# Cross-Class Cram Downs

*Under Part 26A Companies Act 2006, Corporate Insolvency and Governance Act 2020, Schedule 9*

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## Introduction[1]

This article considers the potential implications for UK restructurings arising out of the new Part 26A of the Companies Act 2006 ("**Part 26**") which was introduced by Schedule 9 of the Corporate Insolvency and Governance Act 2020 ("**CIGA**") and received Royal Assent on 25 June 2020.

The purpose of this article is to alert lawyers and other practitioners to the potentially far reaching implications of Part 26A. It is not, as was first envisaged by the Government, a mere efficiency saving that rolls into one process the attendant benefits of a scheme of arrangement coupled with a pre-pack administration. Its terms are not so constrained and the ability to impose a cross-class cram down may require a fundamental rethink to the approach to the constitution of classes and the assessment of fairness. These and other issues are considered below alongside the following other matters:

(1) the impetus to reform;

(2) the Government's original proposals;

(3) the existing ability to cram down a single class;

(4) the new thresholds of financial difficulty and purpose;

(5) the new voting thresholds;

(6) the constitution of classes and the potential for 'gerrymandering';

(7) the need for a new standard of fairness; and

(8) the ability to 'cram up' as well as 'cram down'.

## Impetus to reform

Part 26A originates from the Government's proposals in May 2016. The spur to those proposals was the World Bank's "*Doing Business*" ranking. In 2016, the UK was ranked 6th overall and 13th on the World Bank's "*Resolving Insolvency*" ranking. The US was ranked 7th overall but 5th for "*Resolving Insolvency*". The Government was, therefore, incentivised to emulate aspects of Chapter 11 of the US Bankruptcy Code, as it was the lower "*Resolving Insolvency*" ranking that impacted most on the UK's overall ranking and the Government's ambition to take 5th place from the Hong Kong Special Administrative Region, which ranking had been inaccurately reported as indicating that China, as a whole, was a better place to do business than the UK[2]. The focus of the World Bank's report on "*Resolving Insolvency*" (at pp.99 to 104) was the correlation between post-commencement financing and a successful restructuring proceeding. This explains the initial proposal in relation to rescue financing, being a proxy for DIP financing under Chapter 11. It however provides no explanation for a cram down mechanism, which was not discussed in the World Bank's report at all[3]. As explored below, the reason for its inclusion appears to have been a desire to emulate part of Chapter 11 in a way which the Government perceived would not change UK law in a radical or substantive way. Part 26A does not however correspond to the Government's initial proposal nor to the terms of its response to the initial consultation. It appears that it will be for the courts to decide the principles that should guide the exercise of the new power to cram down a single dissenting class. There is little guidance in the text and the decision not to implement the guidance proposed in the Government's response to its initial consultation is a puzzle that is likely to reduce the assistance the court can derive from the pre-legislative material.

## Original proposals

The original proposals were summarised by the Government as follows (p.22):

- Companies will be able to bind all creditors to a restructuring plan.
- Introduce 'cram down' provisions allowing for a restructuring plan to be imposed on a junior class of creditors even if they vote against the plan, as long as they will be no worse off than in liquidation.
- The classes of creditors would be proposed by the distressed company on a case by case basis.
- For a class to vote in favour, 75% of creditors by value, and more than 50% by number must agree to the plan.

In support of these reforms, the Government cited World Bank Principle C14.3 (p.23, §9.7):

*"For voting purposes, classes of creditors may be provided with voting rights weighted according to the amount of a creditor's claim. Claims and voting rights of insiders should be subject to special scrutiny and treated in a manner that will ensure fairness. Plan approval should be based on clear criteria aimed at achieving fairness among similar creditors, recognition of relative priorities, and majority acceptance, while offering opposing creditors or classes a dividend equal to or greater than they would likely receive in a liquidation proceeding. Where court confirmation is required, the court should normally defer to the decision of the creditors based on a majority vote. Failure to approve a plan within the stated time period, or any extended periods, is typically grounds for placing the debtor into a liquidation proceeding."*

World Bank Principle C14.3 does not require the inclusion of cross-class cram downs. It is a principle equally consistent with a cram down under Chapter 11 and the current law on schemes of arrangement and CVAs. Nonetheless, the Government's original proposal continued (p.23, §9.8-9.9):

1. We are extremely grateful for the comments on a draft of this article received from James Peck, of Morrison & Foerster and formerly a United States Bankruptcy Judge for the Southern District of New York, and from Michael Crystal QC. The opinions, errors and omissions are our own.

2. For those who are interested, Singapore claimed the number one spot for "Doing Business" in 2016. It was however ranked 27th for "Resolving Insolvency".

3. Save for a passing reference (on p.112) to N Segal's 2007 article "The Effect of Reorganization Proceedings on Security Interests: The Position under English and U.S. Law." Brooklyn Journal of International Law 32 (3): 927–82.

*"9.8 One tool that can be used to achieve this is a 'cram-down,' whereby a restructuring plan can be imposed on dissenting classes of junior creditors, on the condition that they would not be worse off under the restructuring than if the business went into liquidation.*

*9.9 The cram-down of a rescue plan onto 'out of the money' creditors is currently possible in the UK only through a costly mix of using a scheme of arrangement and an administration. The Government believes that developing a more sophisticated restructuring process with the ability to 'cram-down' may facilitate more restructurings, and the subsequent survival of the corporate entity as a going concern."*

## Existing ability to cram down a single class

In the light of the Government's recognition that its original proposal amounted to a more sophisticated process of what is already possible, it is useful to rehearse the existing law:

- A company can choose the class of creditors to whom it puts a scheme of arrangement, and it need not include all putative members of a class if there are commercial reasons for excluding certain members of that putative class: see *Sea Assets v Garuda* [2001] EWCA Civ 1696 (Peter Gibson LJ), affirmed in *In re SA Miller* [2017] Ch 173 (Snowden J).
- A company is not bound to put a scheme of arrangement to a class with no tangible or realistic economic interest in the company and any value given to that class pursuant to the scheme is treated as a gift by the company and other creditors, not as an indication of inherent value: see *In re Tea Corp Limited* [1904] 1 Ch 12 (Buckley LJ), affirmed and applied in *In re My Travel Limited* [2005] 2 BCLC 123 (Mann J) and *In re Bluebrook Limited* [2010] 1 BCLC 338) (Mann J).

In *Bluebrook* (the IMO Carwash case) a scheme of arrangement was proposed by the senior lenders; it being necessary as not all could agree on the way forward, absent which there would simply have been a security enforcement. The scheme authorised the security enforcement, overriding the moribund contractual mechanism in that case. The mezzanine debt holders objected. However, on the basis of the above propositions, the mezzanine creditors had no basis to object on class or fairness grounds. The mezzanine creditors' evidence, which was based on a 'Monte Carlo' valuation as to where value broke, was rejected, as was the asserted comparator of another potential restructuring.

An unusual feature of *Bluebrook* was that the court entertained the mezzanine creditor's objections at all. Their essential objection was as to value that would be realised by the administrator appointed following the sanction of the scheme. Rather than requiring the mezzanine creditors to seek to enjoin the proposed sale, for which they would have been required to offer a cross-undertaking in damages, the court was prepared to entertain their objection within the forum of a scheme hearing notwithstanding that the mezzanine creditors were *not* scheme creditors. (This observation is important because, as we shall see, one feature of Part 26A is that it too provides objectors with such a forum.)

There are important limitations in the ability to cram down an entire class by the means summarised above however:

(1) It is dependent upon the jurisdiction to open a pre-pack administration, given the likely reluctance of directors to effect the necessary disposal. If the company's COMI is not in the UK and cannot effectively be shifted to the UK, then the approach used in *Bluebrook* is not available.

(2) There must also be a sufficiently broad intercreditor agreement in place that subordinates the rights of the junior creditors to those of the senior creditors in an enforcement scenario and permits a release of the security. It will not otherwise be possible for the pre-pack administration sale to sell free of the existing security following the scheme between the company and the senior creditors. As already explained, *Bluebrook* was, in very simplified terms, a scheme in aid of a security enforcement where, for a variety of reasons, the senior creditors could not (or would not) agree amongst themselves.

Whilst many responses to the initial consultation were unenthusiastic (in large part because of the arguable over-reaction of the Government to the Word Bank's "*Doing Business*" rankings), the ability to cram down a single class prior to the enactment of Part 26A was subject to important practical limitations. These limitations

may become increasingly significant in the future because of the accelerated development of a substantive EU insolvency law following Brexit which may make it less likely that EU companies will seek to COMI-shift to the UK for purposes of making use of UK restructuring tools.

## Part 26A: a review of the new law

### Financial difficulty threshold

Part 26A, Section 901A(2) defines "Condition A" to the application of Schedule 10 as follows:

*"Condition A is that the company has encountered, or is likely to encounter, financial difficulties that are affecting, or will or may affect, its ability to carry on business as a going concern."*

The financial difficulty threshold for the new regime has, therefore, been extended to include a futurity aspect that is intended to be more forward looking than that permitted under Schedule B1 ("*...likely to become...*") in the case of administration. The likely reason for this low threshold is to permit a financial restructuring in anticipation of financial difficulties.

One immediate issue is what conceptual and practical bounds limit this potentially almost unrestricted test of financial difficulty. The need for such bounds was one specifically noted by the Chancery Judges' response to the Government's initial proposals (albeit in connection with the related new moratorium) (§4-5):

*"As to the conditions for entry, the proposed moratorium is a unilateral act of a company which "is experiencing or anticipates imminent financial difficulty". To use it otherwise e.g. to frustrate court proceedings or to secure commercial advantage in the renegotiation of a contract, would be an abuse of process. It is therefore essential that the circumstances in which the relief can be invoked are clearly defined, that the conditions for entry are such that it can be clearly demonstrated that they are satisfied, and that creditors can have confidence in the person or persons making the judgment.*

*We do not consider that the anticipation of imminent financial difficulty provides a sufficiently stringent test. A test that the company "is or is likely to become insolvent" employs a defined, effective and well-known statutory test of insolvency and the need publicly to acknowledge this state of affairs will deter abuse."*

The Government did not refine its proposals in this respect. In its response to the consultation, it said (p.66, §5.130-5.132):

*"**No financial conditions will be set in order to qualify for a restructuring plan.** This means **both solvent and insolvent companies** will be able to propose restructuring plans to their creditors.*

*The Government believes allowing solvent companies to address emerging financial difficulties will reduce stigma and encourage earlier action on the part of directors, thereby avoiding value-destructive action and leading to better outcomes on the whole for creditors and other stakeholders in a company. The protections built into the proposals will safeguard creditors from unfair detriment where their contractual rights are interfered with by the effect of a restructuring plan.*

*As there will be **no financial entry criteria**, a company in an insolvency procedure, acting through the insolvency office-holder, may propose a restructuring plan to creditors. This is in line with existing provisions in the framework such as the ability of a liquidator to propose a CVA. While the Government does not think this would happen often, maximum flexibility is desirable to ensure viable businesses do not fail unnecessarily."* (Emphasis added.)

