STEPHENSON HARWOOD

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Who is the creditor in a bond restructuring?

Introduction

Towards the end of 2020, while businesses were reeling from the challenges of grappling with a global pandemic, the end of the Brexit transition period and LIBOR transition, the Law Commission published a paper analysing the current law underlying intermediated securities – Intermediated securities: who owns your shares? A Scoping Paper.

Given the other rather more obvious priorities during 2020, it may be tempting to see the publication of this paper as being equivalent to Nero fiddling while Rome burned. However, the legal issues and problems which this Law Commission scoping paper explores are likely to become highly relevant when the economic consequences of the events of the Covid-19 global pandemic start to play out. It seems inevitable that when the current government-backed support measures for businesses start to be withdrawn there will be a marked increase in insolvencies, restructurings and general corporate distress.

Difficult issues of law often have to be tackled and new law commonly emerges from insolvency and distress. It is surely no coincidence that some key legal developments in the area of intermediated securities resulted from the *Lehman* litigation following the global financial crisis.

Therefore, as the economic climate chills, it seems inevitable that some of the problems, uncertainties and issues this Law Commission scoping paper raises will be brought before and settled by the courts.

Who is the noteholder?

In our October 2019 thought piece "Who is the noteholder? Confusion between the law and practice" we flagged that it can be surprisingly difficult to answer the question "*who is the noteholder?*" when dealing with intermediated debt securities.

In our article, we discussed court decisions[1] in line with the "*no look through*" principle. This principle confines an ultimate investor's ability to sue anyone in an intermediated securities chain to their immediate intermediary. It is consistent with trust law, under which there is a general rule that a beneficiary of a sub-trust may not have recourse against the head trustee. In *Re Lehman Brothers International (Europe) (in administration)* [2] the court categorised the legal nature of an intermediated securities chain as a series of trusts and sub-trusts.

We also flagged in our earlier article that this principle can present particular challenges for a note trustee, who owes its fiduciary duties to the noteholders as a class and who will often see this duty as being owed to those with the ultimate beneficial interest in the notes, rather than to the financial institutions fulfilling mechanistic roles in an intermediary chain.

The Law Commission scoping paper looks in some detail at the "*no look through*" principle in the context of intermediated securities. The conclusion reached appears to be that the "*no look through*" principle cannot and should not be swept away – it is an inherent part of the UK trust and contract law system and provides certainty, as it means that each party in the intermediary chain is certain of its rights and obligations in contract or trust law to each other party.

The Law Commission has nonetheless discussed some discrete changes which could be made to improve the position for ultimate investors. These include a review of legislation (such as the Companies Act 2006 and the Financial Services and Markets Act 2000) to identify provisions where it is clear there was no conscious intention to strip away

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[1] For example, ***Secure Capital SA v Credit Suisse AG*** [2015] EWHC 388 (Comm), 24 February 2015 and [2017] EWCA Civ 1486, 6 October 2017 and ***Business Mortgage Finance 6 Plc v Greencoat Investment Limited & others*** [2019] EWHC 2128 (Ch).
[2] [2012] EWHC 2887 (Ch).

rights of ultimate investors who happen to hold their investments in an intermediated structure, but where this has been the effect.

The Law Commission scoping paper does not tackle directly the specific issues for corporate trustees which we identified in our October 2019 article, or address the fundamental problem that it serves to disenfranchise the ultimate investors who bear all the economic risk. The Law Commission scoping paper is nonetheless useful to acknowledge, in clear terms, the legal problems which intermediated holding structures of all kinds can present. This may well lead to a greater appreciation of the issues involved, and consequently a greater likelihood of the issues being explored before the courts in the future. However, it seems clear there will be no fundamental changes to the status quo in the short term.

Who is the creditor in a bond restructuring?

Another area significantly complicated by the existence of intermediated holding arrangements is voting on certain court-based restructuring and insolvency processes.

A whole chapter of the Law Commission's scoping paper is dedicated to voting on schemes of arrangement.

What is a scheme of arrangement?

A scheme of arrangement is a binding compromise between a company and its creditors or members. A creature of company, rather than insolvency, law, the scheme of arrangement has long been a key part of a restructuring lawyer's toolkit.

A scheme of arrangement must be approved by a meeting of creditors or members and sanctioned by the court under section 899 of the Companies Act 2006.

