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Tips for Dissenting Stakeholders Challenging a Cram Down (or Up)

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Background

This article considers the key issues a dissenting creditor or shareholder (Dissenting Stakeholder) should consider when challenging a UK Restructuring Plan (Plan) under Part 26A of the Companies Act 2006. For convenience, the article assumes that the proponent of the Plan is the debtor company (Company), and that the Dissenting Stakeholder is a member of the class of creditors (Dissenting Class) that voted against the Plan and is therefore at risk of having the Plan imposed on them by way of a so-called "cross-class cram down" (cram down).

Since coming into law in June 2020, only 20 companies have applied to restructure their balance sheet pursuant to a Plan[1]. Dissenting Stakeholders have not fared well so far. Notwithstanding that only six of the 20 Plans have resorted to cram down, Dissenting Stakeholders have succeeded in only three of the six[2] cases.

Of those three, one failed because the Company applied prematurely.[3] On the Company's own evidence, the "Relevant Alternative" (as discussed below) was insolvent administration, which it anticipated would not occur for approximately 18 months from the date of the Company's application. The court observed, within that period of time, that the Company's fortunes could turn favourably. In the remaining two Plans, the Dissenting Stakeholder was HM Revenue and Customs[4] (HMRC), a creditor considered to be in a special category given its secondary preferential status in respect of certain claims (National Insurance and PAYE) in administration, as well as its critical public function as collector of taxes.

Whilst HMRC is in a category of its own, principles applicable to creditors generally can be elicited from the cases.

The legislation that introduced the Plan is still relatively new and case law continues to evolve, so there is plenty of scope for arguments to develop. To state the obvious, of all the nuances and inconsistencies in the cases, one thing is crystal clear: a Dissenting Stakeholder must advocate its case in court. It is insufficient to simply vote against the Plan.

Executive Summary

The Plan legislation is only three years old and the case law is still developing. Dissenting Stakeholders should think beyond existing case law when preparing their case, and look to Chapter 11 and elsewhere for inspiration.

In particular, Dissenting Stakeholders should:

- think tactically about your end goal and how it can be achieved. Getting the Company to the negotiating table is a good start.
- to your advantage, use the fact that the burden is on the Company to establish its valuation case. You should forensically examine the Company's evidence with a view to discrediting it, casting doubt on it or revealing internal inconsistencies.

[1] As at the time of writing: August 16, 2023

[2] Re Hurricane Energy PLC [2021] EWHC 1418 (Ch), Re Great Annual Savings Company Ltd (Re Companies Act 2006) [2023] EWHC 1141 (Ch), and Re Nasmyth Group Ltd (Re Companies Act 2006) [2023] EWHC 988 (Ch)

[3] Re Hurricane Energy PLC [2021] EWHC 1418 (Ch)

[4] Re Great Annual Savings Company Ltd (Re Companies Act 2006) [2023] EWHC 1141 (Ch) and Re Nasmyth Group Ltd (Re Companies Act 2006) [2023] EWHC 988 (Ch) (GAS)

- canvas ***all*** options when considering what the Relevant Alternative might be, including foreign insolvency processes, contractual processes or any other alternatives available.

- consider whether there are items of value that would accrue to you in the Relevant Alternative that the Company has not accounted for. Conversely, consider whether there are items of value that the Company has asserted would accrue to you in the Plan that are not in fact attributable to the Plan, but attributable to factors external to the Plan.

- scrutinise every incident in which the Plan returns value otherwise than as per the priority of payment waterfall in the Relevant Alternative, and force the company to justify it.

- for the purposes of influencing the court in connection with its exercise of discretion:
  - analyse every aspect of the Plan that may not provide a fair distribution of its benefits.
  - consider whether the Company has followed due process in relation to all aspects of the Plan.
  - challenge an "out of the money" verdict with a "legitimate interest" enquiry.

- consider whether there are aspects of the Plan that might transgress directors' duties under English law (or other applicable law).

Criteria for Cram Down

A Dissenting Class will be crammed down provided that both of the following conditions are satisfied:

1. The Company establishes that no Dissenting Stakeholder in the Dissenting Class would be "worse off" under the Plan than in the so-called Relevant Alternative [s.901G(3)].

2. The Plan is voted through by at least one class that has a "genuine economic interest" i***n the Relevant Alternative***.

In addition to the above, whether or not a Plan is sanctioned and the Dissenting Stakeholders are crammed down will ultimately be a question of the court's discretion.

