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Schemes of Arrangement

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Schemes of arrangement

As schemes of arrangement continue to hit the headlines, recent examples highlight their parameters and deliver a clear message to mezzanine creditors with no economic interest. Patricia Godfrey explains.

The autumn 2009 Legal update in RECOVERY focused on some of the notable changes in the way debt restructurings are being carried out. It highlighted, in particular, some of the innovative uses of tried and tested restructuring tools such as debt for equity swaps and the use of Companies Act schemes of arrangement (schemes). In demonstrating the way in which schemes could be imposed upon dissenting creditors, two high-profile cases were cited: McCarthy & Stone plc and Crest Nicholson plc. Subsequent developments in this area have reinforced the growing popularity of schemes and how progress cannot be hampered by parties with no economic interest in the situation.

Recent developments that reinforce the ground rules

The decisions in Bluebrook Limited & Others (otherwise known as IMO Carwash) and Countrywide PLC, both concerned proposals for schemes to restructure the debts of corporate groups facing financial difficulty. In both instances, the High Court approved the use of schemes to implement the restructuring of the corporate group’s debt. IMO Carwash demonstrates that a creditor with no genuine economic interest in the distressed company has no standing to challenge the scheme. In ascertaining whether a creditor has a genuine economic interest, the valuation of the assets of the distressed company should be based on its present market value tested on a ‘going concern’ basis. Furthermore, the court will not readily reject a scheme approved by the majority of participants where the scheme has complied with the relevant rules and regulations.

IMO – problems at the car wash

In IMO Carwash, the court was being asked to sanction three schemes in relation to the restructuring of Bluebrook Limited and its subsidiaries, IMO (UK) Limited and Spirecove Limited (the companies) who collectively operate the world’s largest carwash business.

Bluebrook Limited was £313 million in debt to a consortium of senior lenders. One of the subsidiaries, Spirecove Limited, was £119 million in debt to a group of mezzanine lenders. Interest due to both the senior and mezzanine lenders had not been paid and the boards of all three companies were concerned that the companies could not pay their debts as they fell due. Various subordination arrangements in relation to debt and security were set out in the relevant intercreditor agreement. Under the documents, the mezzanine lenders were firmly subordinated to the senior lenders. The effect of the proposed scheme involved the senior lenders writing off approximately £126 million out of the total of £313 million due to them in exchange for substantially all of the equity in a newly formed vehicle to which the assets of the companies were to be transferred. The transfer of assets to the companies was to be done by an administrator. The mezzanine lenders would not receive any repayment of the debt due to them and would be left with claims against the old companies with no assets. This was justified on the basis that the mezzanine lenders had no economic interest in the companies because the value of the companies’ assets was significantly less than the value of the senior debt.

Under the terms of the intercreditor agreement the mezzanine lenders were given an important right. In the event they were not content with enforcement actions, they could compel a sale to themselves of the directors had not breached their duties.

The case is important given the ongoing use and popularity of schemes. In considering the jurisdiction of the court to sanction a scheme against a dissenting class of stakeholders, IMO Carwash focused on two particular issues:

1. The appropriate method of valuation of the companies

The companies and the mezzanine lenders based their valuations on different methodologies and it was for the court to decide which was the most appropriate. The companies based their own valuation on three separate valuation methodologies.

The first was a report commissioned by PricewaterhouseCoopers. The report valued the companies on a going concern basis based upon:

- an income approach, which valued the companies on a discounted cash flow (DCF) basis;
- a market approach by way of comparison with multiples for other (publicly traded) companies; and
- a leveraged buyout basis, which looked at the debt capacity to assess the level of equity investment a potential private equity purchaser would be prepared to make.

The report concluded that a purchaser would pay a sum not exceeding £265 million for the business.

The second valuation method involved a market testing exercise by Rothschild that produced one indicative offer of between £150–£168 million on a cash- and debt-free basis.

The third valuation involved instructing King Sturge LLP to value a number of the companies’ sites. This provided a range of values between £164–£208 million on a full market-value basis. All three methodologies generated values that were well short of the senior debt figure (£313 million).

Clearly unhappy with the outcome the proposed scheme would produce, the
mezzanine lenders relied on an alternative report by LEK Consulting. It carried out a DCF analysis and came to the conclusion that 'The IMO Car Wash business is extremely sound and profitable.'

The report undertook a 'Monte Carlo simulation', which involved a repeated valuation of a discounted cash flow valuation, using random sampling of input and assumptions and then aggregating the results into a distribution of the probabilities of different valuation outcomes.

The LEK report also carried out a comparable transaction valuation using five precedent transactions as a basis for valuation, and a comparable multiples valuation using nine comparable public companies from which data were extracted and applied to figures for the companies. This analysis resulted in a valuation of the companies in excess of the value of the senior debt.

2. Had the directors breached their duties by promoting a scheme that excluded the mezzanine lenders?

As part of their challenge, the mezzanine lenders claimed that the directors of the companies were obliged to extract a benefit for the creditors of the companies. It was further claimed that actions other than the scheme were not explored and that they should have used their negotiating position to ensure some benefit for the mezzanine lenders.

IMO – Mr Justice Mann's analysis and findings

On the two key issues Mr Justice Mann found as follows:

The appropriate method of valuation

It was held that a going concern valuation was the most appropriate method. In reaching this conclusion, Mr Justice Mann stated that the evidence relied upon by the mezzanine lenders was insufficient to justify their valuation. Furthermore, he was very critical of the mezzanine lenders' Monte Carlo valuation technique, which 'seems not to much to produce a range of values, professionally assessed, but a range of possibilities'. He went on to state that a proper approach to valuation in a case such as this requires some real world judgment as to what is likely to happen '…rather than a range to which other ranges are applied in a series of random calculations to come up with some mechanistic probability calculation.' In short, he concluded that the mezzanine evidence was unconvincing and not good enough to establish their case.

