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Restructuring

ALERT

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European Revolution vs. English Evolution

Update on Case Law Developments in English Restructuring

This client alert will focus on three of the key recent cases of the past six months, each of which features the use of English law restructuring tools for non-English companies. Whilst the wave of recent restructurings has slowed in recent times given the uptick in the European economy, these cases are likely to be cited as precedents in the future and the case law developments will be of assistance in the event there is rise in the number of restructurings which may be expected as interest rates rise in the next few years.

In the decade leading up to the Great Recession which commenced in 2008, many European jurisdictions took significant measures to update their antiquated insolvency regimes. The Spanish updated their 1898 insolvency laws in 2003, the Italians updated their 1942 bankruptcy laws in 2005, the French updated their 1984 laws in 2005, the Germans amended their regime in 1999, and finally the UK made radical changes in 2002. The effectiveness of the reforms were mixed and when the stresses of the Great Recession collided with the new regimes, a second wave of reforms, forged by the reality of experience, occurred in every major European country save the UK. In recent years a dichotomy has arisen between European radical change and English gradualism when it comes to restructuring law practice.

In the UK there have been no significant legislative insolvency developments since the Enterprise Act of 2002 did away, for the most part, with administrative receiverships. In the recession of the early 1990s, banks in the UK would use the private law remedy of the appointment of an administrative receiver over a defaulting company who would sell the company to the highest bidder, without court intervention. In practice little has changed in the UK in the sense that many companies are sold by administrators in pre-pack processes not wholly dissimilar to the administrative receiverships prior to the Enterprise Act.

Another development occurring in the 2000s related to the use of schemes of arrangement ("schemes") as a tool to rescue companies in many high value cases, in the energy and telecoms sectors in particular, including for example the restructuring of British Energy and Marconi. Schemes were often attractive as the legislative regime governing them falls under the UK Companies Act, not the Insolvency Act 1986, and so the cost and taint of insolvency is avoided.

Since the commencement of the Great Recession schemes have been revived once again. A practice has arisen where a distressed company is placed into a UK administration process and its assets, usually shares of operating companies, would be sold, its senior debt would be amended under the terms of a scheme, and its junior debt and corresponding security and guarantees released via the intercreditor agreement. Accordingly, the key developments in English law relating to restructuring have been occurring on a piecemeal basis within the practice and case law relating to UK schemes of arrangement, and administrations.

One important development in recent years has been the use of schemes to restructure European companies. This trend has undoubtedly been one of the drivers pressing many European jurisdictions to improve their own laws to retain restructuring cases. None of the major European jurisdictions view themselves in isolation and competition amongst the regimes has led to radical improvement. European insolvency practice, whilst not perfect, has made a quantum leap in recent years and we are moving far closer towards the ideal of a "rescue culture" for businesses in distress compared to the liquidation and value destructive model which previously prevailed.

Magyar Telecom BV

The facts

In early 2013, adverse tax changes allied with the pressures of a distressed economy lead the owner of Magyar Telecom BV, a Dutch business whose operations were focused on Hungary, to contemplate a restructuring. The debt to be compromised consisted of €425m high yield bonds governed by New York law. A deep restructuring was contemplated by the commercial parties where a significant amount of debt would be swapped into equity. The key problem was that, consistent with many New York governed high yield bonds, the percentage required to agree to a compromise of a debt to effect a debt equity swap was 90%. There could be no assurance, given that the bonds were widely held, that this percentage could be reached. To achieve the statutory threshold for a scheme Magyar Telecom BV needed the support of 75% by value and a majority in number of the noteholders present and voting at the meeting – a level of support far lower than the 90% required under the terms of the bonds.

One key test for an English judge to take jurisdiction for a scheme in respect of a foreign company is that there must be sufficient connection with England and Wales. There might be a number of ways of showing this connection. The simplest, established by Rodenstock (Re Rodenstock GmbH [2011] EWHC 1104 (Ch)) has been to demonstrate that the debt documents were governed by English law – something which was not the case with Magyar Telecom BV’s New York law bonds. Another method for showing sufficient connection is to shift the centre of main interest or "COMI" of a company. The significance of the COMI concept is that within the European Union (except Denmark), the EC Regulation on Insolvency Proceedings (1346/2000/EC) (Insolvency Regulation) which came into force on 31 March 2002, provides that a company must file for insolvency in its jurisdiction of incorporation unless its COMI is within another member state. If a company can show that its COMI is in England and Wales the case law has shown that English judges will likely accept jurisdiction for a scheme. COMI can be shifted relatively easily for holding companies which are asset light; for example by holding board meetings in the jurisdiction, setting up an office, and informing creditors that the COMI has moved.

