Schemes of arrangement and Chapter 11 of the US Bankruptcy Code: a comparative view

Antony Zacaroli QC and Alexander Riddiford compare the US Chapter 11 and English schemes of arrangement restructuring processes in light of recent English case law

Given the slew of recent decisions by the English High Court relating to the scope of the English Court’s jurisdiction to sanction schemes of arrangement promulgated by overseas companies or corporate groups, it is timely to consider afresh the respective strengths and weaknesses (from the points of view of both companies seeking to restructure their debts and those companies’ creditors) of the English scheme of arrangement and the restructuring processes available under Chapter 11 of the US Bankruptcy Code.

The international effectiveness of a restructuring will often be a critical consideration for those corporate groups with multinational operations, and for this reason (among others) the US and English Courts are often considered the most attractive forums in which to promulgate the restructuring of a multinational corporate group.

Accordingly, this article presents a broad overview of the pros and cons of the two restructuring processes from the points of view of debtor companies and their creditors, with particular reference to the jurisdictional thresholds required for each process (an area where the English law has developed markedly in recent years).

Schemes/Chapter 11 in the broader restructuring landscape

In comparing schemes and Chapter 11 reorganisation, it is useful to keep in mind that, while they share common features, they perform significantly different functions within the context of their different legal systems. Indeed, a full comparison of the English and US reorganisation procedures would require, on the English side, administration and corporate voluntary arrangements to be brought into the picture. That is because, in the US, the Chapter 11 procedure combines moratorium, debtor-in-possession management, reorganisation and restructuring of creditors’ rights. The same ends in England are ordinarily achievable only via a combination of an administration and a scheme or voluntary arrangement. In this article we are concerned to compare those aspects of Chapter 11 that correspond to the English scheme jurisdiction.

It is particularly important to keep in mind the broader functions of Chapter 11 when comparing the jurisdictional thresholds for the two systems. The fact that Chapter 11 is what may be termed a ‘full service’ reorganisation procedure means that the jurisdictional threshold focuses on connections between the debtor and the US, in particular on the presence of assets within the jurisdiction. A scheme, on the other hand, is not

1. It is emphasised that the authors are not qualified US law attorneys and so do not purport to give any expert view on any substantive issue of US law.
necessarily an insolvency procedure at all (hence its foundation in a section of the Companies Acts, and its use by solvent as well as insolvent companies), and the jurisdictional threshold reflects this. Whilst a scheme of arrangement can in theory be used as a means of compromising the claims of all creditors of a trading company, it is rarely so used. The relatively recent (10-15 years) growth in the use of schemes of arrangement as a restructuring tool of choice is largely confined to ‘financing’ companies, being those companies within a larger group that transact with the longer term financial creditors, and then on-lend the money raised to the wider group. Such companies tend to have no significant creditors other than the financing creditors and the legal rights of all such creditors are generally found in a suite of documents (senior loan, junior loan, security deed, intercreditor deed) governed by a single system of law. In these circumstances the main, if not the entire, focus of a scheme of arrangement is on the amendment of the contractual rights of the creditors, as contained in those documents. The courts have for a long time recognised the ability of a company to enter into a scheme of arrangement with some only of its creditors, provided that there is a sound commercial justification for the choice: see PT Garuda Indonesia (2001) WL 1171948, per Lloyd J: “I do not particularly see why the company should not be free to determine in a way which is not merely arbitrary what is the particular group or body of creditors with whom it wishes or needs to deal by a statutory procedure.”

Jurisdictional thresholds

The generous jurisdiction assumed by the US Courts under Chapter 11 of the US Bankruptcy Code over multinational corporate groups is well established. Section 109(a) of the US Bankruptcy Code permits a Chapter 11 filing in a US bankruptcy court by a person, defined to include a corporate person, “that resides or has a domicile, a place of business, or property in the United States”.

