European Perspective

Note From the Editors:

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Roll Up! Roll Up! Schemes Roundup

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Introduction

In this article, we will review some of the recent developments in the way schemes of arrangement under English law have been used and some of the legal issues that have arisen. Schemes of arrangement have been in the English statute books for well over 100 years. The current provisions are found in five short and terse sections of the UK Companies Act 2006 (the “Companies Act”) (sections 895–899). The brevity of the sections belies their importance and complexity, and a body of case law has developed over time concerning the correct procedures and formalities that have to be complied with and the legal hurdles that have to be overcome in order for the court to approve the scheme.

Until relatively recently, schemes, in an insolvency context, have tended to be used by insurance companies as a means of settling long-term and contingent claims and distributing assets to policyholders. However, in the past few years, schemes have become a popular rescue procedure for a much wider audience and, in particular, for complex financial distressed-based restructurings involving one or more tiers of secured debt, filling the void left by the potentially more user-friendly company voluntary arrangement (“CVA”). A CVA cannot be used to compromise claims of a secured creditor without that creditor’s expressed consent.

What Is a Scheme of Arrangement?

A scheme of arrangement can be used in both solvent and insolvent contexts. It is a procedure that can be used by a company to implement a compromise or arrangement with either its creditors generally (or a class of them) or its members (or a class of them). A scheme is a court-driven process and involves the proponent of the scheme (invariably the debtor company) making two applications to court. At the first hearing, the company seeks an order of the court to convene the relevant creditor meetings to vote on the proposed compromise embodied in the scheme documentation.

It is at this stage that the court decides whether the company has correctly identified the classes of creditors to attend the meeting and vote on the scheme. The creditor meetings are then held. If the creditors approve the scheme, the company makes a second application to the court for "sanction" (*i.e.*, approval). The court at this stage is concerned with ensuring that the scheme is one which a creditor could reasonably have approved, that the majority has not unfairly coerced a minority to accept a position contrary to its interests, and that each creditor class has been fairly represented at the meeting. If the court gives sanction, the scheme becomes binding once the court order has been filed at the UK Companies Registry.

A scheme is approved by creditors if a majority in number of the creditors of each relevant class and at least 75 percent in value of the claims of creditors in that class represented at the meeting have voted in favour of it.

Recent Developments in Schemes of Arrangement

By far the most significant development that has taken place in the past year relating to schemes has been their use by overseas companies. It may at first sight seem strange that a foreign company would want to make use of an English law procedure to compromise claims with creditors (few or none of whom may be English-based) and even odder when one considers that the EC Regulation on Insolvency Proceedings 2000 (the "Insolvency Regulation") has been in force for many years and provides for automatic recognition throughout the EU (except in Denmark) of a debtor's main insolvency proceedings initiated in the country where its centre of main interests ("COMI") is located.

The odd becomes the truly bizarre when one considers that an English scheme is not an insolvency procedure which falls within the ambit of the Insolvency Regulation and therefore has no legal status thereunder. So why are foreign companies coming here to propose schemes? Is it because they like the food or the weather? Alas, no. The more mundane reasons why schemes are proving popular with foreign companies are as follows:

- Schemes of arrangement (like CVAs) have at their heart a "cramdown" procedure whereby a dissenting minority of creditors can be bound by a compromise approved by a majority. Although cramdown is a well-established concept under both English and U.S. insolvency law, it is comparatively rare in civil-law countries. Where cramdown does not exist, a company must obtain the consent of each of its creditors if it is to implement successfully a restructuring. In practice, this 100 percent threshold often is unachievable. Therefore, where cramdown does not exist under local law or the law of its COMI, the debtor may find cramdown procedures in England worth a closer look.

- Even where cramdown procedures do exist under the law of the debtor's COMI, there may be little track record of the procedures' having been used successfully, and there may be a lack of experience in local courts in overseeing them. The German *Insolvenzplan*, for example, is still an underused procedure even though it allows for cramdown.

- The English scheme is a trusted and well-understood mechanism with predictability of result.

England has already demonstrated its ability to attract debtor “immigrants” (both corporate and individual) to make use of its debtor- and creditor-friendly bankruptcy and insolvency procedures. For example, Wind Hellas in 2010 migrated its COMI to England from Luxembourg in order to enter into an English administration (as a “main proceeding” under the Insolvency Regulation) and to effect a prepackaged sale of its business. However, moving COMI is, to put it bluntly, a hassle at best and wholly impractical or impossible at worst (assuming the “command and control” test for COMI is not resurrected). The recent European experience is that, as far as corporate debtors are concerned, only a company with few or no employees or physical assets can readily move its COMI (and even then, there may be significant tax considerations which might mitigate against it). However, English insolvency lawyers and English courts do not give up the fight easily, and English schemes are another form of the wares we offer to the curious and financially distressed who choose to shop within our stores. This has been witnessed recently in *La Seda de Barcelona* (a partially reported decision) and a number of unreported decisions (*Tele Columbus Group* and *Rodenstock GmbH* (German), *Metrovacesa SA* (Spanish), and *Gallery Media* (Russian)).

