

Was a proposed scheme of arrangement a 'reconstruction'? The MyTravel Group case

Introduction

The *MyTravel Group* case (first instance and Court of Appeal) is reported at [2004] All ER (D) 385 (Nov) (Mann J) and [2004] All ER (D) 221 (Dec) (Court of Appeal). This article deals in more detail with the main issues raised.

To recap, the court was concerned with whether a proposed scheme of arrangement under section 425 of the Companies Act 1985 amounted to a 'reconstruction' for the purposes of section 427 of the same Act.

Main issues

MyTravel (the 'Company') had issued subordinated convertible bonds. Under the terms of a trust deed, payment in respect of the bonds was subordinated if an order was made, or a resolution passed, for the Company to be wound up. MyTravel was clearly insolvent.

The Company applied for an order seeking the convening of meetings of shareholders and certain creditors to consider a scheme of arrangement under section 425. The intention was for the assets and undertaking of the Company to be transferred to a new company, 'Newco', pursuant to section 427. Existing shareholders in the Company would see their equity reduced to a 4% holding in Newco, and a majority of the Company's debts would be turned into equity in Newco. The Company had apparently offered the bondholders an 8% stake in Newco but said that if they did not accept that then the Company would implement a scheme that would see the bondholders end up with just 2%. Bondholders objected to this attempt to force them into a corner and commenced legal opposition.

So far as the Company was concerned, the main issue was whether or not the bondholders had a sufficient interest in the assets of the Company to require them to be given an opportunity to vote at a scheme meeting. The bondholders were additionally concerned as to whether or not the proposed arrangement was, in fact, a 'reconstruction' within the meaning of section 427.

The High Court decision

The scheme was not a 'reconstruction'

It is in the nature of a debt for equity conversion that a company's debts are reconstructed. In the High Court, Mann J held that the scheme was not a reconstruction for the purposes of section 427, as (i) in order to fall within that section substantially the same business must be carried on by the new company as was carried on by the old company, and (ii) the persons interested in each company must be substantially the same. 'Persons interested' meant shareholders and not creditors — even where a company was insolvent. As the Company's existing shareholders would only hold 4% of the shares in Newco, there would be no substantial identity between shareholders in the Company and in Newco. The court would not be able to sanction the scheme under section 427 and so it declined to order the meetings requested.

The nature of the bondholders' interest

In case the judge's findings on section 427 were subsequently challenged, Mann J then considered whether the bondholders had any economic interest in the Company's assets, although this was on an obiter basis. The court commented that:

- as a matter of principle, its jurisdiction under section 425 to sanction a scheme could be exercised without regard to the wishes of a class of creditors who had no real interest in its assets; and

- when ascertaining the rights of a creditor it was appropriate to see if those rights could only realistically be enforced in a winding-up and, if so, to use a notional winding-up as a method of assessing what those rights would be.

The latter point is of particular relevance where the circumstances are such that liquidation is the only real alternative to restructuring through a scheme. The fact that the bonds might have a market value, or that creditors may have been prepared to do a deal and so receive something in a consensual restructuring, was irrelevant to the bondholders' actual economic interest in the Company when assessed by reference to a winding-up. Where a court concludes that a creditor has no realistic prospect of recovery in a liquidation, this is sufficient to conclude that the creditor has no economic interest in the company. On the facts here there would be no return to the bondholders as subordinated creditors, so they had no economic interest in the Company and therefore no right to be consulted in relation to a scheme.

The bondholders' objections

The Company's bondholders argued that, regardless of the position on insolvency, the Company was still trading and might be rescued by the restructuring plan. Until the Company actually became insolvent — at which time they accepted their claim would be subordinated — they argued that they had a right to a say in any deal. The bondholders presumably felt that the exclusion of subordinated convertible bondholders from the Company scheme potentially threatened the owners of any category of subordinated debt and, if left unchallenged, the ruling on sufficient economic interest would allow companies to seek to avoid obligations to unsecured creditors.

The amended scheme

After Mann J's judgment, the Company returned to court with an alternative proposal for a scheme under which the transfer of assets and liabilities to Newco would be effected by way of a contractual agreement rather than by court order under section 427. The court made an order convening the requisite meetings on this basis. However, in line with Mann J's obiter comments, the order contained a recital that the bondholders had no economic interest in the company. The bondholders appealed, seeking to strike out that recital.

The Court of Appeal decision

The Court of Appeal held that the recital to the order was not necessary in relation to the amended scheme and so should be struck out. The bondholders were not parties to the amended scheme, they were not being asked to approve it and it did not propose any compromise or arrangement under section 425 with them.

In the end the two sides reached a 'consensual agreement' just hours before the court hearing to decide whether the Company could implement an £800 million debt for equity swap via a scheme of arrangement. This would have left bondholders with just 2% of Newco. The bondholders decided to take the 8% stake in Newco which the Company had originally offered them. Existing shareholders received 4% of the shares in Newco and other creditors (basically the banks) the rest. In return, the bondholders agreed to drop their threat to sue the Company and its directors, and seek to block the arrangement.

Conclusion

Both sides might say that this was a satisfactory outcome. The Company completed its restructuring and the bondholders had removed the obiter statement that they did not have an 'economic interest' in the company and therefore did not have to be consulted. That was clearly of importance to bondholders generally. Whilst they might argue that Mann J's comments only applied to subordinated convertible debt issued by a UK company (and so should not affect the international or European bond markets), the bondholders were concerned that the finding of Mann J raised an important issue of principle for all holders of publicly traded debt securities who might otherwise find their negotiating power in corporate restructurings reduced.

The decision has also resulted in a much more narrow interpretation of section 427 than had hitherto been understood to be the case. Of general concern will be the fact that this case creates an unwelcome precedent for those involved in restructurings and that unless the decision is overturned, a debt for equity conversion — a common feature of many restructurings — is unlikely to be available under section 427. Although the company could have appealed the High Court's decision regarding the meaning of 'reconstruction' for the purposes of section 427, it apparently decided not to do so for commercial reasons.

Keith Bordell

Travers Smith

This article appeared in the March 2005 issue of Tolley's Company Law and Insolvency newsletter, published by LexisNexis Butterworths.