Weil

Scheme Hot Topics Bulletin: Part II

March 2015

Overview

In this bulletin, we analyse the relevance of valuation and offer an international perspective on third party releases. We then look at voting by ultimate beneficial holders of scheme debt (and suggest we may soon see sub-participants voting) and provide a practical analysis of when courts will allow amendments to schemes.

Two restructurings disputed on valuation grounds

- *MyTravel*:
  - a "purely theoretical or merely fanciful" possibility that surplus assets may be available would be insufficient to establish an economic interest
  - company was insolvent, therefore liquidation was the appropriate comparator by which to assess bondholders' entitlement (namely zero, as there was "no serious prospect of [the bondholders] getting anything out of a liquidation")
  - price at which bonds were trading was irrelevant
- *IMO Carwash*:
  - no single valuation method is automatically favoured; court did not attempt to set out broad principles for valuation
  - "Monte Carlo simulation" valuation proposed by mezzanine lenders was very much a theoretical exercise (as opposed to debtors' and senior creditors' three forms of going concern valuations)
  - Judge noted the fact that mezzanine lenders had not exercised their option to purchase the senior debt at par; he believed this suggested the mezzanine lenders were not really prepared to stand behind their valuation

Valuation

Valuation issues tend to be at the heart of any intercreditor dispute in a restructuring. And the art of valuation becomes absolutely critical in the context of a scheme, because creditors with no economic interest need not be invited to vote on a scheme which seeks to compromise creditor claims[1]. (Although such creditors will not be bound by the scheme and some other legal mechanism will need to be used to "burn off" their claims, for example, intercreditor release mechanics, disposal or security enforcement.) There is no prescribed method of valuation, which leaves significant room for debate.

Scheme + transfer

Valuation is especially important in the case of "transfer schemes". This is where the business/ assets of the company are transferred to a newco, in return for the newco assuming certain of the company's liabilities (often the "right-sized debt"). Effecting the sale within administration provides additional protection against a challenge by junior creditors. The administrators must be satisfied that the sale is for the best price reasonably obtainable. The court will draw comfort from the administrators' judgment (as independent third parties) and it is the administrators who assume the risk of any challenge on valuation (as on e.g. *IMO Carwash, WIND Hellas* and *European Directories*).

When assessing the relevance of valuation to a restructuring, it is important to consider whether valuation is relevant to the scheme process or to the transfer process. (The latter may not be implemented by the scheme at all, and the two processes may raise different issues.) For example, the *IMO Carwash* scheme did not compromise the junior creditors' claims — it simply bound the senior lenders into a collective enforcement decision. Instead, the junior creditors' allegations regarding value were relevant to the transfer mechanism (i.e. the pre-pack) deployed to implement the restructuring.

[1] Established principle originating in *Re Tea Corp.*

Some schemes may, however, raise their own valuation issues; for example, a scheme which compromises senior creditors and disenfranchises junior creditors will raise arguments on where the value breaks (and therefore whether those junior creditors should be required to vote on the scheme). Similarly, a scheme which seeks to compromise all creditors' claims (perhaps in different classes) may raise valuation issues in terms of appropriate values for voting or class analysis.

Class analysis may result in a slightly different valuation exercise — one which goes to determining whether creditors have sufficiently similar rights and can consult together — and the consideration of an appropriate "comparator" in the event the scheme failed, which may point to a liquidation comparator. That does not necessarily mean that all questions of valuation fall to be assessed by reference to a liquidation model.

Other contexts

Restructurings such as *Stablilus*[2] and *EMI*[3], outside the context of schemes, have also tested valuation issues. In those cases, value clearly broke well within the senior debt.

Indeed, in *Stabilus*, the judge considered that the fact the company's senior debt traded at a very steep discount to par value in the secondary market provided "strong corroborative force" for the conclusion that the mezzanine lenders were underwater by a very large margin.

