Milbank

Financial Restructuring Group

Client Alert

COURT GIVES IMPORTANT JUDGMENT ON CHALLENGED SCHEME OF ARRANGEMENT

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On Monday 14th September 2020, Mrs Justice Falk issued her reasoned judgment, in respect of the application by Codere Finance 2 (UK) Limited (the "**Company**") to convene a single class of its creditors to consider and vote on a proposed scheme of arrangement under Part 26 of the Companies Act 2006 (the "**Scheme**").

In a hearing spanning three days, the High Court of England and Wales addressed multiple grounds of challenge from a dissenting noteholder but nonetheless granted the Company's request to convene a single meeting of its scheme creditors.

Background

The Company is part of the Codere group of companies, an international gaming operator with operations in Latin America, Spain and Italy.

An affiliate of the Company originally issued €500m 6.75% senior notes and $300m 7.625% senior notes, each due November 2021 (the "**Existing Notes**", and the holders thereof, the "**Noteholders**"). The Company became a joint and several co-issuer of the Existing Notes pursuant to a consent solicitation in July 2020, for the purpose of proposing the Scheme.

Codere experienced significant liquidity issues due to venues being closed and live sporting events being suspended as a result of the COVID-19 pandemic. This was conveyed to the market by a series of announcements during March and April 2020, which also disclosed that Codere was looking at financing options to raise additional liquidity.

An ad hoc committee of Noteholders (the "**AHC**") formed in April 2020. Following extensive discussions with the AHC, in mid-July, Codere signed a lock-up agreement in relation to a restructuring transaction.

At the same time, Codere concluded that its liquidity position was such that emergency financing would be needed to enable it to continue trading whilst the restructuring was implemented. The interim financing was provided by certain members of the AHC in the form of an issuance of €85m of super senior secured notes (the "**Interim Notes**"). Due to the urgency of Codere's liquidity need, there was insufficient time to offer a participation in the Interim Notes to the broader Noteholder group.

The Scheme

The restructuring proposal contemplated by the lock-up agreement comprised (amongst other things):

(a) amendments to the Existing Notes, including an extension of maturity;

(b) the right to participate the issuance of €165m of additional notes (the "**New Notes**") to provide additional liquidity to Codere; and

(c) the repayment and discharge in full of Codere's €95m revolving credit facility.

Over 80% of Noteholders acceded to the lock-up agreement, thereby agreeing to support the restructuring and, in August, the Company commenced a process to propose a scheme of arrangement to implement, amongst other things, the amendments to the Existing Notes.

Kyma Capital Limited ("**Kyma**") sought to challenge the scheme at the convening hearing, contending that the Noteholders should be divided into two classes for the purposes of considering and voting on the scheme proposal. In their contention, Noteholders who were members of the AHC should have formed one class, with non-AHC Noteholders forming a second class. Codere, and the AHC, rejected that contention, arguing that on a proper construction of the authorities and application to the facts, there should be only one class of Noteholders.

Key points: class composition

Falk J's judgment includes a valuable summary of the established principles of class composition. In summary:

- The basic principle is that a class "*must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest*" [1]. This is a relatively high hurdle.
- The Court must consider the creditors' 'rights in and rights out' of the Scheme – that is an analysis "*(i) of the rights which are to be released or varied under the scheme and (ii) of the new rights (if any) which the scheme gives, by way of compromise or arrangement, to those whose rights are to be released or varied.*"[2]
- Legal rights, not interests (commercial or otherwise) or opportunities, are relevant for class composition purposes. Interests may instead be taken into account at sanction stage.[3]
- The question the Court must answer is "*Are the rights of those who are to be affected by the scheme proposed such that the scheme can be seen as a single arrangement; or ought the scheme to be regarded, on a true analysis, as a number of linked arrangements?*".[4] It is not necessarily the case that all different treatments under a scheme mean that rights are so dissimilar. Creditors may have 'sufficiently similar' rights that would allow them to properly consult together.

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[1] *Sovereign Life Assurance v Dodd* [1892] 2 QB 573 at 583, Bowen LJ, emphasis added
[2] *Re Hawk Insurance Ltd* [2002] BCC 300, at [30] and [34], Chadwick LJ, emphasis added
[3] *Re UDL Holdings Ltd* [2002] 1 HKC 172, pp184-185, Lord Millet and *Re Primacom Holding GmbH* [2013] BCC 201 at [44]-[45], Hildyard J
[4] *Re Hawk Insurance Ltd* at [23], Chadwick LJ, emphasis added

- Caution must be taken not to break creditors up in such a way that each class has an opportunity to veto the scheme. This would undermine the basic approach of decision by a large majority.[5]

Core elements at issue

Codere's restructuring involves many elements which are typical in transactions of this nature and which have previously been considered by the Court in relation to either class composition or fairness of schemes of arrangement under Part 26 of the Companies Act 2006. These are:

- **Consent fees**: Fees were available to all Noteholders who acceded to the lock-up agreement by specified dates, comprising an early bird consent fee (equal to a *pro rata* share of 0.5% of the principal amount of the Existing Notes) and a consent fee (also equal to a *pro rata* share of 0.5% of the principal amount of the Existing Notes) (the "**Consent Fees**"), payable at completion of the restructuring.

