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GLOBAL INSIGHT

News, Views and Analysis from DLA Piper's Global Restructuring Group

THE VALIDITY OF EXIT CONSENTS UNDER ENGLISH LAW

Two recent cases have tested the legality of exit consents and the use of consent payments under English law: *Assenagon Asset Management S.A. v Irish Bank Resolution Corporation (formerly Anglo Irish Bank Corporation Ltd)* ("*Assenagon*") and *Azevedo and Another v Importacao Exportacao E Industria De Oleos Ltda and Others* ("*Azevedo*").

WHAT IS AN EXIT CONSENT?

An exit consent is a restructuring tool used by the issuer of bonds or loan notes to entice a group of holders to accept an offer of bonds or notes of a lesser value and/or subject to less advantageous terms.

A bondholder who fails to agree to accept new bonds in exchange takes the risk that, if the resolution is passed by the requisite threshold of other bondholders, his bonds will be either devalued or destroyed by the resolution, while he will receive no new bonds.

WHAT IS A CONSENT PAYMENT?

A consent payment is a payment of cash or other consideration offered to bondholders in exchange for their agreement to vote to amend the terms of their bonds in a way that will diminish their rights under them.

A bondholder who fails to agree to the proposal runs the risk that, if the resolution is passed by the requisite threshold of other bondholders, his bonds will be devalued by the resolution and he will not receive the payment given to those who voted in favour of the resolution.

ASSENAGON

Anglo Irish Bank, previously a leading Irish bank, was nationalised in September 2010, with the Irish finance minister, Brian Lenihan, announcing that subordinated debtholders would share in the bank's losses. Lenihan stated that this would initially be done through voluntary restructuring, but also by means of legislation if necessary.

Part of this subordinated debt consisted of bonds, which were due in 2017. Under the terms of the bonds, 75 per cent of the bondholders could *"assent to any modification of the provisions"*.

The bank's restructuring offer to the bondholders was to issue EUR 0.20 of new notes in exchange for every EUR 1 of existing notes, subject to the condition that the bondholders vote at a subsequent meeting in favour of a resolution allowing redemption of the existing notes for a sum equal to EUR 0.01 per EUR 1,000 of existing notes. A total of 92 per cent of the bondholders agreed to this exchange and voted accordingly. Assenagon Asset Management S.A. held EUR 17 million of bonds. They did not agree to the exchange. Subsequently, following the vote, its EUR 17 million of bonds were redeemed for EUR 170.

Assenagon claimed that the vote had been unlawful and set out three main arguments to support this claim:

1. The resolution was *ultra vires*, because the terms of the existing bonds did not confer the power to completely destroy the value of the existing bonds.
2. At the time of the vote, the bondholders who had agreed to the exchange already held their bonds beneficially for the issuer and therefore, under the terms of the existing bonds, their votes ought to have been disregarded.
3. The resolution was an abuse of power by the voting majority because it conferred no benefit on the bondholders as a class.

The High Court found in favour of Assenagon as follows:

1. The complete extinguishment of the bondholders' rights *was* within the powers conferred by the terms of the bonds, therefore, Assenagon failed on this argument.

> *"The manner in which any such an offer is structured and communicated should be considered more carefully in light of these cases."*

2. However, the votes of the bondholders who had agreed to the exchange should have been disregarded pursuant to the terms in the bonds dealing with conflicts of interest. This was based on the reasoning that those who voted in favour held the bonds beneficially for the issuer, having concluded their agreement to exchange them a day before the vote. (However, it should be noted that this is not reflective of market practice and was a particular feature of this exchange offer. Normally acceptance of the bond exchange is expressly conditional on the second resolution being passed).
3. In addition, it was held to be unlawful for the majority bondholders to aid the coercion by the issuer of the minority by voting for a resolution that would destroy the minority's economic rights under their bonds.

AZEVEDO

In 2006, the Imcopa Group of companies issued US$100 million of notes due in 2009. The group subsequently sought to restructure its indebtedness by postponing certain interest payments under them. Payments were offered to all of the noteholders, provided they voted in favour of a resolution postponing the payment of interest under the notes.

The notice of the meeting explained that a payment would be made to those voting in favour of the resolution but would not be made to other holders.

In the *Azevedo* case, two individual investors who held notes brought claims, seeking a declaration for repudiation and breach of contract, on two main grounds:

1. Firstly, it was argued that the consent payments were, in essence, a "bribe" and, therefore, the noteholders' resolution was invalid under English law.
2. Secondly, it was argued that a class of noteholders must be treated on a *pari passu* basis, so the differing treatment of consenting and non-consenting noteholders violated this requirement.

