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DTEK Exchange Offer and Scheme of Arrangement: facilitating high-yield debt restructurings.

Speed read

In the recent financial restructuring of DTEK's high yield bonds, via a parallel-track exchange offer, consent solicitation and a scheme of arrangement, the English High Court accepted jurisdiction to sanction a scheme of arrangement, on the basis of a change in the governing law of the indenture relating to a series of high yield bonds from New York law to English law. The decision is a further example of the English court's readiness to facilitate financial restructurings, where appropriate, irrespective of the debtor's place of incorporation.

Significantly, this transaction:

- confirms that a change of a debt's governing law to English law is sufficient – on its own – to create jurisdiction for scheme purposes; and
- emphasises the importance in complex liability management exercises of structuring bondholders' incentives appropriately to minimise possible holdouts and maximize the likelihood of a successful restructuring; but
- is unlikely to affect the practice adopted to-date in high yield restructurings of having to shift a foreign issuer's "centre of main interests" to the UK where recognition under US Chapter 15 is important.

Linklaters advised Deutsche Bank, as dealer manager, on the exchange offer run contemporaneously with the successful scheme of arrangement.

Background

The DTEK group of companies (the "**Group**" or "**DTEK**") comprise the largest privately owned energy group in Ukraine with a significant market share in the country's coal production, energy generation and electricity distribution. Among the large Ukrainian industrial groups, DTEK was particularly affected by the conflict in the Donbass region and the overall deterioration of the economic situation in Ukraine. Nearly all of its sales were generated domestically and denominated in Ukrainian hryvnia, but the depreciation of the national currency in the second half of 2014 and early 2015 threatened the Group's ability to meet its liabilities which were mainly denominated in US dollars, euros and Russian Rubles.

The Group's management therefore took steps to extend the maturities of the Group's current liabilities. The restructuring via a parallel-track exchange offer, consent solicitation and an English scheme of arrangement concerned the Group's outstanding US\$500m 9.5% Guaranteed Senior Notes which had been issued by DTEK Finance B.V. (the "**2015 Bonds**") and were due to mature on 28 April 2015. As is typical for many high yield issuances, the 2015 Bonds were governed by New York law.

The Group announced an exchange offer for the 2015 Bonds on 23 March 2015. For each \$100 in the 2015 Bonds, the Group offered an exchange consideration consisting of \$20 in cash and \$80 in new bonds maturing in 2018 (and otherwise on substantially identical terms to the 2015 Bonds) (the "**New Bonds**"). The exchange offer was subject to achieving a minimum participation condition of 85% – a threshold that was increased to 98% on 1 April 2015.

By submitting an exchange instruction, the holders also automatically:

- consented to change the governing law of the 2015 Bonds to English law; and
- submitted an irrevocable instruction to vote to approve the scheme of arrangement in respect of the 2015 Bonds run in parallel with, and on the same economic terms as, the exchange offer (the "**Scheme**").

DTEK expressly stated that the purpose of changing the governing law of the 2015 Bonds was to aid in establishing the jurisdiction of the English courts with respect to the Scheme.

By 9 April 2015, 88.6% of the holders of the 2015 Bonds had submitted an exchange instruction approving the change in governing law and the Scheme. DTEK executed a supplemental indenture changing the governing law of the Bonds to English law on the same date. By 23 April 2015, the date of expiration of the exchange offer, bondholder participation rose to 91.14%. Although this was below the minimum participation condition threshold for the exchange offer, it was well in excess of what was required to approve the Scheme. As the minimum participation condition was not satisfied, DTEK terminated the exchange offer and continued to pursue the Scheme. The Scheme was subsequently approved by the holders of the 2015 Bonds at a creditors' meeting on 24 April 2015, and the High Court sanctioned the Scheme on 27 April 2015.

Significance of the Scheme: change in governing law as an independent path to jurisdiction

The DTEK scheme of arrangement sets a precedent for high yield bond restructurings and the taking of scheme jurisdiction.

In addition to changing the governing law of the 2015 Bonds to English law, DTEK also moved its 'centre or main interests' ("**COMI**") to England a few weeks before the convening hearing. While this approach is not without precedent (for example, the 2012 Mobile-8 scheme also saw a UK COMI shift

and change from New York to English law), the DTEK Scheme is the first time that the High Court has stated that a change of governing law to English law is, by itself, sufficient to confer jurisdiction.

