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Bankruptcy

Potential Pitfalls for Hedge Fund Managers in the Ever-Expanding Use of English Schemes of Arrangement

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The English scheme of arrangement has surged in popularity in recent years as distressed hedge fund managers tackle Europe. The appeal of this procedure is easy to identify. First, the scheme is predictable: its legal requirements and parameters are clearly set forth in a robust body of law, and it is administered by sophisticated and commercially-minded courts in the United Kingdom. Second, the scheme permits the company to continue operating (and its management to remain in control) throughout the restructuring – a feature that is prevalent in the United States but which is lacking in many other jurisdictions. From the perspective of fund managers with American roots, the English scheme has the added benefit of familiarity as it resembles in many ways a "pre-packaged" chapter 11 procedure.[1]

Due to a series of recent rulings in which English courts broadly interpret the scope of their own jurisdiction, the English scheme also has become ever-more accessible. The courts, for example, have permitted companies with no UK presence to bind creditors under a scheme where the sole jurisdictional nexus to the UK was that the governing law clause of the debtor's financing documents provided for the choice of English law. Within the past few months, one English court went a step further and held that even when the foreign debtor's financing documents originally were governed by foreign law, English jurisdiction could nevertheless be established through the amendment of the governing law clause to provide for English law.

As the English scheme becomes the preferred method of restructuring European companies, it is important to consider whether a scheme that has been "sanctioned" (or confirmed) by an English court will be given effect in other jurisdictions where the debtor has assets or where the debtor's creditors might reside. Indeed, before an English court will sanction a scheme, it must be satisfied that the terms of the sanctioned scheme will be respected in all of the relevant jurisdictions. This article identifies a potential blind-spot where a foreign company with assets or creditors in the U.S. seeks to restructure its debts through an English scheme of arrangement solely on the basis of the governing law being English law, and discusses potential ways to resolve issues that might arise.

Schemes of Arrangement Generally

A scheme of arrangement is a court-supervised procedure that can be used for a myriad of corporate purposes, including for the compromise of a company's debts. The scheme technically is not an insolvency procedure (it being a creature of the Companies Act 2006, the UK corporate statute, and not the Insolvency Act 1986, the UK insolvency statute), and therefore, does not bring about automatic stay relief. In circumstances where such protection is needed, however, the scheme can be used in conjunction with an administration, a formal UK insolvency procedure that gives rise to a "moratorium" against creditor enforcement actions. In this and various other respects, the scheme is flexible

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enough to be adaptable to the debtor's needs, and may be used as a stand-alone alternative to insolvency proceedings or along-side such proceedings.

A principal benefit of a scheme is that, regardless of any contractual voting requirements that may exist in the company's financing documents, a restructuring can be made binding on all creditors in a given class with the affirmative vote of a simple majority in number and three-quarters by value of those voting in the class, assuming certain other procedural safeguards are met. Thus, for example, a scheme can be used to circumvent unanimous consent requirements that may exist in a company's loan documents so long as the proposed amendments have the support of the requisite majority of lenders.

In the restructuring context, a scheme of arrangement typically is commenced when a distressed company, having reached an agreement with one or more classes of its creditors, applies to the court for permission to convene a meeting of creditors. The court filing includes, among other things, the draft scheme documents as well as a draft "explanatory statement" designed to contain sufficient information to ensure that the affected parties will be able to make an informed decision in voting for, or against, the scheme. The court then holds a "convening hearing" to examine, among other things, whether there are any insurmountable obstacles to ultimate approval of the scheme, and whether creditors should be divided into separate classes. Upon obtaining court approval, the debtor convenes the creditors' meeting at which voting is conducted on the basis of the classes established in the scheme. If the requisite majority of scheme creditors in each class votes in favor of the scheme at the meeting (either in person or by proxy), the debtor makes another court application for an order confirming the scheme.

At the "sanction hearing" (or confirmation hearing), the court will consider, among other things, whether (i) the scheme is fair to all parties and (ii) the scheme voting thresholds (as described above) have been met for each affected class. Although there is no "cram-down" mechanism similar to that found in the U.S. under chapter 11 of the Bankruptcy Code (where a plan can be confirmed despite one or more classes having voted to reject it), the scheme can be structured so that a particular class of creditors has no right to vote because the scheme does not compromise the rights of that class. Creditors who are not invited to participate in a scheme because their rights are deemed to be unaffected are entitled to object on the ground of unfairness.

