Cross-border bond restructurings

James Sprayregen, Lyndon Norley, Richard East and James Wong,
Kirkland & Ellis

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More than ever before investors conducting business in Europe need to be aware not only of the local laws and practices of the relevant jurisdictions in which they are investing, but also of pan-European legislation and the influence of US investment and restructuring practices. In particular, US investors have brought their own style of conducting financial restructurings, which has had a growing significant influence on bond restructurings in Europe.

Recent years have seen a marked trend in the UK and the wider European market of following the US practice of forming bondholder committees, which in turn appoint their own financial and legal advisers for purposes of negotiating with the bond issuer, debtor and other creditor groups.

Restructuring transactions in Europe have also been influenced by US legal principles of reorganisation, particularly the Chapter 11 process (*see chapter Potential advantages of a Chapter 11 Restructuring for non-US companies or more information*). There is perhaps some increasing coherence in Europe with respect to the conduct of formal insolvency procedures as cross-border insolvency proceedings in Europe are now governed by the EC Regulation on Insolvency Proceedings (*Council Regulation (EC) No 1346 of 2000, introduced by the Council of the European Union, which came into effect on 31 May 2002* (the EC Regulation)).

Against this background, this chapter examines the legal frameworks governing and influencing cross-border restructurings, in particular:

- The existing bond restructuring processes in the EU with particular reference to the UK and the influence of the US on UK practices.
- US cross-border restructuring processes.
- The effect of the EC Regulation on cross-border transactions.

BOND RESTRUCTURING

Background. The move in Europe towards US-style bondholder representation is a result of the increasing presence of US investors in Europe and the shift towards companies raising capital through corporate bonds rather than through bank debt. In the 1990s, companies in traditional industries raised cash from banks secured to those banks by all or substantially all of the company's assets. These companies could further obtain financing through increases in their equity. However, companies more recently, especially those in the telecommunications industry, do not have the typical assets banks are able or willing to take security over. As a consequence, businesses have sought alternative means to raise money. This has been mainly by the issuing of bonds.

In the midst of the technological and telecommunication expansion, many other companies have also raised funds through bond issues, which are perceived as being a more flexible financial instrument to meet the financial requirements of the debtor, particularly by the imposition of less onerous financial and reporting covenants. For many companies, particularly those in the early years of formation, bonds were issued with the intention of refinancing them through business expansion and more traditional financial instruments. However, in many cases, the business has not expanded in accordance with the company's business plans and bond defaults have been common.

US-UK differences. The trading of distressed debt is more developed in the US than the UK, with significant trading actively occurring in the UK only in the last five years or so. With an increasing presence of US investors in Europe, European markets have adopted bond indentures that are US based and typically governed by New York law to further attract US investors, who prefer to negotiate and deal with documents they are familiar with (in effect based on US indenture terms).

The US-style indenture has principal differences from its English or Eurobond counterpart. US indentures usually contain more extensive terms setting out rights of the bondholders against the issuer company, whereas generally, English trust deeds contain broader and less stringent provisions.

The threshold requirements for amendments to the bond documentation differ between the two jurisdictions. In the US, on some matters, the consent of a simple majority (51%) in value of the bondholders is sufficient to amend terms of the bond, while for some other matters, for example alteration of fundamental terms such as the maturity period, interest rates and payment obligations, the unanimous consent of all bondholders is required. In contrast, English bond documents usually require a threshold of only two-thirds or three-quarters in value of the bonds to amend the rights of bondholders. An English trust deed may be formed purely on negotiated commercial terms, while a US indenture, regardless of its existing terms, is also subject to provisions of the US Trust Indenture Act of 1939 which overrides inconsistent terms contained in the bond document.

Where the principal bond document is based on US law, the dynamics of bond restructuring often differ significantly from a bond restructuring based on European bond documentation. As all parties will be aware of the unanimity requirement in US indentures, parties are likely to be more adversarial, using the courts for deliberation and "cram-down" of recalcitrant parties under Chapter 11. In contrast, a European restructuring can be a more consensual process which may therefore avoid the court process.

