

IMO Carwash:¹ Valuation Issues in UK Restructurings

Contributing Editor:

Adam Gallagher

Freshfields Bruckhaus Deringer; London
adam.gallagher@freshfields.com

Editor's note: *The basis of valuation of distressed companies has long been a critical point of focus in chapter 11 cases. That focus is now being brought to bear in the U.K. when determining the economic interests of junior creditors in the context of schemes of arrangement.*

The IMO Carwash group operates the largest carwash business in the world. On Aug. 11, 2009, in a case that was closely followed in European restructuring circles, the English courts sanctioned a scheme of arrangement put forward by IMO Carwash, which was a key part of its debt restructuring. On the face of it, the judgment appears to pave the way for a debtor, working with its senior lenders, to use schemes of arrangement as a tool by which junior lenders can be left with claims against a shell company. However, whilst this will be the case where value clearly breaks in the senior debt, the legal analysis has become even less clear where there is real doubt as to which creditors have an economic interest.

The current economic downturn has seen a resurgence in the use of schemes of arrangement. One of the highest profile schemes of recent months was of the leading U.K. residential real estate agent, Countrywide. That restructuring was implemented by way of parallel schemes of arrangement in England and the Cayman Islands, alongside a chapter 15 recognition procedure in New York.

The threat of a scheme of arrangement can often be enough to bring parties to the table and ultimately secure a consensual restructuring. Understanding how schemes operate, and their implications for various stakeholders, is therefore relevant to many restructurings, not just those that are ultimately achieved through schemes.

In this article, Ken Baird, Catherine Balmond and Anna Biganzoli of Freshfields Bruckhaus Deringer's London office explain how schemes of arrangement operate and why they can be useful tools in a restructuring context. They then discuss the IMO case in more detail and

About the Authors

Adam Gallagher and Ken Baird are partners and Catherine Balmond is a senior associate in the Restructuring and Insolvency Group of Freshfields Bruckhaus Deringer LLP's London office. Anna Biganzoli is a trainee solicitor at Freshfields Bruckhaus Deringer LLP, also in London.

look at what it may mean for creditors and directors involved in future schemes.

A scheme of arrangement is a procedure under English corporate law whereby a company can enter into a compromise or arrangement with its members or creditors, or with any class of them, cramming down a dissentient minority. A scheme of arrangement must be approved by a majority, representing three-fourths in value of members or a

mergers, schemes are in no way restricted in their subject matter. As such, schemes may be used in other contexts, for example, and as was the case here, to push through a restructuring.



Ken Baird

In addition to the requisite majorities being achieved, before a scheme of arrangement can be implemented, it must be sanctioned by the court. This requirement for court approval is an important safeguard

against majority oppression. The court has a real discretion as to whether to sanction the scheme, notwithstanding that the voting thresholds have been met. The case discussed in this article was concerned with precisely this issue, namely whether, notwithstanding the fact that the scheme had the support of the company and of the senior

European Update

class of members or creditors or a class of creditors (as the case may be)² present and voting at the meeting.



Adam Gallagher

If the vote is carried and the scheme is sanctioned by the court, it will then bind the entire class of members or creditors, whether or not the individual members or creditors within the class voted in favor of

the scheme. Schemes of arrangement therefore provide a useful squeeze-out procedure where unanimous consent to a proposal cannot be obtained. However, unlike in a plan of reorganization under chapter 11, a scheme cannot be used to cram down the members of a class as a whole who have not voted in favor of the scheme—even if they are out of money. While they are mainly a company law tool often used to approve corporate

lenders to whom it was proposed, the court should exercise its discretion to sanction a scheme that—allegedly—unfairly compromised the rights of junior creditors.

The Restructuring Scheme in IMO Carwash

The restructuring proposal put forward by *IMO Carwash* involved the transfer of assets of certain group companies (being shares in the trading companies) to a newly incorporated company in which the senior lenders and existing management had an equity stake. The transfer was affected after the company had gone into a formal insolvency process, and was also affected by the administrators of the scheme companies. Although the scheme itself did not effect the transfer, it was an integral part of the restructuring process as it released part of the senior lenders' claims against the scheme companies in exchange for the shares in the new holding company and debt to be owed by the new restructured group. A scheme

¹ The schemes of arrangement under §895 of the Companies Act 2006 of Bluebrook Ltd., IMO (UK) Limited and Spirecov Ltd. were sanctioned by J. Mann on Aug. 11, 2009.

² For voting purposes, creditors and/or members may be divided into classes. These will be constituted of creditors or members (as the case may be), whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest.

continued on page 82

European Update: IMO Carwash and Valuation Issues in UK Restructurings

from page 24

was required because a small minority of the senior lenders had not agreed to the restructuring. It enabled the senior lenders to credit-bid their debt for the company's assets without any value leakage to the senior lenders who had not agreed to the proposal.