The English scheme of arrangement shares much in common with a pre-packaged chapter 11 case in the U.S. Under either procedure, the debtor and its creditor constituents come to an agreement on the terms of a financial (as opposed to operational) restructuring, then seek the court's limited involvement to obtain its blessing. The duration of both types of proceedings can be as short as one-and-a half to two months. Even the required documentation is very similar. For example, the "explanatory statement" relating to the scheme serves the same purpose as a chapter 11 disclosure statement – to provide adequate information so that creditors can vote to accept or reject the scheme or the plan on an informed basis. The scheme document itself also resembles a chapter 11 plan in many respects.

Schemes for Foreign Companies

Under the Companies Act 2006, English courts are given the statutory authority to sanction schemes in relation to a "company," which is defined in the statute to include "any company liable to be wound up under the Insolvency Act

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1986." The Insolvency Act 1986, in turn, gives the courts the power to wind up a foreign company. Therefore, English courts have the ability to sanction schemes in relation to foreign companies, so long as a "sufficient connection" to the UK exists for jurisdictional purposes.

A sufficient connection can be established if the distressed company has its "center of main interests" (or "COMI") in the UK. (COMI is generally understood to refer to the location of the debtor's administrative headquarters.) English courts also have held that a "sufficient connection" exists for foreign companies that do not have any physical presence in the UK but whose debt documents provide for the application of English law and jurisdiction.[2] This was true even in a case where all of the affected creditors were domiciled outside the UK.[3]

This line of reasoning was further extended recently to a situation involving an affiliated group of companies called the APCOA Parking Group (collectively, "Apcoa").[4] Apcoa was party to a German law-governed credit facility under which the debt was due to mature on April 25, 2014. When it became apparent that the terms of Apcoa's ongoing restructuring would not be finalized prior to the maturity date, Apcoa sought to extend the date to July 25, 2014. Such an amendment would have required the unanimous consent of the lenders, however, which Apcoa did not have. Lacking any meaningful connection to the UK for jurisdictional purposes, Apcoa and the consenting lenders – representing far in excess of two-thirds of the outstanding debt (the required consent threshold under the governing debt documents) – amended the credit agreement to provide for English law and English court jurisdiction. Having made this amendment, Apcoa commenced an English scheme to extend the maturity date to July 25, 2014 with the backing of its consenting lenders.

The English court determined that through the amendment of the governing law and jurisdiction clauses, a sufficient connection to the UK existed. The court made clear that it might have arrived at a different conclusion had the solicited lenders not been fully informed of the true purpose of the amendments (sufficient evidence having been presented that they had been). The court was also satisfied that all of the technical and fairness requirements were met, and therefore, confirmed the scheme. A few of the key considerations for the court:

- Apcoa was able to produce expert testimony that the amendment of governing law and jurisdiction clauses, and the scheme itself, would likely be recognized in the jurisdictions in which the debtors were incorporated; and
- The English scheme had the overwhelming support of the scheme creditors (creditors' votes by value in support of the scheme reached between 86.89% and 100% of the relevant debt classes).

The decision in *Apcoa* makes the English scheme ever-more accessible for non-UK companies. Foreign debtors, so long as their lenders consent, seemingly have the ability to access English court jurisdiction through a simple amendment of their debt documents.[5]

One often-overlooked factor, however, is how to prove to the English court that the terms of the scheme will be given effect in all the jurisdictions that matter. The debtor will need to produce evidence to that effect for each of the key jurisdictions.

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Lack of Recognition under Chapter 15

The traditional way in which to seek U.S. court recognition of a foreign restructuring is through chapter 15 of the U.S. Bankruptcy Code. Chapter 15, which is predicated upon the Model Law on Cross-Border Insolvency that was adopted by the United Nations Commission on International Trade Law in 1997, enables U.S. courts to grant ancillary relief in support of foreign insolvency proceedings. Its stated objectives are to (i) facilitate cooperation between U.S. courts and foreign courts, (ii) provide greater legal certainty for international trade and investment, (iii) provide for the efficient administration of cross-border insolvencies that protect the interests of stakeholders, (iv) protect and maximize the value of foreign debtors' assets in the U.S., and (v) protect investment, preserve employment and facilitate the reorganization of troubled foreign debtors. To implement these goals, chapter 15 grants access to the U.S. courts for the purpose of facilitating a foreign debtor's restructuring (to conduct discovery, pursue claims, etc.).

