Linklaters

An Overview of Creditor Schemes of Arrangement.

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An Overview of Creditor Schemes of Arrangement

1. Background

A Scheme of Arrangement is neither a new legal concept nor a formal insolvency procedure – they have been used for well over 100 years for a variety of purposes, including implementing takeovers and mergers – but there has recently been a clear move towards using them to deliver debt restructuring solutions. Schemes of Arrangement, or Schemes, have been used in this way for some time by insurance companies, for technical reasons, but they are now being seen as a powerful restructuring tool by a wider range of companies.

Given the growing popularity of using Schemes as a tool to "cram down" creditor claims, we have aimed in this overview to:

> summarise the different types of such "Creditor Schemes" recently seen in the market and the problems which they can be used to solve;

> highlight a number of practical traps for the unwary where a Scheme is proposed; and

> answer questions which are often asked about Schemes.

The outline procedure and timeline for a Scheme proposed to a company's creditors are set out in Schedule 1, while typical structures are set out in Schedule 2, together with a commentary on the three main types of "Creditor Scheme".

References in this overview to "Schemes" are to Schemes of Arrangement which are being used to compromise creditor claims.

2. Putting Schemes into their commercial context

2.1 Debt restructuring problems that a Scheme can solve

> It allows secured creditors to be crammed down. The claims of a secured creditor may therefore be compromised (or, in some cases, effectively written off) without their individual consent. The alternative English cram-down procedure, the Company Voluntary Arrangement, does not allow this.

> It addresses the leakage risk that could arise on a pre-pack sale to a creditor owned vehicle for a non-cash consideration, where there are hold-out creditors who do not want to participate in the process.

> If additional liquidity is required, it may provide a mechanism allowing existing shareholders or rescue investors to keep, or take, equity interests in the business, subscribing for new shares in an entity whose balance sheet has been right-sized (even at the cost of writing off secured debt).

> It allows a company whose business is being hindered by the existence of significant contingent claims (such as litigation relating to industrial injuries) to reach a binding, court approved, compromise with those potential claimants.

> It offers a more flexible alternative to a formal liquidation process, particularly where there are questions about contingent liabilities and/or identifying assets which could delay a distribution to creditors.

2.2 The three main types of Scheme:

While there are few limits on what a company can propose to its creditors in a Scheme, three main types of Scheme have evolved, namely:

> the Pre-Pack Scheme, which typically contemplates the transfer of the company's business to a new creditor-owned company, in return for the assumption by the latter of agreed liabilities – a typical structure is set out in Schedule 2, Part A;

> the Cram Down Scheme, which usually involves an equity restructuring at holding company level, followed by a restructuring of all or part of the financial indebtedness, with the existing obligors carrying on business – a typical structure is set out in Schedule 2, Part B; and

> the Distribution Scheme, which is a means of returning assets to the company's creditors and is normally used as an alternative to liquidation – a typical structure is set out in Schedule 2, Part C.

2.3 Recent "Creditor Schemes":

To put the growing popularity of Schemes into context, significant Schemes agreed this year have included McCarthy & Stone, Crest Nicholson, Countrywide and IMO Car Wash, each of which built on the experience of earlier high profile Schemes including Marconi, British Energy, Drax, My Travel and Telewest.

3. What is a Scheme?

A Scheme is a statutory procedure which permits a company to make an arrangement or compromise with its members or creditors (or any class of them) which, if approved by the requisite majority of such members or creditors and sanctioned by the court, will be binding on all of them, whether or not they vote in favour of it. The relevant law is found in Part 26 (Sections 895-901) of the Companies Act 2006.

One key feature of a Scheme is that it is not a formal insolvency process. The company proposing the Scheme does not have to be insolvent, or facing imminent insolvency, before it can propose a compromise to its creditors. In reality, creditors would be very unlikely to approve any compromise proposal in the absence of obvious financial difficulties, but directors and, where relevant, sponsors may take comfort in the fact that proposing a Scheme is not necessarily an admission of imminent insolvency. It should, however, be noted that, while a Scheme is not a formal insolvency process, proposing a Scheme to a company's creditors will still often trigger insolvency related events of default contained in finance documents, highlighting the need for the company to obtain creditor support before launching a Scheme.