The Court of Appeal ruled against the claimants as follows:

1. The court held that the consent payments were not fraudulent or illegal as they:

- were openly disclosed to noteholders prior to the vote taking place;
- were payable on an equal basis to those voting in favour of the relevant resolution; and
- each noteholder was entitled to vote as it saw fit and, therefore, to participate in the consent payment if it so chose.

2. The consent payments constituted separate consideration paid by a "solicitation agent" to the noteholders in return for accepting the issuer's offer. Furthermore, these monies had not originally been held by the trustee for the noteholders, nor were they being paid pursuant to the terms of the loan note documentation. Therefore, these payments fell outside the contractual provisions requiring *pari passu* treatment of noteholders.

WHAT WOULD BE CONSIDERED COERCIVE?

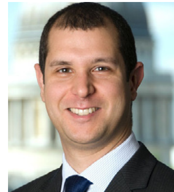
Assenagon has clearly raised concerns about the validity of exit consents under English law issuers will need to carefully consider any element in an exchange offer that could be considered "coercive".

In trying to determine what constitutes coercion, it is possible to draw a distinction between the two cases by characterising the exit consent in *Assenagon* as a "stick" and the consent payment in *Azevado* as a "carrot". The outcome for the dissenting minority bondholders in *Assenagon* was a total destruction of their stake and the High Court stressed that a relevant consideration could be whether a scheme is *"designed in substance to destroy rather than enhance value…"*. By contrast, in *Azevado*, the resolution only postponed certain interest payments and all noteholders still ended up with the same class of notes with the same rights, albeit that some received an incentive payment.

The carrot-and-stick metaphor is an oversimplification. It is important not to draw too definitive a conclusion as to what features distinguish unlawful coercion from lawful incentive. It also should not be assumed that consent payments are immune from being called coercive. Both these cases essentially featured a request to vote in favour of a resolution that would diminish the value of some notes. All noteholders had equal opportunity to weigh
the risk that, if they dissented but the resolution passed anyway, their overall financial loss would be greater than those who had agreed. It should also be noted that the *Azevado* claimants did not try to argue there was any coercive element or bad faith to the consent payment offer; therefore, this was not considered by the court.

In conclusion, what constitutes an acceptable level of coercion/incentive remains unclear, and it is unlikely these decisions will cause those engaged in debt restructuring to stop using the exit consent or the consent payment as possible tools when parties have contracted under English Law. Nevertheless, the manner in which any such an offer is structured and communicated should be considered more carefully in light of these cases.

It should also be noted that in decisions under US law, exit consents have survived judicial scrutiny in the face of a challenge by minority creditors on the basis of coercion.Those seeking to raise finance via bond issues in future may wish to consider whether to request the application of US law and the jurisdiction of the US courts.



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WHEN A CHARITY FACES FINANCIAL DIFFICULTY

According to recent figures released by the UK Charity Commission, 52 per cent of UK charities have been adversely affected by the recession.

This statistic is hardly surprising: many charities rely on donations from individuals and businesses as their main income and, in a recession, some consider charitable donations to be a luxury - one they can ill-afford. As the recession has dragged down the value of property and shares, the financial worth of legacy donations (gifts made in wills) has also fallen.

In addition, Her Majesty's Revenue & Customs (HMRC) and the Charity Commission have begun challenging the charitable status of entities that do not appear to provide sufficient public benefit - also impacting many UK charities. These challenges have become particularly prevalent in the fee-paying independent school sector, where test cases have recently been brought requiring independent schools to prove that they provide public benefit or face losing their charitable status, and hence the associated valuable tax breaks. Some charities are having to modify their activities (sometimes at significant cost) to ensure they are providing sufficient public benefit.

FACTORS TO CONSIDER

The impact of the abovementioned factors is that the insolvency profession is now seeing an increase in the number of cases involving charities.

The insolvency rules relating to charities are lengthy and complex, so this article aims to highlight the particular requirements that apply in circumstances where charities borrow money and grant security in respect of such borrowing. Establishing whether these requirements have been complied with should be the first step for any insolvency professional or lender dealing with a charity in financial difficulty.

"When dealing with a charity in financial difficulty it is important to first establish that the underlying loans provided to, and security provided by, the charity are valid."