The below considers how a Dissenting Stakeholder should approach the preparation of its case by reference to the above criteria.

Challenging the Company's Case on the Relevant Alternative

The Relevant Alternative is whatever the Court considers would be ***most likely*** to occur ***in relation to the Company*** if the Plan were not to be sanctioned. To date, the accepted Relevant Alternative has invariably been a value destructive formal insolvency process, whether that is administration or liquidation. The extent of the court's enquiry has thus been limited.

However, depending on the facts, there is scope for Dissenting Stakeholders to argue a wider universe of alternatives. The Dissenting Stakeholder's task is to cast doubt on the Company's evidence. In this respect, lessons from Chapter 11, where the baseline is not necessarily a Chapter 7 liquidation, might be helpful.

Dissenting Stakeholders should consider whether a Relevant Alternative might properly be a foreign restructuring or insolvency process if the Company has a connection to a foreign jurisdiction because of its jurisdiction of incorporation or otherwise, or be a process under the terms of the Company's contractual matrix (e.g., a distressed disposal under an Intercreditor agreement or a liability management exercise under a bond indenture).

Separately, Dissenting Stakeholders should query whether:

- the Company has appropriately scoured the market for its capital needs.

- the Company has engaged adequately with its stakeholders.

- the Company's evidence as regards its liquidity runway has been scrutinised — for example, would there be a market for new money to support the Company through further negotiations?

If the Company fails to satisfy the evidential burden, the question of whether the Dissenting Stakeholders would be "no worse off" in such a Relevant Alternative may then fall to be considered.

Challenging Whether the Dissenting Stakeholder Would Be 'Worse Off' in the Plan Than the Relevant Alternative

This question involves a range of considerations, some of which are considered below

It is the Company's evidential burden

The Company must establish, on the balance of probabilities, that no Dissenting Stakeholder would be *worse off* under the Plan than in the Relevant Alternative.

The Dissenting Stakeholder should therefore consider whether it can cast doubt on the Company's case, such that the Company fails to satisfy its evidential burden. The following points can be drawn out of the cases so far.

- *The Company's case may fail even if the Dissenting Stakeholder does not adduce its own valuation evidence.*

Although the test is fundamentally one of valuation, case law has confirmed that a Dissenting Stakeholder need not necessarily adduce its own competing valuation evidence. As such, the onus is on the Company's management to provide accurate forecasts and assumptions. Thus, Dissenting Stakeholders may discredit the Company's evidence simply by scrutinising, criticising and undermining it. There will be no cram down if the Company is unable to refute the challenge and satisfy the court that the Dissenting Stakeholder would not be any worse off than in the Company's Relevant Alternative. In this regard, the evidential burden on the Dissenting Stakeholder is relatively low. It must simply provide a factual basis for the challenge — it is not required to satisfy the court that it would be better off.[5]

This tactic was successful in the case of Great Annual Savings Company Ltd (GAS). In its capacity as Dissenting Stakeholder, HMRC scrutinised the Company's valuation figures without adducing its own alternative valuation evidence and successfully persuaded the court that the Company had failed to satisfy its evidential burden.[6] Over many pages of analysis, the court combed through the Company's valuation evidence and found it to have been unexplained, internally inconsistent and without independent scrutiny in critical respects. Even though the Company had commissioned an independent expert to compile a report of the recovery analysis in the Relevant Alternative, that report was based entirely on figures provided by the Company, without any independent scrutiny or analysis.[7]

The court specifically mentioned the following data points:

- The Company's evidence in respect of one book of receivables (with a face value of £18.2m) valued expected recoveries at "*nil or almost nil*" in the low-case scenario. The court observed that this recovery rate was "*on any view a dramatic one*".
- The Company's valuation methodology was based on "*high-level assumptions*", which the court observed provided no allowance for the possibility that they might be wrong, even in part.
- On the Company's projections, the return to the Dissenting Stakeholder under the Plan was so marginal compared to the return expected in the Relevant Alternative that any viable challenge to the assumptions underlying those projections would give rise to a different outcome — specifically, one in which the Dissenting Stakeholder would be better off in the Relevant Alternative than under the Plan.

'Worse off' is a broad concept that includes the impact of the Plan on all incidents of the Company's liability to the Dissenting Stakeholder, as well as the broader benefits to Dissenting Stakeholder

Returns from sources other than the Company's assets may be included when valuing the Dissenting Creditor's rights in the Relevant Alternative, thereby raising the bar for the benefit of the Dissenting Stakeholder.[8] This is because the terms of the legislation apply the "worse-off" test by reference to the recovery under the Plan vs. the Relevant Alternative (***not*** as against its rights against the Company specifically).