One key advantage of a COMI shift – which Magyar Telecom undertook in the summer of 2013 - is that if the English courts were to find that the COMI of Magyar Telecom BV was in England, the New York courts would likely follow suit. In the event, the New York bankruptcy courts did make that finding and in December 2013 granted an order under Chapter 15 of the Bankruptcy Code recognizing the scheme. Chapter 15 provides that where the main proceeding of an insolvency or debt compromise is in a foreign jurisdiction the US bankruptcy court may recognize the "main proceeding" and hence no bondholder could take action in a New York court to seek recovery under the bonds. To avoid piecemeal dismembering of insolvent companies in different jurisdictions a number of countries have enacted similar measures based on the Model Law on Cross Border Insolvency Proceedings to recognize "main" proceedings. Accordingly if a restructuring or insolvency is taking place in a "main" proceeding the "secondary" proceeding (such as a Chapter 15 hearing) will recognize the measures taken in the "main" proceeding. The US has a long history of granting comity to foreign insolvency or compromise procedures and the recent codification of Chapter 15 within the Bankruptcy Code is part of that tradition.

Why is the case significant?

Whilst the COMI shift is now an established way of achieving jurisdiction for a scheme, the US case law relating to Chapter 15 was in an uncertain position at the time of the application. The scheme involved the need to compromise the guarantees of the operational companies given by members of the Magyar telecom group in favour of the bondholders. Prior to the Magyar Telecom BV case there were two reported cases which involved the recognition of a foreign restructuring where releases of guarantees were at issue. In re Metcalfe & Mansfield Alternative Investments 421 B.R. 685 the request for relief was granted. In another case, Ad Hoc Group of Vitro Noteholders v Vitro S.A.B de C.V. the recognition of the third party releases was rejected. In the event, the bankruptcy judge in the Magyar Telecom BV case granted the requested recognition.

This was an important precedent as the judge may have concluded that as such releases are not a feature of Chapter 11 cases, the release proposed by the scheme in the Magyar Telecom BV case was contrary to public policy. Whilst the relief was not contested in the Magyar Telecom BV case, in making his ruling Judge Lane pointed out that the scheme under consideration could not function without such a release and this is likely to give confidence to other applicants seeking the same type of relief based on the same logic. The deal also incorporated some rare, if not unique, features where the new notes and the new shares granted to the noteholders were linked so that holders could only trade a unit representing interests in both. This model may be replicated in the future to the extend stakeholders' wish to ensure the interests of creditors and equity holders do not diverge.

Apcoa Parking AG

The facts

Whilst the Magyar Telecom case related to a deep restructuring involving a significant debt for equity swap, Apocoa Parking AG's recent scheme at the beginning of 2014 involved a three month extension to the maturities of Apoca's loans. The scheme was sanctioned by the UK High Court in London on 14 April 2014. The purpose of the three-month maturity extension to 25 July from 25 April allowed lenders and the group to continue deeper restructuring discussions. In Germany insolvency laws require companies experiencing payment defaults to file for an insolvency process within 21 days of the occurrence of the default and so the scheme allowed the discussion to continue outside the possible shadow of an insolvency filing.

Why is the case significant?

The governing law of the debt subject to the scheme was originally German law. In order to pass the sufficient connection test to allow the High Court to take jurisdiction the lenders agreed to change the law of the documents to English law, a process which could be achieved by a majority lender vote (in contrast to a higher threshold necessary for an extension of the maturities). The court received expert evidence that the change of the governing law and jurisdiction and the schemes themselves would be recognised in the local jurisdictions where the scheme companies were located. In Rodenstock, Briggs J emphasized that lenders to a German company had chosen English law to govern the law of the debt and noted "the senior lenders' choice of English law clearly did have the consequence that their rights as lenders were liable to be altered by any scheme sanctioned by the court". Notwithstanding this, in the Apcoa case the lenders had not chosen English law to govern the contract and they could not have expected an English scheme to amend their rights and yet the court still decided it would use its discretion to take jurisdiction so long as the change of law was valid under German law.