Case Studies

Let us take a closer look at the developing law relating to the ability of non-English companies to use English schemes of arrangement successfully.

La Seda

La Seda was a Spanish company with its COMI in Spain. The company entered into individual compromise agreements with bilateral lenders and trade creditors. Predictably, it could not obtain unanimous consent of the members of its secured bank syndicate to a restructuring of its facilities. The only option available to it in Spain was a formal insolvency. However, the negotiations with the bank syndicate had shown that a majority of the syndicate was in favour of a restructuring which, if exported to England, would be sufficient to approve a scheme. La Seda therefore came to England and proposed a scheme of arrangement among the members of the syndicate (which comprised one class of creditors). The requisite majority of creditors voted in favour. A number of interesting issues emerged from the case, but the one that concerns us for present purposes was the basis on which the English court held that it had jurisdiction to approve La Seda's scheme.

Section 895 of the Companies Act provides that "a company liable to be wound up under the [UK] Insolvency Act 1986 [(the 'Insolvency Act')]" may propose a scheme. Section 221 of the Insolvency Act allows an unregistered company (which includes a non-English company) to be wound up in England. Before the Insolvency Regulation came into force, the English courts had assumed a liberal and wide discretion to make winding-up orders over foreign companies (and hence, there was a wide window available for foreign companies to propose schemes). Under common law, a threefold test needs to be satisfied in order for an English court to exercise jurisdiction:

- The debtor must have a sufficient connection with England;
- There must be a reasonable possibility that if the company were to be wound up in England or a scheme were to be approved, someone would benefit from the winding-up order or scheme; and

- There is at least one person interested in the distribution of the assets in the winding-up or under the scheme who would be subject to the jurisdiction of the English courts.

It is not quite clear if all of these elements are mandatory or if (in the case of the last two) they merely go towards the court's exercise of its discretion whether to assume winding-up jurisdiction.

Two issues of interest arose in *La Seda*. First, did the company have a sufficient connection with England, and second, had the Insolvency Regulation displaced the common-law rules as to what constituted a company "liable to be wound up under the Insolvency Act"? As for the first issue, the court held that La Seda did have a sufficient connection. This was because the banking agreements between La Seda and the syndicate were governed by English law and gave the English courts jurisdiction. It was also significant that La Seda had an English subsidiary and its own branch office in England.

As for the second issue, the Insolvency Regulation introduced a problem, perhaps unintentionally. Under the Insolvency Regulation, a company (wherever it is incorporated) cannot be wound up in England as a "main proceeding" unless its COMI is in England, and it cannot be wound up in England as a "nonmain" (secondary, or "territorial") proceeding unless the company has an "establishment" in England.

The court held that the Insolvency Regulation had not displaced the previous rules relating to what amounted to a company "liable to be wound up" in England. According to the court, since

La Seda satisfied the threefold test referred to above, it was liable to be wound up in England, and that was the end of the matter.

So far, so good. However, would a scheme approved by the English court bind all the scheme creditors, particularly those who are in a position to initiate an insolvency in the home country, Spain? Because the Insolvency Regulation does not confer recognition on schemes in EU member states, it would be a matter for Spanish law as to whether the English scheme would be recognised in Spain. Evidence was adduced in *La Seda* that a Spanish court would recognise the English scheme because of the presence of the English governing law and jurisdiction clauses in the banking facility agreements. The scheme would be seen in Spain to be an amendment of creditors' rights under the La Seda facility agreements, and because that amendment would be binding under the law of the facility agreements (English law), a Spanish court would recognise the scheme.

Tele Columbus Group* and *Rodenstock

Hot on the heels of *La Seda*, the Tele Columbus Group and Rodenstock successfully implemented English schemes of arrangement. In both cases, the companies in question were German, and each had its COMI in Germany. Once again, the scheme purported to compromise the claims of secured creditors whose rights and obligations were governed by English-law loan agreements that contained English jurisdiction clauses. What emerges from these two cases as a practical pointer is that it is important to adduce evidence that an English scheme would be recognised in the home country (this could be provided by an academic, a retired judge, or an officeholder in the home country). The rationale for this requirement is not entirely clear, but it appears to go to the issue of fairness and reasonableness. If the scheme bound those creditors who were subject to the jurisdiction of the English courts, but not those creditors who were not, the former would be in an unfair position compared to the latter, and it would not be reasonable for a scheme to become binding in these circumstances.

