Scheme Hot Topics Bulletin: Part I

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Background and headlines

As market participants will know, the English courts have been increasingly willing to accept jurisdiction to sanction schemes in respect of foreign companies (in a series of cases culminating in *Apcoa*'s change of governing law – see further below). Reaching a consensual restructuring grows ever more challenging in a world where more complex capital structures and creditor composition create divergent interests. With unanimity or very high thresholds generally required to change payment terms, the use of a scheme allows borrowers effectively to alter voting thresholds under finance documents in order to facilitate a restructuring. Please see our introductory guide, "Schemes of Arrangement as Restructuring Tools", for further background.

European borrowers in particular have increasingly used English schemes to implement "amend and extend" transactions (e.g. *Cortefiel*, *Icopal*, *Apcoa I*). We regard schemes as an example of "good" forum shopping, in permitting corporate rescues which would not have been possible under domestic law, to the advantage of most stakeholders. However, as numerous European jurisdictions reform their insolvency laws, will the English scheme continue to "rule the waves"?

Evolving path of scheme jurisdiction

- English companies
- Foreign companies, based on a "sufficient connection" to England: *Stocznia Gdanska*, *Drax*
- EU Insolvency Regulation opens up use of COMI shift to access English scheme: *European Directories*, *WIND Hellas* (and later *Zlomrex*, *Magyar* in respect of non-English law-governed documentation)
- Becomes standard that English-law governed finance documents are subject to a scheme: *Rodenstock*, *Primacom*, *Seat Pagine*, *NEF Telecom*, *Cortefiel*, *Vietnam Shipbuilding*, *TeleColumbus*, *Global Investment House* etc.
- There is an alternative route to scheme jurisdiction for contracts subject to non-exclusive jurisdiction clauses, via Art. 23 of the Judgments Regulation (see *Vietnam Shipbuilding*, recently confirmed by *hibu*)
- Envelope pushed further, whereby a change of governing law to English law – merely to gain access to scheme – is accepted by English courts: *Apcoa I*

Jurisdiction

The exercise of the jurisdiction of the English courts to sanction schemes of foreign companies has expanded significantly since 2011. Having adopted the requirement for companies to have a "sufficient connection" to this jurisdiction (*Stocznia Gdanska*, *Drax*), the courts have accepted that such a connection can be established on the basis of:

- assets or a significant presence in England;
- a shift of a company's centre of main interests (CoMI) to England;
- finance documents governed by English law, even if the governing law has been changed to English law specifically in order to facilitate the scheme; or
- finance documents subject to the jurisdiction of the English courts, whether conferring exclusive or non-exclusive jurisdiction.

Local recognition

The English courts are careful not to exercise their jurisdiction in vain and will not generally make any order which has no substantial effect.

Therefore, before the court will sanction a scheme, it will need to be satisfied that the scheme will achieve its purpose (*Sompo Japan*, *Rodenstock*). Although the reasoning adopted by the courts for exercising their jurisdiction in the various cases listed is not straightforward (nor always consistent), the conclusion reached is pragmatic and generally facilitative of restructurings.

The courts are usually prepared to sanction a scheme of a foreign company upon evidence of *de facto* recognition, i.e. that courts in other relevant jurisdictions, including the company's jurisdiction of incorporation, would be likely to recognise that the scheme had validly compromised the underlying debt and give effect to the scheme. This applies even absent evidence of *de jure* recognition, i.e. that such courts must, or could, formally recognise the scheme as a matter of law.

The courts will require expert evidence on recognition from lawyers in relevant jurisdictions. This includes not only the scheme company's jurisdiction of incorporation, but also the jurisdictions of incorporation of third party guarantors and jurisdictions in which scheme companies / other obligors have granted security. Ideally, independent experts unconnected with law firms professionally engaged in the scheme should provide such evidence, especially absent opposition to the scheme.[1]

Jurisdictions in respect of which English courts have heard recent expert evidence on recognition of English schemes (2012 to date)

Austria	France	Norway
Bahrain	Germany	Poland
Belgium	Hungary	Singapore
Bulgaria	Italy	Spain
Czech Republic	Kuwait	US (including New York and Delaware)
Denmark	Luxembourg	Vietnam
Finland	Netherlands	

The English courts sanctioned each of the relevant schemes.