The absence of financial entry criteria was an intention repeated in the December 2019 briefing paper for the House of Commons (p.28).

The language of Condition A means that it will prove difficult to set any conceptual bounds on what amounts to qualifying "*financial difficulties*". For instance, an attempt to differentiate "*legal difficulties*" (e.g. a foreign import restriction on a UK exporter) will likely fail because the legal restriction is merely the proximate cause of "*financial difficulties*". The causal connection between events affecting the company and its financial position, therefore, makes it very difficult to say what disqualifies a company from satisfying Condition A.

### The purpose threshold

Part 26A, Section 901A(3)(b) defines "Condition B" to the application of Schedule 10 as requiring that:

*"the purpose of the compromise or arrangement is to eliminate, reduce or prevent, or mitigate the effect of, any of the financial difficulties mentioned in subsection (2)."*

Thus, although Condition A permits a company to propose a restructuring in a very wide range of financial circumstances, Condition B requires that any such restructuring is for a particular purpose, namely to address such financial difficulties.

This condition is plainly intended to limit the permitted nature and effect of a restructuring under Part 26A. It has to address financial difficulties, rather than have any other purpose. Given, however, the broad nature of such financial difficulties and their causes, it is not clear what constraints Condition B will in practice provide, nor how the courts will control the scope of restructuring proposals to ensure that they are not used, in whole or in part, for some extraneous or collateral purpose.

In this regard, however, a lesson might usefully be drawn from the US jurisprudence under Chapter 11 of the US Bankruptcy Code. There is no insolvency requirement for the commencement of a Chapter 11 case. However, a case can be dismissed early if it has been filed in bad faith or without reasonable hope of success: see e.g. *SGL Carbon Corporation* 200 F. 3d 154 (3rd Cir., 1999), which dismissed the proceedings for a lack of "*reorganizational purpose*". This approach is not dissimilar to the English case law concerning an interim moratorium for an individual voluntary arrangement. The Court requires a proposal to be "*serious and viable*" if a moratorium is to be sustained: see *Hook v Jewson* [1997] 1 BCLC 664 (Rimer J).

In the absence of qualifying financial criteria with any teeth and the inclusion of a broad requirement as to purpose, the protection against abuse is, therefore, likely to have to be developed by similar means.

### Voting requirements

The attitude to voting requirements has varied throughout the course of the legislative process. The Government's initial proposal was to retain the same numerosity and value thresholds as apply to scheme of arrangement

(p.24, §9.19-9.20). It was however pointed out by, amongst others, Professor Jennifer Payne, that the numerosity threshold had been heavily criticised and served little apparent purpose. Why, rhetorically, should two creditors each owed £100,000 have the whip-hand over one creditor owed £800,000 in respect of a company that owes £1,000,000?[4] The Government modified this proposal to require 75% by value and 50% of the independent creditors: see the Government's response to the consultation at p.63, §5.114 and p.70-71, §5.153-5.155. This proposal too was dropped and the text of the Act provides for a single 75% majority by value threshold; a late amendment for a 66 2/3 threshold having been rejected. Part 26A, Section 901F(1) provides:

*"If a number representing 75% 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 section 901C, agree a compromise or arrangement, the court may, on an application under this section, sanction the compromise or arrangement."*

The words *"a majority in number representing 75% in value"* do not appear and one simply has *"a number representing 75% in value"*.

## Classes

### A rights-based class test

Before turning to the connection between classes and the cram down power, it is first useful to look at the approach to classes under Part 26A in isolation. Part 26A, Section 901C is as follows:

"(1) *The court may, on an application under this subsection, order a meeting of the creditors or class of creditors, or of the members of the company or class of members (as the case may be), to be summoned in such manner as the court directs.*

(2) *An application under subsection (1) may be made by—*

*(a) the company,*

*(b) any creditor or member of the company,*

*(c) if the company is being wound up, the liquidator, or*

*(d) if the company is in administration, the administrator.*

(3) *Every creditor or member of the company whose rights are affected by the compromise or arrangement must be permitted to participate in a meeting ordered to be summoned under subsection (1).*

(4) *But subsection (3) does not apply in relation to a class of creditors or members of the company if, on an application under this subsection, the court is satisfied that none of the members of that class has a genuine economic interest in the company.*

(5) *An application under subsection (4) is to be made by the person who made the application under subsection (1) in respect of the compromise or arrangement."*

The basic process is not therefore that different to the existing scheme of arrangement regime. The intention appears to be to piggy-back on the existing learning as to class compositions; a matter emphasised in the explanatory notes to the iterations of the bill as it passed through Parliament. In this regard, one might reasonably expect the two-stage rights-based class analysis to carry over.

The only apparent difference is the option for the proponent to make an additional application to exclude 'out of the money' creditors within a putative class, defined as creditors without a "*genuine economic interest*". It is not however clear as to how sub-paragraphs (3) and (4) are to operate against the background of the existing law.

The power of the company, recognised in *Sea Assets v Garuda*, to control to whom a compromise or arrangement is put does not appear to be overridden by the new provision. Sub-paragraph (3) merely requires that all putative members of a class be permitted to participate at meetings. It does not, as such, preclude a company from carving out members of that putative class for commercial reasons (for instance, because they are willing to enter into bilateral arrangements, as was the case with the government creditors in *Sea Assets v Garuda*).

The intention of sub-paragraph (4) appears to be that creditors whose rights are affected by the compromise or arrangement do not have to be permitted to participate in a meeting if, on an application, the court is satisfied that none of the members of that class has a genuine economic interest in the company. This represents a change in the law and avoids the need for security enforcement structures, such as in *Bluebrook*, being used to dispose of the company's assets to a new SPV for the benefit of the senior creditors, whilst leaving the (uncompromised) junior creditors with a claim against a now empty shell.

As to what is meant by "*genuine economic interest*", the phrasing is unusual because "*genuine*" connotes sincerity, and, however sincere, a belief in value is irrelevant to an objective test of value. The phrase is likely to be construed as akin to a "*tangible*" or a "*real*" (as opposed to a "*fanciful*") economic interest in the company. Further, given the apparent adherence to the existing law on class composition, it is reasonable to suppose that the Court will construe that economic interest as one that has to flow from the rights of the creditors against the scheme company. For instance, the value in rights against a guarantor or a third party such as an insurer or a market counterparty under a CDS would not, on this

4. A majority in number makes some sense applied to a members' meeting or, indeed, on the model that debenture holders might also be initial capital subscribers. This is because it might be said that all initial subscribers coming together at one time might accord weight to the views of each member or initial subscriber in addition to the value of the holdings subscribed. It is however a requirement that makes much less sense applied to creditors whose debts may have been acquired at different times and for different, disparate reasons.

approach, constitute a "*genuine economic interest in the company*".

**Gerrymandering and the artificial creation of classes**

On its face therefore, Part 26A does not appear very different from the approach to classes under Part 26. The modern approach to the constitution of classes under Part 26 is against the proliferation of classes, in particular, in circumstances in which the division of a putative single class would create an unjustified veto or hold-out position. This approach is both commercially required, if the scheme of arrangement is to continue as a viable restructuring tool, and consistent with the purpose of Part 26 as a means of binding dissent *within* a class. If creditors or members can properly consult together within a single class, differences in their rights against the company which might fracture that class should not do so, so that the aim of consultation together on a proposal in their common interest can be achieved. It is this impulse that drives the modern line of cases following *Re Hawk Insurance Company Limited* [2001] 2 BCLC 480.

Part 26A however is very different, notwithstanding the use of some of the same concepts as Part 26, namely of a "*compromise*" or "*arrangement*" and a rights-based class test, because Section 901G, considered in detail below, permits a cram down of a dissenting class provided that another class with a "*genuine economic interest*" in the relevant comparator votes for the proposal and the dissenting class is not any worse off than in the relevant comparator. Part 26A is therefore concerned with inter-class dissent, as opposed to intra-class dissent. The seismic implications of this change for the test of fairness are considered in the next section of this article. The change is, however, also likely to have profound implications for the constitution of classes because the affirmative vote of an economically enfranchised class is the gateway to the cross-class cram down. The "someone likes it" rule, as Section 901G(5) might be termed, controls access to the cram down power. There will be an incentive on the part of the proponent, be it the company or another creditor, to constitute the classes to ensure that there is someone who does like the proposal in order to cramdown someone who does not.

The problem posed by the new legislation is what limits, if any, should the court set on the constitution of classes. As noted above, insofar as Part 26A addresses classes, Section 901C borrows from the language of Part 26 in part and would appear to direct the court to a rights-based class test: see, in particular, the language of Section 901C(3) ("*Every creditor or member of the company whose rights are affected by the compromise or arrangement must be permitted to participate in a meeting ordered to be summoned under subsection (1).*") Part 26A provides no assistance on the question of whether or how the court should further control the constitution of classes.

What limits, if any, the court should set is an area in which the court might usefully examine the Chapter 11 caselaw, which has dealt with the "*artificial*" creation of an impaired class (sometimes termed "*gerrymandering*") for decades.

Chapter 11 requires the classification of claims against a debtor for two reasons. First, each class of creditors will be treated in the debtor's plan of reorganization based upon the similarity of its members' priority status and other legal rights against the debtor's assets: see §1122. Proper classification is essential to ensure that creditors with claims of similar priority against the debtor's assets are treated similarly. Secondly, the classes must separately vote whether to approve a debtor's plan of reorganization: see §1129(a)(8). A plan may not be confirmed unless either (1) it is approved by two-thirds in amount and more than one-half in number of each "*impaired*"[5] class: see §1126(c), 1129(a)(8); or (2) at least one impaired class approves the plan (see §1129(a)(10)), and the debtor fulfils the cramdown requirements of §1129(b) to enable confirmation notwithstanding the plan's rejection by one or more impaired classes.

