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ARTICLE

Schemes of Arrangement: IMO Car Wash Case

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1. Introduction

A scheme of arrangement is a statutory procedure pursuant to Part 26 of the Companies Act 2006 ('CA 2006') whereby a company is able to reach a compromise or arrangement with its creditors and members (or any class of them). The procedure is available to both solvent and insolvent companies. Schemes of arrangement are becoming an increasingly popular restructuring tool because of the flexibility they allow a company in its proposals which can implement a wide range of internal reorganisations merger or demerger. Recent examples include the use of schemes for home-builders McCarthy & Stone, foam manufacturer British Vita, and in the restructuring of holiday company MyTravel.[1]

The procedure for a scheme of arrangement essentially involves three stages:

(i) the company (or any creditor, shareholder, administrator or liquidator) applies to court for an order convening a meeting of each class of creditor or shareholder affected by the proposed scheme;

(ii) the meeting or meetings are held and, for the scheme of arrangement to be approved, a majority in number representing 75% in value of each of the different classes of creditors and shareholders must vote in favour of the proposed scheme; and

(iii) if the proposal has been approved at each meeting, a further application is made to court to sanction the scheme.

A number of issues will commonly arise in this process. For instance, the 'fairness' of the scheme is considered. This means that the court must be satisfied that a number of conditions are met, including that the statutory procedure has been complied with, that the majority in every class is acting *bona fide* and that the arrangement is one which an intelligent and honest man who is a member of the relevant class and acting in respect of his own interest might approve. Other issues arise in connection with the composition and proper identification of the particular 'classes' for the purposes of voting and a number of principles have been set out by the courts in this respect.[2]

However, a further key issue which is becoming increasing prevalent in schemes of arrangement (and upon which this article focuses) concerns the question of which classes of creditors or members need to approve the scheme, and the principle that it is not necessary for the company to consult any class of creditors (or contributories) who are not affected, either because their rights are untouched or because they have no economic interest in the company.[3] In *In re Tea Corporation Ltd*[4] Vaughan Williams LJ, confirming the view that it would be nonsensical to allow those with no economic interest in the assets of a company to prevent the implementation of a scheme to restructure such a company, said:

> 'It would be very unfortunate if a different view had to be taken, for if there were ordinary shareholders who had really no interest in the company's assets and a scheme had been approved by the creditors... the ordinary shareholders would be able to say that it should not be carried into effect unless some terms were made with them.'

If there is any dispute about this, and clearly in the current market conditions this is an increasingly likely prospect, then the court is entitled to ascertain whether a purported class actually has an economic

Notes

1 *Re MyTravel Group Plc* [2004] All ER (D) 385 (Nov); *Re MyTravel Group Plc* [2004] All ER (D) 221 (Dec).

2 See, for instance, *Sovereign Life Assurance Co v. Dodd* [1892] 2 QB 573; *Re Hawk Insurance Company Ltd* [2001] 2 BCLC 480; *Marconi Corporation Plc and Marconi Plc* [2003] EWHC 663 (Ch); and *Re Telewest Communications plc (No 1)* [2005] BCC 29.

3 This should be distinguished from the principle that a company is free to select the creditors with whom it wishes to enter into an arrangement and need not include creditors whose rights are not altered by the scheme (see *Sea Assets Ltd v. Pereroan etc Garuda Indonesia* [2001] EWCA Civ 1869 and In re British & Commonwealth Holdings plc [1992] 1WLR 672.

4 *In re Tea Corporation Ltd* [1904] 1 Ch 12.

interest in a real, as opposed to a theoretical or merely fanciful, sense.[5]

Fundamental to establishing this point, and whether creditors or members are unaffected (due to either their rights being untouched or because they have no economic interest in the company), is the issue of the valuation of the company's business and assets, and it is this issue that is key to the decision discussed below, namely *In the Matter of Bluebrook Ltd and others* which has become known as the IMO Car Wash case.[6]

2. The IMO Car Wash case

The High Court's decision in the recent IMO Car Wash case concerned the sanction of three schemes of arrangement between the heavily indebted car wash business and their senior lenders as part of the group's overall restructuring. It has received significant attention in the legal press and is likely to be of interest to many professionals working in restructuring and distressed and mezzanine investor circles alike. The decision reinforces the need for valuation evidence in these types of cases and, more importantly, confirms that the English courts are interested in the real price a purchaser might pay for a business today, rather than a future 'intrinsic' value of a company based on improvements in asset prices and market conditions.

