Ep. 45: Creditors' Fees and English Law Schemes of Arrangement

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Jose Garriga: Hello, and welcome to *OnAir with Akin Gump*. I'm your host, Jose Garriga.

We have with us today Akin Gump London-based financial restructuring partners Lois Deasey and Liz Osborne for a conversation in which they'll be offering an overview of creditors' fees related to English law schemes of arrangement.

Welcome to the podcast.

Liz, Lois, thank you both for making the time to appear on the show today. Over to you.

Liz Osborne: Hi, everyone. Thank you very much for taking the time to listen to this podcast. As Jose said, today, Lois and I will be talking about the fees payable to creditors as part of restructurings and how this needs to be thought about in the context of schemes of arrangement. As many of you will know, schemes continue to be the tool of choice in U.K. and cross-border restructurings. In particular, since the start of the COVID-19 pandemic, we have seen a steady stream of cases in the English courts, and we expect that to continue.

One issue we have seen coming up more and more in recent years in some of the more-complex financial restructurings are fees being paid to creditors as part of scheme transactions, and recent case law shows that the courts are placing significant judicial focus on the payments that are made to creditors. Therefore, in the next 20 minutes or so, we wanted to provide you with a roundup of the different types of fees we are seeing being paid to creditors and consider how the court is approaching the class and fairness issues that these fees may raise.

Lois Deasey: That's right. And listeners will probably be aware that, last year, the U.K. Corporate Insolvency and Governance Act of 2020 introduced the so-called restructuring plan into U.K. law. And we've already seen a number of cases coming through under the new law. For example, Pizza Express, Virgin, Deep Ocean, Gategroup and Premier Oil. These cases show that the courts are likely to draw on a vast body of scheme case law when hearing restructuring plan applications, and, so, our expectation is that generally

speaking, what we say today in respect of schemes should broadly apply to restructuring cases too.

And whilst we are focusing today on lockup fees, work fees and backstop fees in particular, there are other fees that are frequently paid on schemes, for example, the payment of creditors' advisors fees. And with that, Liz, shall we recap briefly on the tests for classes under English law? This is relevant when we consider whether fees payable in restructuring could potentially fracture the class.

Liz Osborne: Sure. Thanks, Lois. And look, as listeners probably know, a key part of the scheme process is a convening hearing at which the court will consider the appropriate classes of creditors for the purposes of voting on the scheme. In a scheme, creditors representing at least 75 percent by value and a majority in number of each class must vote in favor of the proposals. This is in distinction to the new restructuring plan or a chapter 11, for example, which do permit cross-class cramdown. There is, therefore, an obvious benefit to minimizing the number of classes in a scheme, and the court will be alive to the risk of classes proliferating, as this could create a veto right for a minority.

In order to determine classes, the court will ask the following question: Are creditors' rights so dissimilar as to make it impossible for them to consult together with a view to their common interests? And if so, those creditors would need to form separate classes and vote separately. If not, they can fall in the same class and vote together. There are a couple of key points that we should all remember here. Firstly, the test is looking at what are the creditors' legal rights against the debtor, not what their commercial interests are. Interests are just not relevant to the class test.

Secondly, rights do not need to be identical in order for creditors to be in the same class, and the test is, therefore, somewhat flexible. Indeed, creditors with different interest rates, different debt instruments, or even different types of claims, for example, actual or contingent claims, could all be put in the same scheme class. As well as analyzing what creditors' existing rights are, the court will also consider what their rights would be in the so-called comparator. Now, the comparator is the circumstance most likely to occur if a scheme is not sanctioned. That oftentimes will be an insolvency of the debtor, but it's not always the case.

Assuming that the requisite majority of each class has approved the scheme at a creditor meeting or meetings, there is then a sanction hearing at which the court will decide whether to exercise its discretion to sanction the scheme. And, of course, this is not a rubber-stamping process, and even if creditors have approved the deal, it remains open to the court to refuse to sanction the scheme. In particular, the court will need to be satisfied that the statutory requirements have been complied with, but also that the scheme is fair.

And in terms of fairness, the court will be principally focused on two things. Firstly, was each class fairly represented at the meeting, and were creditors acting in good faith in voting for the scheme as a member of their class? And second, is the scheme one that an intelligent and honest member of the class acting in their own interests might reasonably approve?

Okay. That's a bit of background just recapping on schemes and how classes are determined and how the court will consider fairness at a sanction hearing. Having done that background, Lois, should we move on to look at how different types of fees are

considered from the class and fairness perspective? How about we start with lockup fees? Lois, would you like to give a quick summary of what they are?