4. The two Key Statutory Requirements

There are two main hurdles which must be cleared for a Scheme to become effective. In summary, creditors will only be bound by a Scheme if:

(a) it is approved by those creditors or, if the Scheme involves more than one class of creditors, by each class of creditors, at meetings convened by the court for the purpose of considering the Scheme. A Scheme would be approved if it received the support of a majority in number representing 75% in value of the creditors (or each class of creditors) present and voting at the relevant court meeting, either in person or by proxy; and

(b) it is sanctioned by the court at a formal court hearing, and, following the hearing, an office copy of the court order is delivered to the registrar of companies in Cardiff for registration.

5. How long does it take to get a Scheme approved?

This will depend in part on how long it takes to agree the commercial deal and to prepare the (normally lengthy) scheme documents, but there is usually a period of around 5 weeks between scheme documents being posted to creditors and a Scheme becoming effective.

6. Pitfalls and Risks – 10 practical points to watch out for

6.1 Classes

Traditionally, the most difficult aspect in any Scheme was the correct identification of creditor “classes”. This is still crucial, as if those proposing the Scheme get this wrong, the court will not sanction it. Historically, this caused major concerns, as the court would not express a view until the final sanction hearing (after the creditor meetings had taken place), as to whether the classes had been correctly identified. This is no longer the case as the court will now, at the time of the initial application to convene the creditors’ meeting, formulate a *prima facie* view as to whether the class or classes of creditors put forward are appropriate.

While this remains the best known potential Scheme pitfall, those described below still need to be navigated around.

6.2 Confidentiality

Even if tight confidentiality is maintained, the main terms of the Scheme will normally become public before the scheme documents are posted. Except in exceptional cases, the court expects a “creditors’ issues” letter to be sent, before the formal process starts, to those creditors whose rights are likely to be impacted by the Scheme, setting out the broad commercial terms of the Scheme and describing how creditors will be classed for voting purposes. This requirement also has timetabling implications, which can be particularly relevant if some creditors are only subject to a limited contractual standstill period and are looking to enforce their rights once that period has expired.

6.3 Commercially sensitive terms

All key agreements will normally need to be put on display for inspection by scheme creditors. This would normally include the terms of any amended finance document. It is therefore necessary to consider whether there are any sensitivities about (for example) the disclosure of financial covenants or covenants imposing a timetable for a disposal process and, if so, whether such provisions need to be included in a document to be made available for inspection.

6.4 Obtaining a majority in number

The requirement to obtain the approval of a majority in number of each class can create an effective veto for smaller creditors where (for example) two large creditors hold 90% of the debt in a class, while the remaining 10% is held by a number of smaller creditors. A Scheme should therefore only be launched where it appears that the majority in number test is likely to be satisfied, as well as the 75% in value test. One possible option where the majority in number test may not be satisfied would be to split the debt, so that the two large holders in the example above would transfer part of their debt to affiliates. While this should ultimately address the majority in number problem (assuming that the debt is transferrable and there are sufficient willing holders of that debt), splitting the debt in this manner may support an argument at the sanctioning hearing that the larger creditors were not acting in good faith.

This means that, in practice, splitting holdings in order to defeat a Scheme is easier than splitting holdings in order to support a Scheme, as if holdings are split such that the majority in number test is not satisfied, the court has no jurisdiction to sanction the Scheme. The motives of those splitting their holdings would be irrelevant in this case.

6.5 Release of security

A Pre-Pack Scheme may provide for the transfer of assets free from security, but release documents will normally still need to be executed in order to give effect to this. Problems can arise in this respect where a Pre-Pack Scheme contemplates a business sale for a non-cash consideration, such as an assumption by the purchaser of agreed liabilities. A security trustee may be reluctant to execute the necessary release documents if, as sometimes occurs, the security documents only provide for the release of security where assets are sold for a cash consideration as part of a formal security enforcement. If the documents do not expressly require security to be released where assets are sold for a non-cash consideration, hold-out creditors may put pressure on a security trustee not to execute release documents.

