Untying the Gordian Knot: Restructuring Russian and CIS Companies Using English Law Schemes of Arrangement

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SINCE THE START OF THE 2008 FINANCIAL CRISIS, there has been an upsurge in the use of English law schemes of arrangement in cross-border debt restructurings by businesses located in Russia and its neighbouring countries. The scheme's key advantage is that it can provide companies with a way to implement a restructuring solution at a lower approval threshold than may otherwise apply pursuant to the terms of the underlying debt documents. Coupled with the English court's increasing willingness to sanction schemes for foreign companies, it is no surprise that schemes are emerging as the favoured tool of choice for those engaged in complex cross-border restructurings. This article provides an overview on how schemes may be used as a debt restructuring tool, particularly by businesses in Russia and other countries located in the Commonwealth of Independent States (CIS).

Scheme seduction

The attraction of an English law creditor scheme lies in its elegant simplicity: as long as a scheme receives the support of the statutory majority of creditors and is sanctioned by the English court, the scheme will be binding on all creditors, whether they voted for or against it.

There are two prongs to the statutory threshold. First, a majority in number (that is, headcount) of each class of creditors and/or shareholders represented at the meeting must have voted in favour of the scheme. Second, at least 75% in value of the class of creditors and/or shareholders represented at the meeting must have voted in favour of the scheme. These statutory majorities may be lower than those provided for in the underlying debt documents. For example, in a typical English law facility agreement based on the Loan Market Association form, changes to key financial terms may not be made unless the consent of all lenders is obtained. The use of a scheme can therefore counteract dissident creditor minorities who could otherwise frustrate a restructuring that is widely supported by other creditors.

The availability of a scheme to foreign companies is appealing as there may be limited tools under the local law which could be used to facilitate the amendment of a financial contract. In the context of a Russian borrower for example, the basic principle of the Russian Civil Code is that agreements must be kept: the debtor must perform its obligations in compliance with the terms of an agreement. Amendments can generally be made only with the consent of all parties. There is no Russian law equivalent to an English law scheme of arrangement. The closest approximation to a scheme is Article 451 of the Russian Civil Code which provides that a party can ask the Russian court to amend a contract, but only if such amendment is required due to a material change of circumstances. The Article 451 procedure is limited in two material ways: it is available only in relation to contracts governed by Russian law and the bar set for what constitutes a material change of circumstances is very high.

Therefore, Russian debtors may need to look beyond the four walls of their domestic legal system for a more flexible restructuring tool. The fact that, as a general matter, Russian courts should recognise amendments made to an English law contract pursuant to a scheme of arrangement makes the scheme route a very intriguing prospect.

Another important aspect of a scheme is that it is not a formal insolvency procedure. After all, the statutory provisions relating to schemes are found in the UK corporate legislation rather than the insolvency legislation and schemes are used in other circumstances not related to insolvency, including takeovers and solvent reorganisations. This makes their use more palatable to companies, directors and sponsors who may wish to avoid any perceived insolvency-related stigma.

Creditor democracy

Any form of democracy, including creditor democracy, could very easily degenerate into a form of "tyranny of the majority" in the absence of appropriate safeguards. The role of the English court in the scheme process helps mitigate some of these concerns. Procedurally, two court hearings need to be held.

The first court hearing is held to convene the creditor meeting. Issues of class composition are considered in the first hearing. It is the responsibility of the scheme company to formulate the class or classes of creditors for the purposes of convening meetings to consider and, if thought fit, approve the proposed scheme. Meetings must be properly constituted so that each meeting consists of creditors whose "rights [against the scheme company] are not so dissimilar as to make it impossible for them to consult together with a view to their common interest."

The second hearing is held to sanction the scheme after the holding of the creditor meeting. Any issues concerning the fairness of the scheme are typically dealt with in the sanction hearing. The sanction hearing is not a rubber-stamp exercise as the court has full discretion whether to sanction the scheme. The judge would look at various factors to ensure that there is "no blot on the scheme". This means that the judge would need to be satisfied that, among other things, the statutory requirements are met, the creditors were put into the appropriate voting classes and each class was fairly represented at the creditors' meeting, the majority was acting *bona fide* in the interest of the class and there is no inherent unfairness in the scheme.

