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Scheme Hot Topics Bulletin: Part III Schemes vs Chapter 11

June 2015

Overview

In this bulletin, we compare English schemes of arrangement with US Chapter 11 proceedings. The shape of a restructuring is often influenced by a number of key factors; we highlight those that are most likely to be relevant.

Case study facts	
Principal debtor:	Oilco Inc., the US holdco of Oilco Group, incorporated in Delaware and listed on NASDAQ
Guarantors:	Various subsidiaries within Oilco Group, incorporated in England, Norway and Texas
Operations:	Oil & gas exploration and production in **Texas and the North Sea**
Debt:	▪ **Senior secured RCF** governed by English law, with guarantees and security from Midco and Opcos ▪ **Junior unsecured high yield bonds** governed by New York law, with guarantees from Midco and Opcos ▪ **Unsecured** trade and employee creditors ▪ Preliminary valuations suggest value breaks well within the senior secured RCF
Covenants:	Maintenance covenants in senior secured RCF
Restructuring trigger:	▪ **Major liquidity issues** following recent oil price volatility and delays in bringing key new oil development online ▪ US$10m **interest payment due** next month ▪ Most creditors are willing to grant forbearance, but **holdout creditors** (holding c.20% of Oilco's debt by value) have refused to waive or defer the forthcoming interest payment and Oilco fears one particular junior bondholder will **make demand** for the amount owed to it

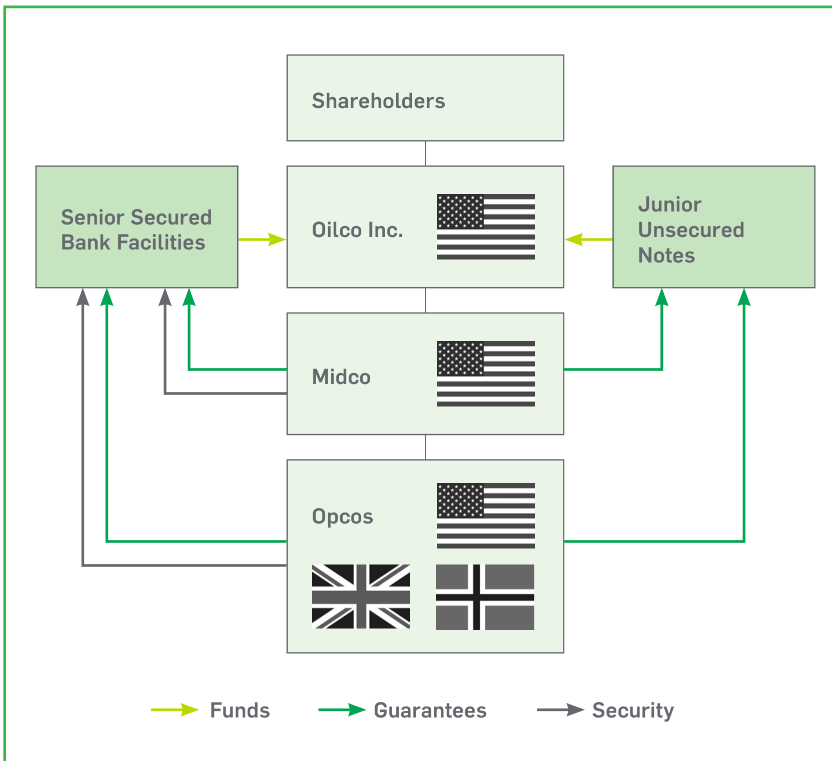
Using the key features of our case study below, we compare schemes and Chapter 11 proceedings on the following grounds:

- jurisdiction (filing requirements and cross-border recognition);
- moratorium;
- scope, i.e. which creditors can be included in (or excluded from) the relevant proceedings;
- control;
- new money;
- cramdown;
- valuation;
- third party releases;
- disclosure;
- market impact;
- timing and costs; and
- special Chapter 11 rules on oil & gas interests.

Determining Plan B

In the absence of a fully consensual route, Oilco Group has two main potential restructuring implementation options:

- an English scheme of arrangement, combined with an order under Chapter 15 of the US Bankruptcy Code; or
- reorganisation proceedings under Chapter 11 of the US Bankruptcy Code.



Jurisdiction

Jurisdictional threshold

Scheme: The English court has wide jurisdiction to sanction a scheme of arrangement. The requirement for a "sufficient connection" to England can be satisfied where the debtor's finance documents are governed by English law (as in this case). This applies even if the debtor's finance documents were originally governed by a different governing law – see *Apcoa* and, in a US HY bond context (accompanied by a shift of the debtor's centre of main interest, as a belt-and-braces approach), the recent case of *DTEK*.