Negotiating parties and process. The negotiation process in restructuring deals has become increasingly complex with the involvement of more parties. For example, it is common for an issuer company to have debt owed to secured bank lenders, mezzanine financing lenders and multiple sets of bondholders, each with their own set of financial and legal advisers. Secondary distressed debt traders may also join in the restructuring process by acquiring a certain stakeholding of the bonds or other debt instruments. Given the multiplicity of parties it is again common to find very differing interests between the various stakeholder groups which often take considerable time to work through to some form of consensus.

In view of the complications and different interests represented at the negotiating table in any debt restructuring, certain mechanisms have evolved in recent years to address these issues. In the past, the debt structure of a company was often simple (primary obligations to a bank lender, where any restructuring negotiations involved could be conducted in private and with respect to a defined group of known banks). In the case of bond restructurings, where such bonds can be freely and publicly traded, the exact ownership of the bonds cannot be easily determined and could be ever changing unless there are in place mechanisms to impose restrictions on trading.

In anticipation of entering into restructuring negotiations, it may be essential to enter into lock-up agreements to enable the debtor to negotiate with an ascertained group of bondholders. The function of the lock-up arrangement is to restrict bondholders from trading and disposing of their holdings for a certain period of time to facilitate discussions between the debtor and the bondholders, who are typically represented by an ad hoc committee formed from a representative group of the bondholders.

The restricted period for discussions is for a negotiated term, usually expiring in 90 days or such longer period as may be extended by agreement, or on a successful restructuring. Without such lock-up arrangements, it would be difficult for the debtor to negotiate any viable restructuring plan or, at worst, the debtor might be close to finalising a restructuring only to discover that those bondholders who have been in negotiations on such an arrangement have traded out of the bonds to a new group of bondholders with different objectives.

It is also typical to negotiate standstill agreements, where bondholders agree to forbear taking legal action or any form of enforcement against the debtor should the debtor be in breach of any terms of the bond. The purpose of a standstill agreement is to allow the debtor a reasonable opportunity to enter into candid discussions with the bondholders without fear that its full and frank disclosure would trigger an enforcement action or legal proceedings. A standstill agreement also prevents any creditor or bondholder who is a party to the agreement from insisting on their full rights during the restrictive period stated or to take any serious adverse action against the debtor, for example, to wind up the company on grounds that it is insolvent. Like the lock-up arrangement, the period of forbearance is for an expiring term or until a successful restructuring.

To assist the restructuring process, bondholders often need to obtain from the debtor information they were otherwise not entitled to and which may be confidential. In such circumstances, it is necessary to negotiate appropriate confidentiality agreements. The function of the confidentiality agreement is to facilitate discussions between the parties concerned, while preventing abuse or leaks of material and price sensitive information relating to the company that is received by external parties in the course of discussions.

In bond restructurings, it is typical that only bondholders who agree to be restricted by such confidentiality agreements have access to such information. Other creditors or bondholders who are otherwise not bound by terms of confidentiality with the company are just provided with general information. This is in contrast to a bank debt restructuring in which the banks are aware of most information through information covenants contained in the bank loan documentation.

An additional group of advisers involved in the restructuring process are those who take an active role in the reorganisation of the management and business of a company. This is important, particularly after a debt to equity swap restructuring, where creditors then own a significant stake in the company. Creditors' returns, at or soon after the restructuring, are derived from the profitability of the company and the improvement in its equity value. In some cases, bondholders may require, as part of a debt for equity swap, a representation on the board of the company. Such advisers will be particularly important in a full financial and operational restructuring, rather than just a balance sheet fix for the short term.

US influence. US hedge or distressed investors have become popular in the US for their aggressive approach to bond issuer debtors. A recent example of a US distressed fund attempting to use US-style litigation tactics on a company in the UK is the case of *Colt Telecom*. In that case, Highberry, an affiliate of Elliot Associates (a US hedge fund), attempted to place Colt Telecom Group plc, a FTSE mid-250 index company, into administration. Administration is usually explained to US lawyers as being the equivalent rescue type procedure to the Chapter 11 proceeding in the US, although there are important differences between the two, namely that the Chapter 11 is primarily a debtor in possession proceeding, and the administration order contemplates the appointment of a third party insolvency practitioner, who is an officer of the court (*see also chapter Potential advantages of a Chapter 11 restructuring for non-US companies*).

