**English versus US bond restructures**

**A comparison of English Schemes of Arrangement and “Pre-packs” under the US Chapter 11 Regime**

***Peter Bowden***

**ABSTRACT**

England and the USA have different insolvency (or bankruptcy) regimes and various, and diverse, procedures available for restructuring distressed businesses. Depending on the restructuring method, Court intervention may or may not be required. Two of the more popular methods for effecting restructures and/or restructuring debt, that require Court intervention, are Schemes of Arrangement (or “Schemes”) in England and pre-packaged bankruptcies (or “Pre-packs”) under the USA’s Chapter 11 regime. While these approaches certainly have their similarities, there are also various, and important, differences. The purpose of this paper is to highlight such differences and compare and contrast the use of an English scheme of arrangement with the use of a US Chapter 11 “Pre-pack” to restructure a single class of bond debt while leaving other creditors and equity holders unaffected.

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# INTRODUCTION

Both England and the United States of America (**USA** or **US**) have vibrant restructuring markets where debtors (including external administrators) and creditors have numerous tools that can be utilised to effect corporate restructures. Such tools are varied and, depending on the facts, parties may have several options in terms of what procedure could, and should, be implemented. For example, depending on the nature of the situation, the parties may favour seeking to implement the restructure outside of a formal Court process. Other times, for various reasons, a procedure that requires Court intervention may be necessary and/or preferred.

With parties relying upon more complicated, and diverse, debt instruments to raise capital resulting in increasingly complicated capital structures, those looking to restructure companies are relying upon more flexible and intricate tools.

An example of a tool that can be used under English law to effect a restructure that requires Court involvement is a Scheme of Arrangement (often referred to as a **Scheme**). While a Scheme is not technically an insolvency proceeding,[[1]](#footnote-1) it is a procedure enabling a company incorporated in England and Wales to reach a compromise or arrangement with its creditors or with certain classes of its creditors.[[2]](#footnote-2)

Under the laws of the US, and under Chapter 11 of the US Bankruptcy Code (**Chapter 11**), there exists a different, but in some respects comparable, method to effect restructures, also requiring Court involvement, called a pre-packaged bankruptcy (or a **Pre-pack**). Under a Pre-pack, the debtor company negotiates the terms of, and solicits votes in respect of, a Plan of reorganization (a **Plan**) before the company “files its Chapter 11 bankruptcy petition.”[[3]](#footnote-3)

While these restructuring tools certainly have their similarities, there are also various, and important, differences. In this respect, the purpose of this paper is to highlight such differences and compare and contrast the use of an English Scheme of arrangement with the use of a US Chapter 11 “Pre-pack”. For the purposes of this paper, an example of the restructure of a single class of bond debt (while leaving other creditors and equity holders unaffected) is used as a basis of comparison (the **Case**).

# ENGLISH SCHEMES

## **Summary of English Schemes**

Schemes are one of two mechanisms under English law that can be used to impose an arrangement on dissenting creditors through Court intervention.[[4]](#footnote-4) The other procedure, which is called a company voluntary arrangement (a **CVA**), is governed by the *Insolvency Act 1986* (UK). Schemes, on the other hand, are governed by the *Companies Act 2006* (UK) (**Companies Act**).[[5]](#footnote-5)

In essence, a Scheme provides a platform to enable a company to enter into a compromise arrangement with its creditors (including any secured creditors).[[6]](#footnote-6) Thus, upon implementation, a Scheme effects a binding agreement between a company and its creditors, or any class of them, regarding the company’s debts.[[7]](#footnote-7) It is important to note that a Scheme is “not an insolvency proceeding.”[[8]](#footnote-8) Therefore, there is no moratorium to protect creditors’ claims in a Scheme and, as a result of this, creditors may take enforcement action against the company up until the point at which the Scheme is sanctioned (unless Court orders are obtained).[[9]](#footnote-9)

Given the above, unlike certain insolvency administrations, a Scheme can enable the company to avoid (at least to a certain degree) the kind of reputational stigma that is associated with formal insolvency proceedings. In some cases, avoiding a technical insolvency process can also be extremely valuable in ensuring that the company does not trigger insolvency event of default wording in its contracts (sometimes referred to as *ipso facto* clauses).[[10]](#footnote-10) An *ipso facto* clause is a contractual clause which allows a counterparty to terminate a contract, or exercise rights in respect of a contract, upon the counterparty entering into an insolvency process.