Please see our first bulletin in this series for more detail regarding the English courts' jurisdiction to sanction schemes of foreign companies.

Chapter 11: The jurisdictional threshold for filing a Chapter 11 proceeding is also very low, making the procedure readily available. A company can file for Chapter 11 proceedings so long as it resides or has a domicile, place of business or any property in the US at the time proceedings are opened. This will be established for the US companies in the Oilco Group and can easily be met in the case of the non-US Opcos (e.g. by opening a US bank account).[1]

A note of caution – there are limits to the US Bankruptcy Court's exercise of its worldwide jurisdiction, especially where the jurisdictional link is very low. For example, the US Bankruptcy Court ultimately dismissed *Yukos Oil*'s Chapter 11 petition, finding the proceedings were inappropriate in the "totality of the circumstances". A number of reasons were given, including:

- the inability of Yukos to effect a reorganisation without the co-operation of the Russian government (the very body Yukos was seeking to restrain); and
- the timing and intent of the transfer of funds deposited in a US bank account less than two hours before the Chapter 11 filing, for the express purpose of attempting to create jurisdiction.

Clearly, the US courts do have regard to the international dimension of cases and the appropriateness of Chapter 11 proceedings in respect of foreign debtors.

Recognition in other relevant jurisdictions

This is a highly complex area; we give only a high-level flavour of the issues here.

Scheme: Whether a scheme is recognised in other jurisdictions – e.g. the US and Norway – is a matter for the private international law of those countries. This is a developing area of the law.

Schemes have been recognised as main or non-main proceedings under Chapter 15 of the US Bankruptcy Code on many occasions.[2] And the English court has sanctioned a scheme in respect of a Norwegian company, having heard expert evidence as to the likelihood of recognition of the effects of the scheme in Norway (in *Apcoa*).

The English court (in an uncontested case) has taken a pragmatic approach to compromising foreign law debt under a scheme (see *Magyar*), but this is a potential area for challenge.

[1] Whilst a filing not made in good faith can be the subject of a later challenge, there is no requirement for a substantive connection to the jurisdiction.

[2] As in *Magyar*, *Zlomrex* and *hibu*.

Chapter 11: The Chapter 11 proceedings are likely to be recognised in England, under the Cross-Border Insolvency Regulations 2006 (which implemented in the UK the UNCITRAL Model Law on Cross Border Insolvency).

However, following the Supreme Court's decision in *Rubin*,[3] there are significant limitations on what assistance or relief the English court will offer in aid of the US bankruptcy case – the boundaries of which are beyond the scope of this bulletin. Suffice to say that there is uncertainty as to the scope of the assistance that may be provided by English courts in aid of foreign insolvency proceedings such as Oilco's potential Chapter 11 proceedings.[4]

Moratorium

The worldwide automatic stay under Chapter 11 is often perceived as a key advantage; in contrast, simply initiating a scheme procedure does not result in any automatic stay. (Although a scheme can and often does provide for a stay pursuant to its terms, that can only take effect once sanctioned.)

Limits on Chapter 11 automatic stay

However, the ability to enforce the Chapter 11 stay overseas is dependent upon whether the relevant overseas jurisdiction will recognise it or whether a creditor is amenable to the US or other recognising jurisdiction. This is not clear-cut as a matter of English law. Nonetheless, Oilco's creditors with assets in the US are likely to voluntarily abide by the automatic stay – as they otherwise risk having their assets in the US seized by way of damages for violation of the stay.

There are several limits and exceptions to the automatic stay (including actions against non-debtors such as guarantors). It is also possible for Oilco's creditors to seek relief from the automatic stay on various grounds (including, in the case of a secured lender, the lack of adequate protection of the lender's interest in property).

Stay under scheme?

Although there's no formal moratorium under the scheme procedure, the English courts do have discretion to stay litigation or any judgment[5] in special circumstances pending the scheme outcome. There is authority for them doing so if a scheme has been proposed and there is a reasonable prospect of the scheme going ahead.

For example, in the *Vinashin*[6] case, the court stayed proceedings brought by two creditors to enforce their debt claims, as otherwise granting the creditors' application for summary judgment would have destabilised a proposed scheme. The company had entered binding lock-up arrangements with the requisite majorities of creditors required to approve the scheme. Although the scheme documents remained in draft form, the court found the scheme had reasonable prospects of going ahead.

We consider this akin to an implied stay – short of an automatic statutory stay, but nonetheless a helpful defensive tool for a company such as Oilco and its majority creditors to buy negotiating time. However, unlike the Chapter 11 moratorium, this implied stay does not purport to prevent creditors bringing proceedings in other jurisdictions – it is simply the English court staying English proceedings.