The facts surrounding Highberry's petition for an administration order were, in the context of English insolvency law, extraordinary: Colt, at the time of the petition, had a market value of in excess of GB£550 million (about US$860 million) and had net assets of GB£977 million (about US$1,527 million). Colt had also recently raised GB£500 million (about US$782 million) through an equity rights issue in December 2001. The Bonds which had been issued by Colt were not in default and were not due until the period 2005 to 2009. Highberry held about 7% of

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the issued bonds. The Bond Indenture also contained a standard "no-action" clause which provided that a holder of the bonds "may not pursue any remedy with respect to this Indenture or the Notes unless" among other things, 25% of the bondholders requested the Trustee to pursue the remedy. The Indenture was subject to New York law.

Highberry's primary case, which was supported by an expert report issued by a partner of KPMG, was that it was inevitable that Colt was or would become insolvent (either on a cash flow or balance sheet basis). Highberry also argued that it was not prevented by the "no-action" clause from bringing the administration petition, because the clause only excluded contractual type remedies and was not intended to exclude statutory actions or remedies, such as an administration petition or a winding up. Colt's position was that it was not insolvent (and therefore the Court had no jurisdiction under the Insolvency Act to place Colt in administration) and that the "no-action" clause was a clear bar to the petition brought by Highberry.

Mr Justice Jacob in his judgment was critical of the actions taken by Highberry and its advisers. He considered that the petition should never have been brought and that Highberry's financial expert should never have purported to give an opinion on the financial position of Colt and simultaneously proffer himself as the eventual administrator of Colt. Mr Justice Jacob also found that Colt was not insolvent on either a cash flow or balance sheet basis and that Highberry was prevented by the "no-action" clause from bringing such a petition. He also made a number of more telling comments. He stated that even were he to have had the jurisdiction to place Colt in administration, he would not have done so for the following reasons:

- The making of an administration order would have constituted an Event of Default under the Bonds, which in itself could have destroyed the business of Colt rather than serve the statutory purpose of the survival or rescue of the company.

- The petition had no real support from bondholders at large (Highberry was the only petitioning bondholder, which held only about 7% in value).

- The petition was premature.

- There was no indication that an administrator (without telecoms knowledge) once appointed could improve on the current management.

- An administration order would simply add to the company's cost.

This is not a surprising judgment. In relation to the "no-action" clause, MR Justice Jacob, after hearing expert testimony on New York law, found support for his view that the petition was prevented by such a clause as it was consistent with the limited New York cases he had considered. Despite the increasing influence the US may have on European transactions, for the reasons stated, the case of Colt represents the current limit on the amount of influence that can be exerted on UK companies.

CROSS-BORDER RESTRUCTURING : US PROCESSES

The reorganisation effect of Chapter 11 bankruptcy in the US is becoming increasingly familiar with pan-European investors. Certain jurisdictions in Europe give either automatic recognition to Chapter 11 or recognition by local proceedings. Although Chapter 11 is not recognised in the UK, protocols provide that if a US parent company files for Chapter 11, its UK subsidiary should petition for a similar protective proceeding and the respective office holders through the protocol should determine the scope of their respective functions. Two recent cases highlight the current practice with respect to recognition between the US and the UK.

The first case (January 2003) involved a ferry company, Cenargo International plc (Cenargo). Cenargo, a UK company, filed for Chapter 11 protection without initiating any English procedure. The idea of using a Chapter 11 order is to enable the existing management to maintain control of the company (concept of debtor in possession) rather than to hand control to an officer of the court or an independent insolvency practitioner. However, one of Cenargo's creditors, Lombard, challenged this approach on the basis that an independent third party should be involved in administering the process and petitioned for Cenargo to be placed under provisional liquidation in the UK. This case has attracted controversial discussion on issues of the UK not respecting Chapter 11's worldwide jurisdiction.

The second case (January 2003) involved Budget-Rent-a-Car (BRAC), a US company incorporated in Delaware, which was made subject to an English administration order on the basis that its centre of main interest was deemed to be within a member state of the EU, because its business was conducted in the UK (*see below, Jurisdictional interaction: effect of the EC Regulation on cross-border transactions*).

Correspondingly, the US courts give recognition to certain restructuring proceedings in the UK. For instance, a UK scheme of arrangement, formed under Section 425 of the Companies Act, with creditors can be given recognition in the US (s*ection 304, Bankruptcy Code*), in effect imposing a stay on creditors if the requisite threshold of consent has been achieved.

