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A Bank, a Bankruptcy, and the World of Shariah Law

The Chapter 11 restructuring of Bahrain-based Arcapita Bank, led by Gibson Dunn, saw U.S. bankruptcy courts faced for the first time with the world of Shariah law.

BY CHRIS JOHNSON

THE $1.6 BILLION RESTRUCTURING OF BAHRAIN-BASED Arcapita Bank B.S.C. has a significance that extends far beyond simply returning value to its creditors.

Arcapita was established in 1996 as the world's first Islamic investment bank. This means it had to comply with principles set out by Islamic law, known as Shariah, such as a ban on the payment or receipt of interest. But these Islamic principles are not actually codified in law—they are more a set of moral and religious guidelines. There isn't even a Shariah court; each financial institution has its own Shariah board, consisting of Islamic scholars, which interprets the rules and ensures its company's compliance.

This absence of black-letter law makes Shariah notoriously difficult for Western courts to deal with. Arcapita's restructuring could change all that. It was not only the first Gulf-based company but also the first Shariah-compliant entity to go through a U.S. Chapter 11 bankruptcy. The process included creating the first Islamic debtor-in-possession financing. By the time Arcapita emerged in September 2013, the case had set important precedents about how U.S. and Western courts will deal with Shariah contracts and disputes.

"Arcapita showed that the U.S. bankruptcy code is flexible enough and the power of the U.S. court is pervasive enough that you could apply them to Middle Eastern structures, financings and claims," says Michael Rosenthal, cochair of the business restructuring and reorganization group at Gibson, Dunn & Crutcher, which represented Arcapita. "Any restructuring that now takes place in the Middle East has to consider the possibility that if the parties don't reach a consensual deal, they may find themselves in a U.S. court, where U.S. principles can be applied to exert some leverage to get them to reach a deal. That threat will now be the backdrop for negotiations."

True debt restructuring is somewhat of an alien concept in the Middle East. The region's bankruptcy laws are largely untested—the bankruptcy law in Bahrain, where Arcapita is based, has never been used—and strict rules surrounding foreign ownership of domestic assets mean that creditors seeking enforcement actions often face an uphill struggle.

Instead, such situations tend to be worked out through privately negotiated deals, typically involving a so-called amend and extend, whereby a company amends its credit agreement and extends the debt maturities to avoid a default. "It's the classic extend and pretend," says one of the lawyers involved in the Arcapita restructuring, in a deliberate play on words. "They just extend the debt repayment dates in the hope that the company will eventually be able to pay."

Arcapita wasn't afforded such an easy ride. The bank ran into difficulties in 2012, when it was unable to refinance a $1.1 billion syndicated *murabaha*, a form of Islamic loan, that was due in March. (Instead of charging interest, which is banned under Shariah law, a *murabaha* sees the lender buy the asset subject to the financing and then sell it to the borrower at a marked-up price, payable at a future date. Where a debtor requires financing for general purposes, rather than an acquisition, as was the case with Arcapita, the lender uses the same structure but instead buys a freely tradable asset—often a physical commodity, such as the precious metal palladium—and sells this to the borrower for a profit. The borrower then sells this to a third party, thereby receiving an immediate cash infusion.) A combination of the global economic crisis and the Arab Spring had seen finance markets all but dry up, while the plummeting value of many of Arcapita's assets meant a sale was out of the question.

"We knew that we were bumping up against a deadline with the loan due to mature and so we tried to raise new capital, but market conditions meant we were unable to do so," says former Arcapita general counsel Henry Thompson, now general counsel at London-based Gatehouse Bank plc, a Shariah-compliant investment bank.

Thompson says that Plan A was a consensual restructuring via a three-year extension to the term of the $1.1 billion debt. "With the banks so timid due to the crisis, that was

Michael Rosenthal of Gibson Dunn, who represented Arcapita Bank.

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flavor of the season," he adds. But the move was blocked by some of Arcapita's nonbank creditors.

So, working with a team of lawyers at Magic Circle firm Linklaters, Arcapita investigated various potential restructuring options, including initiating proceedings in the Cayman Islands, home to an Arcapita subsidiary that held a significant portion of the bank's balance sheet investments.

But what had begun as an orderly process was thrown into turmoil when hedge fund Euroville Sarl, represented by David Friedman of Kasowitz Benson Torres & Friedman, threatened to file liquidation proceedings against Arcapita's Cayman holding company.

"This hedge fund wanted to be bought out and said that if they weren't bought out at par, they were going to file suit," says Rosenthal, who had been brought in to advise Arcapita on the viability of a U.S. bankruptcy proceeding. "That accelerated things substantially. We initially got a call from the client saying that we needed to get ready to file within three to four weeks. We then got another call a few days later saying we had to be ready within three to four days."

The liquidation proceedings would have been "destructive" to Arcapita's value, Rosenthal adds, so the firm, having devised a new strategy with the company's financial advisers, Rothschild, moved quickly to file for Chapter 11 bankruptcy in New York and to have a provisional liquidator appointed in an ancillary case in Cayman. (Despite being a Bahrain-based company, Arcapita was eligible for Chapter 11 since it carried out investments in the United States through a Delaware-incorporated holding company, Arcapita Inc., which had offices in Atlanta. The bank at one time owned majority stakes in

U.S. coffee chain Caribou Coffee Company Inc.; fried chicken franchise Church's Chicken; women's clothing retailer J. Jill; and moving and storage company PODS Enterprises Inc.)