The High Court decision embraces the approach of last year's APCOA scheme of arrangement concerning bank debt and extends it to bond debt. Even though the change in governing law took place only a handful of days before the Scheme convening hearing, the High Court held (adopting the language of the APCOA decision) that English law was not "*alien or indiscriminate*" in DTEK's case, and "*is commonly used in capital market debt obligations*". The High Court also noted that some of the holders of the 2015 Bonds were based in the United Kingdom and that the 2015 Notes were listed on the London Stock Exchange.

The DTEK decision means that sufficient connection to England can be deliberately created to enable the taking of scheme jurisdiction by changing the governing law of the bond debt to English law.

What about COMI?

The DTEK restructuring does not mean, however, that foreign issuers should now ignore the need to consider whether to shift COMI to the UK.

The rationale for a COMI shift to England in other high yield bond restructurings has not only been to ensure sufficient connection to the UK for the purposes of establishing the English court's scheme jurisdiction (where the governing law of the bonds has remained New York law). Having a UK COMI also makes it more likely that the scheme will be recognised as a "foreign main proceeding" under Chapter 15 of the US Bankruptcy Code. A corollary of recognition of a scheme as a "foreign main proceeding" is the mandatory imposition of a stay upon, among other things, the ability of any dissenting noteholders from filing suit on their pre-scheme claims in the US courts. While having an establishment in the UK may also entitle a scheme to recognition under Chapter 15, it would only be as a "foreign non-main proceeding" and so any relief (such as a stay on proceedings or enforcement) would be discretionary rather than mandatory.

Accordingly, where obtaining US recognition and associated relief is important, a foreign issuer is benefitted by shifting its COMI to the UK.

Having a UK COMI, and thereby increasing the probability that a US court would both recognize and afford injunctive and other relief in support of a UK scheme, is also likely to assist the English court in exercising its discretion whether to take jurisdiction or sanction a scheme in the first instance. It is interesting to note that, at the convening hearing for the *Zlomrex* scheme in November 2013, Mann J expressed "*misgivings*" about the inclusion of wording in the scheme which enabled the company (with the consent of the note trustee) to waive a condition to implementation of the scheme that it seek Chapter 15 recognition. Although he did not insist on its removal and duly convened the relevant creditor meetings, his concern was that the English court might give "*the impression of blithely overriding New York law rights and any legitimate interests of the New York court*". In view of Mann J's "misgivings", it is noteworthy that simply having a scheme with respect to an English law governed indenture will not, on its own, be sufficient grounds for obtaining Chapter 15 recognition – either as a DTEK Exchange Offer and Scheme of Arrangement – facilitating high-yield debt restructurings

foreign main or non-main proceeding – because it would not signify a UK COMI or establishment. If a foreign issuer chose not to move its COMI to the UK and had no UK establishment, such that Chapter 15 recognition would not be possible, a dissenting creditor may be able to point to Mann J’s comments and open up a line of inquiry which would not exist with a UK COMI.

Finally, it is not particularly difficult to shift the COMI of a foreign issuer holding company. It generally requires the taking of a number of now well-established steps. While the COMI move in DTEK was unusual in that it took place over such a short time frame, it nevertheless illustrates that moving the COMI of a foreign issuer to the UK need not be a particularly high hurdle to overcome.

Structuring the deal: incentives matter

Even with the possibility of a “cram-down” via the Scheme, the initial investor reception to DTEK’s exchange offer proposition was relatively lukewarm. A key reason for this was that the initial 85% minimum participation condition, while high, still offered a meaningful possibility that an exchange offer would be consummated while the holdout bondholders would be repaid in full when the 2015 Bonds matured on 28 April. An economically rational holder of a relatively small position in the 2015 Bonds could estimate the possible risks and outcomes in the DTEK transaction as follows:

