

KEY POINTS

- Insolvency procedures under the Insolvency Act 1986 do not provide a mechanism to cram down the claims of secured creditors and the Companies Act 2006 scheme of arrangement procedure cannot be used by senior creditors and debtors to cram-down secured subordinated creditors (and shareholders) unless a transfer scheme is implemented and effective releases of guarantor claims can be obtained under the intercreditor agreement (where one exists).
- The author argues for a single Insolvency Act 1986 procedure providing a workable mechanism with clear valuation rules for senior and junior classes alike.
- The US Bankruptcy Code's treatment of cross-class cram-down and valuation is a useful starting point for any reform.

Author Geoff O'Dea

Craving a cram-down: why English insolvency law needs reforming

English insolvency law deals well with simple financing structures and provides relatively clear and consistent implementation pathways in that context. However, as the complexity of capital structures increases, such as those seen in leveraged buy-out ('LBO') structures, it is clear that English insolvency law is inadequate and does not provide clear and consistent implementation pathways. The European High Yield Association has identified several major areas it considers to be in need of reform and the debate amongst stakeholders continues, following the launch of the recent consultation on insolvency reform.

HYPOTHETICAL STRUCTURE

The structure set out overleaf is common in the LBO market. The ultimate parent (the 'Parent') and two intermediate holding companies are incorporated in England¹ and it is assumed that its centre of main interests for the purposes of Council Regulation (EC) No 1346/2000 of 29 May 2002 on Insolvency Proceedings ('The European Insolvency Regulation') is in England. As an aside, if the company had its COMI in another European member state and likewise no English establishment, a further issue potentially arising would be whether the English courts would have jurisdiction to sanction the scheme.² Alternatively, to work round this potential issue, consideration might be given to moving the centre of main interests of the relevant company(ies) to the UK to establish jurisdiction in England. This was done in the British Vita (a Luxembourg company) scheme of arrangement and the Schefenacker (a German AG which 'transformed' for the purposes of German law into an English public limited company) in the context of a company voluntary arrangement ('CVA').

This article considers the recent use of schemes of arrangement under Pt 26 of the Companies Act 2006 ('CA 2006') to implement restructuring proposals in respect of LBO structures. Particular focus is given to the absence of an adequate statutory cram-down mechanism under English law and the *ad hoc* approach to valuation taken by English courts which has resulted from CA 2006 and the Insolvency Act 1986 ('Insolvency Act') not directly dealing with these issues.

The immediate subsidiary ('Holdco 1') of the Parent is the original borrower under a £200m mezzanine credit agreement. The immediate subsidiary ('Holdco 2') of that company is the original borrower under a £100m second lien facility and a £600m first lien facility provided under a senior credit agreement. The first lien facility is divided into a £100m super priority revolving credit facility and several tranches of term debt. All of the facilities are cash pay, the mezzanine debt has a bullet maturity and the senior term debt includes amortising and bullet facilities.

All of the facilities share the same guarantee (the guarantee in the Loan Market Association standard form is a guarantee and indemnity) and security package and have a common security agent. The mezzanine credit agreement and senior credit agreement were arranged in London, based on the Loan Market Association's leveraged finance standard form and are each governed by English law. The rights of the finance parties under the mezzanine credit agreement and the finance parties under the senior credit agreement are regulated by an intercreditor agreement, which is also governed by English law.

At closing, the Target will be the immediate subsidiary of Holdco 2. The Target is incorporated in England and Wales and has subsidiaries throughout Europe, Asia and the US (the Parent and its subsidiaries being the 'Group').

After closing, the lenders under the senior credit agreement and the mezzanine credit agreement agree to a debt-push-down under

which some of the senior term debt and the mezzanine debts of Holdco 1 and Holdco 2 are transferred by novation to and assumed by certain operating company subsidiaries. The commercial rationale for the debt-push-down is to allow those (profitable) subsidiaries to claim tax deductions for the interest payable under the senior term and mezzanine debt.

The intercreditor agreement ranks the senior and mezzanine debt, guarantees and security in the following order:

- first, revolving credit facility debt;
- secondly, the senior term debt, *pari passu* and rateably amongst the senior term debt lenders;
- thirdly, the second lien debt; and
- fourthly, the mezzanine debt.³

FAILURE TO MEET BUSINESS PLAN AND INITIAL RESTRUCTURING STEPS

The Group's performance is significantly below that forecast in its business plan. Accordingly, it is unable to meet a looming amortisation payment on the senior term debt and cannot afford to pay the interest on its mezzanine debt. The Group is cash flow positive at the operating level (ie sales minus the cost of goods sold). There is a business worth saving, however, the initial business plan (on which the leverage at closing was based) was far too optimistic and the Group has no chance of ever being able to repay all of its senior and mezzanine debt.

