WHITE & CASE

Insight: Financial Restructuring and Insolvency

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'Flip-Up Pre-Packs' – A new approach to accessing the UK insolvency regime

The UK has long-since established itself as a jurisdiction of choice for complex cross-border restructurings involving corporate groups whose principal operations are overseas. Typically, the English Court has accepted jurisdiction because the borrower or issuer entity had shifted its centre of main interests ("**COMI**") to England, opening-up substantially the full range of restructuring and insolvency options available under English law; or because the obligations being restructured were English-law governed and expressly subject to the English Court's jurisdiction, which provides a 'sufficient connection' to the UK for the court to sanction a scheme of arrangement.[1]

Notwithstanding the above, in certain situations, a COMI shift may not be practical (e.g. for tax reasons) and/or possible (e.g. if the debt was borrowed by an operating company), and a borrower group will often need to restructure obligations that are not governed by English law. The recent decision in *Re Christophorus 3 Ltd*[2] establishes that, if an intercreditor agreement containing certain commonly used terms is in place, there is a third way of accessing the UK insolvency regime – namely, by 'flipping-up' the borrower group to an English (former) subsidiary of the principal borrower, and placing that English company into a UK insolvency process. The new 'flip-up' technique will not displace the COMI shift and/or the use of English law governed documents as methods of establishing the jurisdiction of the English Court, but the door is now open for more overseas groups to access the UK regime.

Facts

The Auto-Teile Unger Group (the "**Group**") is a car repair business and spare parts retailer operating in Germany and certain other European markets.

So far as material, the Group was financed by:

- An English law revolving credit facility (the "**RCF**") borrowed by Auto-Teile Unger Handels KG GmbH ("**Handels**");
- New York law governed senior notes (the "**Senior Notes**") issued by Handels; and
- New York Law governed junior notes (the "**Junior Notes**") issued by Handels' immediate (German) parent ("**Investment**").

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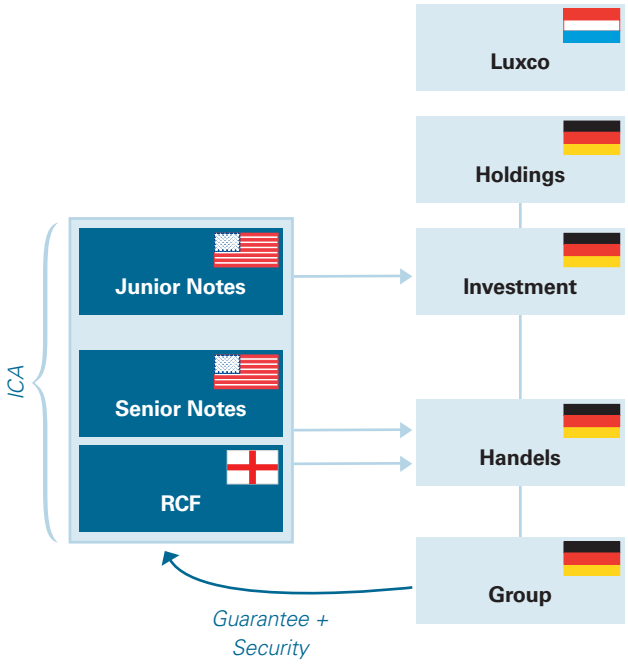
1 See e.g. *Bluecrest Mercantile BV v Vietnam Shipbuilding Industry Group & Others* [2013] EWHC 1146 (comm).

2 *Re Christophorus 3 Limited* [2014] EWHC 1162 (Ch).

An English law intercreditor agreement (the "**ICA**") provided that the RCF would rank senior to the Senior Notes, which would in turn rank senior to the Junior Notes. The Junior Notes were also structurally subordinated to the Senior Notes.

The Group's overall ownership structure was complex, but principally involved a combination of German and Luxembourg holding and operating companies. For present purposes, it is sufficient to add that Investment was owned by another German company ("**Holdings**"), which was in turn owned by a Luxembourg holding company ("**Luxco**"). Prior to the restructuring, the group had no connection with the UK.

A simplified structure chart is set out below.



