Addressing Multijurisdictional Complexity in Europe

A Junior Creditor's Perspective

BY DR. LEO PLANK, PARTNER & CARL PICKERILL, ASSOCIATE, KIRKLAND & ELLIS

The European Union is not a "United States of Europe," as legal practitioners and investors are painfully aware. The restructuring space is no exception.[1] Junior creditors active in a distressed European company's debt structure face a variety of complex interjurisdictional challenges in protecting their investments. Local insolvency regimes are often value-destructive, particularly in the context of multijurisdictional groups with subsidiaries that have interdependent operations.

During the current downturn, European companies have taken recourse to English law procedures, including administrations under the Insolvency Act 1986 and "schemes of arrangement" under the Companies Act 2006, to reach restructuring resolutions in the absence of unanimous consent.[2] A scheme with respect to a non-English company with little connection with England is a relatively new restructuring tool and may not be available or desirable in all circumstances. Accordingly, junior creditors should actively consider the full spectrum of alternative strategies in the distressed environment.

This article therefore analyzes junior creditor alternatives in the context of real-life examples. In particular, it focuses on: (a) prearranged share enforcements and sales, (b) releases and waivers, (c) so-called center of main interests (COMI) shifts, (d) schemes of arrangements, and (e) other emerging alternatives in light of new legislation, particularly in Germany.

Pre-Arrangement Share Enforcements, Sales

Standard senior and mezzanine financing packages generally include a pledge of shares in borrower and guarantor subsidiaries. Although junior creditors' enforcement rights in most credit structures are subordinate to those of senior creditors, several opportunities for junior creditor leverage often exist. These include negotiation of junior-led enforcement in light of the tax risks associated with senior-led enforcement, junior credit bidding at sale to obtain control of a distressed company, and senior debt buyout or buyback.

In an enforcement scenario, senior creditors may be tempted to enforce nonconsensually against pledged shares, leaving junior creditors with minimal or no returns. One particularly convincing argument that juniors have on their side is that seniors may obtain damaged goods in an enforcement by virtue of the credit documentation. In many instances, senior-mezzanine intercreditor agreements may contain release mechanisms, which, upon senior enforcement of shares pledged by a guarantor in satisfaction of senior debt, will result in release of junior debt obligations held against the borrower.

This leads to cancellation of debt at the borrower level, triggering a potentially non-insubstantial tax liability for the borrower and saddling the senior's newly captured enterprise with a significant liability, especially for German borrowers.[3] The result is often unpalatable for seniors, which juniors can make abundantly clear in the context of intercreditor negotiations. While careful structuring can often circumvent an adverse tax impact, the authors have been involved with situations in which senior lenders have not been able to do so, even with company cooperation.

As an alternative, juniors may seek control over the corporate enterprise by proposing their own enforcement strategy. This could take the form of either piggybacking off a senior enforcement or, if the financing documentation contains standstill restrictions against junior enforcement (as it typically does), by negotiating a consensual enforcement sale. Juniors would credit bid their junior obligations in an auction of the shares and subsequently buy out senior debt. This arrangement would involve negotiating a senior waiver of waterfall distribution rights and financing a buyout of senior obligations.

However, in many jurisdictions, and in particular in Germany, these strategies pose considerable procedural risk and complexity. For example, as in a senior-led enforcement, tax considerations likely will play a role in a mezzanine-led enforcement as well. To ensure control of the entire corporate enterprise, juniors may need to enforce at the parent guarantor level. While the parent guarantor would then obtain a recourse claim against the borrower, it is highly unlikely the liability would ever be enforced, and thus, German tax authorities may view the transaction as creating cancellation of indebtedness income at the subsidiary borrower level.

Further, to the extent the enforcement occurs in Germany, juniors would need to comply with a complex set of legal procedural requirements or risk endangering their clean title to the purchased shares. Indeed, company shareholders may attempt to exploit procedural hurdles to maintain control, and an insolvency administrator in a subsequent bankruptcy of the parent guarantor may seek to avoid the enforcement sale as having disadvantaged creditors. Enforcement of a Luxembourg share pledge, as often is the case for enforcement of shares pledged by parent guarantors, would involve less procedural complexity but would not address the tax implications.

