The cram up: Power to the people.

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Insolvency litigators have a new tool in negotiating and litigating over assets in UK insolvencies thanks to the Corporate Insolvency and Governance Act 2020 (CIGA). The cram down is a well-known mechanism in insolvency procedures in the US, which offers a debtor-in-possession regime arguably superior to the UK system for saving businesses, jobs and wealth. CIGA provides a ray of hope that a fresh start will come to be favoured over collective debt collection for more UK companies in financial difficulty. This article considers use of the new procedure by junior creditors and shareholders in a UK insolvency. Can those interests deploy the cross-class cram down (or ‘cram up’) to force a senior secured creditor to give the business a chance? In principle, yes.

CIGA

CIGA, rushed through parliament during the early days of the pandemic, represents to many a missed opportunity for insolvency law reform in the UK but it did successfully introduce a new procedure for arrangements and reconstructions which should be used to improve the chances of solvent rescues of businesses in financial difficulty.

CIGA does this through the introduction of new Part 26A to the Companies Act 2006, with details of conditions to be met, rules for meetings of creditors and shareholders and the involvement of the court in a cross-class cram down. The new procedure provides at least some opportunity to address the failure in practice of the Enterprise Act 2002 to encourage the pursuit of solvent rescues of companies in administration, originally intended as the primary objective of that procedure.

Classes of creditor and shareholder

New section 901A(3) of the Companies Act 2006 provides that Part 26A applies on condition that “a compromise or arrangement is proposed between the company and its creditors, or any class of them, or its members, or any class of them” and the purpose of the compromise or arrangement is to “eliminate, reduce or prevent, or mitigate the effect of, any of the financial difficulties” that are affecting, or will or may affect, its ability to carry on business as a going concern.

This is wide wording, aimed at enabling a deal to be struck to save a business. The issue in practice in the way of solvent rescues may well be the senior secured creditor: the bank. Shareholders are not equal to creditors and creditors are not equals amongst themselves. English law provides a hierarchy for payment out from the proceeds of insolvency procedures (broadly, expenses of the insolvency procedure followed by fixed charge holders, preferential creditors, the ‘prescribed part’, floating charge holders, unsecured creditors and then the equity). CIGA’s new mechanism legislates both for cooperation between classes and also for coercion against a class which, in principle, may include the senior secured creditor class as ‘victim’ of a court-sanctioned arrangement initially struck in principle between other interests. The deal can be done before or during an insolvency process.

The aftermath of the 2008 financial crisis laid bare the real state of power relations as between company owners, employees, banks and large accountancy firms. With the support of insolvency practitioners from the large accountancy practices, the banks (with lending typically on the basis of security in various forms, including first-ranking fixed charges) jumped quickly to shore up their own balance sheets or avoid risk at the expense of businesses, wealth and jobs outside the City of London, particularly in the SME sector. The trigger was often an asset valuation procured by or at the instigation of the banks and unsurprisingly reporting in at the bank-favourable end of a range of reasonable opinions as to value (at best: many SME victims alleged impropriety in the procuring of unreasonably low asset valuations).

The ‘cram up’ permitted by CIGA is likely to see applications to court by junior creditors and shareholders, making the case for a solvent rescue. The proposal must not cause “any member of the dissenting class to

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be any worse off than they would be in the event of the relevant alternative”. This is defined as “whatever the court considers would be most likely to occur in relation to the company if the compromise or arrangement were not sanctioned”.

**Taking action – application to court**

An application to court may be made before any formal insolvency steps are taken but it is also possible after that point in time. An administrator, once appointed, can be subjected to requirements with respect to the conduct of the administration on an application under the new provisions or the administration stayed (put on hold) or terminated under section 901F(4).

If creditors or shareholders (or administrators or liquidators2) consider that management is fundamentally honest and competent then the new procedure might be used to ensure that, similarly to the US debtor-in-possession model, directors maintain control of the business.

**A worked example**

Take the position of a significant unsecured creditor (but for immediate purposes not a pension scheme, in respect of which the position is complex) which has reached agreement in principle on a rescue proposal with the junior secured creditor and the directors and shareholders which sees those interests aligned in favour of a continuation of business subject to a rescheduling of debts and, possibly, the conversion of some equity to debt3. Assume no Part A1 moratorium. The senior secured creditor is not interested and wishes to appoint its panel administrator, sell assets and exit its lending, leaving the business to fold.

The goal is a court order under Companies Act 2006 new section 901F sanctioning the “compromise or arrangement for a company in financial difficulty”.