The Group's liabilities significantly exceeded its assets. A liquidation analysis confirmed that, in a German liquidation, whilst the RCF would be repaid in full, the Senior Noteholders would receive only 3.72% of the amounts outstanding to them, and the Junior Noteholders would receive nothing.

The Group also faced a challenging debt maturity profile. It is unclear whether a collapse of Investment and/or Handels could have been avoided without the continued support of the Group's major creditors (which appears to have been forthcoming, at least for the purposes of the restructuring). Owing to intercompany loan relationships and upstream guarantees, payment of which would likely have been called in such a scenario, a German insolvency of Handels or Investment would have threatened the ability for the Group as a whole to continue trading.

The Intercreditor Agreement

The ICA contained provisions, common in this type of financing structure, relating to:

- *Upstream security from new subsidiaries:* new subsidiaries of Handels were, under certain circumstances, required to provide security in respect of the liabilities owed directly by Handels and Investment (the "**Liabilities**"), and to accede to the ICA by signing an Accession Deed – following which they would be deemed "**Obligors**";
- *Release of obligations and security:* the security agent under the ICA (the "**Security Agent**") was entitled to release the debt obligations and guarantees/security granted by an Obligor under certain circumstances, including upon a sale of all of the shares held by an Obligor in the shares of another Obligor, where such sale was "implemented under a court approved process".

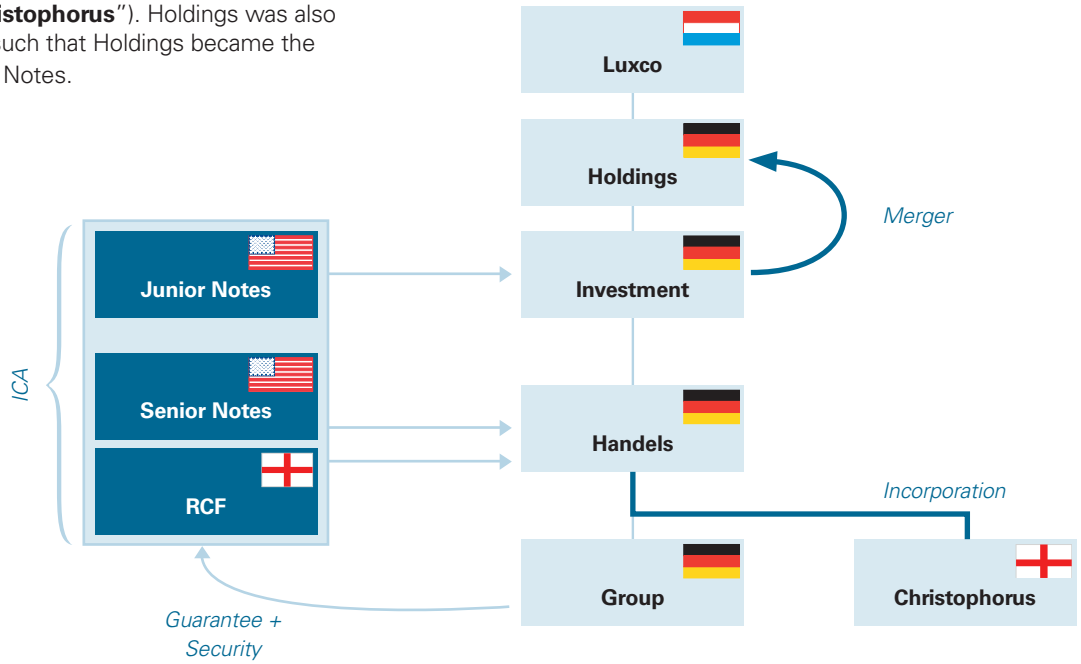
'Flip-Up' and 'Pre-Pack' Administration

Although Handels, Investment, and certain other Group companies were party to the English law-governed ICA, this would not (in itself) have given the Group access to the English restructuring and insolvency regime. Shifting COMI would have had adverse tax consequences, and changing the governing law of the Senior Notes in order to effect a scheme of arrangement (as was done in the recent *Apcoa* decision[3]) appears not to have been considered a viable option. Nonetheless, in its particular circumstances, the Group determined that an English law pre-pack administration was the most viable means of effecting a restructuring and therefore looked into ways to structure jurisdiction to the UK.