Finally, other complications may arise from the financing documentation itself. The security agent, for instance, may resist distributing in-kind proceeds (i.e., the shares) through the waterfall or may take issue with seniors' voluntary waiver of waterfall rights. Any enforcement strategy, therefore, would require considerable coordination of efforts.

In some intercreditor agreements, the security agent has the power not only to release obligations, but also to transfer obligations. This language is hugely preferable to the release-only language from a senior perspective, as it allows circumvention of the tax issues surrounding a release and a cancellation of indebtedness income. In lieu of a release enforcement, the intercreditor may allow transfering obligations from a borrower to a separate group entity in an attempt to avoid cancellation of indebtedness income. If the intercreditor agreement allows such a transfer, the position of the junior creditors becomes much weaker.

Junior creditors, therefore, are well-advised to carefully examine the terms of the security documentation and the intercreditor agreement. If the intercreditor agreement does not contemplate "transfer and/or release" by the security agent, making use of the strategy will require an amendment to the documentation with the necessary majorities (likely 100 percent), which may be difficult or impossible to achieve. Further, while cancellation of indebtedness income in the context of a rehabilitation (in Germany, so-called Sanierungsgewinn) once benefited from tax-neutral treatment, The European Commission currently is considering whether tax-neutral treatment of Sanierungsgewinn is a form of illegal state aid.[4]

A related strategy that was implemented in connection with a share pledge enforcement against the French Monier Group involved "warehousing" bank creditor claims that the banks otherwise would have released in a newly created Monier subsidiary. The credit documentation specifically allowed the transfer, which avoided the liabilities inherent in a release due to cancellation of indebtedness income and facilitated an efficient enforcement procedure. This has now been replicated in other restructurings.

COMI Shift

In recent years, companies in various European jurisdictions, faced with the unpalatable option of using domestic insolvency proceedings to effect financial restructurings, have availed themselves of English procedures through use of a COMI shift and administration sale. The argument made is that by establishing head office functions in England and advising creditors of the fact, the company's COMI, for purposes of Article 3(1) of the European Insolvency Regulations,[5] no longer rests in its country of incorporation, but in England.

In the *Eurofood IFSC Ltd.* case, the European Court of Justice provided some clarity on the COMI issue. It stated that Article 3's presumption that COMI exists where a company is registered can only be rebutted with "objective and ascertainable" factors showing that the company's COMI is in a different jurisdiction. However, the court went on to state that companies relying on the "registered office" rule must meet a certain threshold level of operations in the registered office jurisdiction.[6]

A few months after *Eurofood*, German construction company Hans Brochier GmbH & Co. KG sought to commence an English administration in the U.K. Subsequent to filing of competing insolvency proceedings by Brochier's creditors in Germany, the English High Court, which had previously entered a commencement order, revoked its order, noting that, other than a registered office, Brochier had little in the way of operations that would even rise to the level of an "establishment" for purposes of Article 3(3) of the European Insolvency Regulations.[7] Brochier was clearly an abuse of the COMI shift process, but the European Court of Justice has now expressly sanctioned a COMI shift of an Italian company to the U.K., which was done solely for the purpose of preparing a restructuring.[8] Therefore, junior creditors should be aware that COMI

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shifts may occur more frequently, and they need to be mindful of their position in an English proceeding, even if lending to a non-English company.

To the extent that it can successfully shift COMI to England, a debtor can avail itself of an administration proceeding, which allows, among other things, the prepackaged sale of assets, as with *Wind Hellas* and *European Directories*,[9] to a company voluntary arrangement, allowing debtors to restructure unsecured debt with a majority in number and 75 percent in amount but without a moratorium unless an administration order is obtained, as with *Schefenacker*.[10] In addition a COMI shift also bolsters the ability of a company to use a scheme, in which restructuring measures can be approved with an absolute majority in number and 75 percent in amount but without a moratorium, unless an administration order is obtained, as with *Rodenstock* and *La Seda De Barcelona*.[11]

COMI shifting is not always achievable and, if secondary proceedings cannot be prevented, could lead to substantial loss of value, to the detriment of junior creditors. Moreover, an English administrator and England-based management may pursue objectives inimical to juniors' desires or interests. This occurred in both *Wind Hellas* and *European Directories*, which used COMI shifts combined with English administration prepack sales, with the effect of disenfranchising junior lenders' interests.

