Schemes of Arrangement: The comeback king?

The relative attractions of alternative restructuring tools.

low, cumbersome and costly for everyone involved'. Although we could be talking about England's World Cup performance, we are in fact referring to how Schemes of Arrangement are often perceived. As a restructuring tool, Schemes tend to be regarded as the less attractive, older brother of Company Voluntary Arrangements (CVAs) due to the level of court involvement, the lengthy timetable and the thorny issue of dividing creditors into classes. That said, Schemes have had a comeback in recent years and can be, where the circumstances dictate, a very attractive tool to restructure debt obligations. This stems from their flexibility, availability to foreign companies and their most striking feature, the ability to bind secured creditors and disenfranchise those with no economic interest, features which are not shared in many cases by CVAs.

In this article, we consider when a Scheme may be a more appropriate restructuring tool than a CVA and touch on the differing role of an insolvency practitioner in each. The comparison table opposite highlights the key differences between CVAs and Schemes, some of which we will discuss in greater detail.

How to Scheme

A Scheme is a compromise or arrangement between a company and its members or creditors or any class of them.[1] Unlike CVAs, Schemes are not formal insolvency procedures and have always been governed by the Companies Acts (now contained in ss.895-899 of the Companies Act 2006) and never by the Insolvency Act 1986. They are available in solvent and insolvent situations and have been historically popular as a means of a company takeover and for insurance company insolvencies. Schemes are flexible and can essentially be anything a company and its creditors/members agree between themselves. There must, however, be an element of 'give and take'[2] in order to qualify as a scheme of arrangement for statutory purposes. Schemes are usually proposed by the company (or its administrator/liquidator) but can in theory be proposed by a shareholder or creditor.

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Planning stage

One should not underestimate the amount of work involved before getting to court, including drafting all necessary documentation and engaging with impacted stakeholders, who sometimes sign a lock-up agreement committing to vote in favour (often for a fee). For the reasons discussed below, at the initial stage, serious thought will go into class constitution.

Convening hearing

The hot topic for the court at this stage is creditor classes. Classes should be determined based on whose legal rights vis à vis the company are not so dissimilar that they would be able to consult together and engage in sensible dialogue with a view to their common interests.[3] Generally, one would expect a company with tiers of secured debt to have different classes of creditors in accordance with their respective rights under intercreditor arrangements, ie separate classes for the senior and junior secured creditors on the one hand and unsecured creditors on the other.

Meetings

The voting threshold is a majority in number holding 75 per cent in value of each class of those present and voting. A key distinction and attraction of Schemes compared to CVAs is that if a creditor's rights are not affected by the proposal on the ground that they do not have any economic interest in the company's assets, they are not entitled to vote.[4] If therefore, the value of the business breaks in the senior debt level, the junior creditors are effectively 'out of the money' and need not be invited to vote on the Scheme. The valuation of the business is therefore fundamental as it dictates who is in the driving seat. Currently, a going concern valuation is considered best practice.[5]

Sanction hearing

The court can refuse to approve the Scheme if stakeholders have not been treated fairly or the classes were not fairly represented. The review by the court is not just a box-ticking exercise. It will also consider any creditor objections who may challenge on unfairness grounds. The test for fairness is whether the Scheme is one a reasonable, honest man, having regard to his own interests might properly approve.[6]

The court is concerned that the Scheme appears fair and equitable, as opposed to considering its commercial strengths. The court may also consider how the classes would have fared in a comparative liquidation (if that is the likely alternative).

Once the Order is made and delivered for registration at the Companies Registry, the Scheme becomes fully effective and binds everyone,[7] including secured creditors and anyone that opposed it. This is a key advantage for companies with various levels of secured debt and a crucial distinction to CVAs, which cannot affect secured creditors without their consent. A Scheme is deemed final at this stage, whereas CVAs are challengeable for 28 days after notice of the result of the creditor's meeting is filed at court.

When to Scheme

Nowadays, CVAs are seen as better suited to smaller companies or companies that only seek to compromise unsecured creditors. Schemes, on the other hand, are becoming a popular alternative when tackling more complex corporate restructurings with various debt levels. This is because Schemes have three key benefits over CVAs: their ability to bind secured creditors and to disenfranchise junior creditors and their availability to foreign companies. That said, in the context of a company in need of a financial restructuring, a Scheme is not usually 'Plan A' and is often instead used as a back-up threat to focus stakeholders' minds in order to encourage a consensual restructuring.

