International Corporate Rescue

ChaseCambria
SOUTH SQUARE
Centre for Commercial Law
UCL LAWS

Published by:
Chase Cambria Company (Publishing) Ltd
4 Winifred Close
Barnet, Arkley
Hertfordshire EN5 3LR
United Kingdom

www.chasecambria.com

Annual Subscriptions:
Subscription prices 2017 (6 issues)
Print or electronic access:
EUR 730.00 / USD 890.00 / GBP 520.00
VAT will be charged on online subscriptions.
For 'electronic and print' prices or prices for single issues, please contact our sales department at:
+ 44 (0) 207 014 3061 / +44 (0) 7977 003627 or sales@chasecambria.com

International Corporate Rescue is published bimonthly.

ISSN: 1572-4638

ARTICLE

Estimating Outcomes: Lessons from the House of Fraser Scheme of Arrangement

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Synopsis

The recent House of Fraser scheme of arrangement raised interesting new considerations in relation to class composition and estimated outcome statements. A difference in interest rates where the return to creditors on insolvency was expected to be high could be sufficiently material to prevent those creditors from consulting together with a view to their common interest even where, if the anticipated return was lower, they could have done so. The case further demonstrates the importance of the scheme company obtaining reliance on any estimated outcome statements that form part of the evidence submitted to court.

Introduction

This article discusses points of interest arising from the judgment of Birss J handed down at the convening hearing for the English scheme of arrangement proposed by House of Fraser. The article does not deal with the parallel and interconditional Scottish scheme.

Background

House of Fraser is a long-established UK department store chain. At the time of the schemes of arrangement, it was majority-owned by Nanjing Cenbest, a Chinese department store chain, and operated 58 stores in the UK, as well as one store in the Republic of Ireland. At that time, a sale process was ongoing, whereby Nanjing Cenbest would sell 51% of its stake in the House of Fraser group to C.banner, another Chinese group. Upon completion of this transaction, approximately £70 million was due to be injected into the group.

The House of Fraser group had, at the time of the schemes of arrangement, approximately £390 million of senior secured debt, which comprised an RCF, a term loan, ancillary facilities, a short term facility and high-yield bonds. The bank facilities had all been borrowed by House of Fraser (Stores) Limited ('Stores'), a Scottish-registered company which was the main operating company in the group. The bonds were issued by House of Fraser (Funding) PLC ('Funding'), an English-registered issuer entity whose sole purpose was to issue the bonds.

The senior secured creditors benefitted from a common security package, including fixed and floating charges and cross-guarantees from a number of group companies, including Stores and Funding. A single intercreditor agreement dealt with inter-creditor matters, including loss-share provisions.

Prior to the schemes, the maturity dates of the bank facilities and bonds differed. Due to the operation of an extension option in the senior facilities agreement, a portion of the RCF and term loan totalling approximately £26,120,000 was due to mature on 29 July 2018, while the remaining RCF and term loan and the ancillary facility of approximately £196,380,000 in aggregate was due to mature on 29 July 2019. The bonds were due to mature on 15 September 2020.

Stores and Funding proposed inter-conditional schemes of arrangement in Scotland and England respectively in order to, in summary:

(a) extend the maturity dates of the RCF, term loan and bonds to 30 October 2020;

(b) amend the change of control provisions in the finance documents to facilitate the proposed sale transaction to C.banner;

(c) add a permitted basket of up to £50 million of super-senior indebtedness; and

(d) provide for a 1% extension fee payable to the senior secured creditors on a pro rata basis.

The schemes of arrangement were proposed on the basis that, if the schemes were not passed, the £26,120,000 first tranche of RCF and term loan would fall due and the group companies would be unable to repay the required amounts, due to a cash shortfall. In such a situation, the group companies would be in default and were likely to fall into insolvent administration or liquidation, resulting in a return of an estimated 16% or 6% respectively to the senior secured creditors.

Judgment of Birss J: Class composition

When deciding whether to make an order convening the scheme creditors' meeting (in respect of the English scheme of Funding), the 'most significant question' for Birss J to consider in an otherwise relatively straightforward case was class composition.

The specific question facing Birss J was whether all of the senior secured creditors (being four bank lenders and an unknown number of noteholders) could constitute a single class for the purposes of voting at the scheme creditors' meeting.