An event of default has occurred under the senior credit agreement and the mezzanine credit agreement. The lenders agree to suspend their rights to accelerate their debt and to

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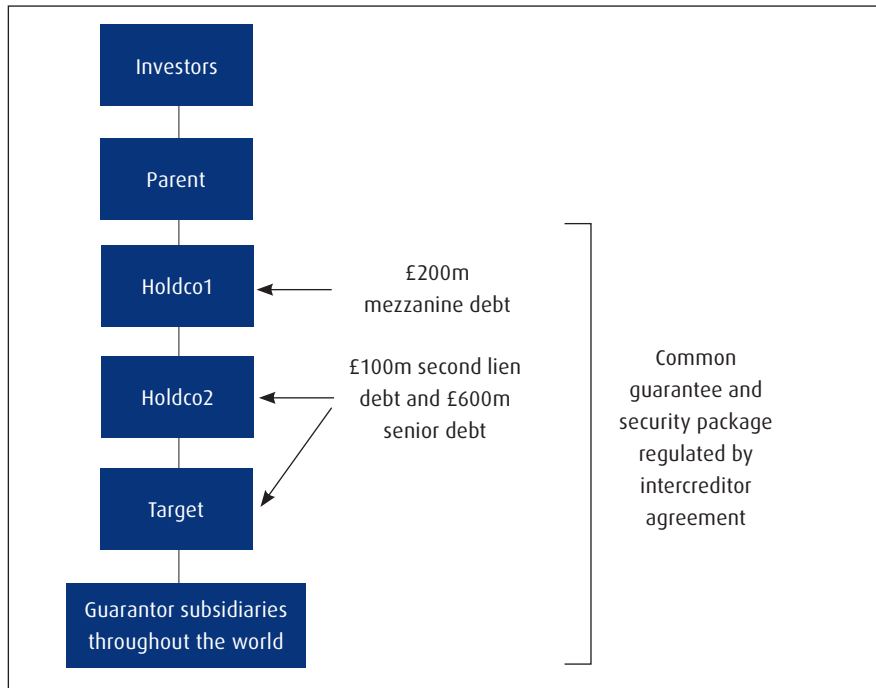
enforce their security while a financial adviser conducts an independent business review and a valuation of the business. The valuation will be used to determine which lenders have a stake in the reorganised Group and their proportionate shares of any consideration which is offered in return for their agreement to the reorganisation proposal ('reorganisation consideration'). A debt capacity valuation shows that the Group is only currently able to support £400m of financial indebtedness, but that this may increase if the economy improves and the Group meets some of the targets in its revised business plan.

Reorganisation consideration is usually a combination of new debt instruments, primary equity and the right to receive equity at a future date if certain thresholds are met (warrants or options). Debt instruments rarely trade above par (although if the debt instruments are stapled to equity instruments the debt may trade above par). However, if the Group performs well in the future it is possible that the equity instruments allocated to the lenders could exceed the par value of their original claims against the Company. Returns would obviously be further enhanced if a lender had acquired the debt in the secondary market at a discount to par.

The methodology by which reorganisation consideration is allocated amongst the lenders will have regard to their relative priority. For example, provided there are clear implementation pathways, if the valuation is less than or equal to the revolving credit facility debt, the lenders under that facility would logically be allocated all of the reorganisation consideration and so on down the waterfall in the intercreditor agreement shown above. Otherwise, there would be no economic incentive for the revolving credit facility lenders to agree to a transaction which saved the Group from insolvency but resulted in their economic return being diminished. Accordingly, lenders with higher priority will usually adopt a conservative valuation because it will give them a greater share of the reorganisation consideration and the possibility of recovering more than 100 pence in the pound of their debt claims against the Group, should the Group perform well and its equity value increase.

Conversely, lenders with lower priority, such as the mezzanine debt, will adopt a more

Structure at closing



liberal valuation in the hope that it exceeds the total senior debt, thus allowing them to be allocated a share of the reorganisation consideration. In order to increase the value of their potential hold-out claims, subordinated creditors will also wish to find as many holes as possible in the implementation pathways.

CRAM-DOWN AND VALUATION UNDER ENGLISH LAW

Cram-down

The only statutory composition procedure available under English law which is capable of binding secured creditors, including an opposing statutory minority, is a scheme of arrangement under Pt 26 of CA 2006. Section 899(1) of CA 2006 provides that:

'If a majority in number representing 75 per cent in value of the creditors or class of creditors or members or class of members (as the case may be), present and voting either in person or by proxy at the meeting summoned under s 896, agree a compromise or arrangement, the court may, on an application under this section, sanction the compromise or arrangement.'

