before the Court of Appeal and Supreme Court pending, which had the potential to further delay a final resolution, the administrators were keen to achieve a commercial settlement that would deal with all outstanding litigation and provide a mechanism for the payment of statutory interest.

Any commercial settlement would require the support of the two key groups of LBIE's creditors, who each held over 25% in value of senior claims and so would be able to block a proposed scheme of arrangement. These two groups were the Senior Creditor Group, or SCG, an informal group of three funds, and the Wentworth group of entities formed as a joint venture between LBIE's shareholder, LB Holdings Intermediate 2 Limited (in administration) ('LBHI2') and two creditor funds.

The primary purpose of the scheme was to provide a framework to facilitate payment of statutory interest by:

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1 See [2018] EWHC 1980 (Ch).

2 See R. Tett and L. Hingston, 'Schemes of arrangement: Part 1', *Int. C.R.* 2017, 14(2), 90-94.

1. bringing to an end the outstanding waterfall and related proceedings;
2. barring challenges by creditors to the claims of other creditors where these had been admitted by the administrators;
3. providing a process for creditors claiming statutory interest at a rate higher than 8% p.a. on the basis of their cost of funding, with any issues to be resolved by means of an independent expert adjudicator; and
4. releasing LBIE from further claims (save for certain exceptions) through the introduction of a bar date.

Importantly in relation to point 3 above under the Insolvency Rules 1986 and the Insolvency (England & Wales) Rules 2016, a creditor can claim interest at the greater of the rate specified under s. 17 of the Judgments Act 1838 (currently 8% p.a.) or the rate applicable to the debt apart from the administration. The scheme provided for creditors entitled to claim a higher interest rate than 8% to either elect to receive 8% p.a. plus a settlement premium of 2.5% of the value of their claim (the 'settlement option'), or to certify for a higher rate, with this being open to challenge and counter-offer by LBIE.

The scheme was opposed by three creditors appearing at the convening hearing, with others opposing through correspondence at the convening and sanction hearing stages. Hildyard J set out his reasoning for both approving the proposed scheme classes and for sanctioning the scheme in a judgment which provides a helpful recap on existing scheme points and considers points not raised in previous schemes. A summary of some of these points is set out below.

Convening hearing - issues on class composition

Relevance of lock-up agreement

Prior to the launch of the scheme in early 2018, Wentworth and the SCG entered into a lock-up agreement with LBIE under which they agreed not only to support the scheme but also to accept the settlement option (see paragraphs 41 and 42 of the judgment).

Challenging creditors argued that in entering into the lock-up agreement, Wentworth and the SCG had altered their legal rights as against LBIE in such a way as to fracture class composition, on the basis that it was now impossible for them to consult together with other creditors with a view to their common interest. Hildyard J disagreed, and held that essentially pre-selecting from a 'menu' of options offered to scheme creditors in this way did not alter the relevant creditors' legal rights. Committing to exercise rights in a certain way did not affect the existence or nature of those rights.

Fee paid otherwise than by the scheme company

At paragraph 43 of the judgment, Hildyard recounts that

> 'late in the evening on [the day that the practice statement letter had been circulated to creditors], the LBIE Administrators received a letter from LBHI2's administrators which indicated that Wentworth ... and certain members of the Senior Creditor Group had entered into a separate settlement agreement in parallel with the Lock-Up Agreement (the "Settlement Agreement").'

The Settlement Agreement provided that the SCG would receive from Wentworth the sum of £35m by way of a 'consent fee' in the event that the scheme becomes effective (see paragraph 43(2) of the judgment). No similar consent fee was offered to other creditors (see paragraph 43(3)). The LBIE administrators then sent a second practice statement letter referring to and explaining the consent fee, and proposing that the SCG should vote in a separate class in order to avoid a dispute about class composition (see paragraph 43(3) of the judgment).

