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Commentary

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English Court of Appeal Overturns Adler Sanction: What Next for Restructuring Plans?

The decision represents the first appellate-level ruling on the Part 26A regime.

On 23 January 2024, the Court of Appeal set aside the sanction of the Adler restructuring plan (RP) in the first appellate-level decision on the still-nascent Part 26A regime. As such, the decision provides valuable commentary on the exercise of the court's power to cram down a dissenting creditor class.[1]

This Client Alert explains the key points arising from this important decision and considers its implications for the restructuring market.

Adler: What Happened?

The RP was sanctioned in April 2023, and was accompanied by a lengthy judgment of Mr Justice Leech.[2] Adler had issued various series of unsecured notes with maturities running from 2023 to 2029, and the RP proposed the following:

- The retention of the existing maturities of each series of notes, with the exception of those notes due 2024 which, in exchange for a maturity extension of 12 months, received security and, therefore, priority over all of the longer-dated notes.
- New money was provided by a subset of noteholders, which was urgently required to repay a series of 2023 notes that matured in late April 2023 and to fund capex.
- A staged wind-down of the group's operations by the disposal of its assets (existing real estate properties with paying tenants, and development assets) over an extended time period, paying off each series of notes in full in accordance with their temporal priorities.

Each noteholder series was placed in its own class, and each class voted in favour of the RP by the statutory majority of 75% by value, other than the 2029 notes, which voted only 62% in favour.

It was common ground that the "relevant alternative" was a formal liquidation of the group in Germany. A minority of the 2029 notes opposed the RP, arguing that, because their notes would be paid last in time and bore the greatest risk of the group's disposal programme, they would be better off in an immediate liquidation of the group. If that were true, the first condition permitting the court to exercise cross-class cram down would not be fulfilled.[3]

The outcome for noteholders under the RP compared to the relevant alternative was the subject of much debate at the sanction hearing. The judge was persuaded that the RP *was* likely to repay all noteholders (including the 2029 noteholders) in full. Even were they not repaid in full, there was a sufficient margin of error to conclude that the 2029 notes would be in a better position than in the relevant alternative of liquidation.

Despite the opposition of a minority of the 2029 noteholders, the judge sanctioned the RP. In reaching his decision, he noted that he was not given a compelling reason why the existing maturity dates needed to be preserved and asked why they had not been realised at the outset. That would have saved "a great deal [of] time and intellectual effort in demonstrating to the Court why a default would result in a pari passu distribution". This point formed the crux of the appeal.

Grounds of the Appeal

The 2029 noteholders sought and obtained leave to appeal the sanction judgment on the basis that the judge had:

- failed to appreciate that the RP materially departed from the principle of *pari passu* distribution of assets that would apply in the relevant alternative, placing the 2029 noteholders at a materially greater risk of non-payment without justification. This fundamental unfairness meant that the court should not have exercised its discretion to cram down the dissenting 2029 noteholder class.

- wrongly applied the "rationality test" from Part 26 scheme of arrangement cases in order to assess the fairness of the RP, and had failed to ask whether the company could (or should) have proposed a fairer plan in the alternative.

- wrongly attached significant weight to the fact that the RP had been approved by the statutory majorities of each other class and by a simple majority of the 2029 noteholder class, and wrongly conflated satisfaction of the "no worse off" test with the exercise of the court's power of cross-class cram down.

Departure From *Pari Passu*?

The Court of Appeal found the RP's departure from the *pari passu* treatment of each unsecured class of notes proved fatal to the overall fairness of the RP. This cardinal principle of insolvency law — that all creditors of equal standing should receive equal treatment and losses should be borne by unsecured creditors equally — was given heightened prominence in *Adler* because each class of notes was unsecured and differed from any other class only in its respective maturity date.

The Court of Appeal endorsed the use of a "horizontal comparison" test in the context of a cross-class cram down to examine whether a plan provides for differences in how classes of creditors are treated between themselves and, if so, determine whether any such differences are justified. The test is borrowed from company voluntary arrangement case law, in which affected creditors vote as a single class. When translated to restructuring plans in the context of whether the court should cram down a dissenting class, the Court of Appeal emphasised that the test is more than a mere restatement of the "no worse off" requirement. That alone was insufficient to justify cram down. Instead, the court should consider whether the proposed distribution of the benefits of the restructuring between the assenting and dissenting classes under the plan was fair. This approach was not novel: a number of first instance decisions have concluded the same, as indeed did Mr Justice Leech in his own judgment. However, the Court of Appeal found that he had erred in his application of those principles to the facts.

In *Adler*, the relevant alternative of liquidation rendered irrelevant the different maturity dates of each series of notes. Furthermore, there would be no ongoing business because the plan proposed an extended solvent wind-down of the group's assets through strategic disposals. The Court of Appeal had little difficulty in concluding that the preservation of the existing temporal juniority of the 2029 notes did not represent a fair distribution of the RP's benefits because its terms disproportionately favoured the earlier maturing noteholders who — aside from the 2024 noteholder class — were making no contribution to the RP. Moreover, the company had not adequately addressed in the explanatory statement the consequences for the 2029 noteholders.

The 2024 notes were distinguishable because the security granted to them was in exchange for a 12-month maturity extension, thereby allowing the group to benefit from a longer "runway" to effect asset disposals. Their elevation was justifiable and did not offend the *pari passu* principle.

The Court of Appeal found that the valuation evidence presented to the judge at first instance did not provide any assurance that sufficient sums would be realized to pay all classes of noteholder in full under the plan. Although the evidence may have been sufficient to satisfy the "no worse off" test on the balance of probabilities, the inherent uncertainty around the outcome fundamentally offended the fairness of preserving the existing note maturities.