In respect of transactions entered into before 14 March 2012, the provisions of the Charities Act 1993 (as amended) must be complied with; for transactions entered into after this date, the Charities Act 2011 sets down the applicable requirements.

CAPACITY TO BORROW AND GRANT SECURITY

Many charities have restrictions in their constitution around borrowing and granting security. Therefore, the charity's constitutional documents (which may take the form of a deed of trust for an unincorporated trust, or memorandum and articles of association for an incorporated charity) should be carefully reviewed.

Due to the nature of charities, it is arguable that unless the constitution of a charity specifically permits borrowing and granting security, that activity is prohibited under its constitution. Therefore, the cautious view is to require the constitution of the charity to be amended if necessary before entering into a loan agreement with a charity.

INDEPENDENT ADVICE ON GRANTING SECURITY

Pursuant to Section 38 of the Charities Act 1993 or Section 124 of the Charities Act 2011, a charity is not permitted to grant a mortgage (which includes a legal charge and a debenture) without considering independent, written advice on:

- whether the loan to be secured is necessary in order for the trustees to pursue the course of action they propose;
- whether the terms of the loan are reasonable; and
- whether the charity is able to repay the loan.

Such advice is required at the time security is granted initially, and if such security is stated to be 'all monies', each time further monies are advanced.

Evidence of such advice (which may take the form of a confirmatory statement in the loan/ security documentation)

should be kept, as failure to follow such procedure may result in the security being invalid.

Due to the potentially fatal consequences that lack of compliance with Section 38 or Section 124 can have on security, it is advisable to enter into new security, rather than rely on pre-existing 'all monies' security each time new facilities or further advances under an existing facility are provided to a charity.

EXECUTION OF DOCUMENTS BY A CHARITY

Under Section 82 of the Charities Act 1993 or Section 333 of the Charities Act 2011, a charity, acting by all its trustees, may grant authority to a minimum of two trustees. This comprises a general or limited authority to sign deeds and other documents, including loan and security documents, to which the charity is a party.

When checking the correct authority, care should be taken to establish who the trustees were at the time. This may be difficult if the number of trustees is large or if the trustees frequently change.

As with Sections 38 and 124, evidence of independent legal advice (which may take the form of a confirmatory statement in the document) should be kept: failure to follow such procedure may result in the facility or security in question being invalid.

ENFORCING SECURITY AGAINST A CHARITY

Provided the security documentation contains the relevant triggers, the general rule that a lender may enforce its security if the principal amount secured is not paid when due applies equally to charities. In addition, an administrator or receiver may be appointed in respect of a charity.

While the general rules of security enforcement apply to charities, when assets come to be sold delays may be encountered due to the fact that many purchasers may be wary about buying charity assets from an administrator or receiver. Real estate owned by charities and registered at the Land Registry will have restrictions placed on the title preventing sale unless certain conditions are met (for example, consent from the Charities Commission or all the trustees): while this can be overreached by a receiver, purchasers and the Land Registry may not be familiar with this and any sale process may be delayed. Therefore, written confirmation that the land can be sold free of the Charities Act restrictions should be sought from the Land Registry before any sale process is commenced.

CONCLUSION

When dealing with a charity in financial difficulty it is important to first establish that the underlying loans provided to, and security provided by, the charity are valid.

Given the number of rules imposed by the relevant Charities Act in relation to how a charity may enter into loan documentation and grant security, our experience has been that there are very often defects in relation to the loan and/or security. While failure to follow the requirements can have fatal consequences for the validity of loans and security, identifying such defects at an early stage is essential to enable a lender to take steps to improve its position.

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ARE YOU AT RISK FROM FINANCIAL DISTRESS IN YOUR SUPPLY CHAIN?

The number of insolvencies in the UK is falling and there is a general sense that the manufacturing sector is now quite resilient. It can, therefore, be tempting to dismiss or simply forget about the significant risks manufacturers face from financial distress within the supply chain.

We need only look back to 2011, where a natural, rather than financial, disaster in Japan resulted in global manufacturers, dependant on steady supplies of specialist components, facing significant delays not just to future projects but to day-to-day production. The Japanese earthquake and tsunami caused a significant break in the supply chain, and while some manufacturers had arrangements for alternative supplies, many others did not. For them, the impact was catastrophic.

Thankfully, such events are rare. A much more prevalent cause of supply chain disruption is that of financial distress or insolvency among companies within the chain. In the modern world, our globalised economy sees companies focusing on reducing costs and trimming the fat on their supply chains, leaving little room for spare capacity in supplier strategies. Add in cross-border relationships and logistical frailties, and one creates greater likelihood of complications within the supply chain and a higher chance that complications may be more difficult to predict and potentially impossible to manage.