The ability to select the classes arises under §1122. §1122 permits a plan to place "*a claim or an interest*" in a particular class only if such claim or interest is "*substantially similar*" to the other claims or interests of such class. It is a test based on claims or interests; concepts which include rights against the debtor, but which it appears are not limited to (nor dictated by) such entitlements.

Gerrymandering can involve, among other things: (i) the joint classification of supporting creditors' claims with the claims of creditors who are not, with the expectation that supporting claims will sufficiently outnumber dissenting claims to ensure acceptance of the plan by the class as a whole (something which can be done under an existing Part 26 scheme); or (ii) separately classifying the claims of dissenting creditors from the claims of supporting creditors to ensure that the dissenting creditors cannot block the exercise of the power to cram down the dissenting class (something which cannot be done under an existing Part 26 scheme). In response to, or in anticipation of such action by the debtor, creditors may seek to purchase the claims of other creditors to block a majority vote within a class or to hollow out an impaired class whose vote might otherwise be used to engage the cram down power.

In response to such tactics, the US courts have developed two principal controls. The first is to articulate a limit on the power to classify claims under §1122. The second is to "*designate*", i.e. to disqualify, votes whose acceptance or rejection of

5. "Impairment" is, in broad summary, defined under §1124 as an alteration of the legal, equitable, and contractual rights to which the holder of the claim or interest is entitled.

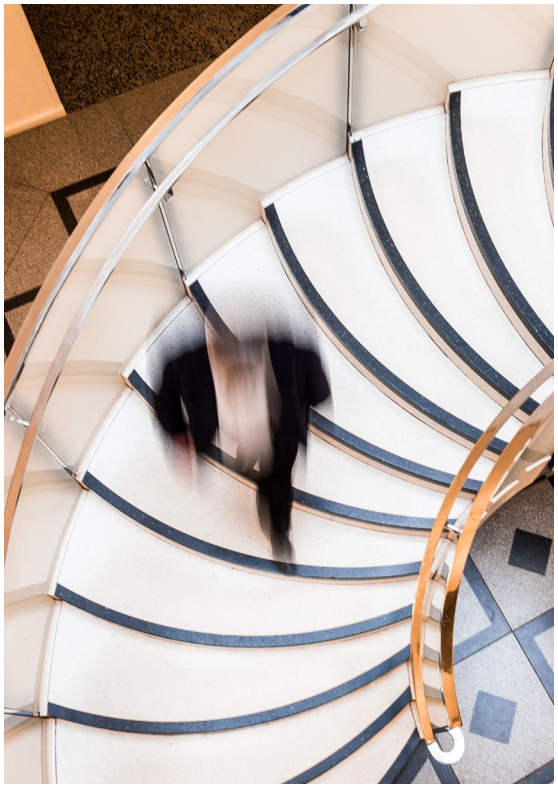
6. §1111(b) deems a non-recourse secured claim to rank as an unsecured claim in respect of a deficiency upon the secured creditor's election. The creditor may elect recourse status and obtain the right to vote in the unsecured class, or it may elect to forego recourse to gain an allowed secured claim for the entire amount of the debt.

the plan was "*not in good faith*", as provided for by §1126(a).

As to the first of these controls, the US courts have identified inherent limitations in the power to select classes under §1122. In *In re Greystone III Joint Venture* 995 F.2d 1274 (5th Cir. 1992), the US Court of Appeals for the Fifth Circuit overturned the decision of the lower court to the effect that the "*legally different*" unsecured claims of trade creditors were to be classified differently from the deemed unsecured claim of a non-recourse[6] secured creditor. The premise of the reasoning of the lower court was that §1122 does not "*unambiguously prevent classification of like claims in separate classes*". The Fifth Circuit held that this construction was wrong because, first, §1122(b) had to specifically except "*convenience claims*", i.e. claims of a *de minimis* value set by the court which would otherwise form part of a given class. It was inherent within §1122 that there was some notion of a properly constituted class. Secondly, having regard to the "*substantially similar claims*" test, it said:

"*A fair reading of both subsections suggests that ordinarily 'substantially similar claims,' those which share common priority and rights against the debtor's estate, should be placed in the same class*"

In the light of this inherent limitation within §1122, which the court emphasised in place of the "*otherwise muddled caselaw on §1122 claims classification*", the Fifth Circuit emphasised "*the one clear rule*": "*thou shalt not classify similar claims differently in order to gerrymander an affirmative vote on a reorganization plan*". In support of this rule, the Fifth Circuit approved the observation of the Sixth Circuit in *In re U.S. Truck Co.*, 800 F.2d 581, 586 (6th Cir. 1986):



"*[T]here must be some limit on a debtor's power to classify creditors in such a manner...Unless there is some requirement of keeping similar claims together, nothing would stand in the way of a debtor seeking out a few impaired creditors (or even one such creditor) who will vote for the plan and placing them in their own class.*"

In conclusion it said:

"*We conclude that if §1122(a) permits classification of "substantially similar" claims in different classes,* ***such classification may only be undertaken for reasons independent of the debtor's motivation to secure the vote of an impaired, assenting class of claims****.*" (Emphasis added.)

The Fifth Circuit, accordingly, focused its assessment on the 'independent' reasons given for the separate classification. On the facts, it concluded that the different juridical bases for the two sets of unsecured claims was irrelevant. Trade creditors had an unsecured claim of the same quality in the circumstances as the deemed unsecured claim of the non-recourse secured creditor who had elected an unsecured claim in respect of the deficiency in its security. There was no independent reason (distinct from the desire to skew the classes in favour of a cram down) that justified the difference.

Under Part 26 the court already scrutinises claims of creditors to determine whether their rights are sufficiently similar to permit them to vote together with a view to their common interests. One difference is that, under Part 26A, a court may now need to examine more closely a proposal which asserts that the rights of two different groups of creditors are sufficiently different to require them to be placed in separate classes.

A scrutiny of a company's commercial reasons for proposing a particular class is also already undertaken by the court under Part 26 in the context of a company's decision to exclude creditors or members from the putative class, as was the case in *Sea Assets Ltd v PT Garuda Indonesia* [2001] EWCA Civ 1696 and *In SAB Miller plc* [2017] Ch 173. An enquiry into a company's reasons for a particular classification is not, as such, impracticable nor a matter on which the court cannot adjudicate.

A principal difficulty for the development of a control akin to that described above is the rights-based test under Part 26A. Legal, equitable and other rights are the stock in trade for a court of law, and differences in rights and how the same will perform in the relevant comparator, is likely to prove to be a fertile source of justification for the separate classification of particular creditors

in order to target others with the cram down power under Section901G. The obvious riposte to an asserted distinction based on a difference in rights in the relevant comparator is that the company's assessment of what those rights are and how those rights will perform is wrong. If the court is satisfied that there is no relevant difference because the company's assessment is wrong, the conclusion is that the asserted separate classes are in fact a single class. This approach explains Greystone above. It also explains the factually similar later case of *Travelers Insurance v. Bryson Properties, XVIII* 961 F.2d 496 (4th Cir. 1992) in which the Fourth Circuit said:

*"Where all unsecured claims receive the same treatment in terms of the Plan distribution, separate classification on the basis of natural and unnatural recourse claims is, at a minimum, highly suspect. In this case, Bryson has failed to offer any reason for separate classification of the unsecured claims which will withstand scrutiny."*

In the context of a rights-based class test, it may well be possible to stop the enquiry after an assessment of the rights in the comparator and under the proposal without having to enquire further into "*any reason for separate classification*". This may well prove to be a better control of "*gerrymandering*" than a separate doctrine that is hard to define and harder to apply.

It is likely for this reason that no law has yet been developed under Part 26 further to Hildyard J's obiter dictum in *Re Apcoa Parking Holdings GmbH* [2015] 2 BCLC 659. In response to Mr Snowden QC's submission that "*the court should be very astute to detect attempts to manipulate the class composition to achieve a particular result*" (for which *Sea Assets* was cited as authority), Hildyard J said, at [171]:

*"[I]t seems to me that the Sea Assets case was really concerned with the selection of who are to be scheme creditors. But I can well understand and accept more generally that the court will be astute to avoid gerrymandering or its like."*

On the facts of *Apcoa*, Hildyard J rejected the challenge to the composition of classes on orthodox principles, and no subsequent case has sought to develop the above observation. Part 26A may in due course provide the occasion for such development; however, given the rights-based approach to classes that Part 26A shares with Part 26, we think the court will likely seek to resolve disputes as to the correct constitution of classes without developing an additional doctrine. If, however, the traditional rights-based approach to class composition is not adequate, there does appear to be support for the incremental development of additional controls.

In this regard, one potentially difficult problem arises if the different classes are sought to be justified by differential treatment *under* the restructuring. Class manipulation can also take the form of manufacturing an impaired class even though impairment is unnecessary. For example, a plan could pay creditor claims nearly, but not entirely, in full or modify their rights in some minor but not immaterial respect such that they are still willing to vote to accept the restructuring (such as a minor but not immaterial change in interest rates or rest periods for interest calculation). To the extent that the restructuring proposal treats creditors differently, they will need to form a different class on the rights-based approach. There may be further scope for companies to use this fact to artificially manufacture supporting and dissenting classes. This may be one area in which additional controls are required.

As to the second of the controls developed by the US courts, in *Young v. Higbee Co*, 324 U.S. 204 (1945), the Supreme Court considered the predecessor of §1126(e). It declared, at pp.210-11, that if certain persons "*had declined to accept [the] plan in bad faith, the court…could have denied them the right to vote on the plan at all.*" It went on to explain that the provision was intended to apply to those "*whose selfish purpose was to obstruct a fair and feasible reorganization in the hope that someone would pay them more than the rateable equivalent of their proportionate part of the bankrupt assets.*"

In *In re Figter Limited* 118 F.3d 635 (9th Cir. 1997), the US Court of Appeals for the Ninth Circuit took the decision in *Young v Higbee* as a starting point, recognising that the sweeping dictum was too broad. It said, at p.639: "*If a selfish motive were sufficient to condemn reorganization policies of interested parties, very few, if any, would pass muster.*" It continued:

*"On the other hand, pure malice, "strikes" and blackmail, and the purpose to destroy an enterprise in order to advance the interests of a competing business, all plainly constituting bad faith, are motives which may be accurately described as ulterior."*

In that case, the respondent (Teachers, the sole secured creditor) had purchased the majority of the claims in the impaired unsecured class at 100c/$ to block the debtor (Figter, the owner of a single residential complex in Los Angeles) from using the approval of the plan by the unsecured class to engage the cram down power. On the facts the appeal court said that there was no basis to interfere with the judge's finding that the respondent's actions in its self-interest to protect its existing claims amounted to bad faith.