The inclusion of a direction to the security trustee (together with hold harmless wording) in the scheme documents, requiring it to release the security, may be sufficient to overcome any concerns, but, if not, it may be necessary for the administrators (who will typically be selling the business on behalf of the company) to make a separate application to court under the Insolvency Act to allow them to sell the relevant assets free from security. This may have timing implications for the transfer of the business.

6.6 Release of guarantees

A Pre-Pack Scheme may provide for the transfer of shares (perhaps just the shares in a holding company) to the purchaser. If shares are to be transferred, check to ensure that any guarantees provided by an acquired company would be released following the transfer if they relate to liabilities which are not being assumed under the Scheme. This may be a particular issue if not all of the senior debt is being assumed, and there are senior “hold-outs”, as intercreditor agreements may provide for the release of guarantees of junior debt, but not for the release of guarantees of senior debt.

Guarantees from subsidiaries may also be relevant in a Cram Down Scheme, as it will be necessary to consider how to deal with any guarantees provided by subsidiary companies if those companies are not proposing to compromise those liabilities through their own Scheme. Recently used techniques to address this point have included provisions in scheme documents under which scheme creditors are deemed to authorise the execution by the company, on their behalf, of deeds of release in respect of such guarantees.

6.7 Equalisation and loss sharing provisions

If the Scheme amends documents which include equalisation or loss sharing provisions, care should be taken to ensure that the terms of the Scheme (such as a debt/equity conversion) will not create uncertainty as to what payments would be due under those provisions, once the Scheme becomes effective. If there is any doubt, it may be advisable to incorporate making any required payments into the Scheme, potentially as part of an escrow arrangement.

6.8 Valuations

It is important to obtain, and provide scheme creditors with, recent independent valuations of the company’s business and assets. This typically takes the form of a valuation prepared on a forced sale basis (so that scheme creditors can understand the value of their claim in an insolvency, assuming this is the most likely outcome if the Scheme is not approved, and measure what is proposed under the Scheme against this).

It is, however, normally advisable to have a second valuation prepared, on a going concern or managed realisation basis, particularly where a Pre-Pack Scheme is proposed, in order to address the concerns of scheme creditors whose claims rank below the point where the value breaks on a forced sale valuation. Failing to do so could create uncertainty as to whether such creditors still have an economic interest (and thus a right to vote in respect of the proposed Scheme) and this uncertainty could fuel challenges to the Scheme, particularly where a sale of the business was still a viable option. More practically, if those proposing the Scheme do not obtain such a valuation, any creditor who felt that value could break in or below their debt on a going concern basis could always obtain their own going concern valuation. In addition, the company's directors could face criticism (or worse, litigation) if they failed to obtain such a valuation – the argument being that their fiduciary duty to the company's creditors required them to do so. It is, however, as demonstrated by the IMO Car Wash Scheme, not usually necessary to go further and to establish the "inherent value" in the business - normal going concern valuations should be sufficient.

6.9 Risk of security being set aside

If a Pre-Pack Scheme is being put in place, creditors of the company acquiring the business would normally expect to receive a full security package, including a floating charge over its assets. If such security is taken, it could potentially be void under Section 245 of the Insolvency Act 1986 during the two-year period following its creation. This risk arises as:

- those creditors having the benefit of the security package will normally also be shareholders in the acquiring company, making them "connected persons" for the purposes of the Insolvency Act;
- if a floating charge is created in favour of a "connected person", it is irrelevant that the company creating the floating charge was solvent at the time when it did so; and
- as a result, such floating charge will only be valid to the extent that the creditors benefitting from the security package provided the acquiring company with cash or services on or after the date when the floating charge was created. This requirement could cause concerns if creditors were not advancing new money to the acquiring company (as could occur if the acquiring company needed little or no additional funding, and the consideration payable by the acquiring company was in the form of an assumption of liabilities, rather than a cash payment).

6.10 Recognition by other courts:

There is a general recognition point, arising in part from the fact that a Scheme is not a formal insolvency procedure. There is also a more specific US recognition point, which can be dealt with in the Scheme documents.

