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EDITOR'S NOTE: DECISIONS, AND MORE . . .
Victoria Prussen Spears

SECOND CIRCUIT COURT OF APPEALS PARTIALLY RESUSCITATES TRIBUNE LEVERAGED BUYOUT LITIGATION
Benjamin Mintz and Justin Imperato

A WARNING TO CONTRACT COUNTERPARTIES: A DEBTOR CAN SELL YOUR FULLY PERFORMED CONTRACT WITHOUT CURING DEFAULTS AND PAYING YOUR CLAIM IN FULL
Andrew M. Troop and Andrew V. Alfano

"TAKE THIS PILL, IT'S GOOD FOR YOU": FIFTH CIRCUIT CONCLUDES THAT FORCED CHANGE OF CONTROL WAS NOT THE PRODUCT OF DURESS
Arthur J. Steinberg, Jonathan W. Jordan, and Sarah L. Primrose

CONTRACTUALLY REIMPOSING FIDUCIARY DUTIES IN AN LLC OPERATING AGREEMENT DESPITE CLAUSE WAIVING FIDUCIARY DUTIES
Glenn D. West

TRIMARK: ARE "SACRED RIGHTS" STILL SACROSANCT?
Jonathan T. Edwards, Michael G. Parisi, C. Jordan Myers, and Adam R. Monich

PROTECTING NET OPERATING LOSSES IN DISTRESSED INVESTMENTS
Matt Ehinger and Michael Ott

DELAWARE BANKRUPTCY COURT REBUFFS U.S. TRUSTEE EFFORT TO COLLECT STATUTORY FEES FROM LITIGATION TRUST DISTRIBUTIONS
Jacob A. Adlerstein, Robert A. Britton, Claudia R. Tobler, and Miriam M. Levi

ENGLISH COURT REFUSES TO APPROVE RESTRUCTURING PLAN BASED ON CROSS-CLASS CRAMDOWN
Philip Hertz, Lewis Cymbal, Gabrielle Ruiz, and Douglas Deutsch

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VOLUME 17 NUMBER 8 Nov./Dec. 2021

Editor's Note: Decisions, and More . . .
Victoria Prussen Spears 395

Second Circuit Court of Appeals Partially Resuscitates Tribune Leveraged Buyout Litigation
Benjamin Mintz and Justin Imperato 398

A Warning to Contract Counterparties: A Debtor Can Sell Your Fully Performed Contract Without Curing Defaults and Paying Your Claim in Full
Andrew M. Troop and Andrew V. Alfano 405

"Take This Pill, It's Good for You": Fifth Circuit Concludes That Forced Change of Control Was Not the Product of Duress
Arthur J. Steinberg, Jonathan W. Jordan, and Sarah L. Primrose 410

Contractually Reimposing Fiduciary Duties in an LLC Operating Agreement Despite Clause Waiving Fiduciary Duties
Glenn D. West 413

***TriMark*: Are "Sacred Rights" Still Sacrosanct?**
Jonathan T. Edwards, Michael G. Parisi, C. Jordan Myers, and Adam R. Monich 419

Protecting Net Operating Losses in Distressed Investments
Matt Ehinger and Michael Ott 425

Delaware Bankruptcy Court Rebuffs U.S. Trustee Effort to Collect Statutory Fees from Litigation Trust Distributions
Jacob A. Adlerstein, Robert A. Britton, Claudia R. Tobler, and Miriam M. Levi 429

English Court Refuses to Approve Restructuring Plan Based on Cross-Class Cramdown
Philip Hertz, Lewis Cymbal, Gabrielle Ruiz, and Douglas Deutsch 433

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English Court Refuses to Approve Restructuring Plan Based on Cross-Class Cramdown

By Philip Hertz, Lewis Cymbal, Gabrielle Ruiz, and Douglas Deutsch*

This article discusses the first English case to reject the attempt to cram down under Part 26A of the Companies Act 2006. The case provides a timely reminder that the English court will not act as a rubber stamp to the wishes of the majority of creditors (or shareholders).