Catherine Balmond

Once the assets of the scheme companies had been transferred, the mezzanine lenders were left with claims against the companies with no assets. Although the mezzanine lenders were not asked to vote as part of the schemes and their claims were not being compromised, they argued that the schemes unfairly prejudiced them. The crux of the mezzanine lenders' challenge was based on valuation evidence showing that they had an economic interest in the business. The judge ultimately found against them on the ground that they had not established that they had a sufficient economic interest, making the overall arrangement unfair of which the schemes formed part.

The judgment builds on previous cases such as *MyTravel*³ and *McCarthy & Stone*,⁴ where a scheme of arrangement has been used as a tool to implement a restructuring where junior creditors were left with little or nothing without their consent where they have no economic interest in the company being restructured. It also discussed the extent to which directors needed to regard the interests of "out of the money" creditors when negotiating a restructuring.

Valuation Evidence

Valuations are key to establishing which creditors have an economic interest. In the *IMO* case, the scheme companies and the senior lenders commissioned a report from PricewaterhouseCoopers (PwC) valuing the business on three different approaches, conducted a marketing process and extrapolated a value for the business based on a surveyor's valuation of a number of the group's

sites. The methodologies adopted in the PwC report were: (1) the income approach, which valued the business on a discounted cash-flow (DCF) basis; (2) a market approach, which looked at comparable publicly-traded companies; and (3) a leveraged buy-out analysis looking at the debt capacity to assess the level of equity investment that a private-equity investor could be prepared to make. Based on these valuations, it was estimated that a purchaser would pay a sum not exceeding £265 million for the business, an amount falling well short of the £313 million of outstanding senior debt.



Anna Biganzoli

By contrast, immediately prior to the scheme proceedings, the mezzanine lenders countered this with a valuation range of £210 million to £700 million, which they said showed that it had a "realistic chance" of having an economic interest. This was based on a report that undertook a Monte Carlo simulation that involved the repeated calculation of the DCF valuation using random sampling of input and assumptions, and then aggregating the result into a distribution of the probabilities of different valuation outcomes.

All the valuations were conducted on a going-concern basis. The company and its senior lenders nevertheless made the important point, in argument, that a liquidation valuation would have been appropriate, the only real alternative to the proposed restructuring being enforcement by the senior lenders in an unplanned insolvency process. This turned out not to be material to the facts, even on a going-concern basis, as the value of the business was held to be less than the senior lenders' debt.

The point as to the correct valuation basis was therefore not properly debated in court. However, the apparent agreement on a going-concern valuation prompted the judge to comment that "for the purposes of this case, and in order to assess the fairness of the schemes, a going concern value is appropriate."

This statement may be linked to the specific facts of the case where each of the parties had put forward valuations on a going-concern basis to support their arguments about economic interest. However, going forward, where there is doubt as to who has an economic interest, junior lenders may argue that valuations on a going-concern basis are appropriate in all circumstances—even where the support of the senior lenders is necessary for the business to continue. Notwithstanding this potential argument by junior lenders, nothing in this case would prevent an argument by the senior lenders in cases where it is clear, based on the facts that the only alternative to the restructuring is a liquidation, that a liquidation valuation is appropriate. An example of this was in *MyTravel*,⁵ where the Civil Aviation Authority was likely to revoke the company's operating license if the restructuring was not implemented.

The judge considered the methodologies of the valuations that were put before him. The DCF analysis was viewed as the most reliable (with other valuations obtained by the scheme companies providing a useful cross-check). The judgment is highly critical of the Monte Carlo simulation model analysis put forward by the mezzanine lenders. The judge dismissed it as a "robotic exercise," "not often used in valuation exercises" and wholly inappropriate in the circumstances, since IMO has a relatively well-established business model. This case provides support for using conventional valuation methods when promoting a scheme of arrangement as opposed to more unconventional valuation methodologies. Not surprisingly, given the judge's views on the mezzanine lenders' valuation in comparison to the valuations provided by the scheme companies, the judge found that the mezzanine lenders did not have a relevant economic interest.

Buy-Out Rights for Junior Creditors

As is common under an intercreditor agreement, the mezzanine lenders had the right to buy out the senior debt and do the restructuring themselves.

³ *Re MyTravel Group Plc*, [2004] All ER (D) 385 (Nov), and *Re MyTravel Group Plc*, [2004] All ER (D) 221 (Dec).

⁴ Unreported.

⁵ *Re MyTravel Group Plc*, [2004] All ER (D) 385 (Nov).

