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Telewest Scheme of Arrangement

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The recent court hearings to obtain sanction for the Telewest Communications plc scheme of arrangement have thrown some light on the approach which will be adopted by the courts to the issue of identification of classes and general considerations of fairness.

The Telewest scheme of arrangement involved a debt for equity restructuring. The debt in question principally comprised bonds, of which some eighty per cent were denominated in US dollars and the remaining twenty per cent in sterling. The Telewest scheme was opposed by a group of bondholders whose bonds were denominated in sterling. Their particular complaint arose as a result of the exchange rate proposed under the scheme.

In order to enable the new equity to be distributed, it was necessary for the claims of the bondholders to be denominated in a common currency. Rather than using a spot rate on a particular date for converting the value of claims, the scheme proposed using an average exchange rate over a period from the date when there was first default under the bonds until the latest practical date before distributing the explanatory statement (so that the rate to be used would be known to the creditors). The commercial reasons for using an average exchange rate rather than the spot rate on a particular date included the prevention of entitlements to the new equity being susceptible to short-term exchange rate fluctuations.

The opposing sterling bondholders claimed that the effect of using the average exchange rate was that the value of the claims of sterling bondholders was reduced by some five per cent, as compared with the US dollar bondholders, as a result of movements in the exchange rates after the proposed use of the average rate had been made public. In short, they claimed that as a result of the average exchange rate, they would receive unequal treatment as compared with the US dollar bondholders who would in effect receive a corresponding windfall.

There were two court hearings. The first, held in April 2004, was the initial hearing for directions at which the procedure set out in the Practice Statement [2002] 1 WLR 1345 was followed. That procedure was put in place following the decision of the Court of Appeal in *Re Hawk Insurance* [2001] 2 BCLC 480 to enable, so far as possible, the determination of all issues in relation to the composition of classes of creditors for the purposes of a scheme to take place at the hearing of the application to convene meetings. Previously, if issues were raised as to the composition of classes they could only be dealt with at the hearing for the sanction of the scheme, and if it transpired that the classes had been incorrectly identified, a good deal of time and expense would have been wasted in convening and holding the meetings.

The class issue

At the first hearing, the opposing sterling bondholders argued that the court should not give leave to convene the meetings unless the terms of the scheme were altered so as to provide for conversion at the spot rate on the date for valuing claims under the scheme ('the merits issue'). Alternatively, they argued that the sterling and dollar bondholders fell into two separate classes and that separate meetings of each class should be called ('the class issue').

As regards the merits issue, the judge (Mr Justice David Richards) emphasized that the first hearing was not a hearing to consider the merits and fairness of the scheme. The matters for consideration at that hearing concerned the jurisdiction of the court to sanction the scheme if it were to proceed, i.e. principally to decide the question of the composition of the classes. Issues arising on the merits including fairness would only arise for consideration at the later hearing to sanction the scheme. However, as described below, there remained a question as to the extent to which the general merits and fairness of a scheme would be considered at the sanction stage.

As regards the class issue, the judge reaffirmed the distinction between rights and interests and stressed that differences in rights, not interests, are relevant to the composition of classes. This followed from the classic test laid down by Bowen LJ in *Sovereign Life Assurance v Dodd* [1892] 2 QB 573 at 583 that the meaning of class 'must be confined to those persons whose rights are not so dissimilar as to make it impossible for them to consult together with a view to their common interest'. But as subsequent decisions have shown, this test is not always easy to apply in

practice. The approach of Mr Justice David Richards is instructive on this aspect.

The Telewest scheme was proposed as an alternative to liquidation. In considering the rights of the bondholders, the judge held that the relevant rights of creditors to be compared against the terms of the scheme are those which would arise in an insolvent liquidation.

In this context it is important to note that the provisions of a scheme can differ from the regime which applies in an insolvent liquidation without giving rise to issues as to the composition of classes. It is the purpose of most schemes to produce an arrangement which is different from an insolvent liquidation. If the differences apply equally to all creditors (such as a pari passu distribution to all creditors in the form of new equity rather than in cash as would occur in a liquidation), the question of separate classes does not arise. However, it was argued by the opposing sterling bondholders that the use of the average exchange rate involved a departure in the template of rights in a liquidation which had an impact as regards a particular group of creditors which was sufficiently material to require separate classes to be formed.

Accordingly, in resolving the class issue, the court had to decide firstly whether bondholders had a right to a particular exchange rate formula and, if so, secondly whether the adoption of the average exchange rate created a sufficiently material disparity of result for the sterling bondholders that they should be constituted as a separate class. The first point was decided in the affirmative in favour of the opposing sterling bondholders. It was held that conversion at the date of valuation of claims in a liquidation is an essential part of a pari passu distribution. It followed that a scheme which provided for distribution on a different basis (in this instance, the use of an average rate) involved a departure from the creditors' rights to pari passu distribution.

The decision on the second point, namely whether the difference in rights was sufficiently material, is of particular interest. The judge held that, in accordance with earlier cases, a broad approach was to be taken and that differences in rights may be material, and more than de minimis, without leading to separate classes. Thus, in the scheme proposed in *Re Hawk Insurance*, the 'crude or rough and ready' procedure for the estimation of claims involved a departure from the rights arising in a liquidation without requiring separate classes; and the treatment of the mis-selling claims in *Re Equitable Life Assurance Society* [2002] 2 BCLC 510 as if they had the same strength, when this was almost certainly not the case, did not prevent the court from holding that all the claimants fell into the same class.