The US Courts have long relied on the “property” limb of section 109(a) as an anchor for a broad jurisdiction over foreign corporations, and have taken a broad approach as to what constitutes sufficient property for this purpose. For example in In re Global Ocean Carriers Ltd 251 B.R. (Bankr. D. Del. 2000), the Delaware Court heard a Chapter 11 petition filed by a shipping company headquartered in Greece (along with 15 of its subsidiaries) and, overruling a motion to dismiss brought by a minority creditor and a minority group of members, held that it was sufficient to establish jurisdiction under section 109(1) for
the debtor company to hold a few hundred US$ in a bank account in the United States. The meaning of the statute was clear, so as to “leave the Court no discretion to consider whether it was the intent of Congress to permit someone to obtain a bankruptcy discharge solely on the basis of having a dollar, a dime or a peppercorn located in the United States.”

A note of warning was, however, sounded in In re McTague, 198 B.R. 428, 432, in which it was said that placing property in the US for the sole purpose of being eligible to make a voluntary Chapter 11 filing (where that eligibility would not otherwise exist) may be treated as evidence of “bad faith” justifying the dismissal of a filing on that basis.

Further, the broad jurisdiction conferred by section 109(1) is subject (inter alia but in particular) to: (a) whether there are already foreign proceedings pending (section 305(a)(2)); and (b) the “best interests” test under section 305(a)(1), which provides that the Court may dismiss or suspend all proceedings in a case if the interests of both creditors and the debtor would be better served by such dismissal or suspension. The case of In re Aerovias Nacionales de Colombia SA Avianca 303 B.R. 1 (Bankr. S.D.N.Y. 2003) represented an early decision in which a US Court had to weigh up these section 305 factors in the context of a voluntary Chapter 11 filing by a foreign company (a Colombian airline). The Court relied on the fact that there was no proceeding pending in a foreign Court, and placed weight (inter alia) on the creditors’ willingness to submit themselves to the US jurisdiction, and on this basis the Chapter 11 filing was successful.

By contrast, although the basis of jurisdiction in England stems from a similar root, namely sufficient connection between the company and this jurisdiction, and although the English Courts have also adopted a broad approach to what constitutes sufficient connection, they have done so in a markedly different way. The origins of the sufficient connection test in English law are found in cases concerned with insolvency proceedings proper, for example liquidation. The three-fold test applied there requires (i) that the company had a sufficiently close connection with England usually, but not invariably, in the form of assets within the jurisdiction; (ii) that there was a reasonable possibility of benefit accruing to creditors from the making of a winding up order; and (iii) that one or more persons interested in the distribution of assets were persons over whom the English court could exercise jurisdiction.

In the context of a scheme, it is the first limb which is generally critical. An early application of the sufficient connection test in the case of a scheme of arrangement was in Re Heron International NV [1994] 1 BCLC 667, where the English Court sanctioned a

---

2/. For the need to satisfy both requirements, see for example In re Eastman, 188 B.R. 621 (B.A.P. 9th Cir. 1995).
scheme promulgated by an overseas entity, accepting jurisdiction on the basis that the company held substantial assets in England.

Since the introduction of the concept of centre of main interest (COMI), the existence of COMI in England will invariably be sufficient to establish sufficient connection for the purposes of a scheme of arrangement. However, in recent years, in those cases where the purpose of the scheme is to restructure financing debt (as opposed to compromise the debts of a trading company) the English Court has considerably expanded its reach in the scheme context, not by a liberal approach to what constitutes sufficient assets (as in the US) but by concluding that there is sufficient connection with England if the law governing the debt to be restructured is English law. These developments are a relatively recent phenomenon. In May 2011 Briggs J held in Re Rodenstock GmbH [2012] BCC 459 that the English Court had jurisdiction to sanction a scheme of arrangement proposed by an overseas company where the relevant liabilities were governed by English law and subject to English jurisdiction. In June 2013, in Re Vietnam Shipbuilding Industry Group [2014] 1 BCLC 400 the Court clarified that there was a “sufficient connection” between the overseas company and the English jurisdiction where the only connection was that the company’s liabilities were governed by English law. Things were taken a step further in November 2014 when Hildyard J held that it could be (and was on the facts before him) sufficient for the purposes of establishing the “sufficient connection” required to establish the English Court’s jurisdiction, for the governing law of an overseas company’s liabilities to be changed to English law so as to enable the English Court to take jurisdiction (see Re APCOA Parking Holdings LmbH and others (No 2) [2014] EWHC 3849 (Ch)).

