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Client Alert Commentary

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# The DTEK Scheme: A New Way to Restructure US Law Bonds?

***Double First: A Ukrainian group of companies breaks ground — first by changing the governing law of its high yield bonds from US to English law and then by being the first Ukrainian-based group to restructure via an English law scheme of arrangement***

## The Debate: Chapter 11 vs Scheme of Arrangement

The restructuring market has for some time been engaged in a spirited debate about the appropriate forum in which to restructure US law governed high yield (HY) bonds issued by European and American corporates. Which is more appropriate, in the US by way of a Chapter 11 or London via the scheme of arrangement?

Given that NY law generally governs HY bonds, Chapter 11 is the typical knee-jerk response. However, a multitude of corporates worldwide have in recent years already turned to the scheme, for its flexibility, dependability, reduced stigma (it is a Companies Act, as opposed to an Insolvency Act process), low cost (in comparison to a full-blown Chapter 11) and for the English court's ever-increasing amenability to accept jurisdiction – see the use of schemes to restructure in cases such as *Gallery* (2010), *Magyar* (2013), *Zlomrex* (2013) and *New World Resources* (2014). These companies have accomplished this by shifting their 'centre of main interests' (COMI) to the UK as a way of establishing 'sufficient connection' required for English courts to accept jurisdiction for the purposes of a scheme.

The DTEK scheme goes one step further and may prove pivotal to the Chapter 11 vs Scheme debate, squarely in the latter's favour. In the DTEK case, the English Court recognised jurisdiction prima facie on the basis of DTEK's HY notes' governing law and jurisdiction clause, which had been purposively changed from New York to English law in order to get jurisdiction for a scheme. Moreover, the DTEK decision has potentially far wider ramifications than last year's *Apcoa*[1] case (as explained below).

## What Happened in the DTEK Scheme?

### Background

The DTEK group of companies (the Group), advised by Latham & Watkins,[2] is the largest privately owned energy business in Ukraine and comprises coal mining, power generation, electricity distribution and sales. DTEK is responsible for the supply of electrical power and heat to a significant proportion of domestic and industrial end users in Ukraine. The recent civil disturbance and political instability in Ukraine and its strained relations with Russia significantly and negatively impacted the Group's business and financial condition (including as a result of the severe devaluation of the Ukrainian hryvnia). Consequently, DTEK found itself facing the prospect of failing to redeem its outstanding US$200 million

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9.5 percent Senior Notes (the Notes) on their maturity date of 28 April 2015. Failure to redeem the Notes could have produced enormous knock-on effects across the Group's capital structure, or indeed, across the Ukrainian economy.

## A twin-tracked path

DTEK Finance BV (DTEK), the entity which issued the Notes, embarked on a twin-tracked exchange offer/consent solicitation (Exchange Offer and Consent Solicitation) with a fall-back of an English law scheme of arrangement (Scheme) process, aiming to cancel/release the Notes (and underlying guarantees) and issue new notes. The new notes were to be issued on substantially the same terms but with a maturity date of March 2018, at an exchange ratio of 80 percent of the par value of the Notes and a cash consideration of 20 percent of such par value. The company sought to exchange the Notes solely on the condition that it received valid tenders from at least 98 percent of the Noteholders, absent which it would seek to implement the deal via the Scheme. When it was clear the exchange offer threshold had not been met, DTEK considered the Scheme process was in the best interests of all creditors by ensuring a better return and would preserve the value of the business.

Consenting Noteholders were automatically deemed to have (a) approved the change in governing law from New York to English, and (b) to have voted in favour of the Scheme. This process proved an efficient and effective way to meet the scheme voting threshold; by the time of the Scheme creditors' meeting, well over 75 percent in value and 50 percent in number (of those present and voting) had been locked up to vote in favour of the Scheme. DTEK moved through the whole Scheme process in record time – a mere three and a half weeks as compared to the usual six to eight weeks (see timeline in the endnotes).[3]

## Change of governing law

A simple majority vote was required to change the governing law and jurisdiction of the Notes, as well as the Notes' indenture and some of the underlying guarantees, from New York to English law. As it turned out, 88.6 percent of Noteholders — well beyond the required threshold — had offered their consent by 9 April 2015, which allowed DTEK to enter into a supplemental indenture expressly subject to English law.