- Creditors taking action in other jurisdictions: While creditors with claims governed by English law should be bound by the terms of a Scheme, careful consideration needs to be given to (i) the continuing enforceability of any non-English law claims and (ii) whether, if those claims may still be enforceable, this matters in practice. There is a risk, as a Scheme is not a formal insolvency procedure, that creditors whose relationship with the company is governed by a law other than English law (such as a creditor under a French law contract) may not be prevented by a Scheme from pursuing an action against the company or its assets outside the UK. This is, in practice, most likely to be a concern where a Cram-Down Scheme is proposed by a company which has significant assets located outside the UK. In some cases, it could result in the company being put into administration while the Scheme is implemented, in order to mitigate the risk of hostile creditor action outside the UK.

> Recognition by the US courts: The question of recognition is particularly relevant where the Scheme relates to documents governed by New York law, as a Scheme will not be recognised as being effective in the United States unless it is recognised in the US courts (effectively using Chapter 15 of the US Bankruptcy Code to make the Scheme effective in the US). If such recognition is needed (typically where there is a Cram Down Scheme), the scheme documents should ideally provide for the appointment of an "authorised representative" of the scheme company, who would be given the power to make any Chapter 15 application.

7. 10 Frequently Asked Questions

7.1 What is meant by "creditor" for the purposes of a Scheme?

The court has adopted a very wide interpretation of the term "creditor" so as to include every person who has a quantifiable claim against the company, whether actual, contingent, unliquidated or prospective. This means, to take one recent example, that it may be possible to include bondholder claims in a Scheme, even where legal ownership of the bonds is in the name of a trustee, on the basis that such bondholders may be contingent creditors where they have a right to become the lender of record in certain specified circumstances. Key Cases: *Re T&N Ltd* [2007] 1 All ER 851 and *Re Castle Holdco 4 Limited (Countrywide)* [2009] (unreported).

7.2 What constitutes a class of creditors?

The original test was that a class "must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest". This test has recently been developed so that, in one case, bondholders were treated as members of the same class, despite the fact that the bonds were denominated in different currencies and had different maturity dates. More recent cases have tended to treat all creditors as being capable of consulting together in a class unless it is possible to identify very significant differences between their rights. Key Cases: *Sovereign Life Assurance Company v Dodd* [1892] 2 QB 573, *Re Hawk Insurance Co Ltd* [2001] 2 BCLC 480 and *Re Telewest Communications plc* [2004] EWHC 924 (Ch).

7.3 Do all creditors in a class have to be included in the Scheme?

No. The court will sanction a Scheme that excludes certain creditors if it can be shown that there were good commercial reasons for doing so. It may, for example, not be desirable to include trade creditors in a Scheme so as to ensure continuity of supply, even though other unsecured claims are included. Key Case: *Re PT Garuda Indonesia* [2001] All ER (D) 53.

7.4 What amounts to a "compromise" or "arrangement"?

For there to be a compromise or arrangement, the Scheme must include some element of commercial give and take. This is the rationale for the court's refusal, to date, to sanction a Scheme which simply removed a party's rights for no consideration. Key Case: *Re NFU Development Trust Ltd* [1973] 1 ALL ER 135.

7.5 Can creditors with no economic interest block a Scheme?

Possibly not, although this may depend on the type of Scheme. It has been held that a class of bondholders (who would have received nothing in a formal insolvency process) should not vote on a Pre-Pack Scheme as they did not have a sufficient economic interest. They could, quite simply, be ignored. This position differs from the position in a Cram Down Scheme where, rather than ignoring a creditor with no economic interest, the

Scheme seeks to amend that creditor's rights. Key cases: *Re Tea Corpn Ltd* [1904] 1 Ch 12 and *Re My Travel Group plc* [2004] EWHC 2741 (Ch).

7.6 What test will the court apply in deciding whether to sanction the Scheme?

The court needs to be satisfied that (i) the relevant statutory requirements have been complied with, (ii) the classes of creditors were properly identified, (iii) each class was fairly represented by those attending the court meeting, (iv) the statutory majority was acting bona fide in the interests of the class, and (v) it would be reasonable to approve the Scheme. Key Case: *Re Anglo-Continental Supply Co Ltd* [1922] 2 Ch 723.