Chapter 15

Combining a scheme with an order under Chapter 15 of the US Bankruptcy Code can offer additional protection, by obtaining recognition of the scheme as a foreign main proceeding (as in *Magyar*, *Zlomrex* and *hibu*). This allows the scheme company to access related relief, which can include the protection of the automatic stay under section 362(a) of the US Bankruptcy Code and injunctions preventing scheme creditors from taking action inconsistent with the scheme (as on *Magyar* and *Zlomrex*).

Limits and future developments

The English courts have taken a pragmatic approach to exercising their jurisdiction to sanction schemes of foreign companies, especially where there is no clear alternative under local law (e.g. *Metrovacesa*, *Rodenstock*, *Apcoa*). Courts are more cautious about accepting jurisdiction when the rights of junior creditors and shareholders are being compromised via a restructuring (as opposed to a simple "amend and extend"). We expect to see the courts set some limits, such as that identified in *Rodenstock*[2] and, in a separate context, *Re Buccament Bay*[3] - especially where a local proceeding offers a viable alternative or the facts suggest some form of abusive forum shopping.

The technique used in the *ATU* pre-pack administration may offer an alternative solution to reaching English jurisdiction for schemes, via the "flip up" of a new English-incorporated obligor to sit directly under the parent and become the principal company to effect the

[1] *Per* Richards J in *Magyar* (at paragraph 27).

[2] *Per* Briggs J at paragraph 69, considering a hypothetical case of a Japanese shipping company whose ship-owner creditors had each separately chosen charterparties governed by English law. Briggs J questioned whether the "sufficient connection" test would be satisfied by such a structure, in which each ship-owner had an entirely separate relationship with the company governed by a separate contract.

[3] In which the English court declined to assume jurisdiction to wind up two foreign companies, despite the existence of a sufficient connection (the same test as for jurisdiction regarding schemes). This case is a timely reminder that English courts will not automatically assume jurisdiction even if a sufficient connection is proved; they will assess all the evidence when exercising their discretion. *Re Buccament Bay Resort Ltd.*; *Re Harlequin Property (SVG) Ltd.* [2014]

restructuring. A scheme of that new English company could present a robust alternative to CoMI shifting, in a less expensive, shorter process with fewer tax issues.

We welcome the exclusion of schemes from the final text of the amended EU Regulation on Insolvency Proceedings (published in December). This will enable the continued use of schemes to restructure international groups with no CoMI test required. Yet with many European jurisdictions recently reforming their insolvency laws (such as Spain, France, Germany and Portugal) and further reforms proposed (in Luxembourg and the Netherlands), will the English scheme continue to rule the waves, or will London's crown as the capital of European restructuring lose its lustre?

Stays on challenges in foreign courts

Parties to schemes of arrangement are often concerned that dissenting creditors may seek to challenge or undermine the scheme by:

- pursuing their (pre-scheme) contractual claim in a foreign court; or
- initiating a separate insolvency/restructuring process in another jurisdiction,

whether against the scheme company or another obligor.

English courts are however concerned to ensure they are properly deferential to local courts and tend to leave it to local courts to determine the effect of the scheme in their jurisdiction.

Considerable attention was given to foreign stays in the early restructuring schemes of the 1990s. Care was taken to ensure such schemes did not preclude foreign challenges, trusting that local courts would recognise that the scheme validly compromised the underlying debt. This contrasts sharply with the US courts' traditionally wider approach to stays and the relief available under Chapter 15 of the US Bankruptcy Code.

The *Apcoa II* scheme originally included an unqualified undertaking on behalf of all scheme creditors not to commence any proceedings or other similar process to challenge the scheme. A dissenting creditor objected to that provision as being in the nature of an anti-suit injunction against access to other EU courts to vindicate pre-existing rights. The dissenting creditor sought especially to protect its rights under German law in respect of the existing intercreditor agreement. The parties amended the stay provision after the court raised concerns. This is but the latest example of the English courts' reluctance to interfere with creditors' access to other forums (especially in a case involving German companies and originally with German governing law!).

Schemes will therefore remain vulnerable to foreign challenges. We believe the likelihood of a successful foreign challenge may increase as local jurisdictions add scheme-like compromises to their suite of insolvency procedures, as local courts conclude that the jurisdiction of incorporation of the scheme company was the proper forum for the compromise.

