Insight: Financial Restructuring & Insolvency

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Schemes of Arrangement – Current Hot Topics and Market Trends

The English law scheme of arrangement (or "scheme") has re-emerged as a favoured tool of choice for those engaged in complex financial restructurings, in particular where a consensual solution may not be capable of implementation. This bulletin focuses on the key terms of the most high profile recent schemes, including those of *WIND Hellas*, *La Seda*, *European Directories* and *Cattles*, and identifies current hot topics and market trends.

Background

A scheme is a formal statutory procedure commenced under the Companies Act 2006 pursuant to which a company may propose and settle on a compromise or arrangement with some or all of its creditors. A key advantage of a scheme is that it can provide an opportunity to implement a restructuring solution at a lower approval threshold than would ordinarily apply under the terms of financing documentation (often avoiding the need for the unanimous consent of a particular group of creditors). This can counteract the potential 'hold-out' value of dissident creditor minorities who could otherwise frustrate a widely-supported restructuring process. Schemes have also been combined with English law pre-packaged (or 'pre-pack') administration sales to facilitate the realisation of value from materially overleveraged financing structures.

Schemes have become instrumental in the restructuring of the indebtedness of overseas-incorporated companies and group structures (with the necessary "sufficient connection" to England) as they can be more efficient and user-friendly than certain local law alternatives. Last year alone saw schemes implemented in relation to companies incorporated, or with key operations, in Spain, Germany, Russia and Luxembourg.

Restructuring Trends

In the table on page 4, we identify the key terms of some high-profile scheme processes of this economic downturn. It is inherently difficult to identify any themes and trends emerging from the table, as each financial restructuring is invariably fact-specific, influenced by many different factors and stakeholder interests. However, we set out below some of the issues that we consider to be 'hot topics' in schemes implemented over the past two years.

Valuation

Valuation is a key consideration in all financial restructurings, including those involving schemes, to determine creditors' interests in the underlying value of a company or group. It is a long-established principle of English law that those creditors without a genuine economic interest may be disregarded for the purposes of a scheme[1]. However, the English courts have demonstrated a varying approach to valuation.

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[1] Re Tea Corpn. Ltd. [1904] 1 Ch. 12

In *My Travel*, Mann J. concluded that a liquidation valuation should be applied to determine the interests of stakeholders, as liquidation was the only viable alternative should the scheme proposal fail. When evaluating the fairness of schemes in *IMO Carwash,* the Court held that a going concern approach to valuation should apply and indicated that the appropriate valuation methodology will vary from case to case. In *IMO Carwash*, a 'Monte Carlo simulation' valuation proposed by a certain group of creditors was considered not to involve sufficient 'real world judgment' to determine creditors' relative interests. In the recent *WIND Hellas* restructuring, the company and its advisers conducted an extensive M&A bidding process prior to selecting a preferred bidder for the underlying business. This process supported the company's indicative valuation range and thereby protected against challenge from an aggrieved creditor on grounds of valuation.

While *IMO Carwash* indicates that a 'Monte Carlo' simulation is an unsafe approach to valuation for purposes of a scheme, the question remains as to whether other methodologies may be viable. Given the inherent uncertainty, we expect to see more litigation on valuation issues going forward, particularly with junior creditors otherwise facing having their claims wiped out. In the meantime, we also expect an increased usage of schemes in conjuncion with pre-packaged administration sales (as was employed in the recent *WIND Hellas* and *European Directories* restructurings) so that the sale of the distressed company's business to the restructured group is carried out by the administrator who, therefore, assumes the risk of any challenge on valuation with the directors becoming distanced from the transaction.

New Money – Cash is King

One of the trends evident from the table is that in this downturn, junior creditors are increasingly being left behind and having their claims compromised unless they are willing to provide the distressed group with a capital injection. For example, in the *British Vita* restructuring, the sponsor and mezzanine lenders provided a €60 million cash injection with a debt write-down of approximately €500m, but emerged with a significant equity stake. In *WIND Hellas*, those existing senior secured noteholders (the class of creditors subject to a scheme of arrangement) who provided additional funding through participation in an equity offering shared approximately 90% of the restructured group. By contrast, the second lien lenders in *European Directories* did not provide any new money, and were subsequently excluded from the restructuring. Going forward, experience suggests that if value breaks in the senior debt, junior lenders will likely have to provide new money in order to secure a significant stake in the restructured business.

Release of Transaction Security and Guarantees

A key issue in many restructurings is whether transaction security and guarantees may be released (and the terms of any such release), to facilitate a transfer of the underlying business out of an overleveraged group structure.

In most situations, any release of security and guarantees will be effected through the contractually agreed release mechanic in the intercreditor agreement. However, if the relevant release provisions give rise to uncertainty (or indeed if the release is simply considered not to work), the parties may look to achieve a release of claims through a scheme of arrangement. In the High Court judgment approving *La Seda* [2], Proudman LJ adopted the language of Neuberger LJ from an earlier *Lehman*

[2] [2010] EWHC 1364 (Ch)

Brothers decision[3] and applied it in order to determine whether the third party release was effective. In brief, creditors can agree to releases in schemes that are "*necessary in order to give effect to the arrangement proposed for the disposition of the debts and liabilities of the company to its own creditors*". This may, in practice, include the release of contractual rights or rights of action against related third parties.