7.7 How does the court decide whether it is reasonable to approve the Scheme?

The court will ask whether the Scheme is one that an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve. The question is not whether the Scheme is reasonable, but whether a creditor could reasonably have approved it. Courts have taken the view that it is not their role to second guess decisions made by creditors who are acting honestly, provided that they have had sufficient information and enough time to properly consider their options. Key Case: *Re Dorman Long & Co Ltd* [1934] 1 Ch 635.

7.8 Is the court's sanction of the Scheme just a rubber stamping exercise?

No. The court would not sanction a Scheme if there were technical irregularities, if it considered that those creditors approving the Scheme were unfairly pushing their special interests or if there was inherent unfairness in the Scheme. Key Case: *Re BTR plc* [2000] 1 BCLC 740.

7.9 Is the court therefore likely to refuse to sanction the Scheme?

Again, no. "Unless something is glaringly wrong with the Scheme, the principle of creditor democracy ought to be respected". Key Case: *McCarthy & Stone [2009]* (unreported).

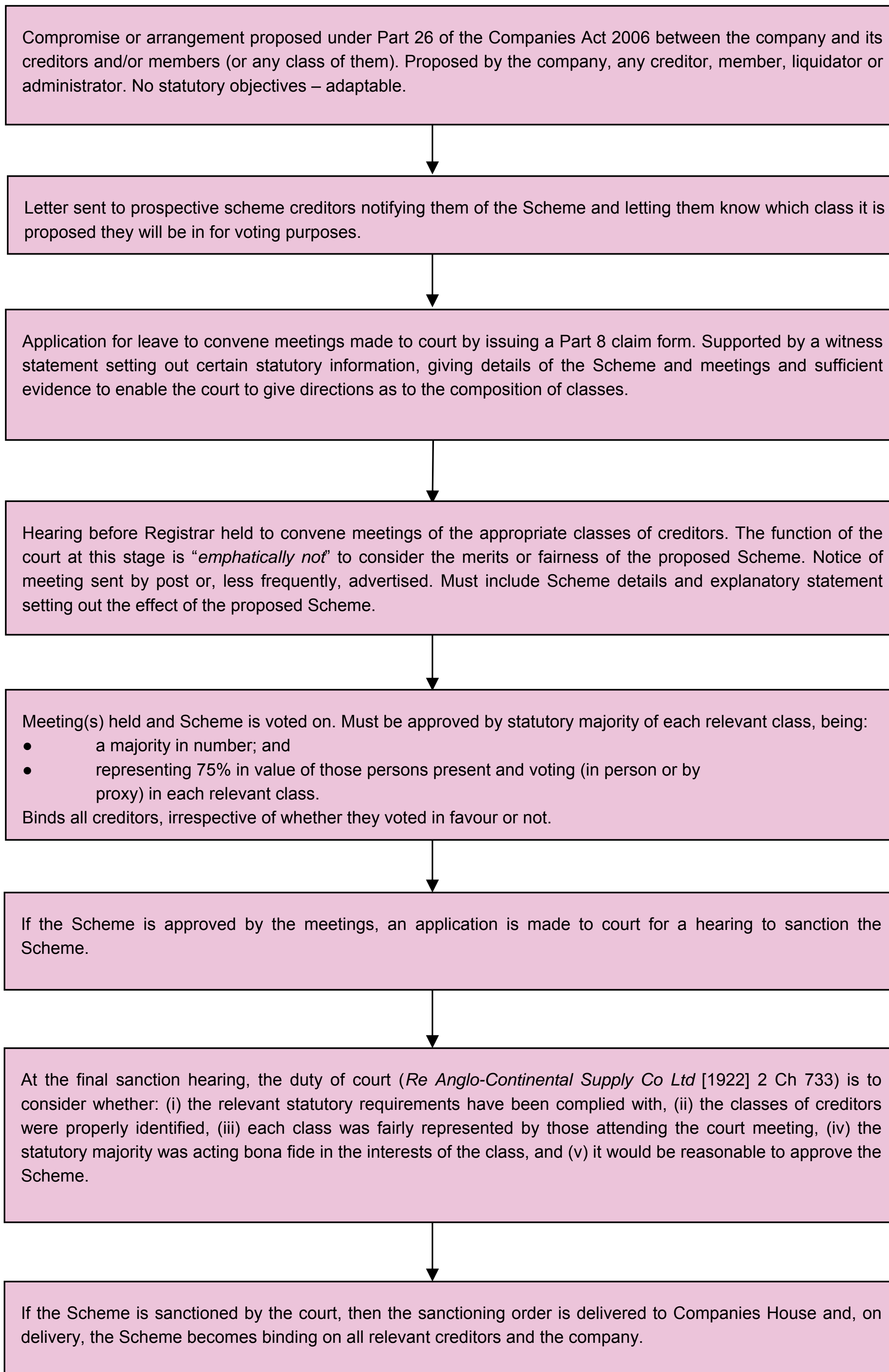
7.10 Who can object to the Scheme?