Some might say that the decline in the rate of corporate failures both within and beyond the UK is evidence that this risk of distress is overstated. However, if we examine the underlying reasons behind the figures, little comfort can be taken from this idea. The fall in the number of insolvencies in the UK can be partly attributed to extremely low interest rates. A quick Internet search of the term "zombie companies" throws up a definition applicable to the large numbers of businesses who remain in existence purely because of their ability to cover interest repayments, which are currently at historically low rates. These businesses, many of whom are in the traditional manufacturing sectors, are all vulnerable to solvency pressures when rates eventually increase. Furthermore, the difficulties encountered by the UK banks since 2008 have helped disguise some of the stresses affecting UK businesses. Politically, as a result of the state ownership of a number of the banks, and structurally, as a result of financial controversies concerning alleged LIBOR (the London Interbank Offered Rate) rigging and financial product mis-selling, the ability or appetite within the banks to enforce their rights against struggling companies, particularly by seeking repayment, has been significantly diminished.

"Manufacturers should take advantage of the current climate to address all potential risks in the supply chain."

Assuming there are significant numbers of such companies within the manufacturing sector and supply chains, are businesses prepared for the risks posed by their suppliers' potential insolvency? It may seem implausible to suggest that a significant change to market conditions will result in the mass financial distress of these companies, yet there is no certainty that today's unusual circumstances will continue to shield many businesses from the worst effects of the economic downturn.

While this climate remains, manufacturers should take advantage of the circumstances to address all potential risks in the supply chain. This may include sourcing alternative suppliers, achieving greater levels of reporting within the chain or adopting a more risk-based approach to procurement. Not doing so would leave companies highly vulnerable to the inevitable damage that failure within the supply chain will cause.

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BELGIAN DRAFT BILL SEEKS A WORKAROUND FOR ITS LAW ON THE CONTINUITY OF ENTERPRISES

Three years after the introduction of the Belgian Law on the Continuity of Enterprises (LCE), the Belgian Government took stock of the law's practical results. Alarmingly, one of the major findings was that a large majority of companies resorting to the LCE when in financial distress, ultimately enter into bankruptcy or liquidation.

The Belgian Government believes it is too soon to do away with the LCE, partly due to the current uncertain economic climate. Nevertheless, Parliament is considering a draft bill that would make some important changes to the LCE, which we have outlined below.

THE LCE – A SHORT OVERVIEW

Introduced on 31 January 2009, to remedy the lack of success found by the former law, the LCE offers various tools to companies in financial distress to help them to avoid bankruptcy. The LCE introduced a new formal restructuring procedure, providing legal protection from creditors ("*gerechtelijke reorganisatie*" or "*reorganization judiciaire*"), as well as informal measures that distressed businesses can apply as a means to safeguarding the continuity of their business activities (such as requesting a court-appointed 'mediator' to act as a truly independent third party in the drafting of agreements between debtors and creditors). In this article, we intend to focus on the provisions set out under the formal restructuring procedure.

FORMAL RESTRUCTURING UNDER THE LCE

In Belgium, a formal restructuring procedure can be initiated from 'the moment the continuity of the debtor/company is threatened either immediately or in the long term'. The threshold provided for a company to resort to the tools of the LCE and the formal restructuring procedure, in particular, is intentionally very low: Article 23 of the LCE explicitly states that the state of bankruptcy of the debtor/company does not rule out initiating a judicial restructuring procedure.

Access to the tools provided by the LCE may only be obtained through the filing of a written request with the competent court. Only the debtor (company) can initiate a formal restructuring procedure. The fact that the debtor stays in control of the procedure and its business was one of the most important innovations of the LCE.

The legislation provides for three different formal restructuring procedures:

1. The debtor may negotiate an agreement with at least two of its individual creditors, which can then be ratified by the court.
2. Through a court-based procedure set out by the LCE, the debtor may present a restructuring plan to all its creditors. The debtor is protected from creditors while it is preparing this plan.
3. The LCE provides a further court-based procedure that aims to ensure the continuity of the business, or part of it, rather than safeguarding the legal entity itself. This procedure of a transfer under the court's supervision involves the appointment of a court representative, who is tasked with organising the sale of the company's assets in order to ensure the continued operation of the business.