The focus on a motive that is "*ulterior*" and the recognition of its rarity and difficulty of definition is, on one view, similar to the reasoning of Vos C in *In re Dee Valley Group plc* [2017] 3 WLR 767, which decision held that a meeting convened under Part 26 was a court meeting under the control of the court and that, as such, the court had power to discount votes split for numerosity purposes to defeat an otherwise proper scheme of arrangement. In that case, the employees who opposed a takeover had acquired and split a small shareholding to defeat the takeover scheme because they did not consider it in their interests as employees. Vos C said, at [43] and [47]:

*"[The Court] is then deciding, amongst other things, first whether the statutory pre-requisites have been fulfilled, and secondly whether the class attending the meeting the court called was fairly represented by those attending the meeting,* ***whether the statutory majority were acting bona fide and not coercing the minority in order to promote interests adverse to those of the class they purport to represent.*** *It is quite clear from that exercise that the court is indeed concerned with those matters in sanctioning a scheme. The clue as to what members are supposed to be doing in voting at the court's class meeting is also, I think, to be found in that second well-established formulation.* ***The members are supposed to be fairly representing their class, and acting bona fide, and not***

*Restructuring proceedings in England have not tended to encourage trials to determine contested issues. This may need to change*



***coercing a minority in order to promote interests adverse to the class they purport to represent.***

...

*I have therefore concluded that members voting at a class meeting directed by the court must exercise their power to vote "**for the purpose of benefiting the class as a whole, and not merely individual members only**": see Viscount Haldane's formulation in the **British America Nickel** case. I am not sure that the gloss suggesting that members at such a meeting must not vote for extraneous reasons is helpful. The key is that the members of the class must vote in the interests of the class as whole and not in their own specific interests if they are different from the interests of the class. I turn under the next heading to consider when a vote might be held to contravene this requirement."*

On the facts, Vos C held that the "*only*" explanation for the employee shareholders' vote was their interest as employees, not as shareholders. He said, at [58]:

"*[T]he only possible explanation for the conduct of the Individual Shareholders was to further a share manipulation strategy to defeat the Scheme by use of the majority in number jurisdictional requirement. The actions of the Individual Shareholders in accepting the gift of a single share in the circumstances I have described demonstrated that they could have given no consideration to the interests of the class of members which they had joined. They can only have joined that class with the pre-conceived notion of voting down the Scheme.*"

The result in *Dee Valley* makes for an interesting comparison with *Figter*. The defensive acquisition of shares and vote splitting was, on the evidence, sufficient to support an inference of a purpose adverse to the class interest in Dee Valley. It was not so in *Figter*, despite the respondent having paid 100c/$ for the claims acquired, thus negating any possible commercial explanation for the purchase other than to defensively block the exercise of the cram down power. The difference in result is in large part likely the result of the view, explicit in the reasoning in Figter, that in an inter-class context there should be greater tolerance of self-interested action. In comparison, *Dee Valley* and the line of cases relied on, dating back to *British America Nickel Corpn Ltd v MJ O'Brien Ltd* [1927] AC 369, are all cases of intra-class conflict in which the defined class interest should be given priority.

The Chapter 11 cases therefore serve to highlight that the English court should not uncritically borrow from the case law under Part 26 to develop appropriate controls for Part 26A. The case law under Part 26A might therefore rationally develop to permit the sort of defensive acquisition of claims allowed in *Figter*.

One difficulty in this area, however, is that traditionally proceedings for a restructuring in England have not tended to encourage the possibility of trials to determine contested issues of fact, as that would delay the outcome of the restructuring. If, however, controls are to be placed on the ability of creditors to buy up claims to frustrate a restructuring or which require a more detailed assessment of the reasons for structuring the classes in the manner proposed, this may need to change.

## Cram down upon approval by the Court

Section 901F(1) quoted above is subject to section 901G, pursuant to section 901F(2)(a). Section 901G contains the means to cram down a dissenting class. It relevantly provides:

"(1) *This section applies if the compromise or arrangement is not agreed by a number representing at least 75% in value of a class of creditors or (as the case may be) of members of the company ("the dissenting class"), present and voting either in person or by proxy at the meeting summoned under section 901C.*

(2) ***If conditions A and B are met, the fact that the dissenting class has not agreed the compromise or arrangement does not prevent the court from sanctioning it under section 901F.***

(3) ***Condition A*** *is that the court is satisfied that, if the compromise or arrangement were to be sanctioned under section 901F,* ***none of the members of the dissenting class would be any worse off than they would be in the event of the relevant alternative*** *(see subsection (4)).*

(4) *For the purposes of this section "the relevant alternative" is* ***whatever the court considers would be most likely to occur in relation to the company if the compromise or arrangement were not sanctioned under section 901F.***

(5) ***Condition B*** *is that the compromise or arrangement has been agreed by a number representing 75% in value of a class of creditors or (as the case may be) of members, present and voting either in person or by proxy at the meeting summoned under section 901C,* ***who would receive a payment, or have a genuine economic interest in the company, in the event of the relevant alternative.***" (Emphasis added.)

An entire dissenting class can therefore be bound by the compromise or arrangement *provided that* (A) no member of that dissenting class would be worse off than they would be in the likely relevant comparator; and (B) at least one 'in the money' class votes for the scheme.

The drafting of sections 901F and 901G means that the satisfaction of the above conditions does *not* mandate the exercise of the discretion of the Court. The conditions in section 901G regulate the power of the Court to approve the compromise or arrangement but do not compel the exercise of that power. Accordingly, a critical question unresolved by the legislation is what standard the Court should develop to regulate the exercise of its discretion. For instance, if Condition A is satisfied, should there be a presumption that the Court should sanction the compromise or arrangement, as it has, on that premise, been established that the dissenting class is no worse off than in the comparator? Notwithstanding the satisfaction of Condition A, can the dissenting class nonetheless successfully oppose sanction, for example because the terms of the proposal allow value to be ceded to a lower ranking class such as shareholders? These and other questions will require the Court to formulate the standard which it is to apply to govern the exercise of its discretion.

**Is there room for the honest, reasonable and intelligent creditor test?**

The test of fairness fashioned by the Victorian judges and received into the modern era under Part 26 is a test of rationality. It postulates a hypothetical honest, intelligent and reasonable member of the class to be bound by the scheme and asks whether such a member could approve the scheme. In the event of a representative majority vote, the Court will presume rationality and thus fairness; hence, the expression that the Court should be "*slow*" to differ from the view of the scheme expressed by a representative majority vote. The presumption does not mean the Court is a rubber-stamp and will not apply its own mind to the question of fairness. It means that the Court will recognise that creditors are usually the best judge of their own interests and give weight to their views in assessing the view of the hypothetical honest, intelligent and reasonable member of *that* class.

So assessed, it is readily apparent that the test of fairness developed in the existing scheme case law is manifestly inadequate as a test of whether it is fair to cram down a distinct, dissenting class. Whatever test should be fashioned it must be capable of sensible operation even if *all* members of the dissenting class should vote against the scheme. A test based on the view of a hypothetical honest, intelligent and reasonable member of the class in question makes no sense when all members of that class may have dissented. Part 26A is a new set of provisions intended to achieve outcomes that could not be achieved under Part 26, and the Court is likely to recognise that, much as it recognised that it was not appropriate in all cases to burden the 1986 legislation with the intellectual freight of previous regimes[7].

No substantial guidance is to be found in other related lines of English case law because, although the amorphous standard of "*just and equitable*" has been in the Companies Acts since before 1862[8], it has always been applied on the facts and has resisted definition. In *Re Wear Engine Works Co* (1875) LR 10 Ch App 188, James LJ said, at 191: *"[T]he equity must be founded on facts alleged in the petition."* In the context of a winding up this has been taken to mean that whether it is *"just and equitable"* that a company should be wound up is *"an inference of law from the facts of the situation"*: French,

7. See, for example, *Re a debtor (No 1 of 1987, Lancaster), ex parte the debtor v Royal Bank of Scotland plc* [1989] 2 All ER 46, 50 *per* Nicholls LJ.

8. See section 5 of the Joint Stock Companies Winding Up Act 1848, which was re-enacted by sections 79 (for registered companies) and 199 (for unregistered companies) of Companies Act 1862.

*Applications to Wind Up Companies*, 3rd Ed, at 8.137. The previous case law on the meaning of *"just and equitable"* will provide no guidance because no cram down situation has hitherto been considered. The latest statutory iterations of the "*just and equitable*" standard have settled on "*fair*". In Part 2 of the Banking Act 2009, which deals with bank insolvency (i.e. of deposit taking banks), section 93(8) defines "*fair*" as follows:

*"The expression "fair" is used in this Part as a shorter modern equivalent of the expression "just and equitable" (and is not therefore intended to exclude the application of any judicial or other practice relating to the construction and application of that expression)."*

Notwithstanding the lack of definite content to the expression "*just and equitable*" (and its *"shorter modern equivalent", "fair"*), it is this form of words that the Government alighted upon in its 'fact sheet'[9] on 5 June 2020 and in the explanatory notes to the bill introduced to Parliament:

*"The court has an absolute discretion whether to sanction the [restructuring plan] and may refuse to sanction if it is just and equitable to do so."*

*"[T]he court will still have an absolute discretion whether or not to sanction a restructuring plan, and may refuse sanction on the grounds that it would not be just and equitable to do so, even if the conditions in section 901G have been met."*

There is however no expression to this effect in Part 26A itself, and the notion that the court would have an "*absolute discretion*" is contrary to the objective standard that the words "*just and equitable*" imply. If taken at its word, an "*absolute discretion*" would in most cases bar an appeal against a sanction decision as a matter of law and would require the appellant to make out the higher standard of irrationality or caprice in the judge's decision. As such, it is doubtful that the draftsman intended to confer an "*absolute discretion*" and therefore an essential first question is what standard of fairness should be developed.