3 http://www.whitecase.com/alerts/052014/apcoa-parking-uk-scheme-arrangement-foreign-corporates/

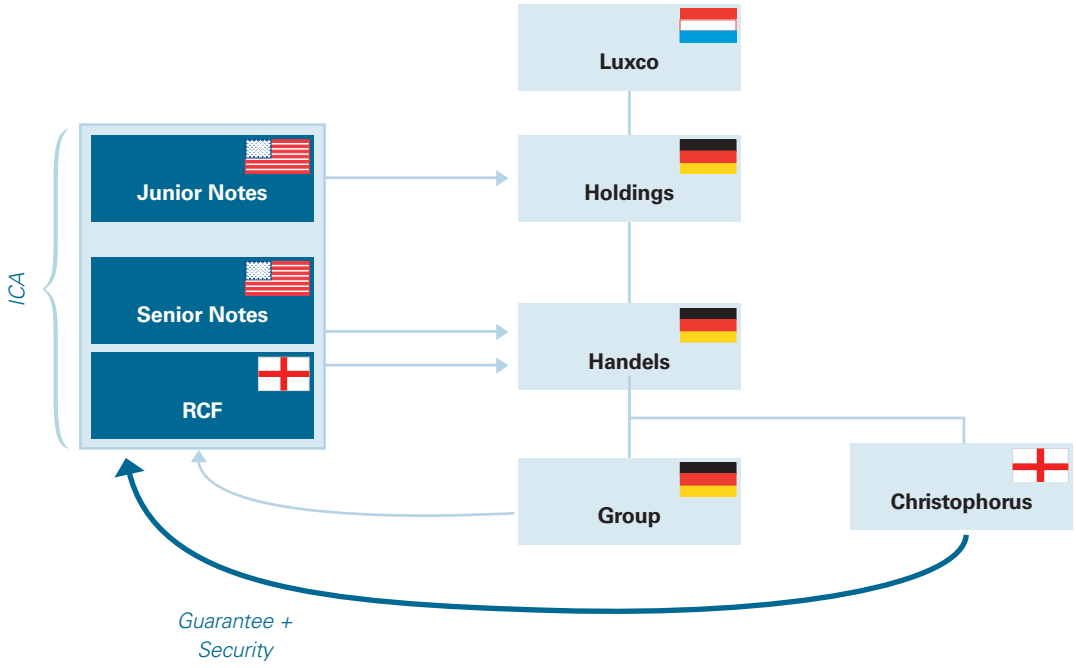
In order to achieve this, the Group implemented a seven step process as follows:

1. *Incorporation of English subsidiary and merger of Investment with Holdings:* Handels incorporated a new English subsidiary, Christophorus 3 Ltd ("**Christophorus**"). Holdings was also merged into Investment, such that Holdings became the borrower under the Junior Notes.



Step 1: Incorporation of English subsidiary.

2. *Christophorus acceded as an Obligor:* Christophorus purchased an intercompany debt for a nominal sum, granted a German pledge over that debt in favour of the secured parties under the ICA, and entered into an Accession Deed. Accordingly, Christophorus acceded as an Obligor under the ICA.

