Distressed Debt Investing and Loan to Own Strategies

Should a Cayman Islands Scheme of Arrangement be your next play?

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Overview: Identifying the Most Viable Restructuring Jurisdiction

Where debtors and creditors need to have recourse to, or a contingency plan for, a court process to implement a debt restructuring (including a debt for equity swap), the first step is to identify the most viable jurisdiction to implement the restructuring. This jurisdiction needs to provide a legal process that is efficient, cost-effective and sufficiently robust to deal with any minority dissenters who may seek to derail the restructuring. The earlier consideration is given to the most viable jurisdiction and the more pre-planning that is carried out before filing, the better the results are likely to be for the distressed debt investor.

In many cases, a US Chapter 11 will be the natural or possibly only choice (particularly if consideration of strategic options has been left until late in the day and a Chapter 11 filing is needed to obtain the worldwide automatic stay). However, as demonstrated by their use in England over the last ten years, schemes of arrangement – which are available in the Cayman Islands – can also be a powerful company restructuring and rescue tool. Cayman Islands schemes are available to both domestic and foreign companies and for non-Cayman Islands law-governed debt. In the right circumstances, they can deliver real value to debtors and investors seeking to implement a restructuring.

This is demonstrated by the successful and highly publicised 2017 Ocean Rig restructuring, where it has been widely recognised that the costs of implementing the restructuring through Cayman Islands schemes was a fraction of the likely costs if the restructuring had, instead, been implemented through Chapter 11. A more cost-efficient restructuring returns greater value to creditors and debtor alike.

The Ocean Rig restructuring involved the compromise of US$3.69 billion of New-York-law-governed debt through four interlinked Cayman Islands' schemes of arrangement – essentially the debt was swapped for equity in the Ocean Rig parent. The four schemes concerned the Cayman Islands' registered parent and three of its Marshall Islands incorporated subsidiaries. The debt was New-York-law-governed and the schemes were recognised and given full force and effect through Chapter 15 proceedings in the US.

The restructuring was heavily (and unsuccessfully) contested by a minority creditor and issues such as class composition, consent fees, cross-holdings, commercial and legal fairness all came under intense scrutiny. The Cayman Islands court applied established English case law, providing a high level of certainty as to the legal outcome of future challenges.

Unlike a Chapter 11, a scheme does not come with an automatic stay. However, in the Cayman Islands there is a well-established precedent of using a light-touch 'restructuring provisional liquidation' as a way to obtain a moratorium on legal proceedings in order to give the debtor and its creditors breathing space to negotiate a restructuring. Although the Cayman Islands moratorium itself does not prevent the enforcement of security, where the company's centre of main interests ("CoMI") is in the Cayman Islands on the appointment of restructuring provisional liquidators, a temporary restraining order can be obtained in the US pending Chapter 15 relief to: (i) protect secured assets and (ii) prevent legal proceedings and competing restructuring proceedings being commenced in the US (both common threats of the hold out ransom creditor). A restructuring provisional liquidation wrapper was used in Ocean Rig for these and other reasons.

A restructuring centre needs more than an established and certain legal process. Trusted legal and court systems and professionals who embody a rescue culture are also required. The Cayman Islands ticks these boxes.

(a) The legal system is an English common law system – a system that is one of the most established and respected in the world.
(b) The courts are experienced in handling large cross-border multinational financial disputes. Owing to the nature of the Cayman Islands as a jurisdiction, the vast majority of business that flows through the Islands is of a cross-border nature. Furthermore, the judiciary contains a number of highly respected former English practitioners who have experience of cross-border restructurings in both the English and US markets.
(c) The professionals are largely made up of experienced ex-City solicitors, barristers and insolvency practitioners who will have handled many large and complex restructurings. The professionals' default setting is not to liquidate but to rescue.

The Cayman Islands therefore has the essential elements for a successful restructuring jurisdiction as demonstrated in Ocean Rig.

Foreign Incorporated Companies Can Utilise Cayman Islands Schemes and Can Take Steps to Create Jurisdiction

Jurisdiction

It has become commonplace over the last ten years for the English courts to scheme foreign incorporated companies. Ocean Rig opens up the same possibilities to the Cayman Islands.

Under Cayman Islands law, the court has jurisdiction to scheme any company that is 'liable to be wound up'. This includes Cayman Islands incorporated companies and in certain circumstances foreign incorporated companies. Section 91 of the Cayman Islands Companies Law (2018 Revision) (the "Companies Law") provides that the Cayman Islands court has jurisdiction to make winding up orders in respect of a foreign company that: (i) has property located in the Cayman Islands; (ii) is carrying on business in the Cayman Islands; (iii) is the general partner of a limited partnership; or (iv) is registered as a foreign company with the Cayman Islands Registrar of Companies.