Lois Deasey: Sure. As listeners may know, it's customary that the debtor will seek to enter into lockup agreements with a number of its creditors before launching the scheme. That's so that the debtor has a high degree of certainty that creditors will vote in favor of the deal at the meetings and that the time and expense of preparing for a scheme will not have been in vain. The lockup agreement typically provides that creditors who sign it agree to vote in favor of the scheme and to support a broader restructuring transaction. The lockup may also provide waivers and forbearances that the debtor may require under its existing debt documents.

Often the debtor will offer a fee for creditors to sign the lockup or to sign it within a particular period of time, as a so-called "early bird fee." Depending on the commercial context, lockup fees may be paid in cash or by issuing equity, as was the case on the Syncreon scheme, or even by issuing new senior notes post-closing, as in the schemes for Hema and Petra Diamonds. Lockup fees have been a feature of schemes for many years, and the law in this area is relatively well settled. While the fees are usually paid before the scheme is even launched, and, therefore, collateral to the scheme rather than a term of the scheme itself, the court will consider class and fairness implications at the convening and sanction hearing.

Liz Osborne: Thanks, Lois. That's right. When it comes to lockup fees, the thing the court will be most focused on is whether or not the fees have been offered to all creditors, which is likely to be the case, because the debtor's intention will be to seek to obtain as many signatures to the lockup as it can. And the courts have consistently found that, where the lockup fee is offered to all creditors, the fact that some of those creditors did not, in fact, sign up to the lockup and receive the fee should not in and of itself fracture the class, as all creditors had the same entitlement to the fee.

It is typical for lockup fees to be calculated as a percentage of a creditor's debts claim, and these fees tend to be relatively low in percentage terms. Debtors will usually stick to something like 1 or 2 percent in terms of the size of the lockup fee. The rationale for paying a modest fee, aside from the cost or liquidity implications for some debtors if the fees were higher, is to avoid the implication that a creditor is committing to vote for a scheme in circumstances where, if not for the fee, it would not do so, or it would not be in that creditor's commercial interest.

That is relevant to the sanction hearing, as it could give rise to a question around the fairness of the scheme, if a creditor was seen to have voted for a deal simply in order to receive a large consent fee, rather than because it was a deal that it made good sense to support. The courts often test this by looking at whether creditors who have not received the fee voted in favor of the scheme. For example, on the FESCO scheme, the court noted the 26 other creditors who had not entered into a lockup agreement nevertheless approved the scheme at the meeting. So, when it comes to lockup fees, practice has developed that the court is generally comfortable with. Lois, let's move on to talk about work fees, because these have proved more controversial. Can you start off by explaining what a work fee is?

Lois Deasey: Of course. Work fees are a relatively new feature of schemes in the U.K. market, I would say. They are fees that are paid to creditors who take on a lead role in the restructuring, and the fee is to compensate them for the investment of their time and resources into the transaction. I think, as restructurings at the top end of the market have become

increasingly complex and protracted, we have seen a shift in the expectations of some creditors, usually those who represent the ad hoc group, as to the compensation that they receive for their time in negotiating a deal which is really for the benefit of all stakeholders and the debtor.

Ad hoc groups also want to be properly compensated for agreeing to be provided with inside information and restricted from trading for a period while a deal is agreed. We saw an example of that on the recent Petra Diamonds scheme, where the ad hoc committee received a fee of 1 percent of their face amount of debt as compensation effectively for the inability to trade whilst negotiating a restructuring deal.

Liz Osborne: Got it. And why have the fees been such a focus for judges, then, in recent cases?

Lois Deasey: Well, for one thing, the aggregate amount of these fees in simple monetary terms has appeared high at first blush. So, for example, in KCA Deutag's scheme last year, the aggregate amount of the work fee was over $23 million. And in the Noble scheme, the work fee was around $36 million. Now, those sorts of amounts will naturally get the court's attention, and they may be a source of complaints from dissenting creditors too, as was the case in the KCA scheme. More broadly, though, as the judge in that case put it, and I quote from the judgment, "Work fees are naturally susceptible to characterizations as disguised consideration for an agreement by the recipients to the rearrangement of its rights in accordance with the terms of the scheme. Where their receipt is limited to the small group of influential creditors involved in the design and formulation of the arrangement to the exclusion of other members of the same class, there are real grounds for concern."

And those comments are echoed by the judge, I think, in the 2020 Codere scheme, who also noted that the payments of work fees could, at least in principle, fracture a class. Part of the issue is that these fees are, by definition, not offered to all scheme creditors. And as with the lockup fees, there is at least a risk that a large fee creates a fairness issue, if it can be shown that creditors receiving the fee are voting in favor of the scheme to obtain the work fee, rather than as a member of the class approving a broader restructuring. But again, that's backdrop. We thought it would be helpful to spend some time summarizing how the courts have analyzed work fees. Liz, do you want to go through some of the courts' points on that?