Almost a year to the day since the introduction of the new English restructuring plan under Part 26A of the Companies Act, an application to approve a restructuring plan in respect of Hurricane Energy plc, an AIM listed company, which is part of an oil extraction group, was rejected on June 28. This was on the basis that the plan failed to satisfy one of the key conditions set out in Section 901G of the Companies Act 2006, namely that for cross-class cramdown, no members of the dissenting class are worse off under the plan when compared with the relevant alternative.

THE RESTRUCTURING PLAN IS A POWERFUL TOOL TO OVERRIDE EXISTING RIGHTS

The introduction of a new English restructuring tool in June 2020 has enhanced the ability of distressed debtors to restructure. In particular, the restructuring plan's ability to impose a compromise on a dissenting class of creditors or shareholders is a powerful tool, essentially allowing a rewrite of previous bargains.

It Is Not Without Limits

It is not however without limits or important safeguards for those who are affected by the restructuring plan. The limits take the form of two conditions that must be satisfied, namely:

- That any dissenting class must be no worse off than in the relevant

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alternative; and

- That the class or classes that votes in favour of the plan must have a genuine economic interest in the relevant alternative.

In addition to these prescribed conditions, there is also a final hurdle that has to be satisfied when the court considers the restructuring plan at a formal sanction hearing. The court sanction is dependent upon the two considerations being satisfied and also on the court being willing to exercise its discretion. The English court has long been regarded as both predictable and reliable in exercising such discretion, not least in the restructuring arena where schemes of arrangement have been the tool of choice for compromising creditors in the context of both English and international cases. In exercising its discretion, the court considers the fairness of the scheme or restructuring plan and has to balance the interests of a company's stakeholders against the likely alternative.

HURRICANE ENERGY FAILED THE "NO WORSE OFF" TEST IN RESPECT OF SHAREHOLDERS

In the *Hurricane Energy* case, we are provided with a timely reminder that the English court will not act as a rubber stamp to the wishes of the majority of creditors (or shareholders). In that case, the court was not prepared to sanction a restructuring plan that deprived shareholders of the vast majority of their equity in favour of the company's bondholders. This was on the basis that the restructuring plan did not ensure that the shareholders were no worse off when compared with the relevant alternative, so did not meet the necessary conditions. The judge concluded that this test did not require the court to be satisfied—in order to find against the company—that the most likely outcome from the relevant alternative is that there will be a return to shareholders at some point in the future. In the judgment, the fact that there is "a realistic prospect" that the company will be able to discharge its obligations to the creditors, leaving assets with at least potential for exploitation, is "enough to refute the contention that the shareholders will be no better off under the relevant alternative than under the Plan."

The facts of the case were such that there were no immediate liquidity issues, with the company currently meeting its obligations to pay interest under the bonds and predicted to be able to continue to do so until maturity, but the company was anticipated to become unable to meet its obligations in full to bondholders at maturity in July 2022. The agreed position was that the relevant alternative would see the company continuing to trade into 2022, however the application was sought on an urgent basis.

The directors had promoted the restructuring plan on the basis that they were not prepared to enter into a significant contractual arrangement in the

form of a bareboat charter unless they could come to an agreement to restructure the bonds. The bondholders were equally not prepared to restructure their bonds, including any extension of their maturity, outside of a restructuring plan. The judge ultimately rejected the contention that it is unlikely that an extension of the charter could be negotiated and entered into without the plan.

The restructuring plan was also pursued on an urgent basis due to the fact that certain shareholders had requisitioned a shareholders' meeting to replace the board of directors soon after the practice statement letter was launched. The relevance here, it was submitted, was that unless the plan was sanctioned in good time before the annual general meeting on June 30, the likelihood was that a new board will be appointed who would withdraw the plan. As with the charter, the judge held that the fact that the board is likely to be replaced was not a legitimate ground of urgency.

