

**CORPORATE
RESTRUCTURING:**
THE BREAKING WAVE

EDITED BY HENRY GIBBON AND QUENTIN CARRUTHERS



REUTERS

SECTION 04 UK: CRAM-DOWN OF JUNIOR CREDITORS USING SCHEMES OF ARRANGEMENT

CHAPTER 18

By Jackson Taylor, partner, and Nicola Stewart, associate, Latham & Watkins

After nearly three decades of legislative reform of English insolvency laws, including the radical introduction in 1986 of the administration process, which was intended to promote the rescue and rehabilitation of financially troubled companies, large and complex financial restructuring still occurs in England almost entirely as an ad hoc, out-of-court process. The reasons for this have been canvassed amongst the media and numerous symposiums, but have perhaps been most prominently articulated by the European High Yield Association (EHYA), an industry group representing restructuring professionals and market participants.

Criticisms of the current insolvency regime

Among the criticisms voiced by the EHYA of the existing English insolvency framework, is that it lacks a clear and predictable procedure to implement a cram-down of junior creditors who are ‘out of the money’. It is axiomatic to restructuring practice that value in a reorganised company should be allocated to creditors in order of their legal priority (absent some commercial imperative for doing otherwise, such as keeping trade creditors whole), such that those creditors with claims ranking below ‘where value breaks’ should not be allocated any interest in the restructured entity. Moreover, the implementation of a restructuring should not be conditional on the agreement of such out of the money creditors, who would otherwise have the ability to achieve an unmerited consent payment upon the threat of exercising any power of veto should they have one.

In both of these respects, the existing insolvency regime has been criticised, with justification, as inadequate to ensure that restructurings can be implemented in observance of these two fundamental principles. The EHYA’s Insolvency Working Group in a letter to HM Treasury in England in 2007 on Insolvency Law Reform observed that “there is currently no clearly established method for valuing companies undergoing a restructuring”; and, as for the implementation of a restructuring over the objections of out of the money creditors: “traditionally, [their] agreement would nevertheless be required before an ‘out-of-court restructuring’ could be implemented”. While an ad hoc approach had achieved some success in circumventing these approvals, the authors remarked that “this issue is too important to be left the subject of the vagaries of each individual case”.

These concerns were aired over the course of 2007 and 2008, a time at which the last completed pipeline of restructurings in England consisted mainly of ‘bank and bond’ deals put together earlier in the decade (as for example in Telewest, Marconi, British Energy and MyTravel, to name a few). From a structural viewpoint, those deals involved comparably simple capital structures. And yet as the concerted challenge to the British Energy restructuring in 2004 showed, they were still susceptible to significant implementation risks because of the challenge of dealing with dissident, out of the money stakeholders. As the EHYA letter noted, these difficulties were expected to multiply for the forthcoming restructuring wave (now upon us), which would be characterised by a deal pipeline of multi-layered and complex debt structures, involving many different types of investor constituencies. In anticipation of the difficulties achieving consensual restructurings of this complexity within the existing framework, the EHYA lobbied the government for the insolvency laws to be urgently reformed, including the creation of “a framework for the fast judicial resolution of valuation disputes” and “a judicially supervised process . . . to allow a restructuring to proceed without the necessity of extracting a consent from a class of creditors or shareholders with no economic interest”.

We are now able to evaluate those concerns with the benefit of about a year’s experience of restructuring the complex LBO deals of 2005–07 vintage. Does that experience show that the concerns about the lack of an effective cram-down technique in England have been overplayed? At first glance it might look that way. In the first half of 2009 the English courts assisted in the implementation of a quick succession of restructurings that have deleveraged companies leaving out of the money creditors with little, if any, economic value in the restructured entity: Countrywide (approximately £465m deleveraged); McCarthy & Stone (approximately £525m

deleveraged); Crest Nicholson (approximately £500m deleveraged) and British Vita (approximately £580m deleveraged) all closed between March and May of 2009. At the time of writing, several further deals are preparing to go before the courts.

The feature that every one of these deals shares is the use of an English law scheme of arrangement to implement the restructuring. In each, a restructuring was achieved in which junior classes of debt were judged or conceded to have been out of the money and accordingly received little or no allocation of debt or equity in the restructured enterprise. According to publicly available information, McCarthy & Stone wiped out the second lien and mezzanine debt in its entirety, Vita wiped out the mezzanine debt in exchange for 2.5% of the equity plus warrants and a chance to participate in the new money facilities, Crest Nicholson plc rolled some existing mezzanine debt to its restructured balance sheet but did not offer mezzanine lenders any equity in a newco owned 90% by existing lenders and 10% by management, and Countrywide converted senior secured notes of £470m into £175m of debt and 35% of equity in new holdco and converted the unsecured notes of £170m debt into 5% of equity in a new holdco.