In addition to satisfying certain procedural steps, the key elements of a scheme of arrangement are:

- its terms must include a compromise or arrangement. It is clear that a scheme of arrangement which effects a debt-to-equity swap in order to reduce the indebtedness of the relevant company will be both a compromise and an arrangement (see *Re Norfolk Island and Byron Bay Whaling Company* (1969) 90 WN (Part 1) (NSW) 351 at 354; *Re NFU Development Trust Ltd* [1973] 1 All ER 135 at 140; North J in *Re Alabama, New Orleans, Texas and Pacific Junction Railway Co* [1891] 1 Ch 213 and In *Re Guardian Assurance Company* [1917] 1 Ch 431 and as is further illustrated by the recent sanctioning of schemes in respect of Countrywide, Crest Nichols, McCarthy and Stone, IMO, Polestar and British Vita which dealt with secured debt);
- that it is approved by at least:
 - a majority of creditors in number within the relevant class of creditors;
 - 75 per cent in value of the creditors within the relevant class; and
- that the court exercises its discretion to sanction the scheme.

Classes

The relevant class(es) of creditor must approve the scheme. The test for determining the number of classes is that a class must be confined to persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest; not upon the similarity or dissimilarity of their private interests arising from matters extraneous to such rights (see *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin & Ors* [2001] HKEC 1440 at para 17 and see *Sovereign Life Assurance Co v Dodd* [1892] 2 QB 573, 583).

In the context of an LBO scheme of arrangement, the relevant classes will usually follow the ranking provisions in the intercreditor agreement. Following our example and absent a transfer scheme, the likely relevant classes whose consent would be needed to approve the scheme of arrangement are: first, the lenders under the revolving credit facility; secondly, the lenders under the senior term facilities; thirdly, the lenders under the second lien facility; and fourthly, the lenders under the mezzanine facility.

The English courts have tended to be relatively pragmatic regarding class issues and have appreciated that drawing fine distinctions between rights, and therefore increasing the number of relevant classes, is in no one's interest. Notwithstanding this pragmatism, various factors may be relevant in determining whether more classes are needed (see *Re Jax Marine Pty Ltd* [1967] 1 NSW 145 at 148-9; *In Re Landmark Corporation Ltd* [1968] 1 NSW 759 at 766; *UDL Argos Engineering & Heavy Industries Co Ltd v Li Oi Lin & Ors* [2001] HKEC 1440 at para 26; and *Re English, Scottish & Australian Chartered Bank* [1893] 3 Ch 385 at 409). In the context of an LBO there may be potential for a sponsor who owns shares as well as various tranches of debt to constitute a separate class. Further, an arbitrary choice of the record date, where the applicable loans are denominated in different currencies, may complicate class issues (notwithstanding the decision of David Richards J in *Re Telewest Communications plc Re Telewest Finance (Jersey) Ltd* [2004] EWHC 1466 (Ch)).⁴

Cram-down

Unless a scheme of arrangement is combined with a security enforcement, an administration sale (see the *Crest Nichols, McCarthy and Stone, IMO* and *British Vita* schemes of arrangement) or a sale by the directors (as threatened by the directors in the aborted *MyTravel* scheme of arrangement), it may only be used to cram-down the minority within each class.

Where, as in the above example, the second lien debt and the mezzanine debt have the benefit of security and guarantees from a number of members of the Group these rights can only be released pursuant to the release clause in the intercreditor agreement (discussed below) (or with their consent in separate class votes). This also means that the economic interest doctrine (see *Re Tea Corporation* [1904] 1 Ch 12, the first instance decision in *MyTravel* [2004] EWHC 2741 (Ch) and *Vinelott J In re British & Commonwealth plc* (No 3) [1992] 672 and *Re Maxwell Communications plc* [1993] 1 WLR 1402) which provides that the court may sanction a scheme of arrangement which is passed without the consent of creditors who would receive nothing in a liquidation (and thus have no economic interest) could not apply, because the guarantees and security given by the guarantors could not be released in that circumstance ie in the absence of full creditor consent or separate class vote. The release conditions in the intercreditor agreement usually provide for an enforcement sale by the security agent or by the directors or an insolvency official at the request of the security agent.

Where then does this leave the Group in trying to effect a restructuring which leads to only £400m of financial indebtedness on its consolidated balance sheet? As the second lien and mezzanine debt would form separate classes for the approval of the schemes, the debtors have three major options.