Factors relevant to class composition

As described above, there was a great deal of commonality between the rights of the bank creditors and bondholders. All of the senior secured bank and bond debt:

(a) ranked *pari passu*;

(b) benefitted from a common security package under a common intercreditor agreement and security documents;

(c) would, if the schemes were approved, have the same maturity date;

(d) would, if the schemes were approved, rank junior to any super-senior secured debt put in place as part of the new basket, and

all of the senior secured bank and bond creditors:

(e) were entitled to participate as lenders in any super-senior secured debt incurred under the new basket; and

(f) were entitled to receive the 1% extension fee.

However, there were a number of differences between the rights of the bank creditors and bondholders, including the fact that:

(a) the maturity dates of the debt varied; and

(b) the bonds had an interest rate of LIBOR plus 5.75%, whereas the bank debt had an interest rate of LIBOR plus 3.75%.

Case law on class composition

The question for a judge considering class composition is whether the creditors proposed to be grouped into a class have 'rights against the company [that] are not so dissimilar as to make it impossible for them to consult together with a view to their common interest' (*Sovereign Life Assurance v Dodd* [1892] 2 QB 573 and *Re Hawk Insurance Co Ltd* [2001] EWCA Civ 241).

In making this assessment, the court generally considers the rights of the creditors should the scheme not be implemented (often called the rights 'going in' to the scheme) and the rights of the creditors in the event that the scheme *is* implemented (often called the rights 'coming out' of the scheme), in line with the approach described by Hildyard J in *Re Apcoa Parking Holdings GmbH [2015] Bus LR 374*.

Differing maturity dates in respect of debt prior to a scheme's effectiveness have been held not to require separate classes where, if the scheme were not to become effective, there would be (i) a formal insolvency process; and (ii) an acceleration of the debts resulting in the debts ranking *pari passu* (*Re Metinvest BV* [2016] EWHC 79 (Ch)).

Relatively small differences in interest rates have been held not to render the creditors' rights so dissimilar as to make it impossible for them to consult together. In *Primacom Holding GmbH v A Group of the Senior Lenders & Credit Agricole* [2011] EWHC 3746 (Ch), a 2% difference in interest rights did not fracture the class.

Birss J's decision on class composition

Birss J held that the creditors *could* properly constitute a single class. Having accepted that insolvency was the correct comparator in the event that the schemes did not come into effect, Birss J noted that 'in the event of insolvency, the maturity dates of the various indebtedness will all accelerate and become the same' and the differences in maturity dates would therefore become irrelevant. On this basis (which broadly follows the reasoning of Mann J in *Metinvest*) Birss J was satisfied that the different maturity dates of the debt did not require the creditors to be placed into separate classes.

While the court's analysis of the maturity date issue followed existing case law, the analysis with regard to the different interest rates raised some new points.

Birss J stated that 'if the insolvency was likely to produce a return in the pound in the order of a low number of pennies [...] and given the term extension in the scheme of about 18 months, then that difference in the interest rates is not sufficient to justify treating the two sets of creditors as two classes for the purpose of coming together and considering their rights'. However, in Birss J's view, 'if the insolvency was to produce a return of [...] 99p in the pound, then it seems to me that that difference in interest rates, even though the term extension is only about 18 months, could (at least conceivably) make a difference.'

Birss J explained the reason for this distinction, namely that a creditor may be less amenable to being 'locked in' to a lower interest rate for a longer period of time where the return to them upon an immediate insolvency in practice resulted in minimal losses. In Birss J's view, a creditor who would receive an interest rate lower than that of another creditor may be more likely to reach this conclusion. He therefore considered that the difference in interest rates where the return to

creditors on insolvency was high could be sufficiently material to prevent those creditors from consulting together with a view to their common interest even where, if the return was lower, they could have done so.

This is, as far as we are aware, the first time this point has been expressly addressed in a scheme of arrangement judgment, and introduces a new consideration for debtors proposing schemes. The reasoning applied by Birss J in relation to interest rates in this case could presumably also apply to other differences between the rights of creditors 'coming out' of a scheme, meaning that where any differences in such rights arise, advisers should be careful to assess materiality by reference to the estimated recoveries upon an insolvency (or other appropriate comparative scenarios).

