Schemes of Arrangement as Restructuring Tools

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Since the start of the current credit crunch there has been a huge increase in the use of schemes as a restructuring tool. In most cases a scheme will be the fall-back strategy for use in cases where consensual changes to creditors' and/or shareholders' rights under finance documents cannot be negotiated. Often the need for a scheme will fall away, but the prospect of a scheme will have helped deliver the consensus. So as well as those schemes that see their way through to implementation, there are many draft schemes in the marketplace. The purpose of this client note is to provide an overview of the use of schemes as a creditor restructuring tool and to highlight some of the key practice points.

1 What is a scheme?

A scheme of arrangement is a very flexible and long-established Companies Act procedure which can be used to vary the rights of some or all of a company's creditors and/or shareholders. As long as a scheme receives the support of the statutory majorities of each class of creditor and/or shareholder whose rights are affected by it, and the court sanctions it, the scheme will be binding on all creditors and/or shareholders, including those within each class voting against the scheme. These characteristics make schemes a very useful strategic device in a wide range of circumstances including takeovers and mergers.

2 Who can use a scheme?

Schemes need to be implemented in accordance with the Companies Act 2006 and include two court applications. Scheme applications are usually initiated by the company which is proposed to be schemed. If the company is in administration, the scheme application process will be initiated by the administrators. Where a planned restructuring involves varying rights of creditors and/or shareholders across a group of companies, parallel and inter-related schemes will sometimes be launched and dealt with together at consolidated court hearings. In limited circumstances a scheme may include provisions which release or alter related rights of creditors against third parties (for example guarantors) which are not themselves party to the scheme.

Creditors and shareholders are also permitted to initiate scheme applications. In practice, however, scheme applications are usually made by the company, although the driving force behind a scheme strategy as a conduit to a restructuring and the core focus of negotiations concerning the terms of a scheme will come from the creditor or shareholder/sponsor constituencies. The dominant driver of the creditor negotiations will usually be the creditor(s) who hold security and/or enjoy a priority in repayment on an enforcement at the point at which the value of the business breaks (known as the fulcrum). That said, the question of the value of a business will invariably be a contentious point between the various stake-holders in a restructuring and the value of the business is in any event likely to move during the course of restructuring negotiations as the business continues its operations. At the fulcrum point creditors who are able to command the majorities to vote through a scheme have the key control of a restructuring. The flip side to this is that creditors able to control the minority vote capable of blocking a scheme vote are also in a very strong position in restructuring negotiations. Other stakeholders, for example those in a position to inject new monies, are also likely to command strong negotiating positions.

3 When can schemes be used?

Schemes can be used in a wide range of contexts and can extend to cover any agreement which the court is satisfied will amount to a 'compromise' or an 'arrangement' between a company and its creditors and/or shareholders or some class(es) of its creditors or shareholders. The statutory terms 'compromise' and 'arrangement' are interpreted broadly by the courts, and new contexts for the use of schemes are continuing to be developed. A scheme will need to provide some beneficial outcome involving give and take between the parties, or in limited circumstances, closely connected third parties.

Schemes are derived from corporate rather than insolvency legislation and are not classified as insolvency procedures. They are available to solvent and insolvent companies alike, and, unlike various forms of insolvency procedure (for example, administration), there is no

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baseline threshold of financial distress before a scheme can be used. This means that a restructuring can be progressed before the company has reached a point of no return in terms of its financial difficulties. Schemes also permit existing management to remain in control of the company (unlike formal insolvency procedures which involve the appointment of an insolvency office holder, who then takes control of the company). In some cases a chief restructuring officer (CRO) is appointed to oversee the restructuring negotiations.

