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PART 26A RESTRUCTURING PLANS - MOST SIGNIFICANT CHANGE IN 20 YEARS

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Legal Briefings

In what is likely to be the most significant change to the UK restructuring and insolvency market since the Enterprise Act 2002, the Court has yesterday[1] paved the way for restructuring plans under Part 26A to the Companies Act 2006 ("RPs") to be used to compromise the rights of landlords, financial creditors and other unsecured creditors provided the company shows that those creditors are "*out of the money*". There may even be no need to ask those compromised creditors to vote on the RP. This emphasises the very broad scope of RPs and is likely to make them a feature of the restructuring market going forward – creating very different dynamics for stakeholders. It may also place significant reliance on valuation evidence as to those creditors likely to receive a distribution in an insolvency (who are therefore "*in the money*").

THE BACKGROUND TO RPS

RPs were introduced as part of the package of emergency measures introduced at the outset of the pandemic in the Corporate Insolvency and Governance Act 2020 ("**CIGA**"). This Act introduced RPs as a new Part 26A to the Companies Act 2006.

The main feature of an RP is that it introduced a new cross-class cram down provision which enables a company to bind dissenting classes of creditors under an RP, provided at least one class approves the RP by at least 75% by value of those present and voting. This is in stark contrast to a scheme of arrangement under Part 26 of the Companies Act which must be approved by each class of creditors. In the *Virgin Active* decision, the Court has for the first time had to address how it will approach sanctioning an RP when a substantial number of classes of creditors have voted overwhelmingly against the proposal.

Typically, there are two hearings in relation to an RP. The first is known as the convening hearing. At this hearing, the Court principally considers whether classes have been properly constituted and meetings of those classes of creditors ought to be convened to vote on the RP. Following the vote, the Court reviews at the sanction hearing the result of the votes and has to decide whether to sanction the RP.

THE TERMS OF THE RPS

The RPs at issue in this case offered different compromises to different groups of creditors: between secured lenders, landlords (further sub-divided into classes A to E), and general property creditors. Borrowing from approaches to leasehold company voluntary arrangements under Part I of the Insolvency Act 1986 ("**CVAs**"), landlords were offered different commercial terms relating to arrears built up during the pandemic and rent going forward based on the company's assessment of the profitability of the sites. Importantly, depending on the class to which the relevant lease was assigned, certain landlords were offered only a reduced rent going forward, de minimis payment of accrued arrears calculated to be 20% higher than the (very low) anticipated distribution in an administration, or the ability to exercise a break clause introduced by the RPs. The remainder of Virgin Active's creditors, including employees, HMRC and trade creditors, were excluded from the RPs on the basis that the plan companies considered that those creditors are essential to the day-to-day business.

The RP also imposed a compromise on the secured lenders. This was required because the Judge accepted that the company was unlikely to obtain the required support of all lenders to impose that compromise under the terms of the finance documents. There was no reduction in the principal owed to the secured lenders. There are however compromises relating to the extension of the maturity date by three years, deferral of certain interest payments, relaxation of financial covenants and introduction of a more permissive disposals regime.

Importantly, the plan companies' evidence was that the value of the business was insufficient to repay the secured debt – i.e. value "broke" in the secured debt and any unsecured creditors were "out of the money" in the sense that, were the companies to enter administration, the unsecured creditors would not obtain a recovery beyond a very small recovery from the prescribed part.

When a number of the classes of landlord or general property creditors voted against the RPs, at the sanction hearing Mr Justice Snowden was faced with the question of whether to cram down dissenting classes.

CROSS-CLASS CRAM DOWN: THE STATUTORY TEST

Part 26A of the Companies Act 2006 provides that two conditions must be satisfied to enable the Court to exercise cram down:

- Condition A: the Court must be satisfied that if the plan is sanctioned, none of the

members of the dissenting class would be any worse off than they would be in the "*relevant alternative*". The "*relevant alternative*" is "*whatever the Court considers would be most likely to occur in relation to the company if the compromise of arrangement were not sanctioned*…"; and

- Condition B: that the plan has been approved by at least one class who would receive a payment or have a genuine economic interest in the company in the event of the "relevant alternative".