5 GAS at [62]

6 GAS

7 Re GAS at [70]

8 Re Fitness First Clubs Ltd [2023] EWHC 1699 (Ch) (Fitness First)

- For example, in the case of landlords, if the Relevant Alternative is a sale in administration, the evidence may suggest that, in the Relevant Alternative, they may receive payments from a third-party buyer by way of accrued and unpaid rent. These returns may be taken into account in valuing their rights in the Relevant Alternative.[9]
- The potential for so-called "antecedent claims" against third parties (e.g. wrongful trading and preference claims) may, depending on the *prima facie* evidence available, also be taken into account (though no case has yet attributed value to these potential claims, primarily because of the absence of evidence).

Conversely, the Dissenting Stakeholder should scrutinise the returns that the Company asserts would accrue to the Dissenting Stakeholder under the Plan.

- In the context of HMRC, future tax payments that the Company will be likely to pay should not be taken into account in analysing the return to it under the Plan. In GAS's proposed Plan, the court held that the Company's obligation to pay taxes in the future was not an obligation that arose under the Plan: rather, it arose independently under the relevant tax legislation, and was not being offered up as part of the package of rights made available by the Company by way of compromising its existing liabilities. The benefits flowing from such future payments were held to be too remote from the Plan to be relevant in applying the no worse-off test.[10]

Limits to the 'worse off' enquiry

The courts have made it clear that they will not entertain arguments as to alternative Plans, or whether the Plan is the "best plan or the only fair arrangement available". Thus, it seems that it is not open to a Dissenting Stakeholder to argue that another Plan would yield better recovery. The courts will not choose between two contrasting assessments of the likely returns under the Plan. The court's enquiry is limited to deciding whether, on the balance of probabilities, the Dissenting Stakeholder would be no worse off under the Plan than in the Relevant Alternative (thereby emphasising the importance of challenging the Company's evidence regarding the Relevant Alternative).

Discretion: 'Fairness'

If the court finds that the first two conditions for sanctioning the Plan are satisfied, the last vestige for the Dissenting Stakeholder is to persuade the court that it should not exercise its discretion to sanction the Plan. It is worth pointing out the court's approach to its exercise of discretion: it must affirmatively determine that the Plan is fair. It is not the case that the court will sanction the Plan unless it finds the plan to be unfair.

The court will consider whether the Plan is "fair" and, in doing so, will weigh a variety of factors, including the following:

i. the existing rights of the stakeholders and how they would be treated in the Relevant Alternative.

ii. what additional contributions stakeholders are expected or prepared to make under the Plan and in particular, whether they are taking on additional risk by making available "new money".

iii. if stakeholders are disadvantaged under the Plan as compared to the Relevant Alternative, then whether the difference in treatment is justified.

iv. if the order of payment priorities in the Plan differs from what it would be in the Relevant Alternative, the Company must justify it.[11] For example: if an additional contribution is being made by a class under the Plan, the Dissenting Stakeholder should test whether the contribution is appropriate and that the appropriate value of the additional contribution has been attributed to it.[12]

v. whether all relevant stakeholders and market participants have been given an opportunity to bid for new money requirements.

vi. whether some unsecured creditors are not being compromised and if it can be justified by reason of their "critical" service provider or supplier status.

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[9] Fitness First

[10] GAS

[11] Re Houst Ltd [2022] EWHC 1941 (Ch) at [35]

[12] In Chapter 11 bankruptcy plans, the value of DIP financing is given due scrutiny, both in terms of whether it has adequately been marketed, and whether the value attributed to it (e.g., by way of shares or hybrid instruments) is reasonable.

Together, these questions boil down to whether the Plan provides a fair distribution of the benefits generated by the restructuring between those classes who have agreed to it and those who have not, notwithstanding that their interests are different.[13] In other words, is one class getting too much or too little for no valid reason?[14]

A Chapter 11 style enquiry has been hinted at being appropriate, insofar as one court said, "This exercise may involve comparing the Plan with other possible alternative structures to the effect that 'things could and should have been done differently'".[15] It is worth thinking of the outer limits of this: would this be an opportunity for a Dissenting Stakeholder to argue that an alternative Plan would have been fairer?