The change of governing law, as DTEK had carefully explained to Noteholders, was primarily aimed at establishing the English court's jurisdiction to hear the application for the Scheme. Using English law as the governing law of the debt documentation subject to the Scheme's proposals provided an unequivocal 'sufficient connection' to the English courts.

This is the first time an English court has ruled on a change of governing law as an effective and independent path to jurisdiction in respect of HY notes. Rose J (as per her judgment) was satisfied that the change of law *alone* had conferred on the court jurisdiction to approve the Scheme.

She additionally accepted jurisdiction on the basis of:

- The governing law of the Ukrainian Opco guarantees being governed by English law
- DTEK's effective COMI shift from the Netherlands to England
- The presence of assets in the UK by way of cash in a London bank account

### The challenge and the response

A hedge fund investing in distressed debt which claimed to hold a beneficial interest in a substantial proportion of the Notes initiated a challenge shortly before the Scheme convening hearing. The fund raised a number of areas it saw as contentious, mainly that the change of governing law required more than 90 percent consent because it would 'impair' and 'affect' rights of creditors to bring enforcement proceedings. In response, DTEK garnered expert evidence from former Judge James M. Peck[4] (a retired high-profile United States Bankruptcy Judge in the Southern District of New York, now practicing insolvency law with an international law firm in New York) in order to prove that only a bare majority vote was required.

DTEK, with the invaluable assistance and support of Judge Peck, accordingly countered that:

- A change of governing law would not 'impair or affect' a bondholder's right to receive payment or to bring (enforcement) proceedings and therefore did not require a 90 percent resolution. The plain language of the Indenture provided that a change of governing law could be modified based on consent of holders of a majority of the Notes; parties never intended to require 90 percent consent (reserved for so-called 'sacred rights') for such a change and if they had so wanted, they could have expressly provided for the higher threshold to apply to a change in governing law.

- Parties' freedom to contract is paramount and embedded in US and European law and public policy alike; therefore taking steps to establish the jurisdiction of a court to preserve the viability of a business should be permitted. As per Rose J: "*The indenture governing the 2015 Notes has always included provision for the possible change of governing law. This was, therefore, part of the bargain that the noteholders signed up to.*"

- Extensive precedents show that a US federal court or New York state court would: (a) extend comity to the judgement approving the Scheme; and (b) grant Chapter 15 recognition of the Scheme based on DTEK's COMI (or alternatively establishment) in England (to that end, Rose J helpfully confirmed that DTEK had successfully moved its COMI to England).

On the eve of the sanction hearing, further votes came in which took the approval number to over 90 percent and for that and other reasons the dissentient creditor withdrew its challenge, which led Rose J to comment: "*There is some debate about whether New York law requires a 50 per cent or 90 per cent approval before the change is binding on all noteholders but this does not matter since consent was given to the change by over 90 per cent of the noteholders*."

The challenger fund also raised a class composition issue on the basis that the 3 percent 'early bird fee' offered to all Noteholders had, according to the fund, induced Noteholders to tender their Notes (which they would not have done otherwise).

DTEK countered that the fee was immaterial to Noteholders' decision whether or not to participate and produced supporting evidence revealing discussions between DTEK's dealer manager and certain Noteholders which backed this up. Rose J was satisfied that the fee did not create two classes or go to the fairness of the Scheme.

## Significance and Implications

The wider implications of this judgment should not be underestimated. It may well enable both European and, crucially, US-based issuers of US law governed HY bonds to use the English scheme of arrangement as a way out of the typical HY Indenture unanimity/90 percent threshold conundrum and

instead restructure via a scheme, which only requires 75 percent of noteholders by value and a majority in number to consent. Crucially, both these tests only apply to those ‘present and voting’ at the creditors’ meeting.