In *EMI*, the judge considered that robust valuation evidence demonstrating that value broke in the junior creditor's debt was required before an application for pre-action disclosure of the administrators' valuation analysis would be allowed. Further, in terms of the administrators' duty to get the best price reasonably obtainable, the existence of anti-embarrassment clauses helped to diffuse allegations that the pre-pack administration benefited only the senior creditor.

Impact of buy-out rights

Intercreditor agreements often provide a safeguard for junior creditors in the form of a right to buy out the senior creditors. Such provisions often have a great strategic impact. The courts are likely to draw inferences as to valuation where the junior creditors choose not to exercise that buy-out right (as, for example, in *IMO Carwash*). However, drawing such inferences risks ignoring other factors which may be at play (such as lack of available funds, credit limits or junior creditors' internal policies).

Ripe for challenge?

We have said there is no prescribed valuation methodology and that courts want to see a "current and real world valuation", largely focused on current sale price. So what happens if one "real world" valuation suggests junior creditors are out of the money but another suggests they still have skin in the game: if a market testing process suggests one valuation range, but an illustrative DCF suggests a valuation of, say, twice that range, and the debt breaks within the range of the latter? How would the court evaluate the valuations and balance creditors' interests in such a case?

This is especially debatable because a restructuring backdrop to a market testing process usually "chills the sale"; this results in a less-than-optimum valuation range, as bidders know it is rare to see an actual sale in such a scenario and that creditors will have the "last look". We think this area is ripe for challenge.

In Part III of this bulletin, we'll contrast the English approach to valuation with the focus on future going concern value — the post-restructuring enterprise value — in Chapter 11.

Takeaways on valuation

- Starting point should be a going concern valuation; would be unwise to rely on liquidation valuations (particularly in the context of assessing whether a transfer scheme has resulted in achieving the best price reasonably obtainable)
- Market should ideally be tested via a proper sale process, to achieve a "current and real world valuation"
- If value breaks within the senior debt, junior creditors are likely to have to provide new money in order to maintain a stake in the business post-restructuring
- If value breaks within senior debt by only a small margin, advisable to create an instrument e.g. warrants / contingent value rights into the deal, to ensure senior creditors do not reap an excessive benefit over time (this is a relatively standard feature in Chapter 11)

[2] *Saltri III Limited v MD Mezzanine SA SICAR & ors* [2012]
[3] *Maltby Holdings Ltd v Spratt and another* [2012]

Third party releases; international perspectives

In order to give practical effect to a restructuring, it is often necessary for the company and/or creditors to release — or compromise — claims against third parties.[4] This is because such third parties may have claims of contribution against the company in the event that creditors sought to pursue those third parties, which would then defeat the objective of the restructuring. To the extent that such releases cannot be effected under the intercreditor agreement, it may be necessary to do so via a scheme.

However, uncertainties remain. Would the English courts be prepared to approve a scheme containing releases which, whilst not essential, were perhaps beneficial to the scheme? How would the court determine whether releases are "commercially important" as opposed to "an extraneous feature"?

Vulnerability may also remain if dissenting creditors seek to challenge third party releases in foreign courts. Also, given that certain overseas processes do NOT allow for third party releases without that third party being a party to that process (for example, Chapter 11), could an English scheme be used "purely" to implement a third party release, say in conjunction with Chapter 11 proceedings?

Different jurisdictions adopt widely varying approaches to the release or compromise of third party debt, as illustrated in the table on the following page.

Criteria for releasing/restructuring claims against third parties

- *La Seda*[5]:
  - Release of guarantor contained the "requisite element of give and take" and offered "benefits to the scheme creditors"
  - Creditors' rights of action against the guarantor were "closely connected" with their rights against the company
  - Court's reasoning implied that the release was "essential" to the scheme
- *Magyar*: release of guarantors was "not an extraneous feature but [was] a commercially important part of the proposals and indeed [was] integral to them"
- Also done recently on *New World Resources, hibu* and *Zlomrex*, without substantive analysis

Voting by ultimate beneficial holders

The vast majority of bonds are issued under a global note structure, with a trustee as the registered holder of a global note. The covenant to pay is generally expressed to be in favour of the "holder" of the bonds i.e. the trustee, whilst the bond is in global form. On a scheme, this global note structure raises a number of issues:

- fulfilling the controversial numerosity requirement (for over 50% in number of creditors voting to vote in favour of the scheme);
- whether the trustee's vote can be split in order to vote both in favour of and against a scheme (the answer is yes: *Re Equitable Life Assurance Society*, but that then cancels the trustee's vote for numerosity purposes); and
- a risk that the trustee may refuse to vote on the scheme.