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Bind-ability and disenfranchisement

In recent times, two key types of debt restructuring Scheme have evolved, which cannot be achieved via a CVA:

1. Pre-pack/transfer Schemes

This is a method used by senior 'in the money' creditors to enforce their security and effectively bypass junior creditors, who are so far 'out of the money' that they do not get a vote. It involves a schemed company ('OldCo') transferring its assets to a NewCo owned by the senior creditors. NewCo pays for the price of the assets by 'credit bidding' the claims of the senior creditors equal to the value of the assets such that their claims are reduced by this value. Some or all of the remaining senior liabilities may be assumed and secured by NewCo. OldCo will often be in administration or in the context of real estate assets, a receiver will have been appointed. This ensures an independent assessment of the value of the assets, therefore limiting the risk of challenge. For this process to work, there ought to be an intercreditor agreement in place, which allows the administrator/receiver to sell the assets to NewCo free from the existing security. As a result, the disenfranchised junior creditors' liabilities remain unaffected against OldCo, which effectively becomes a valueless shell. In *Re Bluebrook*,[8] junior creditors tried to object to such a Scheme on unfairness grounds but their arguments were rejected as they had no economic interest in the company.

2. Cramdown Schemes

Such Schemes have developed as a way of circumventing unanimous or high majority lender consent provisions in loan agreements where consensual discussions have broken down. Schemes

	SCHEME	CVA
Timing and cost	Court involvement and creditor class issues generally result in a 2–3 month timetable and therefore higher costs.	No court sanction required and no classes – generally quicker and cheaper to implement.
Classes of creditors	Yes – classes based on sufficiently similar rights against the company.	No – one creditor pool votes on the CVA proposal.
Who is bound?	All members and creditors including secured creditors and those who oppose.	Unsecured creditors only. Only affects secured or preferential creditors who opt in.
Who votes?	Only creditors/members impacted by proposal, ie no economic interest = no vote.	All unsecured creditors. Secured creditors can vote in respect of any unsecured element of their debt.
Available to foreign companies?	No COMI test – company must be capable of being wound up in the UK and have a sufficiently close connection to this jurisdiction.	COMI test applies.
Moratorium?	No unless coupled with administration. Court has recently granted a stay of creditor legal action but extent of the jurisdiction to do so is uncertain.[9]	Generally no unless the company is also in administration. There is a 28 day moratorium available for smaller companies (though rarely used).
Proposal content	Can affect part or all of a company's creditors or members – as a result, tends to cater for more complex restructurings.	Compromise with all unsecured creditors only.
Voting threshold	Majority in number representing 75 per cent in value of each class present and voting.	Creditors comprising: (a) 75 per cent in value of those present and voting; and (b) 50 per cent in value of unconnected creditors.
IP involvement	No IP required (unless company in administration or liquidation).	IP required to act as Nominee and subsequently as Supervisor.
Effectiveness and scope for challenge	Effective once court order sanctioning the Scheme is delivered for registration at Companies House. Can be challenged on unfairness grounds at sanction hearing stage – also susceptible to challenge due to class issues at the convening hearing.	Effective from date of creditors' meeting. Challengeable on grounds of material irregularity or unfair prejudice for 28 day period after notice of meeting result filed at court.

Scheme process

- **First court hearing (the convening hearing)**
  The company seeks the court's permission to call a meeting of the relevant creditors/ shareholders;
- **Meetings**
  The relevant classes of stakeholders meet to vote on the proposal; and
- **Second court hearing (the sanction hearing)**
  – the court decides whether to approve the Scheme.

Likely timetable:

1. First court hearing – likely to take 2–3 weeks to get a hearing date.
2. Meetings usually held 14 or 21 days after the hearing (depending on articles of association).
3. Second court hearing – again likely to take 2–3 weeks to get a hearing date.

Total: likely 2–3 month process excluding the planning stage and depending on court availability.

have recently been used to implement debt for equity swaps and amendments and extensions to facilities, which would not have otherwise been possible. As a further example of how innovative Schemes have become, a recent case involved a 'pension deficit for equity swap' whereby a Pension Trustee released various entities from their obligations in exchange for a cash payment and majority shareholding in the company.[10]