First, the Group could support the lenders under the revolving credit facility and the senior term facilities in implementing a pre-packaged enforcement or insolvency sale to a bid vehicle owned by those lenders or a trade buyer who is prepared to bid at least the senior debt, on the basis that a quick sale would do the least damage to the business. In our example, the cheapest and simplest route would be to

enforce the share mortgage given by Holdco 2 over its shares in Target by selling those shares to a bid vehicle owned by the senior lenders. This would be combined with a release of the debt, guarantee and security claims of the second lien and mezzanine lenders pursuant to the release clause in the intercreditor agreement (discussed below). However, if not all of the lenders under those senior facilities agree to write down their debt, provide any cash, bid for their own debt or agree to the novation of their debt to a bid vehicle⁵ in order to fund the purchase by the bid vehicle of the assets of Holdco2 out of an enforcement sale, such a strategy is likely to be untenable in practice.

Secondly, the debtors could propose schemes which require the consent of at least 75 per cent by value and a majority in number of the revolving credit facility debt, the senior term debt, the second lien debt and mezzanine debt as four separate voting classes. This structure has several benefits and one major draw-back for senior lenders. The benefits include that the existing corporate group is kept intact (which eliminates tax and change of control issues), there is no need to enforce any security nor to place any scheme company into an insolvency process and the terms of the release clause in the intercreditor agreement would not need to be tested. The major drawback for the senior lenders is, of course, that the consent of the subordinated lenders needs to be paid for.

Thirdly, if valuation and market testing evidence showed that the second lien and mezzanine lenders would not receive any distributions from a sale of the group, a scheme of arrangement could be proposed which required the consent of at least 75 per cent by value and a majority in number of the revolving credit facility debt and senior term debt only. Valuation and market testing evidence would be relevant at two stages. First, at the scheme sanction hearing. Secondly, when the administrator decides to sell the assets of the company to Newco, each described below, in order to discharge his duty to obtain the best price.

The key features of this scheme (known as a transfer scheme) are as follows:

- a scheme of arrangement would be proposed by each borrower under the senior credit agreement;
- there would only be two classes under the

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scheme of arrangement. The lenders in respect of the revolving credit facility and the lenders in respect of the senior term debt. In this way the statutory majorities in each of those senior classes could bind the dissentient minority lenders;

- under the scheme of arrangement terms:
 - (a) the revolving credit facility lenders would agree to become bound by the terms of a new credit facility under which the final maturity date of the revolving credit facility would be extended and a newly incorporated company ('Newco') would be substituted for Holdco 2 and Holdco 2 would be released from its obligations under the new credit agreement. This is usually done by the scheme creditors appointing the company proposing the scheme as their agent to execute any necessary documents.⁶ The debts owed by Newco would then be pushed-down to Target or other subsidiaries. A commercial term of the restructuring is that they would also be allocated 15 per cent. of the fully diluted equity in Newco;
 - (b) the senior term facility lenders would agree to become bound by the new credit facility under which the final maturity date of the senior term facilities would be extended, their loans would be written down to £300m and Newco would be substituted for Holdco 2 and Holdco 2 would be released from its obligations under the new credit agreement. A commercial term of the restructuring is that they would also be allocated 75 per cent of the fully diluted equity in Newco – the remainder being allocated to existing management;
 - (c) the scheme would be conditional upon Holdco 2 and Newco entering into a business transfer agreement, under which all of the assets of Holdco 2 would be transferred to Newco in consideration of Newco agreeing to assume the obligations of Holdco 2 under the new credit agreement. The business transfer agreement could be executed by either the directors of Holdco 2 or an administrator appointed to Holdco 2. In recent schemes of arrangement the sale has been made by an administrator who engaged in the pre-marketing of the asset before his

appointment so that he could be confident that his duties under paras 74 and 75 of Sch B1 to the Insolvency Act were met;

- (d) a further condition of the scheme would be that the security agent under the senior credit agreement and the mezzanine credit agreement is able to release:
 - the claims (including in respect of borrowings, guarantees, security and other surety claims) of the lenders under the second lien facility and the mezzanine facility against any relevant member of the Group; and
 - any intercompany (including surety) claims of the Parent, Holdco 1 and Holdco 2 against the Group.

This is usually provided for under the terms of the intercreditor agreement (see for example, the very cumbersome, cl 13 of the Loan Market Association standard form). The terms of the intercreditor agreement will usually provide that the security agent will (subject to indemnification) be required to act on the instructions of the majority senior lenders (usually a two-thirds majority) only.⁷ Various law firms have adopted different approaches to these provisions and many of them do not, for example, allow borrower or intercompany claims to be released. If this is the case, it may be necessary to sell the assets of all of the obligors (borrowers and guarantors) under the senior credit agreement and the mezzanine credit agreement to Newco instead of enforcing or selling the shares of the Target only, in our example above. The costs associated with multiple asset sales and the need to transfer contracts etc can make enforcement of security so expensive and deleterious to the business as to, effectively, make enforcement of security worthless. This gives junior creditors significant hold-out value. It also means that, in such circumstances, a scheme of arrangement cannot be used to cram-down junior creditors, in our example, the second lien and mezzanine lenders – notwithstanding that they would not receive anything in a Group-wide liquidation.