## **Implementation of a Scheme**

The implementation of a Scheme requires two Court hearings as well as creditors’ meetings to be called. A Scheme is commenced by making an initial application to Court (ordinarily by the company, but this could also be made by any creditor, a liquidator or administrator) for an order that creditors’ meetings be summoned.[[11]](#footnote-11) There must be a separate meeting of each “class” of the company’s creditors and the number of classes will be dependent on the composition of a company’s creditors (accordingly, in the ordinary course there is likely to be more than one group of creditors: e.g. secured and unsecured; however, in respect of the Case, we are only dealing with one class). Each voting class must comprise creditors whose “rights are not so dissimilar for it to be impossible for them to consult together with a view to their common interest”.[[12]](#footnote-12) This test is determined in accordance with the creditors’ rights under the Scheme, as opposed to broader collateral interests. Whether a group of creditors form a single class depends on the analysis of the rights that are to be released or varied under the Scheme as well as any rights that the Scheme gives, by way of compromise or arrangement, to those whose rights are to be released or varied.[[13]](#footnote-13)

Creditors are provided with an explanatory statement which sets out the information necessary to decide whether to vote to approve the Scheme and, following the meeting of creditors, the Court is asked to sanction the Scheme.[[14]](#footnote-14) At the Scheme meetings the Scheme creditors consider and, if thought fit, vote to approve the Scheme. To ultimately be sanctioned, a Scheme requires approval in each class of voting creditor by more than half in number (50%) and 75% in value.[[15]](#footnote-15) Once sanctioned and delivered to the Registrar of Companies, the Scheme will be binding on all the company’s creditors who are affected by the Scheme (regardless of whether they voted in favour, against or abstained).[[16]](#footnote-16) The Scheme will not be sanctioned unless it is fair; that is, a Scheme that an intelligent and honest person who is a member of the class concerned, and acting in respect of his or her interest, might reasonably approve.[[17]](#footnote-17) If the Court sanctions the Scheme, it is binding on all affected creditors (even those who voted against it) and the company.[[18]](#footnote-18) While the Scheme is in place (and its duration depends on the terms of the Scheme itself), the directors of the company remain in control. Once the Scheme is concluded in accordance with its terms, the company reverts to its former status.[[19]](#footnote-19)

# OVERVIEW OF US PRE-PACKS

## **Summary of Chapter 11 Pre-packs**

A Pre-pack is a Chapter 11 bankruptcy in which the debtor company negotiates and documents the terms of, and procures support in respect of, a Plan before it submits its Chapter 11 petition.[[20]](#footnote-20) Accordingly, the restructure is said to be "pre-packaged" because “all debtor-creditor and intercreditor disputes are resolved and all necessary votes are solicited before the debtor files its bankruptcy petition.”[[21]](#footnote-21) The relevant authority for Pre-packs is found in § 1121(a) and § 1126(b) of Chapter 11. The key components of a Pre-pack, being the entire negotiation, documentation and solicitation, are conducted out of Court.

The purpose of a Pre-pack is to use the bankruptcy process to agree, outside a Court process, to a restructuring between a debtor and its major creditors and then effect it through a formal Chapter 11 process. Unlike traditional Chapter 11 filings, Pre-packs are generally not used to restructure a debtor's business operations. Instead, they are more appropriate for “restructuring the financial debt on a debtor's balance sheet, with non-financial claims (such as those of trade vendors or employees) typically being paid in full and otherwise legally unaffected by the bankruptcy.”[[22]](#footnote-22) Notwithstanding the terms of a Pre-pack are developed and negotiated outside of the formal bankruptcy regime, the Plan must still comply with the same requirements as a traditional Chapter 11 Plan.[[23]](#footnote-23) Before commencing a Pre-pack, the debtor and its supporting creditors will typically execute a restructuring support agreement (**RSA**), which is generally binding and enforceable in bankruptcy and binds the parties to the agreed terms of a restructuring. Creditors who sign up to a RSA will agree to support the terms of the Chapter 11 Plan contemplated by it.[[24]](#footnote-24)

According to *Pullo* a “successful prepack is generally faster, more efficient, and less costly than a traditional Chapter 11 case.” Despite this, “prepacks are less common than traditional bankruptcies”,[[25]](#footnote-25) as they are only appropriate when the parties can agree in advance to a restructuring solution.[[26]](#footnote-26) While the idea of a quick and successful exit from bankruptcy is appealing, implementing a Prepack can be “very difficult”.[[27]](#footnote-27)

## **Implementation of a Chapter 11 Pre-pack**

As above, a Pre-pack is initiated by the debtor who seeks to negotiate with its creditors (or at least its major creditors) to formulate a Plan. Thus, a Prepack can generally be thought of as a two-stage process.[[28]](#footnote-28) That is, the “pre-petition” stage and the “post-petition” stage.[[29]](#footnote-29)