IMPORTANCE OF CONSIDERING ALL THE STAKEHOLDERS AFFECTED BY THE RESTRUCTURING

The case demonstrates the moving parts and complex issues that arise in most restructurings and the difficulty that a company has in navigating the demands of its different stakeholder constituents. In this case the company had simply pursued its restructuring with its bondholders. The original restructuring plan did not include the company's shareholders at all notwithstanding the fact that the shareholders were essentially being disenfranchised by the restructuring plan. At the first hearing of the restructuring plan, the court was not prepared to limit the consideration of the restructuring plan to the bondholders alone but gave directions to the company to consult with its shareholders on the basis that the rights of shareholders (with an economic interest in the company) to participate in the capital and profits of a company are "affected by" a restructuring plan that would dilute such participation. This meant that at the sanction hearing the company relied upon the powerful ability to cram down its shareholders after 92.34 percent voted against the plan.

DIRECTORS' DUTIES IN PURSUING A RESTRUCTURING

The case is a good reminder of the difficult situation directors are in when a company is in financial difficulty. In this case the judge was clear to emphasise that duties to shareholders do not cease entirely and whilst the directors must have regard to the interests of creditors, when a company's solvency is in doubt, those interests are not to the exclusion of other stakeholders (provided that if it can be shown that there is no economic value in the shares, the creditors in a restructuring are entitled to determine allocation of value as between interested

stakeholders). The directors in this case clearly took steps to take appropriate legal and financial advice in promoting the restructuring, but seemingly failed to take into account the interest of other stakeholders, in particular their shareholders. On the facts of this case, it appears that the directors pursued a course of action which ultimately relied on them being able to simply override the rights of the shareholders. While in some cases this may be possible (especially in cases where the relevant alternative is immediate insolvency), the court in *Hurricane Energy* considered other potential restructuring possibilities were available and could be explored before the bonds matured in 2022, which meant that there was a realistic prospect available that would have meant the shareholders were better off.

TIMELY RESTRUCTURING AND REALISTIC ALTERNATIVES

Generally speaking, it is important for debtors to engage with stakeholders early as this will enable the debtor to consider fully its options, but it should also be remembered that the power of the cramdown mechanism (both in the context of schemes and across classes in a restructuring plan) is not without limits and safeguards. Using it as a strategic tool, prematurely to disenfranchise particular stakeholder groups will not mean that it passes muster with the court. The English court will be careful to ensure that it is only used in appropriate circumstances and in the absence of realistic alternatives. This means that for companies looking to restructure they must have consulted all those affected by the scheme or restructuring plan and ensure that they provide the court with sufficient evidence in respect of the relevant alternative when seeking to rely on cross-class cramdown. It, of course, remains the case that reaching a consensus with all stakeholders is by far the preferred and most cost-effective way of restructuring distressed businesses.

A CLOSER LOOK AT THE CASE—SOME LESSONS TO BE LEARNED

In this case it is significant that the relative alternative was a continuation of trading for at least a year. This is the first case in which the English court has refused to sanction a restructuring plan (see the box accompanying this article for a summary of the terms of the restructuring plan) which relied upon the cross-class cramdown mechanism. While on its face, the decision is perhaps not surprising, the case provides some useful general guidance on the English court's approach to the operation of cramdown. Other cases to date where cross-class cramdown has been relied upon to approve a restructuring plan have involved the cramming down of creditors. The novelty in this case was that the cramdown related to shareholders. The other cases have also taken place in the

context of clear evidence demonstrating that the relevant alternative was a formal and imminent insolvency process.

