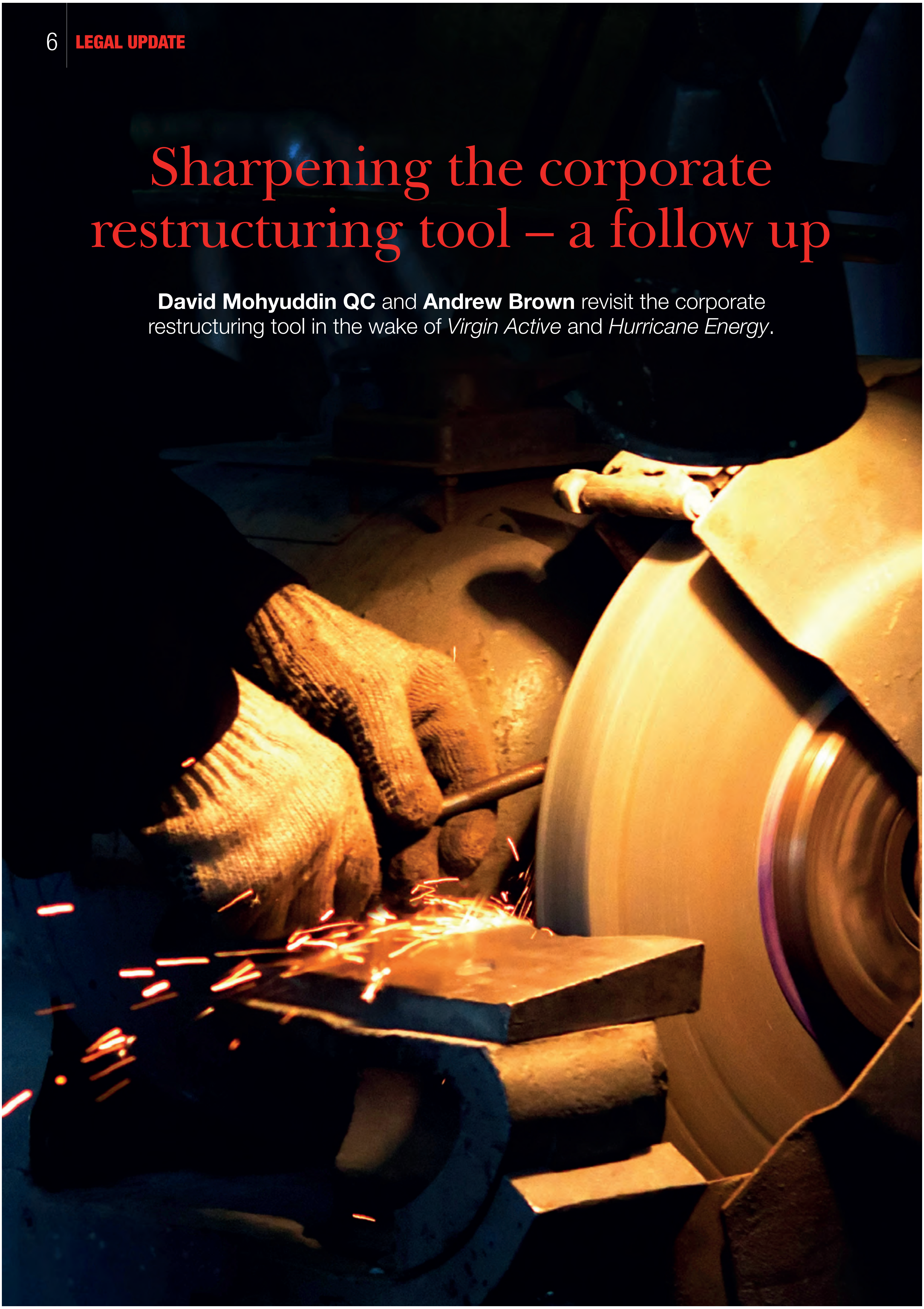
Sharpening the corporate restructuring tool – a follow up

David Mohyuddin QC and **Andrew Brown** revisit the corporate restructuring tool in the wake of *Virgin Active* and *Hurricane Energy*.