Before sanctioning a scheme, the court will require there to be approval by a majority in number of the creditors or members (or class of creditors or members) – known as the "***headcount***" test. The court will also require approval by 75% in value of the creditors or members (or class of creditors or members) – known as the "***majority in value***" test.

Who should vote on a scheme in an intermediated note issue?

In a note issue, frequently there will have been only one permanent global note issued (held by the common depositary), and each ultimate investor will hold his or her notes through a chain of intermediaries. Furthermore, the note trustee will be the legal creditor of the covenant to pay.

Consequently, it can be less than clear who should be voting on the scheme or arrangement as the relevant scheme creditor(s). This issue is not helped by the fact the term "creditor" is not defined in the Companies Act 2006.

Should it be the common depositary as the "holder" of the permanent global note? This is not practical as there is no mechanism by which the noteholders could instruct the common depositary to take this kind of action (and it would have no legal or practical incentive to do so).

Should it be the note trustee as the legal creditor of the covenant to pay, in reliance on one or more extraordinary resolutions of noteholders? This is more logical, but there are various obstacles:

- Many trust deeds only empower noteholder meetings to authorise a trustee to vote in favour of proposals to compromise the debt. How can the views of dissenters be represented in any vote on the scheme?
- Even if mechanisms are put in place to empower the note trustee to represent dissenters and vote against (not just for) scheme proposals, there are still problems to overcome. If a single corporate trustee is representing its beneficiaries and casting the votes, how can the headcount test be satisfied? Furthermore, if a single corporate trustee were to vote some securities one way and others the opposite way, how do you address the issue that some of the votes may cancel each other out?

We grappled with these (and many more) scheme-related issues for our corporate trust clients during a number of restructurings in the 1990s and early 2000s. It is possible (albeit complicated and involving a number of enabling steps) to structure voting arrangements so that the corporate trustee can vote on a scheme in a manner which represents the wishes of the underlying investors and does not trigger the issues discussed above. We represented the bond trustees when this was done in the British Energy restructuring, and in Barings before that.

The other logical alternative is to find a way of empowering the ultimate investors to vote on the scheme directly. We also represented the bond trustee in the Marconi scheme of arrangement which broke new ground in this regard. The right in the relevant note documentation for noteholders to call for the issue of "definitive" notes in certain circumstances was relied upon to justify the issue of new individual instruments which enabled and entitled the ultimate investors to vote on the scheme directly.

In all cases, complex instruction mechanics will need to be in place throughout the intermediary chain to ensure that, regardless of whoever ultimately casts the scheme vote, the instructions of the ultimate investors can flow up the chain and be reflected in the votes cast. This can also be important in connection with the compromise of claims.

Since the ground-breaking restructurings of the early 2000s, it has become much more common for ultimate investors to vote directly on schemes. It is clear from a number of court decisions that, where the note documents enable the global note to be "definitivised" (such that individual notes can be issued in paper form to the entitled noteholders – usually upon the occurrence of certain adverse events), this has been relied upon to justify treating the ultimate investors as "contingent creditors" of the company and therefore "creditors" for the purposes of voting on the scheme under the Companies Act 2006.

However, this is not a perfect fix. Even where such a right is included (and it is drafted in a way which engages the analysis), the contingent creditor argument has not yet been fully tested before the courts. Furthermore, academics have noted that the very nature of the contingency being relied upon to allow the analysis that ultimate noteholders are "contingent creditors" raises some difficult legal issues.

In short, while it is now common for ultimate investors to vote directly on a scheme as "contingent creditors", the current solution is not a panacea. It has been arrived at in the interests of pragmatism and policy, rather than being a solution which strictly adheres to legal principles.

As financial products and transactions have become more highly structured, this inevitably also adds to the complexity of any analysis of who is entitled to vote on a scheme of arrangement. The Law Commission scoping paper specifically references the 2015 case of *Re Public Joint-Stock Company Commercial Bank "Privatbank"*[3], explaining that in the Privatbank scheme of arrangement the transaction had been structured such that Privatbank was not the issuer of the relevant notes. Therefore, the noteholders were not, absent other arrangements being put in place, "creditors" of Privatbank. In this particular case, the noteholders were in fact entitled to vote on a proposed scheme of arrangement as contingent creditors of Privatbank specifically because particular steps had been taken. These included Privatbank giving the noteholders an express right of direct recourse against the company in certain circumstances, and Privatbank entering into a deed poll creating direct liability to the noteholders.