This is the first scheme we are aware of in the context of a leveraged structure where the law was changed to create jurisdiction for a scheme. This judgement considerably widens the scope of a scheme and raises the question of whether the COMI shift to achieve jurisdiction used by Magyar Telecom BV is redundant as it is clearly simpler and more cost effective to change the law rather than change the entire COMI of a company which may well have tax implications as it is invariably associated with changing tax domicile to the UK. We suspect that in a high yield context where the documentation is significantly different to English law, bond trustees will require comfort in the form of legal opinions when amendments to the law from New York law to English law are proposed that the change in law is not adverse to the bondholders. Whether law firms will be able to provide opinions to the satisfaction of bond trustees is an open matter.

A.T.U. Auto-Teile-Unger

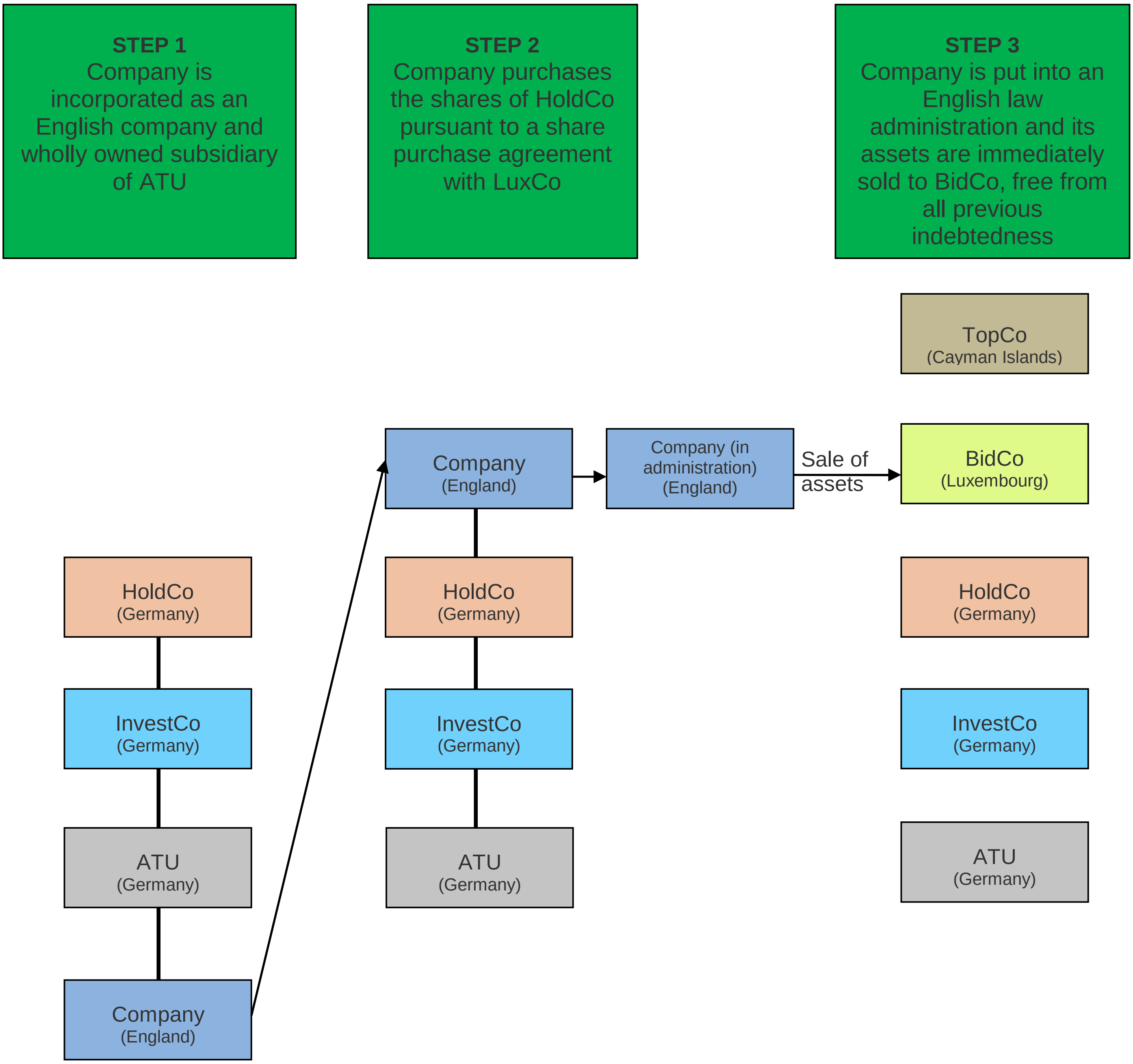
The facts

The restructuring of A.T.U. Auto-Teile-Unger (ATU), the German auto car parts reseller, was completed in January 2014 following the pre-packed sale of ATU through a UK administration to a new owner, set up by senior noteholders of ATU. Prior to the restructuring the group had a €45m Revolving Credit Facility, €400m of NY governed Senior Notes and €130m of Junior Notes all of which were governed by an intercreditor agreement ("ICA"). The senior notes were converted into preferred equity and the junior notes were released using the release mechanics under the ICA which provided that the Senior Notes and Junior Notes and their corresponding guarantees and security could be released (the "Release") in the event of an enforcement.

The implementation of the deal was elaborate and is explained here with the help of Figure 1 below. Step 1 involved incorporating an English incorporated company ("Company") which started its existence as a subsidiary of

ATU. The reason an English company was chosen was to take advantage of the UK's pre-pack administration regime. The Company purchased intercompany debt for nominal consideration then signed the ICA to become an "Obligor" for the purposes of the ICA. The ICA provided that the Release would only operate if the group was sold by an "Obligor". The definition of "Obligor" included a company which was a subsidiary of ATU, hence the Company's incorporation as such. The Company was then moved above ATU in the group structure (Step 2), placed into a UK administration process and its assets (shares in HoldCo) were sold to a new Bidco (Step 3). As the sale was taking place in an enforcement process, the terms of the ICA allowed the security agent to effect the Release. Bidco is owned by TopCo, a Cayman entity, which is partly owned by the former senior creditors of ATU.