Birss J's reasoning also adds to the importance of the estimations of recoveries for creditors in the event of insolvency of the debtor company. Previously, the primary purpose of such estimations in the class analysis was to determine the similarity of the creditors' rights 'going in' to the scheme. Following this decision, the estimations take on a new dimension: they are relevant not only to the commercial question of whether creditors prefer the scheme to the likely alternative outcome and the question of the creditors' rights 'going in', but also to the jurisdictional question of whether creditors' rights coming out of the scheme are sufficiently similar to allow them to consult together with a view to their common interest.

Ultimately, Birss J held that in this case the estimated outcome upon an insolvent administration or liquidation was low enough, at 16% or 6% respectively, that the difference in interest rates between the bank facilities and bonds was not sufficiently material to fracture the class of creditors. This, however, leaves open the question of the level of recoveries at which differences between the creditors' 'rights out' of the scheme do become problematic.

Estimated outcome statement: Issues of reliance

In this case, as is common in most schemes of arrangement, especially following the decision of Snowden J in *Re Van Gansewinkel Groep BV* [2015] EWHC 2151 (Ch), an 'estimated outcome statement' setting out the estimated return to creditors upon an insolvent administration and liquidation of the various group companies was produced by KPMG LLP, a financial adviser to the group. This estimated outcome statement was appended to the explanatory statement to be sent to creditors.

The estimated outcome statement was prepared on a 'non-reliance' basis, a relatively common basis on which financial advisers provide estimates and opinions. The directors of Funding confirmed in the explanatory statement that they had reviewed the estimated outcome statement and that they were satisfied that it presented a fair description of the position of the company.

Birss J was, however, concerned that the estimated outcome statement was of little value to the Court if the scheme company was not entitled to rely on its contents. Drawing a parallel to expert witness evidence, Birss J noted that 'the court is never going to accept evidence from an expert witness who comes to court, gives their opinion and then explains in the second sentence that that opinion is provided on a "non-reliance basis" where the person receiving it cannot rely on it.'

This was another point which had not previously been clearly tested or developed by the court. Although a similar point had been considered by Snowden J in *Re Indah Kiat International Finance Company B.V.* [2016] EWHC 246 (Ch), his comments were limited to stating that the company must clarify 'whether or not the authors [...] are prepared to accept responsibility to Scheme Creditors for that opinion.' As a result companies have subsequently attempted to and indeed did in this case draw particular attention to the basis of preparation of the estimated outcome statement.

Birss J's judgment helpfully clarifies that: (i) the Court will expect to see an estimated outcome statement on which the company proposing the scheme of arrangement can rely; and (ii) there is no suggestion that reliance must be extended to the scheme creditors or the Court. It is notable that, as explained above, the estimated outcome statement had been given particular weight by Birss J in his determinations on class issues.

In this case, reliance on the estimated outcome statement was extended to Funding. Birss J was then content to make an order convening the scheme meetings.

Concluding remarks

The House of Fraser schemes were approved which allowed the group more time to pursue recapitalisation options. While the sale to C.banner did not proceed, House of Fraser was bought by Sports Direct via a prepack sale implemented a few weeks after the schemes completed.

Birss J's judgment follows a trend towards increasing focus on the insolvency comparator and how this is evidenced through the estimated outcome statement (see *Van Gansewinkel Groep* and *Indah Kiat*). However, we believe that this is the first time there has been a suggestion that the estimated recoveries are relevant in assessing the materiality of any difference in rights coming out of the scheme, which has the potential to make the class analysis considerably more complex. The clarification as to the basis on which the estimated outcome statement should be prepared is more welcome, and any future scheme companies would be well advised to ensure they have reliance on the estimated

outcome statement even if this reliance is not extended to their creditors.

It appears that this decision will be relevant not just for schemes, but also for the proposed 'restructuring plan' into which the government intends to import scheme jurisprudence. The Government's proposals highlight the importance of assessing the 'next best alternative' in the context of the restructuring and expressly reference the need for 'detailed valuation data' to evidence this. It appears inevitable that comparator issues will continue to be a focus for practice around restructurings for the foreseeable future.

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