

TRAVERS SMITH

# *Washed Out?*

*The court upholds schemes of arrangement which leave mezzanine creditors with no assets to satisfy their claim*

The high court has sanctioned linked schemes of arrangement proposed by three companies (Bluebrook Ltd, IMO (UK) Ltd and Spirecove Ltd) (the "**IMO companies**") which have the effect of compromising the claims of their senior creditors for value, but leave the claims of the mezzanine creditors unpaid.

The IMO companies, which own what is said to be the biggest carwash business in the world, owed approximately £313 million to their senior creditors and approximately £119 million (including unpaid interest) to their mezzanine creditors. The companies had underperformed to such an extent that they were in default under their facilities and so were at great risk of insolvency.

The IMO companies had negotiated with both senior and mezzanine creditors, but ultimately proposed schemes of arrangement (together, the "**Scheme**") with only the senior creditors. The Scheme involved the transfer of the business to a new group of companies owned primarily by the senior creditors. This new group would assume all but £12 million of the outstanding senior debt. Nothing was offered to the mezzanine creditors.

## **Basis of the challenge**

The mezzanine creditors asked the court to exercise its discretion to refuse to sanction the Scheme because it was unfair to them. The IMO companies argued that it was not unfair because valuations of the group showed that the value broke in the senior debt with the mezzanine debt being effectively worthless. The IMO companies also pointed out that the mezzanine creditors had agreed to contractual subordination of their rights to the senior creditors under intercreditor arrangements. The mezzanine creditors did not contest the validity of this subordination.

The key issue was whether the mezzanine creditors had any economic interest in the IMO companies which could be prejudiced. The judge (Mann J) found that they did not. The evidence provided by the IMO companies as to the value of the group was very full, and included three different valuations on a going concern basis (a "discounted cash flow" approach, a "market" approach and a "leveraged buy-out analysis") using reasoned assumptions and judgements. These analyses led to the conclusion that the value of the group was, at most, £265 million (giving a shortfall of £48 million against the £313 million senior debt).

The mezzanine creditors put forward their own valuation based on a "discounted cash flow" approach using a "Monte Carlo simulation", which involved repeated calculations of the valuation using random inputs and assumptions resulting in a distribution of the probabilities of different outcomes. This simulation showed a majority of outcomes exceeding £320 million. Relying upon this, the mezzanine creditors argued that the probability was that the value broke in the mezzanine debt, and that therefore the Scheme should offer value to the mezzanine creditors to reflect this.

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### Key principles

Mann J confirmed the basic approach to schemes of arrangement, that a company is not obliged to accommodate any class of creditors which does not have an economic interest in the company. If there was doubt or dispute on this point, the court was entitled to ascertain whether a class had an economic interest in a real sense, rather than a "theoretical or merely fanciful" sense, citing the reasoning in *In re MyTravel Group plc* [2005] 2 BCLC 123 at first instance. The judge added that the court in *In re MyTravel Group plc* indicated that the possibility of establishing a negotiating position and extracting a benefit from a deal is not the same as having a real economic interest. In the light of those principles, and the circumstances that the Scheme proposals had been overwhelmingly passed by the senior creditors, the judge went on to assess the mezzanine creditors' objections.

### Was the Scheme unfair?

First, he confirmed that, for the purposes of this case and in order to assess the fairness of the Scheme, a going concern value was appropriate. However, he decided that he would not give equal weight to the mezzanine creditors' valuation as he would to those provided to support the Scheme. Not only did he express dissatisfaction in the timing and "mechanical" nature of the mezzanine creditors' valuation evidence, he also found that it was not sufficient to establish their case, finding that the valuations provided by the IMO creditors reflected a potential purchaser's subjective assessments far better.

Secondly, he rejected the assertions that the IMO companies' directors breached their duties to their companies and their creditors, or at least should have done better in looking after the interests of the mezzanine creditors. The mezzanine creditors had consistently organised themselves as a negotiating party (forming a committee) and there was no expectation that the IMO companies should represent their interests. In addition, coupled with the valuation evidence, the directors would have been entitled to conclude that the mezzanine creditors would never make any recovery.

Thirdly, the directors had no substantive bargaining position as against the senior creditors in any event, given that the IMO companies were technically insolvent and in default under their facilities agreements. Consequently the directors' agreement to the Scheme merely reflected the reality of the situation. As regards the independence of the boards, although no independent committee considered the transaction, the boards' decisions had been unanimous and included assent from two directors who were to have no relationship with the business after completion of the transfer. This was sufficient, in the judge's opinion, to deal with any concerns regarding independence.

Other points raised by the mezzanine creditors were dismissed reasonably summarily. As a final point, the judge highlighted that in agreeing to the Scheme the senior creditors were taking a considerable risk. The mezzanine creditors did not wish to take that risk (as they could have done, by exercising contractual rights which they had to buy the senior debt). As a result, the only options open for the directors were to propose the Scheme, or to face enforcement by the senior creditors, or to embark upon further negotiations without knowing if the mezzanine creditors would act reasonably. Mann J stated that: "refusing to sanction the scheme in order to throw the parties into a further negotiation is not a legitimate or sensible use of the court's power".

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## Points to note

Some commentators are already regarding this as an important decision, particularly as regards the judge's approval of the "going concern" valuation (although this was arguably qualified by the facts of this case). However, it also provides further recognition for contractual subordination, gives support for the analysis of economic interests in *In re MyTravel Group plc*, and, importantly, deals a significant blow to junior creditors who often use the threat of litigation as a negotiating tool in distressed situations. The scathing tone of the judgment in dealing with the arguments raised by the mezzanine creditors suggests that the English courts are not prepared to give speculative and obstructive litigation an easy ride.

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