The judge would also need to consider whether the scheme is one that an intelligent and honest man as a member of the class and acting in respect of his interest might reasonably approve. This does not mean that the court has to conclude that the scheme was the only scheme or the best scheme which could have been agreed, but simply one that could reasonably be approved by the class of creditors.

The scheme's key advantage is that it can provide companies with a way to implement a restructuring solution at a lower approval threshold that may otherwise apply pursuant to the terms of the underlying documents.

Overall, the cases have shown that the courts have been generally slow to refuse to sanction a scheme which has the support of the statutory majorities; in fact, the more creditors support the scheme, the more reasonable the scheme would appear, and the less likely the judge would second-guess the decision of the majority who supported the scheme.

A corollary of the court's reluctance to refuse to sanction a scheme is the gradual erosion of a hold-out creditor's ability to block a proposed scheme. This is a welcome development as this reduces the likelihood that a maverick minority could derail a restructuring or extract any preferential treatment from a company in distress to the detriment of not only the company but also the supportive creditor majority.

As the scheme route becomes a more well-trodden path, there is no reason why a carefully conceived and conducted scheme could not withstand the scrutiny of the courts.

No stay, no problem

Outside of the scheme process, hold-out creditors could still disrupt the proceeding by pursuing parallel litigation in order to destabilise the restructuring negotiations. One of the key factors distinguishing an English law scheme from a US Chapter 11 procedure is that there is no statutory moratorium on creditor action pending the completion of the scheme process.

Whilst this is true, English courts have proved to be pragmatic in such circumstances and have been prepared to use their broad case management powers to impose a *de facto* moratorium on creditor proceedings whilst the scheme process is still ongoing. Under the English Civil Procedure Rules, an English court has the power "to stay the whole or part of any proceedings or judgment either generally or until a specified date or event". Although the courts have stressed that there must be special circumstances to grant a stay, thereby denying a creditor the immediate fruits of a judgment, the courts have accepted that a scheme of arrangement may amount to such special circumstances if there is a reasonable prospect of the scheme going ahead.

In addition, it is now common practice for a scheme company to request that scheme creditors sign up to a lock-up agreement where they will agree in advance to vote in favour of the scheme. The consenting creditors will also agree in the lock-up agreement not to take any enforcement action whilst the scheme process is ongoing. If a sufficient number of creditors provide their consent, this would prevent actions requiring the consent of a prescribed majority of lenders from being taken, thereby limiting the actions that the holdouts may take without the consent of the other lenders. For example, if the loan may be accelerated only with the consent of two-thirds of the lenders, but 60% of the lenders have entered into a lock-up agreement, then the remaining holdout creditors would not be able to accelerate the debt as they only comprise 40% of the lenders.

"Sufficient connection"

The jurisdiction of the English court to sanction a scheme in respect of a foreign company depends on whether the company has "sufficient connection" with England. One way to establish connection is by moving the scheme company's "centre of main interests" (COMI) to England. This may include carrying out all the company's functions from its sole office in London, arranging for the day-to-day management of the company to be conducted by a London-based company, holding meetings of the board of directors in London and holding its cash in a London-based bank account. Whilst having an English COMI used to be the way to establish a connection, recent case law shows that this is no longer a prerequisite: if English law is the governing law of the relevant debt documents, this alone is sufficient to create a link.

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Conclusion

A purely voluntary debt restructuring is often messy, frequently time-consuming and invariably open to exploitation by opportunistic creditors. In the absence of a contractual framework which allows for the imposition of the will of the majority, even the most ruthful creditors would be at the mercy of their most ruthless brethren. The alternative to a successful workout is likely to be liquidation, which would be equally devastating for both the borrower and its creditors. The English law scheme of arrangement has come of age and is now a credible weapon in the restructuring armoury. Given the English court's increasing readiness to accept jurisdiction and their pragmatism in sanctioning arrangements approved by the statutory majority of creditors, a scheme may offer a solution where none is in sight.

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CASE STUDY #1

Gallery Media

The first Russian business to implement a debt restructuring by way of an English law scheme of arrangement in the immediate aftermath of the 2008 financial crisis was Gallery Media, one of the largest outdoor advertising groups in Russia and Ukraine. The group suffered substantial losses as a result of the fall in advertising spend by companies generally in the wake of the economic downturn. Between 2008 and 2009, the turnover of the group more than halved, with Gallery reporting a net loss for 2009. By June 2009, Gallery Media defaulted under its high yield bonds and needed to implement a debt restructuring.