In *Hurricane Energy*, shareholder challenges at the first stage of the process were already apparent, having been left out of the proposed restructuring altogether. Amendments were made at the direction of the judge to provide shareholders with an opportunity to vote on the restructuring plan. Shareholders do need to be included as a party to a restructuring plan in order to rely on the exemptions from obtaining shareholder approval for actions under the Companies Act 2006 or cross-class cramdown under Part 26A (unless excluded from voting by the court for having no economic interest following an application under Section 901C(4)). The result of the bondholder meetings and shareholder meetings however continued to demonstrate the divide between the two different classes: 84.89 percent of bondholders voted in favour of the restructuring plan compared to only 7.66 percent of shareholders. The reason for the fierce opposition by shareholders was due to the fact that under the restructuring plan, bondholders would receive 95 percent of the equity whilst existing shareholders would retain only five percent and would be prevented from seeking to replace the board of directors.

In providing general guidance on how the courts approach cross-class cramdown the judge described a three-step approach:

- Identifying what would be the most likely alternative if the plan is not sanctioned;
- Determining what would be the outcome or consequence of that for the shareholders; and
- Comparing that outcome and consequences for shareholders if the plan is sanctioned.

In this case it was common ground that the relevant alternative was the continuation of trading for at least a year, and on the evidence the company was operating at a profit and would continue to do so up until the maturity of the bonds in July 2022.

Based on the evidence the court concluded that the shareholders would be in a better position without the plan and being allowed to retain their shares in a company that is continuing to trade and with a realistic prospect of being able to repay the bonds in due course, rather than giving up 95 percent of their shares with the prospect of a "less than meaningful return." This was because there were realistic possibilities of the company being able to repay the bondholders by exploring a number of different options including refinancing or a rights issue, or potentially buying back the bonds.

The company on the evidence failed to demonstrate that the shareholders would not be better off if they retained their shares and the company was to continue to trade for at least a year. The fact that the company was involved in the extraction of oil which by its nature is a speculative business and where the company's fortunes depended on the estimates of future oil prices meant that the analysis as to the relevant alternative was not straightforward. But more significant in this case was the fact that on the company's own evidence it was profitable and would remain so until the maturity date of the bonds and possibly beyond that time. In addition, the potential shortfall between the value of the bonds and the company's ability to pay, was not insurmountable and there were realistic possibilities of that being resolved with a potential upside for shareholders.

KEY CONCLUSIONS

- This was not a case where the relevant alternative involved any immediate insolvency.
- The thresholds for cross-class cramdown must be satisfied including Condition A: dissenting creditors and/or shareholders are no worse off than in the relevant alternative.
- The burden of proof when relying on cross-class cramdown is on the company promoting the restructuring plan.
- The interests of equity holders are fundamentally different to debt-holders: while debtholders have priority over shareholders in respect of amounts due to them (absent any contractual arrangements), share-holders alone have the right to share in the potential upside from the development of the company's assets.
- Unless the company goes into a formal insolvency process the management is under the ultimate control of the shareholders. Absent a formal insolvency process, shareholders' rights under the articles of association, including the right to appoint and remove directors, continue. Their rights are not purely economic.
- Actual or likely insolvency causes a change in the duty of directors, so that directors must have regard to the interests of creditors. This does not mean that directors can simply ignore all other stakeholder interests.
- No sufficient grounds of urgency: bondholders' desire to obtain control of the company was not a good reason for the irrevocable deprivation of the rights of the shareholders.

Plan Summary

Bonds in the sum of $230 million due to mature in 2022 extended to 2024

- Reduction of $50 million of capital of bonds
- Increase in cash coupon 7.5 percent to 9.4 percent and introduction of additional five percent PIK coupon
- Provision of security and guarantees to bondholders
- Other amendments to the terms and conditions of the bonds
- Issue of shares such that 95 percent of shares are held by bondholders, five percent remaining held by existing shareholders

Contingent on extension of bareboat charter which the directors were not prepared to enter into without the extension of the bond maturity.

Bondholders indicated they were not prepared to restructure their bonds outside of the restructuring plan.