Structuring solutions

- Definitive certificates
  Trust deeds commonly give bondholders the right to require a definitive (i.e. individual) certificate.[7] However, actually definitising the notes may create an administrative burden, especially if there are large numbers of bondholders and the company's resources are already stretched.

[4] Such as third party guarantors/security providers, creditors' committee(s), advisors, directors and administrators/liquidators.

[5] Applying *Re T&N*, as interpreted by *Re Lehman Brothers*.

[6] For example, the Canadian court has held that a third party release (of a company's auditor) was appropriate where there was merely a "**reasonable connection** between the third party claim being compromised in the plan and the restructuring achieved by the plan to warrant inclusion of the third party releases in the plan": *In re Sino-Forest Corp.* (2013).

[7] For example, in the 2004 *Marconi* scheme, all those who wished to vote on the scheme were issued (as part of the voting mechanics) with bonds in definitive registered form. The definitive bonds were held to the order of a specified bondholder, thereby avoiding the cost and expense of distributing the definitive bonds to the disparate bondholder group.

- "Contingent creditor" approach
  The so-called "contingent creditor" approach is now the tried and tested alternative to definitive certificates. This pragmatic solution allows bondholders to vote on the scheme as contingent creditors, on the basis of their right to require definitive certificates. It has recently become the customary approach in a series of cases including *Countrywide (Re Castle Holdco 4 Ltd), Gallery Capital, Co-operative Bank, Magyar, Zlomrex* and *New World Resources*. It also supports the method adopted in the *Schefenacker CVA*, for example. However, this solution has yet to be challenged. It also depends on the nature of the trust or obligation that is sought to be "looked through" — some may not allow the beneficiary to "elevate their status" in this way.[8]

  To avoid any danger of double-proof or double-counting of votes, it's advisable to obtain confirmation from the trustee that it will not itself vote on the scheme (as in *Countrywide, Co-operative Bank* and *WIND Hellas*).

Next step: voting by sub-participants?

If courts really want the ultimate beneficial owners of scheme debt to consider the scheme[9], would they take account of sub-participation arrangements? We see no reason why not, where the sub-participation agreement provides for elevation of the sub-participant (as in the LMA funded participation agreements). This has yet to be tested, but follows and respects the "contingent creditor" approach observed in the context of bonds, described above. Of course, the participant can instruct the grantor how to vote. But what if the grantor has entered into multiple sub-participations, those sub-participants have different views or wish to increase the numerosity count beyond the level of the grantor and they are unable to elevate (because the borrower has not consented or there is no event of default)? Looking through to the participants for voting purposes could then make a real difference to the outcome.

Jurisdiction	Procedure	Effect on third party guarantees
England	Scheme	Can be used to compromise / release guarantees without guarantor proposing scheme
US	Chapter 11 Chapter 15 (where company is in a non-US proceeding and is seeking recognition of that proceeding in US)	No effect (without guarantor also being in a process) Extremely wide relief available in the form of broad injunctions enjoining claims against third parties (see e.g. relief granted on *Magyar*)
Canada	Proceedings under Companies' Creditors Arrangement Act	Can be used to compromise / release guarantees with guarantor proposing proceedings; extremely wide interpretation[6]
Germany	Insolvency plan with protective shield proceedings	No effect (without guarantor also being in a process)
Spain	*Homologación*	No effect (without guarantor also being in a process)

[8] See for example the occupational pension scheme trusts in *Re Equitable Life Assurance Society*.
[9] Norris J in *Countrywide* considered that the scheme "ought obviously to be considered by the ultimate beneficial owners of the debt, that is to say, by the ultimate beneficial owner or principal".