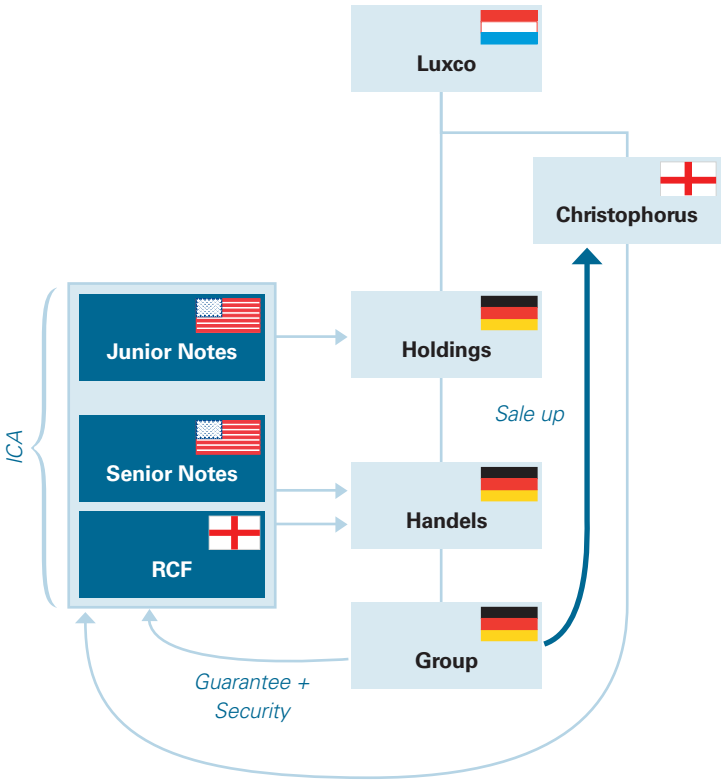


Step 2: Christophorus acceded as an Obligor.

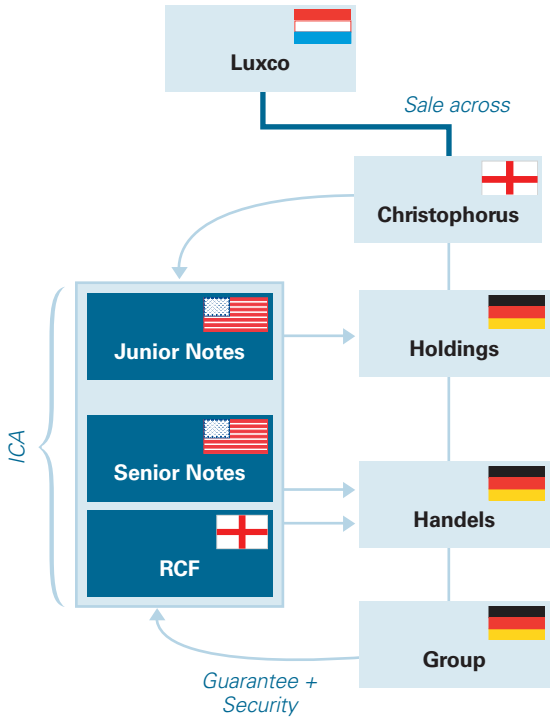
3. *'Flip up':* This involved two sub-steps:

   a. *Handels sold Christophorus to Luxco:* six months later, Handels sold all of the shares in Christophorus to Luxco.

   b. *Luxco sold Holdings to Christophorus:* the operating part of the Group was thus indirectly owned by Christophorus.



Step 3(a): Handels sold Christophorus to Luxco



Step 3(b): Luxco sold Holdings to Christophorus.

4. *Acceleration of the Senior Notes and call of Christophorus' guarantee:* the Trustee under the Senior Notes demanded repayment of the Senior Notes, and called upon the guarantee given by Christophorus under the ICA.

5. *Administration:* Christophorus applied to the court for an order placing it into administration. The administrators proposed to sell all of the shares in Holdings to a new holding company owned (substantially) by the Senior Noteholders (the "**Sale**"), whereby the RCF would be repaid in full, the Senior Notes would be surrendered for new debt, equity, and cash consideration, and the Junior Notes would be released. The Court placed Christophorus into a UK administration and approved the Sale.

6. *Release of obligations and security:* in conjunction with the Sale, the Security Agent released all outstanding obligations, security, and guarantees (including in respect of the Junior Notes) covered by the ICA.

7. *New capital structure:* the restructured Group put in place a new capital structure, under which the total debt burden of the Group was reduced from over €645 million to approximately €160 million.

Issues considered by the court

The Security Agent confirmed that it was in principle willing to agree to Step 6 (i.e. the release of obligations and guarantees/ security), but required a court order to confirm:

- that Christophorus remained an "Obligor" for the purposes of the ICA, even after it ceased to be a subsidiary of Handels;
- that the Sale constituted a "sale implemented under a court approved process", notwithstanding that it would be effected by the administrators and not by the court.