4 What types of schemes can be used?

Schemes are increasingly being used in the leveraged buyouts arena as a way to reduce a company's debt burden and in some cases to exchange debt for equity. Schemes are sometimes structured as secured debt transfer schemes in which the scheme is combined with a contractual transfer of the scheme company's assets (by the security agent) to a new secured-creditor-owned company, to effect a senior enforcement. The transfer of assets is often implemented by either an administrator or by a receiver acting as agent of the scheme company. This should provide the scheme company directors with an element of comfort as to the valuation of the assets transferred. The consideration for the sale will typically comprise a write-off of the debt (or a substantial part of it) so that secured creditors will not be required to pay cash consideration. The remaining liabilities are left behind in the scheme company. Junior creditors below the line at which value breaks are unable to vote on the scheme provided that their legal rights are not varied under it. The claims of the junior creditors remain against the schemed company, now a company with little or no value. The junior creditors will nevertheless have standing to challenge the fairness of the scheme at the sanction stage. A secured creditor transfer scheme is only likely to be a potential option if the terms of the intercreditor agreement include release provisions which can be imposed on the junior creditors enabling the assets to be transferred free of security. If it is not possible for secured creditors to reach agreement consensually, in accordance with whatever threshold majorities are required under the finance documents, then a scheme may provide a solution.

In cases where junior creditors' rights are proposed to be varied, for example in a case where their debt or some part of it is to be converted into equity, the junior creditors will be entitled to vote on the scheme and the court may well decide, depending on the precise facts, that they should form a separate class. The effect would be to improve the negotiating position of the junior creditors.

Schemes have also recently been used to effect an amendment and extension of finance facilities (without necessarily also involving more fundamental financial restructuring) where this could not be achieved consensually. We expect to see this trend continuing, not least as certain creditors, for example holders of collateralised loan obligations, may be restricted under the terms of the relevant investment management agreements from agreeing to extend out the term of a given facility, unless this is ordered by the court. Schemes can be used as a device to permit new liquidity (potentially at a super-priority level) to be injected into a company either by existing sponsors or by third-party funders and on terms which differ from the existing finance and inter-creditor documentation.

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5 What are the voting requirements?

The statutory voting majorities necessary for scheme implementation are calculated by reference to those creditors and/or shareholders in each class exercising their voting rights in relation to the scheme. These majorities can have much lower thresholds than those provided for in the relevant finance documents (which in some circumstances may contemplate unanimity or calculation by reference to lender commitments, irrespective of whether a lender votes.)

Companies Act provisions require a scheme to be approved by:

a. a majority in number (i.e., headcount) of each class of creditor and/or shareholder voting in person or by proxy at whatever separate class meetings which the court has ordered must be convened; and

b. 75% in value of the creditors and/or shareholders of each class voting in person or by proxy at each meeting.

If those statutory majorities are obtained, a court application must be made to sanction the scheme. The scheme becomes binding on all creditors/shareholders whose rights are dealt with under the terms of the scheme if and when the court sanction order is delivered to Companies House for registration. The effective date of the restructuring may be a different, later date (as provided for within the scheme terms) and typically corresponds with the date when the finance documents required to implement the restructuring have been completed and any conditions precedent have been satisfied.

The sanction hearing is not a rubber-stamp exercise as the court has complete discretion to decide whether or not to sanction the scheme. The court must be satisfied that the statutory requirements have been met, the vote is fairly representative of the creditors concerned, there is no 'blot' on the scheme, and the scheme is substantively fair. The onus is on the party proposing the scheme (i.e., generally the company) to satisfy the court. The court's approach to assessing fairness will be to consider whether the scheme is one that an 'intelligent and honest man, a member of the class concerned and acting in respect of his interest might reasonably approve'. The court does not have to decide that the scheme which it is evaluating was the only scheme or the best scheme which could reasonably have been agreed, but rather whether a creditor could reasonably have agreed the particular scheme. Generally, the court will be loath to refuse to sanction a scheme which has the support of the statutory majorities unless there are technical irregularities concerning, for example, the court's jurisdiction or where there is evidence of some unfairness or the information in the scheme circular is deficient or misleading such that the voting result might be doubted. Unfairness might, for example, arise where if the court concludes that the scheme has involved a party voting in a manner which enabled it to pursue its own special interest at the expense of other members of a particular class of creditors or shareholders.