**What guidance on fairness can be derived from the pre-legislative material?**

The Government's initial proposal was that the cram down was subject to the safeguard that the Court considered the plan "*fair and equitable*" (pp.24-25, §9.21, 9.27). The language was borrowed from §1129(b)(1) of Chapter 11 without elaboration or content. As was observed by the Chancery Judges in their response to the proposal (at §48), it is "*to state the obvious*" that the Court will not approve a plan that is not "*fair and equitable*". In any case, not even this limited expression as to the standard the Court should apply has found its way into Part 26A. Part 26A is silent as to what standard the Court should adopt.

The legislative silence is significant because the issue of fairness was the subject of express consideration by the Government both in its initial proposal and in its response to the consultation. The Government's initial guidance was that a plan would be deemed fair if better than a liquidation comparator. At p.25, §9.27, the Government wrote:

*"The role of the court in the proposed cram-down mechanism will make sure that the rights of creditors are fairly considered and that cram-down only takes place when it is fair and equitable* ***and leaves impaired creditors no worse off than would be the case in liquidation.*** *The power to reject a plan if it is not fair and equitable is a key protection to counterbalance the new class structure and cram-down option."* (Emphasis added.)

And, at p.26, §9.32:

*"A restructuring plan* ***will be*** *considered fair and equitable if the following conditions are met:*

- ***all creditors will be no worse off than in liquidation;***
- *secured creditors will be granted absolute priority on repayment of debts; and*
- *junior creditors should not receive more on repayment than creditors more senior than them."* (Emphasis added.)

This proposal had the merit of clarity but little else. If enacted it would have required the imposition of plan based on a liquidation value, even if the probable comparator was not a liquidation but, for instance, a relatively better outcome in an administration.

The Government's initial paper was however not committed to the view expressed in the above-quoted passages because, in later passages (p.27, §9.35) the suggestion appears to have been that the liquidation value should merely function as a necessary but not sufficient condition to a "*fair and equitable*" plan:

*"Valuations in a restructuring can be particularly contentious and numerous valuations are used in different situations (for example going concerns, fair market, break up and liquidation). For this proposal, the Government is considering legislating for the use of a minimum liquidation valuation, so when determining the value of interests in a restructuring plan, impaired classes should receive* ***at least*** *what they would have received in a liquidation situation. This provides flexibility for the use of other methods of valuation where appropriate, whilst providing a minimum liquidation valuation as part of the court's 'fair and equitable' determination of the plan."* (Bold text in italics in the original text.)

In developing its thinking, the Government appears to have heeded the concerns about a sole liquidation comparator. See, in particular, its response to the consultation (pp.73-74, §5.169-5.176) and in the House of Commons Library briefing in December 2019. In those documents,

9. https://www.gov.uk/government/publications/corporate-insolvency-and-governance-bill-2020-factsheets/restructuring-plan

the Government defined the comparator in terms of *"the next best alternative"*, referencing administration as an outcome that was an alternative to a winding up. In its response to the consultation, it wrote:

> *"The Government agrees administration would often be a likely outcome were a plan to be rejected, and notes the minimum liquidation valuation basis would allow a valuation based on administration (as the valuation is a minimum, not a ceiling). However, this nuance may be lost and a lower liquidation valuation might be used instead.* ***The Government has concluded that the next best alternative for creditors if the restructuring plan was not to be agreed is the best alternative valuation basis.***
>
> ***The next best alternative[10] for creditors is a flexible protection, as it will fit the circumstances of the particular case in question.*** *Administration will often be the next best alternative for creditors, but in some cases administration might not be a realistic option meaning liquidation is the only alternative that can be used. In the event of challenge the court will decide, based on the evidence put before it, what the next best alternative is."* (Emphasis added.)

What amounts to *"the next-best-alternative scenario in the absence of a plan"* is, therefore, a concept that rightly admits of a going-concern valuation as a possibility to be established on the evidence. It is however likely to prove to be a lightning rod for litigation under Part 26A.

The protracted litigation of valuation disputes within a restructuring process may not be a welcome development. Its advantage is certainty at the very end of the process, if the plan should be approved; however, it is likely to protract the process itself with attendant increases in expense and decreases in the certainty of a successful outcome. A concern about the new regime is the encouragement of more sophisticated valuation disputes. The Chancery Judges' response to the Government's initial proposal said frankly (at §23): *"We express apprehension whether the courts have either the resources or the procedures to resolve these issues."*

Chapter 11 was, in contrast, drafted with a different mindset. It is a set of rules purposefully designed to influence the negotiating position of the interested parties and, as such, is prepared to litigate the issues of central importance to those interests. As explained in 1979 by Kenneth Klee, one of the principal draftsmen of Chapter 11:

> *"In some cases, agreement with each class will not be reached and the plan may only be confirmed over the dissent of a class of claims or ownership interests - the 'cram-down' power. In those cases special rules apply to protect dissenting classes of secured claims, unsecured claims, and ownership interests.* ***While these rules will be important in the context of confirmation of a plan when a class dissents, one of the hypotheses of the Code is that the rules will also affect the negotiating posture of the debtor and creditors with respect to formulation of a plan.*** *Hence, an ancillary effect of the cram-down rules will be to produce a plan which all classes will accept voluntarily."* [11] (Emphasis added.)

Chapter 11 and its willingness to embrace valuation disputes was, and remains, a positive attribute from the perspective of a set of rules intended to incentivise the interested parties to negotiate a solution for themselves. This point has been impressed upon us in our discussions with those with direct experience of Chapter 11. It may therefore be the wrong perspective in the long run for the court to be reluctant to engage with and develop appropriate principles and practices to resolve disputes as to value and the appropriate comparator.

Notwithstanding the prospect of development in the future, it is likely in recognition of the potential teething problems with the new regime that the Government has enacted Part 26A as a separate, parallel regime to Part 26, rather than as a replacement.

The need for caution in this regard is reinforced by the prospect of the classification of the new regime as an insolvency proceeding with implications for its EU-wide recognition outside the Recast Insolvency Regulation. Part 26A restructuring plans are likely to obtain extra-territorial effect through a combination of recognition under UNCITRAL Model Law implementations and the fact that choice of law rules globally tend to accept the validity of a contractual discharge or variation where the law of the restructuring aligns with the law of the debt that is restructured. A potential future additional recognition tool is the combination of a Part 26A restructuring plan and a pre-pack Chapter 11 plan, the former providing the framework for the latter.

**What is the next best alternative comparator?**

The next-best alternative comparator is not too far removed from the existing law. The relevant comparator for the purpose of a scheme of arrangement is the likely (counter)factual scenario if the scheme should not be approved. That is a question of fact to be determined in all the circumstances. The company might well assert a particular scenario on the evidence it puts before the court. It is up to creditors to dispute that asserted scenario if they should so wish and to evidence an alternative. In either scenario, the relevant questions of valuation will fall to be determined on evidence consistent with the premises or assumptions of the rival scenarios.

10. Ironically for this Government, "the next best alternative" is the language of the EU Preventative Restructuring Directive 2019/1023. See recitals 2 and 49 and the related operative provisions.

11. K Klee, *All You Ever Wanted to Know About Cram Down under the New Bankruptcy Code* (1979) 53 American Bankruptcy Law Journal 133.

Within this framework, there is no conceptual limit as to what evidence may be admitted save that it must be probative of the issue in dispute and, if expert opinion evidence, justified in the light of the cost of that particular form of evidence.

The present approach to the comparator and to the related issue of valuation has attracted the criticism that English law lags the jurisprudence under Chapter 11 as to its recognition of how value can and should be assessed. These criticisms appear to fall into two categories: (i) English courts are not familiar with particular valuation techniques; and (ii) English law is close-minded in failing to recognise that enterprise value should be assessed on the going concern premise of the success of the plan in question or, at least, of a plan that would be passed but for the plan at issue.

The first of these criticisms is not well founded. *Bluebrook* is one example in the reported cases of the court receiving and assessing multiple forms of valuation evidence, whether based on actual sales processes, a comparable EBITDA analysis or a DCF. If one were to search LexisNexis or Westlaw in these respects, there are dozens of such cases. English judges are entirely familiar with resolving valuation disputes and assessing the appropriateness of particular discount factors and other components of valuation evidence. This is all part and parcel of a fact and evidence-based approach to valuation.

Of greater moment is whether the relevant comparator can be the success of the scheme or of another proposal that might be agreed but for the scheme in question. This is a matter of intense interest, in particular to junior ranking creditors whose interests lie in a maximal enterprise valuation.

This debate is not wholly new and has been canvassed to some extent in *My Travel* and *Bluebrook*. The principal difficulties with an enterprise value based on another proposal are, first, a sufficient level of support for the proposal at hand or, at least, a sufficient level of support against any counterproposal; and, secondly and relatedly, the need for that alternative proposal to articulate and explain its own comparator. These objections have force.

The wording of Part 26A, section 901G appears to preclude a comparator based on the success of *the very* compromise or arrangement under consideration:

*"(4) For the purposes of this section "the relevant alternative" is whatever the court considers would be most likely to occur in relation to the company* ***if the compromise or arrangement were not sanctioned under section 901F."*** (Emphasis added.)

This limitation in Part 26A appears to acknowledge, in particular, the Chancery Judges' response to the Government's initial proposal, which response indicated that the judges would be inclined against speculative, going-concern values based on the success of the plan itself. The Chancery Judges said (at §63):

*"The approach we suggest based upon the counter-factual if the Plan is not approved would, we believe, also mark a principled difference to the approach under Chapter 11 in the US, where the courts frequently entertain contentious and often speculative evidence as to the value that the company will have if the Chapter 11 plan succeeds. This approach has been rightly criticised as enabling creditors and even shareholders who are "out of the money" to claim what (at least on the basis of the prevailing English cases) is an unwarranted benefit in the restructuring negotiations."* (Underlining in the original text.)

In the light of the Part 26A restriction upon a comparator based on the success of the scheme at hand and the apparent reasons for that limitation described above, any argument that the relevant comparator is some *other* compromise or arrangement would have to overcome these apparent hurdles. That prospect is not however ruled out by Part 26A, in particular given the reference in sub-section (4) to what would be likely to occur if "*the compromise or arrangement*" were not sanctioned. Whether and in what circumstances such a comparator can be advanced is likely to be one of the most interesting issues under the new regime. We consider this further below in connection with the potential to 'cram up' a class of senior creditors.

