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Supercharging the Scheme

Cram-down, cram-up and cram-across under the new UK restructuring plan

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Introduction

The introduction of the UK Corporate Insolvency and Governance bill (the **Bill**) to Parliament on 20 May 2020 is nothing less than a watershed moment for cross-border restructuring.

Within its 238 pages are sweeping changes to the insolvency and restructuring landscape, including the introduction of a new statutory restructuring plan (the **Restructuring Plan**). This is modelled on the UK scheme of arrangement and, like the scheme, is incorporated within the Companies Act 2006 rather than an insolvency statute, which has significant implications for cross-border recognition.

In this paper, we consider how the Restructuring Plan will change the way in which restructurings are structured and implemented in the UK and across Europe.

A detailed summary and Q&A analysis of the Bill is available here. It is worth highlighting that the UK government has expressly provided for changes to the Restructuring Plan to be effected through secondary legislation, particularly in relation to the cross-class cram-down process. It is therefore possible that aspects of the legislation may change.

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Cram-downs and cram-ups?

Alternative structures

The absence of a cross-class cram-down, a long established feature of the US Bankruptcy Code, is regarded as a limitation of the UK restructuring toolkit. This has led to the successful development of alternative structures, most notably the combination of a scheme and a pre-pack administration to deliver a senior creditor led restructuring notwithstanding the existence of non-consenting shareholders and/or junior creditors.

The Restructuring Plan provides for two ways of imposing a restructuring on creditors and/or shareholders without their consent.

The genuine economic interest test

The Restructuring Plan enables the compromise of the debt and equity claims of creditors and/or shareholders which the court is satisfied have no genuine economic interest in the company. The consent of these creditors or shareholders is not required and they have no right to participate in the Restructuring Plan approval process. The court has wide discretion as to the assessment of economic interest but is likely to draw on the significant line of scheme of arrangement case precedent in relation to "out of the money" creditors[1].

The new cross-class cram-down

The Restructuring Plan also enables the compromise of the debt and equity claims of classes of creditors and/or shareholders that voted against the Restructuring Plan (a "dissenting class"), provided that:

- the court is satisfied that, if the Restructuring Plan is sanctioned, no members of the dissenting class(es) would be any worse off than they would be in the event of the relevant alternative; and
- at least one class of creditors or members, which would receive a payment or have a genuine economic interest in the company in the event of the relevant alternative, has approved the Restructuring Plan.

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. Again, this gives the court wide discretion as to the benchmark against which to assess the "no worse off" test. However, we anticipate that the starting point will be the appropriate comparator test that the courts use for assessing class composition in schemes of arrangement.

Assessment of the genuine economic interest element of the second condition is likely to draw on the existing jurisprudence relating to "out of the money creditors" referred to above. It is very significant that the approval of any voting class, whether or not impaired but provided that class would receive a payment or have a genuine economic interest in the company in the event of the relevant alternative, is sufficient to engage the Restructuring Plan cross-class cram-down procedure.

[1] This line of authority stretches back to the early 20th century – e.g. see Re Tea Corp [1904] 1 Ch. 12.

The UK government's response to the 2018 consultation on Insolvency and Corporate Governance indicated that the cross-class cram-down procedure would require (i) the approval of at least one class of impaired creditors and (ii) that the claims of a dissenting class of creditors are satisfied in full before a more junior class receives a distribution under the Restructuring Plan. This formulation is similar to the "absolute priority rule" in the US Bankruptcy Code but was proposed to be subject to judicial discretion to deviate from the principle if necessary to achieve the aims of the restructuring if just and equitable in the circumstances.

Neither of these requirements have been included in the Bill. This gives the Restructuring Plan much greater flexibility but also places significant responsibility on the court to adjudicate on the fairness of the restructuring proposal as a whole in determining whether or not to exercise its discretionary power to sanction the Restructuring Plan.

The court's assessment of fairness in the context of schemes of arrangement has historically focused on prejudice to the minority within the class, where the rights of the creditors are broadly similar. Conversely, the cross-class cram-down process will involve the assessment of prejudice and fairness in relation to creditors and/or members of different classes each of which may have significantly divergent rights and entitlements.