PROPOSED CHANGES TO THE LCE: THE DRAFT BILL

The law was initially voted upon in Parliament on 2 May 2013 and was then sent to the Senate for discussion. It is likely that the draft bill will become law before the summer recess of the Belgian Parliament. The most important changes proposed by the draft bill, as amended by the Chamber, include greater

"The draft bill aims to enhance the role played by the company's external accountant or statutory auditor at the outset."

regulation over the filing of requests, the provision of better information to creditors, the development over time of an electronic file for each case, greater involvement of financial experts from the start of each procedure and adapted rules with regards to the procedure for transferring some or all employees under the supervision of the court.

1. Filing a request: new requirements

In order to avoid system abuses, the draft bill proposes the introduction of a EUR 1,000 tax (currently EUR 60), which would be payable when filing a request. Additionally, the request would be automatically dismissed unless all mandatory annexes are submitted simultaneously with the request (currently, some annexes can be submitted up to two weeks after the initial filing). If the debtor does not comply with these requirements, they will no longer be able to use the tools provided by the LCE.

2. The 'fortified' role of the company's accountants

The draft bill aims to enhance the role played by the company's external accountant or statutory auditor at the outset. This would be done through a number of measures, such as new reporting obligations to their client (and even to the court if their client does not take the necessary measures) 'in case the continuity of the business of their client is threatened'. Under the proposed changes, these professionals will be obligated to file new supporting documents about the debtor's financial viability.

Furthermore, the draft bill aims to change some requirements applied to the following documents, which are part of the mandatory annexes that must be filed with the introductory request, in order to strengthen the role played by accountancy experts:

- The annex relating to the accounting situation reflecting the assets and liabilities and income statement of the debtor, dated no older than three months, must be prepared 'under the supervision of an external accountant, an external tax accountant or an auditor.'
- The annex relating to the budget containing an estimate of revenue and expenditure for the duration of the period during which the debtor will enjoy protection from its creditors must be 'prepared with the assistance of an external accountant or an auditor.'

3. Improving the transfer of information to creditors

The draft bill seeks to expand the court's ability to impose an additional information obligation upon the debtor. For instance, the debtor may be required to file an updated list of creditors with the court; the court may allow the debtor to communicate electronically with its creditors.

> *"This fact that the debtor stays in control of the procedure and its business was one of the most important innovations of the LCE."*

Most importantly, the draft bill proposes adding the 'fact that the information provided by the debtor is clearly incomplete or incorrect' as grounds for termination of the formal restructuring procedure by the court.

Currently, the procedure may only be terminated if 'the recovery of the continuity of the business or a part of the business of the debtor has clearly become impossible'.

4. Position of the employees in the case of a transfer under supervision of the court

The draft bill proposes adapting the legal framework of the formal restructuring procedure to the 'collective labor agreement' (CAO or CCT) number 102, which specifically intends to regulate the transfer of some or all of the employees,

in the event of a transfer under supervision of the court. The employer organisations and the trade unions namely concluded this collective agreement at the end of 2011, long after the LCE became effective. The draft bill proposes modifying the law so that it provides a general framework and that for more detailed regulation it refers to the applicable collective agreement.

While these changes will most probably help to prevent abuses of the LCE, we believe that they could actually deter distressed debtors from using the tools set out in the LCE. The 'fortified' role of accountants and the higher tax payable when filing a request, for example, will inevitably increase the associated costs of LCE procedures. In summary, it appears that the legislator has veered away from its initial aim, namely keeping the threshold for debtors as low as possible when embarking on such a procedure.

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SELLING *REVLON*: THE INTERSECTION OF *REVLON* DUTIES AND 363 SALES IN BANKRUPTCY

In 1986, the Delaware Supreme Court created the *Revlon* doctrine when it affirmed a lower court decision to enjoin transactions between Revlon, Inc. and Forstmann Little & Co. designed to avoid a hostile takeover of Revlon (*Revlon, Inc. v. MacAndrews & Forbes Holding, Inc.*). The *Revlon* decision determined that, under the duty of care owed by corporate directors, once a board determines its company is for sale, it must 'maximize… the company's value at a sale for the stockholders' benefit,' adding that the directors' 'role change[s] from defenders of the corporate bastion to auctioneers charged with getting the best price for the stockholders at a sale of the company.' The court further noted that directors breached their duty of loyalty when they entered into the "auction-ending" contract with Forstmann Little.

In his article on the *Revlon* doctrine and the competing corporate law principles of authority and accountability underlying the gatekeeping function of the board of directors during an acquisition (Fordham Law Review), Professor Stephen Bainbridge of UCLA argues that once a target board of directors enters "Revlon-land", its sole *Revlon* duty is to obtain the best deal for the shareholders.