Liz Osborne: Sure. Thanks, Lois. Okay. Looking at the recent cases, we can see that the courts have placed emphasis on some or all of the following factors. First, the work fee should be a reflection of the work by creditors towards negotiating the transaction. This does not mean that creditors need to record their time like a professional advisor would, but being able to demonstrate and link between the work done or time spent and the amount of the fee is going to be important evidentially. This was a particular focus for Mr. Justice Snowden in Global Garden Products and Noble and was echoed in the KCA scheme. Courts may well also want to hear evidence on whether the work fee was the subject of negotiation and whether it is in line with comparable cases.

Second, as the fee is paid for work done, payment of the work fee should not be linked to, or conditional upon, the creditors' approval of the scheme or the wider success of the restructuring. In practice, this means that particular attention needs to be paid to when the fee is payable and when it is actually paid. Where the fee is not tied to a positive vote in the scheme, the courts have said that the fee is unlikely to fracture the class. Third, the quantum of the work fee as a proportion of the total amount of debt held by the creditors receiving it should be relatively modest. And, again, a figure something like 1 to

2 percent of the debt held by the relevant creditors seems to be gaining traction within the market.

Finally, as with lockup fees, the court will consider whether a creditor's entitlement to a work fee would be likely to have any material influence on that creditor's consideration of the benefits of the scheme. Again, the court is likely to test that by seeking evidence on how many creditors not entitled to the work fee nevertheless approve the transaction.

Alright, I think that probably covers work fees. Should we move on now to the final category of fees that we are going to focus on, and these are backstop fees. Again, Lois, why don't you talk us through what these fees are for?

Lois Deasey: Sure, Liz. These are fees that are paid to lenders who agree to underwrite or backstop new financing to the debtor. This is a fairly common feature of restructurings at the moment, given how many companies have been experiencing increased liquidity needs due to the pandemic. The opportunity to participate in lending the new money is usually offered to all creditors in order to avoid splitting creditors into separate classes. That's because agreeing to provide new money often carries with it preferred terms to any existing debt. For example, new money is usually given some form of priority, whether it's structural or contractual, to the existing debt. It's, therefore, typical for scheme creditors to be offered the opportunity to participate in the new money pro rata to their existing debt positions. And as we've already seen, giving them the right to participate is what matters here. The fact that some lenders do not, in fact, subscribe to provide their share of the new money should not fracture the class.

However, before it launches a scheme, the debtor will need to know that it's able to raise the full amount of the new money facility, as the success of the new money raised is usually likely to be integral to the overall viability of the restructuring. To achieve that certainty, the debtor will often seek to have the new facility backstopped. So, a group of lenders will agree, contractually, with the debtor that they will between them fund the full amount of the facility in the event that not all scheme creditors later subscribe for their pro rata share of the new money as part of the deal.

Backstop lenders usually agree to do so at a price. That could be cash compensation or compensation in some other form, for example, increased scheme consideration or being granted a priority or elevated claim in the restructured group. But the practical problem is that the debtor will need a group of backstop lenders signed up at a point in time where it may not have launched the deal to the general body of creditors, and, so, it's usually the case that not all creditors can be given the right to participate in the backstop arrangements. And as we've seen already, that then leads to the question as to whether or not the backstop lenders should form a separate class to the non-backstop lenders, or whether there are any fairness concerns with the backstop arrangements.

Liz Osborne: Great. Thanks, Lois. That's a good background as to where these backstop fees arise and the context in which they come up on restructurings, and, in particular, thinking about them in a scheme context. I know this was something that you spent a lot of time thinking about on the Noble case, and there were some quite interesting points which came up on that. Would you mind just spending a bit of time talking us all through what you did on Noble and the points that came up particularly on the Noble scheme of arrangement?

Lois Deasey: First, we had a group of members in an ad hoc committee who committed to fund their pro rata share amongst them of the entire new trade finance facility in that case. Then,

once the deal was announced, all other financial creditors were offered the opportunity to come into the backstop arrangement and take up their pro rata piece. Finally, all scheme creditors, as part of the scheme, a month later were offered the opportunity to participate in the new money by making election through the scheme. And that was even if they didn't want to be a backstop lender at the earliest stage in the deal.

Now, the ad hoc group were paid a fee of 3 percent of their backstop commitment, and the wider group of financial creditors who backstopped on the second round were entitled to a lower fee of 2 percent of their commitment. So, that's one feature of the Noble scheme, a sort of double backstop arrangement.

The other interesting aspect of the deal was that, in addition to participating in the new money, whether as a scheme creditor or as a backstop lender, by participating in the new money, creditors were entitled to an elevated claim in the restructured group. So, by being a new money lender, they were able to exchange their old debt for new, structurally senior bonds. Now, the court looked at these arrangements and was satisfied that the backstop did not fracture the class or prevent the scheme being sanctioned on fairness grounds.