## Fair and equitable

Returning to the question of what standard of fairness the court might develop, given the silence of Part 26 on the question and the Government's apparent decision not to give further guidance in the form of a UK statement of a 'flexible' absolute priority rule, the English court might again find assistance from an analysis of the Chapter 11 caselaw, as well as its own caselaw developed in the context of CVAs.

### Chapter 11 and its specific safeguards

As above, before descending into the Chapter 11 cases, it is useful to examine the statutory framework. §1129(b)(1) provides that

"*[I]f all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.*"

§1129(a)(8) requires that:

"*With respect to each class of claims or interests—*

*(A) such class has accepted the plan; or*

*(B) such class is not impaired under the plan*".

The standard imposed by §1129(b)(1) is, therefore, a safeguard for those who have rejected the plan or who are deemed bound by it.

§1129(b)(2)(A) provides that for a plan to be "*fair and equitable*" for *secured creditors* it must include provision for, inter alia, the secured creditors to retain their liens, for those liens to attach to the proceeds to any sale to the value of those secured claims, or for the realisation of "*the indubitable equivalent of such claims*".

§1129(b)(2)(B) provides that a plan is "*fair and equitable*" with respect to a dissenting impaired class of *unsecured creditors* if the creditors in the class receive or retain property of a value equal to the allowed amount of their claims or, failing that, no creditor of lesser priority, or shareholder, receives any distribution under the plan. In terms §1129(b)(2)(B)(ii) requires that "*the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property.*"

At first blush therefore, Chapter 11 provides little guidance as to how English judges might develop a workable standard of fairness to apply to compromises of arrangements under Part 26A, given that Part 26A lacks the detailed guidance provided by the text of Chapter 11.

### The absolute priority rule, a codification of the common law

However, as held by the US Court of Appeals for the Second Circuit in *Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC)* 478 F.3d 452 (2d Cir. 2007), which decision is considered further below, §1129(b)(2)(B)(ii) codifies the judge-made "*absolute priority rule*" which provided that any plan of reorganization in which "*stockholders [a] re preferred before the creditor, [is] invalid*": see *In re Armstrong World Indus., Inc.*, 320 B.R. 523, 533 (D. Del.), *aff'd* 432 F.3d 507 (3d Cir. 2005), quoting *Northern Pacific Railway Co v. Boyd*, 228 U.S. 482 (1913).

*Northern Pacific Railway Co v Boyd* was the third in a line of cases in the United States Supreme Court concerning transactions to recapitalise railroad companies. The previous cases, *Railroad Co v Howard* 74 US 393 (1868) and *Louisville Trust Co v Louisville, New Albany & Chicago Railway* Co 174 US 674 (1899) had concerned receiverships in which the former owners had acted with the senior secured creditor to sell the assets to a new company, which they controlled, on terms that eliminated the unsecured debt. *Railroad Co v Howard* held that the sale was fraudulent as against general creditors not secured by the mortgage because if there had been an ordinary foreclosure independent of the arrangement between the mortgagees and the stockholders, the whole proceeds of sale would have belonged to the mortgagees and would not, in that scenario, have been shared in by the shareholders of the old company. The opinion of the Supreme Court was delivered by Justice Clifford, who said (at pp.409-411):

"*Equity regards the property of a corporation as held in trust for the payment of the debts of the corporation, and recognizes the right of creditors to pursue it into whosesoever possession it may be transferred, unless it has passed into the hands of a bona fide purchaser, and* ***the rule is well settled that stockholders are not entitled to any share of the capital stock nor to any dividend of the profits until all the debts of the corporation are paid.***

...

*Creditors are preferred to stockholders on account of the peculiar trust in their favor and because the latter, as constituent members of the corporate body, are regarded as sustaining, in that aspect, the same relation to the former as that sustained by the corporation*" (Emphasis added.)

In the factually similar case of *Louisville Trust* case, the Supreme Court amplified its expression of the absolute priority rule. In its opinion delivered by Justice Brewer, the Supreme Court said, at pp.683-684:

"*Assuming that foreclosure proceedings may be carried on to some extent, at least, in*

*the interests and for the benefit of both mortgagee and mortgagor (that is, bondholder and stockholder),* ***we observe that no such proceedings can be rightfully carried to consummation which recognize and preserve any interest in the stockholders without also recognizing and preserving the interests not merely of the mortgagee, but of every creditor of the corporation.*** *In other words, if the bondholder wishes to foreclose and exclude inferior lienholders or general unsecured creditors and stockholders, he may do so; but a foreclosure which attempts to preserve any interest or right of mortgagor in the property after the sale must necessarily secure and preserve the prior rights of general creditors thereof.* ***This is based upon the familiar rule that the stockholder's interest in the property is subordinate to the rights of creditors -- first of secured and then of unsecured creditors. And any arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation."*** *(Emphasis added.)*

In *Northern Pacific Railway Co v Boyd*, the Supreme Court further clarified that the absolute priority rule operated "*even in the absence of fraud*". In an opinion delivered by Justice Lamar, the Supreme Court said, at pp.504-505:

*"****For, if purposely or unintentionally a single creditor was not paid or provided for in the reorganization, he could assert his superior rights against the subordinate interests of the old stockholders in the property transferred to the new company****. They were in the position of insolvent debtors who could not reserve an interest as against creditors.* ***Their original contribution to the capital stock was subject to the payment of debts.*** *The property was a trust fund charged primarily with the payment of corporate liabilities. Any device, whether by private contract or judicial sale under consent decree, whereby stockholders were preferred before the creditor, was invalid. Being bound for the debts, the purchase of their property by their new company for their benefit put the stockholders in the position of a mortgagor buying at his own sale.* ***If they did so in good faith and in ignorance of Boyd's claim, they were nonetheless bound to recognize his superior right in the property when, years later, his contingent claim was liquidated and established. That such a sale would be void, even in the absence of fraud in the decree, appears from the reasoning in Louisville Trust Co."*** (Emphasis added.)

The corporate trust doctrine that underlies part of the reasoning in these decisions[12] has no parallel in English law. Although English law has used the law of trusts and trustees to develop by analogy the duties of directors, English judges recognised relatively early on in the development of English company law that a company owned its own property and was not a trustee for its members or creditors (see, e.g., *Re Lands Allotment Co* [1894] 1 Ch 616 at 631 *per* Lindley LJ; and *Belmont Finance Corp v Williams Furniture Ltd* (No 2) [1980] 1 All ER 393 at 405 *per* Buckley LJ). There is nonetheless a strong parallel between the emphasised words above and the common law doctrine of fraudulent preference developed by Lord Mansfield. He stated the law in *Alderson v. Temple* (1768) 4 Burr. 2235, 2239–2240:

*"****All acts to defraud creditors or the public laws of the land are void****; and if the nature of the act be a conveyance or grant, 'tis not only void, but an act of bankruptcy.' It has been determined 'that a conveyance by a trader, of all his effects, for the payment of one or more bona fide creditors of the most meritorious kind, though his effect do not amount to half what is due, is void; because it is not an act in the ordinary course of business; it is not such an act as a man could do, but it must be followed by an immediate act of bankruptcy, and* ***it is defeating the equality that is introduced by the Statutes of Bankruptcy****, and the criminal (for the bankrupt is considered as a criminal) is taking upon himself to prefer whom he pleases.'"*[13] (Emphasis added.)

So described, the "*fraudulent*" aspect of the "*fraudulent preference*" at common law was the voluntary act to defeat the result intended by the Statutes of Bankruptcy. It involved no actual fraud by the debtor, just as the violation of the absolute priority rule described in *Northern Pacific Railway Co v Boyd* involved no actual fraud.

Accordingly, in each system of law, the priority accorded to creditors against shareholders, and the equality as between creditors, are derived from the antecedent rights that are respected in a distribution under statute in a winding up or in a bankruptcy. Unsecured creditors rank ahead of shareholders because shareholders' rights under the statutory contract[14] limit shareholders' entitlements to a share of any surplus against creditors in a winding up. Unsecured creditors have equal entitlements in a winding up because each has a right *in personam* against the debtor and all such rights are subject to the collective execution in a winding up. It is not for the debtor acting alone (Lord Mansfield's fraudulent preference) or in combination with a senior creditor (Justice Clifford's conveyance in breach of the corporate trust) to defeat those rights which statute has said are to be respected in a bankruptcy or winding up.

The absolute priority rule is not, therefore, as alien as might first appear. Its importance lies in the recognition that a plan that conforms to the absolute priority rule is, in general, considered to be "*fair and equitable*", whereas a plan that deviates from that rule is unlikely to be confirmed.

In *Motorola, Inc. v. Official Comm. of Unsecured Creditors (In re Iridium Operating LLC)* 478 F.3d 452 (2d Cir. 2007), the US Court of Appeals for the Second Circuit ruled that *the most important* consideration in determining whether a pre-plan settlement[15] of disputed claims should be approved as being "*fair and equitable*" is whether the terms

12. The Supreme Court in *Northern Pacific Railway Co v Boyd* itself lessened the importance of the corporate trust doctrine by its statement that the purchasing new company would be accountable "*nonetheless*" even if it acquired the assets of the old company "*in good faith and in ignorance of Boyd's claim*". It did not therefore analyse the case in terms of the acquisition of an equitable interest that might be defeated by the defence of a bona fide purchaser for value without notice.

13. For the last word on *Alderson v Temple*, see *Lewis v Hyde* per Lord Browne-Wilkinson [1998] 1 WLR 94: "*the basis of Lord Mansfield C.J.'s principle is that an act has been done which in fact defeats the equality between creditors in an insolvency. The intent of the debtor to produce such result is essential.*"

14. In *Soden v British and Commonwealth Holdings plc* [1998] AC 298, Lord Browne-Wilkinson defined the "*statutory contract*" at p.323 as "*the bundle of rights and liabilities created by the memorandum and articles of the company [and the] rights and obligations of members conferred and imposed on members by the Companies Acts.*"

of the settlement comply with the Bankruptcy Code's distribution scheme.