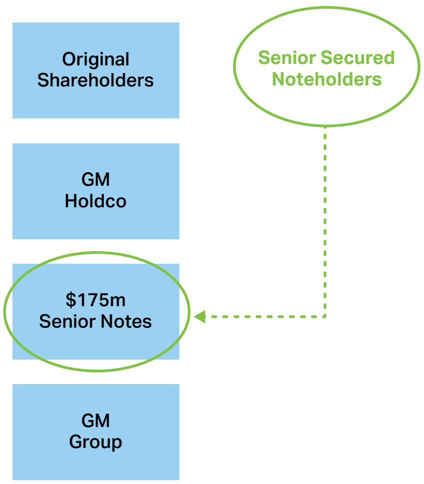
The debt-for-equity swap implemented through two schemes by Gallery Media illustrates the inherent flexibility of schemes as a restructuring tool. Schemes can extend to any agreement which the court is satisfied will amount to a “compromise” or an “arrangement” between a company and its relevant classes of creditors and/or shareholders. The statutory terms “compromise” and “arrangement” have been interpreted broadly by the English courts and practitioners continue to push the boundaries for new situations where schemes may be used. So long as there is some degree of commercial give-and-take, it would appear that schemes can be used in such circumstances. Since the credit crunch, schemes have been deployed in a myriad of restructurings ranging from a simple “amend-and-extend” scheme (e.g., extension of maturity date and resetting of covenants) to more complicated restructurings involving debt-for-equity swaps, such as Gallery Media. In October 2015, the scheme process was used to restructure two series of eurobonds issued by Russian Standard Finance S.A. to fund related loans to Russian Standard Bank, marking the first time an English scheme of arrangement has been used to implement a restructuring to address capital adequacy issues for a Russian bank.

The Gallery Media schemes included as a condition precedent a fcorporate restructuring that involved the incorporation of a new corporate group that will issue new notes in exchange for the existing notes. The noteholders exchanged US$161.5 million face value of existing notes for US$95.0 million of new notes plus a 68% shareholding in the new corporate group. A further 2% of the equity in the new corporate group was allocated to a third party who assisted the negotiating process in the lead-up to the restructuring. The original owners Baring Vostok Private Equity and Anatoly Mostovoy (founder and CEO of Gallery Media) injected US$5.0 million cash in return for 30% of the equity in the new corporate group and US$10.0 million of new notes. The debt-for-equity swap implemented through two schemes was approved by more than 80% of noteholders and sanctioned by the English courts in May 2010. Through the schemes, Gallery Media was able to reduce the group’s total debt from US$342.2 million to US$100.3 million.

Following the 2008 financial crisis, Russian advertising company Gallery Media restructured its financial liabilities by implementing two schemes of arrangement in the English courts and a corporate restructuring of its existing group. The schemes were approved by the scheme creditors on 18 May 2010 and sanctioned by the court at a fairness hearing held on 26 May 2010.

Before

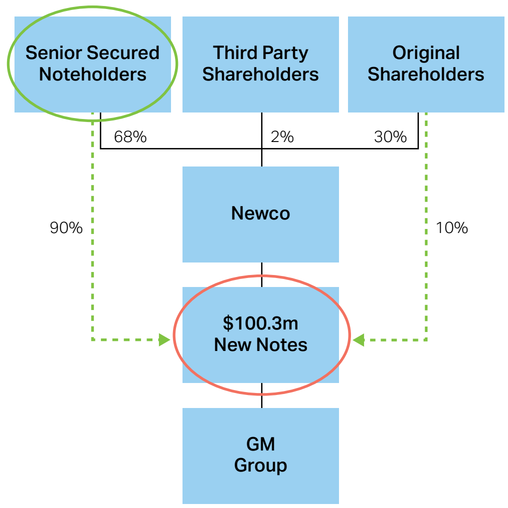
SIMPLIFIED CORPORATE STRUCTURE



Total debt: $342.2m.

After

SIMPLIFIED CORPORATE STRUCTURE



Total debt: $100.3m.