Professor Bainbridge says that a target board enters Revlon-land through one of three checkpoints: (1) when a corporation initiates an active bidding process seeking to sell itself or to effect a reorganization involving the break-up of the company; (2) when the target board abandons its long-term strategy and seeks the break-up of the company in response to a bidder's offer; and (3) when approval of a transaction results in a sale or change of control.

His observations on the fiduciary duties owed by a target board upon entering Revlon-land may be instructive on the fiduciary duties owed by a board of directors during the sale of a company in bankruptcy pursuant to section 363 of the Bankruptcy Code.

REVLON CONSIDERATIONS TO BE MADE DURING BANKRUPTCY

While Professor Bainbridge does not specifically discuss the role of the board of directors during bankruptcy, his analysis of

> *"The Revlon decision determined that once a board determines its company is for sale, it must 'maximize… the company's value at a sale for the stockholders' benefit."*

the way courts view certain corporate decision-making processes may be applied to an in-court process as well.

In bankruptcy, issues regarding *Revlon* type fiduciary duties arise in the context of a sale of assets pursuant to Section 363 of the Bankruptcy Code, the process related thereto and negotiation of terms such as break-up fees (a fee paid to a prospective purchaser if the seller terminates the proposed transaction), no-shop clauses (clauses that preclude the active shopping of the business by the seller once an agreement in principle is reached between a prospective purchaser and a seller) and window shop provisions (provisions that allow limited active solicitation for a superior deal once an agreement in principle is reached between a prospective purchaser and a seller, but that may provide such prospective purchaser notice and an opportunity to match or top any new proposal). In bankruptcy, courts generally agree that officers and directors continue to owe fiduciary duties after the petition date. The fiduciary duties that officers and directors of a bankrupt entity owe are essentially the same as those owed by officers and directors of an entity that is not in bankruptcy (i.e., the duty of loyalty, the duty of care and the duty of good faith). In fact, bankruptcy courts have held that state corporate governance principles continue to apply in bankruptcy.

Thus, the intent of Revlon - to maximize the company's value for the benefit of the shareholders - continues in bankruptcy, because a debtor is required to demonstrate that it is obtaining the highest or otherwise best price for the assets that are to

be sold. Bankruptcy courts have held that in order to receive approval of a proposed sale of assets, the debtor will need to demonstrate to the bankruptcy court that the preferred purchase price is the highest and best offer. Further, in the bankruptcy court sales process, incentives are often needed 'to encourage the making of bids,' especially a "stalking horse" offer (an initial bid on the assets of a bankrupt company that will be used as the starting price to be paid for such assets), which may then be '"shopped around" to attract higher offers.' Accordingly, bankruptcy courts applying the Revlon doctrine will do so to protect the debtor's creditors and shareholders by ensuring that actions taken by a debtor will maximize the value received in exchange for the debtor's assets. For example, in evaluating break-up fees, bankruptcy courts generally examine whether the fee is marked by self-dealing or manipulation; whether the fee hampers, rather than encourages, bidding; and whether the fee is reasonable in relation to the proposed purchase price.

As a result, when negotiating stalking horse purchase agreements, it is important to consider the impact of bankruptcy law as well as state corporate governance principles on both the provisions negotiated in the sale process and the actions the board of directors takes with respect to that process.

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THE CHAPTER 11 PROCESS IS A NEGOTIATION: IF YOU WANT TO BE HEARD, SPEAK UP

Earlier this year, the United States Bankruptcy Court for the District of Delaware rendered a decision in *In re Indianapolis Downs, L.L.C.* that should give comfort to all major stakeholders regarding the fundamental principles underlying the chapter 11 process. The Court's rulings regarding postpetition plan support agreements and third-party release provisions provide much clarity to these often hotly debated issues. At the time of the filing of their bankruptcy petitioners, the debtors were indebted not only to a first lien lender, but also to second and third lien lenders. After months of negotiations and litigation, the debtors, an ad hoc committee representing the second lien lenders and Fortress Investment Group, LLC, which held a substantial portion of the third lien debt, reached an agreement (the RSA) regarding a process for the debtors' plan to reorganize themselves. The agreement was thereafter executed by the parties and filed with the Court. Among the agreed terms was the requirement that the debtors file a plan that included financial terms and treatment of certain creditors as specified in the RSA within a specified period of time. Furthermore, the RSA required that the parties to the agreement vote "yes" for a plan that complied with the RSA's terms and prohibited the parties from voting for or supporting any competing plan.