Having drawn attention to the factors which united the sterling and dollar bondholders, the judge went on to hold that in the context of the Telewest scheme there was not such a dissimilarity of rights of the sterling bondholders that they should form a separate class. This was so even though the figures involved were large – the use of the average exchange rate as opposed to the spot rate at the time of the hearing resulted in a reduction of value for sterling bondholders as a whole of approaching 5 per cent, worth just under USD 50 million. However, this had to be set against the then current market value of all bonds of some USD 3.5 billion and of some USD 1 billion for sterling bonds.

There were good commercial reasons for the departure in the Telewest scheme from the liquidation template by the adoption of the average exchange rate. It was also of some significance that this formula had been proposed by a committee of bondholders which included the holders of both sterling and dollar denominated bonds. In other words it could not be said that the sterling bondholders had been 'stitched up' by the dollar bondholders. But the decision in Telewest also shows that issues as to the composition of classes can be avoided where a scheme is proposed as an alternative to liquidation by drafting terms of a scheme which follow as closely as possible the liquidation template. Where, as will occur in most cases, there has to be some departure from that template, the differences in result should be kept to a minimum and be justifiable on rational grounds. It will also assist if the departure is supported by members of the class who would lose out from the differential treatment.

The decision in Telewest continued the trend laid down in *Re Hawk Insurance* to take a broad approach to the issue of the composition of classes. However, by taking this approach, the court is in effect keeping the threshold low for the establishment of jurisdiction to approve a scheme of arrangement under s. 425 of the Companies Act 1985. Where there is a departure from the liquidation template but a single class is constituted, there is a risk that those members of the class who benefit from the departure can achieve the statutory majorities and impose a scheme on the minority of the class whose position is correspondingly prejudiced. That risk can be mitigated if the court takes a flexible approach to the question of fairness at the hearing to sanction a scheme, which was considered at the hearing in June 2004 when the court was asked to sanction the Telewest scheme. This hearing followed the meeting at which the creditors, voting as one class, including the sterling and dollar bondholders, voted in favour of the scheme by considerably in excess of the requisite statutory majorities.

The fairness issue

The classic formulation of the principles which guide the court in considering whether to sanction a scheme

was set out by Plowman J in *Re National Bank Ltd* [1966] 1 WLR 819. In short the court will see (1) that the provisions of the statute have been complied with, (2) that the class was fairly represented by those who attended the meeting and that the statutory majority are acting bona fide and are not coercing the minority in order to promote interests adverse to those of the class whom they purport to represent, and (3) that the arrangement is such as an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve. Plowman J continued: 'The court does not sit merely to see that the majority are acting bona fide and thereupon to register the decision of the meeting, but, at the same time, the court will be slow to differ from the meeting, unless either the class has not been properly constituted, or the meeting has not considered the matter with a view to the interests of the class which it is empowered to bind, or some blot is found in the scheme.'

As a matter of first impression the classic formulation of Plowman J of the court's role at the hearing to sanction the scheme might suggest that the court will not take into consideration general questions of fairness of the proposed scheme. If that were correct, this formulation would arguably be too restrictive, particularly in view of the apparent recent lowering of the test for establishing jurisdiction by taking a broad view on the question of composition of classes.

However, at the hearing to sanction the Telewest scheme, Mr Justice David Richards made clear that under the test formulated by Plowman J, the court did have to be satisfied that the scheme proposed was fair. It had to be a scheme that an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve. But it need not be the only fair scheme or even, in the court's view, the best scheme. The judge also emphasized that in commercial matters members or creditors are much better judges of their own interests than the courts.

In sanctioning the scheme, the judge was satisfied that the scheme taken as a whole, including the average exchange rate, was a scheme which an honest and intelligent bondholder, whether holding sterling or dollar bondholders or a mixture of the two, could approve having regard to his interests.

In reaching that conclusion the court had regard to the support for the scheme from a number of sterling bondholders and to the votes of the sterling bondholders as a group. In this connection, it is to be noted that sufficient information was presented to the court to enable it to analyse the votes that were cast. Thus, in addition to satisfying the court that the requisite statutory majorities had been obtained, the company also provided a separate analysis showing how the holders of sterling bonds voted which showed that even if they had formed a separate class and held a separate meeting they would have voted in favour by the requisite statutory majorities.

The information provided to the court also showed that certain sterling bondholders voted in favour, notwithstanding that they stood to lose from the adoption of the average exchange rate. It is of some interest to note that in conducting this analysis the court was concerned to ensure that there were no outside arrangements which might have insulated the sterling bondholders in question from the effect of using the average exchange rate. In other words the court's reliance on such votes was dependent on showing that they had the same interests as the group (i.e. sterling bondholders) as a whole, unaffected by outside interests. In this regard, the court also considered whether votes in question were cast on an informed basis and in particular whether the explanatory statement was sufficiently clear to draw attention to the differences in the treatment of sterling and dollar bondholders arising from the use of the average exchange rate.

In all the circumstances the court was satisfied that there was no inherent unfairness in the scheme such as would require the court to refuse to sanction the scheme.

Thus, at the hearing to sanction the scheme the court did take into account general issues of fairness which formed the basis of the complaint of the opposing bondholders. The grounds of the decision show the advantages of being open with the creditors (the proposed use of the average exchange rate was made public as soon as practicable), of obtaining support from affected creditors with no outside interests and of maintaining sufficient records of the voting at the meeting to enable the court to analyse the votes cast to show such support. Those proposing a scheme as an alternative to liquidation will, however, need to be alert to the possibility of challenge where what is proposed departs from the liquidation template.