Accordingly, simply registering the foreign company in the Cayman Islands, a simple administrative filing, creates the jurisdictional hook for a Cayman Islands scheme of arrangement. However, the Cayman Islands court will, as a matter of discretion, also need to be satisfied that it should exercise its jurisdiction and it may be that the court will require more than just registration as a foreign company. This point was untested in Ocean Rig because, as a result of a shift of the scheme companies' CoMI to the Cayman Islands in order to obtain Chapter 15 relief, each scheme company had a substantial nexus to the Cayman Islands (including assets in the jurisdiction). It is expected that most Cayman Islands restructurings will involve New-York-law-governed debt (see below) and therefore require a CoMI shift or the creation of an establishment. This will necessarily create a real nexus to the Cayman Islands. Accordingly, circumstances where applicants are relying solely on registration as a foreign company to persuade the court to exercise its discretion are currently expected to be few and far between.

Jurisdiction Can Be Created – Good Forum Shopping

The Cayman Islands was deliberately selected as the jurisdiction within which to implement the Ocean Rig restructuring. The Cayman Islands court adopted the approach of the English court; that such jurisdictional selection is not abusive where it is carried out with a view to achieving the best possible outcome for creditors. This was found to be the case with the Ocean Rig restructuring.

The scheme companies did not have longstanding connections with the jurisdiction. This is not unusual in the restructuring context – restructuring professionals seek to identify the jurisdiction within which to implement a restructuring in the most efficient and effective manner while returning the greatest possible value to creditors. Other potential jurisdictions that would have been available for Ocean Rig were the Marshall Islands, being the jurisdiction of the subsidiaries; the US being the governing law of the debt or England via a CoMI shift and scheme of arrangement. However, each of these

jurisdictions was discounted. The Marshall Islands has no restructuring regime. Chapter 11 was seen as being unnecessarily expensive and administratively burdensome given that only financial debt was being restructured – the opcos were not filed and there was therefore no need for all the protections and options Chapter 11 provides for trading companies. English schemes were unattractive due to the potential adverse tax consequences of the required CoMI shift.

The Ocean Rig parent had been continued[1] to the Cayman Islands from the Marshall Islands in April 2016 for reasons unconnected to any restructuring of the group's debt. Following the continuation, the parent became a Cayman Islands exempted company. However, the three Marshall Islands subsidiaries were registered in the Cayman Islands as foreign companies in October 2016 for the purpose of the restructuring and the CoMI of all the scheme companies was shifted to the Cayman Islands between October 2016 and early February 2017.

In recognising both the restructuring provisional liquidation and scheme proceedings, the US Bankruptcy Court held that the scheme companies purposefully established the Cayman Islands as their CoMI before filing for recognition of the restructuring provisional liquidation and scheme proceedings. However, those actions were taken for legitimate reasons, motivated by the intent to maximise value for creditors and to preserve assets. There was no bad faith manipulation of CoMI.

Pre-Filing CoMI Shift to the Cayman Islands

The US courts have previously determined that the activities of a Cayman Islands provisional or official liquidator once in office (notably communications with creditors and decision making) naturally shift CoMI to the Cayman Islands.

However, in Ocean Rig, a temporary restraining order was required in the US from the time that the scheme companies were placed into restructuring provisional liquidation in the Cayman Islands. This is because (i) the debt to be compromised was governed by New York law; (ii) there were pending events of default under the credit instruments to be compromised; and (iii) certain creditors were likely to be hostile to the restructuring. In these circumstances, the companies needed the benefit of a moratorium in the US from the outset to continue negotiations with creditors and finalise the terms of the restructuring. This required shifting the scheme companies' CoMI to the Cayman Islands pre-filing.

The steps taken to shift the scheme companies' COMI were similar to those that have been carried out in relation to English schemes of arrangement of New-York-law-governed debt. These steps ensured that the scheme companies' head office functions were conducted from the Cayman Islands and that this was objectively ascertainable to third parties (in particular creditors). Key factors in shifting CoMI were the:

(a) incorporation of a Cayman Islands restructuring subsidiary (a SEZCo, incorporated in Cayman Islands Enterprise City (broadly Enterprise City is a Cayman Islands special economic zone for certain industry sectors, which allows a Cayman Islands company to be incorporated and be business ready, usually within a 4-8 week period)) to perform, pursuant to a Cayman-Islands-law-governed services agreement, a number of the head office and front office administrative functions of the scheme companies in the Cayman Islands;
(b) appointment of Cayman Islands resident directors who were able to chair board meetings from the Cayman Islands;
(c) notification to key financial creditors and investment service providers that all communications be directed to the SEZCo;
(d) issuing of a press release stating that the debtors' principal place of business had been moved to the Cayman Islands and that all communication be directed to the SEZCo (notably the parent was served with English legal proceedings in the Cayman Islands – it was clear that third parties had taken notice of the move to the Cayman Islands); and
(e) holding restructuring negotiations with creditors in the Cayman Islands.