It is possible that the courts will draw on the jurisprudence of other jurisdictions, most notably in relation to the absolute priority rule in the US Bankruptcy Code, in their development of the parameters and scope of the cross-class cram-down process. Clearly, however, the UK government intends for there to be significant flexibility and discretion in the adjudication of Restructuring Plans and we expect the courts to be commercial and pragmatic in their approach.

The imposition of a restructuring on a junior dissenting class pursuant to the Restructuring Plan is likely to lead to significantly more contested hearings and legal challenges than has historically been seen in the context of schemes of arrangement. With the ability to cram down across classes, we expect key battleground areas for dissenting creditors and shareholders will include:

- the court's determination that a class of creditors does not have a genuine economic interest and therefore is disenfranchised and has no entitlement to vote in the Restructuring Plan; and
- what is the appropriate relevant alternative and what value a creditor or shareholder would be likely to receive in the relevant alternative.

The court will increasingly be asked to consider in detail competing expert evidence from creditors and shareholders in relation to the above matters. We expect the courts will adapt to this with ease given their longstanding experience dealing with these issues in other contexts[2].

Cram-up?

We think that it will be feasible for the Restructuring Plan to implement a "cram-up" as well as a "cram-down". A cram-up is where one or more classes of junior creditors and/or members approving the Restructuring Plan imposes a restructuring on one or more dissenting senior classes of creditors, a concept that has been used in US Chapter 11 restructurings.

Provided that the court is satisfied that none of the dissenting class(es) would be worse off than in the relevant alternative and the class(es) approving the scheme would, in the relevant alternative, receive a payment or have a genuine economic interest in the company, the court will have jurisdiction to sanction the Restructuring Plan.

Depending on the formulation of the "no worse off" test, this could enable a wide range of restructuring options including:

- a reinstatement of super senior debt on its original terms with the waiver of all events of default, together with a wider balance sheet restructuring implemented "around" that debt; or
- an extension of the contractual maturity date of the super senior debt, with an increase in pricing based on the company's assessment of the present value of the future cashflows beyond the original contractual maturity.

[2] See for example, IMO Car Wash case (In the matter of Bluebrook Ltd and others [2009] EWHC 2114 (Ch))