The potential for foreign challenges is also relevant for class constitution: if creditors have rights against a company's foreign assets which are governed by a foreign law and which they can assert despite the effect of a scheme, they may be treated as forming a separate class[4].

New money and the imposition of new obligations

Schemes usually impose obligations of an ancillary nature on scheme creditors, such as requiring them to agree and enter into documentation, give securities law representations before they are able to receive scheme consideration, and minor amendments to existing obligations.[5] However, the imposition of more substantive obligations is on the periphery of the courts' jurisdiction and has always been a somewhat sensitive issue.

This issue arose most recently on *Apcoa II*, where the court raised concerns about its jurisdiction to impose new obligations on creditors (which, in that case, consisted of indemnity obligations under a new guarantee facility). The court declined to sanction the scheme in its original form. As the point was fully argued in that case, we expect other

[4] As suggested in *Quincy Mutual Fire Insurance Co. Buckley on the Companies Acts* notes that there is no rule which requires creditors in respect of contracts governed by foreign law to be treated separately from those bound, for example, by English law – and that statement is often cited in written submissions (Issue 27, June 2014, division 16-9). However, this issue has yet to be judicially determined.

judges at first instance to follow Hildyard J's reasoning and to decline to sanction schemes imposing new obligations on creditors (as distinct from reducing / affecting the company's existing liabilities to creditors).

In the boxed text below, we consider where the line might be drawn between ancillary and substantive new obligations.

Requiring creditors to advance new money (or indemnify other creditors which provide new money/guarantees) would clearly impose new obligations on them. It is often useful, however, to deal with companies' new money requirements as part of a scheme (so the new money is super senior and benefits from the existing security structure). Instead of imposing an actual obligation on creditors to advance new money, economic incentives can be used to motivate creditors to do so. This increasingly leads to complex mechanics around weighting recovery - for example, on *Stemcor*. The courts are generally willing to sanction schemes containing such provisions, provided:

- the opportunity to participate in the new money is available to all creditors equally (and therefore creditors are treated fairly); and
- the priority arrangement is a reasonable and proportionate incentive given the need for new funding (as the judge concluded was the case on *Stemcor*).

What else might constitute a "new obligation?"

- RCF "true rollovers"?
- Extensions to existing indemnity arrangements?
- "Requiring" creditors to lend to a Newco (where scheme is combined with a transfer of assets to a new creditor-owned company, to effect an enforcement)?
- Providing for the payment up of partly paid shares (in members' schemes)?

Class composition

The "golden thread" for identifying appropriate class constitution for scheme voting is "whether the constituent creditors' rights in relation to [the] company are so dissimilar as to make it impossible for them to consult together with a view to their common interest"[6]. The starting point is to identify the differences in creditors' legal rights as against the company both (a) going into the scheme and (b) coming out of the scheme – as distinct from creditors' "interests" – a distinction which the courts have examined more closely in the last few years. The next step is to determine whether, if there are differences in rights, they are such as to make impossible sensible discussion with a view to the common interest of all concerned[7].

The order of priority in the Intercreditor Agreement will often be a good starting point for determining the division of classes. But there are exceptions to this general rule. For example, on *GRAND*, six classes of notes, which had different payment priorities, voted together as a single class; crucially, the appropriate comparator in that case was a solvent liquidation rather than insolvency. And on *Apcoa I*, first and second lien lenders voted as a single class, as the scheme involved a very simple extension to the maturity date.

In determining class composition, the court will consider the appropriate counterfactual comparator i.e. the company's likely alternative, absent a scheme. Where the comparator is some form of insolvency proceedings, that usually allows the company to reduce the number of classes – because the spectre of insolvency proceedings would cause reasonable creditors to "unite in a common cause" (and therefore consult together and vote as a single class). The insolvency comparator is not, however, a "solvent for all class differences"[8].