This latter point does depend, however, on it being established that the change in governing law is valid and effective under the relevant system of law, from which it is sought to make a change. This issue arose in DTEK Finance [2015] 1164 (Ch), where it was contended that the change of law from New York law to English law was, as a matter of New York law (which was the old law governing the indenture) ineffective. The matter was resolved immediately before the sanction hearing by the 90 percent threshold of consents being achieved, and so no decision needed to be made on the point. This is an area where further guidance from the English court is likely to be forthcoming before long.

The difference in approach between the US and England on the jurisdictional threshold question reflects the fact that a scheme, although sharing many of the characteristics of a plan of reorganisation under Chapter 11, is focused solely on amending the terms of the debt between the company and its creditors. For an amendment of an English law contract (forced on a dissenting minority by the majority rule embedded in the statutory provisions governing schemes of arrangement) to be effective worldwide, it is generally accepted that it must be one that is valid and effective as a matter of English law.

In some respects the English Court’s jurisdiction is now even more expansive than that of the US Court. For example, whereas a deliberate engineering of the circumstances which would give a debtor company standing to make a voluntary Chapter 11 filing has been ruled as bad faith (and the filing dismissed on that basis), the English Court has not balked at accepting jurisdiction where it is clear that the company has deliberately promulgated a change in the governing law of its liabilities with a view to obtaining the benefit of the English scheme jurisdiction (see APCOA). Moreover, a change of COMI in favour of England, undertaken with a view to taking advantage of English insolvency procedures, is also recognised and given effect to, provided that it is a sufficiently permanent change.

**Procedure and relief**

In terms of procedure, an English scheme of arrangement is promulgated in two stages: (a) first, by way of a convening hearing (at which the debtor applies to the Court for permission to convene meetings of identified classes of creditor and in some cases members); and (b) secondly, by way of a sanction hearing (once the statutory voting majorities have been obtained for all classes of creditor and, where applicable, member). At the convening hearing the Court considers (principally) the terms of the proposed scheme, the accompanying explanatory statement and the way in which the debtor proposes the scheme classes should be constituted. At the sanction hearing the Court has a discretion whether or not to sanction the scheme, taking into account (inter alia) whether all of the procedural requirements have been

A Chapter 11 filing may be made without a reorganisation plan having been fleshed out by the company in advance

met and whether the creditor classes were fairly represented by those that attended the meetings.

By contrast, the initiation of a voluntary Chapter 11 process is rather more straightforward. Upon making a voluntary Chapter 11 filing the debtor company must file a list of creditors, in most cases a schedule of assets and liabilities (and of open contracts and unexpired leases), as well as various other items of information as set out in Rule 1007 of the Federal Rules of Bankruptcy Procedure. Upon entry into Chapter 11 proceedings the debtor is permitted to continue with its business operations (usually without a trustee being appointed), although the bankruptcy court is required to approve most major business decisions such as the sale of assets, entering into secured financing arrangements, and other matters of this kind. Ordinarily, the debtor will have the exclusive right for four months after it has made its Chapter 11 filing to propose a reorganisation plan, but when this exclusivity period (which may be extended) expires, the creditors’ committee or other parties can propose competing reorganisation plans. It appears that competing plans are rare under Chapter 11, since in the normal course dissatisfied creditors will move to dismiss or convert the case to a Chapter 7 proceeding.

Chapter 11 filings fall into one of two categories: (a) the pre-negotiated cases (where a reorganisation plan has been substantially agreed prior to the filing); and (b) the free-fall cases (where the filing is made without an exit strategy having been formulated in advance).

Accordingly, one of the principal distinctions between the scheme jurisdiction and the Chapter 11 process is that, whereas a Chapter 11 filing may be made without a reorganisation plan necessarily having been fleshed out by the company in advance (the filing having been made perhaps primarily so that the company might obtain the protections that come with being in Chapter 11 proceedings), by contrast in the English context the details of the proposed scheme need to a great extent to have been worked out in advance of the convening hearing.