Schemes of Arrangements

As a more light touch alternative to a full COMI shift, English schemes of arrangements are being used more frequently by companies seeking to restructure. A scheme of arrangement does not require a COMI shift; a sufficient connection to England will suffice. This is often

the case when credit agreements are governed by English law. In typical leveraged buyout (LBO) structures, credit agreements are invariably governed by English law. A scheme is a "quasi-consenual" restructuring tool that allows a company to propose a compromise over certain classes of debt. A scheme is approved if 75 percent of the creditors in each class present at the meeting vote in favor of it and the court subsequently sanctions it. The scheme of arrangement is a relatively flexible and efficient tool and is increasingly being used by non-English companies to restructure certain classes of debt.

The High Court's recent opinion in *In re Rodenstock* demonstrates how a scheme can be used.[12] There, German optical equipment manufacturer Rodenstock GmbH restructured its senior debt pursuant to a solvent English scheme of arrangement. The High Court relied extensively on Rodenstock's English law-governed senior credit documentation and the fact that more than 50 percent of Rodenstock's senior creditors were based in England to rule that the company had sufficient connection to England to establish jurisdiction of the English courts.[13]

Junior creditors are in a relatively comfortable position if a scheme is proposed because each class needs to approve with a 75 percent majority. To the extent it is planned to impair junior creditors. a scheme will only be sanctioned if a significant majority of the junior creditors vote in favor of it. However, junior creditors must be mindful if the scheme is combined with a share pledge enforcement or a COMI shift, as this can be used to disenfranchise junior creditors.

Other Emerging Restructuring Alternatives

Partially as a result of domestic companies taking recourse through so-called forum shopping opportunities and partly in response to the perceived efficacy of Anglo-American insolvency regimes, continental governments have begun to implement legislation to better facilitate corporate rehabilitation. For example, as the biggest economy in Europe, Germany has passed the most promising legislative reforms. In particular, the German Bundestag has passed two new laws — the German Bond Act 2010 [Schuldverschreibungsgesetz (SchVG)] and the Law to Facilitate Corporate Rehabilitation [Das Gesetz zur weiteren Erleichterung der Sanierung von Unternehmen (ESUG or InsO-E)].[14]

The Bond Act replaces its 100-year-old predecessor and applies to all German-law-governed bonds issued post-August 5, 2009, whether by German companies or otherwise, as well as bonds issued before that time if 75 percent of all bond creditors agree to make it applicable (subject to applicable credit documentation).[15] Pursuant to the Bond Act, restructuring measures such as maturity extensions, full or partial waivers, subordination, exchange of collateral, and debt-equity swaps can be undertaken with a 75 percent majority, with a quorum requirement of 50 percent.[16]

Alternatively, with a 75 percent majority, creditors can grant this authority to a joint representative.[17] These majorities are significantly less than the 100 percent majority required under the U.S. Trust Indenture Act or the 90 percent majorities generally necessary under U.S. law for high yield bond issuances.[18] The Bond Act already has been used in a number of proceedings to appoint common representatives.[19]

ESUG is a result of lengthy legislative proceedings regarding wholesale revisions to the current German Insolvency Code to implement a more rehabilitation-friendly regime. Primary changes to the law include greater facilitation of the use of debtor-in-possession (DIP) financing, which currently is used in only 1 percent of German corporate bankruptcies;[20] enabling of debt-equity swaps, which was prohibited under current law; and increased influence by creditors over the process, which in traditional administrator-led proceedings currently is nil. ESUG promises to fundamentally change the nature of German insolvency proceedings, which historically have been unfriendly to both creditors and debtors.

These significant changes to the German legal landscape present opportunities and risks for junior creditors to continental debtors. To the extent that corporate debtors make use of the Bond Act, burdens of restructuring may fall more heavily on bondholders, benefitting mezzanine creditors. Similarly, ESUG may preserve value for stakeholders, including junior creditors, by streamlining the insolvency process.