Was There a "Fairer Plan"?

The Court of Appeal held that the judge should have considered other possible restructuring solutions in evaluating the fairness of the proposed plan. Statements made in previous cases to the effect that the court is not required to consider whether a plan is the "best or fairest plan" fitted more readily into a scheme context in which each creditor class is required to vote in favour of the scheme for it to be sanctioned. If there is a dissenting class under a plan, the court must explore the possibility of an alternative (or fairer) distribution of the benefits of the restructuring. The Court of Appeal found that "the parties could easily have produced a fairer plan that eliminated the different treatment of the different series of Notes by agreeing to harmonise the [maturity] dates". This finding echoed Mr Justice Leech's comments at first instance.

A Simple Majority of Dissenting Class Should Not Influence Decision to Cram Down

In deciding whether to exercise its power to cram down a dissenting class, the court should not apply a simple "rationality test" as it has done historically to consenting classes in schemes. The court must instead consider whether a plan is commercially advantageous to the dissenting class when compared to the relevant alternative. By definition, there is no commonality of commercial interest between an assenting and dissenting class, therefore, the approval of assenting classes should carry little or no weight in the court's assessment of whether a plan is fair to the dissenting class. The fact that 62% of the 2029 noteholders that voted approved the RP — falling well short of the 75% statutory threshold — should not have positively influenced the court's decision to cram down the dissenting class.

Out-of-the-Money Creditors or Shareholders Cannot be "Zeroed"

The court does not have jurisdiction to expropriate rights from out-of-the-money creditors or shareholders. Counsel for the 2029 noteholders argued that the retention by the existing shareholder of 77.5% of the restated equity was a further departure from *pari passu* because in the relevant alternative they would receive nothing. However, the Court of Appeal followed longstanding scheme jurisprudence that requires a "compromise or arrangement" to have an element of "give and take" rather than amount to a simple confiscation of rights. Although only tangential to the appeal in *Adler*, the decision overturned recent plan case law[4] that had allowed a plan company to offer nothing to an undisputed out-of-the-money creditor class.

Borrowed Time

The Court of Appeal paid tribute to the first instance judge's "conspicuous diligence" in working under intense time pressure to deliver judgment in the timeframe required by the parties ahead of the new money deadline. However, when deadlines result from "entirely foreseeable scheduled maturities of financial instruments" and the division of the restructuring benefits are negotiated between sophisticated investors, sufficient time to properly conduct a contested plan hearing should be factored into the timetable. This requires full compliance with the Practice Statement[5] and cooperation between the parties and their respective advisers to narrow the contested issues. The time allowed by the parties in *Adler* was inadequate given the complicated valuation issues at play and the high likelihood of challenge from an early stage.

What Next?

The facts in *Adler* were unusual. The relevant alternative of liquidation was common ground, and there was little dispute as to the ongoing value of the group's business because the plan involved its extended run-off outside of formal liquidation and the staggered paydown of each series of notes in full. The slightly puzzling aspect of the case also caused the judge at first instance some difficulty: given the *de facto* liquidation under the plan and the longstanding opposition of the 2029 noteholders, why was there no concerted attempt to harmonise maturities between the series of notes so as to limit the exposure of the longer-dates notes?

When addressing the compressed timeframe, the Court of Appeal was careful to dispel any suggestion that the English courts were reluctant to decide cases expeditiously for companies with genuine and urgent financial difficulties. The clear, unspoken agenda was preserving what until recently has been seen as the international competitive advantage of the English courts. Nonetheless, parties should be wary of running down the clock in negotiations and coming to the court at the eleventh hour. The *Adler* decision reaffirms the court's free licence to adjourn hearings and "take whatever time it requires to give its decision".

In the deliberate absence of any type of absolute priority rule by the legislature, it is perhaps unsurprising that that courts have wrestled with the exercise of the cram down power for a plan that subverts the natural order of priority. Granting such a coercive power without clear guidance as to its exercise has produced inevitable teething problems. It seemed only on a narrow basis that the different treatment of the 2024 noteholders was justified, and we expect more difficult and contentious cases than *Adler* to tread this fine line in the coming months.

Immediately following sanction last April, the Adler Group put the RP into motion by redeeming the 2023 notes with new money and effecting the extension and elevation of the 2024 noteholders. The practical impact of the successful appeal is not therefore immediately apparent. The Court of Appeal heard the case on the express understanding that any decision to allow the appeal would not be moot. But how does one unscramble the omelette? Following the decision, the Adler Group promptly issued an announcement that it would "continue its restructuring path as planned", maintaining that the decision had "no impact on the Adler Group or the effective amendments to the bond terms" because, insofar as it was concerned, they remained valid as a matter of German law[6]. Therefore, only further legal dispute will determine whether the successful appeal is any more than a pyrrhic victory for the dissenting 2029 noteholders.

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Endnotes

[1] https://assets.caselaw.nationalarchives.gov.uk/ewca/civ/2024/24/ewca_civ_2024_24.pdf.

[2] https://assets.caselaw.nationalarchives.gov.uk/ewhc/ch/2023/916/ewhc_ch_2023_916.pdf.

[3] 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" (Condition A under section 901G(3), Companies Act 2006).

[4] *Re Prezzo Investco Limited* [2023] EWHC 1679 (Ch).

[5] https://www.judiciary.uk/wp-content/uploads/2022/07/Schemes-Practice-Statement-FINAL-25-6-20-1.pdf.

[6] https://www.eqs-news.com/news/corporate/adler-group-s-a-continues-on-its-restructuring-path-as-planned/1982177.