On the same day that the RSA was filed with the Court, the debtors filed an RSA-compliant chapter 11 plan and accompanying disclosure statement. The disclosure statement contained a lengthy discussion of the RSA and was ultimately approved by the Court. The Court thereafter held a hearing regarding (i) confirmation of the debtors' plan and (ii) the request of certain senior management and equity holders (the plan objectors) that the votes of the parties to the RSA in favor of the plan not be counted. The plan objectors claimed the RSA constituted a wrongful postpetition solicitation of votes on a plan and that, as a remedy, the votes of the parties to the RSA should not be counted.

In denying the request of the plan objectors, the Court stated that Congress intended for creditors to negotiate and, in fact, "the filing of a chapter 11 petition is an invitation to negotiate." The Court further stated that the provisions of the Bankruptcy

> *"The Court's decisions in* Indianapolis Downs *make it clear that the chapter 11 process is just that: a process."*

Code that prohibit solicitation of votes unless the creditor has received a court-approved disclosure statement were intended to stop practices of soliciting votes at a time when creditors were not informed enough to be able to act in their own interests. The Court held that the parties to the RSA were all sophisticated and were all represented by experienced professionals throughout the pendency of the debtors' bankruptcy cases. Accordingly, the Court held that it would be elevating form over substance to argue that the parties to the RSA should have their votes not counted because they did not receive a court-approved disclosure statement before entering the RSA.

In addition to denying the request of the plan objectors, the Court also overruled the objection of the United States Trustee (the UST) to the third-party releases in the plan. The UST had contended that third-party releases are not enforceable in the absence of the affirmative consent of the third parties and that the debtors had not obtained such consent for the releases set forth in the plan.

In fact, the Court held that there is no requirement that third parties must affirmatively consent to releases. The Court held that (i) creditors who were deemed to accept a plan because they were being paid in full had been adequately compensated for the release being given and (ii) creditors who failed to vote or failed to opt out of the releases per the instructions had been adequately informed of how to opt out and had failed to do so. Thus, the Court held that the parties were deemed to have consented to the releases.

The Court's decisions in *Indianapolis Downs* make it clear that the chapter 11 process is just that: a process. It is designed to give parties every opportunity to reach a consensual agreement on restoring an ailing company to profitability. Accordingly, the Bankruptcy Code and related rules should not be read in a way that would discourage the negotiation process. As long as parties are informed and know how to protect their interests, it is up to the parties to exercise those rights as they see fit. Overly technical readings of the Bankruptcy Code and case law will not be allowed to interfere with the ability of parties to negotiate among themselves.

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ASSERTING OFFSHORE INTERESTS IN MAINLAND CHINA: AN ACTION CHECKLIST

Foreign investors and lenders with stakes in Chinese companies will be keeping a close eye on the ongoing bankruptcy proceedings of solar panel giant Suntech Power Holdings Co., Ltd. ("Suntech"). Historically supported by generous government subsidies, China's growth in the solar power sector has outpaced demand. Over the past four years, however, the severe downturn in global solar panel sales has been felt throughout China's solar industry, with some Chinese solar companies kept afloat only by virtue of local government intervention.

Suntech's core subsidiary in China, Wuxi Suntech, now faces bankruptcy after eight Chinese banks filed an involuntary petition which was approved by a local PRC court in March this year. Currently, Suntech owes around US$541 million to offshore holders of convertible bonds together with some RMB7 billion (US$1.14 billion) to onshore creditors.

In this article, we explain the key drivers influencing this case, the relevant PRC bankruptcy law provisions, the onshore and offshore structural challenges and the role of the PRC government. We also provide an action checklist that may be useful for foreign investors and lenders with distressed interests in the PRC.

I. PRC ENTERPRISE BANKRUPTCY LAW

Submitting an Application for Approval

Effective since 1 June 2007, certain provisions of the PRC Enterprise Bankruptcy Law ("PRC Bankruptcy Law") are similar to the US Bankruptcy Code. Bankruptcy proceedings begin after an application has been approved by the PRC court. The court will then appoint an administrator to take over the debtor's business, which may include law firms, accounting firms and/or asset management companies. Creditors' interests are then safeguarded through a committee of creditors, which holds meetings and supervises the administrator.