In many instances, value will fall at the junior level, leaving seniors a cash payout and juniors in control of the company. However, certain risks remain. The ESUG model is currently untested, and it remains to


Dr. Leo Plank (left) is a restructuring partner in the Munich, Germany, office of Kirkland & Ellis, and **Carl Pickerill** is a restructuring associate in the firm's Chicago and Munich offices. Plank focuses on financial restructuring and bankruptcy matters, concentrating on representing institutional high yield and distressed-debt investors and companies in cross-border and multinational restructurings.

be seen whether legislation can alter a restructuring culture heavily focused on administration with little input from stakeholders. In addition, ESUG will only increase the valuation fights currently engaged in by juniors and seniors and will do so in a public forum. Other risks include the potential for avoidance actions and subordination of claims.[21]

Complexity, Unpredictability

The absence of a unified European insolvency regime results in complexity and unpredictability for stakeholders, including junior creditors. Absent careful consideration of relevant restructuring solutions and active coordination of their members, juniors risk losing value to senior lenders and other constituencies. In contrast to the U.K. and U.S., in-court options may not be a palatable or feasible forum for resolving intercreditor disputes, although that may be changing in light of recent legislation.

Ultimately, junior creditors should ensure that they are intimately familiar with governing credit and security documentation and are sensitive to prior local restructuring precedent. J

[1] Wilkinson, *EUR. LAW*. 2007, 68, 13-14 (discussing absence of unified regime).

[2] See, e.g., Mallon, *INSOLV. INT*. 2011, 24(5), 80 (discussing English scheme of German-based Rodenstock GmbH).

[3] In some other jurisdiction cancellation of indebtedness income can be sheltered more effectively.

[4] Compare Judgment of European Commission (26 January 2011), C 7/2010 (S.A. 29150) (ruling void German provisions allowing companies to continue using tax loss carryforwards, notwithstanding a change of control, where change of control occurred in context of a rehabilitation).

[5] Council Regulation (EC) No. 1346/2000 (29 May 2000), OJ 2000 L 160/1.

[6] See Ringe, E.B.O.R. 2008, 9(4), 579-620 (discussing COMI-shifting generally and the effect of *Eurofoods*).

[7] HCJ, 8 December 2006, 6211/06 [2007] NZI 187 et seq. See also Ringe, supra (discussing same).

[8] *Interedil SrL (in Liquiation) v. Fallimento Interedil SRL* and another [2011] EUECJ C-396/09 (20 October 2011)

[9] See Insolvency Act 1986, Sch. B1; see also *In re Collins & Aikman Europe SA et al*. [2006] EWHC 1343 (Ch) (administration involving subsidiaries incorporated in 10 different European jurisdictions).

[10] See Insolvency Act 1986, Pt. I.

[11] Companies Act 2006 §§ 895-901.

[12] 6 May 2011, [2011] EWHC 1104 (Ch).

[13] See also Pannen, Europäische Insolvenzordnung, Art. 3 Nr. 39 (discussing main criteria for determininig company's nerve center or mind of management, including where administrative decisions are made, accounting occurs, where management is present, how much responsibility management has at the registered office, etc.).

Most recently, the European Court of Justice ruled in *Interedil Srl (i.l.) v. Fallimento Interedil Srl et al* [2011] EUECJ C-396/09 (20 Oct. 2011) that "greater importance" must be attached to a debtor's center of administration. Accordingly, to the extent a debtor can successfully move its "nerve center" or base of administration decision-making facilities, this may suffice to show COMI in the transferee jurisdiction.

[14] Final Report and Recommendation of Parliamentary Legal Committee (Rechtsauschuss), BT-Drucks. 17/7511 from 26 October 2011.

While the Bond Act became law on August 5, 2009, it is anticipated that ESUG will become effective on or around March 1 or April 1, 2012.

[15] See § 24, para. 2 SchVG.

[16] See § 5, para. 4, SchVG.

[17] See § 7 SchVG.

[18] See generally Lürken/Pickerill, *CORP. FIN*. L., 7/2011, 352.

[19] See MAGNUM AG (creditor meeting resolution 26 August 2010); Koch Gruppe Automobile AG (resolution 3 November 2010); Q-Cells International Finance B.V. (resolution 25 October 2011). At least one bondholder challenge has already arisen to use of the Bond Act to restructure debt. See Decision of Frankfurt Local Court 15 Nov., 2011 (voiding creditor resolution approving debt-equity swap of hybrid bonds because subordination provisions in the bonds were governed by Dutch, not German, law).

[20] Kranzusch ZInsO 2008, 1346, 1347 (noting that "debtor in possession" was granted in only 1 percent of all business bankruptcies between 1999 and 2007).

[21] See generally Bruder/Fritz/Meyr-Löwy/Pickerill/Plank, *AM. BANK. INST*. L.J. (forthcoming 2012).