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Workin' at the (IMO) Car Wash: "You might not ever get rich"

For the junior lenders and shareholders of the IMO Car Wash Group (IMO), the world's largest car wash company, the opening line of the 1970s soul classic could not have been more appropriate. On 11 August, an English Court sanctioned a restructuring which leaves the junior lenders and shareholders out of the deal. The case is perceived by many commentators as setting a new legal precedent for the valuation of distressed assets. It may have a significant effect on a number of high profile restructurings in the current market, most notably in relation to the deleveraging that is taking place in respect of over-burdened balance sheets. In this briefing note, partners from our Restructuring Group consider the implications of the decision and how it may affect the current restructuring market.

Background

This case concerned the sanction of three schemes of arrangement in respect of Bluebrook Ltd, a holding company and its two indirect subsidiaries IMO (UK) Limited and Spirecove (together "IMO"). The schemes were part of an overall restructuring which involved the senior lenders writing off approximately £126m out of the total of £313m due to them in exchange for substantially all of the equity in a newly formed company to which the assets of IMO were to be transferred. The transfer of assets to the Newco was outside the schemes of arrangement being proposed and was to be achieved by way of a pre-pack administration. It is anticipated that there will be a hearing on 12 August for (amongst other things) the appointment of an administrator in respect of IMO.

Philip Hertz, partner in our Restructuring Group explains "schemes of arrangement have become a prominent feature of restructurings, as they have the advantage of avoiding the impractical (and often impossible) requirement to get the consent of every creditor to a proposed restructuring." He continues that "a scheme of arrangement is a flexible arrangement which (amongst other things) allows a company to compromise its claims with creditors provided that a requisite majority of creditors agree to the compromise (75% in value and 50% in number in each class of creditors who vote in favour of the scheme) and the sanction of the court is obtained. The court will only sanction a scheme if it passes the "fair and reasonable" test, but once sanction is obtained it will bind all creditors irrespective of whether they voted in favour or not."

The judgment in this case indicates that whilst it was technically possible to achieve the restructuring without a scheme, this would only have been achievable if all senior lenders consented. The schemes related only to the senior debt and therefore, did not require junior lender approval. Despite senior lenders voting overwhelmingly in favour of the schemes at the creditors' meetings (some 95% in value of the senior debt voted in favour of the scheme), a challenge came from the junior lenders (who were mezzanine lenders under an intercreditor arrangement) who had been excluded from the schemes altogether. The basis of the junior lenders' challenge was that IMO would have insufficient assets to meet any of the claims of those junior lenders, who had agreed as part of the intercreditor arrangements to subordinate their claims. The junior lenders argued that although the schemes did not relate to the junior debt, the overall effect of the restructuring was that the schemes appeared unfairly to deprive them of valuable rights against the companies.

Key Issues

Junior lenders "shut out" of the restructuring

Overall restructuring arrangements not unfair

Valuation in a restructuring is key

Valuation on a going concern basis for IMO still meant junior lenders had no economic interest

Directors not in breach of duty for failing to protect junior lenders

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Essentially as a result of the restructuring, the claims of the junior lenders remain with IMO, and will not have the benefit of any assets to meet those claims following the transfer to Newco. The junior lenders argued that whilst not being bound by the scheme or it altering their strict rights, it was "unfair" to them. They argued that the fair and reasonable thing to do was to allow them to participate in the Newco, whilst ensuring that the senior lenders had priority in relation to their debt and received a "proper return" on their equity, (but not such that it would absorb all the equity).

Key Issues before the Court

The following key issues were addressed by the Court:

- What was the appropriate method of valuing IMO?
- Could the junior lenders be validly excluded from the restructuring?
- Had the directors of IMO acted in breach of their duties in promoting a scheme that ignored the interests of the junior lenders?

Valuation issues

There is no statutorily imposed method of valuation in the context of a restructuring. Much will depend upon the nature of the business and the particular circumstances of the debtor and the timing of any realisations. Different methodologies may be appropriate which will normally be determined by an expert valuer. Even then, the values will not be certain or exact and may fall within a wide range. IMO's own assessment of value was based upon three separate valuation methodologies. The first, valuations carried out by PwC as "insolvency practitioner in waiting" were based on: (a) an income approach/discounted cash flow projections; (b) a market approach by way of comparison with multiples for other (publicly traded) companies; and (c) a leveraged buy-out analysis i.e. what would be available to a private investor to make an acquisition using leveraged finance techniques. These provided a range of values between £220m and £265m. The second valuation method involved a market testing or appraisal exercise by Rothschilds which produced one indicative offer of between £150m to £188m on a debt free basis; and the third, a valuation of IMO's sites carried out by King Sturge provided a range of values between £164m-£208m. Each of these valuations found value breaking well into the senior debt (£313m,) a conclusion which was also bolstered by the fact that IMO's debt was trading at 60p in the £.