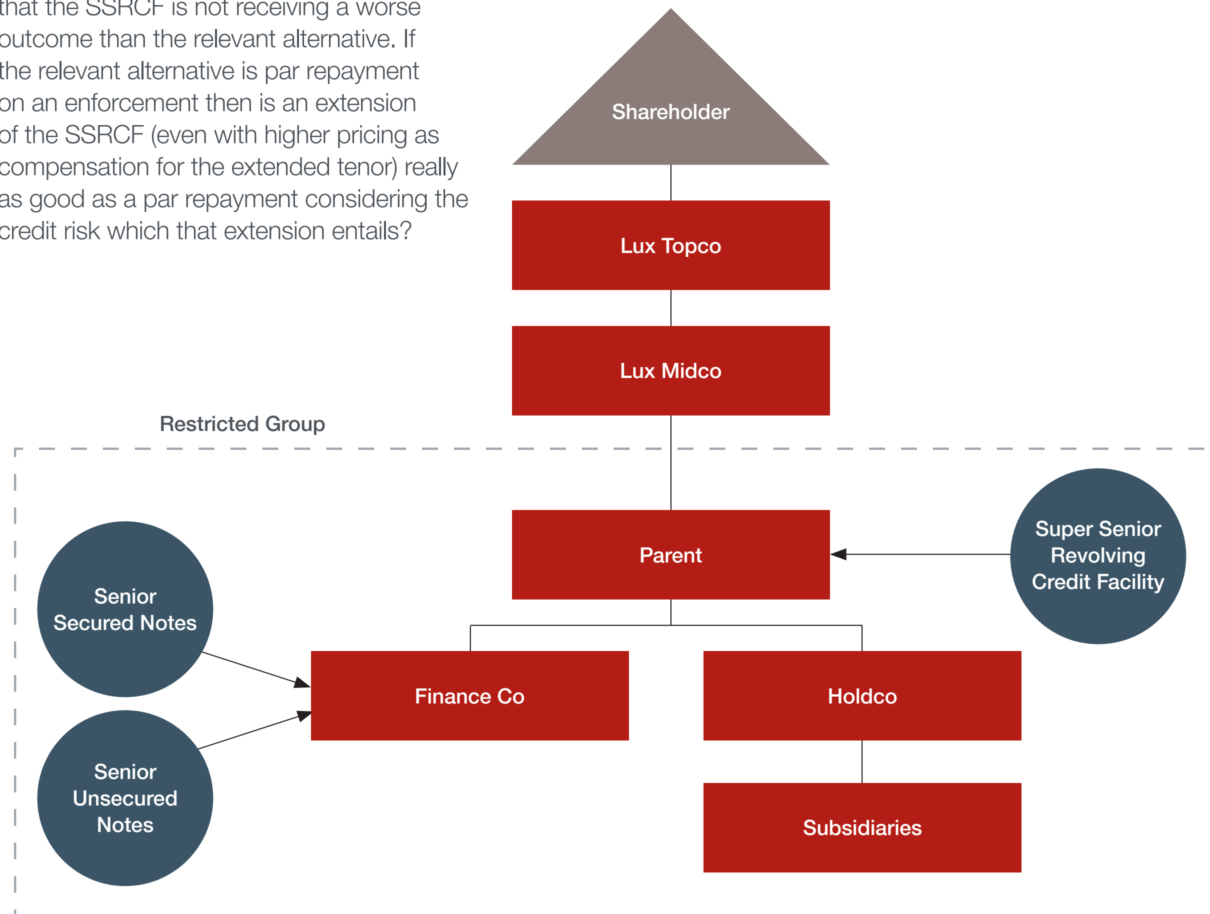
As the Restructuring Plan is modelled on the scheme, we anticipate that the courts will apply and be guided by scheme principles and case precedents. It may therefore be challenging to compel super senior creditors (for example, under a super senior revolving credit facility (**SSRCF**)) to continue to make available undrawn commitments on the basis that those commitments would be contractually drawstopped in the relevant alternative or based on the principle that a scheme cannot impose new obligations on creditors. However, it can be argued persuasively that this is merely a reinstatement of undrawn commitments that were in existence prior to the Restructuring Plan, rather than the creation of new obligations[3].

Cram-up restructurings may be particularly significant in high yield bond transactions involving a SSRCF and one or more issuances of senior secured and/or senior unsecured bonds, where security enforcement is, subject to certain exceptions, typically controlled by the bondholders.

As illustrated below, if all relevant liabilities which are subject to the Restructuring Plan are incurred by a single company or alternatively can be assumed by that company[4], it would be possible to implement a single Restructuring Plan which restructures the SSRCF, bonds and the equity with the approval of only a single class. This would deliver a full balance sheet restructuring and reinstate and/or extend the SSRCF, which, in the context of a restructuring implemented through a pre-pack administration or security enforcement under the intercreditor agreement, might be entitled to a cash-out at par absent its consent.

It will of course be essential to demonstrate that the SSRCF is not receiving a worse outcome than the relevant alternative. If the relevant alternative is par repayment on an enforcement then is an extension of the SSRCF (even with higher pricing as compensation for the extended tenor) really as good as a par repayment considering the credit risk which that extension entails?

This feature provides significant flexibility for junior creditor-led or even equity-led restructurings. As is the case with schemes of arrangement, a Restructuring Plan can be proposed not only by the company but also by any of its creditors or shareholders. However, we expect that the practical difficulties that have limited the feasibility of creditor and shareholder proposed schemes will also apply to the Restructuring Plan.



[3] See Re Apcoa Parking Holdings GmbH [2014] EWHC 3849 (Ch)

[4] For example by the company becoming a co-issuer of the group's bonds in accordance with the terms of the indentures.