Most recently, on *Apcoa II*, a dissenting creditor argued that the existence of:

- a turnover agreement (which effectively made the group's new money facilities super-priority over consenting lenders, whilst not requiring any amendment to the existing intercreditor agreement); and
- a lock-up agreement (under which

[5] As noted in *Schemes of Arrangement, Law and Practice*, O'Dea, Long & Smyth, 2012 (at paragraph 8.41).
[6] *Per* Hildyard J in *Primacom*, identifying a "golden thread" in case law following *Sovereign Life* and *Re Hawk*.
[7] *Telewest*, *UDL Holdings* (Hong Kong), *Primacom*.

consenting creditors committed to vote in favour of the scheme and promised not to take any enforcement action),

created differences of legal rights between the creditors. The court nonetheless held that, on balance, these issues did not justify putting the dissenting creditors in a separate class.

The courts have also scrutinised how the majority bind the minority outside the context of schemes. Courts have upheld the validity of inducements such as consent payments and provisions postponing interest payments (in *Azevedo*[9]), whilst rejecting exit consents on bond restructurings as being unfairly coercive to minority investors (in *Asségnagon*[10]). These cases will be commercially relevant for questions of class composition and fairness in scheme cases. The exit consents in *Assénagon* were clearly unfair and, in our view, would have failed the fairness test on a scheme of arrangement.

Who can vote together?

The following distinctions will not necessarily create a separate class:

- Debts denominated in different currencies (*Telewest**, *PHS*, *Co-operative Bank*)
- Different interest rates and maturity dates (*Primacom*, *McCarthy & Stone*, *Hibu*, *Stemcor*, *Co-operative Bank*, *PHS*, *Icopal*) – unless the change to the interest rate affected by the scheme is great enough to prevent the creditors from consulting together with a view to a common interest (*NEF Telecom*)
- Interest being paid current to some creditors but "rolled up" and paid at maturity to others (*Cortefiel*)
- Lock-up agreement (*Telewest**, *Primacom*, *McCarthy & Stone*, *NEF Telecom*, *Cortefiel*, *PHS*, *Seat Pagine*, *Apcoa II*)
- Consent fee (*Primacom*, *Seat Pagine*, *Magyar*) – provided offer is extended to all lenders and fee is *de minimis*
- Certain creditors being connected to the company (*Telewest**, *Zodiac**, *Metrovacesa*)
- Existence of sub-participation arrangements (*Zodiac**)
- Distinction between RCF and term loans (*Cortefiel*, *Icopal**)
- Certain differences in the operation of facilities required to observe Shari'ah law requirements (*Global Investment House*)
- Creditors' cross-holdings (*Heron International**, *Cattles*, *Primacom*, *NEF Telecom**, *Zodiac**) – although this may raise questions of fairness at the sanction hearing
- Certain creditors having more limited guarantees (*Stemcor*)
- Turnover provisions (*Apcoa II**)
- Different priorities:
  - *Apcoa I* – allowed for simple amend & extend
  - *GRAND* – solvent comparator

* Denotes a challenge to class constitution for the relevant scheme on this specific ground.

Cases listed as examples only – not a definitive list.

Blurred lines between class composition and fairness

Despite the courts' more recent focus on creditors' "rights", differences in "interests" may create a fairness issue and extreme differences of interest potentially create a class issue (e.g. *Heron* and even *Apcoa II* blurs the lines between class composition and fairness issues). On *Apcoa II*, for example, the dissenting creditor argued a number of points at the sanction hearing regarding fairness that it had raised earlier in a different guise (regarding class composition) at the convening hearing.

The importance of this division is that creditor classes have to be correctly constituted (as otherwise the court has no jurisdiction to sanction the scheme), whereas fairness is a matter for the court's discretion. The courts have very often relied on voting outcomes in determining whether to exercise their discretion to sanction schemes, drawing considerable comfort from the fact a large majority of sophisticated, properly-advised creditors have voted in favour of the scheme (and analysing how sub-groups of creditors actually voted). In the context of uncontested schemes, boundaries have often been pushed – hard. This makes the challenge in *Apcoa II* all the more important and likely to be followed in subsequent cases (especially where uncontested) – and all the more unfortunate that two key points, on new obligations and foreign stays, were "parked".

[8] As Hildyard J acknowledged in *Apcoa II*.
[9] *Sergio Barreiros Azevedo v Imcopa Importacao, Exportaacao e Industria de Oleos Limitada* [2012]
[10] *Assénagon Asset Management S.A. v Irish Bank Resolution Corporation Limited* [2012]

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