JURISDICTIONAL INTERACTION: EFFECT OF THE EC REGULATION ON CROSS-BORDER TRANSACTIONS

Europe is in some ways similar to the US, with a body of European regulations and directives binding on member states (like US federal law) but it is distinctly different in that there is no universal code of law applied homogenously across Europe. A first step to introduce a uniform code regulating cross-border insolvency proceedings resulted in the EC Regulation (*see EU Regulation on insolvency and local legislation chapter for further information*).

The EC Regulation provides a common set of rules governing recognition of formal proceedings on cross-border matters which bondholder institutions and their advisers can refer to. For example, bondholders of a debtor company with assets and operations in several jurisdictions in Europe can look to the EC Regulation for a clear framework of rules to work within, for instance, to place the company in administration, if its centre of main interest is in the UK, as part of the restructuring process.

The EC Regulation provides a uniform set of rules to thread together otherwise divergent practices throughout Europe and to give more certainty as to how things will turn out against the many types of proceedings in different countries. The usefulness of applying the EC Regulation is evident where there is a judgment, for example, an administration order, obtained in a member state such as England on the debtor company, as the law of England and Wales is then the predominant law governing how assets are to be distributed to creditors. Creditors within member states can participate in the main proceeding as if they were nationals so they will be able to prove their rights in England without any problems of showing *locus standi* (*Article 3, the EC Regulation*).

Test cases under the EC Regulation. The EC Regulation is aimed at regulating formal insolvency proceedings, and does not therefore apply to administrative receiverships, consensual restructurings or insurance companies. The applicable usefulness and apparent practicality of the EC Regulation has been questioned since its introduction by legal practitioners and its promulgation was received with some scepticism, until the case of *Re: BRAC Rent-a-Car International Inc.* in January 2003. In the *BRAC* case, the company, BRAC, wanted to seek protection from creditors under an administration order. However, BRAC is an overseas corporation registered in Delaware in the US and the existing provisions of the Insolvency Act 1986 arguably do not extend administration to foreign companies. The test of eligibility to open proceedings under the EC Regulation is the definition of "the debtor's centre of main interest", which is presumed to be its place of incorporation. Although it was argued that BRAC's place of incorporation was in Delaware, not in the EU, and therefore BRAC could not rely on the benefit of the EC Regulation to open proceedings, the argument failed as the court held that BRAC's centre of main interest was in England, on the basis that it conducts its regular business in England, rather than its place of incorporation.

Evidential facts which convinced the court that BRAC's centre of main interest was in the UK were:

- BRAC never traded in the US.
- It had no employees in the US.
- Its contracts of employment and trade contracts were all governed by English law.

The court also held that insisting the centre of main interest is solely determined by a company's place of incorporation allows corporations to manipulate the system so as to register in a jurisdiction outside the EU, but arrange for its assets, business and operations to be in a member state to avoid the reach of the EC Regulation.

In a similar case involving a Spanish company which had its head office in England, the UK courts deemed the centre of main interest of the company to be in the UK and not Spain. The court granted an order for the company to be placed in administration (*the EC Regulation*).

These cases affirm the applicability of the EC Regulation. In coming to this conclusion, the judge in the *BRAC* case, Mr Justice Lloyd, adopted a purposive approach in his interpretation of the EC Regulation, consistent with the approach to applying European legislation.

CONCLUSION

Bonds in recent years have become the preferred choice of companies as a flexible form of financial instrument which can be offered to a wide investor base. As more bonds were issued, more bonds defaulted and required restructuring, with more parties being involved in bond restructurings as principals and/or advisers. As a result, there is a greater need for management of the entire process, for example, through mechanisms such as lock-up, standstill and confidentiality agreements.

Recent cases have shown a limit to the influence US processes can have on European bond restructurings. However, much is to be learnt from the experiences of the more developed US market. On the one hand, it must be recognised that European bond restructurings may have their own particular style of development. On the other hand, investors should take advantage of the best elements the more developed US market can offer and have the benefit of documentation which accurately reflects the market within which the bonds were issued. In turn, it should be possible for bond restructurings to be achieved in an efficient and timely manner that is beneficial to all parties concerned.