The purpose of this chapter is to reconcile the apparent success of these completed restructurings with the concerns previously expressed about the lack of effectiveness of restructuring procedures in England, by exploring the use and conditions of the English scheme of arrangement as a device to cram-down out of the money creditors. In doing so, it seeks to demonstrate the limits to that technique, so as to explain why some deals appear to be languishing without the prospect of achieving the cram-down, by a scheme of arrangement, that they require in order to successfully restructure.

Schemes of arrangement – background

Schemes of arrangement stand outside of the formal insolvency apparatus in England. They are a feature instead of the companies laws, and have been around in one form or another since Victorian times. Today, they are set out in Part 26 of the Companies Act 2006 (the Act) and they provide a statutory framework whereby a company may enter into a compromise or arrangement with its creditors (or any class of creditor).

The relevant statutory provisions (ss 895-899 of the Act) provide that where any compromise or arrangement is proposed between a company and its creditors or any class of them, the court may, on the application of the company, any creditor or any member of the company or a liquidator or administrator, order a meeting of the creditors or class of creditors to be called; and if a majority in number representing 75% in value of the creditors or class of creditors, present either in person or by proxy agree to the compromise or arrangement, and it is also sanctioned by the court, it will be binding on all the creditors or the class of creditors.

All classes entitled to vote on the scheme must vote in favour of the scheme. For many current restructurings, the question of class is the single most important question when considering whether to restructure by way of scheme of arrangement. Two key considerations are: (i) the composition of each class entitled to vote on the scheme; and (ii) the classes of creditors not entitled to vote on the scheme.

The classic definition of class comes from the case of *Re Sovereign Life Assurance Company v. Dodd* in 1892. “It seems plain that we must give such a meaning to the term ‘class’ as will prevent the section being so worked as to result in confiscation and injustice, and it must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest”.

The effect of getting class constitution wrong was highlighted in the case of *Re Hawk Insurance Co Ltd* in 2001 where Arden J at first instance held that the differing treatment of creditors’ claims ultimately gave creditors different rights which put them in different classes. Accordingly, she refused to sanction the arrangement on the ground that creditor’s rights were sufficiently different to require their separation into more than one class. Although the Court of Appeal disagreed and subsequently sanctioned the scheme, it was clear that change was required to avoid the cost and expense of schemes proceeding to the fairness hearing and then not being sanctioned because of class issues. Chadwick LJ who gave the leading judgment clarified that the test in *Sovereign* depended on the analysis of the rights which are to be released or verified under the scheme and the new rights (if any) which the scheme gives to those whose rights are to be released or varied.

Following the Hawk case, the Chancery Division of the High Court subsequently issued a practice statement on 15 April 2002 on the procedure to be followed with respect to schemes. The purpose of the practice statement is to enable so called 'class issues' to be identified and resolved early in the proceedings so as to avoid the waste of time and costs associated with the courts refusing to sanction the scheme at the second hearing because the classes have not been properly identified from the start. Although it should be noted that in cases such as *Re British Aviation Insurance Co Ltd* in 2005, the court has held that it has no jurisdiction to sanction a scheme where the classes have been incorrectly constituted.

Also important to note is the case of *Re Heron International NV* in 1994 which considered potential conflicts of interests between classes. In this case, certain banks that also held bonds were not excluded from participating in the general bondholder class despite the fact that they had already signed into a consensual restructuring that gave them certain benefits that were not generally available to other bondholders. It was held that while the banks enjoyed a degree of additional benefits, this was a question of degree and on the facts of the case the benefits were granted to them in their capacity as banks and in any event was insufficient to disenfranchise those banks from the wider bondholder vote.

Treatment of out of the money creditors

In a restructuring context, although the composition of classes are important, of equal importance is the treatment of out of the money creditors and therefore making the decision of which creditors not to include in the scheme.

Case law suggests that the court may sanction a scheme where any dissenting class of stakeholders have no economic interest in the company, although whose rights are not 'affected' by the scheme. The authority in this area stems from the leading case in this area of *Re Tea Corpn Ltd* in 1904. In this case a scheme was proposed in a liquidation whereby the ordinary shareholders were to be given shares in a new company in place of their existing shares. The shareholders as a class voted against the scheme; the other stakeholders voted for it. As the financial state of the company was that the ordinary shareholders had no economic interest in the company's assets, the court held that the shareholders' dissent could be disregarded when sanctioning the scheme. When dealing with the argument that the scheme was rendered defective by the ordinary shareholders' dissent, Vaughan Williams LJ held that "if you have the assent to the scheme of all those classes who have an interest in the matter, you ought not to consider the votes of those classes who really have no interest at all".