**Meetings order**

The first step is to obtain a meetings order from the court by application under section 901C. Although there is room for doubt about the genuine economic interest of the shareholders in the company in our example, that class is on-side with our unsecured creditor and willing to vote in favour of the plan, so our creditor-applicant does not make any application under section 901C(5) to exclude the shareholders from meeting and the senior secured creditor has no standing to apply.

The procedure to be followed is set out in the practice statement issued by the Chancellor of the High Court, Sir Geoffrey Vos, on 26 June 2020. Applying under section 901C to convene a meeting or meetings of creditors and/or members, the attention of the court must be drawn to matters set out in paragraph 6 of the practice direction. Our unsecured creditor will put forward evidence of financial difficulty of the company in question, detail of the proposals, the genuine economic interest of the creditor’s class and, amongst other matters, “any other issue not going to the merits or fairness of the scheme, but which might lead the court to refuse to sanction the scheme”.

The issue of class composition is central to the first hearing. The court may draw on principles established in relation to the pre-existing rules governing schemes of arrangement in Part 26 of the Companies Act 2006. In our example, let us assume the court considers that the scheme has sufficient general support to have a prospect of success4 and approves as correct for voting purposes5 (i) a class of unsecured trade creditors of which the applicant is a member, (ii) a class comprising all shareholders, (iii) a class comprising

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2 Section 901C(2) does not require the application to be made by an administrator or liquidator when the company is in administration or liquidation and is, it is submitted, to be read permissively so that a creditor also has standing to bring the application even when those procedures are underway.

3 See section 901J regarding reconstructions and amalgamations. There is also provision for the disapplication of pre-emption rights in order to facilitate such arrangements.

4 Re Savoy Hotel Ltd [1981] Ch 351.

5 As to which, generally, see the starting point for modern analysis in Sovereign Life Assurance Company v Dodd [1892] 2 QB 573 per Bowen LJ at pages 582-583 and latterly Re UDL Argos Engineering [2001] HKCFA 54 at paragraph 27 per Lord Millett.
the junior secured creditor and (iv) a class comprising the senior secured creditor\(^6\). (Narrower classes than under a Part 26 scheme seem likely; there would seem to be no longer a justification for disapproval of multiple meetings, since the dissenting class or classes do not enjoy a veto right under Part 26A.)

The making of a meetings order is an important moment for the company, bringing with it favourable mandatory rules forcing suppliers to keep the lights on\(^7\).

**Voting**

The second step is to hold the meetings and take votes. The commercial impact of the scheme must be explained and members and/or creditors must be provided with such information as is reasonably necessary to enable them to make an informed decision as to whether or not the scheme is in their interests, and on how to vote on the scheme. The applicant to convene a meeting is responsible for publicising and explaining its position to ‘any person affected’ – likely to be the creditor and shareholder base, but to include indirect (beneficial) holders of interests – and the court will expect to see at the second hearing an explanation of the steps taken and responses received.

In our example, 75% in value of the class of unsecured creditors present and voting in person or by proxy at that meeting vote in favour of the compromise or arrangement, as do 75% in value of the shareholder class at their meeting. The sole junior secured creditor also votes in favour. The senior secured creditor votes against.

Since amongst the meetings summoned under section 901C there was a vote in favour of the compromise or arrangement by 75% in value (with no ‘numerosity’ requirement) of the unsecured creditor class at their meeting\(^8\), our unsecured creditor-applicant may properly make a second application to court to secure the court’s sanction in favour of the proposals. This is done under section 901F and the court may, at the sanction hearing on this second application, grant an order sanctioning the compromise or arrangement under section 901F as well as terminating, staying or imposing conditions on any administration. (The applicant may also seek a court order at the second hearing under section 901J, facilitating reconstruction or amalgamation.)

**The sanction hearing**

At the second hearing the court will consider the substance of the application to approve the plan. This will include addressing objections, but under section 901G(2) the fact that a dissenting class (ie 75% in value of a class disagreeing with the proposals) has not agreed the compromise or arrangement “does not prevent the court from sanctioning it”. In principle, therefore, there is no doubt that Part 26A enables a group of unsecured creditors, for example, to challenge and stop moves by a senior secured creditor to enforce its security.

This is subject to conditions which will engage the parties in a dispute over the cross-class cram down provisions. In particular, the court must be satisfied that, if the compromise or arrangement were to be sanctioned under section 901F, none of the members of the dissenting class would be any worse off than they would be in the event of “the relevant alternative” (which is whatever the court considers would be most likely to occur in relation to the company if the compromise or arrangement were not sanctioned under section 901F); and, broadly, those classes in favour of the compromise or arrangement must stand to receive a payment, or have a genuine economic interest in the company, in the event of the relevant alternative.