Amendments to schemes

Schemes usually involve a complex suite of highly-negotiated transaction documentation. What happens if the deal or documents need to change? The parties and advisors must tread carefully or risk the court refusing to sanction the scheme. If significant amendments are made, the scheme company will need to start the process afresh (and revert to court to obtain fresh directions on the circulation of the new documents and convening of a scheme meeting with proper advertisement).

To what extent can parties make changes after the process commences without needing to start the process over (especially critical when timing is acute)? The following threads emerge from recent case law.

Materiality: The court will be anxious to ensure that:

- the essentials of the scheme as originally proposed remain intact (*Primacom*) and the amendments do not substantially alter the provisions of the scheme (*La Seda*);
- the modifications cause no substantive material detriment to any scheme creditor (*Orizonia, Stemcor*); and
- the amendments do not mean the explanatory statement is falsified or proven irrelevant, or creditors are effectively voting on a different scheme (*Primacom*).

Apcoa amendments

The court in *Apcoa's* second scheme raised concerns regarding two scheme provisions which imposed new obligations on creditors and a stay on foreign challenges. The company and creditors agreed to amend the scheme in the course of the sanction hearing.

Although not raised by the opposing creditor, we **query whether the court had jurisdiction to sanction** a scheme which was amended following the creditor vote. Can it really be said that the creditors, "**present and voting at the meeting**", actually agreed the arrangement (in accordance with s899 Companies Act 2006)? Given the overwhelming support in favour of the scheme and the fact that those majority creditors (and dissenting creditors) approved those changes, the court could be comfortable that the scheme meeting result would not have been affected. However, the legal point remains that changes may impact the outcome of the vote. The court should therefore be slow to allow changes without proper approval by the body of creditors in scheme meeting.

Ideally, the modifications will be minor and insubstantial (*New World Resources*), reasonably discrete and reasonably capable of being described with little modification to the language already circulated (*Co-operative Bank*), or simply "clarify the drafting in a manner consistent with the overall commercial purpose of the transaction" (*Stemcor*).

- **Fair notice:** The company must ensure creditors receive fair notice and are aware of the relevant amendments (see e.g. *La Seda, Orizonia, Stemcor*). The company should take steps to ensure that creditors who submitted proxies for the meeting are aware of the changes (as on *La Seda*).
- **Class composition:** The court will be against modification if it would alter the class composition (*Primacom, Co-operative Bank*).
- **Creditor identity and response:** Where all creditors are sophisticated financial institutions and none has sought adjournment to the scheme meeting or opposed sanction (*La Seda*), the court is likely to draw comfort from that fact.
- **Changes post-scheme meeting:** the court will be more concerned about changes to a scheme following the decision of creditors at the scheme meeting as changes may materially impact the outcome of the vote. Reliance on scheme wording allowing such modifications (even minor) is unlikely to assist, because:
    - such wording only applies once the scheme is effective, i.e. post sanction; and
    - the courts will not allow the scheme company unlimited discretion to modify the scheme.

Later amendments

Amendments by the court, or by the company post-sanction, are much more restricted. The court cannot alter the substance of the scheme and impose on the parties an arrangement to which they had not agreed (*Re Hawk*). The general rule is that a scheme should not be amended, nor provide for the ability to amend it post-sanction. The court does however have jurisdiction, in limited circumstances, to sanction a scheme where scheme provides for amendment post-sanction.[10] The court will balance the need for certainty against exceptional circumstances — the court will not allow a scheme to be re-written post sanction and any amendment provision must be necessary and clearly disclosed to creditors.

[10] *Re Cape plc; Re T&N (No 3)*. The scheme allowed for the use of valuation methodology to assess asbestos claims to be updated from time to time to reflect the latest actuarial science in estimating asbestos claims.

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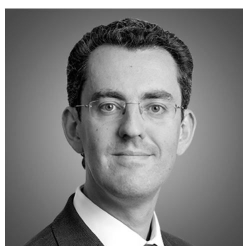

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