In the context of the problems faced by ultimate investors when voting on schemes of arrangement, the Law Commission scoping paper discusses the possibility of removing the headcount test from the scheme of arrangement. This would mean that the court could sanction a scheme where there has simply been approval by a number representing 75% in value of the members or creditors of the company. Removal of the headcount test would appear to be eminently sensible, given the problems it creates. The court retains an inherent and unfettered discretion when considering whether to sanction a scheme anyway, which provides a credible alternative source of protection for small creditors and members.

However, when dealing with intermediated debt securities, removal of the headcount test does not address the fundamental question of who is the creditor entitled to vote on the scheme in the first place. Therefore, unless the "contingent creditor" fix is (and continues to be) available to justify voting on a scheme by the ultimate investors, this will continue to be an issue to grapple with.

The new restructuring plan

In July 2020, the Corporate Insolvency and Governance Act 2020 introduced into Part 26 of the Companies Act 2006 a new restructuring plan for a company in financial difficulties which affect its ability to carry on business.

This article on the Corporate Insolvency and Governance Act 2020 (published on the TACT website and which we co-authored with Abigail Holladay of Ocorian) discussed the restructuring plan and issues for corporate trustees to be aware of.

In particular, there are some key differences between the new restructuring plan and the scheme of arrangement:

- the restructuring plan has no "headcount" test - the restructuring plan must only satisfy the majority in value test;
- the restructuring plan includes a "cross-class cram-down" (addressing a problem often encountered in schemes of arrangement, where one class of creditors or members can cause the scheme to fail); and

[3] [2015] EWHC 3299 (Ch).

- there are two distress-related pre-conditions which need to be met before a restructuring plan can be proposed.

However, notwithstanding these important changes, the genesis of the restructuring plan is very clearly the existing scheme of arrangement. Indications to date are also that the courts are applying the existing body of case law which has developed for schemes of arrangement to restructuring plans wherever this is relevant and appropriate.

Therefore, in the context of intermediated debt securities, it seems likely that the same analysis will need to be run for a restructuring plan as it is currently for a scheme of arrangement when deciding who the creditor is for voting purposes.

CVAs

Unlike a scheme of arrangement and the new restructuring plan (which are creatures of company law), a company voluntary arrangement ("**CVA**") is a process under the Insolvency Act 1986. However, in common with the scheme and the restructuring plan, the aim of a CVA is to prevent the company's insolvency by enabling a binding compromise or arrangement to be made with certain of its creditors.

Importantly, a CVA is not capable of affecting the rights of *secured* creditors unless they agree to the proposals, which is obviously a significant disadvantage of a CVA over the scheme of arrangement and the restructuring plan.

A CVA must be approved by 75% by value of the relevant creditors and more than 50% by value of creditors "unconnected" to the company must vote in favour of it. The latter test ensures that approval of a CVA proposal cannot be achieved without the approval of a majority of third party creditors. In both cases, the majorities relate to those present and voting. However, if the requisite majorities vote in favour, the CVA binds all creditors entitled to vote.

Unlike a scheme of arrangement, a CVA does not suffer from the problematic "headcount" test. However, CVAs are not regularly used to compromise unsecured bond debt. Where we have acted for the bond trustee in transactions involving CVA proposals, typically a contingent creditor analysis is also relied upon to enable direct voting by the bondholders. However, for the reasons set out above for schemes of arrangement and restructuring plans, this remains a somewhat uneasy analysis to operate for intermediated debt securities.

Conclusion

The Law Commission scoping paper has served to shine a spotlight onto a number of the legal uncertainties and difficulties which bedevil intermediated debt securities, including in the context of schemes of arrangement (and probably the other court-based bond restructuring devices too).

In a climate of increasing distress, it seems inevitable that corporate trustees and their advisers will need to grapple with a number of these difficult issues in the coming months.

Authors

Charlotte Drake
Professional support lawyer

T: +44 20 7809 2583

E: charlotte.drake@shlegal.com

Jayesh Patel
Partner

T: +44 20 7809 2238

E: jayesh.patel@shlegal.com

Other contacts

Jonathan Proctor
Partner

T: +44 20 7809 2207

E: jonathan.proctor@shlegal.com

Jeremy Grant
Partner

T: +33 1 44 15 82 69

E: jeremy.grant@shlegal.com

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