The issue of the treatment of out of the money creditors was brought to a head in *MyTravel* in 2004 where bondholders challenged the scheme proposed by MyTravel on the grounds that they had sufficient economic interest in the company's assets to require them to be given an opportunity to vote on the scheme. The High Court was not at this point given the opportunity to consider this issue in detail as the scheme fell down on a different point; however, the court did consider it on an obiter basis. The court commented that when ascertaining the rights of a creditor, it was appropriate to see if those rights could realistically only be enforced in a winding up and if so, to use the notional winding up as the method of assessing what those rights would be. This is particularly relevant where the facts show that a liquidation is the only real alternative to a restructuring through a scheme. On the facts it appeared that in a liquidation there would be no return to the bondholders as subordinated creditors, so the bondholders had no realistic economic interest and therefore had no right to be consulted in relation to the scheme. The MyTravel scheme was later put to the court on an amended basis and the court made the order convening the relevant meetings. The order contained a recital in relation to the court's conclusion that the bondholders had no economic interest in the company. The bondholders appealed, seeking to strike out the recital. The court held that the recital was not relevant to the amended scheme and so should be struck out and expressed no view on the High Court's findings of fact which had given rise to its conclusions that the bondholders had no economic interest in the company. The bondholders and MyTravel eventually reached agreement, so it remains an open point whether the analysis that the bondholders would receive nothing on a liquidation of the company means that they had no real economic interest in the scheme.

MyTravel, while providing some guidance on the determination of class issues and economic interests therefore left the issue undecided. Moreover, to the extent that the Judge's analysis at first instance may continue to have some persuasive authority, the case appears to be distinguishable on its own facts, given that the threatened revocation of the company's licence by the Civil Aviation Authority if the business was likely to fail and the restructuring not implemented. In those circumstances, the hypothesis of a liquidation of the company was a very real threat.

That has left the restructuring community to grapple with how far schemes could be pushed to cram-down out of the money creditors in different situations.

There were rumoured potential challenges to both the McCarthy & Stone and the Countrywide schemes on valuation; however, each scheme proceeded at the sanction hearing without challenge.

More recently, in IMO Car Wash, the company proposed a scheme of arrangement which involved only the senior lenders. The mezzanine lenders had mounted a challenge for the court to hear evidence as to whether they should have been included in the process on the grounds that they disputed the company's method of valuation. The company put forward valuation evidence comprising both a 'desk top' valuation and a market testing process. This was countered by the mezzanine lenders who put forward a DCF valuation predicated on the basis that without the constraints of the existing financial covenants and with a revised debt structure, it was highly likely that the senior lenders would at some time in the future make a full recovery, leaving a surplus for the mezzanine lenders.

Against this background, Mr Justice Mann held in favour of the company and noted that valuation in these circumstances should be based on how much a purchaser would pay today for the relevant assets, although how this is best evidenced remains open for argument.

Debt release

Despite the victory for the company and the senior lenders in the IMO Car Wash case, there is another serious limitation to the use of schemes to cram-down junior creditors. Leveraged deals have been, and continue to be structured, with junior debt, guarantees and security at an operating company level. Such debt, guarantees and security will need to be released as part of the restructuring. It is not the function of the scheme to achieve this, as then those creditors would be 'affected' by the scheme, and would therefore be entitled to vote on the scheme as a separate class. The way around this problem is to transfer the assets of the group to a newco, in accordance with the provisions of the intercreditor agreement which will typically provide that upon the transfer, the junior security and guarantees can be released. It is crucial to this plan, however, that the release clause technically works so as to be able to achieve this. However, as seen in a number of other deals, this is not always the case. Therefore as things stand, the scheme of arrangement cannot get around any defects in the intercreditor release mechanism.

To that extent therefore, there is justification for the EHYA's view that, in spite of the number of restructurings being successfully implemented with the use of a scheme of arrangement, there are still a number of hurdles to be overcome by any company wishing to pursue a successful scheme of arrangement in the UK courts.



Jackson Taylor

Jackson Taylor is a partner in the firm's London Restructuring and Insolvency Group. Jackson's practice focuses on cross-border corporate restructuring and he has advised creditors, insolvency practitioners, debtor companies, and directors on a range of contentious and consensual restructuring and insolvency matters. He primarily acts for institutional creditors and ad hoc creditors' committees on restructuring financially distressed companies outside of formal insolvency proceedings.



Nicola Stewart

Nicola Stewart is an associate in the Restructuring and Insolvency Group in the London office of Latham & Watkins. Nicola has a wide range of experience including several large restructuring transactions as well as more general finance work.

Extracted with permission from the latest Thomson Reuters IFR intelligence report, *Corporate Restructuring: the breaking wave*, edited by Henry Gibbon and Quentin Carruthers. For more information, visit www.ifrmarketintelligence.com