A transfer scheme could also be used by a sponsor to do a deal with the senior lenders to disenfranchise the junior lenders. Usually, the sponsor would invest new money into Newco

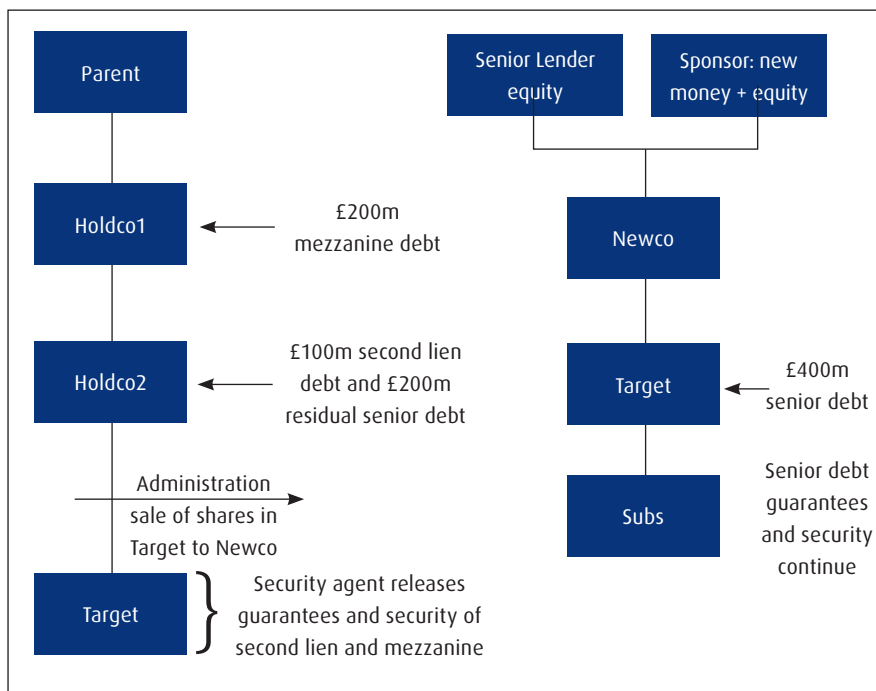
as a commercial term of the restructuring, in order to garner senior lender support. In return for that new money the sponsor would typically be allocated equity consideration. New money would typically rank rateably with the face value of the debt foregone by the senior lenders when determining the proportions of equity consideration to be allocated to the senior lenders and the sponsors.

To summarise, in respect of typical European LBO structures under English law:

- absent using a transfer scheme of arrangement, it is not possible for senior classes to cram-down junior creditors as these creditors would constitute a separate class under a scheme of arrangement – the second lien and mezzanine lenders in our example. Cram-down is limited to the statutory majorities in each separate class cramming-down the minorities within their own class;
- a transfer scheme will not be an effective option if all of the claims of the junior creditors or the holding companies left behind against the Group cannot be released (assuming that multiple asset sales are prohibitively costly to the business). Creditors are left to rely upon the vagaries of the release clause in the intercreditor agreement. This can depend on which law firm the lenders instructed and whether or not there was a debt push-down which included the junior debt. In our example above, the debt-push-down included mezzanine debt. If the release clause in the intercreditor agreement does not allow borrower claims to be released it may be impracticable to implement a transfer scheme; and
- a transfer scheme involves breaking up the relevant group. This may have tax and other costs which make entering into the scheme prohibitively expensive.

Clearly, a well designed statutory composition mechanism would avoid these potential implementation issues. Given that a large number of syndicated loans in Europe are underwritten and documented under English law documentation, it is unsatisfactory that England lacks a comprehensive statutory cram-down mechanism.

Transfer scheme



Accordingly, the evidence that has been put before the court has tended to be based on liquidation methodologies (see *Re Tea Corporation* [1904] 1 Ch 12, the first instance decision in *Re MyTravel Group plc* [2004] EWHC 2741 (Ch) and *Re Telewest Communications plc Re Telewest Finance (Jersey) Ltd* [2004] EWHC 924). In turn, this has often been used as the basis for determining class and fairness issues and, ultimately, how reorganisation consideration is allocated amongst creditors.