Regarding the first issue, the judge considered that Christophorus would remain an Obligor, for five reasons:

1. This was the most natural reading of the definition of "Obligor", certain other provisions of the ICA, and the Accession Deed.

2. It would make "no commercial sense" for a company to cease to be an Obligor if, having executed an Accession Deed, it was sold to a third party or to another entity in the Group. Such a surprising result would have been specified in the relevant Accession Deed.

3. Nothing in the wording of the relevant power of release given to the Security Agent in the ICA required Christophorus to remain a subsidiary of Handels for the release to be effective. The ICA should be read with regard to its commercial intention (following the *European Directories* decision[4]), which was to "maximise the return that can be obtained from the assets sold".

4. Nothing in the ICA prevented an Obligor from being incorporated for any particular purpose – including the purpose of "maximising recovery for the group and facilitating a refinancing which will enable it to continue to trade".

5. Christophorus had remained as a subsidiary of Handels for over six months prior to the "flip-up". Its status as a subsidiary was therefore not so "fleeting or evanescent that it should be disregarded altogether".

Regarding the second issue, the judge was satisfied that a sale by court-appointed administrators (such as the Sale) would be "implemented under a court approved process". The administrators were appointed by the court, subject to its supervision, and in ordering the administration the court was well aware of the administrators' intention to effect the Sale. The judge further expressly granted the administrators permission to effect the Sale, leaving no doubt that the Sale was implemented under a court approved process.

Comment

This is not the first time that innovative techniques have been used to allow a German group to access the UK insolvency regime. Famously, in the cases of Deutsche Nickel and Schefenacker a German AG was transformed into a UK company, with COMI in England, in order to allow the respective groups to benefit from a UK company voluntary arrangement (CVA). In both cases the CVAs were utilised to implement a restructuring of the companies' German bond instruments. The 'flip-up pre-pack' used in A.T.U. allowed for a comprehensive restructuring of the company's capital structure.

As the first decision of its type, the judgment in *Re Christophorus 3 Ltd* necessarily leaves a number of points of uncertainty regarding when a 'flip-up pre-pack' will be available – for example, how long does a subsidiary need to be established in order for its status not to be disregarded as "fleeting or evanescent"? As such, international groups seeking access to the UK insolvency regime are likely to continue to prefer the more established methods of establishing jurisdiction in the UK, namely shifting COMI to the UK and/or using English law governed documents to establish a 'sufficient connection'. In a German context, the Schefenacker and Deutsche Nickel restructurings are well known examples of where a German borrower has moved its COMI to England; *Re Rodenstock GmbH*,[5] *Primacom Holdings GmbH*[6] and *Re Apcoa GmbH*[7] are high profile examples of German companies establishing a sufficient connection for the court to sanction a scheme of arrangement owing to English law finance documents.

Notwithstanding the above, where a COMI shift presents practical, tax, or other difficulties, and where the obligations to be restructured are not governed by English law, the 'flip-up pre-pack' offers a third way for groups to gain access to the UK insolvency regime – particularly where an intercreditor agreement is in place which contains similar terms to those considered in *Re Christophorus 3 Ltd*. Whilst intercreditor agreements are in general highly negotiated documents, such that no two are completely alike, similar terms are relatively common in agreements governing the relationship between English law bank debt and New York law notes.

In the instant case the Group was also able to restrict formal insolvency proceedings to a single company, established primarily for this purpose, and thereby avoid the potential risks posed on the operations of the company by filings for opening of insolvency proceedings of the German group companies in Germany. The prospect of achieving a similar result might prove attractive to other overseas groups looking to restructure.

The popularity of this type of restructuring, as well as its limitations, remains to be tested. However, in granting the order sought, the English Court has again taken a commercial and pragmatic approach to allowing an overseas group facing financial distress to be restructured under the UK regime.

4 *HHY Luxembourg S.A.R.L & Another v Barclays Bank plc & Others* [2010] EWHC 2406. See further http://www.whitecase.com/alerts-10062010/

5 [2011] EWHC 1104 (Ch).

6 [2012] EWHC 164 (Ch).

7 [2014] EWHC 1867 (Ch).