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\(^6\) “Relevant Creditors” are not entitled to vote on the plan and can only be bound if they consent to be bound. Relevant Creditors are creditors with moratorium debts or priority moratorium debts. Certain regulated financial entities may also be restricted in their participation.

\(^7\) Figuratively and, to an appreciable extent, literally. See Insolvency Act 1986, new section 233B(2)(g).

\(^8\) This – one creditor class in favour whether or not multiple classes against – reflects the title to section 901G and para 15 of the explanatory notes to CIGA even if not the singular reference to “a class” in section 901G(1).
A determination that liquidation is the relevant alternative must be more likely once formal insolvency proceedings are on foot and the concept acts, therefore, as encouragement to our unsecured creditor-applicant to apply before that point so as to maintain arguments for a wider range of plausible alternatives as “the relevant alternative”. This will not stop our applicant arguing, for example, that another rescue plan is to be regarded as the relevant alternative in preference to the senior secured creditor’s submission that the court should use liquidation as the relevant comparison.

Assume nonetheless for the purposes of our example that the pro-plan classes concede that the relevant alternative is liquidation. They lead valuation evidence as to the value to be realised on liquidation but this is disputed by the senior secured creditor. On the case supported by all classes except the senior secured creditor, take two scenarios supported by expert evidence relating to the relevant alternative: (A) value would break just into the unsecured debt; (B) value would break just into the equity.

In scenario (A), the shareholders’ vote in favour of the plan is irrelevant to the court’s decision because that class does not have a genuine economic interest, but the views of the unsecured creditors, although they stand to receive only (say) 10p in the pound in the relevant alternative, nonetheless count and would appear, alone, to qualify so that a cross-class cram down could be sought. In scenario (B) the shareholder class similarly qualifies even, it is submitted, if their economic interest is small.

A brighter future for business?

Can unsecured creditors and shareholders apply to court armed with a going-concern valuation and defeat a secured creditor with a fire-sale asset valuation?

This may be the wrong comparison. These groups will need to persuade the court that the “relevant alternative” involves a going concern at the same time as making out the threshold condition of financial difficulty. (This is not impossible: consider the prospect of disputed evidence about alternative rescue plans – nascent actual proposals or even hypothetical proposals – which might ground a submission justifying the use of a going-concern valuation.)

Even without a going concern comparator, there is nevertheless much to play for in rival valuations. The court’s discretion to sanction the compromise or arrangement under section 901F will be exercised according to its view, amongst other matters, of evidence comparing the position of the senior secured creditor (in our example) if forced to leave its money in the business until maturity of its debt as against its position following a sale of assets in the short term by an administrator or liquidator. This may involve our unsecured creditor-applicant leading evidence as to asset or other relevant values at the date of the application as well as market evidence to demonstrate values in the future (taking in, for example, the prospect of winning a large contract in a few months’ time), evidence of differential valuations on a forced sale timetable as against the time available under the plan, evidence of good stewardship to date on the part of the current management and evidence that its business plan will deliver returns in the future sufficient to meet the plan or at least leave the business in sufficiently robust state that the senior secured creditor will be no worse off after the attempted rescue than at the time of the disputed application to court. Whatever the intentions of the drafter of Part 26A these comparisons arise in the context of the statutory language and offer opportunities for creative applications by junior interests faced with the threat, actual or perceived, of value destruction by senior creditors.

The senior secured creditor facing our unsecured creditor’s application is likely to attack the threshold issues above, lead contrary expert evidence on valuation issues and rely on a plea to the court that it should not, on just and equitable grounds, sanction the plan. There must be more than a merely technical risk that a senior secured creditor might lose the full benefit of its priority under fixed or floating charges.

Once the court grants an order sanctioning the plan⁹ at or following the second hearing, it will bind all members of all classes who are part of the plan. On our example, this will include the crammed-up senior creditor.

⁹ And the order has been registered at Companies House (section 901F(6)(b)).
secured creditor and may incidentally have brought a stop to the administrator whom it caused to be appointed to realise the company’s core assets.

The new CIGA cross-class cram down does not include any absolute priority rule favouring senior interests such as appears in US insolvency rules. Tactical deployment of these new rules in our jurisdiction should lead to junior creditors and shareholders encouraging senior secured creditors in negotiations to avoid uncertain court determinations as to value, accept their company valuation and plans for the business and accept an equitable distribution not only of the going concern surplus but even eating into the senior secured interest. This is a welcome shift in the balance of power. It should give hope for a brighter future for jobs and wealth creation by viable businesses.

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