As indicated above, this favours creditors with higher priority and permits such creditors potentially to receive more than 100 pence in the pound for their claims where the reorganisation consideration includes equity or other instruments whose value is tied to the future financial performance of the Group.

Using liquidation methodologies as the sole basis for determining these issues generates an internally inconsistent result because:

- a liquidation value is often the justification used to give junior creditors nothing. If the reorganisation consideration includes instruments, such as shares or warrants, whose value is uncapped (the value of loans can also increase, but that value is usually limited by the par amount of the loan and accrued interest) and varies in accordance with the performance of the business it is possible for senior creditors to make more than 100 pence in the pound on their claims;
- in a liquidation a creditor may not receive more than 100 pence in the pound;
- the whole purpose of the restructuring is to ensure that the relevant company does not end up in a liquidation and that the value destruction that often accompanies it (such as termination of contracts, employees resigning, tax costs, ransom payments/suppliers refusing to supply, damage to brands etc) does not occur. If all the reorganisation consideration is allocated to senior creditors, they will reap the benefit of avoiding this cost, even though the valuation which was used to disenfranchise junior creditors assumed that such costs were incurred; and
- the whole point of the restructuring is to ensure that the business continues

Sanction

As demonstrated in the IMO decision (discussed below) it is relatively rare for the English courts to decline to sanction a scheme that has been approved by the statutory majorities. There appears to be three aspects of the court's discretion as to whether to sanction the scheme of arrangement. First, the court must ascertain that the procedural requirements have been met (*Re Alabama, New Orleans, Texas and Pacific Junction Railway Co* [1891] 1 Ch 212, 239; *Re Anglo-Continental Supply Co Ltd* [1922] 2 Ch 723, 736). Secondly, the court must be satisfied that the classes were fairly represented by those who attended the meeting (*Re Alabama, New Orleans, Texas and Pacific Junction Railway Co* [1891] 1 Ch 213, 245), that the majority acted *bona fide* and that there was no oppression of minorities (*Re Alabama, New Orleans, Texas and Pacific Junction Railway Co* [1891] 1 Ch 213, 238). Thirdly, the court must be satisfied that the terms of the scheme are fair 'such that an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve' (*Re Alabama, New Orleans, Texas and Pacific Junction Railway Co* [1891] 1 Ch 215, 239, 247;

Re Anglo-Continental Supply Co Ltd [1922] 2 Ch 723, 736; *Re Dorman Long & Co* [1934] Ch 635; *Re National Bank* [1966] 1 WLR 819).

A key requirement of a satisfactory cram-down mechanism is a proper and open discussion about valuation issues so as to ensure that junior creditors are treated fairly.

VALUATION

There is no mention of valuation in CA 2006 (but note that Insolvency r 1.3 and Statement of Insolvency Practice 3 require regard to be had to liquidation values in justifying why a CVA is in the interests of creditors and no distinction is made between CVAs used as a restructuring mechanism and a CVA operating as a liquidation mechanism).

As CA 2006 is silent on the valuation issue, the English courts have considered these issues piecemeal and based upon the evidence actually put before the court. In practice, valuation is usually controlled by the senior steering committee of lenders as a condition to their agreeing to a waiver, standstill or restructuring. The case law that we have is therefore, not comprehensive, does not set out parameters for appropriate valuations and does not consider the broad range of interests that it should.

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to be in existence in the future, yet liquidation valuations do not have regard to possible future revenues and financial performance of the Group with a restructured capital structure.

Much has been made in the press of the recent IMO case (*Re Bluebrook Ltd* [2009] EWHC 2114 (Ch) (11 August 2009)) but, as discussed below, the court only had regard to the valuation evidence actually put before it and did not attempt to set out broader principles for determining valuation evidence. The court therefore continued its piecemeal approach so that the precedent value of the IMO case regarding valuation is limited.

The facts of the IMO case were similar to those set out in the example above in that the senior lenders and the debtors were seeking to use a transfer scheme to disenfranchise the mezzanine creditors. The mezzanine creditors argued that the schemes should not be sanctioned on the main ground that, relying on expert evidence, there was a realistic possibility that the IMO group had a value which exceeded the senior debt and that the directors of the relevant debtors had failed to extract proper benefit for the creditors.

The debtors and the senior creditors relied on three forms of going concern valuations: a discounted cash flow approach, a comparable business approach and a debt capacity approach, each of which concluded that the value of the IMO group was substantially lower than their senior debt burden. They also pointed to the 60p in the pound level at which the senior debt was trading at the time of the hearing and noted that the mezzanine creditors had chosen not to buy out the senior debt, although entitled to under the terms of the intercreditor agreement. This supported the arguments of the debtors and the senior creditors that the mezzanine creditors had no economic interest in the schemes. On the facts, the senior creditors did not need to rely on liquidation values because the other valuations were sufficient to justify their arguments. This can be contrasted with the *MyTravel* case where liquidation values were accepted by the court at first instance (and indeed by the same judge) as proper in the circumstances.

