Lehman Brothers fallout

Louise Verrill and Sonya Van de Graaff overview some of the imaginative uses of current insolvency and Company legislation since the insolvency of Lehman Brothers

The insolvency of Lehman Brothers presaged a dramatic collapse of the global economy. This had a major effect on debt and equity holders. Nearly overnight, the global economy went into freefall, causing liquidity in the markets to dry up. The tsunami effect of Lehman caused the most obvious and painful effect on global trade, especially in the financial investment, banking and regulatory arenas.

These events resulted in dramatic measures by the UK Govern ment to try to create stability, through new legislation and regulation. In turn this has led to imaginative uses of current Insolvency and Company legislation.

In conjunction with this, we have seen the introduction of new Banking legislation allowing for the nationalisation of banks and the splitting of banks into "good" and "bad' banks with the side pocketing of toxic assets and debt.

There has been intense debate regarding the breach of contractual terms by a financial institution and the introduction of a new LMA Practice code. With this new legislation and the dramatic events of the last two years, restructuring litigators have been busy. Trying to select some key issues and events from the plethora of developments is very difficult. There have been so many which cannot be covered within the word constraints of this piece. The methods of restructuring debt

LOUISE VERRILL
Brown Rudnick LLP

SONYA VAN DE GRAAFF
Brown Rudnick LLP

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under the new Banking legislation, of applying the UK Insolvency and Company legislation, the interpretation of key contractual terms breached by a financial institution, namely the Lehman entities, are a few of the major challenges that the restructuring industry has had to wrestle with over the last year and a half.

Scheme of Arrangement ('Scheme')

A crash of asset values, unsustainable balance sheets, a growth in multi-judicial corporate structures and in layers of debt have resulted in complex restructurings. Restructuring players have been attracted to the UK insolvency regime, which has features not readily available elsewhere, in particular, the use of a Scheme to compromise stakeholder interests. This includes the following features:

1) Cramming down stakeholder rights through the class principle where each class of stakeholder votes within their own class.
2) Up to 25% of dissenting stakeholders in each class may be crammed down.
3) Only those stakeholders who are affected by the Scheme and have an economic interest need be consulted.

There were several notable cases in 2009, in which the cost of sidelining stakeholders has taken a new dimension. These included:

1. *In the Matter Of Castle Holdco 4 Ltd & 10 Ors* [2009] EWHC 1347 (Ch) ("Countrywide"). The court sanctioned a Scheme whereby the existing rights of fixed rate noteholders were replaced by a mixture of debt and equity, in the form of new notes and new equity consisting of 35% of the new increased equity in Countrywide, after a fresh subscription. In contrast, the senior noteholders would not receive any replacement debt, and gave up their existing rights in return solely for 5% of the new increased equity in Countrywide. The increased equity was to be achieved through a share subscription, with a facility for an additional share offering. In addition, existing shares held in Countrywide by another of the overseas companies were to be cancelled, and inter-company debts owed by Castle 4 and the subsidiaries to any superior holding companies released.

2. Another Scheme that utilised a debt for equity swap was Crest Nicholson. Here the senior debt was reduced from £1.1 billion to £620 million in exchange for 90% equity in the company. The remaining 10% went to the management, leaving the mezzanine out of the money as they were deemed to have no economic interest.

3. In the case of McCarthy and Stone, following a valuation, the value of the company was found to be less than the total senior debt, and the second lien and the mezzanine were deemed to have no realistic prospect of recovery. Utilising a Scheme and an administration process, followed by a prepack, the company's assets and part of the senior debt were transferred to a NewCo. The senior creditors entered into a debt for equity swap with NewCo, taking 100% of the new company's equity. This left the second lien and the mezzanine to prove against the old company, which was now a shell. There were market rumours that the valuation would be challenged by those disadvantaged by the cram down.

4. Valuation is the key issue as to whether a stakeholder class is "in the money" or "out of the money." In the case of *Bluebook Ltd: re IMO (UK) Ltd* [2009] EWHC 2114 (Ch), which was a combination of a Scheme, administration and a prepack, the senior debt compromised part of the senior debt novated to the NewCo. The court sanctioned the Scheme as it deemed that mezzanine creditors were excluded from participation and receiving any benefit under the Scheme as they were "out of the money" on the approved going concern valuation. This is not a new phenomenon and upholds the longstanding principle from *Re Tea Corporation Ltd* [1904] 1 Ch 12 that it is not necessary to consult with any class unaffected by the Scheme because their rights are untouched or they have no economic interest in the company. The use of Schemes as a "de-leveraging" tool has fuelled speculation that foreign companies will try to utilise the process by migrating their Centre of Main Interest ('COMI') to the UK. Under the Companies Act 2006 any company that can be wound up under the Insolvency Act 1986 can use a Scheme.