The proposals put forward by the company did not provide any new rights for the mezzanine lenders and did not leave any assets in the group to pay them. The court held that the mezzanine lenders were not able to prevent the implementation of the schemes as they had no economic interest in their outcome. The valuation evidence submitted by the senior lenders showed that the 'value break' was in the senior debt tranche, therefore putting the mezzanine lenders 'out-of-the-money'. The mezzanine lenders challenged this valuation and claimed that the schemes unfairly prejudiced them.

3. Facts of the case

3.1. Background

The three applicant companies were Bluebrook Limited ('Bluebrook'), IMO (UK) Limited ('IMO'), and Spirecove Limited ('Spirecove') (together, the 'Group'). Bluebrook was the holding company of a group of companies which operate one of largest carwash businesses in the world. IMO and Spirecove were subsidiary companies over which Bluebrook exercised indirect ownership and control. Bluebrook was indebted to a consortium of senior lenders (the 'Senior Lenders'), including HBOS and US distressed debt investor Angelo Gordon, for approximately GBP 313m (the 'Senior Debt'). The indebtedness was supported by a range of debentures in which the Senior Lenders were granted security over certain assets of the Group. The Senior Debt was also guaranteed by other companies in the Group. Spirecove was indebted to another group of lenders (the 'Mezzanine Lenders'), led by Partner Group, for a debt of around GBP 119m (the 'Mezzanine Debt'), which was also secured over the assets of the Group. The Senior and Mezzanine Debt was provided to fund expansion and the acquisition of the trading arm of the Group in 2006.

Various arrangements were in place which fully subordinated the Mezzanine Lenders to the Senior Lenders under an intercreditor agreement. The Group then became balance sheet insolvent by over GBP 300 million. Valuations were obtained and the assets of the Group were seen to be insufficient to discharge the Senior Debt and the Mezzanine Debt in full. The board of directors of Bluebrook concluded that a restructuring of the business was required to secure its long term future.

3.2. Restructuring proposals

The Group's restructuring proposals were embodied in three schemes of arrangement (the 'Schemes') together with a number of other transactions to give effect to a partial debt-for-equity swap.

Essentially, the components of the Schemes were as follows:

- Bluebrook, by a pre-pack administration sale, would transfer its business and assets to a new company group ('NewCo')
- The sale proceeds would discharge in part the debt due to the Senior Lenders
- GBP 12m of existing Senior Debt was to remain in the existing group ('OldCo')
- A significant proportion of the remaining debt would be novated to NewCo
- Senior Lenders would exchange the remaining debt due from Bluebrook for equity in Newco
- OldCo would be released from the debt (other than the GBP 12m referred to above)
- Mezzanine Lenders would receive no return on any debt due to them by the Group
- The overall restructuring would involve the enforcement processes contained within the

Notes

5 See the reasoning *In My Travel Group plc* [2005] 2 BCLC 123.
6 *In the matter of Bluebrook Ltd and others* [2009] EWHC 2114 (Ch).

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intercreditor agreement including the compulsory release of security and guarantees held by the Mezzanine Lenders and regarding the transfer of assets

3.3. Effect of the proposals

The proposals would effectively exclude or 'shut out' the Mezzanine Lenders as there would be no assets left in the Group in order to pay them. The applicants argued that the justification for this was that the value of the Group was such that the Mezzanine Lenders had no economic interest since the value of the assets (or the value of the group as a whole) was significantly less than the value of the Senior Debt.

Many of the Mezzanine Lenders did not accept that the Schemes should be sanctioned. As such, they set up a respondent co-coordinating committee to challenge the Schemes (the 'Mezzanine Co-ordinating Committee'). The Senior Lenders set up a steering committee to represent their interests.

4. Issues

4.1. Valuation

The Senior and Mezzanine Lenders separately commissioned valuation reports which were submitted as evidence in court.