Anyone affected by the Scheme is entitled to appear at the final court hearing to sanction the Scheme and can raise any objections at that hearing. Key Case: *B.A.T. Industries plc v B.A.T. Reconstructions Ltd.* [1998] (unreported).

8. One final question – what about CVAs?

A Company Voluntary Arrangement or CVA, like a Scheme, can be used as a tool to push an agreed contractual restructuring through to completion, imposing an agreed solution on any hold-outs. While Schemes are sometimes seen as being more complex and costly solutions than CVAs, there are many occasions (such as when dealing with secured claims) where a CVA is not an available option.

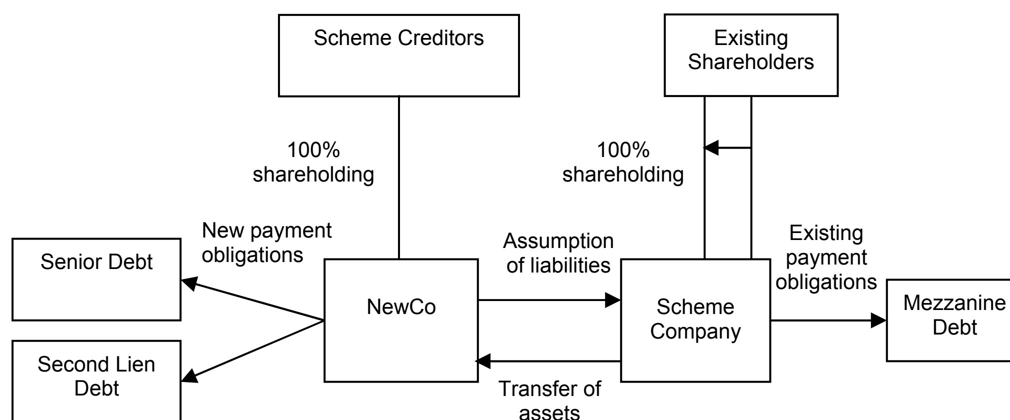
Schedule 1 – Outline of Procedure



Schedule 2 – The Three Types of Scheme

The main differences between the three types of Scheme currently seen in the market are illustrated below. For the purposes of these examples (which have been simplified for purposes of illustration), it is assumed that the company proposing the Scheme has three classes of secured financial debt (Senior Debt, Second Lien Debt and Mezzanine Debt), but that it only has sufficient assets to repay the Senior Debt and the Second Lien Debt.

PART A – The Pre-Pack Scheme – e.g. McCarthy & Stone or IMO Car Wash



What is involved?

> Once the Scheme has been approved, the business or assets of the company proposing the Scheme are transferred (typically by an administrator) to a new company owned by its creditors, in return for the new company agreeing to assume certain of the scheme company's liabilities.

> As the level of liabilities assumed will correspond to the value of the assets being transferred, the new company would be expected to assume those liabilities above the level where the value breaks (in this case, Senior Debt and Second Lien Debt) and to leave behind those liabilities below that level. The Senior and Second Lien creditors will therefore, in this case, obtain their repayment from NewCo.

> The Senior and Second Lien creditors will not necessarily own 100% of NewCo. Where there is an additional liquidity requirement in NewCo, the scheme company's existing shareholders may be allowed to retain an equity interest in the business by subscribing for new shares in NewCo.