6 What are classes?

Companies Act provisions require creditors (and where applicable shareholders) to vote in separate meetings for each separate class of creditor/shareholder. The statutory majorities must be achieved for each class before the court can be asked to sanction the scheme. No hard and fast rules can be stated as to how classes should be identified, because the facts of any scheme are so variable. The core guidance which has emerged from the cases, however, is that a class must be made up of creditors (or shareholders) whose rights are 'not so dissimilar as to make it impossible for them to consult together with a view to their common interest'. Fundamentally, this involves identifying classes by looking at commonalities as to how their strict legal rights (rather than their commercial interests) are to be affected by the scheme and grouping those affected accordingly. If a creditor's (or shareholder's) rights are not varied by the scheme, then that creditor (or shareholder) will be neither required nor entitled to vote on the proposed scheme.

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As a rule of thumb, a good starting point for identifying appropriate creditor class composition is to look at and group according to the priority order in which creditors rank on an enforcement, although there will be cases when creditors ranking at different levels on enforcement can appropriately be combined to form a class.

Because the issue of class constitution is of such fundamental importance and the court has no discretion to correct wrongly constituted classes at the sanction hearing (in that the correct creditor groups must be constituted and invited to vote), the court will carefully consider the proposed class constitution at the first court application, known as the convening hearing.

7 Is there a cramdown?

Cramdown is a term which is borrowed from US restructuring terminology and refers to the ability under US law for the US Bankruptcy Court in certain circumstances to approve a restructuring even though a class of creditors has voted against the restructuring. The class voting against the restructuring can be compelled by the court to be bound by the restructuring and is in this way 'crammed-down'. Unlike the position under US Chapter 11, the English courts are not permitted to sanction a scheme unless each and every class of creditor (and, if applicable, shareholder) has voted in favour of the scheme, clearing the required statutory majorities. There is therefore no strictly equivalent 'cramdown' power in the UK. Sometimes, however, the phrase 'cram down' is used in a much looser, non-technical way to refer to the fact that, provided the threshold votes have been established for each class, creditors (or shareholders) forming part of any minority in any class voting against a scheme will be bound by any scheme which is subsequently sanctioned by the English court.

8 What is the legal process and likely timing of putting in place a scheme?

The procedure to put in place a scheme is set out in Part 26 Companies Act 2006, supplemented by court practice directions. The legal process consists of three key stages:

a. obtaining a court order to call the necessary class meetings following an initial court convening hearing;

b. convening the class meetings and carrying out the vote; and

c. assuming the statutory majorities have been obtained, applying for the court's sanction for the scheme.

In practice the overall scheme process is usually very front-loaded with the greater part of the time incurred before the legal process is initiated. Before then the terms of the proposed scheme and any ancillary documents will need to be negotiated with the relevant stakeholders, and the scheme and ancillary finance and other documentation drafted. Depending on the terms of the scheme, further finance documentation may need to be finalised and executed after sanction of the scheme and before the scheme becomes effective. Directors have a duty to provide full and frank disclosure.

9 What is the practice statement letter, and what other key documents are required?

Court rules require that in most cases a company wishing to implement a scheme must notify prospective scheme creditors ahead of the convening hearing that a scheme is being promoted and of its purpose. The letter must also state whether the company considers that more than one meeting is required of creditors and/or shareholders and if so how it considers that the different classes of creditors and shareholder meetings should be made up. The intention is that the letter will lead to class issues being flushed out at an early stage so

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that they can be considered and dealt with by the court at the convening hearing rather than at the later sanction stage. The correct formulation of classes is essential to ensure that the scheme can be capable of being sanctioned, but deciding on it can potentially be a contentious issue between the parties. Sending the letter is designed to save costs by ensuring that the class meetings are properly constituted before the meetings are called.

The Companies Act and court rules specify details of other documentation which is required to be filed at court, advertised or filed at Companies House, and/or sent to creditors.