In a reorganisation application, the debtor must submit a detailed reorganisation plan to the court and the creditors' committee for approval within six months of its application for reorganisation. This plan, unlike US plans, is not made publicly available to creditors. The plan is then voted upon by the creditors' committee; approval requires at least a majority vote of the creditors in each class, with those creditors representing at least two-thirds of the value of the liabilities therein. If the reorganisation plan fails to receive the requisite approval at this stage, the debtor will face liquidation.

Asserting Your Interests

As in the US Bankruptcy Code, a moratorium applies during the reorganisation process.

Under Chinese law, creditors are reimbursed only after the payment of (1) administrative bankruptcy fees; (2) employees' salaries and social insurance premiums; and (3) government taxes. This is similar to the US Bankruptcy Code except that PRC law requires employees' salaries and social insurance premiums to be paid before creditors and taxes. After these are paid, secured creditors who have registered their claims in accordance with Chinese law are paid next. Failure to register secured debts on time will impact the priority ranking, notwithstanding the secured status.

Enforcing Offshore Judgments

Article 5 of the PRC Bankruptcy Law dictates how Chinese courts deal with both inbound and outbound bankruptcy proceedings. Foreign judgments may only be recognised in PRC courts on the basis of reciprocity, international treaties and bilateral agreements to which China is a party. However, this is further subject to the caveat that such judgments do not go against, among others, PRC 'sovereignty, safety or social interests of the state'. How successfully this "sovereignty" or "public interest" provision can be invoked therefore remains to be seen, although a court in a case such as *Suntech* may look at the wider community impact of a bankruptcy and consider the number of jobs the employer provides, rather than focusing solely on economic interests.

In practice, the enforcement of the PRC Bankruptcy Law is often complicated by a range of factors. Local governments also play an important role in determining the outcome.

II. STRUCTURAL ISSUES

As a consequence of the lending restrictions on foreign investors, investments are generally structured by lending to an offshore holding company from which the target's Chinese subsidiaries then borrow. The subordinated nature of lending in this way presents the main challenge to Suntech's offshore bondholders as they are not a party to the onshore reorganisation proceedings of Wuxi Suntech.

III. ROLE OF THE GOVERNMENT

Bankruptcy proceedings of Chinese government-backed entities is inherently a politicised process. The success of a reorganisation will usually (if not always) hinge on local government support. The Chinese government will pay attention to: (a) maintaining community stability and minimising any impact of a large bankruptcy/reorganisation case; and (b) protecting the interests of any state-owned assets.

Although the approval of Wuxi Suntech's bankruptcy raised hopes that this would herald an era of reduced government interference, it has become evident that this is not likely to be an independent process. The appointment of Zhou Weiping, the previous executive at SOE Guolian Development Co., Ltd., to the board of directors as well as the appointment of several local government representatives onto Wuxi Suntech's administrative committee, makes it clear that the Government intends to control exactly how the bankruptcy unfolds.

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IV. POTENTIAL STRATEGIES

Any investor and/or lender looking to invest in China should first assess whether it is possible to invest directly in the onshore entity or, at the very least, secure onshore assets, pledges or other mechanisms through which it can gain a direct course of action against a potential PRC debtor. In instances where this is not feasible and there are indications that bankruptcy proceedings are imminent, we set out below some recommended strategies for investors/bondholders:

Take control early. This means getting on the ground in China and starting conversations with management, shareholders and local government as soon as possible:

- Be proactive and try to negotiate a pre-packaged restructuring plan. If consensus is achieved between the requisite majority of creditors, a pre-packaged plan may be approved by the court.
- Seek engagement with the local government, which may well want to keep the company afloat and are prepared to support a restructuring when there is a viable plan or supportable interests are at stake.

Bring litigation onshore and find pressure points. If the company and other key stakeholders will not engage, identify the majority shareholders and other onshore creditors and apply as much pressure as you can:

- Conduct research on these entities and individuals to determine whether you can apply pressure onshore through countersuits of subsidiaries, contractual relationships or other possible legal strategies.
- Determine whether you are able to bring any form of litigation onshore that is related to the case or any of the entities or individuals with onshore creditor claims and attempt to freeze any of their shares, assets or interests as an indirect means of ensuring your interests are recognised in the reorganisation process.
- Litigation is not the endgame but often a necessary means to drive a recovery.

Settle. Offshore creditors often prefer to settle the case outside of a PRC court rather than await the outcome of onshore bankruptcy/reorganisation proceedings. You should look to develop a strategy, employing the methods discussed in this article, as a means to achieving a settlement.

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