Hildyard J noted in the judgment that he thought the issue of the fee really went to fairness (and was therefore an issue to be considered at sanction) rather than class composition. However, he noted that 'after the arrangements (to which the Administrators were not party) were revealed, a separate class for the Senior Creditor Group was conceived to be advisable and probably necessary' (paragraph 81). This point may become relevant for future schemes of arrangement where it is envisaged that a fee will be paid by an entity other than the scheme company.

Sub participations

The court had to consider whether debts not legally owned by the SCG but ultimately controlled by them should also be included in the separate SCG class. He held that this was not the case.

Hildyard J reached the view that the fact that the legal owner of a claim may be required to vote in accordance with the instructions of a third party, e.g. a beneficial owner or a sub-participant, is not relevant to class composition as it does not affect the rights of the legal owner as against the scheme company. He also noted that the scheme company's contractual relationship is with its legal creditors, and it would be unworkable to compose classes by reference to the position of third parties who may be able to control the exercise of the legal creditor's voting rights. The involvement of those third parties may be relevant in assessing the fairness of the scheme at sanction, but is not relevant for the purposes of class composition.

Sanction hearing

Three stage test

Hildyard J reaffirmed the three-stage test to be used by the court when deciding whether to sanction a scheme:

1. whether the statutory provisions have been complied with;
2. whether each class was fairly represented at its meeting and whether the majority are coercing the minority in order to promote interests adverse to those of the class whom they purport to represent; and
3. whether the scheme is one which a creditor might reasonably approve.

A fundamental issue in this regard is to distinguish between the legal rights which scheme creditors have against the scheme company, and their separate commercial or other interests or motives (whether or not related to the exercise of those rights).

A major source of opposition to the LBIE scheme was that one of the members of the Wentworth group held the subordinated debt owed by LBIE and therefore had an interest in minimising the amount of statutory interest paid out under the scheme, which was due to be paid in priority to the subordinated debt.

It was argued that the other Wentworth entities, which held senior unsubordinated claims, could not consult as part of a class with other creditors because their interests were aligned with the Wentworth entity which held the subordinated debt and not with the other (non Wentworth) creditors.

Hildyard J considered whether the very close association between the Wentworth entities created a class issue, and whether he should treat each Wentworth entity as having, for the purposes of class composition, cross-holdings and/or the legal rights enjoyed by each other, so that they would have to be moved into a separate class. He held that this was not the case, but noted that it might have been different had evidence been provided that the Wentworth entities were not merely connected but were actually alter egos of each other. He also considered this by analogy with cross-holdings, which have been held to not of themselves fracture class composition.

Was the class fairly represented at the scheme meeting/the 'but for' test

One of the classes of creditors voting on the scheme was the 'Higher Rate class', being those creditors entitled to certify for a rate of statutory interest higher than 8%. This class included the Wentworth entity holding senior claims. With the inclusion of this entity, the class voted in favour of the scheme with the requisite thresholds by number and value. Had the Wentworth entity been excluded from the class, the vote would not have passed the threshold of 75% in value. It was argued by those opposing the scheme that the Wentworth senior creditor voted in favour of the scheme because it was focused on enhancing the payments to the subordinated creditor rather than on its own interests as senior creditor entitled to statutory interest. It was therefore argued that the other 'Higher Rate' creditors were not fairly represented.

Hildyard J held that the fact that the majority creditors (here the Wentworth entities) have a special interest for supporting a scheme does not, without more, entail that the class was not fairly represented. The concern is whether the relevant creditors have a special interest which is *adverse to*, or clashes with, the interests of the class as a whole. A special interest which merely provides an additional reason for supporting the scheme does not undermine the representative nature of the vote.

Hildyard J reiterated his own reasoning in *Apcoa*,[3] that in order to undermine the representative nature of the vote there must be a strong and direct causative (i.e. 'but for') link between the creditor's decision to support the scheme and the creditor's adverse interest, such that it is the creditor's adverse interest which drives its voting decision. In the absence of such link, there is not a sufficient reason to treat the creditor's vote any differently from the remainder of the class.