The key documents

Claim form

Witness statement in support and exhibiting scheme circular

Draft form of order convening meetings of creditors and/or members

Draft advertisements of meetings

Scheme document containing:

- **Letter from company chairman/director**
- **Expected timetable of events**
- **FAQ or summary of key implications of the scheme**
- **Scheme of Arrangement**
- **Explanatory statement (Although not part of the scheme itself, this document is also required to be produced, and it comprises effectively an executive summary of the scheme. The explanatory statement must accurately and fairly explain the effect of the scheme and must include details of any material interests of the directors and how the scheme impacts on those interests. The court is unable to sanction a scheme if the explanatory statement is found to be misleading.)**
- **Notice of meetings**

Ancillary documents, including: form(s) of proxy of class meetings, witness statements confirming service of the meetings, chairman's report of meetings, witness statement confirming votes cast at meeting, advertisement of court hearing to sanction the scheme, and draft order sanctioning the scheme.

Additional requirements apply in the case of listed companies.

10 What is a lock-up agreement?

Lock-up agreements are not required under the scheme legislation, but will almost invariably feature in the context of an LBO scheme. Under a lock-up agreement the company's creditors commit themselves in advance (subject to whatever limitations, including rights to terminate the agreement, are detailed in any specific lock-up agreement) to vote at the relevant class meeting in favour of the contemplated scheme. In some cases (including where the scheme puts into effect a debt for equity swap) shareholders are also encouraged to sign up to a lock-up agreement. Lock-up agreements serve the very useful commercial purpose of giving a marker as to whether any particular scheme is likely to be supported, before further time and expense is incurred in finalising negotiations and documentation concerning the restructuring. Typically lock-up agreements will also include a clause prohibiting the relevant creditor from trading its debt before the scheme process has concluded, unless the purchaser of the debt agrees in turn also to be bound by the terms of the agreed lock-up agreement. Lock-up agreements will also commonly include terms whereby the creditor, subject to the company and/or its management satisfying agreed milestones as to performance/provision of information, agrees to waive its rights to take enforcement action under the finance documentation. This will provide comfort for directors in the context of their on-going duties to the company and its various stakeholders.

A consent fee is often offered to creditors agreeing to sign up to a lock-up agreement, and this has led to the court having to consider the question of whether creditors who have signed up to a lock-up agreement should be treated as a separate class from creditors who would ordinarily be in the same class but who have not signed up to the lock-up agreement, and wider issues as to the validity of such provisions. The general approach of the courts has been to analyse the existence of consent fees within the existing and established framework of analysis

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which focuses upon the rights of the relevant stakeholders at the class constitution stage, leaving it for the court to consider any differing interests of the class members as part of its discretion to sanction the scheme when it considers more fluid aspects of fairness. In practice where consent payments are offered openly to all creditors affected by the proposed scheme it is unlikely that the courts will consider that the class compositions require adjustment. If the consent fee amounts are de minimus, when compared to the principal amounts of the sums undergoing restructuring, the risk of the scheme failing for lack of fairness at the sanction stage is not great. This area of the law (although in the slightly different context of an exit consent mechanism in respect of bond rather than bank debt) is expected to be considered and ruled upon by the Court of Appeal during the first half of 2013. Pending that higher court analysis there remains some uncertainty in this area. In view of the uncertainties, it is clear that lock-up agreements require careful negotiation and formulation.

11 Can schemes be used for overseas companies?

Schemes can be used to restructure overseas companies as well as English companies, and because of their very flexible scope and other key characteristics, there has recently been a surge in the use of schemes by European LBO companies in distress. As they are not a form of insolvency proceeding, schemes do not fall within the scope of the EC Insolvency Regulation (EIR). One consequence (which the English courts have confirmed) is that it is not necessary to show that the company to be schemed has either its ‘centre of main interests’ (COMI) or an ‘establishment’ in England for the English courts to have scheme jurisdiction and the EIR rules do not apply to limit the scope of the English court’s jurisdiction to sanction a scheme. This means it is not necessary (unless and except to the extent that part of the restructuring is proposed to be effected through a pre-packed administration) to analyse and potentially look to change the location of the COMI of the scheme company. This may save time and costs.