The strategy successfully protected Arcapita against attack in the Cayman Islands, but the rush meant it was unable to put together a so-called prepack, a procedure common in Chapter 11 bankruptcies, where the restructuring plan is already agreed in advance. Thompson says that, as a result, the initial stages of the restructuring were rather chaotic. "Owing to the twists and turns, it was a scramble to complete the filings," he says. "It wasn't until after the first day of motions that we could put in place the steps you would normally go through for months prior to a Chapter 11 filing—it was a total free-for-all."

THE CHALLENGES DIDN'T END WITH THE COMMENCEMENT of the Chapter 11 proceedings, however. The combination of aggressive U.S. hedge funds and more conservative Middle Eastern investors on the official creditors committee led to "internal conflict," according to Jon Henes, a restructuring partner at Kirkland & Ellis, which represented an ad hoc committee of noteholders. (The internal dynamic was all the more delicate because Arcapita's chief regulator, the Central Bank of Bahrain, was also on its creditor committee as its largest single creditor, with $255 million owed.)

"One of the real challenges was pushing those two groups together to do a deal," adds Henes, who led Kirkland's team alongside fellow restructuring partner Nicole Greenblatt. "Middle Eastern creditors are all about reputation and tradition, whereas U.S. hedge funds are economic animals—they will be constructive, because it's in their best interests to be, but they will also take openly aggressive positions."

Henes should know: His clients in the restructuring—a group of U.S. hedge funds comprising Silver Point Capital, Taconic Capital Advisors and York Capital Management Global Advisors—filed an objection in September 2012 to Arcapita's request for a four-month extension of the exclusivity periods. In a colorfully worded reply, Gibson and Arcapita dismissed the objection as showing a "profound lack of understanding of the various issues confronting the debtors," saying that it "reads like a book report on a novel they haven't yet read." It added: "As the only objecting party, perhaps [they] simply felt the need to signal their entry into the case by barking at the moon."

The objection ultimately failed, with the bankruptcy judge granting Arcapita the extension in October, but Henes says the aggressive move was still worthwhile. "We knew that the likelihood of success wasn't great, but it meant the debtor and the [creditors] committee had to take our group seriously," he says. "And we didn't just throw it out there—it was a serious objection. We wanted to make a point to the judge that this was a very, very expensive case—every dollar coming out was a dollar hit to recoveries—and that it didn't have to linger on."

Arcapita also faced a challenge from an investor over its $150 million Shariah-compliant debtor-in-possession financing from a Goldman Sachs-led syndicate—the first ever Islamic debtor-in-possession financing—but this too was eventually approved by the U.S. court.

THE 18-MONTH PROCESS FINALLY CAME TO AN END IN THE fall of 2013, with the company emerging from Chapter 11 on September 17. Arcapita's restructuring plan, which was approved by 99 percent of its more than 1,200 creditors, who collectively held in excess of $2 billion in claims, will see it gradually dispose of its assets over the next five years.

"We didn't want to initiate a fire sale," Rosenthal says. "The plan allows time for these businesses to mature, and for Arcapita to then liquidate its assets at a time and at a price that maximizes the value."

In order to facilitate this wind-down of operations, the bank was effectively split into two. Arcapita's existing assets have been transferred into a new company, RA Holding Corp., which is owned by the creditors. RA Holding will work to realize the value of Arcapita's portfolio, which at the point of its bankruptcy comprised about 30 investments totaling $7.4 billion in assets under management. The reorganized Arcapita, which has been renamed AIM Group Limited, meanwhile, will seek to raise money from the bank's existing investors and continue to make investments in the education, health and logistics sectors. Most Arcapita senior managers remained with the company to lead AIM.

Proceeds from the sale will initially be used to repay a $350 million exit facility, again provided by a Goldman Sachs-led syndicate, that is funding the bank's continued operations. (The exit financing was also used to repay the $150 million debtor-in-possession financing and $100 million of senior secured debt owed to Standard Chartered Bank—Arcapita's sole secured creditor.) Next in line are the unsecured creditors of the $1.1 billion *murabaha*, who Arcapita estimates will recover 64 percent of their cash—partly through the bank's issuance of a new $550 million Islamic bond. The sale process is already underway: In January 2014, Arcapita raised $740 million through the sale of U.S.-based mining drill bit manufacturer Varel International Energy Services Inc. to Swedish engineering group Sandvik AB.

Including numerous related actions and claims, the restructuring involved no fewer than 27 law firms. Thompson says the restructuring helped "demystify" Islamic finance, and that the consensual nature of the negotiations between the bank and its creditors was "essential" to the positive outcome. "During what was a difficult and stressful process, there was no wrongdoing or skullduggery," he says. "It's important to remember that the shareholder base and board of directors consisted of Gulf citizens, who are not that familiar with U.S. court processes, and the U.S. courts certainly weren't that familiar with Shariah law." Thompson says the situation was a test of nerves and patience. "If everyone hadn't hung together and demonstrated a united front, then it might not have worked," he says.

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