Wrapping a Scheme within a Restructuring Provisional Liquidation

Specific statutory provisions exist in the Cayman Islands enabling a restructuring provisional liquidation to be used as part of the legal armoury. Where a winding up petition has been presented, provisional liquidators may be appointed where the company: (i) is, or is likely to become, unable to pay its debts; and (ii) intends to present a compromise or arrangement to its creditors. This allows a restructuring of the company to be pursued with the benefit of the moratorium on creditor action (although there is no stay on the enforcement of security). The restructuring may take the form of a scheme of arrangement (as was the case in Ocean Rig) or a consensual deal with creditors. Further, where a stay on creditor action in the Cayman Islands may be beneficial, a restructuring provisional liquidation may be used to support restructuring efforts in other countries, for example, a plan of reorganisation in Chapter 11 proceedings.
The court has wide flexibility in conducting a provisional liquidation (including in relation to the powers granted to the provisional liquidators). In the restructuring context it would be usual to allow the existing management to remain in control of the company's affairs as debtor in possession (subject to the restructuring provisional liquidators' high level overview). The order will be tailored to the requirements of the case, which means that the role to be played by the provisional liquidator can be crafted to fit the needs of each specific restructuring.

Restructuring provisional liquidators can also provide an independent voice in negotiations with dissenting creditors - in Ocean Rig, the provisional liquidators successfully struck a deal with one set of dissenters. Further, the restructuring provisional liquidators are, as officers of the court, able to provide confirmation that, having subjected the restructuring to independent scrutiny that the schemes are fair and should be sanctioned. This means that the bar for the challenging creditor to surmount is a higher one than if the restructuring provisional liquidation wrapper is not used – the challenging creditor has to persuade the court to disregard the recommendation of its own independent officer.

In a contested situation, a light-touch restructuring provisional liquidation can provide an important protective wrapper to a restructuring while, importantly, not adding significantly or at all to the time taken to implement the restructuring.

When to Select a Cayman Islands Restructuring

The Ocean Rig restructuring sets a precedent for the use of the Cayman Islands as a centre within which to conduct modern, complex cross-border restructurings. But when will a Cayman Islands scheme be the right to tool to effect a restructuring?

As English law debt can only be compromised through an English proceeding, in order for the scheme to be effective in England the governing law of the debt would need to be changed from English to Cayman Islands law. Such a change may not be commercially palatable to creditors. Accordingly, it is more likely that Cayman Islands schemes will be used in order to amend or compromise New-York-law-governed debt.

In a targeted restructuring of a company's or group's financial indebtedness (rather than a restructuring that includes operational subsidiaries and / or requires all creditors to be compromised) a Cayman Islands scheme has a number of advantages over a Chapter 11 (particularly in a contested situation). Importantly, schemes are likely to be quicker and more cost effective than a Chapter 11.

With schemes there are only two court hearings, no first day motions and no creditors' committees. There are also limited legal grounds upon which a creditor can challenge a scheme and challenges

based purely on commercial unfairness are not likely to succeed once the majorities have approved the restructuring. This does not mean that, with a scheme, the restructuring is not properly scrutinised by the court; only that the opportunities for challenge and disruption by a dissenting creditor are more focused – this inevitably means a shorter and more cost-effective process.

Furthermore, with schemes there is a much lower risk of full and time consuming discovery / disclosure being ordered by the court – it is therefore more difficult for dissenting creditors to hold the restructuring hostage to hostile litigation tactics.

Unlike Chapter 11, there is the ability to release third party liabilities through a scheme and, therefore, no need to file guarantors – again resulting in lower costs due to the lower number of debtors that may require filing. Despite the Ocean Rig restructuring being hotly contested the scheme proceedings were concluded in just over three months (and the scheme companies were in provisional liquidation for just under six months).

Although an English scheme also has these advantages, shifting CoMI to England (or creating an establishment in England) in order to secure Chapter 15 relief may result in adverse tax consequences (and, at least, the incurrence of fees to establish the position). The Cayman Islands is a tax neutral jurisdiction – there are no Cayman Islands tax consequences of a Cayman Islands CoMI shift; indeed if the debtor is paying tax in its current jurisdiction there may be a tax benefit to the CoMI shift. This means that where the debtor is either in a no or low tax jurisdiction, a Cayman Islands scheme of New York law debt may be particularly attractive.

Further, as demonstrated by Ocean Rig the Cayman Islands restructuring provisional liquidation wrapper is particularly useful in a contested context. Where a moratorium and independent court officers are likely to be helpful in getting a restructuring completed, Cayman Islands restructuring provisional liquidators can play an important strategic role with little or no real loss of debtor control. **THFJ**

This article is intended to provide only general information for the clients and professional contacts of Maples and Calder. It does not purport to be comprehensive or to render legal advice.

FOOTNOTES

1. Continuation allows a company incorporated in one jurisdiction to be seamlessly transferred to the Cayman Islands. There are a number of requirements that need to be fulfilled before a company can be 'continued' to the Cayman Islands which are beyond the scope of this article.

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