It may be difficult to distinguish between an adverse interest and an additional one in circumstances where commercial creditors may be expected to have a variety of additional interests which may be in competition, but which are not the dominant causative reason for casting a vote one way or the other. The focus is on whether the special interest in question is the only, or at least the deciding, factor.

Hildyard J noted that he continued to think that with suitable caution or nuance in its application, the 'but for' test may be helpful in conveying the extent to which the special interest must be demonstrated to be an adverse one before the vote of a member of a class at a duly constituted meeting should be discounted or disregarded.

He also held that it is important to recognise that any special advantage as regards a particular right may need to be weighed against the overall benefits of the proposed scheme. The broader interests that members of the class have in common may neutralise or displace any suggestion of a coordinated majority having voted in order to obtain the special interest or advantage.

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3 See [2014] EWHC 3849 (Ch).

Finally, Hildyard J considered the effect if the court were to conclude that a creditor's special interest was the dominant causative reason for it having voted in favour of a proposed scheme. In these circumstances, the court could either discount the weight given to the majority vote, or disregard the votes of 'special interest' creditors altogether. This assessment was not required on the facts as the judge held that the special interest of Wentworth was not adverse to a clashed with the interests of the class as a whole. Although the Wentworth senior creditor had an additional interest of wanting the scheme to pass because it could mean increased recoveries on the subordinated debt held by another Wentworth entity, its main purpose in voting in favour of the scheme was that of a normal creditor wanting to get paid statutory interest now rather than waiting a number of years for the litigation to finally conclude.

Jurisdiction

Hildyard J considered the question of jurisdiction and whether the scheme would fall within the Recast Judgments Regulation[4] (assuming it to be applicable).

There was a concern that the application of Article 8 might be subject to Article 25(1), which would prevent the scheme from affecting creditors whose claims arose under finance documents with exclusive jurisdiction provisions in favour of the courts of another member state. In particular, Hildyard J questioned whether the scheme could properly be treated as falling within a contractual jurisdiction clause for the purposes of Article 25(1), given that the primary purpose of the scheme was to facilitate the payment of statutory interest under the English insolvency regime.

Ultimately, he relied on Article 26(1), which provides that a court of a Member State where a defendant enters an appearance shall have jurisdiction. Creditors having lodged proofs of debt in LBIE's administration had submitted to the jurisdiction of the English court for the entire insolvency process. He held that the scheme should be viewed as part of the administration procedure, and therefore any creditor having lodged a proof of debt had entered an appearance for the purposes of Article 26(1).

Other points of interest

Bar date

The scheme imposed a bar date for the submission of claims, which of itself is not uncommon. Unconventionally, however, the bar date was fixed as the date on which the scheme became effective, rather than a few days or weeks later as is more common.

This was justified in the context of the unusual facts of the scheme (taking place in an administration running for nearly 10 years, where creditors were first invited to prove for their claims in December 2009). Caution should therefore be exercised before relying upon the LBIE scheme as a precedent for fixing a bar date on the scheme effective date.

'Compromise or arrangement'

One of the arguments made by a creditor opposing the scheme was that the scheme did not in reality involve any compromise or arrangement, because creditors were not receiving any additional benefit as a result of it. However, Hildyard J dismissed this, confirming that the terms 'compromise' and 'arrangement' have been construed widely by the courts. All that is required is a sequence of steps involving some element of give and take, rather than merely surrender or forfeiture.

Commentary

As mentioned above, Hildyard J provides a careful and thorough restatement and analysis of the legal tests to be considered at both the convening and sanction hearings in relation to a proposed scheme of arrangement.

Hildyard J went to great lengths to ensure the court was not acting as a rubber stamp on a scheme which had both huge commercial support behind it but was equally challenged by some creditors. The court made clear that it would need to be genuinely satisfied that the scheme was fair and appropriate for it to be sanctioned. In doing so, Hildyard J has produced a judgment that serves as a useful summary of the existing law, and will undoubtedly become one of the 'go to' cases for restructuring lawyers looking for clear guidance on the relevant principles.

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International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

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