The appeal concerned the lower court's approval of a pre-plan settlement between the official committee of the unsecured creditors, on the one hand, and the secured lenders, on the other hand. The settlement accepted the secured creditors' liens and distributed the estate's cash to the lenders and to a litigation vehicle set up to sue Motorola. Motorola – a priority creditor – objected to the settlement on the grounds that it took a portion of the estate's property and distributed it to lower priority creditors (i.e. the litigation vehicle and the unsecured committee) before any payments were made to Motorola (p.462):

"*Motorola claims that a settlement can never be fair and equitable if junior creditors' claims are satisfied before those of more senior creditors.*"

In response, the court said (p.465):

"***In the Chapter 11 context, whether a settlement's distribution plan complies with the Bankruptcy Code's priority scheme will often be the dispositive factor.*** *However, where the remaining factors weigh heavily in favor of approving a settlement, the bankruptcy court, in its discretion, could endorse a settlement that does not comply in some minor respects with the priority rule if the parties to the settlement justify, and the reviewing court clearly articulates the reasons for approving, a settlement that deviates from the priority rule.*" (Emphasis added.)

However, the court was careful to observe that the case before it was a pre-plan settlement in which many variables, including the rights that claimed priority, were disputed and uncertain. In that context, which was distinct from a confirmation hearing under Chapter 11, the court said:

"*It is difficult to employ the rule of priorities in the approval of a settlement in a case such as this when the nature and extent of the Estate and the claims against it are not yet fully resolved. In our view, a rigid per se rule cannot accommodate the dynamic status of some pre-plan bankruptcy settlements.*"

On the facts, the court held that the departure from the absolute priority rule was justified to fund the litigation but that it was not justified in respect of the distribution of a residual amount to the unsecured creditor committee. In respect of that residual amount, the court remitted the matter to the lower court for further assessment. The absolute priority rule was so important that a minor deviation from it in a pre-plan settlement required remission for specific explanation.

So assessed, the significance of the *Motorola* case for present purposes is its recognition that, provided the priorities are clearly established, adherence to those priorities by the terms of a plan will "*often be the dispositive factor*". This emphasis is underlined by the actual decision in the case, which required specific and sufficient justification for any deviation.

The observations in the *Motorola* case are not far removed from the description of the vertical comparator test developed in the context of CVAs. "*Vertical comparison is with the position on winding up (or, in the case of individuals, bankruptcy)*": *Prudential Assurance Co Ltd v PRG Powerhouse Ltd* [2007] BCC 500, at [75]. Of this comparator, Etherton J continued, at [81], to approve David Richard J's statement of the law in his judgment in *Re T & N Ltd* [2005] 2 BCLC 488, at [82]:

"*While I am wary of laying down in advance of a hearing on the merits of any scheme or CVA any particular rule, there is one element which can be mentioned at this stage. I find it very difficult to envisage a case where the court would sanction a scheme of arrangement, or not interfere with a CVA, which was an alternative to a winding up* ***but which was likely to result in creditors, or some of them, receiving less than they would in a winding up of the company,*** *assuming that the return in a winding up would in reality be achieved and within an acceptable time–scale.*" (Emphasis added.)

Of this statement, Etherton J said, at [82] of his judgment in *Powerhouse*:

"***A linked principle is that****, on an application under IA, s.6,* ***it is not for the court to speculate whether the terms of the proposed CVA were the best that could have been obtained, or whether it would have been better if it had not contained all the terms it did contain.***" (Emphasis added)

The principles are "*linked*" because the Court should not speculate as to what the "*best*" or "*better*" arrangement might have been proposed if the arrangement in fact approved does confer a non-speculative benefit relative

15. A settlement presented for approval as part of a plan of reorganization constitutes part of the plan and may only be approved if it too is "fair and equitable" in the sense of conforming to the absolute priority rule: see *TMT Trailer Ferry*, 390 U.S. at 424, 88 S. Ct. 1157. This observation has been extended to apply the absolute priority rule to pre-plan settlements: see *United States v. AWECO, Inc.* 725 F.2d 293, 298 (5th Cir. 1984).

to that in a liquidation. The satisfaction of the vertical comparator test is, for this reason, often dispositive of an unfair prejudice challenge in the context of CVA.

Whilst care is needed in relying on CVA cases in which liquidation is the relevant vertical comparator (as it is expressly *not* the necessary comparator under Part 26A), both the CVA cases and the Chapter 11 absolute priority cases suggest that the Court might usefully bring greater certainty to the operation of Part 26A by developing a rule to the effect that a compromise or arrangement that respects the basic scheme of priorities in the relevant comparator is presumptively a fair one.

The converse is implied, as is apparent from the CVA cases also. A divergence from the basic scheme of priorities in the relevant comparator is one that must be sufficiently justified. Etherton J said, at [83]-[90] (with reference to Ferris J's earlier decision in *Re a Debtor (No.101 of 1999))* that:

*"Differential treatment, which is not assented to by a creditor who considers that he has been less favourably treated, may well give cause for an enquiry, but it does not necessarily prove unfair prejudice.*

...

*Differential treatment may also be necessary to secure the continuation of the company's business which underlies the voluntary arrangement, for example where it is necessary to pay suppliers in full in order to ensure that the company can continue to trade."*

The recognition that differential treatment might be permitted "*where it is necessary*" chimes with certain of the Government's observations. In its response to the consultation, the Government wrote (at §5.164-5.165):

*"The Government wants to inject flexibility into the APR, given the criticisms of US approach. The ability to act flexibly and pragmatically are not just desirable features in a restructuring procedure, but essential ones if the framework is to facilitate business rescue. The Government intends to permit the court to confirm a restructuring plan even if it does not comply with this rule where noncompliance is:*

- *necessary to achieve the aims of the restructuring; and*
- *just and equitable in the circumstances."*

*This two-stage test for permitting non-compliance creates a high threshold. The basic principle that a dissenting class of creditors must be satisfied in full before a more junior class may receive any distribution will, in most cases, be followed. But there is sufficient flexibility to allow departure from it (with the court's sanction), where the departure is vital to agreeing an effective and workable restructuring plan. This will provide adequate protection for creditors while also achieving the best outcome for stakeholders as a whole."*[16]

There is no explanation as to why this proposal has been dropped from Part 26A. It did not even make it into the bill. An explanation is that the Government took the view that, as indicated above, there is ample legal material for the court to act to fashion an appropriately principled and flexible standard.

To conclude this section, an example of a derogation from the basic rule of priorities that might prove acceptable is the allocation of an equity interest to the existing shareholders whose efforts are required for the successful future operation of the restructured business, notwithstanding the impairment of junior creditors. This is, on its face, a breach of the absolute priority rule and it would fail the vertical comparator test unless sufficiently justified. A potential justification is that the equity is gifted from what would otherwise have been the senior creditors' share, and this analysis has been adopted in previous scheme of arrangement cases. So far as Chapter 11 is concerned, in *Official, Unsecured Creditors' Comm. v. Stern (In re SPM Mfg. Corp.)*, 984 F.2d 1305, 1307, 1312 (1st Cir. 1993) in a Chapter 7 case, the First Circuit accepted the proposition that *"if the cash on hand...was perfected collateral of the Secured Lenders for valid debt, the Secured Lenders had the right to dispose of such cash in any manner that they chose so long as the cash did not exceed the debt owed to the Secured Lenders."* In Motorola, the Second Circuit declined to rule on whether *SPM* could be relied on in a Chapter 11 case to derogate from the absolute priority rule. The rule in *SPM* is however, in its effect, the equivalent to the rule in *In re Tea Corp Limited* described above. From the perspective of the English court, such a derogation is therefore likely to prove less controversial than has been the case in Chapter 11. The hard case will be the justification of an equity allocation to former shareholders in circumstances in which the senior creditors are not prepared to gift that value from what would otherwise have been their entitlement and it is instead to be taken from value that might otherwise be enjoyed by junior creditors.

## Cram ups of senior creditors by junior creditors?

To explore the potential for Part 26A to change the practice of UK restructuring, we end by considering certain forms of proposal likely to be of interest in the post-COVID-19 world and which would be likely to prove difficult to implement using the current range of restructuring tools. In particular, in what circumstances can the company or its junior creditors impose a plan on the senior creditors in order to sustain the company until its economic recovery is complete?

16. See also p.29 of the House of Commons briefing paper published in December 2019: "*Safeguards would provide that a dissenting class of creditors must be satisfied in full before a more junior class may receive any distribution or keep any interest under the plan, unless it is both necessary to achieve the aims of the restructuring, and just and equitable in the circumstances.*" Footnote 36 explains: "*This is a modified version of the absolute priority rule in US Chapter 11 proceedings.*"

17. For a useful summary of cram up reorganisations, see J Levitan, *Ingredients for a Successful Cram Up Reorganisation*, New York Law Journal (1 March 2010).

Cram up plans under Chapter 11 involve the restructuring of secured debt without the lenders' consent by repaying the debt in full over time[17]. There are two common forms of cram up plans. The first is a reinstatement of the pre-default terms by a deemed cure of the events of default and the reversal of any acceleration. The second is a restructuring of the pre-default terms to provide different terms albeit terms that the court is satisfied have "*indubitable equivalent*" value. The first technique is attractive in circumstances in which a debtor considers that market interest rates will rise relative to the terms of the existing secured financing. In contrast, if interest rates are likely to remain low for the longer term, it is in the interests of the debtor to compel lenders to refinance using interest rates that are lower than the existing applicable rate. Which kind of cram up the debtor or junior creditors might wish to implement is, accordingly, likely to be sensitive to how interest rates are likely to play out in the longer term in the light of the stimulus measures in response to Covid-19. An important initial question for UK lawyers, therefore, is whether Part 26A permits a cram up in the forms recognised under Chapter 11. This question is considered below first by the assessment of what a cram up under Chapter 11 involves and, secondly, by a review of Part 26A.

**Reinstatement cram up**

§1124 of the Bankruptcy Code provides a description of the concept of impairment. §1124(2) includes the cure of default and reinstatement of maturity terms, and so on, within that description. The reinstatement of defaulted debt is, as such, expressly contemplated by Chapter 11.

*In re Charter Communications*, 419 BR 221 (Bankr SDNY 2009) is an example of a reinstatement cram up following the 2008 global financial crisis. The senior creditors were owed in excess of $11.8 billion and the reinstatement of the pre-default terms provided a saving in interest expense, relative to then current market rates, of $500 million. The plan was unsuccessfully opposed on the grounds that certain of the defaults were said to be non-curable and, thus, the proposed reinstatement not viable. The senior creditors argued, in particular, that (i) the company was over-indebted and so a re-set of the covenants would result in a second default immediately; and (ii) that the upstreaming of dividends to fund the interests payments under the re-set facility was not permitted and thus a second default was inevitable for that reason also.