- **New Notes backstop fee:** The New Notes are backstopped by certain members of the AHC in exchange for a backstop fee of 2.5% of the principal amount of the New Notes, payable on issuance of the New Notes.

- **Interim Notes and fees:** The Interim Notes were issued at an original issue discount of 3% and those AHC members who participated received a backstop fee of 2.5% of the principal amount of the Interim Notes. The Interim Notes accrue interest 2% higher than the rate applicable to the New Notes, dropping to the same rate following issuance of the New Notes at completion.

- **Work fee:** The AHC received a work fee equal to 1% of the principal amount of the Existing Notes, shared between the AHC *pro rata* to their holdings in the Existing Notes and paid before the Scheme was launched; and

- **Adviser fees:** Codere agreed to pay the costs and expenses of the AHC's legal and financial advisers.

Key points of the judgment

Comparator: The judge accepted the Company's evidence that, absent the scheme, the most likely scenario was a group-wide insolvency process. The delta between the expected recovery for Noteholders in the liquidation scenario and a successful implementation of the scheme proposal was particularly stark: with an expected 0 and 4.1% recovery if the scheme failed versus par if the scheme succeeded.

Rights or interests: The judge also considered that the "rights" which fell to be considered for the purposes of class composition should be narrowly construed and should be distinguished from ancillary or collateral interests. However, in her judgment, Falk J did not accept the idea of a bright line test based on what was or was not dependent on the scheme. It was acknowledged that the totality of the circumstances may be relevant, and Falk J therefore assessed each element of the transaction to determine, on the facts, what was and what was not relevant to the scheme creditors' ability to consult together in a single class. In this context, she concluded:

- **Interim Notes**: Not relevant on the basis that (i) they are not new rights which the scheme gives by way of compromise to scheme creditors, (ii) they were issued on commercial terms (an assessment that was assisted by the results of a new money marketing process run by Codere), without any element of "bounty" and in exchange for the funds advanced for them and, therefore,

[5] Chadwick LJ in *Re Hawk Insurance*, citing *Nordic Bank plc v International Harvester Australia Ltd* [1982] 2 VR 298

(iii) did not have the features of "disguised consideration", to which Snowden J was referring in *Re Noble.*[6].

- **Adviser fees**: Not relevant on the basis that there was insufficient connection between the commitment to pay the adviser fees and the Scheme.

- **Work fee**: Relevant as, although paid prior to and unconditional on the scheme, the judge felt it could potentially be considered closer to "disguised consideration" for the release or variation of rights under the Scheme.

The New Notes backstop fee and the consent fees, which in both cases were conditional on the scheme, were clearly relevant rights to be taken into account.

Individual and cumulative basis: The judgment confirms that differences, and even material differences, in rights do not necessarily result in a fractured class. The question to ask is one of materiality: are the rights so dissimilar that it is impossible for creditors to consult together?

Falk J took the approach in her judgment of considering both the materiality of individual elements, as well as the cumulative effect of those elements[7]. The judgment is a thorough one as elements which had been already determined to be not relevant for consideration were nonetheless considered in the materiality test.

The judge did not find any of the elements, on an individual basis, to be material:

- **Interim Notes**: issued on commercial terms, in exchange for money advanced without an element of "bounty". The overall economics were priced at or below the market rate;

- **Adviser Fees**: 'benefit' to the AHC members not likely to be considered as such commercially. Falk J acknowledged the value the advisers provided to Codere in working towards achieving agreed terms and documents that command significant creditor support;

- **Work Fee**: although identified as one of the more problematic elements, because it was not directly linked to a "time cost" or success element, it was nonetheless considered insufficiently material to fracture the class;

- **New Notes Backstop fee**: payable in exchange for a commercial service, and at a level comparable to or below the market rate;

- **Consent Fees**: available to all scheme creditors and not at a level likely to exert a material influence on voting decisions.

In terms of cumulative effect, the judge considered that, taking into account (i) the cumulative benefits, (ii) what AHC members provided in exchange for them, and (iii) the likely alternative of a liquidation, the differences in rights between AHC members and other Noteholders were not so material as to fracture the class.

Conclusions

The judgment provides a valuable review of the authorities and principles relevant to class composition for schemes of arrangement. It is clear that rights, not interests, are key. However, it is not possible to

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[6] *Re Noble Group Limited* [2019] BCC 349 at [131] and [132], Snowden J.
[7] The importance of the cumulative effect being consistent with the Court's judgment on Codere's last scheme: *Re Codere Finance UK Ltd* [2015] EWHC 3206 (Ch) at [4].

draw a bright line between rights conferred directly by the scheme and those which are not dependent on the scheme.

The Court clearly recognised the beneficial role that ad hoc groups play in restructuring transactions and that ad hoc group members may receive fees or other benefits in exchange for value and commercial services provided. The Court was equally clear to confirm that fees or other benefits with an element of "bounty" or which should rightly be considered "disguised consideration" will be closely scrutinised.

The AHC was represented by Milbank partners Yushan Ng and Jacqueline Ingram and associates Kate Colman and Henry Ellis, together with Felicity Toube QC of South Square. The company was represented by Clifford Chance LLP together with David Allison QC and Ryan Perkins of South Square. Kyma was represented by Jenner & Block LLP together with Tom Smith QC of South Square.

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