The junior lenders argued that the valuations were too low and failed to take into account the fact that IMO did not suffer from any liquidity issues. In this case the judge was very critical of the junior lenders' "Monte Carlo simulation" valuation technique which produced "not so much a range of values, professionally assessed but a range of *possibilities*...the proper approach to valuation requires real world judgments as to what is likely to happen...rather than a range to which other ranges are applied in a series of random calculations to come up with some mechanistic probability calculation". In addition to the Monte Carlo valuation method which produced a value in excess of £320m, the junior lenders also submitted valuations on the basis of comparable transactions (£330m); and indicative valuation (£300m -£385m), all of which were in excess of the level of senior debt and showed value breaking in the junior debt. The judge did not lend much weight to this valuation evidence which he considered "unconvincing" and not good enough for the junior lenders to establish their case.

Junior lenders can be legitimately excluded from a restructuring

The rationale to IMO's approach in the restructuring was that given (i) IMO's assessment of value, (i.e.there would be insufficient assets available to pay debts due to the senior lenders in full) and (ii) the junior lenders' ranking in the debt structure (they had contractually agreed to be subordinated to the interests of the senior lenders), junior lenders could be validly excluded from the restructuring. It was accepted that IMO was free to select creditors to include in the scheme and it was not necessary to consult any class of creditors (or shareholders) who did not have an economic interest in it or who were not affected because their rights were untouched. This follows the thinking set out in earlier cases, most notably referred to in the judgment: ***Re Tea Corporation [1904] 1 Ch 12*** and more recently in the first instance case of ***Re MyTravel Group Plc [2005] 2BCLC 123*** with the same judge, Mann J, who presided in this case. He held in the circumstances of the MyTravel restructuring, a liquidation valuation was the appropriate benchmark when considering whether the bondholders of MyTravel had an economic interest but this was largely driven by the factual matrix in that case, where the MyTravel Group was reliant upon licences issued by the Civil Aviation Authority, without which liquidation was the most likely outcome. In the present case the most likely alternative to the restructuring was a disposal of the business as a going concern, and the price for the disposal was what a person was prepared to pay now. The principal reason for this was that it was not possible for the directors to continue to trade the company themselves given the default under the finance documentation and the fact that the company was balance sheet insolvent. Hence, it was considered more appropriate to use the "going concern" valuation method. Given the significant gap between the preferred valuation provided by IMO and the level of its senior debt, it was difficult to see, absent any convincing expert evidence from the junior lenders, that the challenge was any more than an attempt by the junior lenders to try and negotiate some value, where economically they in fact had no interest.

Management not in breach of duty to lenders

The allegations of breach of duty by the board arose at a late stage and were not referred to in the court documentation filed previously. The allegation made was that the directors ought to have bargained for something to have been provided for the junior lenders. The Court dismissed the arguments that the directors "could and should have done better by Mezzanine and other creditors" as unrealistic. Mark Poulton, partner in the Corporate practice and member of our Restructuring Group, notes that "the judge was simply not persuaded that the directors ought to have made a better bargain on behalf of the junior lenders, he recognised that throughout the restructuring negotiations the junior lenders were "fighting their own corner... a separate negotiating party trying to protect their own interests" and on the facts of this case was satisfied that the directors were not required to take additional steps aimed at protecting them." In connection with these allegations, the junior lenders also alleged that all the directors were doing here was to give effect to the wishes of the senior lenders. The judge did not think this was a fair reflection of the evidence since there had been initial discussions with the junior lenders and when they came to nothing, the directors agreed the schemes with the senior lenders as being the only people whom they, the directors, could see as having an economic interest in the company. In the circumstances of the present case it was considered unrealistic to expect the directors of IMO to threaten the senior lenders that they would continue trading as a means of leveraging a better deal for the junior lenders, without fear of reproach or the possibility of incurring personal liability for wrongful trading. This part of the judgment is most welcome for directors and their advisers. Significant, perhaps in this case is that the board of directors included 2 out of a total of 7 directors who were considered independent (i.e. not transferring to the Newco with bonus incentives). The board of directors also sought independent advice in relation to the restructuring.