> While the structure is very similar to pre-packs put into effect without using a Scheme, the key difference is that, under a "typical" pre-pack, leakage risks would arise if any secured Senior creditors or Second Lien creditors did not participate in the process. Under this structure, the leakage risk is removed as the restructuring solution is imposed on all Senior Debt and Second Lien Debt creditors once the Scheme is sanctioned, provided that the administrator implementing the business transfer is also satisfied with its terms. This outcome may mean that just the threat of implementing a Pre-Pack Scheme is sufficient to deter hold-outs.

Important Note

It is important, as illustrated by the My Travel Scheme, to distinguish between a Pre-Pack Scheme of this nature and a Scheme for the reconstruction or amalgamation of a company which falls within Section 900 of the Companies Act 2006. While both are Schemes of Arrangement which involve a transfer of the company's business, a reconstruction scheme requires the shareholders in the transferee company to be the same, or substantially the same, as the shareholders in the existing company. This requirement would almost certainly not be satisfied in

a debt restructuring, as the shareholders in a company facing financial difficulties would, at best, expect to see their existing equity interest diluted under the terms of any Scheme.

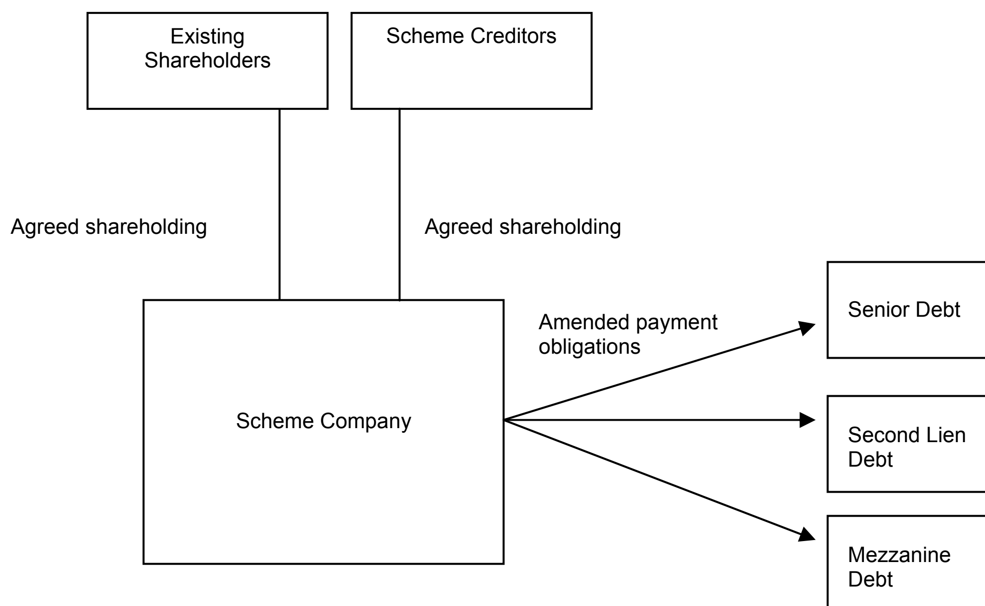
What is the main advantage?

Liabilities which the business can't service can be left behind in the scheme company as part of a court-sanctioned process, and there is no need to consult with, or obtain the approval of, those creditors whose claims are being left behind, as long as it can be shown that they no longer have any economic interest in the business.

And the main disadvantage?

The structure involves the sale of the scheme company's business or assets, typically by an administrator. Some assets may not be transferrable, while other rights may be lost because the relevant agreements contain termination rights exercisable on the scheme company's insolvency or on a sale of its business. It is therefore normally used when restructuring holding company indebtedness, rather than that of operating companies.

PART B – The Cram Down Scheme – e.g. Crest Nicholson



What is involved?

The scheme company proposes amended financing terms, which may involve all or part of its equity being transferred to scheme creditors, in satisfaction of the excess financial indebtedness which the business cannot service. In this example, this would probably involve most, if not all, of the mezzanine debt being converted into equity. The process will typically involve an initial group restructuring, often with the imposition of an intermediate holding company, in order to facilitate the transfer of the agreed proportion of the company's equity to the scheme creditors.