This was seen to provide an important safeguard for the mezzanine lenders, in the event that they thought that the senior lenders were getting more than their debt was worth, leaving the mezzanine lenders with a raw deal. As the mezzanine lenders were not willing to take the risk of buying the senior debt at a time when the senior lenders were willing to take the risk of taking equity in the restructured group, however, the senior lenders should benefit from any upside if the restructured group performed well. The mezzanine lenders were not taking such a risk, so should not be entitled to a share in the upside. This was also considered to be relevant to the valuation of the assets: The valuation should be carried out at the time of the restructuring.

Directors' Duties to Different Creditor Groups When Negotiating a Restructuring

Under English law, directors' duties are owed to the company. When a company is solvent, this means that the directors must consider the interests of the shareholders. However, where a company is in financial difficulty and is insolvent or on the verge of insolvency, then the interests of the creditors intrude.

Counsel for the mezzanine lenders argued that the directors should have used their bargaining position with the senior lenders to secure a deal that preserved the mezzanine lenders' interests. The issue was only raised by the mezzanine lenders at a very late stage in the proceedings, and consequently it was not fully argued. Nevertheless, the following points can be drawn from the judgment:

- On the facts, it was questionable as to whether the directors really had any bargaining power, given the difficult financial position of the group, the agreed need for a restructuring and the risks for the directors of personal liability for wrongful trading⁶ if they continued with the business without coming to an agreement with the creditors;
- That was not to say that the directors had to give in to any demand of the senior lenders, and negotiations for a consensual restructuring had indeed

been entered into with both the senior and mezzanine lenders;

- It was ultimately acknowledged that the board was “not in a position to bargain for some additional return to other creditors if the Senior Lenders resisted that.” In other words, when negotiations between the different creditor groups failed, it was legitimate for the directors to focus on the company's senior creditors—in that sense, only acknowledging economic and business realities and giving effect to the subordination provisions as envisaged in the loan documentation.

There are many different ways of modelling a going-concern valuation.

In this case, all the valuations provided were going-concern, but the only one that showed an interest for the junior creditors was provided by them and had been hastily put together without sufficient details.

How far can the directors be expected to push the negotiations for the junior creditors? In the present case, the mezzanine lenders had set up a committee to conduct negotiations on their behalf. The judge noted that:

The Mezzanine Lenders seem at all material times to have been fighting their own corner, and in no way expected the directors to fight for them. They were a separate negotiating party, trying to protect their own interests, and whilst that might not of itself in every case absolve the directors from trying to take additional steps to protect them, in facts such as the present it goes a very long way.

This suggests that sophisticated lenders should be able to look out for their own interests, particularly where the directors believe that they do not have an economic interest in the company. However, it leaves open the question of what directors would be expected to do in instances where the junior creditors challenging the scheme are not in such a strong bargaining position. All valuations at the time the IMO restructuring was

being negotiated pointed to value breaking in the senior debt.

What Impact Will This Case Have on Future Restructurings?

First, in finding against the mezzanine lenders, the judgment provides great support to the “no economic interest” argument classically run in such cases, and on the basis of which reluctant junior creditors may be excluded from restructuring negotiations. Where value clearly breaks in the senior debt, such a restructuring does no more than implement the subordination provisions envisaged in the loan documents. The senior lenders are recognized as being “the sole beneficial owners of the assets anyway (because of the security and subordination position).” In such cases, schemes are done “not at the expense of the Mezzanine lenders at all (because of the valuations and the absence of an economic interest in the asset).”

Second, the judgment is also helpful in that it confirms that, where valuation is not in dispute and the lenders cannot agree to a restructuring deal among themselves, the directors do not have a duty to protect any theoretical interests of the out-of-the-money creditors.

We should not lose sight of the fact that the judge makes it clear that his judgment is “fact specific.” Nevertheless, it will be harder now for parties to argue that the relevant “universe” of valuations can be other than going-concern. There are many different ways of modelling a going-concern valuation. In this case, all the valuations provided were going-concern, but the only one that showed an interest for the junior creditors was provided by them and had been hastily put together without sufficient details. That leaves plenty of scope for properly-substantiated valuation models to be put forward, which may open the door to a challenge, even where the conventional valuation models are showing no economic interest.

Finally, the evidential benefit of the junior lenders' ability to buy out the senior debt should not be underestimated. The judge made quite a lot of the failure of the junior lenders to exercise their contractual rights on the basis that they would “not take the risk” of paying the full value of the senior debt. ■

⁶ Liability for wrongful trading arises under §214 of the Insolvency Act of 1986 when a director who concludes (or should have concluded) that there is no reasonable prospect of avoiding insolvent liquidation does not take every step to minimise loss to creditors. An action for wrongful trading can only be brought by a liquidator when a company has gone into insolvent liquidation.