SLAUGHTER AND MAY

Financing Briefing

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IMO Car Wash: what it means for restructurings

A scheme of arrangement is a statutory procedure under Part 26 of the Companies Act 2006 for effecting a compromise or arrangement between a company and its creditors (or any class of them) with the sanction of the court. It is increasingly being twinned with a pre-packaged administration to effect the transfer of the business to a newco predominantly owned by senior creditors, leaving "out of the money" junior creditors stranded in the insolvent rump. The recent restructuring of the IMO Car Wash group provides judicial guidance on whether such a scheme may be challenged on the grounds of fairness. In particular, it gives guidance on the valuation standard to be used and the duties of the board in promoting a scheme of arrangement.

This briefing summarises the case of "In the matter of Bluebrook Ltd and others [2009] EWHC 2114 (Ch)", commonly referred to as the IMO Car Wash case, and considers its implications for future debt restructurings.

Case Summary

Background

Bluebrook was the holding company of a group of companies (together, the IMO group), which operates the largest carwash business in the world. As a result of a leveraged buy-out of the IMO group by private equity firm Carlyle Group in 2006, the group had two major secured debt facilities: a senior credit agreement and a mezzanine credit agreement, of which approximately £313 million and £119 million was outstanding respectively. An intercreditor agreement firmly subordinated the mezzanine debt to the senior debt. The balance sheet insolvency of the group, breaches of financial covenants under the senior credit agreement, arrears of interest under both facilities, and withdrawal of some credit insurance, among other things, had led the board to the conclusion that a capital restructuring of the business was necessary in order to secure its long term future.

Proposed restructuring terms

The group's restructuring proposal, backed by the senior lenders, involved the transfer of the business and assets of the existing group to a new group via a pre-packaged administration sale. The business and assets of the group were to be transferred free of the security and guarantees held by the mezzanine lenders, at the direction of the senior lenders pursuant to their contractual rights under the intercreditor agreement. A large portion of senior debt (approximately £185 million) was to be novated to the new group, with the remainder being exchanged by the senior lenders for the bulk of the equity in the new holdco (subject to a small interest in favour of management). The old group was to be released from the debt (other than £12 million which was to remain in the existing group in case some asset unforeseeably came in). It was necessary to implement the proposal via schemes of arrangement not in order to transfer the assets (which, although conditional on the schemes being sanctioned, was taking effect outside of the schemes) or in order to release the security and guarantees held by the mezzanine lenders, but rather to effect the release of the senior debt in the absence of all senior lender consent (a small percentage of the senior lenders were not in favour). The mezzanine lenders were to be left behind in the old group, the justification of this being that a number of valuation exercises (*see below*) indicated that the value broke well into the senior debt (i.e. the value of the group was less than the value of the outstanding senior debt). As the mezzanine lenders were not party to the schemes, they were not summoned to vote at any class meeting. The class meetings of senior lenders were held on 29 June 2009, at which the schemes were approved by 90 per cent. in number representing 95 per cent. in value of the senior lenders.

The mezzanine lenders challenged the schemes on the grounds of fairness. Their two main arguments (although not their only ones) centred on valuation and directors' duties. They had commissioned their own valuation (*see below*) which indicated that value broke within the mezzanine debt. The mezzanine lenders further contended that the directors of the scheme companies, whilst not acting in bad faith, had failed to comply with what was said to be their obligation to extract a proper benefit for all creditors (including the mezzanine lenders), and not just the senior lenders. They argued that the board should have considered or at least threatened other options, and used their negotiating position to bargain for something to be provided to the mezzanine lenders.

Valuations

The group had commissioned three valuation exercises. All three were conducted on a going concern basis, as opposed to a liquidation or break-up valuation (although the King Sturge exercise came up with a figure for a quick sale as an alternative figure). Each valuation sought to answer the question of what a purchaser would pay now for the business, although adopted different techniques for doing so.

A valuation by PricewaterhouseCoopers LLP (the administrators in waiting) valued the group using an income approach (based on discounted cash flow), a market approach (comparing IMO to comparable publicly traded companies), and a leveraged buy-out analysis (assessing the level of equity investment a private equity investor could be prepared to make in the current market, given a typical required equity rate of return). The maximum valuation came out at £265 million.