Time marches inexorably onwards, which for the law provides steady refinement and clarity through argument, judicial analysis, and case law (or so the theory goes). For the writers of legal update articles, the remorseless march of time results in a constantly moving, and never achievable, target of being up-to-date with the law. Such is the case for the ourselves and our article in *RECOVERY* of summer 2021 (page 6 of that edition) exploring the case law relating to the restructuring tool one year on from its inception. No sooner had we submitted our article for publication than the courts published two new judgments considering for the first time contested sanction hearings: *Re Virgin Active Holdings Limited* [2021] EWHC 1246 (Ch) and *Re Hurricane Energy Plc* [2021] EWHC 1759. The effect was to render our article in need of its own update. This article will explore those two judgments, their impact upon our understanding of contested restructurings, and specifically upon the most likely issue to be considered by the courts at such hearings.

Sanctioning a restructuring plan

As previously discussed in our June article, the restructuring tool is a mechanism under part 26A of the Companies Act 2006 to enable a company to reorganise its liabilities when it is, or envisages that it soon will be, in financial distress, by way of a compromise or arrangement with its creditors. The novel feature of the tool is its ability to 'cross-class cram down' (or up) dissenting groups of creditors, an option allowed in other jurisdictions such as the US, but not previously allowed in the well-trodden domestic fields of schemes of arrangement. The court process is multi-staged, with two successive court hearings sandwiching a creditors'/members' meeting. The first hearing is called a convening hearing, and its primary purpose is to satisfy the court that class meetings of creditors and/or members should be convened, that they have been given sufficient and appropriate information, and that the classes of creditors/members are appropriately constituted. The second hearing is to consider whether the plan should be approved, including any consideration of any cross-class cram downs or the views of dissenting creditors/members.

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The cases explored in our previous article mostly concerned matters arising at the first convening hearing, namely issues of class composition and the applicability of the restructuring tool when faced with foreign elements from outside the jurisdiction. This article will focus on contested sanction hearings where a class of creditors or members takes an active legal role in attempting to prevent the sanction of a plan by challenging the financial conditions necessary to allow a cram down.

Re Virgin Active Holdings Limited

Snowden J, as he then was, handed down judgment in *Virgin* on 12 May 2021. As is obvious from the name, the case concerned the restructuring of the Virgin chain of gyms, which faced significant financial issues as a result of Covid-19-related lockdowns. The creditors were divided into seven classes: the secured creditors (who would receive 100% of their debt, but have the maturity date for their lending facilities extended by three years), five sub-groups of landlords divided by the profitability of their particular gyms (the difference in approach to each group included no substantial difference for the class A landlords, changes in leases to turnover-based rents, or zero-rent leases in exchange for a single pay out of 120% of the return expected in the relevant insolvency alternative – administration), and unsecured creditors (who would receive a payout equivalent to 120% of that expected in an administration).

Unsurprisingly, the secured creditors and class A landlords – who would receive no significant financial detriment if it was sanctioned – voted to approve the plan. Those landlords and unsecured creditors who would only receive payouts in relation to the relevant alternative vehemently rejected the plan. Thus, Snowden J was faced with the question of whether to sanction a cross-class cram down despite the objections of a significant number of creditors who were being treated differently from the supporting creditors.

Part 26A of the Companies Act 2006 allows the cross-class cram down only where certain conditions are met. These can be divided into two conditions:

- **Condition A:** the court must be satisfied that none of the members of the dissenting class would be any worse off than they would be in the event of 'the relevant alternative'. The 'relevant alternative' is whatever the court considers would be most likely to occur in relation to the company if the restructuring plan were not sanctioned. This itself involves a three-step process:
  - First, identifying the likely future of the company if the plan were not sanctioned (step 1);
  - Second, determining what the consequences would be for creditors/members in that postulated future (step 2); and
  - Third, comparing that outcome with the likely outcome and consequences for creditors/members were the plan sanctioned (step 3).
- **Condition B:** the restructuring plan must have been approved by 75% in value of at least one class of creditors or members who would receive payment or have a genuine economic interest in the company in the event of the 'relevant alternative' (the 'in-the-money creditors').

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In *Virgin*, condition B was clearly met by the secured creditors and class A landlords approving the plan. The case turned on condition A, and the 'relevant alternative'. The company submitted that the relevant alternative was administration involving the accelerated sale of the most valuable parts of the companies' businesses. In support, the company submitted evidence of various valuations and calculations, which the court considered to be reasonable and capable of being relied upon for the purposes of determining whether to sanction the plans. The dissenting landlords provided no competing evidence. Based on the evidence, each dissenting class of plan creditor would be no worse off under the plans than in the relevant alternative.