Figure 1. Please note: this represents the restructuring in a highly stylised form



Why was the case significant?

UK pre-packs have been used before in restructurings where the company being placed into an insolvency was a non UK company. Most famously in 2010 a number of the Luxembourg holding companies of Greek telecoms operator Wind Hellas were placed into a UK administration process to effect a sale of Wind Hellas via a UK pre-pack. In the Wind Hellas case the COMI of the holding companies were shifted to the UK. In the ATU case there was no need to undertake a COMI shift as a new English holding company was placed above ATU to effect the sale via the pre-pack. This then removed the need to shift the COMI which can often be an elaborate and time consuming process which also has a significant tax effect. We also speculate that the purpose of putting this complex structure in place was to avoid having to enforce the German share pledges over ATU or other holding companies which would offer awkward technical challenges. German law requires that debt is outstanding to enforce a pledge. Therefore once the debts had been accelerated, ATU would have to have been put into an insolvency process within 21 days, which may have been insufficient to effect the enforcement. It remains to be seen whether this rather convoluted transaction will be copied by other parties who wish to avoid the COMI shift process.

Conclusion – the way forward for high yield restructurings?

The revival of the scheme occurred as a response to the wave of defaults of high yield bonds in the early 2000s. Restructuring professionals needed to find a way of compromising debt of companies which often had their operations across Europe where it would be close to impossible to contact let alone negotiate with hundreds if not thousands of individual bondholders and where individual insolvency cases in numerous countries would make the restructuring highly likely to fail. The high yield product was a US invention made famous in the 1980s merger boom and when it made its way to Europe it often included standard high yield amendment terms which either required a 100% consent from bondholders to change key "money terms" or close to 100% agreement. Whilst debt compromises could be made in the US using Chapter 11, in Europe it is still likely that, notwithstanding significant improvements in insolvency laws, local insolvency processes will be still be seen as value destructive compared to some of the techniques described above. Given the massive wave of high yield issuance in recent years and the likelihood of a return to an average default rate there is every possibility that restructuring professionals will be using these helpful precedents of the past six months in the important work of saving companies from uncontrolled and value destructive insolvencies in the coming years.