And in reaching this conclusion, the court focused on a number of elements that it's probably helpful for me to just summarize now. Firstly, the fees and the increased elevation were found to compensate the backstop lenders for their commitment to underwrite the new money in circumstances where not all scheme creditors would be willing to provide that financing. So, the 3 percent payable to the initial lenders for their commitment was to compensate those creditors for their early commitment to underwriting a full facility at a time when the lockup agreement had only just been announced, and it was very uncertain as to whether any other backstop lenders would subsequently come in and take up their pro rata share. And the court was satisfied that that was a commercial arrangement and risk they were taking and, therefore, were entitled to be compensated for.

The second point is that the size of the backstop fees were held to be *de minimis* relative to the total claims of creditors, which were in the billions in aggregate. Thirdly, the fees were found to be in line with market comparisons for underwriting on similar cases, and the court was satisfied that Noble would have been unlikely to obtain underwriting from a third party on equivalent terms in the market at that time and in the time available to it.

The fourth point was that the comparator in that case was an insolvent liquidation, and it was, therefore, very unlikely that any of the backstop creditors would have been persuaded to vote in favor of the scheme purely by virtue of their entitlement to backstop fees. In other words, the court was satisfied it did not impact their decision to vote in favor of the scheme as a member of their class and considering their interests within that class.

And the final point is that all scheme creditors were offered a proportionate right to participate in the new money, and, consequently, they received their share of elevated debt. That was not just for the backstop lenders. The fact that some lenders were ultimately unable or unwilling to do so was actually really more a result of their individual situations and commercial interests rather than any difference in their legal rights, and, therefore, the court was satisfied that it did not fracture the class.

I think one other point that's worth noting to listeners is that, whilst Mr. Justice Snowden in the case concluded that the class had not been fractured, he did pay very close

attention to the amount of time that creditors had been given to make a decision as to whether or not to lend the new money or backstop it. The implication is that if creditors are not given sufficient time to take up a legal right, the court may take a different view as to whether or not the arrangements are fair or give rise to class concerns.

Liz Osborne: Thanks, Lois. I think it's fair to say that courts since Noble have adopted a similar approach when considering backstop fees. So, in Syncreon, Hertz and Petra Diamonds, the courts focused on the fact that the fees were on arm's-length commercial terms and were not payable to scheme creditors in that capacity, but rather for providing a source of liquidity. In Codere's 2020 scheme, which was unsuccessfully challenged by a dissenting creditor, including on the basis of the various fees paid to the ad hoc committee in that case, the court was persuaded that the backstop fee did not fracture the class and was, indeed, payable for a commercial service. And in that regard, Mr. Justice Falk noted the fact that one member of the ad hoc group did not participate in the backstop arrangements, and this provided further support for the proposition that the fee was at a commercial rate.

I think, Lois, we should also note as a general remark that not all cases would involve the payment of all of the fees that we have discussed today. But it is important to bear in mind the comments of the judge in Codere's 2015 scheme, which were echoed by the judge in the later Codere scheme in 2020, and that is the point that it is important to assess fees on a cumulative basis rather than looking at the impact of each individual fee in isolation. So, in both Noble and Codere, the court called for further evidence at the hearings, and actually that resulted in adjournment to the different scheme hearings in those cases in order to have all the information the court considered it needed to make an assessment as to the cumulative effects of the fees in question. And I think, in short, the takeaway really is that the court will be focused on seeing the overall picture.

Lois Deasey: I think that's right, Liz, and I think another couple of points that I would highlight. First, in all of these cases where the fees are being paid, it's really crucial to think about structure and the commercial impact of the fees with legal and financial advisors in the early planning stages. And secondly, preparation of the sound financial evidence that's needed to underpin these legal arguments really does matter. It needs to be clear to creditors and the court the basis upon which the debtor is paying these fees and to whom and when. The court has shown it's prepared to send debtors away to provide that additional evidence if necessary on the day, even if that results in delays to the transaction. And that's been again demonstrated very recently in the Port Finance scheme, where the judge called for further witness statements to be given on the structure and payment of certain fees in connection with that scheme.

Liz Osborne: Indeed. Okay, well look, I think that's all we have time for today. Thank you, Lois, and thank you to everyone who is listening to this podcast as well. We do hope that you have found it useful, and, obviously, if you have any questions, please don't hesitate to get in touch with one of the Akin team. Thanks, everyone. Bye.

Jose Garriga: Thank you. Listeners, you've been listening to Akin Gump financial restructuring partners Lois Deasey and Liz Osborne. Thanks to you both for appearing on the show to share your thinking on this topic with listeners.

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Until next time.

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