Restructuring Equity – The Restructuring Plan and Pre-pack Administrations

Pre-pack administrations and dissenting creditors and shareholders

Pre-pack administrations have become a key restructuring tool to deal with dissenting "out of the money" junior creditors and shareholders. The administrators of a holding company sell its subsidiaries to a newco, often owned and funded by the senior creditors, for nominal consideration (on the basis of valuation evidence and potentially some form of market testing). The claims of "out of the money" junior creditors are released or sold by the security trustee pursuant to the distressed disposal provisions of the intercreditor agreement.

The Restructuring Plan enables a restructuring of both "out of the money" debt and equity to be implemented within the existing corporate structure without the need for a sale of the business and/ or subsidiaries through a pre-pack administration. The Restructuring Plan would be imposed on the relevant creditors and/or shareholders:

- without their having a right to vote in relation to the Restructuring Plan provided that the court is satisfied that none of those creditors and/or shareholders has a genuine economic interest in the company; or
- pursuant to the cross-class cram-down procedure described above.

On the basis of the framing of the Bill, we think it is very likely that the courts will apply scheme principles and authorities to the Restructuring Plan. Accordingly, the longstanding principle that a compromise or arrangement must involve some element of reciprocal accommodation and cannot simply consist of an expropriation of rights (such as solely a cancellation of shares)[5] is likely to apply to Restructuring Plans. In practice, this may be relatively straightforward to satisfy by delivery to shareholders of a deeply "out of the money" contingent value instrument or even by paying a nominal amount of consideration, the adequacy of which is supported by valuation evidence.

Pre-pack administrations have also been regularly used in the context of restructurings of companies with publicly listed equity. The Bill amends and/or disapplies elements of various statutes in order to facilitate the restructuring of both listed and unlisted companies, such as the disapplication of pre-emption rights under the Companies Act 2006, although the interaction of the Restructuring Plan and the additional rules and regulations applicable to listed companies will need to be navigated carefully.

Cross-border implications

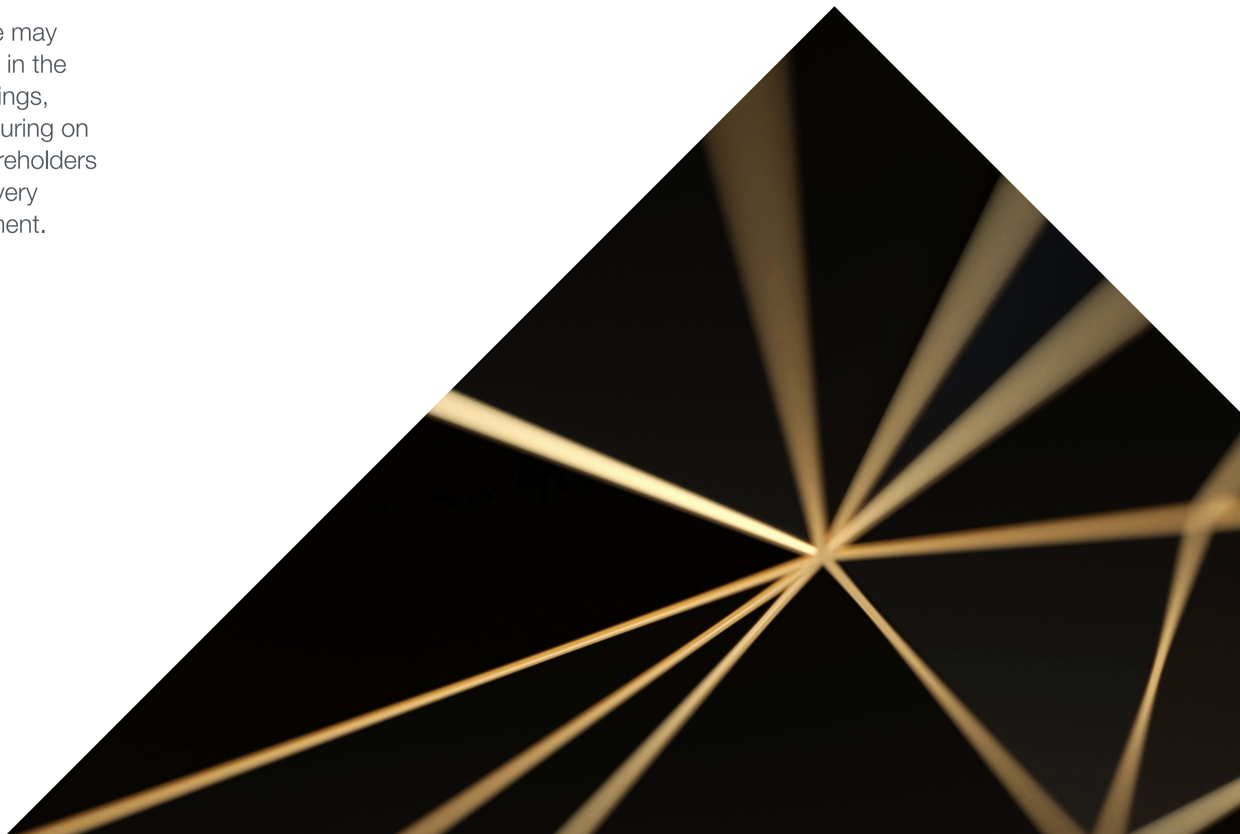
Schemes of arrangement are frequently used to restructure the indebtedness of foreign companies. This is achieved either on the basis of the relevant company having a sufficient connection to the jurisdiction or following a relocation of the company's CoMI to the UK, particularly in the context of restructurings of New York law governed bonds where recognition of the scheme under Chapter 15 of the US Bankruptcy Code is desirable.