The pre-petition stage includes the negotiation process which, amongst other things, involves the disclosure to creditors regarding the proposed Plan and the solicitation of their votes. In the pre-petition stage, the debtor must also engage in many of the same case preparation activities as if it were preparing a traditional Chapter 11 filing.[[30]](#footnote-30) However, many of the activities that typically occur within the first few days and weeks after the filing of a traditional Chapter 11 case are not required, with the exception of negotiating with prepetition lenders and, if required, debtor in possession lenders (also known as **DIP** lenders) “and the filing of statements and schedules (which are usually filed with the bankruptcy petition in a prepack).”[[31]](#footnote-31)

The post-petition stage, which is more formal in nature, includes seeking and obtaining the bankruptcy Court's approval of the Plan and the disclosure statement used in the pre-petition stage.[[32]](#footnote-32) The post-petition stage also may involve many of the same procedural and substantive matters that are typically dealt with in the post-filing stage of a traditional Chapter 11 case, depending on the extent to which issues with any stakeholders remain unresolved (or unexpected issues arise). Generally, these could include retaining counsel and other professionals. More substantively, however, these could include, for example, “responding to motions to compel the debtor to assume or reject executory contracts or for relief from the automatic stay.”[[33]](#footnote-33)

§ 1126 of Chapter 11 provides that a class of “claims” accepts a Plan if it is approved by creditors holding at least two-thirds in dollar amount and more than half in number of the allowed claims in that class voting on the Plan (§ 1126(c) of Chapter 11).[[34]](#footnote-34) Equally, a class of “interests” accepts a Plan if it is approved by parties holding at least two-thirds in number of the allowed interests actually voting on the Plan (§ 1126(d) Chapter 11).[[35]](#footnote-35) Typically, a debtor seeking to implement a Pre-pack will undertake an analysis of the likely voting outcome in respect of the total outstanding claims or interests entitled to vote on the Plan. This is to get an idea as to the likely outcome and manage any risk that a party who did not vote may come forward and ultimately object to the Plan.[[36]](#footnote-36) Note that if an impaired class rejects a Plan, it is possible for the Plan to be confirmed, but only through a “cramdown” (see below).[[37]](#footnote-37)

# COMPARATIVE ANALYSIS

## **Similarities between Schemes and Pre-packs**

English Schemes and Chapter 11 Pre-packs have some undeniable similarities, but also some important differences. They are both popular tools for restructuring companies and are focused on rehabilitation rather than winding up. These regimes also require an element of pre-planning and work, as well as engagement with appropriate stakeholders, before they are filed. Notably, both the UK and US restructuring jurisdictions are stable and robust and offer familiarity to restructuring practitioners. Such parties can take confidence from the decades of case law, numerous supportive precedents and judges experienced in bankruptcy and insolvency matters. Thus, US and English Courts are often considered the most attractive forums “in which to promulgate the restructuring of a multinational corporate group.”[[38]](#footnote-38) Further, and importantly, neither regime requires insolvency as a prerequisite for relief; accordingly, a debtor does not need to be insolvent to implement either a Scheme or a Pre-pack.

Both regimes are clearly suitable for restructuring overseas, or foreign entities.[[39]](#footnote-39) The generous jurisdiction assumed by the US Courts under Chapter 11 over foreign entities is well established. § 109(a) of the US Bankruptcy Code permits a Chapter 11 filing in a US bankruptcy court by “a person that resides or has a domicile, a place of business, or property in the United States”.[[40]](#footnote-40) US Courts have long interpreted the reference to “property” in § 109(a) broadly providing justification for a wide-ranging approach as to what constitutes sufficient property for this purpose. Caselaw suggests that this would extend to, for example, a debtor company with a few hundred US dollars in a bank account in the US. [[41]](#footnote-41) In England, Courts have also adopted a wide approach to what constitutes sufficient connection to England, but they have done so in a markedly different way.[[42]](#footnote-42) Since the introduction of the concept of a company’s centre of main interest (**COMI**), the existence of COMI will invariably be sufficient in England to establish sufficient connection for the purposes of a Scheme.