The scheme creditors will not necessarily own 100% of the scheme company going forward. Where there is an additional liquidity requirement, its existing shareholders may be allowed to retain an equity interest by subscribing for additional shares in, or providing new loans to, the scheme company. Alternatively, if shareholder consent is required (for example, if the Scheme involves a debt to equity conversion and shareholder consent is required for the issue of new shares), retention of a proportion of the equity may be the price of obtaining such consent.

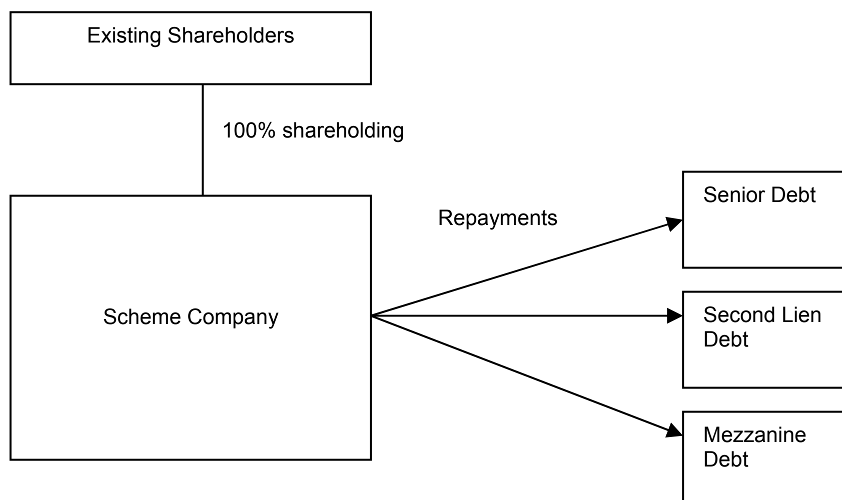
What is the main advantage?

Liabilities which the business can't service can be compromised without using a formal insolvency procedure, as part of a court-sanctioned process.

And the main disadvantage?

While there is some academic debate on this point, most commentators currently take the view that implementing this solution requires the consent of each class of creditors whose claims are being compromised. This means that, in this case, the mezzanine creditors would have to be given a sufficient economic incentive to approve the Scheme. Shareholder consent may also be required, where the solution involves a debt to equity conversion, and the security or group structure does not allow creditors to implement this without shareholder approval.

PART C – The Distribution Scheme – e.g. Enron Capital & Trade Resources Ltd



What is involved?

This type of Scheme, which has evolved from insurance company run-offs, provides a more flexible alternative to a formal liquidation of the scheme company. The terms of a Distribution Scheme will set out an agreed procedure for distributing the company's assets between its creditors, where there are issues concerning the identification of the assets and/or the quantification of its liabilities.

Distribution Schemes have been most widely used by insurance companies in run-off, but they were also used as part of the Enron realisation process.

What is the main advantage?

A Distribution Scheme can be particularly useful where the assets of various entities have become hopelessly intermingled, or where (as was often the case with insurance companies) there are a significant number of contingent claims which are hard to quantify and a judgement would have to be made as part of a formal liquidation process as to whether (for example) an insured event was likely to occur or not.

In such circumstances, a liquidator would be faced with a number of difficult decisions given the statutory framework that they must work within, potentially with the result that cash would have to be retained for several years until it became clear whether or not a contingency would arise. A Scheme could impose an agreed valuation mechanism, which could result in the earlier release of assets to the company's creditors.

And the main disadvantage?

The scheme creditors will need to be satisfied that the Distribution Scheme offers them a better alternative than liquidation. While this should normally not be a problem, the terms of any Distribution Scheme will include commercial judgments and a scheme creditor may challenge a provision contained in the Distribution Scheme which reflects such a commercial judgment, if its effect could prejudice their position.

Further information

Linklaters has a global restructuring and insolvency practice, of which the United Kingdom is a significant part. This guide covers matters of English restructuring and insolvency law only. Guides for other jurisdictions may be available on request from your usual Linklaters contact.

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