Some additional helpful points can be taken from Mr Justice Mann's decision in IMO:

- confirming the existing law, a debtor 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 ie a scheme can bind the senior lenders only (para 24);
- in proposing the scheme, it is not necessary for the debtor to consult any class of creditors who are not affected (such as junior classes of debt and trade creditors whose claims are not being impaired by the scheme of arrangement), either because their rights are untouched or because they have no economic interest in the debtor. However, such unaffected classes, as creditors of the debtor, may contest the scheme on fairness grounds if it can be demonstrated that the scheme unfairly affects them in ways other than altering their strict rights. If there is any dispute about this, the court is entitled to ascertain whether a purported class actually has an economic interest in a real, as opposed to a theoretical or merely fanciful, sense. The basis on which the assessment of that interest and other fairness issues is to be carried out will vary from case to case (paras 25 and 26);
- a judge might refuse to sanction such a scheme if the valuation evidence of the senior classes can be challenged by cogent evidence indicating that value might break in the subordinated debt (the judge touches in para 49 on the possibility of an attack on the basis that the senior will reap an excessive benefit over time), but in reality, if the valuation evidence is uncertain, it will be difficult to persuade the administrator to effect the transfer;
- the court was unconvinced by the argument of the mezzanine creditors (albeit that the argument was very generalised and raised late in the day) that the duties of directors of the scheme companies prevented them from entering into schemes which favoured the senior creditors over mezzanine creditors in that it provided the senior creditors, but not the mezzanine creditors with a better outcome than would have been achieved through an immediate enforcement or liquidation. The court appeared to accept

that directors of debtors could have regard to the relative priority of creditors in discharging their duties as directors. The judge seems to have given little weight to the fact that some members of the existing board would continue as directors and managers of Newco and would potentially benefit from an incentive package to be offered by Newco. He concluded that sufficient independent scrutiny was given to the schemes as there were some independent directors on the board, the board decisions were all unanimous and the board was independently advised.

NEED FOR REFORM

As demonstrated above, in the absence of a transfer scheme and, *inter alia*, an intercreditor agreement release clause which works, a scheme of arrangement cannot be used by senior creditors and debtors to cram-down secured subordinated creditors (and shareholders). This and other issues (such as change of control issues) can lead to extra cost, delays and uncertain implementation pathways.

Cram-down and valuation go hand-in-hand. There needs to be a centralised forum, procedural fairness and clear valuation rules for senior and junior classes alike. The cases discussed above indicate that this is currently not provided for under English law. The appropriate place to deal with such issues is in the statutes and the applicable principles should not be left to the courts and the vagaries of intercreditor agreements and group structures conceived on tight deadlines.

Investors in senior and junior elements in the capital structure need to be able to appropriately price the risks which they are taking on. Without clear implementation pathways it is not possible to price those risks with any certainty. A streamlined composition procedure with clear rules and implementation pathways is, therefore, essential to ensure that London maintains its position as the financial centre of Europe.

SUGGESTED APPROACH

The scheme of arrangement procedure is not listed as either a main or secondary proceeding under the European Insolvency Regulation. The CVA procedure is. This has given rise to the jurisdictional uncertainties in respect

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Geoff O'Dea is an associate in the London office of the Business Finance & Restructuring Group of Weil Gotshal. All views expressed are his own and do not necessarily reflect a firm view. Email: geoff.odea@weil.com

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of schemes of arrangement discussed in the DAP case (referred to above). In addition, if one were starting with a clean slate, one would not have both a scheme of arrangement procedure and a CVA procedure.

The logical approach would therefore be to amend Part I of the Insolvency Act (and the Insolvency Rules) to allow CVAs to bind secured and preferential creditors and shareholders. Class concepts could be imported from the scheme of arrangement procedure (though keeping a single class for unsecured creditors) so as to ensure that the interests of those creditors are adequately protected. As per schemes of arrangement, debtors should not have to seek the approval of those classes who are unaffected by the composition or arrangement and other sensible features of schemes of arrangement, such as the ability to release guarantees and security, would continue. The statutes should also be updated to provide for a cram-down mechanism across classes and based on valuation evidence.

Section 1129 of the United States Bankruptcy Code sets out the cram-down mechanism which applies in the context of confirmation of a plan of reorganisation. The text of that section also specifies the need to conduct various valuations, thus centralising the valuation process. While the text of the section is convoluted and could be improved upon and adapted to English law, it deals with the issue of cross-class cram down and valuation directly and would form a useful starting point.

