Cayman Court clarifies sanctions' impact on schemes of arrangement

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In the recent Cayman Islands case of *Re In the Matter of E-House (China) Enterprise Holdings Limited*, [1] dealing with creditors' schemes of arrangement, Justice Segal gave a helpful decision that provided judicial clarity on, among other matters, the potential impact of the recent sanctions regimes in the US, UK and Europe on the scheme, and the international effectiveness of the scheme.

Given the current macro-economic climate and levels of distress that global markets are experiencing, this is a timely reminder of the Court's willingness to take a flexible, proactive role in seeking to support a bona fide restructuring to facilitate a company's continued existence as an ongoing concern post restructuring.

Read our article on A new beginning for restructuring in the Cayman Islands about the Court's first appointment of a restructuring officer in the Cayman Islands for the purpose of presenting a compromise of arrangement with a company's creditors, once again demonstrating Cayman as a pre-eminent jurisdiction for restructurings.

Background and scheme of arrangement proposal

E-House (China) Enterprise Holdings Limited is a Cayman Islands incorporated company that acts as the parent company to a 300-entity group operating in the real estate sector in the People's Republic of China.

The company's shares are listed on the Hong Kong Stock Exchange and had issued US$600m of New York law governed debt with maturity dates in 2022 and 2023 (**notes**) with a further convertible note in the principal amount of US$135 million. The notes were guaranteed by BVI and Hong Kong subsidiaries (**subsidiary guarantors**). The entity group was experiencing financial distress and needed to effect a restructuring of this debt. The company did not appoint restructuring officers or provisional liquidators but did engage Alvarez & Marsal to oversee the scheme.

US$300 million of the notes matured on 18 April 2022 and the company was unable to repay this which gave rise to a cross-default under the convertible note and a cross-default under the notes maturing in 2023. After an earlier unsuccessful attempt to effect a consensual restructuring of the notes, the company launched the scheme in order to restructure the notes, with the holder of the convertible note waiving the default thereunder.

The scheme of arrangement

The scheme of arrangement as proposed by the company sought to, in summary

1. release the noteholders' claims arising out of the notes and the scheme in exchange for new notes and certain cash consideration (**scheme consideration**)
2. discharge the notes and release the subsidiary guarantors
3. pay an incentive fee of 1% of the aggregate principal amount of that noteholder's notes that entered into a restructuring support agreement prior to the effective date of the scheme

Sanctions

The company had to navigate three separate sanctions regimes

1. US sanctions regime due to the governing law of the notes (New York law)
2. UK sanctions regime because the company is a Cayman Islands company and the Cayman Islands is subject to the UK's sanctions regime as a British Overseas Territory
3. European Union sanctions regime because one of the clearing systems through which the notes were held are subject to certain sanctions

With the assistance of its information agent, the company determined that no underlying noteholders were personally subject to sanctions but that 6.65% of the noteholders held their accounts through a sanctioned clearing system (the Russian National Settlement Depositary (**NSD**)). Accordingly, the company concluded that noteholders who held notes through the NSD (**blocked noteholders**) were unable to receive documents or give instructions via the clearing system, being the ordinary means of communication with noteholders. The company's bank also confirmed that it could not make direct payments to those blocked noteholders.

The company's approach to the blocked noteholders

In order to resolve the sanction issues, the company proposed to not allow the blocked noteholders to vote on the scheme and to issue the new notes in global form. In addition, if the scheme was approved by those creditors who were allowed to vote, any scheme consideration (and any

incentive fee for those who had acceded to the restructuring support agreement which had been communicated outside of the NSD) due to the blocked noteholders would then be held on their behalf by a trustee.

The Court's decision

Schemes of arrangements in the Cayman Islands require two hearings, the first is a convening hearing to approve the manner of the scheme meeting at which creditors vote on the scheme of arrangement and communication to the creditors in relation to voting and the second a sanction hearing to assess the results of the voting at the scheme meeting and to consider whether the outcome of the vote should be sanctioned by the Court and become binding on all creditors, including those who voted against or didn't (or couldn't) vote.

At the e-House convening hearing, Justice Segal did not agree that it would be permissible to deprive the blocked noteholders of the right to attend and vote at the scheme meeting. He accepted that the position would be different if the blocked noteholders themselves were subject to sanctions but given that was not the case here and that all creditors who are parties to the scheme should be entitled to vote at the scheme meeting and be provided with adequate information to enable them to determine how to vote. The company's sole rationale for not permitting the blocked noteholders to attend was because the usual method of communicating with and obtaining instructions from the noteholders (through the clearing systems) was not available because of the impact of the sanctions. In response to the Judge's concerns, the company confirmed that arrangements could be made with the blocked noteholders to circulate documentation and collect their voting instructions via other means and, as such, Justice Segal held this reason alone was not sufficient to deprive the blocked noteholders of their right to attend and vote at the scheme meeting and allowed an amendment to the timetable to facilitate the provision of information.

The Court had no objection to the trust arrangements that the company proposed for the blocked noteholders as regards the scheme consideration.

International effectiveness

At the convening hearing (on a preliminary basis), and then at the sanction hearing, as part of its decision as to whether to sanction the scheme, the Court must consider whether the scheme will ultimately be effective. A scheme may be considered to be ineffective, for example, because the scheme would not bind creditors and would be of no effect in other jurisdictions in which the company had valuable assets or could be subject to insolvency proceedings.

This issue has come into sharper focus when involving companies that deal with Hong Kong (in which one of the subsidiary guarantors was incorporated) in particular, because of the judgment of Mr Justice Harris *In re Rare Earth Magnesium Technology Group Holdings Limited* [2022] HKCFI

16896 (**Rare Earth**). By reference to a judgment of Glenn J *In re Agrokor d.d., No. 18-12104* (Bankr. S.D.N.Y. Oct. 24, 2018) (MG), Harris J found that an order under Chapter 15 of the US Bankruptcy Code (**Chapter 15**) recognising and enforcing a foreign proceeding (such as a scheme) does **not** discharge the underlying US debt such that "a scheme sanctioned in an offshore jurisdiction and recognised under Chapter 15 in the United States will not be treated by a Hong Kong court as compromising US debt".

In order to ensure that the scheme of arrangement was binding and given effect as a matter of New York law (the governing jurisdiction of the notes), the company confirmed to the Court that, if the scheme was sanctioned, it would seek such relief under Chapter 15 and that the scheme would be conditional upon such relief being granted by a US Court.

Given the concerns raised by Rare Earth, the company submitted expert evidence from a highly respected and experienced US bankruptcy judge (Judge Gropper) which, in short, opined that the US Bankruptcy Court would give "full force and effect" to the provisions of the scheme upon an order under Chapter 15 being granted. Judge Gropper noted that Glenn J had considered Harris J's summary of applicable US law in *In re Modern Land (China) Co., Ltd* 2022 WL 2794014 (Bankr. S.D.N.Y, July 22, 2022) and concluded that such summary was incorrect and that an order under Chapter 15 **does** have the effect of discharging US governed debt.

In the circumstances, Justice Segal was satisfied that an order of the US Court under Chapter 15 would be enforced in the US and the relief granted pursuant to the scheme would therefore have the effect of discharging the debt and releasing the guarantees against the subsidiary guarantors.

[1] FSD No 165 of 2022 (NSJ), unreported, 17 November 2022.

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