In practice, though, financial creditors often agree to formal or informal standstill arrangements whilst a scheme is being implemented.

Scope

One advantage of a scheme is that Oilco would be free to select the creditors to whom a scheme of arrangement should be put.[7] It could seek to compromise the RCF lenders and bondholders only and need not include trade creditors.

[3] *Rubin & Another (Joint Receivers and Managers of the Consumers Trust) v Eurofinance SA & Others* (2010).

[4] Common law assistance remains, but only to provide relief that is both available in the office-holder's own (foreign) country e.g. the US **and** as a matter of the (domestic) common law of the country in which he seeks assistance e.g. the UK: see *Singularis Holdings Ltd. v PricewaterhouseCoopers* (2014) and *Fibria Celulose S/A v Pan Ocean Co. Ltd & Another* (2014).

[5] Under rule 3.1(2)(f) of the Civil Procedure Rules, as part of the court's general powers of case management.

[6] *BlueCrest Mercantile BV v Vietnam Shipbuilding Industry Group*; *FMS Wertmanagement AOR v Vietnam Shipbuilding Industry Group* (2013), citing a number of older cases on stays of execution.

[7] *Sea Assets v PT Garuda Indonesia* (2001).

In contrast, in Chapter 11 proceedings, all creditors are entitled to be heard by the court (but unimpaired creditors will not be able to block confirmation of a Chapter 11 plan, and see the following page, under Cramdown, for how dissenting impaired creditors can be bound).

Control

Oilco's existing management will remain in control of the group throughout the restructuring process in either a scheme or Chapter 11 proceedings. In practice, however, a chief restructuring officer and/or interim CFO may well join the board, usually at the creditors' insistence.

New money

A key advantage of Chapter 11 is the possibility of new, super-priority DIP (debtor-in-possession) financing to help finance the struggling company (although this may be a disadvantage to senior creditors who do not wish to participate in new monies and who then see their position "primed" by others). However, a note of caution – there may be difficulties where:

- Oilco's non-US assets are already secured e.g. under English / Norwegian law; or
- the relevant assets are secured under US law but owned by a group company not in Chapter 11.

The US Bankruptcy Code allows DIP financing to non-consensually prime existing liens on any assets of a debtor, regardless of the assets' location. However, like the issues with enforcing the automatic stay outside the US, a debtor's ability to impose the priming liens on non-US assets will depend on whether the applicable non-US jurisdiction will enforce the financing order and/or the lien-holder will obey an order of the US court to permit the senior lien. In practice, this means DIP financing may or may not effectively "prime" the existing security.

Effecting a debt-for-equity swap: summary comparison

Issue	Scheme	Chapter 11
Process	Scheme of arrangement + transfer of Oilco's assets to Newco via director sale or (more likely) pre-pack administration – i.e. two separate processes Transfer to Newco depends on release mechanics in finance documents. If e.g. the intercreditor agreement has weak release mechanics, enforcement closer to Opco level may be required (which is likely to be less attractive)	Debt and equity of Oilco Group's Chapter 11 debtors restructured within Chapter 11 itself (most likely via either a Chapter 11 plan and/or s.363 sale of Oilco's assets to Newco) – i.e. one single process The Bankruptcy Court order approving the 363 sale or confirming the Chapter 11 plan will eliminate any liens on debtors' assets regardless of any release provisions in the financing documents, with existing liens automatically attaching to any proceeds from the sale of collateral
Value	Valuation methodology based on current sale price – junior bondholders unlikely to get a share of Oilco's ownership or assets Junior bondholders "burned off" via transfer to Newco	Valuation methodology reflects a going concern premium – therefore junior bondholders more likely to get a share of Oilco's ownership or assets Cramdown of junior bondholders occurs within Chapter 11 plan process. Absolute priority rule means junior bondholders will be totally wiped out unless senior lenders are repaid in full or vote as a class to confirm a plan that provides some recovery to the junior creditors
Third party releases	Midco and Opcos will not necessarily enter scheme – can benefit from third party releases within scheme	Most likely that Midco and Opcos would need to join Oilco's Chapter 11 proceedings in order to restructure their obligations (unless this could be done under the terms of their debt documents), adding a greater degree of complexity

The new money can benefit from super-priority status over US assets owned by Chapter 11 debtors, but only second-ranking security over assets which are already secured and are either non-US assets or assets owned by non-debtors (in the absence of creditor consent, which must ordinarily be unanimous).

A scheme cannot impose new obligations on creditors to advance new money – but the existing debt documents may be tweaked to allow new money super-priority. Please see our first bulletin in this series for more detail on new money under schemes.