In order to obtain relief under chapter 15, a duly-authorized representative of a foreign proceeding must seek "recognition" of that proceeding by a U.S. bankruptcy court. A foreign proceeding can be recognized only if it qualifies as either a "foreign main proceeding" or a "foreign nonmain proceeding". As used in chapter 15:

- a "foreign main proceeding" is a foreign proceeding that is pending in a country in which the debtor has its COMI; and
- a "foreign nonmain proceeding" is one that is pending in a country in which the debtor has sufficient presence to constitute an "establishment".[6]

The term "establishment" in turn is defined as "any place of operations where the debtor carries out a nontransitory economic activity."[7] Recognition therefore is an operations-based analysis, in that either type of proceeding requires the foreign debtor to have some degree of presence in the country where the foreign proceeding is pending.

Although a scheme of arrangement under English law generally has been recognized as a type of proceeding that can be recognized under chapter 15 (notwithstanding that it technically is not an insolvency procedure),[8] the ability (and willingness) of the U.S. courts to recognize schemes founded solely on the basis of English law being the governing law is less clear. A company whose scheme is predicated exclusively on that basis, by definition, would not have its COMI or an establishment in the UK, and thus the scheme of arrangement proceeding would not satisfy either of the two statutory prongs for recognition. As a result, a U.S. court arguably would not be authorized to grant any relief under chapter 15 in support of such foreign proceeding.[9]

Recognition through Common Law Principles of Comity

Notwithstanding the challenges that may arise when seeking an affirmative recognition of an English sanction order through chapter 15, U.S. courts ultimately are likely to recognize and give effect to such an order, even if chapter 15 relief was never sought. If, after the scheme proceeding has closed, a dissatisfied creditor were to commence a lawsuit in the U.S., the debtor could seek an enforcement of the sanction order from the presiding court[10]. U.S. courts, guided by common law principles of comity (i.e., the courtesy a court of one jurisdiction shows to another jurisdiction in giving effect to the other's laws and judicial decisions), tend to

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enforce foreign judgments liberally, and can be expected to do so where the following factors are met:

- The participants in the foreign proceeding were given an opportunity for a full and fair hearing;
- The hearing was conducted before a court of competent jurisdiction;
- The hearing was conducted upon regular proceedings following due citation or voluntary appearance;
- The hearing was conducted under a system of jurisprudence likely to secure an impartial administration of justice between citizens of that country and those of other countries;
- There was no evidence of fraud in procuring the judgment, or evidence of prejudice in the country's legal system or in the court; and
- The judgment is not contrary to the public policy of the United States or of the forum enforcing the judgment.[11]

The first five factors, which focus on the court's jurisdiction and provision of due process, typically are deemed satisfied with respect to proceedings before English courts. U.S. courts will generally assume that the English legal system, and by extension scheme of arrangement proceedings within that system, are fair and consistent with fundamental principles of due process.[12] U.S. courts will also generally defer to the English court's determination as to its own jurisdiction.

The key question informing enforcement of the scheme sanction order, therefore, is the sixth factor, which examines whether the judgment violates the public policy of the U.S. or the state in which enforcement is sought. Although this would be a forum-specific, case-by-case inquiry, the public policy exception tends to be narrowly construed.[13] For example, U.S. courts have enforced foreign judgments where the foreign proceeding:

- denied parties certain rights to which they would be entitled in the U.S. (e.g., right to a jury trial);[14]
- limited access to information (e.g., where the liquidation proceedings were confidential and all records were sealed);[15] and
- provided relief that would not be available in U.S. courts (e.g., where the foreign judgment provided third-party non-debtor releases).[16]

Thus, barring exceptional circumstances, a U.S. court could be expected to recognize an English court's order sanctioning a company's balance sheet restructuring. To date, however, there does not appear to be any case law directly addressing whether a scheme, presided over by an English court solely on the basis of the debtor's debt documents being governed by English law and sanctioned by it, will be given effect by U.S. courts based on common law comity principles.[17] Moreover, this reactive approach lacks certainty in that the final determination of the enforceability of the scheme in the U.S. would occur only after the scheme proceeding has been closed.