All the parties accepted that the basis of the valuation should be as a 'going concern' rather than on a liquidation or break up basis (which may be significantly lower), a view endorsed by Mr Justice Mann.

LEK Consulting produced the valuation evidence on which the Mezzanine Lenders sought to rely. Their report was based on a 'Monte Carlo simulation'. This is a complex and technical valuation methodology involving (briefly speaking) repeated calculations of the discounted cash flow (DCF) valuation, using a random sampling of assumptions and input and then aggregating the result into a distribution of the probabilities of different valuation outcomes. The result of this complex and somewhat theoretical valuation methodology was that the report calculated mean and median results of GBP 385m and GBP 398m, and concluded that '… it appears highly likely that the value of IMO 'breaks' in the Mezzanine tranches on IMO's current debt structure.' In other words, giving the Mezzanine Lenders an economic interest in the outcome of the restructuring proposals (and therefore the ability to prevent the implementation of such).

In their submissions, the Mezzanine Lenders contended that a '… proper view of the value of the companies (the "intrinsic" value) demonstrated that there was a realistic possibility that they had a value which exceeded the Senior Debt, so that the companies had a real value to the Mezzanine Lenders notwithstanding their subordination'.[7]

The Senior Lenders instructed a number of organisations including PricewaterhouseCoopers (PwC), Rothschild and King Sturge for their valuation evidence. A number of alternatives were put forward including a Discounted Cash Flow (DCF) income approach (PwC), a market comparables approach (PwC), a PE/ LBO approach (PwC), a third party M&A sale process (Rothschild), and a surveyor's valuation of the sites (King Sturge).

Each analysis undertaken tried to ascertain valuation on a 'present value' basis and applied a discount (which was called the 'alpha' factor) to take account of current market conditions and find out the price a purchaser would pay for the business. The valuations undertaken produced slightly different ranges of value, but the highest valuation was that a purchaser would not pay a sum exceeding GBP 265m for the business. This amount '… fell well short of the value of the Senior Debt (£313m)' and '… that even if one strips out the 'alpha' factor which PwC used, the value is still well short of the … Senior Debt.'[8]

Mr Justice Mann concluded that he had misgivings as to the soundness of the LEK valuation, partly in light of the reticence which the Mezzanine Lenders had shown in disclosing the supporting material. Mr Justice Mann did not think that the 'intrinsic value' approach put forward by the Mezzanine Lenders was the proper way of addressing the valuation point, stating that:

> 'It is an attempt to play with the same sort of assumptions that are used more conventionally in valuations such as the PwC valuation, but in a more mechanistic way which avoids having to make real judgments in an area in which judgments are very important. It does not, in my view, demonstrate with sufficient clarity that market conditions are currently giving the Senior Lenders an unfairly good deal'.[9]

Ultimately, Mr Justice Mann did not decide which of the various alternatives was the correct approach, but rather looked at the valuations as a whole, finding some more persuasive than others.

Notes

7 See judgment, paragraph 30(i).
8 See judgment, paragraph 18.
9 See judgment, paragraph 50.

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4.2. Unfairness

The Mezzanine Lenders contended that the directors of the scheme companies had failed to extract a proper benefit for the creditors of the companies and in particular for the Mezzanine Lenders. Mr Justice Mann stated that the directors had entered into arrangements with, and in the interests of, the Senior Lenders. The fact that the Mezzanine Lenders would effectively not have any interest in the assets because of their subordination was entirely different from the situation where directors advanced the interests of one creditor at the expense of other creditors who thereby lost a benefit they would otherwise have.

The Mezzanine Lenders also contended that the directors should have used their bargaining position with the Senior Lenders to preserve the Mezzanine Lender's interests. On the facts, however, it was questionable as to whether the directors of the group had any real bargaining power. Indeed, Mr Justice Mann thought this proposition was 'somewhat unrealistic'.[10] Should the directors have threatened to carry on trading in circumstances where they had quite properly recognised that the company was balance sheet insolvent, the directors would have exposed themselves to liability under section 214 of the Insolvency Act 1986 (as amended) for wrongful trading.