[5] Re NFU Development Trust [1972] 1 WLR 1548

The status of the Restructuring Plan as a compromise or arrangement under a company law statute has significant implications for cross-border recognition, particularly in the context of Brexit. As discussed in our bulletin here, we anticipate that a scheme of arrangement (and by analogy a Restructuring Plan) that compromises English law debt will be widely recognised in other jurisdictions following the Brexit transition period. This recognition is likely to be based either on private international law or other cross-border frameworks. The requirement for the company subject to the Restructuring Plan to have encountered, or be likely to encounter, financial difficulties may increase the prospects of recognition by jurisdictions that have implemented the UNCITRAL Model law on Cross-Border Insolvency. However, the cross-class cram-down process may apply some degree of pressure to the above analysis, depending on the jurisdiction.

The position in relation to equity restructurings of companies incorporated outside of the UK but subject to a Restructuring Plan is significantly more complicated. The key issue is whether the jurisdiction of incorporation of the company whose equity is being restructured will recognise and give effect to the terms of the Restructuring Plan. This is clearly critical in terms of the effectiveness of the restructuring itself and will also be an important factor in the court's determination as to whether to exercise its discretion to sanction the Restructuring Plan, in accordance with the established principle that the court will not make an order which would be ineffective.

Pre-pack administrations therefore may still have a role to play, particularly in the context of cross-border restructurings, but the ability to impose a restructuring on dissenting "out of the money" shareholders under the Restructuring Plan is a very significant and welcome development.



The Future of the CVA

The CVA

The use of company voluntary arrangements (**CVAs**) has increased substantially in recent years, principally in the context of the restructurings of UK companies with significant real estate lease liabilities.

In addition, the designation of the CVA as a Main Proceeding for the purposes of the EU Regulation on Insolvency Proceedings (**EIR**)[6] has enabled its use in cross-border restructurings, most notably in the restructuring of the Steinhoff group.

Landlord CVAs

The use of the CVA by retail businesses to restructure their lease obligations, while leaving liabilities owed to their other creditors largely unaffected, has been the subject of controversy and challenge in the courts. The Debenhams case[7] provided clarity on a number of areas of uncertainty, including the ability of a CVA to compromise future rent claims, the treatment of a landlord's right of forfeiture and the fairness of differential treatment between landlords and other creditors.