English courts have jurisdiction to sanction a scheme of a foreign company where, on an examination of all of the relevant facts, the court is satisfied that there is a ‘close connection’ between England and the company proposed to be schemed. This close connection has been established (and confirmed in a series of lower court decisions) on the basis that the creditors whose rights were to be affected were creditors under one or a series of connected English-law governed finance agreements. Various additional connecting factors are present in some of the cases, including the fact that some of the creditors may be domiciled in England and sometimes assets have also been present in the jurisdiction. The principle that the English court has jurisdiction to approve a scheme where the parties have signed up to English law finance documents is fully consistent with related principles which (leaving aside the application of any special statutory provisions) permit the English court only to recognise a foreign variation or discharge of a contractual agreement where the variation/discharge complies with the applicable ‘proper law’ of the contract. Where the parties have expressly chosen an applicable law this will be the proper law of the contract.

12 What about overseas recognition or application?

The question of whether the English court has jurisdiction to approve a scheme may be raised at either the convening or the sanction hearing. Generally it is at the sanction hearing in relation to a foreign company that the court will determine any issues relating to the question of whether the English scheme will be recognised in the country in which the company is incorporated or in any third-party country in which the company has assets. This is because the English court will not exercise its discretion to sanction a scheme if there is evidence before it that it is unlikely that the scheme will be enforced overseas or that a local law procedure capable of delivering the same outcome is available. If there were significant doubts as to recognition abroad, then the English courts would consider the exercise of their jurisdiction on the one hand

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to be futile and on the other potentially exorbitant.

The practice has been for expert evidence from foreign law experts to be put before the English court and the English court, will wish to be satisfied that there is at least a 'reasonable prospect' that the relevant foreign court(s) will recognise and give effect to the scheme.

13 What are the key issues or risks?

Although the English court has discretion whether or not to sanction a scheme, where a scheme has obtained the necessary statutory majorities, the court is satisfied that the scheme results are fairly representative of the classes, and there is not a procedural 'blot' on the scheme, the English court will be very slow to interfere with the commercial decision of the creditors and will ordinarily sanction the scheme. The widespread use of lock-up agreements also appreciably reduces the risks of a scheme failure. Indeed in practice it is not uncommon to see the need for a scheme fall away and for unanimity to be achieved amongst the various classes prior to sanction, enabling the scheme process to be vacated.

Along the road towards implementation of a scheme there are a number of potential problem areas and risks. The key areas here include the following:

Issues and risk areas in connection with the scheme process:

- **Class constitution** – As discussed above, issues here should be resolved at the convening hearing
- **Numerosity** – Potentially issues can arise where the scheme is to be implemented to vary bondholder rights where the bond is held by a single trustee. It is usually possible to devise structural solutions to deal with such an issue.
- **Foreign companies** – The most significant generic risk factor here is whether an English scheme will be recognised in a relevant foreign jurisdiction as the court will not sanction such a scheme unless it is satisfied that it is likely to be recognised there. Recently the English court has sanctioned schemes of companies incorporated in Germany (Rodenstock, PrimaCom), Spain (La Seda, Cortefiel), Italy (Seat Pagine), the Netherlands (Vivacom), Bulgaria (Vivacom), and further afield in Kuwait (Global Investment House). There are many examples of schemes of companies incorporate outside the European Union including the US (TI Automotive), Jersey, and the Cayman Islands (Drax).
- **Valuation issues** – This is commonly a contentious area with different views (and interests) among the stakeholders as to where value (at any particular point in time) breaks and related issues as to whether a category of creditor has an economic interest in the proposed scheme and should be entitled to vote, for example, in a transfer scheme. The stakeholders driving the scheme implementation will need to ensure that they have robust independent valuations to support value.
- **Release of security** – Problems can arise where the intercreditor agreement does not readily facilitate the transfer of assets free from security.
- **Fairness** – Because the court has discretion whether or not to sanction a scheme, it necessarily follows that in all scheme cases there will be a residual element of execution risk.

Commercial issues and risk areas:

Other issues which will need to be considered on a case-by-case basis include the taxation consequences of the proposed restructuring and whether there are ways in which the deal can be restructured to produce a more tax efficient but equally workable outcome.