A further point of comparison between Schemes and Pre-packs is the ability under both regimes to “cramdown” creditors. Under Chapter 11, these provisions are set out in § 1129 and provide that, amongst other things, so long as the Plan satisfies all the other applicable provisions, a Plan may be confirmed notwithstanding that a class or classes have rejected it, subject to the Plan “not being unfairly discriminatory” and being “fair and equitable”. Central to these propositions, is the “absolute priority rule”.[[43]](#footnote-43)

The absolute priority rule is enshrined in the Bankruptcy Code and guarantees that, in the absence of consent, distributions to creditors must follow the rule. Accordingly, lower priority creditors will only receive a distribution after more senior classes are paid in full. A Plan cannot, therefore, be crammed down on unsecured creditors unless, for example, shareholders (who rank below unsecured creditors), receive no distributions.[[44]](#footnote-44) In essence, the class voting against the Plan can be compelled by the Court to be bound by the Plan, and, in this way, be effectively “crammed-down”, but only where the absolute priority rule is followed.[[45]](#footnote-45)

The phrase “cramdown” is “borrowed from US restructuring terminology.”[[46]](#footnote-46) Under a Scheme, the English courts cannot approve a Scheme unless (as above) each class of creditors has voted in favour of it. There is therefore no strict equivalent “cramdown” power in the UK and no absolute priority rule.[[47]](#footnote-47) However, the phrase “cramdown” is often used in England but in a “much looser, non-technical way” to refer to the fact that, provided the threshold votes have been established for each class, creditors forming part of any minority in any class voting against a Scheme will be bound by it if the Scheme is ultimately sanctioned by an English court.[[48]](#footnote-48) In this way, Schemes provide a mechanism by which the majority of a class of creditors can impose a debt restructuring on a dissenting minority (and such minority is therefore effectively crammed down).

## **Differences between Schemes and Pre-packs**

While Schemes and Pre-packs share common features, it is important to remember that they perform significantly different functions within the context of their different legal systems. In the US, the Chapter 11 procedure combines, amongst other things, the moratorium (see below), DIP funding, reorganisation and the restructuring of creditors’ rights.[[49]](#footnote-49) In England, the same ends are only achievable via a combination of a Scheme and another form of external administration (such as an administration or a CVA).[[50]](#footnote-50)

One of the key differences between Schemes and Pre-packs is that an “automatic stay” is in place from day one under Chapter 11. This prevents creditors from proceeding against the property of the debtor and stays all pending litigation and the filing of new litigation.[[51]](#footnote-51) This position can be contrasted with a Scheme, where there is no statutory moratorium or stay provided under Part 26 of the *Companies Act 2006* (UK), but the debtor may apply to an English Court for a stay against proceedings brought against the debtor pending the voting on the Scheme.[[52]](#footnote-52)

So far as voting within classes is concerned, the other major difference between the two regimes is that, as above, the requisite majority by value under a Chapter 11 Pre-pack is two-thirds, whereas it is 75% in an English Scheme.[[53]](#footnote-53)

# IS ONE OPTION PREFERRED?

## **Considerations regarding the regimes**

As above, there are many similarities between English Schemes and Chapter 11 Pre-packs. It is thus difficult to determine whether one regime is preferred over the other. However, in the context of the Case (comparing the operation of the regimes in the restructure of a single class of bond debt while leaving other creditors and equity holders unaffected), some themes emerge.

Chapter 11 is undoubtedly a more comprehensive regime. There is, as noted above, an automatic stay that occurs in a Pre-pack once the case is filed, whereas the debtor must apply to the Court to have a stay implemented in the context of a Scheme. Further, to implement a Pre-pack, a debtor must file under Chapter 11 which may trigger *ipso facto* provisions in relevant contracts and, despite the circumstances, may result in attracting the stigma associated with bankruptcy. On the other hand, whilst a Scheme can be used as a means of compromising the claims of all creditors of a company, it is rarely used for such a broad purpose. Schemes are more often associated with compromising finance debt.[[54]](#footnote-54) Accordingly, in relation to the Case (being a single class of bond debt), a Scheme may be a softer approach than a Pre-pack (and associated filing under Chapter 11).

In favour of Pre-packs, however, is the voting thresholds. As above, the necessary majority (by value) under Chapter 11 is two-thirds, whereas it is 75% in a Scheme. On its face, this indicates Pre-packs have some advantages. However, the requisite majority is not the only consideration in a Pre-pack and parties utilizing Chapter 11, or seeking to do so, must also consider the absolute priority rule.

In essence (and as above), the absolute priority rule (enshrined in § 1129 of Chapter 11) provides that, in the absence of consent, junior creditors may only receive a distribution after more senior classes of creditors are paid in full. Thus, using the Case as an example, it can be inferred that the intention of the restructure is that the claims of the single class of bondholders (the **Bondholders**) are compromised while other claims (being those of other creditors and equity holders) will not be. This appears to be, on face value, contrary to the absolute priority rule.