However, the CVA process has a number of structural features which may be considered less flexible and attractive than the Restructuring Plan including:

- the lack of involvement of the court in the CVA process creates significant uncertainty as to the finality of the restructuring process and consequential risk of challenge;
- the approval threshold for the Restructuring Plan is 75% with no numerosity component, unlike a scheme, and no unconnected creditor approval threshold requirement, unlike a CVA;
- although creditors in a Restructuring Plan are required to vote in classes and therefore the cross-class cram-down procedure does not benefit from the dilutive effect of the vote across all unsecured creditors that is a feature of the CVA, the cross-class cram-down procedure does allow a restructuring to be imposed on a dissenting class of creditors; and
- unlike a CVA, the Restructuring Plan can compromise the claims of both secured and unsecured creditors.

Differential treatment of the claims of landlords in relation to other creditors with similar rights is almost certain to result in the landlords constituting a separate class. However, cross-class cram-down permits the Restructuring Plan to be imposed on a dissenting class, provided that the conditions outlined above are satisfied. Accordingly, the court must be satisfied that none of the landlords constituting that class would be any worse off than they would be in the event of the relevant alternative and, in order to exercise its discretion to sanction the Restructuring Plan, that the restructuring is fair.

Our view is that, in practice, the "no worse off" test is likely to be substantially similar to the CVA "vertical comparator" test. Furthermore, when determining whether it should exercise its discretion to sanction the Restructuring Plan, the court will consider, among other matters, the relative fairness of the effect of the Restructuring Plan on any dissenting class of creditor by reference to the other classes, which will include considerations substantially similar to the CVA "horizontal comparator" test.

[6] Regulation (EU) No 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (recast)

[7] Discovery (Northampton) Ltd v Debenhams Retail Ltd [2019] EWHC 2303 (Ch) – currently subject to appeal

The CVA may therefore continue to have a role in the future but the ability of the Restructuring Plan to implement a restructuring of different categories of liabilities that would otherwise require separate processes as part of a full balance sheet restructuring solution is a welcome addition to the restructuring toolkit and creates substantial optionality for companies in financial distress.

Cross-border restructurings

As noted above, CVAs have been used successfully in certain cross-border restructurings. The designation of the CVA as a Main Proceeding for the purposes of the EIR ensures automatic recognition of the CVA in each EU Member State and therefore permits the compromise of non-English law governed debt subject to the exclusive jurisdiction of the courts of another EU Member State. It is generally considered that any such debt could not currently be compromised pursuant to a scheme due to Article 25 of the EU Judgments Regulation[8].

However, unless the UK and the remaining EU Member States agree to a reciprocal arrangement which largely replicates the effects of the EIR, the utility of the CVA in European cross-border restructurings following Brexit is likely to be limited.

[8] Regulation (EU) No 1215/2012 of the European Parliament and of the Council of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters (recast)

Conclusions

Our expectation is that the Restructuring Plan will very quickly become the restructuring implementation tool of choice in cross-border restructurings.

The Restructuring Plan incorporates the many benefits of the scheme with considerable additional flexibility. The use of the scheme of arrangement as the basis for the Restructuring Plan enables the courts to draw on the extensive jurisprudence relating to schemes of arrangement which has developed for over a century. We expect a significant body of case precedent to develop quickly which will provide greater certainty as to the parameters and scope of the Restructuring Plan, particularly the cross-class cram-down process.

The UK government decided not to include in the Bill specific mechanisms to enable rescue financing similar to US Chapter 11 DIP financing, which may be the subject of a future consultation. However, based on scheme precedents, our view is that the Restructuring Plan is sufficiently flexible to enable new money financing to be raised through the Restructuring Plan itself. Subject to satisfying the terms of the cross-class cram-down process and depending on the rights of the creditors under the existing finance documents, this new financing could be structured on a super senior basis and with rights to participate allocated to certain classes of creditors only.

The application of the Restructuring Plan will of course be refined over time but we anticipate that valuations will play an absolutely central role, particularly in the context of the current COVID-19 crisis where the challenge of valuing assets has never been in greater focus.

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