The courts are becoming alive to the possibility of a "stitch up", a situation where the shareholders and principal financial creditors have negotiated with the sole purpose of capturing value that should properly be allocated to the Dissenting Stakeholder.[16] In such a case, the Plan should be viewed as operating unfairly. In GAS, the court was of the view that this was such a case, even though the Company had sought to communicate openly with Dissenting Stakeholders about the Plan. This was because the end result was still a Plan which involved a serious imbalance in the way anticipated benefits of restructuring were to be allocated.[17]

Relevance of the Dissenting Stakeholder being 'out of the money'?

If the Dissenting Stakeholder is "out of the money" on the Relevant Alternative, there is generally little scope for challenging the Plan on the basis of discretion. This is partly because a class of creditor in respect of which none of its members has a "genuine economic interest ***in the Company***" can be excluded from voting to consider the Plan under s.901C(4) of the Act.[18]

Note the distinction, in this regard, with the "worse-off" test, where the comparison is referable to the Dissenting Stakeholder's recovery ***under the Plan***.

In other words, in determining whether a class is "out of the money" for the purposes of exercise of discretion, the court will not attribute value to returns that it would receive from sources ***other than the Company's assets*** in the Relevant Alternative.

'Legitimate interest' exception?

In a recent case,[19] the court refused to exercise its discretion to sanction a Plan even though the Dissenting Stakeholder was "out of the money". It held that there was no rigid rule equating "out of the money" creditors with a creditor who has a "legitimate interest" in opposing the Plan.

The Dissenting Stakeholder, HMRC, was held to have had a "legitimate Interest" in the "Plan outcome" because it had an ongoing interest in the Company's subsidiary entities in the form of claims against them, even though the court accepted that HMRC would not have recovered anything from the Company itself. This reasoning is surprising given the well-established principle of corporate separation.

However, the court also ruled that there was a "blot" on the Plan on the basis that it was conditional on HMRC agreeing to compromise its indebtedness against the subsidiaries, a condition that HMRC had not agreed to.

On the face of the judgment, it does not seem like the court considered the two issues to be inextricably intertwined.

Other considerations for Dissenting Stakeholders

Due process

- If the Company has not provided proper notice, or if the Explanatory Statement is inadequate or incorrect, this will be a matter to which the court will give due weight.[20]

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[13] GAS at [103]

[14] Professor Sarah Paterson of the London School of Economics, "Judicial Discretion in Part 26A Restructuring Plan Procedures" (January 24, 2022)

[15] GAS

[16] GAS at [133], citing Professor Paterson of the London School of Economics, "Judicial Discretion in Part 26A Restructuring Plan Procedures" (January 24, 2022)

[17] GAS at [135]

[18] Fitness First at [71, 108 – 112]

[19] Re Nasmyth Group Ltd (Re Companies Act 2006) [2023] EWHC 988 (Ch)

[20] Re Nasmyth Group Ltd (Re Companies Act 2006) [2023] EWHC 988 (Ch)

Categorisation of critical creditors

The court will scrutinise the Company's categorisation of critical service providers and suppliers whose claims are not proposed to be compromised under the Plan. The test is whether the relevant creditor is 'essential,' such that the board has respectable commercial reasons for classifying them as such.[21]

Directors' duties — English law

It should not be forgotten that the directors of an English Company are susceptible to various categories of personal liability when the Company continues to trade through insolvency. Dissenting Stakeholders should consider probing the tension between directors' duties to consider creditors' interests when approaching insolvent liquidation (and the primacy to attribute to those interests[22]) on the one hand, and the treatment given to Dissenting Stakeholders under a Plan. This could be a fruitful source of Dissenting Stakeholder enquiry in future cases.

Parliament's three-year anniversary review[23]

Dissenting Stakeholders should continue to watch for any amendments to the law and procedure of Plans. The government recently published a "Post Implementation Review" of the Plan and other legislation implemented by the Corporate Insolvency and Governance Act. Proposals for reform include the following:

- addressing information asymmetry as between the Company and Dissenting Stakeholders.
- reducing costs associated with challenging a Plan.
- introducing multiple debtor entities in a Plan.
- introducing mandatory upside for Dissenting Stakeholders, whereby creditors would receive a share of the future profit should a rescue Plan be successful.

[21] Re Nasmyth Group Ltd (Re Companies Act 2006) [2023] EWHC 988 (Ch)

[22] BTI 2014 LLC v Sequana SA and others 2022 - UKSC 25

[23] Corporate Insolvency and Governance Act Post Implementation Review, published 26 June 2023

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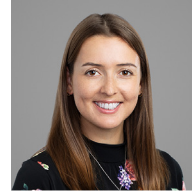

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