English Scheme with Concurrent Chapter 11 Pre-pack

One way to be certain that the restructuring embodied in the English scheme will take effect in the U.S. would be to conduct a separate, stand-alone proceeding in the U.S. through a pre-packaged chapter 11. Non-U.S. entities have the ability to commence a chapter 11 bankruptcy case so long as they have assets in the U.S. (even if of relatively small

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value). As discussed above, a chapter 11 pre-pack shares many similarities with an English scheme, including timing and documentation. The two procedures, therefore, could run simultaneously, and the documentation required for one can readily be converted for use in the other. The scheme and the explanatory statement, for example, can easily be converted to a chapter 11 plan and disclosure statement. Below is an illustrative timeline for the two procedures running concurrently:

- Day X: Chapter 11 solicitation materials (including disclosure statement and form of proposed chapter 11 plan) sent to chapter 11 creditors; practice statement letters enclosing draft explanatory statement and draft scheme documents sent to scheme creditors.
- Day X+7: Commence scheme process through the issue of claim forms and other filings with English court (such as witness statement exhibiting draft explanatory statement, draft scheme documents and draft orders).
- Day X+9: End of chapter 11 solicitation period.[18]
- Day X+10: English court hearing to authorize convening of the scheme meetings; commence chapter 11 case through filing, among other things, of chapter 11 petition, motion to set hearing to authorize disclosure statement and confirmation of plan.
- Day X+11: Notice of scheme meeting given; send final explanatory statement, final scheme documents and court order convening scheme meetings.
- Day X+32: Hold scheme meetings.
- Day X+33: Filing of report of scheme meetings, and swearing and filing of witness statement regarding service of notices and results of scheme meetings with the English court.
- Day X+40: Bankruptcy court hearing to consider authorization of disclosure statement and confirmation of chapter 11 plan.
- Day X+43: English court hearing to sanction scheme.
- Day X+55: Effective date of chapter 11 plan; file sanction order with registrar of companies; effective date of scheme.

Although a concurrent chapter 11 filing might appear at first blush to be a simple solution, there may be business reasons why it might not work. One of the benefits of an English scheme is that it technically is a corporate procedure and not a bankruptcy or an insolvency procedure. Debtors, therefore, have the ability to avoid the stigma very often associated with bankruptcy filings, particularly throughout Europe. Moreover, depending on how contract terms are worded, it is possible that the commencement of a scheme would not constitute a "bankruptcy event of default," the triggering of which can lead to a wide range of adverse consequences for the debtor (possibly including cross-defaults of the debtor's operating affiliates). For companies that elect to invoke an English scheme principally for this reason, a concurrent chapter 11 filing is unlikely to be viable. This option, therefore, should be considered on a case-by-case basis.

Conclusion

The English scheme of arrangement is a useful tool to help repair corporate balance sheets, regardless of whether the debtor is domiciled in the UK or a foreign jurisdiction. In light of the recent case law in the UK, the scheme seemingly has become accessible to virtually any distressed company with English law-governed debt documents, or even to those that do not, so long as the debtor has sufficient creditor support to effectuate an amendment to provide

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for English law as the governing law. It is important to bear in mind, however, that though the English court may accept jurisdiction over the scheme, the scheme may not be sanctionable without a sufficient showing that its terms will be respected in all of the relevant jurisdictions. In the U.S., there is a significant risk that English schemes that are premised solely on English law being the governing law of the underlying debt documents would not be recognized in a chapter 15 case. Scheme debtors, therefore, may be compelled to rely on common law principles of comity to demonstrate to the English court that the sanction order is likely to be recognized and given effect in the U.S. In certain circumstances, the preferred option may be to implement a pre-packaged chapter 11 plan in the U.S. concurrently with the English scheme and thereby obtain a stand-alone chapter 11 confirmation order.

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[1] A "pre-packaged" chapter 11 entails a plan of reorganization that is negotiated and for which votes are solicited prior to the filing of a chapter 11 case. The plan approval process for a pre-packaged case can take as little as thirty days from the date the plan is filed with the bankruptcy court.

[2] *Re Rodenstock GmbH* [2011] EWHC 1104 (Ch); *Re Nef Telecom BV* [2012] EWHC 2944 (Ch).

[3] *Primacom Holding GmbH v Credit Agricole* [2012] EWHC 164 (Ch).

[4] *Re Apcoa Parking Holdings GmbH and others* [2014] EWHC 1867 (Ch).

[5] It is important to avoid overstating the significance of the *Apcoa* decision, however. In that case, the scheme had the overwhelming support of the scheme creditors, the sanctioning of the scheme was uncontested, and the proposed change solely related to a short extension of the maturity date. It is unclear whether the court would have reached a different result had dissenting creditors raised objections.