Cramdown

Chapter 11:

The way Chapter 11 cramdown operates is that a plan may be confirmed despite its rejection by one or more impaired creditor classes, provided at least one non-insider accepting class is impaired and the plan does not unfairly discriminate and is fair and equitable (to the dissenting class as a whole). This is a very litigious area, ripe with disputes.

A plan will be fair and equitable with respect to a dissenting impaired class of secured lenders if it proposes to issue them with a replacement note:

a) in the amount of the existing secured claim;

b) secured by the same collateral that secures the existing secured claim; and

c) paying a stream of cash payments with a present value at least equal to the amount of the existing secured claim.

Dissenting classes of secured lenders frequently litigate with debtors over the likelihood that the reorganised debtor will be able to make the future payments required by the note (e.g., the "feasibility test") and the interest rate necessary to satisfy the "present value" prong of the test, with US courts sometimes permitting interest rates substantially lower than market rates.[8]

A plan will be fair and equitable with respect to dissenting impaired classes of unsecured creditors if the plan satisfies the "absolute priority rule" by providing no distributions to any creditors or equity holders in classes junior to the dissenting class unless the dissenting class will receive property equal in value to the amount of the unsecured claim. This often leads to litigation over the reorganised debtor's value and the value of distributions to senior unsecured creditors.

Scheme:

In contrast to Chapter 11 proceedings, there is no formal statutory cramdown mechanism under a scheme for dissenting creditor classes. Cramdown within a scheme is limited to the statutory majorities in each separate class cramming down the minorities within their own class.

In order to "burn off" Oilco's junior bondholders, some other process, such as a pre-packaged administration, would be needed. The scheme would novate all or a substantial amount of the debt owed to the senior lenders to a Newco, with the scheme companies' business and assets sold to Newco via the pre-packaged administration sale. This leaves the debt owed to junior bondholders stranded in the original company. Please see our second bulletin in this series for more detail on valuation issues on schemes.

Valuation

Differences in valuation methodology in Chapter 11 proceedings and schemes mean that Chapter 11 tends to favour the junior bondholders getting a share of Oilco's ownership or assets. Chapter 11 valuations are much more generous than scheme valuations as they tend to reflect a going concern premium, assuming the Chapter 11 results in a favourable restructure. Popular methods for Chapter 11 valuations include the discounted cash flow and comparable transactions methods.

In contrast, the English approach is much more focussed on a market-based approach to valuation – i.e. a "current and real world valuation", largely focussed on current sale price. Again, please see our second bulletin in this series for more detail on valuation issues on schemes – an area we think ripe for challenge.

[8] There are other, rarely invoked, ways in which a Chapter 11 plan may be fair and equitable with respect to a class of dissenting secured creditors. See 11 U.S.C. s. 1129(b)(2)(A).

Third party releases

In order to give practical effect to the restructuring, it may be necessary for Oilco and/or the creditors to release — or, more likely, to compromise — claims against third party co-obligors/guarantors, such as Midco and the Opcos. This is because such third parties may have claims of contribution against Oilco in the event that creditors seek to pursue Midco and the Opcos, which would then defeat the objective of the restructuring. To the extent that such releases cannot be effected under the intercreditor agreement, we would look to a scheme or Chapter 11 process to achieve this.

Here, schemes have an advantage over Chapter 11, in that a scheme can be used to compromise/release guarantees without the guarantor itself proposing a scheme. This means proceedings could be limited to Oilco only, which can ease execution and avoid procedures lower down the group/at the opco level.

In contrast, in Chapter 11 proceedings, each co-obligor/guarantor would have to enter Chapter 11 in order to release or compromise creditors' claims against those companies. (However, the US bankruptcy courts sometimes approve releases of claims against non-debtors if the non-debtors make an important contribution that is necessary for the debtor's successful consummation of a Chapter 11 reorganisation plan.)

Disclosure

Chapter 11 involves a court-driven process which requires extensive and public disclosure.[9] Scheme disclosure requirements are pretty extensive,[10] but in practice are generally somewhat lower than Chapter 11 (or at least are not as readily accessible to those other than scheme creditors, unless a scheme is being promulgated by a listed company or in relation to listed securities). As Oilco is listed on NASDAQ, it will have additional disclosure requirements with which it must comply irrespective of which implementation route is selected, unless it decides to delist.

Market impact

The market's perception of Oilco entering either a scheme or Chapter 11 would be fairly similar, in our view. As schemes are corporate proceedings rather than insolvency proceedings, they avoid the taint and trauma which can apply to the latter. In the US, Chapter 11 is broadly welcomed as a rescue procedure which provides a debtor with the legal protection necessary to give it the opportunity to reorganise.

