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INSOLVENCY AND RESTRUCTURING ADVISORY

UK High Court Hands Down Decision in *Sova Capital*

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KEY POINTS

- This application was brought in the wake of sanctions imposed by the United Kingdom, United States and European Union in response to the Russian invasion of Ukraine and involved a complex assessment of potential breaches.

- Although common and enshrined in statute in the United States, "credit bid" transactions are not legislated for in the United Kingdom, and this case represented the first unsecured credit bid to be approved by an English court.

- The *pari passu* principle (by which all unsecured creditors must share equally any available assets) was raised in opposition to the application brought by a third party. The UK High Court held that the principle was not engaged on the facts as the proposed transaction was considered to be a sale rather than a distribution to creditors.

Background

The judgment of the UK High Court in *Re Sova Capital Ltd. [2023] EWHC 452 (Ch)* was handed down on 2 March. The full judgment can be found here.

Prior to entering special administration on 3 March 2022, Sova Capital Limited (**Sova**) was a Financial Conduct Authority authorised investment broker providing services to institutional and corporate clients primarily trading in the Russian markets. The sanctions imposed by the United States, United Kingdom and EU member states following the Russian invasion of Ukraine on 24 February 2022, combined with Russian countermeasures (such as prohibiting *"hostile"* residents from trading on the Moscow Stock Exchange), rendered Sova cash-flow insolvent and *"effectively trapped"* its Russian securities (which amounted to 87 percent of the value of Sova's assets).

The joint special administrators (the **JSAs**) applied to the Court for directions to enter into two transactions (together the **Transaction**) with LLC Holding Company Dominanta (**Dominanta**), one of Sova's largest unsecured creditors. The Transaction would involve Dominanta waiving its claim against Sova (circa £233 million) in return for a portfolio of Russian securities. The JSAs' application was opposed by a competing unsecured creditor, who wished to purchase the securities in return for £125 million in cash and a waiver of its £19.9 million claim. Dominanta was not subject to sanctions and, unlike the competing creditor, had obtained the requisite consent from the Russian government on 11 January.

The Dividend Bid Model

A transaction in which a creditor uses its debt as consideration to "bid" to buy an asset, although recognised under US bankruptcy legislation, is not legislated for in the United Kingdom. In his judgment, Mr Justice Miles noted that

the *Sova* case presented *"novel issues which have not previously been decided by the courts"*. Here, although the term "credit bidding" was not explicitly used, the judgment provided comprehensive guidance on this procedure in the context of an unsecured creditor as well as an evaluation of competing bids.

The JSAs calculated the Transaction's cash equivalent value (**CEV**) as a percentage of the face value of Dominanta's claim as follows:

(a) *Start with the final dividend payable to creditors assuming that the Transaction does not take place. (This will be a positive number even if the relevant Russian Securities cannot be realised as there are other realised or realisable assets in the insolvent estate.)*

(b) *Then assume that the Transaction happens (and that the full amount of the Dominanta Adjudicated Claim is waived) and determine the final dividend for the other creditors.*

(c) *Then calculate the amount that would have to be contributed to the estate to pay the dividend that would be payable under (b) above, but on the assumption that the Dominanta Adjudicated Claim remains. This is the cash equivalent value (CEV) of the Transaction to Sova.*

This CEV can also be understood by *"notionally"* assuming that Dominanta *"iteratively receives and bids subsequent dividends until it has acquired"* all the Russian securities in a process now known as the "Dividend Bid Model".

The JSAs' Application

The JSAs provided a number of reasons to support the contention that the Court should approve the Transaction, on the basis that it:

- would benefit Sova and creditors by increasing the dividend rate (projected final dividend to increase from 36.7 percent to 50.3 percent (low case) and 62.1 percent (high case));
- would result in a good return, equating to 42.8 percent (low case) and 52.8 percent (high case) of the value of the trapped Russian securities;
- would make Sova's business more attractive by reducing exposure to the Russian securities; and
- remained the best offer available in relation to these Russian securities.

Further, in light of the additional Russian securities unrealised in the business, the JSAs considered that:

- the Transaction would set a precedent to allow similar transactions to maximise value for the benefit of creditors;
- there were concerns in relation to the deliverability of the competing offer (on the basis that the Russian government's consent had not been received);
- there was support from 97 percent of the voting independent creditors; and
- the situation was urgent in light of Sova's financial position.