Concurrently, Rothschild conducted a third party sales process with a view to seeing if a buyer for the existing group could be found. The sales process produced only one indicative offer which placed a value on the group of £150 million to £188 million on a cash and debt free basis. (This was not considered by the board to be an appropriate level of interest to pursue.)

A further exercise by King Sturge LLP valued a number of the group's sites, from which an overall value was extrapolated. This produced a valuation of £164 million on a swift sales basis and £208 million on a full market value basis.

Each of the three valuations indicated that the value of the group fell significantly short of the £313 million of senior debt outstanding. Furthermore, the senior debt was trading in the secondary market significantly below par (at about 60p in the pound).

The mezzanine lenders relied on a report from LEK Consulting to argue that the value of the group broke in the mezzanine debt. The LEK report used a "Monte Carlo simulation" to assess on a statistical basis the most likely valuation outcomes given a variety of inputs. It involved repeated calculation of a discounted cashflow valuation, using random sampling of input and assumptions, and then aggregated the result into a distribution of the probabilities of different valuation outcomes. The result indicated a range of £210 million to £700 million, with a significant majority of outcomes exceeding £320 million.

Judgment

The High Court sanctioned the schemes.

Mr Justice Mann confirmed that although the mezzanine lenders were not involved in the schemes, they were still entitled to object as creditors on the grounds of fairness if the schemes unfairly affected them in ways other than affecting their strict legal rights. The court, in exercising its discretion as to whether to sanction a scheme, can as a matter of principle consider unfairness in this sense. However, in the present case, Mann J did not find that the overall restructuring worked unfairly to the mezzanine lenders for the following reasons:

1. Given the valuation evidence, he considered that the mezzanine lenders had no economic interest in the group.

2. Under the terms of the intercreditor agreement, the senior lenders could procure the release of any interests of the mezzanine lenders.

3. The mezzanine lenders had the safeguard of buying out the senior lenders under the terms of the intercreditor agreement, although they had chosen not to do so.

4. The senior lenders, in not having the debt repaid and in undertaking a debt to equity swap, were taking a genuine risk.

5. Absent the schemes, enforcement was a serious possibility.

6. The overall arrangement provided an additional safeguard in that an administrator had to be satisfied that the deal was appropriate.

7. There was no evidence to suggest any breach of duty or other shortcomings on the part of the boards of the scheme companies.

8. The court only has the option of sanctioning or refusing to sanction the schemes. If the schemes were not sanctioned and the parties were left to negotiate again, there was no certainty that the mezzanine lenders would not make unreasonable demands.

Comment

"No economic interest" / fairness

It is a well established principle that a company is free to select the creditors with whom it wishes to enter into a scheme and need not include those whose rights are unaffected by a scheme. Mann J recognised as a separate principle (perhaps unsurprisingly given that he was also the High Court judge in *MyTravel*) that it is not necessary for a company to consult with any class of creditors who are unaffected because they have no economic interest in the company, citing in support the 1904 case of *re Tea Corporation Ltd*. In *re Tea Corporation*, a scheme was proposed in a liquidation, separate meetings of creditors, preference shareholders and ordinary shareholders were proposed, and the ordinary shareholders voted against the scheme. The Court of Appeal in that case held that the dissent of the ordinary shareholders would not stop a scheme being sanctioned, because although the ordinary shareholders did form a separate class, they in fact had no economic interest in the company because the assets were insufficient to generate a return to them.

IMO Car Wash therefore continues this line of authority which establishes that consideration should be given to the "no economic interest" principle when determining the issue of fairness at the sanction hearing to approve a scheme. The court clearly confirmed that junior creditors who are left out of a scheme because their rights are unaffected, may still challenge the scheme on the grounds of unfairness. However, for them to mount a successful challenge, they must at least show that they have economic interest in the company, or put another way, there is de facto unfair prejudice against them.

It remains to be seen whether the "no economic interest" principle may be applied more extensively to a set of facts similar to those in *re Tea Corporation*, i.e. where a class of creditors have their rights compromised by a scheme and vote against the scheme but whose votes are nevertheless discounted by the court in determining whether to sanction a scheme on the basis that they have no economic interest. The application of this principle to such a context is likely to be much more controversial and may well be limited to fairly specific factual circumstances.