Three principles are central to that section. First, the plan cannot give impaired classes less than they would receive in a liquidation, based on a liquidation analysis (known as the 'best interests of creditors test'): s 1129(7)(a). This concept is familiar to English law. Secondly, the plan must treat each member of each class fairly: s 1129(b). Again, this concept is familiar to English law. Thirdly, the plan must be fair and equitable: s 1129(b). This concept is at an undeveloped stage under English law, largely due to our statutory regime's shortcomings.

US jurisprudence has supplemented 'fair and equitable' requirement with the 'absolute priority' rule which essentially requires that the plan of reorganisation pay any non-consenting class in full before any class junior to that class receives or retains any property under the plan on account of its claim or interest. In addition, a

senior class may not receive more than 100 per cent of its claim where a dissenting junior class will receive less than 100 per cent.

The US courts have long accepted that liquidation values are, for the reasons referred to above, usually not an appropriate basis to determine allocation of reorganisation consideration in the context of cram-down. Rather, the US courts have preferred income methods (the discounted cash flow method), market methods (what prices have been paid for similar businesses) and asset methods (what prices have been paid for assets similar to those owned by the debtor).⁸ Of those, the discounted cash flow method is the one most commonly accepted. *Valuation: Measuring and Managing the Value of Companies* by McKinsey & Company Inc, Copeland, Koller and Murrin, probably the leading text on valuation, sets out numerous variations on the discounted cash flow (and other models). In summary, the discounted cash flow model:

- assumes a 'going concern' approach and ascribes a present value to cash flow during an explicit forecast period. This is often five years; and
- ascribes a present value to cash flow after an explicit forecast period, a perpetuity or terminal value.

The inputs used to determine those values will vary according to the business, industry and circumstances of the case. However, the methodology or formula used to get to those values is well understood by the US bankruptcy courts. Given the specialist knowledge required, a separate specialist bankruptcy court would be a helpful addition in England.

This approach is very sensible and could be incorporated into our statutes relatively easily (hopefully avoiding the American drafting). In our example, if the valuation evidence justified it, the court could hold a valuation hearing and apply an English version of the ultimate priority rule. This could be used to achieve the same result as the transfer scheme without the need to place any of the scheme companies into administration, enforce security, break up the group (thus avoiding change of control costs), rely on the efficacy of the intercreditor release clause or the shape of the corporate group structure – the end result being more

certain implementation pathways and greater certainty for all stakeholders. ■

- 1 These are often incorporated in tax efficient jurisdictions such as Luxembourg; however, England is used for the sake of simplicity.
- 2 In the *Matter of DAP Holdings NV and others* [2005] EWHC 2092 (Ch) in which Lewison J held that the court had jurisdiction to sanction a scheme of arrangement in respect of a Dutch company which had neither its centre of main interest nor an establishment in the UK.
- 3 Intercompany & sponsor debt would usually also be subordinated to senior and mezzanine debt too and be subject to the intercreditor release provisions discussed below. Hedging providers will often be party to the intercreditor as well and will usually rank with senior debt.
- 4 Concerns over the ability to use schemes of arrangement in respect of a single class of debt only (see *Sea Assets Ltd v Perusahaan Perseroan (Persero) PT Perusahaan Penerbangan Garuda Indonesia* [2001] EWCA Civ 1696) and in respect of secured debt (see *Re Empire Mining Company* (1890) 44 ChD 402; *Re Alabama, New Orleans, Texas and Pacific Junction Railway Co* [1891] 1 Ch 213; *Re Bond Corporation Holdings Ltd* 5 ACSR 304 and *Re Chevron Sydney Ltd* [1963] VR 249) are no longer of concern following the recent Countrywide, Crest Nichols, McCarthy and Stone and British Vita schemes of arrangement in respect of specific classes of secured debt.
- 5 It is clear that an administrator can accept non-cash consideration for an asset, see *Thurlow v Mackeson* (1868) LR 4QB 97 and *Belton v Bass, Ratcliffe and Ghretton Ltd* [1922] 2 Ch 449.
- 6 This appointment mechanism is yet to be tested, particularly with executing deeds. A well drafted scheme of arrangement should set out the key steps rather than delegating them to ancillary documents which are then signed by the debtor pursuant to the signing authority.
- 7 If hedging providers have acceded to the intercreditor agreement they will usually be part of the instructing group for this purpose and the close-out amount owed to them is treated for voting purposes as if it were a loan or commitment under the senior credit agreement.
- 8 See 'Valuation Uncertainty in Chapter 11 Reorganizations', 2005 *Columbia LR* 403, Kerry O'Rourke.