The judge also raised the issue of the risk that the Senior Lenders were taking. The intercreditor agreement in the present case, as is common in intercreditor agreements, entitled the Mezzanine Lenders to buy out the Senior Debt and carry out the restructuring themselves. Mr Justice Mann noted that the Senior Lenders had decided to run 'a real risk',[11] in restructuring the business to keep it alive. If the business proved unsuccessful the Senior Lenders may end up in a worse position than they were at present. The Mezzanine Lenders however were not prepared to take this risk themselves.

4.3. Section 899 of the Companies Act 2006

The Mezzanine Lenders argued that the Schemes did not fall within the definition of a scheme of arrangement under section 899 CA 2006, as an arrangement or compromise '... involves an element of reciprocity of benefit, and that in a situation in which one party gives up everything and gets nothing in return then there is no compromise or arrangement'.[12] The Mezzanine Lenders sought to rely on the NFU case to support their argument.[13] Mr Justice Mann distinguished the present situation from the NFU case. In the NFU case, the scheme provided that all existing members of a company apart from five gave up all of their respective rights, and it was held that a 'total surrender' of rights did not constitute an arrangement. In the present case, although the Schemes released the scheme claims, it was part of an arrangement whereby those claims were substituted by new claims against the Group and the assets of OldCo were transferred to NewCo. In the NFU case, there was absolutely nothing passing back to the members and therefore could not be described as a 'compromise or arrangement'. In the IMO Carwash case, the Schemes did not include a complete surrender of rights and therefore the Schemes were a 'compromise or arrangement' within the meaning of section 899.

5. Decision

The High Court sanctioned the Schemes. The Mezzanine Lenders were not bound by the Schemes, and therefore their legal rights were unaffected. Mr Justice Mann did not find that in the circumstances the Schemes were part of an overall arrangement that worked unfairly towards the Mezzanine Lenders.

A company is free to select the creditors with whom it wishes to enter into an arrangement and need not include creditors whose rights are not altered by the scheme.

In promoting and entering into a scheme, it is not necessary for the company to consult classes of creditors (or contributories) who are not affected, either because their legal rights are unaffected or because they have no economic interest in the company. The mere fact of a possibility of establishing a negotiating position and extracting a benefit from a deal is not the same as having a real economic interest.

6. Implications for the future

The case highlights the loss in value suffered as a result of recent financial turmoil, as it was understood that the business in the present case had lost approaching half its value meaning that the mezz and equity were entirely wiped out.

This decision provides guidance on the approach the courts will take on the issue of the valuation of a company's business and assets in these types of cases. The decision indicates that on the question of valuation the English courts will consider what a purchaser might

Notes

10 See judgment, paragraph 60.
11 See judgment, paragraph 79.
12 See judgment, paragraph 72.
13 *In re NFU Development Trust* [1972] 1 WLR 1548.

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pay for a business today, rather than its break-up value, or some theoretical long term intrinsic value.

It is also evident that where restructurings are conducted under English law the junior creditors may be more easily excluded following this decision (in that if a sale of the company will yield less than what is owed to its senior creditors, then the junior creditors will have no economic interest and their rights will be 'untouched' by the restructuring). Senior lenders are likely to take a less consensual approach in restructurings with regard to their interaction with more junior creditors, as it is clear senior lenders are entitled to take action to restructure a company without reference to subordinated lenders who have no real economic interest.

In any event, this case is causing subordinated lenders to reassess their risk to address the fact that they are potentially in a worse position and have less protection than they previously thought.

A further point to note is that the decision may also give reassurance and comfort to the company's directors so that they are able to restructure failing companies without fearing personal liability from disgruntled lenders that ultimately have no economic interest.

These implications aside, in the present case Mr Justice Mann found that the valuation evidence presented by the Mezzanine Lenders did not '… demonstrate with sufficient clarity that market conditions [were] giving the Senior Lenders an unfairly good deal'[14] and that the proper approach to valuation in a case such as this requires '… real world judgments as to what is likely to happen … rather than [a range] which is applied in a series of random calculations to come up with some mechanistic probability calculation'.[15] This approach to valuation will clearly impact on how future restructurings are handled.

Notes

14 See judgment, paragraph 50.
15 See judgment, paragraph 45.

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International Corporate Rescue

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