OUTCOME STRATEGY	(A): EO SUCCEEDS	(B): EO FAILS; SCHEME SUCCEEDS	(C): EO AND SCHEME FAIL; DEFAULT
Hold out	100% cash	20% cash, 80% New Bonds	Almost nothing
Participate	22% cash (including “early bird” fee of 2% ¹), 80% New Bonds	22% cash (including “early bird” fee of 2%), 80% New Bonds	Almost nothing

For this hypothetical holder, “participate” is the optimal strategy *only* in scenario B, where the exchange offer fails while the Scheme succeeds. If the exchange offer is consummated (scenario A), this holder would be better off by not participating, because such holder would be paid in full at the original maturity date. Finally, in a default scenario there is no difference between the two strategies, so this scenario could be ignored for purposes of the holder’s decision – for so long as such holder’s lack of participation was by itself unlikely to affect the ultimate outcome. Accordingly, in order for this

¹ The “early bird” fee was amended to 3% on 1 April 2015, simultaneously with the change of minimum participation condition from 85% to 98%. The High Court accepted that this did not create any class issues for the scheme.

hypothetical holder to choose to participate in the exchange offer, it would have to believe that the scenario A, where the exchange offer is consummated is significantly less likely than the scenario B, where the exchange offer fails while the scheme succeeds. For example, with the early bird fee at 2%, and if the market price of the New Bonds is assumed to be 60% of their par value, this holder would have to believe that A is *at least 15 times* less likely than B. With the “early bird” fee increased to 3%, this holder would have to believe that A is almost 10 times less likely than B.

When the minimum participation condition threshold was increased to 98%, all but the holders of a *de minimis* amount of the 2015 Bonds would have to participate in order for the exchange offer to have a chance of success. As a result of this move to 98%, the likelihood of success of an exchange offer was very low. Moreover, almost every holder of the 2015 Bonds who was eligible to participate in the Exchange Offer would no longer be able to “free ride” on participation by others: every exchange instruction would matter. As a result, holding out became a much less attractive option for virtually all holders of the 2015 Bonds (notwithstanding the challenges to the Scheme that DTEK encountered from certain holders).

DTEK’s success in reaching a remarkably high rate of participation from its bondholders (91.14% at final tally) can, at least in part, be attributed to setting the parameters of the “game” correctly – such that participation in the exchange offer was the better strategy for almost all holders.

The lessons from the foregoing are clear. In complex liability transactions, like DTEK’s exchange offer and scheme of arrangement, the importance of setting the structure of bondholder incentives, and aligning these incentives with the range of possible and likely outcomes, is difficult to overstate. Finally, clear and focused communication of the range of possible outcomes and their implications for both the issuer and the bondholders is essential in ensuring that the bondholders are able to understand this incentive structure and can determine the economically rational strategy correctly and act accordingly.

DTEK highlights the importance of the English scheme tool

Many European high yield structures involve Dutch or Luxembourg finance companies as issuers of New York law bond debt whose provisions, including on changing the governing law, are largely the same as in DTEK. For these, an English scheme may offer a number of potential advantages over alternative approaches, including a consent solicitation to “amend and extend” the maturity of the bonds or a restructuring under Chapter 11 of the US Bankruptcy Code. In particular:

- the scheme process may be less expensive and time consuming than a Chapter 11 proceeding. DTEK’s scheme in particular was completed very rapidly, with only 3½ weeks elapsing between the launch of the Scheme on 2 April and the date of the Scheme sanction order on 27 April (and just five weeks from the launch of the exchange offer on the 23 March);

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- because a scheme of arrangement is a process under the UK Companies Act, it avoids whatever perceived stigma may be associated with restructurings under the UK Insolvency Act or free fall bankruptcies under the US Bankruptcy Code;
- a scheme of arrangement can be utilized to restructure a single series of debt, leaving the remainder of the capital structure of the issuer unaffected;
- a scheme of arrangement enables changing significant terms of the bonds (including maturity dates and interest rates) with the approval of 75% by value and a majority in number of the noteholders *present and voting* at the creditors' meeting, as compared to the much higher consent thresholds customary in non-SEC registered New York law governed debt securities and mandatory in SEC registered debt securities; and
- issuers can, in a single transaction, solicit bondholders' consents to effect a change in governing law to gain jurisdiction of the English courts, as well as approvals to implement the scheme of arrangement.

This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

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