Compared to a full-blown Chapter 11 process, the English scheme of arrangement is undoubtedly a cheaper and faster way out of distress. It is also not an insolvency process. US issuers may not be as concerned about the US-style litigation inherent in the Chapter 11 process, but they could certainly be swayed by the heftier costs involved and the generally lengthier period required for the debtor to exit its Chapter 11. That is not to say that Chapter 11 is not fit for purpose; it does have a number of features which are absent from the scheme of arrangement, such as an effective moratorium; a ‘cross-class’ cram-down; the rejection of executory contracts and the process enables access to debtor-in-possession financing.

## *Apcoa* is Limited in Practice; DTEK has Potentially Wider Ramifications

*Apcoa* was all about changing the governing law of bank debt documentation from German to English so as to facilitate a scheme of arrangement. The resulting ‘*Apcoa I’* judgment generated much media heat but not much light about its deeper implications.

In retrospect, *Apcoa II*’s precedent value will be of limited value where the governing law (and jurisdiction) change relates to post-2012 bank debt, as opposed to bond debt, as most English (and German) law governed loan documentation will be based on the revised leveraged finance standard published by the Loan Market Association (LMA) in September 2012, in which the LMA recommended a governing law change to be a matter for all-lender consent.

*Apcoa I* is only of potential use to deals with pre-2012 majority consent documentation and possibly to continental European borrowers (*e.g.* Spanish, French and Italian borrowers) with local law governed bank documents which veer away from the LMA standard and towards majority, as opposed to unanimous, consent regarding a change in governing law.

Moreover, many continental European bank deals (whether pre or post 2012) are constructed with English law already baked in as the governing law – that was the route into a scheme of arrangement for Spanish companies such as *La Seda de Barcelona* (2010), *Cortefiel* (2012, 2014) and *Orizonia* (2013).

There is a wave of HY maturities on the horizon – in Europe, $178 billion of maturities in 2018 and $183 billion in 2019 and in the US, $170 billion in 2018 and $224 billion in 2019[5] – and if that maturity wall translates into a tide of restructurings, then the DTEK gateway into a scheme may well become the blueprint, wherever the issuer is based – the EU, US or indeed globally.

## Conclusion

In conclusion, the DTEK Scheme has moved the Chapter 11 vs Scheme debate considerably, giving US governed HY issuers — European and US alike — much better access to a very powerful rescue tool; the English scheme. In validating the established principles in last year’s *Apcoa* case, but going the extra mile, the DTEK Scheme will undoubtedly serve as an incredibly useful precedent.

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**Endnotes**

[1] *Re Apcoa Parking (UK) Ltd and others*, [2014] EWHC 996 (Ch)

[2] Latham advised DTEK in this first ever scheme of arrangement for a Ukrainian company, much in the same way that we advised Gallery Media in their 2009 restructuring: the first ever scheme of arrangement for a Russian borrower.

[3] **CHRONOLOGY OF DTEK EXCHANGE AND SCHEME EVENTS**

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|---|---|
| ***Commencement of the Exchange Offer*** | 23 March 2015 |
| ***Launch of the Scheme*** | 2 April 2015 |
| ***Early Exchange Deadline*** | 5 pm (NY time) 13 April 2015 |
| ***Convening Hearing*** | 14 April 2015 |
| ***Final Form Explanatory Statement available*** | 15 April 2015 |
| ***Exchange Expiration Deadline*** | 5 pm (NY time) 22 April 2015 |
| ***Scheme Record Time and Deadline for submitting Form of Proxy*** | 5 pm (NY time) 22 April 2015 |
| ***Scheme Meeting*** | 23 April 2015 |
| ***Sanction Hearing*** | 27 April 2015 |
| ***Scheme Effective Time*** | 27 April 2015 |
| ***Scheme Settlement Date*** | 28 April 2015 |

[4] Judge Peck presided over the Lehman bankruptcy (amongst many other key cases); the biggest transatlantic insolvency in history.

[5] *Source: Bloomberg*