[6] The determination with respect to whether a foreign proceeding is "main" or "nonmain" can make a difference in the scope of relief that is granted. For example, if a proceeding is recognized as a foreign main proceeding, an automatic stay against creditor actions takes effect in the U.S. without the need for a court order, but the same is not true if the foreign proceeding is determined to be a nonmain proceeding – the foreign representative of a foreign nonmain proceeding must affirmatively seek such relief.

[7] 11 U.S.C. § 1502(2). One court has remarked that the "bar is rather high" to prove that a debtor has an establishment in a particular jurisdiction. *In re Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd.*, 374 B.R. 122, 131 (Bankr. S.D.N.Y. 2007), aff'd, 389 B.R. 325 S.D.N.Y. 2008). Based on existing case law, it appears that something more than merely being incorporated in the

foreign jurisdiction, only conducting bankruptcy proceedings or only having assets there is required. An establishment is much more likely to be deemed to exist where the debtor conducts stable local business activities in the foreign jurisdiction, even if the activities are controlled offshore. See, e.g., *In re British American Ins. Co. Ltd.*, 425 B.R. 884, 914-16 (Bankr. S.D. Fla. 2010).

[8] The Bankruptcy Code defines the term "foreign proceeding" as "a collective judicial or administrative proceeding in a foreign country, including an interim proceeding, under a law relating to insolvency *or adjustment of debt* in which proceeding the assets and affairs of the debtor are subject to control or supervision by a foreign court, for the purpose of reorganization or liquidation." 11 U.S.C. § 101(23) (italics added). See, e.g., *In re Magyar Telecom B.V.*,Case No. 13-13508 (SHL) (Bankr. S.D.N.Y. Dec. 11, 2013).

[9] Although beyond the scope of this article, one option for the foreign debtor may be to either shift its COMI (i.e., relocate its administrative headquarters) or create an establishment (i.e., commence significant business activities) in the UK for purposes of obtaining chapter 15 recognition. This of course is likely to be operationally burdensome, and therefore might not be viable for many foreign debtors.

[10] The legislative history behind chapter 15 provides that the chapter was intended to be the "exclusive door to ancillary assistance to foreign proceedings." See H.R. Rep. No. 109-31, Pt. 1, 109th Cong., 1st Sess. 110 (2005). This statement has been cited in several decisions for the proposition that all matters relating to a pending foreign proceeding must be centralized in a chapter 15 case before a U.S. bankruptcy court. To date, however, there does not appear to be any case law interpreting whether this policy would apply in relation to judgments and orders that were entered by foreign courts in foreign proceedings that since have closed. The text of chapter 15 makes clear that chapter 15 relief may only be granted in relation to open foreign proceedings (the definitions for both "foreign main proceeding" and "foreign nonmain proceeding" use the word "pending"). It also appears logical that where chapter 15 relief is unavailable due to the foreign proceeding having closed, the existing common law principles of comity (discussed *infra*) would apply.

[11] See *Hilton v. Guyot*, 159 U.S. 113, 202-03, 16 S. Ct. 139, 40 L. Ed. 95 (1895).

[12] See, e.g., *Tropp v. Corp. of Lloyd's*, No. 07 Civ. 414, 2008 U.S. Dist. LEXIS 30635, at *53, 2008 WL 5758763, at *14 (S.D.N.Y. Mar. 26, 2008) ("[I]t borders on the risible to argue that the English system, from which ours explicitly derives, does not afford due process.") (citations and internal quotation marks omitted).

[13] See *Collins v. Oilsands Quest Inc.*, 484 B.R. 593, 597 (S.D.N.Y. 2012) ("[T]he public policy exception should be narrowly interpreted and is restricted to the most fundamental policies of the United States. Accordingly, a foreign judgment should generally be accorded comity if its proceedings are fair and impartial.") (citations and internal quotations omitted).

[14] *In re Ephedra Prods. Liab. Litig.*, 349 B.R. 333 (S.D.N.Y. 2006).

[15] *In re Fairfield Sentry Ltd.*, 714 F.3d 127 (2d Cir. 2013).

[16] *In re Metcalfe & Mansfield Alt. Invs.*, 421 B.R. 685, 697 (Bankr. S.D.N.Y. 2010).

[17] See also fn. 10.

[18] This illustrative timeline assumes the restructuring of bank debt, not publicly-issued bond debt.