Ultimately, Snowden J sanctioned the plan for various reasons, but primarily based upon the economic evidence tendered by the company. He noted that part 26A gives little guidance on the factors that are relevant when the court is exercising its discretion, but since the opposing landlords would be out of the money in the relevant alternative, the court attached little weight to the numerical opposition to the plans in the lower-ranking classes. Instead, it was for those creditors who are 'in the money' to determine how to divide up any value that might accrue post-restructuring. The differential treatment between landlord classes was accepted due to the variable profitability and commercial importance of the relevant clubs. Snowden J further held that there was nothing inappropriate in choosing to use a restructuring plan rather than a CVA (where a CVA was likely to be blocked by the landlords' votes). Finally,

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the retention of equity by the shareholders was predicated on substantial 'new value' offered by them, where the court accepted that the new money lent by the shareholders could not have been obtained on the same or better terms from any other source in the market.

The lessons to be learned from *Virgin* are that those creditors who have an economic interest in the relevant alternative will be the ones to whom the court gives its favour. This is not a surprising outcome in the insolvency sphere, but an important reminder that if one challenges the sanctioning of a plan then they must consider filing evidence disputing the company's financial projections.

Re Hurricane Energy Plc

Zacaroli J handed down judgment in *Hurricane* on 28 June 2021, and it provides a useful counterpoint to *Virgin* on approaches to the consideration of 'relevant alternatives' when considering whether to sanction a cross-class cram down. In 2017, the company raised US $230m (£172m) through the issue of convertible bonds. This was done with the intention of embarking on the discovery and extraction of oil. The maturity date for the bonds was July 2022 with the hope that sufficient oil would be discovered and extracted so as to repay or refinance the bonds. However, as the maturity date approached, the company realised that its oil wells had significantly fewer reserves than previously estimated.

In response to this impending financial cliff, the company proposed a restructuring under part 26A. Under the plan, the maturity date of the bonds would be extended to December 2024, and the capital amount due would be reduced to $50m (from the original $230m). The company would issue shares to the bondholders in exchange for the haircut to the value of the bonds, with the result that the bondholders would hold 95% of the diluted equity, with the existing shareholders retaining only 5%. The company would then undertake a wind-down and liquidation of its assets. Unsurprisingly, the plan was opposed by 90% of shareholders, but approved by 100% of bondholders. To add fuel to the fire, the company's annual meeting was due to be held in June 2021 with the likely replacement of the directors by a new board (at the behest of aggrieved shareholders), who were unlikely to pursue a restructuring plan. The current board of directors, through the company, submitted this was a reason for urgency. Further, the company submitted that the relevant alternative was a near-term insolvency, and adduced a report by PwC containing a detailed analysis of the financial position of the company, and the relevant alternatives such as liquidation.

After considering condition A and its relevant substeps, Zacaroli J refused to sanction the plan. He held that there was no apparent threat of imminent liquidation under step 1, and the company could continue to trade profitably for another year. With regard to steps 2 and 3, the judge disagreed with the company, and held that there was also a realistic prospect that it would be able to meet its payment obligations to the bondholders (through potential refinancing of any shortfall in payment), while leaving assets with at least a potential for exploitation. That was enough to refute any contention that the shareholders would be no better off under the relevant alternative than under the plan. To retain 100% of the equity in a company that was continuing to trade, with a realistic prospect of being able to repay the bonds in due course and a potential share in eventual profits, was a better position than immediately giving up 95% of the equity with a prospect of a less than meaningful return as to the remaining 5%.

> **Whereas in *Virgin*, the company got it right in providing appropriate evidence (which was not challenged), in *Hurricane*, the company got it wrong and jumped the gun too early.**

Nor did the judge take a favourable view of the company's submissions on the likely change in directorship. He held that unless the company entered formal insolvency proceedings, the issue of directorship was ultimately one to be decided by the shareholders. Further, the bondholders were unsecured creditors with no right to opine upon the control of the company.

As with *Virgin*, the court will be acutely concerned with the evidence of the company's finances and the relevant alternative, where there is much scope for argument. It will pay close attention to the issues of the hypothetical impact on dissenting creditors/members inside and outside of any plan. Whereas in *Virgin*, the company got it right in providing appropriate evidence (which was not challenged), in *Hurricane*, the company got it wrong and jumped the gun too early.

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