Valuation

Valuation is likely to be at the heart of any dispute over the sanction of the fairness of a scheme. Prior to the IMO Car Wash judgment, there had been little direction from the English courts on the valuation standard to be used in such disputes. The restructurings of both Tea Corporation and MyTravel involved unique sets of circumstances. Tea Corporation was already in liquidation, and in MyTravel the withdrawal of the Civil Aviation Authority licence would have resulted in liquidation. Consequently a liquidation valuation was appropriate in both those cases. The more recent restructuring of McCarthy & Stone offered a more "typical" set of circumstances, but the mezzanine creditors in that case ultimately chose not to mount a challenge at the sanction hearing.

The following approaches to valuation may be deduced from the IMO Car Wash judgment:

1. The court confirmed that in order to assess the fairness of the scheme in this particular case, valuation should be done on a going concern basis, as opposed to a liquidation or break-up basis. By giving more weight to the valuation reports prepared by the scheme companies, which were done on a "market value today" basis (i.e. what the purchaser would be prepared to pay for the business in the market today), and less weight to the LEK report which sought to demonstrate the "intrinsic value" of the business, the court appeared to accept that the appropriate benchmark for valuation is the "market value today" basis where there is a realistic possibility that, in the absence of a successful scheme, enforcement of security is likely. Mann J confirmed that it may be possible to demonstrate unfairness in circumstances where it can be shown that the senior lenders are getting too much unfair value because sales are unlikely to be achievable in the present market and it is thought that the same group will be more valuable when economic conditions improve. He did not however think that there was good enough evidence in the present case to establish such an argument.

2. Mann J clearly preferred to give greater weight to valuation evidence to which it was evident that professional and expert judgement had been applied, in contrast to the Monte Carlo technique which he considered to be less of a valuation and more of a mechanistic analysis of probabilities providing little judgmental assessment as to the likely value of the business. He

considered that a proper approach to valuation requires some real world judgments as to what is likely to happen (for example, judgment as to the correct weighted average cost of capital which is a very important element in a discounted cashflow valuation).

3. To successfully challenge the fairness of a scheme on the grounds of valuation, there needs to be clear evidence showing a realistic (as opposed to theoretical) chance that the value of the group is in excess of the value of the senior debt, and that allowing the senior lenders to proceed as suggested in the current market conditions would give the senior lenders an unfairly good deal.

Duties of directors

Much comfort can be sought from the judgment in relation to the duties of directors in promoting a scheme. It was not disputed that the directors of an insolvent company have to pay proper regard to the interests of the creditors. However, any allegation of breach of duties is a serious one and the discharge of such duties in practice will be very fact sensitive. In the present case, the absence of any evidence during the negotiation of the schemes that the mezzanines lenders had any economic interest, the fact that the mezzanine co-ordinating committee was undertaking direct negotiation with the senior lenders, the lack of evidence that the board had authority to or had been requested to negotiate on behalf of the mezzanine lenders, and the risk of wrongful trading if the board had carried on trading, all suggested to Mann J that the board had not acted improperly.

It is important to note that the board had independent professional advisers at all times and although no committee of independent directors was set up to consider the schemes, two directors were independent in the sense that they would not be transferred to the new group and all the decisions of the board had been unanimous.

More to come...

Following this judgment, the combination of a scheme of arrangement with a pre-arranged sale, as utilised in the IMO Car Wash restructuring, is sure to continue to be a favoured method by which to restructure the capital structure of a distressed group. It was first utilised in the MyTravel restructuring and more recently in the restructuring of McCarthy & Stone. With value breaking in the senior debt, divergent interests amongst creditor groups, and high voting thresholds being the hallmarks of many distressed leveraged buy-out deals, it is an attractive method by which to reduce an unsustainable level of subordinated debt, preserve a sustainable level of senior debt, and effect a debt for equity swap of the senior debt without having to secure all senior lenders' consent.

Slaughter and May has extensive experience and expertise in advising on the most complex and challenging insolvency and restructuring and distressed M&A transactions. Our recent experience includes advising RHJ International S.A. in relation to the Honsel Group restructuring, the parent company of Countrywide plc on the group's restructuring and certain creditors on the restructuring of the Pearl Insurance Group.