Events of default and termination provisions would need to be carefully assessed in light of a potential scheme or Chapter 11. This exercise would extend from the RCF and HY bonds to the Oilco Group's joint operating agreements, licences and supply contracts, for example. A scheme of Oilco would be unlikely to trip an event of default under supply contracts lower down the group. An Oilco Chapter 11 would likely cross-default any contracts it guaranteed, but would otherwise be unlikely to cross-default non-financial contracts entered into by non-debtor subsidiaries.

The *ipso facto* rule in Chapter 11 prevents counterparties exercising termination provisions in unexpired leases and non-financial executory contracts.[11]

[9] Before acceptances of a plan can be solicited, the plan proponent must provide creditors and shareholders with a disclosure statement approved by the bankruptcy court as containing adequate information of a kind and in sufficient detail to enable a hypothetical investor typical of a creditor or shareholder to make an informed judgment about the plan: 11 U.S.C. s. 1125.

[10] The scheme's explanatory statement must explain the effect of the compromise or arrangement and any material interests of the directors of the company: section 897, Companies Act 2006. The contents of the explanatory statement should be sufficient to enable a creditor to (a) "exercise a reasonable judgment on whether the [scheme is] in his interest or not" and (b) reach a sensible decision on the pros and cons of the [scheme]" (*Re Heron International* (1994)).

[11] An executory contract is one under which performance remains due to some extent on both sides. The automatic stay in Chapter 11 has been held to preclude one party to an executory contract from unilaterally terminating it pursuant to its terms: *Computer Communications, Inc. v. Codex Corp.* (1987).

In contrast, under English law, contractual provisions providing that a contract may be terminated upon the commencement of insolvency or restructuring proceedings are valid, provided they do not offend the anti-deprivation principle,[12] which has been construed very narrowly.[13]

Examples: when might Chapter 11 not be appropriate in a European restructuring?

- Where the debtor will struggle to bear the expense of the Chapter 11 process or prefers to avoid the more onerous disclosure obligations
- Where the need for a restructuring is driven by systemic operating problems of the non-US businesses, rather than overleverage
- When financial creditors are unwilling to treat local (labor/trade) creditors generously
- Where the debtor has little/no prior connection with the US and it's unlikely that non-US creditors will mount a forceful challenge

Timing and costs

Timing for a scheme and a Chapter 11 process is broadly comparable, the most time-consuming element being negotiations between the parties rather than court timetables. A full debt-for-equity restructuring effected via a scheme and pre-pack administration is likely to take at least three months.

A pre-pack Chapter 11 case may be concluded within the first two months. A Chapter 11 case without having obtained, prior to the bankruptcy, binding votes sufficient for a pre-pack Chapter 11 plan could take anywhere from two months to a year or longer. This depends on the existence of a pre-negotiated Chapter 11 plan (where some parties have agreed to the plan prior to the bankruptcy but, in contrast to a pre-pack plan, the debtor still needs to solicit additional votes for the plan during the bankruptcy case), support for any pre-negotiated plan and the complexity of issues.

Chapter 11 is widely recognised as an expensive process. It is generally much more expensive than an English scheme, owing to the greater number of court hearings and disputes which tend to be aired in a Chapter 11 process. Challenges to schemes have been quite rare in practice (notwithstanding a number of notable exceptions).

Treatment of oil & gas interests

Special rules apply in respect of specific oil and gas property interests in Chapter 11. For detailed analysis, see Weil's recent series of bankruptcy blog posts, "Drilling Down: A Deeper Look into the Distressed Oil & Gas Industry", here.

Conclusion

There's no clear winner for the best restructuring implementation technique for the Oilco Group. Much will depend on the appetite of Oilco and its creditors to undergo the different processes, as well as the specific circumstances of the case.

In the current market, the need for a full analysis of both schemes and Chapter 11 in order to establish the optimal Plan B is greater than ever.

[12] That parties cannot, on bankruptcy, deprive the bankrupt of property that would otherwise be available for creditors: *Whitmore v Mason* (1861).
[13] *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services* (2011); *Lomas v JFB Firth Rixon Inc.* (2010).

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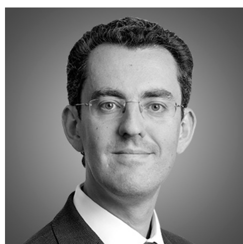

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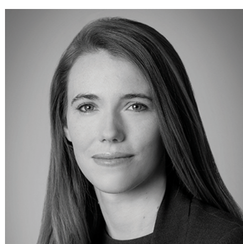

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