The court disagreed with the senior creditors. It held that the relevant over-indebtedness covenant should be read as a present inability to pay covenant only, and it held further that, in the turbulent market of 2008 and 2009, it could not be said that the directors, based on the valuation advice they had received, could not up-stream the required cash to service the reinstated debt. On this basis, the court found that the defaults were curable. By emphasising the decision that the directors had to make as regards the upstreaming of cash, the court did not need to resolve the heavily contested enterprise value in dispute between the parties. Judge Peck said, at pp.235-236:

"*Valuing a business such as Charter's is neither simple nor objective, and no single generally accepted standard exists for measuring value. Valuation of an enterprise as complex as this one calls for using multiple approaches to value, comparing the business to be valued with others having similar characteristics, making appropriate adjustments and reasoning by analogy. The art of valuing a business requires the exercise of well-informed judgment.*

...

*Depending on the weight given to the testimony of these witnesses, the Court could conclude that Charter's business was worth more than $21 billion in November 2008 or as little as $15.4 billion in September 2009. The swing in value is major and hard to reconcile. The challenge in fairly valuing Charter is also illustrated by the fact that conflicting indications of value were offered by Charter itself.*

...

*What this demonstrates is that valuation is a malleable concept, tough to measure and tougher to pin down without a host of explanations, sensitivities and qualifiers. Because point of view is an important part of the process, outcomes are also highly dependent on the perspectives and biases of those doing the measuring. When it comes to valuation, there is no revealed, objectively verifiable truth. Values can and do vary, and consistency among valuation experts is rare, especially in the context of high stakes litigation.*

...

*Given the inherent unpredictability of future events and Charter's multiple strategies for moving cash within the corporate family, it is not practical for a lender to declare a default based on what may seem to be well-founded presumptions as to the ability of a holding company to pay debts in the future. Those presumptions could well be wrong.*"

In a related later part of the judgment, Judge Peck explained that, at p.247:

"*There are sufficient facts presented here for the Court to defer to the Charter board... The board also reviewed information that sensitized the financial projections, utilizing substantially lower levels of assumed EBITDA growth, and still concluded that there would be sufficient surplus for a dividend... Given the foregoing, there is no showing of bad faith or fraud, and the Court will not substitute its judgment for that of the board.*"

The margin of business judgement accorded to company directors under (in that case Delaware) company law thereby provided a means for the court to confirm the plan without resolving a difficult and contested valuation dispute. It is far from clear whether the English court would adopt such a technique in assessing whether defaults were curable as part of its assessment of the viability of a cram-up to reinstated pre-default financing terms. The English court is more likely to separate the construction of the financing terms from the directors' duties and, as a consequence, have to resolve any valuation dispute.

**Indubitable equivalent cram up**

As explained above, §1129(b)(2)(A)(i) defines the concept of "*fair and equitable*" as regards a class of secured creditors to include: (i) the retention of their security (liens) and (ii) the receipt of deferred cash payments with a present value equal to the amount due, or equal to the value of the security, whichever is less. §1129(b)(2)(A)(iii) however provides for an alternative ("*or*"): "*for the realization by such holders of the indubitable equivalent of such claims.*" The provision of the "*indubitable equivalent*" accordingly

allows for greater latitude as to what a cram-up might involve than the deferral of cash payments (with an equivalent present value to the original covenants) contemplated by §1129(b)(2)(A)(i).

*In re DBSD North America Inc*, 419 BR 179 (Bankr SDNY 2009) is an example of a cram up under §1129(b)(2)(A)(iii). The plan involved an injection of new money and was supported by the second lien creditors, whose prior second lien debt was to be equitized. It was opposed by the holder of the first lien debt. Under the plan the first lien debt was to be stripped of its (worthless) equity security and to be restructured under an amended facility with a four-year term and PIK interest at 12.5%. The amended terms negated all cash interest that would otherwise have been paid in the meantime to the first lien creditor. This freed up further working capital to fund the development and launch of a satellite.

The question for the court was whether the first lien creditor's claim was protected to the same extent it was preconfirmation, in particular, as to the amount it was over-collateralized. Based on the enterprise valuation evidence before it, the court was satisfied that the assets securing the debt had an enterprise value six times the obligations due at maturity. The court further held that PIK interest at 12.5% was appropriate for a four-year term given the then prevailing low rate on US Treasury Bills. In explaining why the new rights amounted to an "*indubitable equivalent*", Judge Gerber said:

*"Although the developmental nature of the Debtors' business and absence of present revenue would at first blush suggest uncertainty as to repayment under the Amended Facility, I find that the risk is not new, or increased, to warrant awarding DISH an interest rate higher than the one proposed under the Amended Facility. Rather, the risks associated with the Debtors' business existed (to a substantially similar degree) at the time the original holders of the First Lien Debt entered into the Prepetition Facility and certainly in July 2009, when DISH purchased the First Lien Debt at par.*

*Most significantly, upon Plan confirmation, the Debtors will have deleveraged by over $600 million. The Plan currently contemplates that the Debtors will have $81 million in total debt at the Effective Date, and the total indebtedness can be projected to be in the range of $260 million by 2013. This major change in the Debtors' debt load resulting from the Debtors' reorganization considerably reduces the risk on First Lien Debt."*

On the question of valuation, and in contrast to the approach taken in *In re Charter Communications* above, Judge Gerber was required to make a finding of value based on his assessment of the rival experts and their opinions based variously on competing comparable and DCF analyses. He concluded:

*"I find that the value of the reorganized Debtors' business is in the range of $492 million to $692 million. That valuation provides the First Lien Lender with liens on assets that (on an enterprise valuation basis) are worth more than approximately 6 to 8.44 times the amount (approximately $82 million) that the First Lien Lender will be owed under the Amended Facility at maturity, based on the Debtors' lowest and highest estimated enterprise values, respectively.*

*That leads me to find, and I do find, that the First Lien Lender's principal and interest will be safe over the next four years, and that the proposed interest rate for the Amended Facility is satisfactory."*

The DBSD case is therefore a useful example of a junior creditor-led cram-up which recapitalised a business and which required the court to assess the present value of that business in order for it to be imposed upon the senior creditors. There are many other examples, including as to the appropriate interest rate for restated senior debt; a live and lively question that is sensitive to the market for the debt in question and which has built up a substantial body of case law.

## Cram ups under Part 26A?

As explained above, section 901G removes the bar on sanction under section 901F if one or more classes should dissent provided that (reversing the specified Conditions) (B) a class with a genuine economic interest in the relevant alternative votes for the proposal; and (A) no members of the dissenting class(es) *"would be any worse off than they would be in the event of the relevant alternative"*, which is: *"whatever the court considers would be most likely to occur in relation to the company if the compromise or arrangement were not sanctioned under section 901F"*

The words *"if the compromise or arrangement were not sanctioned"* likely exclude a comparator based on the success of the very proposal under consideration. As already explained above, those words do not however exclude as a matter

of language or logic other factual comparators that would support an enterprise valuation. The basic premise for a cram up of the kinds encountered in *Charter Communications* and *DBSD*, therefore, appears to be present within Part 26A.

The viability of a cram up as a matter of law is likely to turn on how narrowly or broadly the Court interprets the directions in Condition A that the members of the dissenting class should not be "*any worse off*". If this is construed narrowly with the emphasis on "*any*", the prospect of a cram-up is limited because even a reinstatement cram-up involves a change to the pre-default rights, reversing the existing rights to accelerate and enforce which have (and would remain) accrued in the relevant alternative.

Such a narrow construction is unattractive because it would dramatically diminish the potential utility of the new provisions, and presumably the Government intended to change the law to make a significant improvement to the UK restructuring regime, given that its spur was to improve the standing of the UK as compared to competitor regimes. This broader construction also finds support in the language and logic of the new provisions. The purpose of a "*compromise*" or "*arrangement*" is *to vary* the antecedent rights in some way, and the purpose of Condition A is to permit the Court to undertake an assessment of the varied rights relative to those antecedent rights in "*the relevant alternative*". The product of that comparison is an *overall* judgement as to whether the member or members of the class in question are "*any worse off than they would be in the relevant alternative*". The fact that the antecedent rights are changed is therefore the starting point for the enquiry towards that judgement, not the end point.

In more concrete terms, there is nothing in the expression "*any worse off than they would be in the event of the relevant alternative*" that is inconsistent with the conclusion in *Charter Communications* or that in DBSD. In the former case, the evidence as to the enterprise value entitled the Bankruptcy Court to conclude that the reinstated debt terms would be serviced by the debtor according to the reset covenants. In the latter case, the finding as to what the enterprise value was entitled the Bankruptcy Court to conclude that the first lien creditor would enjoy the same level of overcollateralization post-confirmation as pre-confirmation. On the findings made in each case, and as a matter of ordinary language, the secured creditor was not "*any worse off*".

## Conclusion

There may be a temptation, given the terms of certain parts of the Government's initial explanation of its first proposals, to construe the legislation as an efficiency saving that permits a single process to achieve what might otherwise only be achieved by a scheme of arrangement and a pre-pack administration. There is however nothing in the legislation that confines it to the emulation of the result in *Bluebrook* and, indeed, the Government's aim appears to have been much broader than a mere efficiency saving. Part 26A as enacted is far broader in its potential effect than the Government's initial proposals.

Part 26A provides an opportunity for the English court and restructuring profession to develop restructuring proposals hitherto unseen in the English courts. Whether the new legislation will develop in this way will depend to a great extent on how the legislation is first received and explained by the court and to what extent the profession as whole is willing to accept a cultural change in which a proposal is advanced purposively to impose it on an entire dissenting class and, potentially, where that proposal is led by junior creditors against senior creditors.

Part 26A will provide challenges and opportunities for companies, creditors, the court and all restructuring professionals. The selection of issues considered above suggests that the existing tests and principles developed in the context of Part 26 may not be appropriate or adequate in the inter class context of a cram down. The development of new and appropriate principles is unlikely to be straightforward and, as with Chapter 11, the law itself may undergo amendments to fine tune the process.

The recent crisis brought on by the COVID-19 pandemic is likely to provide an immediate test of Part 26A and of the numerous potential ways in which it may reshape restructuring in the UK. ■