Foreign companies

Unlike CVAs, Schemes are not 'main insolvency proceedings' under the EC Insolvency Regulation,[11] which means a foreign company does not have to show that their centre of main interests (COMI) is in England. This is highly convenient when dealing with large multi-jurisdictional corporate groups, which may have their COMIs in many different countries. Instead, a company has to show it is capable of being wound up here (which in theory is open to all foreign entities as 'unregistered companies' [12]) on the grounds that it has a sufficiently close connection to this jurisdiction.[13] This hurdle is fairly low given that recent case law has established finance documents with English governing law clauses will satisfy this requirement (even if a governing law clause is changed to English law from a foreign law by a majority lender vote undertaken in accordance with the terms of the loan agreement solely for the purpose of enabling the company to make use of a Scheme).[14] In addition, the presence of creditors or assets located here will suffice to give the English court jurisdiction. As a result, there has been a recent influx of Schemes for companies from Delaware to Kuwait.[15] That said, if a Scheme is unlikely to be recognised in the company's home jurisdiction or is being used instead of a local equivalent process, the court may reject it.

It is thought England's open arm attitude to foreign corporate refugees seeking to restructure here via Schemes will continue and that it is unlikely Schemes will be brought within the ambit of proposed amendments to the EC Insolvency Regulation to include certain insolvency rescue procedures where a COMI test would apply.

The insolvency practitioner's role – *Scheme* v. *CVA*

Schemes do not impact on the management of a company and unlike nominees and supervisors in CVAs, there is no requirement to involve an insolvency practitioner at any stage. However, where a Scheme is coupled with an insolvency process, the administrator/liquidator will play an instrumental role in preparing and implementing the Scheme proposal and engaging with stakeholders. In addition, if a Scheme is used as a means of distributing

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a company's assets to creditors, an insolvency practitioner's role in a Scheme will be largely similar to that in a CVA and he will be responsible for determining the value of creditors' claims (including the assessment of contingent claims) and the distribution of dividends.

One issue that the court had to consider recently in the *Miss Sixty* case[16] was whether an insolvency practitioner, appointed as administrator by a creditor, could legitimately propose a pre-packaged CVA supported by that same creditor, who alone held sufficient value to vote it through. Whilst the facts related to CVAs, the same issue could equally apply to Schemes. The court held that the insolvency practitioner was able to exercise his discretion to propose the CVA, subject to limits as to how such discretion was exercised. In that case, the court held that an administrator must act professionally and independently, in good faith and not merely on the instruction of the majority creditor, particularly when a CVA is structured such that it is bound to be passed by the majority of creditors whose position is not affected or is improved but there is a smaller class whose rights will be materially affected. The court commented that the administrators in that case 'seemed to have lost a proper sense of objectivity'.

Conclusion

With their venerable roots, Schemes are experiencing a rebirth and are being used in increasingly inventive ways and have become a popular restructuring tool when a unanimous decision among stakeholders is impossible. Their key strengths over CVAs, namely their ability to compromise secured creditors, ability to disenfranchise out of the money creditors and availability to foreign debtors bolster their position as a solid alternative. That said, the heartaches associated with creditor classes and the time and cost implications of court involvement should always be borne in mind as potential drawbacks. Despite this, Schemes are bearing the hallmarks of the Comeback King ready to reclaim his restructuring crown.

1. S895 Companies Act 2006
2. *Re Savoy Hotel Ltd [1981] Ch 351*
3. *Re Hawk Insurance Co Ltd [2001] EWCA Civ 241*
4. *Re Tea Corp [1904] 1 Ch 12, IMO Carwash*
5. *Re Bluebrook Ltd, Re Spirecove Ltd, Re IMO (UK) Ltd [2009] EWHC 2114*
6. *Re Dorman Long & Co Ltd (1934) 1 Ch 635*
7. S899(4) Companies Act 2006
8. *Re Bluebrook Ltd [2010] BCC 209*
9. *Bluecrest Mercantile NU v Vietnam Shipbuilding Industry Group [2013] EWHC 1146 (Comm)*
10. *Re Uniq Plc [2011] EWHC 749 (Ch)*
11. *EC Regulation on Insolvency Proceedings (1346/2000/EC)*
12. S.221 Insolvency Act 1986
13. *Re Drax Holdings Ltd [2003] EWHC 2743 (Ch)*
14. *Re Rodenstock GmbH [2011] EWHC 1104, Re Apcoa Parking Holdings GmbH and others [2014] EWHC 1867 (Ch), Re Drax Holdings Ltd (above)*
15. *Re Icopal As and others [2013] EWHC 3469 (Ch), Global Investment House KSC [2012] EWHC 3792 (Ch)*
16. *Mourant & Co Trustees Ltd v. Sixty UK Ltd (in administration) [2010] EWHC 1980 (Ch)*

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