- — The original shareholders invested an additional $5m in newco in return for 30% of the equity in newco and approximately 10% of the new notes.
- — Third-party holders of old notes received 68% of the equity in newco and approximately 90% of the new notes.
- — 2% of the equity in newco was allocated to a third party who assisted in the restructuring.

CASE STUDY #2

Rusal

As a result of the continuing volatility and uncertainty in the financial and commodities markets, Rusal, one of the world's largest aluminium producers, restructured its US$4.75 billion and US$400 million aluminium pre-export finance term facilities by proposing parallel schemes of arrangement in England and Jersey, the largest-ever schemes of arrangement proposed by a group with its main operations in Russia and the CIS. The main purposes of the amendments to the PXF facilities were to revise the amortisation schedules by introducing a grace period for principal repayments, deferring the final maturity dates and resetting the financial covenants. This is an example of an "amend-and-extend" scheme.

The existence of certain dissenting creditors means that the group was unable to pass the relevant proposal using the contractual route, which required all lenders' consent. Rusal therefore proposed parallel and inter-conditional schemes of arrangement in England (being the governing law of the PXF facilities) and Jersey (being the jurisdiction of incorporation of Rusal), which would only require the approval of a majority in number holding 75% by value of the lenders.

Rusal announced its intention to pursue schemes of arrangement in July 2014 and the first court hearings took place shortly thereafter. After almost a year-long negotiation and the commencement of the parallel schemes process, a consensual deal was eventually agreed and the amendments came into effect in August 2014. The Rusal case study demonstrates a useful practice point. Typically, the preparation of a scheme is done in parallel with the negotiation process in connection with the restructuring. In many cases, the prospect—or, less euphemistically, the threat—of a scheme will help deliver the necessary consent to effect the restructuring and therefore the need for a scheme will usually fall away. However, if the consensual negotiation breaks down, a scheme is useful as a potent fall-back strategy.

In 2014, Rusal proposed parallel schemes of arrangement in England and Jersey to restructure two of its pre-export finance term facilities. This was an "amend and extend" scheme where the principal amounts payable remained unchanged. The main purposes of this restructuring were to revise the amortisation schedules, to defer the final maturity dates and to reset the financial covenants under the pre-export finance facilities.

Terms	Terms of the Scheme
Principal amount	Unchanged
Group structure	Unchanged
Amortisation schedule	Two-year grace period for principal repayments
Final maturity dates	The maturity dates for a substantial portion of the loans were pushed out by two years
Financial covenants	Financial covenants were reset to provide greater headroom for the group
Margin	Margins were increased
Security	Additional security were provided
Other arrangements	Additional cash sweep and cash pooling arrangements were provided

CASE STUDY #3

DTEK

Earlier this year, a scheme was proposed by DTEK, the largest privately owned Ukrainian energy business. The unrest in Ukraine has led to a disruption of its operations and generally poor market conditions which in turn adversely affected DTEK's business. The substantial devaluation of the Ukrainian hryvnia against the US dollar and euro has created significant financial problems for the group with main revenue stream in hryvnia.

The scheme proposed by DTEK in April 2015 is relatively straightforward. The existing notes were to be acquired by DTEK in exchange for new notes with a later maturity date at an exchange ratio of 80% of the original par value and a cash consideration of 20% of such par value. This scheme was notable as it involved what were originally New York law-governed high yield bonds. As part of a consent solicitation process, the governing law of the bonds was changed from New York law to English law.

What is notable in the DTEK case is that the judge confirmed that, despite DTEK moving its COMI to England as a prudential measure, the fact that the notes are now governed by English law is alone sufficient to fulfil the "sufficient connection" test in order to confer on the English court jurisdiction to approve the scheme.

The DTEK case also shows that an English law scheme may be used to circumvent the requirements for unanimity or the 90% consent requirement in a typical high yield bond. Even if the governing law for a debt instrument is New York law (which is very often the case for high yield bonds), DTEK shows that this does not necessarily mean that a US Chapter 11 procedure is the only restructuring route for the debtor company. Given the lower stigma attached to a scheme and the lower cost compared to a full-blown Chapter 11 procedure, issuers of high yield bonds may see an English law scheme as an appealing alternative.

In April 2015, DTEK implemented a scheme of arrangement in the English courts to exchange its $200m notes due 2015 for cash (20%) and new notes due 2018 (80%).