Judgment

Ultimately the judge indicated that he had no difficulty in sanctioning the schemes on the basis that the junior lenders were not bound or affected by the schemes. He firmly rejected the challenge that the schemes were part of an overall arrangement which was unfair to the junior lenders since they did not in his view have any economic interest in IMO. He agreed with the submissions put forward by IMO and the senior lenders that:

- The financial status of IMO meant that a restructuring was required;
- The valuation of IMO as going concern was much less than the level of senior debt;
- The junior lenders had no economic interest (although they had been offered warrants in Newco in recognition of their nuisance value). There are no hard and fast rules. In recent restructurings concerning Countrywide and also the Vita Group of companies, junior lenders who had no economic interest were offered and accepted an interest in the restructured entity, whereas in the case of Crest Nicholson, nothing was offered to junior lenders, nor was any challenge pursued;
- The restructuring gave effect to enforcement rights under the intercreditor agreement whereby the senior lenders could bring about an auction of the companies, without any recourse to the junior lenders;
- The junior lenders had a safeguard if they really thought the assets were being transferred at an undervalue, they could (under the terms of the intercreditor agreement) buy senior debt and so participate in the restructuring;
- Lenders, in converting their debt to equity, were taking a risk that may leave them worse off;
- Absent the schemes, enforcement was likely;
- An administrator who is to effect the transfer of assets to Newco will have to be satisfied as to their value and this therefore provided an additional safeguard;
- There was no realistic alternative to the restructuring; and
- The arrangement benefits IMO because there is a debt due to be written off in excess of the value of assets transferred.

Comment

Unlike the ***MyTravel*** case, the IMO valuation exercises were carried out on a "going concern" rather than liquidation or break up basis. In the context of this case, this amounted to a sale at the "best price reasonably obtainable in the circumstances." Nicholas Frome, partner in our Restructuring Group notes that "This arguably raises the bar for restructurings where the business will continue in a restructured form, rather than being liquidated. It also brings the English court's approach to valuation closer to that of the US bankruptcy court. What it most certainly does is highlight, the importance of companies undertaking a rigorous valuation exercise when pursuing a restructuring which excludes stakeholders on the basis that they lack an economic interest. This case confirms that the English law has a mechanism for dealing with out of the money hold outs."

From the senior lender and company perspective, Mark Campbell, Finance partner and member of our Restructuring Group says "This case is a comprehensive win for the companies and their senior lenders. Although it is important to remember that although the senior lenders may recoup some of their losses in the future, they have taken a risk by entering into the debt for equity swap."

Adrian Cohen, partner in our Restructuring Group comments "Although there may be many who consider that challenges by junior lenders are not worth pursuing after this case, it remains to be seen whether it will in fact dampen the enthusiasm of junior lenders to mount challenges where they have been excluded from a restructuring. This is likely to depend on where the value breaks in the debt layers and the extent to which junior lenders have indeed lost their economic interest and/or are unable to argue to the contrary. It could, however, encourage more consensual restructurings to take place."

Moreover, the case will provide reassurance for directors involved in a restructuring where the company's solvency is an issue, as it supports the view that in most cases it will be unrealistic for junior lenders to allege breaches of duties by the directors in failing to negotiate on behalf of junior lenders in circumstances where the junior lenders have been a separate negotiating party, and where valuation evidence demonstrates that such lenders no longer have an economic interest. Daniel Kossoff, Corporate partner and member of our Restructuring Group, remarks "Having some independent directors who do not have an interest in the restructured business and a board that is separately advised, will be a definite advantage." This approach should also have a positive effect on encouraging management to restructure failing companies where there is a viable business, without directors being in fear of personal liability from disgruntled lenders, who ultimately have no economic interest.

In summary, the wider implications of this case in the current restructuring market are the benefits that can be obtained from a rigorous valuation analysis and confirmation that stakeholders who do not have an economic interest in the company being restructuring may be validly excluded. One thing is for certain, that many restructuring professionals will be “talkin’ about the (IMO) Car wash (case)” for some time to come!

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