While this provides guidance and appears to endorse another mechanism to release creditor claims, the question of whether a release is essential to the operation of a scheme or merely ancillary may not be clear. Further, even if such release is effective as a matter of English law, the question of whether it would be recognised in other jurisdictions will be key. In particular, the US Bankruptcy Court is likely to examine any broad releases closely, particularly those relating to non-debtors, and has shown that it will take a strict view as to whether they should be recognised[4].

Jurisdiction: 'Sufficient Connection' or 'COMI'

It is a long established principle that a 'sufficient connection' with England and Wales must be established before an English court will exercise its jurisdiction to sanction a scheme of arrangement. This is a relatively low threshold and an overseas-incorporated company may well meet this requirement in many situations. For example, in *Orion Cable*[5], the English court recently exercised its jurisdiction to sanction schemes of arrangement in respect of a German-incorporated operating company primarily on the basis of English law-governed finance documentation expressed to be subject to the exclusive jurisdiction of the English courts.

However, despite the ability of overseas companies to avail of schemes on the basis of a 'sufficient connection', they may well be advised to establish the higher threshold of a centre of main interests or 'COMI' in the UK in advance of launching a scheme process. This is because establishing COMI in the UK may well be a pre-requisite for recognition of the scheme in overseas jurisdictions, including in the US. Indeed, certain recent restructurings, including that of *WIND Hellas,* have included recognition of the scheme as a condition precedent to closing the transaction.

Class Issues

One of the key issues in schemes of arrangement has been ensuring that the classes of creditors subject to the scheme have been properly constituted; failing to separate creditors into appropriate classes based on their respective rights would potentially lead to a challenge at the Court directions hearing with time and cost implications for the proposed restructuring.

In the wave of schemes that have occurred post-credit crunch, class composition case law has been relatively scarce. However, one case that has arisen on point is that of *DX Services* in July 2010 in which the key issue concerned the use of reasonable inducement fees in order to expedite the scheme voting process and whether this created class issues between those creditors who accepted the fees and those who didn't. Floyd J approved the use of incentive fees in *DX Services* and held that, in itself, it did not give rise to class issues on the basis that the proportion of the overall restructuring offered as an incentive (2.5%) was relatively low and the fact the amounts would not be considered large enough to unfairly force the hand of creditors who disagreed with the scheme.

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3 [2009] EWCA Civ 1161, at para 83

4 See, for example, the decision in *Metcalfe* (421 B.R. 685)

5 In the Matter of *Tele Columbus GMBH & others*, 14 December 2010

Name of deal/ completion date	Pre-transaction debt	Form of restructuring	Post transaction debt	Post-transaction equity
Crest Nicholson 19 March 2009	£1.12 billion	Scheme of Arrangement	£620 million	■ Senior Lenders - 86% ■ Second lien – 4% ■ Management – 10%
McCarthy & Stone 21 April 2009	£900 million (approx)	Scheme of Arrangement/ Pre pack administration	£515 million (approx)	Senior Lenders – 100%
British Vita Group 22 April 2009	€673.70 million	Scheme of Arrangement	€100 million	■ Sponsor (providing €40 million equity injection) – 33.4% ■ Super senior lenders (providing €35 million revolver) – 9.9% ■ Existing senior lenders subject to debt write down– 37.5% ■ Certain mezzanine lenders (providing €20 million equity injection) - 16.7% ■ Mezzanine lenders – 2.5% (plus warrants)
Countrywide Plc 6 May 2009	£740 million	Scheme of Arrangement/ Pre pack administration	£175 million	■ Sponsors (providing £75 million equity injection) – 60% ■ Senior noteholders – 5% ■ FRN (providing £30.84 million equity injection) – 35%
IMO Car Wash 11 August 2009	■ £313 million senior debt ■ £119 million mezzanine debt	Scheme of Arrangement/ Pre pack administration	£185 million senior debt	■ Sponsor – 0% ■ Senior lenders - £128 million senior debt converted into controlling shareholding in new Holdco ■ Mezzanine lenders – 0%
La Seda 26 May 2010	€600 million (as part of a wider restructuring)	Scheme of Arrangement/ Pre pack administration	■ €236 million term loan ■ €210 million PIK loan	■ Existing shareholders - 17.2% ■ BA Vidro (which backstopped a substantial part of the capital increase) – approximately 41% ■ Term loan lenders - 41%
Gallery Media 26 May 2010	$342 million	Scheme of Arrangement	$100.3 million	■ Sponsors (providing $5 million cash injection) - 30% of Newco shares ■ Existing noteholders - 70% of Newco shares
WIND Hellas Telecommunications SA 16 December 2010	€1.867 billion	Scheme of Arrangement/ Pre pack administration	Nil	Senior bondholders: ■ 90% equity for lenders investing a further €420 million ■ 10% pro rata equity to non-participating lenders
European Directories 23 December 2010	€1.6 billion	Scheme of Arrangement/ Pre pack administration	€1.375 billion	First lien senior lenders – obtained ownership of group
Tele Columbus/Orion Cable 18 January 2011	€1 billion	Scheme of Arrangement	■ €623 million senior debt ■ €280 million mezzanine debt	■ €35 million capital injection ■ Senior lenders - 45% (with 10% ratchet) ■ Mezzanine lenders - 55%
Cattles plc 2 March 2011	£2.4 billion	Scheme of Arrangement	■ £800 million bank facility ■ £239 million private placement notes	100% owned by Bovess Holdco. The Holdco shares are held by a discretionary trust for general charitable purposes

Source: *Debtwire*

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