What Conclusions Did the High Court Reach?

The Court permitted the JSAs entering into the Transaction, after identifying and addressing the following principal issues:

1. *Have the JSAs surrendered their discretion to the Court and is it otherwise appropriate in principle for the JSAs to seek the Court's approval of the Transaction?*

   The Court decided that entry into an agreement which was conditional on the Court's consent did not amount to a surrender of discretion, and in these unusual circumstances (being the *"asymmetry in the value"* of the property,

challenge from an unsecured creditor and sanctions issues), it was appropriate for the JSAs to seek approval from the Court.

2. *Is the JSAs' decision to commit Sova to the Transaction within their statutory powers and/or does it comply with the principles of insolvency law?*

   The Court reviewed the *pari passu* principle, which requires that distribution among unsecured creditors of assets available in an insolvent estate should be equal, and concluded that the Transaction was *"a sale of certain assets in return for the waiver"* of claims, rather than a distribution. As such, the *pari passu* principle was not engaged.

   The judgment also noted that the JSAs' powers were broad enough to cover a transaction whereby a creditor waives its claim against the company, and in exercising this power, the administrator must act reasonably to obtain the best price in the circumstances. Further, the Transaction did not *"infringe the statutory scheme"* and there was no *"real doubt about the powers of the JSAs to enter the Transaction"*.

   The Court also considered the connection between Dominanta and Sova, noting that the ultimate beneficial majority-owner of Dominanta is Mr Roman Avdeev (a dual Russian and Cypriot national), who is *"also the ultimate beneficial owner of Sova"*. It was found that the connection did not *"impair the JSAs' power"*, as an assessment of the commercial value of the Transaction was carried out at arm's length with legal advice, disclosed to creditors and put before the Court.

3. *Is the JSAs' decision to enter the Transaction rational and honest?*

   The Court concluded that the *"decision to enter the Transaction"* was honest and rational and could not be regarded as perverse or irrational. It accepted that the JSAs *"genuinely consider that the Transaction is in the interests of the creditors"* and the decision *"could be reached by reasonable honest office-holders seeking to fulfil their functions"*.

4. *Is there a real risk that the Transaction breaches applicable sanctions laws?*

   The Court reviewed relevant UK and US sanctions and was satisfied there was no *"realistic risk"* the Transaction would breach them. It noted that the Transaction was not subject to the EU regime and Ukrainian sanctions law was irrelevant on the facts.

Practical Implications

For insolvency practitioners appointed over companies facing sanctions-related issues, this judgment demonstrates that the courts are taking a pragmatic approach to complex sanctions-related administrations, with the judge moved by the fact that the JSAs were *"seeking to make the best of a challenging set of constraints"*. The approval of the use of an unsecured credit bid by the High Court in this case identifies a novel solution for insolvency practitioners to maximise value for the benefit of creditors as an alternative to a sale to a third party.

The High Court provided guidance on the issue of connections between creditor and company, noting in this case that a connection might be *"relevant"* in determining how the JSAs exercise their powers (i.e., an arm's length assessment and negotiation of a commercial deal) but, crucially, *"not to the existence of those powers"*. The Court also provided useful guidance to insolvency practitioners in re-emphasising the importance of honesty, rationality and reasonableness in office-holders, who should continue to ensure all avenues have been considered, with clear justification as to why a certain course of action is required. On these facts, it appears crucial that the JSAs' *"comparative assessment of the rival bids"* was not seen as perverse or irrational.

CONTACTS

For further information, please contact your Katten lawyer or any of the following:

Prav Reddy
+44 (0) 20 7770 5213
prav.reddy@katten.co.uk

Sonya Van de Graaff
+44 (0) 20 7770 5221
sonya.vandegraaff@katten.co.uk

Mark Johnson
+44 (0) 20 7770 5214
mark.johnson@katten.co.uk

Dominique Hodgson
+44 (0) 20 7770 5239
dominique.hodgson@katten.co.uk

Dodie James
+44 (0) 20 7770 5207
dodie.james@katten.co.uk

George Warren, a trainee in the Insolvency and Restructuring practice, contributed to this advisory.

Katten katten.com

Paternoster House, 65 St Paul's Churchyard • London EC4M 8AB

+44 (0) 20 7776 7620 tel • +44 (0) 20 7776 7621 fax