In *Rodenstock*, the court was influenced by the fact that the scheme was being used to compromise creditor claims arising under a single facility agreement. What was important was not just that the rights between the company and the creditors were governed by that agreement, but that it also governed the rights between the creditors themselves. The position supporting jurisdiction would have been weaker if each creditor had entered into its own separate loan agreement with the company and there had been no overarching agreement that dealt with intercreditor issues.

Metrovacesa

Another Spanish company, Metrovacesa SA, also successfully proposed an English scheme of arrangement. Its banking arrangements were similarly governed by an English-law loan agreement. Additional testimony was given by a Spanish academic to the effect that the Spanish court would recognise the English scheme as a matter of policy because Spain was in the process of formulating its own cramdown rules.

It is interesting to note that the statutory requirement for the court order sanctioning a scheme to be filed at the UK Companies Registry in respect of English companies in order for the scheme to become binding appears not to apply in respect of foreign companies. This clearly makes practical sense where the foreign company is not registered in England as an overseas company, but the legal rationale for waiving the requirement remains obscure.

There are a few words of caution to offer regarding the attractiveness of English schemes for foreign companies. All of the cases we have considered above involve what was essentially a compromise of rights under English law documents. It is far less clear as to whether an English scheme would be recognised in the country of the debtor's incorporation or (if different) the debtor's COMI if the scheme purported to compromise rights arising under a law other than English law. Interestingly, the regional appellate court in Celle, Germany, has refused to recognise the Equitable Life scheme of arrangement (although the decision is being appealed). The difference in that case is that the English scheme purported to compromise rights arising under German law documents.

Can Schemes of Arrangement Be Used to Compel Creditors to Release Claims Against Third Parties?

The issue of third-party releases also arose in *La Seda*. An English subsidiary, Artenius UK Limited ("Artenius"), was a guarantor of La Seda's bank liabilities. Artenius had been placed into administration and had claims against La Seda and other group companies exceeding £80 million. The scheme contained a term that provided for the scheme creditors to release Artenius from all liabilities as guarantor. If the scheme were approved containing such a term, Artenius was prepared to release its intercompany claims. The question arose whether the court should decline to approve the scheme because it included a term under which creditors would be forced to give up their claims against a third party.

The court had little difficulty in coming to the view that the term in question did not prevent it from giving approval to the scheme. It was satisfied that there was a sufficient element of give and take on the part of the creditors and the beneficiary of the release, Artenius. The “take” on the part of the creditors was that the release would improve the balance-sheet position of La Seda and its subsidiaries. The court explained that the test for these sorts of clauses is that they are unobjectionable if the claims of the creditors against the released party: (i) are closely connected to the scheme creditors’ rights against the company proposing the scheme; (ii) are personal and not in the nature of proprietary rights; and (iii) would, if exercised, result in a reduction of the creditors’ claims against the debtor.

The court found that these three elements had been satisfied. What is not clear from the ruling is whether the claims against Artenius were secured (likely) and whether the claims that Artenius had against La Seda and its subsidiaries were subordinated such that they could not have been paid until the bank debt had been repaid in full (almost certainly). Neither of these factors appeared to be an impediment in satisfying the threefold test.

It is interesting to compare the position to releasing third parties under a CVA. If La Seda had proposed a CVA on identical terms, the result ought to have been the same. It is possible to compromise creditors’ claims against third parties under a CVA, provided that no unfair prejudice has been suffered by a releasing creditor. In *La Seda*, all the scheme creditors had the same rights against Artenius and were receiving the same value for the release (*i.e.*, the cancellation of claims against the remainder of the group), and thus, there was a complete absence of discrimination between the creditors.

Conclusion

Schemes and the law associated with them are evolving to provide a very powerful tool in the restructuring process where debtors have complex capital structures involving one or more tiers of secured debt. This is evidenced by the fact that schemes in the insolvency context have developed from the rather narrow and specialist arena of providing for a distribution mechanism for insolvent insurance companies to what is now emerging as an effective and powerful restructuring process of choice for a broad range of companies (wherever their place of incorporation or the location of their COMI). This says much about their flexibility and popularity among corporate leaders and the welcome readiness of the English courts to assist companies in financial difficulty in providing a restructuring solution that avoids a formal insolvency.

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