Unless the “class” of creditors, being the Bondholders, vote in favour of the Plan it will not be possible for a Court to approve it under § 1129 of Chapter 11 as it would not be *prima facie* “fair and equitable” as required in § 1129(b)(2). There is no corresponding rule (or statutory authority) in respect of Schemes. Despite this, as above, the voting thresholds for Schemes are higher.

## **Is there a preferred regime?**

Despite the absence of the absolute priority rule in England, it is not obvious that there is a material difference between Chapter 11 Pre-packs and English Schemes in the context of the Case. The main reason for this is that, in either a Pre-pack or a Scheme, the arrangement is going to fail if the requisite majority does not vote in favour of it. In relation to a Pre-pack, this is because the absolute priority rule would prohibit the Court from approving the Plan (as lower levels of debt holders and equity are left unaffected and are not voting) if the voting thresholds were not met. In terms of a Scheme, the Court would simply not have jurisdiction to approve it if the one class of creditors that was affected by it did not vote in favour of it.

Given the above, depending on the makeup of the Bondholder class, because of the existence of the automatic moratorium and the lower voting thresholds, it could be argued that a Chapter 11 Pre-pack has some arguable benefits. While the existence of the absolute priority rule may make it difficult for the Bondholders to conceptualize why they should vote in favor of such a Plan, the Court can still make the order under § 1129 if they give consent. If allowed, it would mean that the lower-ranking holders of claims could still enforce their full claims against the company despite a compromise of the Bondholders’ position. In this context, it must be assumed from the facts of the Case that, because only one class of Bondholders is being affected, following a successful restructure of the relevant debt, the company will be able to continue as a going concern notwithstanding the existence of the other claims.

As previously stated, the absolute priority rule provides that claims of a dissenting class of creditors must be paid in full before any class of creditors junior to such dissenting class can receive or retain any property in satisfaction of their claims. A Plan cannot, therefore, be crammed down on creditors unless they either vote in favour of it or lower ranking creditors receive no distributions.[[55]](#footnote-55) In essence, classes can be compelled by the Court to be bound by the restructuring and therefore effectively “crammed-down”.[[56]](#footnote-56) In the context of the Case, a Pre-pack can be used so that the Bondholders can effectively consent to the outcome despite being contrary to the absolute priority rule.

While, as above, there is no absolute priority rule in England, creditors would still need to be conscious of why they are voting in favour of an outcome that, potentially, provides other creditor groups with a better outcome. One reason for this might be that there is just far too much bond debt but a compromise of, for example, trade creditors, would destroy the value of the business. Another reason might be that the equity holders, who could face losses if the Scheme doesn’t go through, might make up a large proportion of the Bondholders. Therefore, despite, “the flexible approach which the English courts have traditionally taken to the definition of classes,”[[57]](#footnote-57) where those creditors and equity holders other than the Bondholders must remain unaffected (as is required for the Case), it would not be possible to broaden the composition of the Bondholder class to try and cram down the Bondholders as this would mean those other parties’ rights, that form part of the class, would also be affected.

To the extent that there was little concern over obtaining the 75% majority, notwithstanding the comment above re Pre-packs, a Scheme may be the slightly preferred method in the context of the Case given the absence of a formal bankruptcy (which cannot be avoided in a Chapter 11 case) and a somewhat softer approach that may result in fewer *ipso facto* triggers.

# CONCLUSION

This paper has summarised the important characteristics of both Chapter 11 Pre-packs and English Schemes. In doing so, it has compared the two regimes to try and elucidate the differences. There are similarities between both regimes including that neither requires insolvency as a prerequisite for filing and the decisions in both cases would be recognised overseas as a matter of course. There are, however, important differences. The most important differences between the two regimes include that there is an automatic stay in respect of Pre-packs, Pre-packs require a lower voting threshold for approval by creditors in an affected class and there is no absolute priority rule in England (although, as above, there are ways in which the composition of classes in Schemes can be used to cramdown creditors).

In the context of the Case, there appears to be minimal differences in utilising either a Scheme or a Pre-pack if the objective is to restructure a single class of bond debt while leaving other creditors and equity holders unaffected. However, this analysis is impacted by the composition of the Bondholders (which is unknown) and thus the likelihood of meeting the requisite voting threshold. If the voting threshold for a Scheme is inherently achievable, there may be a slight advantage in a Scheme over a Pre-pack as it technically avoids a formal bankruptcy or insolvency administration. This may have some benefits for dealing with third-party contracts and relationships with counterparties; particularly where, based on the facts of the Case, there is no pressing need to compromise other classes of debt or equity.

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