14 What are the alternatives?

Implementing a restructuring through a scheme will often be fall-back strategy or Plan B for use if it is not possible to negotiate a consensual agreement. As noted above, it is not uncommon for a scheme and a consensual restructuring to be negotiated in tandem and creditors may ultimately choose to fall into line without there being a need to implement a scheme.

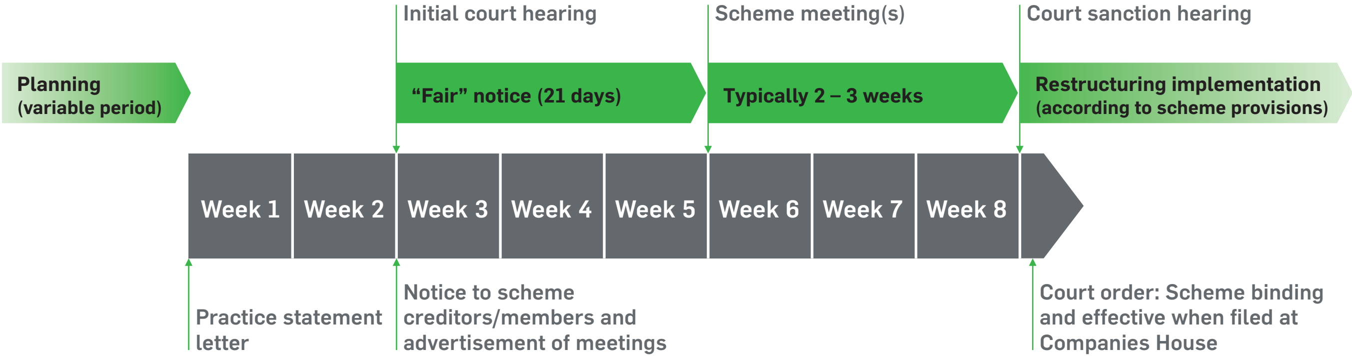
A company voluntary arrangement (CVA) is an alternative formal procedure available under the Insolvency Act 1986 which can also be a mechanism for a contractual restructuring. A CVA is not an option, however, if the rights of secured creditors need to be varied. A CVA is also generally less well-suited as a tool through which to implement a financial restructuring except in the case of non-complex financial structures. CVAs have recently been used with varying degrees of success as tools through which to deliver operational restructurings particularly in the leisure and retail sectors and where there is a need to rationalise a burdensome rental portfolio. In some recent cases restructurings have been delivered through a combination of schemes and CVAs (to deal with the financial and operational restructurings respectively).

Other key points of differentiation between CVAs and schemes are that CVAs are in all cases contingent in that they are capable of being challenged for a period of 28 days after details of the approved CVA are filed at court. A challenge can be made either on the basis that there has been some material irregularity at or in relation to the convened creditor or shareholder meetings, or that the CVA has an effect which unfairly prejudices the interests of a creditor or member of the company. Although a CVA is binding on all unsecured creditors, the notice period for creditors who have not received notice of the CVA runs from the point that they became aware of it so that cumulatively to an extent a 'Sword of Damocles' may hover over a CVA. In contrast, once a scheme is sanctioned (except in the rare case of a court appeal) the sanction provides finality. In a CVA the creditors and members' votes are not split into separate classes, but in cases where a proposed CVA involves more complex and layered financial structures, it is now market practice effectively to incorporate class voting requirements into the CVA proposal so as to reduce the risk of an unfairness challenge.

Final key points of distinction between CVAs and schemes are that: (1) CVAs are insolvency proceedings within the EIR, which means that CVAs are only available to English companies or those with their COMIs in the EC (or in the EEA), a limitation which does not affect schemes; and (2) directors of companies may be more reticent about suggesting or advancing CVA proceedings given that they are insolvency proceedings

The courts may need to have regard to the alternatives to the proposed scheme before it when considering the proper constitution of classes and at the sanction hearing. Depending on the financial circumstances of the company the appropriate comparator may be liquidation (as was the case for example in MyTravel and in PrimaCom).

Indicative scheme timeline



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