Indeed, as noted above, whereas the scheme of arrangement jurisdiction is limited to the restructuring process itself, without any of the incidents of a formal insolvency proceeding (such as the automatic statutory moratorium or the appointment of an officeholder), those features are present in the Chapter 11 proceedings. Similarly, a pre-pack sale, analogous to the pre-pack sales in English administrations, may be effected by way of a Chapter 11 process.

In terms of the relief that may be obtained by a debtor as a result of a Chapter 11 filing, the principal items for present purposes are as follows:

- An automatic stay;
- The presumption that the debtor’s management will remain in place rather than be replaced by a trustee;
- The ability to obtain post-petition financing;
- The ability to restructure financial obligations on a non-consensual basis pursuant to the “cramdown” provisions of the US Bankruptcy Code; and
- The discharge of a debtor from any debt that arose before the date of confirmation of a plan of reorganisation, regardless of whether a proof was filed (or whether the creditor in question accepted the reorganisation plan).

Some of these forms of relief, as noted above, are more reminiscent of the English administration regime than the scheme of arrangement jurisdiction. An important point of comparison with the English scheme jurisdiction, however, is in the Chapter 11 “cramdown” provisions.

To the proviso, this requirement involves two discrete principles: (i) that a non-accepting class of creditors (or shareholders) cannot be compelled to accept less than payment in full while a more junior class of creditors (or shareholders) receives anything (the “absolute priority rule”); and (ii) that a more senior class of creditors (or shareholders) should not be paid more than the full value of its claim while cramming the plan down on a more junior class of creditors (or shareholders).

In contrast to the flexibility of the
Chapter 11 cramdown provisions, the voting majorities required for an English scheme to be approved are quite rigid. In short, a scheme requires approval by at least 75% in value of each class of the members or creditors who vote on the scheme (being also at least a majority in number of each class). If the scheme includes a reduction in the company's share capital then a separate special resolution of the company's members is also required (which is carried by a 75% majority of those voting).

The *quid pro quo* of the English scheme, however, is that although every class must vote in favour, the courts have in general been prepared to adopt a broad definition of 'class' and have (as noted above) a scheme to be entered into with some only of the company's creditors (so that the inability to obtain the agreement of a particular class of creditors – particularly a group with no economic interest in the company's assets in view of where the value breaks within the debt structure – is not fatal to the success of the scheme). So far as the former point is concerned, differences in the creditors' *interests* (as opposed to *rights* against the company) are insufficient to require them to be placed into separate classes. Moreover, even creditors with different rights (either going into, or coming out of, the scheme) may be combined in the same class, provided that those rights are not so dissimilar as to make them unable to consult together on the scheme in their common interest.

So far as voting within classes is concerned, the other major difference between the two jurisdictions is that the requisite majority by value under Chapter 11 is two-thirds, whereas it is 75% in an English scheme.

**Conclusion**
The jurisdictional threshold for a Chapter 11 filing has been low for a long time, extending to companies with a *de minimis* amount of assets held within the jurisdiction. In contrast, it is only in the last few years that English law has developed so as to expand the range of circumstances where an overseas company's connection with England will be considered “sufficient” for the English Court to accept jurisdiction in the context of a proposed scheme of arrangement. This expansion has, however, taken place in the context of schemes designed solely to amend the terms of the debt with a company's financing creditors and has, accordingly, focussed on the governing law of that debt.

This factor, together with the choice afforded to the company as to which creditors to encompass within a scheme, and the flexible approach which the English courts have traditionally taken to the definition of classes, means that the scheme of arrangement remains an extremely important and valuable tool in the restructuring world and one which, in combination with the use of the administration procedures under the Insolvency Act, imports much of the advantages available under the Chapter 11 jurisdiction.

---

For more information, contact antonyzacaroli@southsquare.com or alexanderriddiford@southsquare.com

The full Digest can be viewed at www.southsquare.com/south-square-digest