Provided these two gateway conditions are satisfied, the Court then has discretion as to whether to impose cram down.

KEY FINDINGS IN THE JUDGMENT

1. The Judge accepted that for the purposes of Condition A, he need only consider the relevant alternative as at the date of the sanction hearing. It is not relevant to Condition A if the plan companies (or their directors) might have acted differently or if the plans were negotiated in a way that was unfair to certain creditors or inappropriately elevated shareholders' interests at the expense of landlords. The conduct of the directors or the negotiations is only relevant to the discretionary part of the cram down test and cannot be used to argue that the relevant alternative should have been more favourable to creditors had the directors approached matters differently;

2. It does not matter if the "*most likely*" alternative is not itself probable (i.e. more than 50% likely) to occur. The Judge simply has to assess which of the alternatives is most likely to occur absent sanction of the RP;

3. The Judge did not agree that there is a rebuttable presumption that an RP will be sanctioned where Conditions A and B are satisfied (picking up the suggestion of Mr Justice Trower in *Re DeepOcean* [2021] EWHC 138 (Ch) that there would be a "*fair wind*" behind sanction for such an RP). Further, whilst the Judge noted that the explanatory notes to CIGA refer to the discretion to cram down only being exercised where "*just and equitable*", these should not be read into Part 26A of the Companies Act 2006 and there is no justification for the Court to impose its own views of what is (or is not) fair or just and equitable, particularly in relation to who should receive any potential upside should the company return to good health (and in what proportions);

4. The Judge found that as a matter of fact, value broke in the secured debt. The business and assets of the plan companies therefore in essence belongs to those secured creditors. It is for those creditors to determine how to divide up any value created by the restructuring (often referred to as the "*restructuring surplus*");

5. The Judge concluded that on the facts, the secured lenders had acted commercially

rationally in seeking to obtain the best terms from the shareholders. Those terms (£45m of secured funding and an undertaking to subscribe for £6m of equity) were, the Judge concluded, better than any terms available in the market. The Judge therefore concluded that whilst there may be cases in which incentives offered to shareholders (but not unsecured creditors) could be a disproportionate financial advantage or "bounty" for that stakeholder, this is not such a case. If value were to break in the unsecured debt, there would have been a need to look closely at whether stakeholders' share in the restructuring surplus is proportionate or comparable to the compromise each is asked to make; and

6. Finally, the Judge found that a creditor who is "*out of the money*" has no "*genuine economic interest*" in the company. Provided a plan company could satisfy the Court that this is correct on the evidence, a plan company could apply at the first of the two court hearings (the convening hearing) for an order that meetings of those out of the money creditors are not required to be summoned at all.

Two of the most challenging issues that are likely to arise in a contentious RP process is for the Court to determine what the correct relevant alternative is and how the court is to exercise its discretion.

COMMENT

This is a wide ranging decision that is likely to be relevant to leasehold restructurings, and, given the reasoning can be applied to very different fact patterns, financial restructurings and particularly debates between senior financial creditors, junior financial creditors and equity. For landlords, this is a particularly significant outcome given the decision in *Lazari Properties v New Look* [2021] EWHC 1209 handed down on Monday – which essentially rejected a root and branch challenge by a number of landlords to CVAs. Landlords may well find that RPs nevertheless become the preferred mechanism for tenants or sponsors looking to compromise liabilities in respect of leases that are not considered essential to the future of the business. As with CVAs, the remedy of forfeiture should not be capable of being excluded outright by virtue of the terms of an RP.

Perhaps most importantly, there may be a move in complex restructurings to focus on expert valuation evidence at the outset of the Part 26A process. This puts dissenting creditors in the unenviable position of needing to incur significant costs in a (likely) short period of time to consider and (if appropriate) challenge valuation evidence put forward by the company and facing an uphill battle to obtain information from the company necessary to prepare an alternative valuation or any alternative assessment of the relevant alternative.

Herbert Smith Freehills have acted in connection with a number of restructuring plans to date, including advising in connection with the restructuring plans of Virgin Active, gategroup and Virgin Atlantic

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[1] *Re Virgin Active Holdings Limited* [2021] EWHC 1246

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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