Schemes are not recognised by the EC Regulations. However, in relation to the UNCITRAL Model Law on Cross-Border Insolvency 1997, the Scheme of the French insurer MMA IARD Assurances Mutuelles was recognised by Judge Robert E. Gerber in one of the first Chapter 15 recognition applications in the US. The common law jurisdictions of the Cayman, BVI and Hong Kong have similar procedures so a Scheme can be applied in those jurisdictions. But is a Scheme

necessary? In the recent case of Hellas II, the COMI of a Luxembourg company was migrated to the UK, the debtor put into administration and the assets (being the shares in the operating companies) were transferred to a NewCo, leaving the subordinated noteholders to prove against the shell debtor company. Query whether we are likely to see more of this use of the "pre-pack"? This use raises serious concerns about the lack of intervention by the court or creditor groups and the possible abuse of our legal system. Prepacks should be fully transparent and receive court approval as in a 363 of the US Bankruptcy Code procedure. Given the complex corporate structures and layers of debt, serious consideration should be given to amending the legislation, including the broad powers of office holders. Currently there is a consultation in train regarding the application of pre-packs.

Company Voluntary Arrangements

An alternative to a Scheme is a Company Voluntary Arrangement ("CVA"). CVAs are also a compromise by an insolvent company with creditors. Unlike Schemes, all of the creditors vote on the proposals en bloc, rather than by individual classes. In order for CVAs to be approved, 75% of unsecured creditors attending the sanction meeting and able to vote must vote in favour. CVAs, like Schemes, must be fair. CVAs provide a slightly more well trodden platform for unfair prejudice claims than Schemes (many of which we have been involved with). CVAs have been used in 2009 to cram down in particular landlord rights and claims in retail restructurings. Most notable were JJB Sports, Stylo and Blacks Leisure. The debtors and their advisers seem to have forgotten or disregarded in *Re Park Air Services plc* [2000] 2 AC 172, the House of Lords authority that defined the formula for landlord claims. Landlords are being disadvantaged and it will be interesting to see how they respond.

Banking Act

One other unprecedented way to restructure a balance sheet was introduced by the Banking Acts of 2008 and 2009 which in turn brought into force the Northern Rock plc Transfer Order 2009 ("Transfer Order") and the Transfer Administration Agreement dated 7 December 2009. These were used to split of Northern Rock ("NR") into NR and Northern Rock Asset Management. Notwithstanding the Banking Act 2009, the Transfer Order is an exercise by the Treasury of the powers conferred by the Banking 2008. Interestingly, the Banking Act 2008 appears to not provide for a third party compensation order, while the Banking Act 2009 does in cases of a "partial property transfer" following a share transfer by which a bank was taken into temporary public ownership. This has resulted in the split of NR, leaving the subordinated debt holders with no certainty to the future of their paper, nor, it seems, any right to compensation.

Administrators under the spot-light

Staying with financial institutions, the administrators (the 'Administrators') of Lehman Brothers International (Europe) ('LBIE'), have unsurprisingly been operating under the intense scrutiny of the international financial and legal community: the conduct of their task is of great consequence to a vast number of international customers and counter-parties, and the legal considerations applicable are many, complex, and, in some cases, without precedent. With the passing of 18 months since the Administrators' appointment, and the limited progress made, it seems that the Administrators' task of returning customers' assets and distributing LBIE's assets to creditors is an arduous one.

This part discusses the disappointments and steps taken so far (querying the Administrators' role in that status quo) and notes some of the more interesting legal issues and changes to market conduct which have arisen out of Lehman's demise.

International protocol for prime brokerage customers

In May 2009, the Administrators declined to sign the LBI Securities Investor Protection Act ('SIPA') Trustee's international protocol in relation to prime brokerage accounts. This was in contrast to all but two of the other insolvency officers responsible for the other Lehman entities. LBI was used as the Lehman group's sub-custodian for all US$ securities. US$ securities comprise a large bulk of the prime brokerage customer claims. Given the problems (which had never before been experienced), that a cross-border insolvency of an international prime broker and broker-dealer were giving rise to, the protocol was produced with the objective of establishing agreed terms for the return of customer assets sub-custodied in LBI, to the applicable account holders.

As a result of the Administrators' decision to not sign, the terms on which the SIPA Trustee will return LBIE's customer assets are still unclear (including the question of whether the assets will be returned directly to the customer or via the Administrators (with the Administrators charging a fee for the privilege!) and whether, to the extent possible at least, assets *in specie* or the cash equivalent amount will be returned). The Administrators are endeavouring to reach agreement on a bilateral basis with the SIPA Trustee on these, amongst other, matters, but, as at the date of writing, we are not aware that this has been achieved.

The recent well publicised revelations regarding the controversial balance sheet 'Repo 105' transactions lead to some uncomfortable thoughts. It will be interesting to see how this plays out.