Mr Justice Mann found the approach used by the companies more helpful and relevant. In particular, their approach used assumptions based on professional and expert judgments, including a factor for the current level of market inactivity. He contrasted this to the more 'robotic' mezzanine approach.

On the question of valuation, therefore, the court concluded that the Monte Carlo model failed to demonstrate that there was a realistic chance that the value of the companies was in excess of the value of the senior debt.

Did the directors breach their duty?

The court noted that under the Companies Act 2006 and the Insolvency Act 1986, where a company was insolvent the duties of directors switched from acting in the best interests of the shareholders of the company to acting in the best interests of the creditors of the company.

In recent months, notable examples have reaffirmed the use of schemes as a highly effective restructuring tool, building on the success achieved in McCarthy & Stone plc and Crest Nicholson plc.

In this instance, the directors of the companies had initially engaged in restructuring discussions with both the senior and mezzanine lenders. When these discussions failed the directors agreed the scheme with the senior lenders as they deemed them to be the only parties with an economic interest in the companies.

The court held that the directors did not have to uphold the rights of the mezzanine lenders in circumstances where the valuations showed that they had no economic interest. Furthermore, it was unrealistic to expect the directors to threaten to continue trading as a means of ensuring a better deal for the mezzanine lenders and, in so doing, risk personal liability for wrongful trading. In reviewing their conduct, Mr Justice Mann held that the directors were not promoting the continuation of the group business as a going concern in the interest of the senior lender and at the expense of the mezzanine lenders.

In reaching his conclusion, Mr Justice Mann confirmed the following key principles:

- A company is free to select the creditors with whom it wishes to enter into a scheme and need not include creditors whose rights are not altered by the scheme.

- It is not necessary for a company to consult with any class of creditor that is not affected, either because the creditor’s rights are untouched or because they have no economic interest in the scheme.

- Creditors could still object on the grounds of unfairness if the scheme unfairly affected them in ways other than altering their strict legal rights.

Countrywide Properties plc

Although a number of the well publicised schemes involving debt for equity swaps have been proposed by the debtor, in this case a group of lenders proposed a scheme to implement a debt for equity swap. Countrywide operates an estate agency and property service business. Acquired in 2007, it was funded by debt, including the issue of loan notes, secured over the assets of the group. The particular impact of the credit crunch and the recession on this sector called into question the ability of Countrywide to service its loan notes. The holders of the loan notes proposed a scheme with two classes of creditors: (i) the holders of loan notes with a floating rate of return; and (ii) holders of loan notes with a fixed rate of return. Under the

Schemes of arrangement – where now?

In recent months, notable examples have reaffirmed the use of schemes as a highly effective restructuring tool, building on the success achieved in McCarthy & Stone plc and Crest Nicholson plc. In terms of conclusions to be drawn, the following are suggested.

- Valuation: IMO Carwash is the first decision in which the court has applied detailed consideration to the issue of valuation. Although the question of valuation was relevant between the creditors on My Travel, the issue remained unresolved. Unlike in the case of McCarthy & Stone plc where there was no argument over valuation, Mr Justice Mann was required to apply detailed analysis in light of the different arguments put forward by both sides. The decision clarified valuation by
reference to 'going concern' based on the company's current value rather than some future, imprecise valuation method. By determining that the valuation should be on a going concern basis, as opposed to a lower liquidation or break-up basis, the decision may assist junior creditors in future restructurings where the gulf is not so significant as in IMO Carwash.

- 'Out of the money' creditors: IMO Carwash confirms that only those creditors with a genuine economic interest in the distressed company need to be taken into account when seeking to effect a restructuring through a scheme. A break in value in the senior debt leading to the exclusion of the mezzanine lenders really does no more than apply what was intended by typical subordination provisions contained in loan and intercreditor documentation.

- Disincentive to junior creditor to litigate? Where an administration is involved, it is always possible for creditors to challenge the administrator if it can be established he or she has failed to achieve the best price reasonably obtainable in selling the business. Where a scheme is involved, an additional opportunity to challenge is afforded where a category of creditor can establish that the proposed scheme is unfair to them. IMO Carwash demonstrates: (i) the importance of appropriate valuation evidence and; (ii) where that evidence shows the value clearly breaks at senior debt level, junior creditors with no economic interest will not be able to thwart the proposed scheme. The result should serve as a significant blow to junior creditors using the threat of litigation to negotiate a better position on a restructuring, which involves a scheme.

- Schemes and pre-packs: The IMO Carwash decision reaffirms how traditional Companies Act schemes can be used effectively with Insolvency Act administration and the pre-pack technique to preserve value and effect the best overall outcome for creditors.

- Directors duties: For future schemes, IMO Carwash has clarified that directors have no duty to protect any hypothetical interest of out of the money creditors. Instead, they should focus on those with an economic interest and not be hampered by those who do not.

- Junior creditors - a lost cause? Not necessarily, ongoing points to consider include: Is there an option to buy out which a junior creditor is legally and financially able to exercise? IMO Carwash was fact specific, other cases may also allow room for manoeuvre around the going concern definition. A junior creditor may also be able to demonstrate a more credible valuation exercise as opposed to the more hastily put together exercise presented by the junior lenders in IMO Carwash.

- Distressed European groups seeking to migrate and use a scheme to restructure: Where ordinarily there is no sufficient connection with the UK, we may see further attempts to migrate COMI and effect a restructuring through a scheme. Some commentators are already speculating about such moves for European groups currently facing financial difficulties. Any shift in COMI will require careful consideration, not least because of the inherent complexities and absence of automatic recognition without a contemporaneous insolvency process.

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