

Court of Appeal upholds Thames Water's Part 26A restructuring plan



Challenges by all appellants dismissed before the Court of Appeal

Key takeaways from the Court of Appeal Judgment

CoA clarified no “*hard edged rule*” that out of the money creditors can always fairly be excluded from “*restructuring surplus*” – their treatment will need to feature (to some extent) in the Court’s horizontal comparison and fairness exercise.

“*Restructuring surplus*” or the “*benefit preserved or generated by the plan*” can be intangible, including (as in this case) avoiding insolvency and bridging to a rescue plan / equity raise.

The CoA was satisfied that the terms of the super senior financing and rights granted to Class A creditors under the plan were fair and appropriate; valuation dispute was moot.

Public interest objections were dismissed primarily on the basis that Ofwat and Secretary of State (not the Court) have duty to protect consumer interests in water sector and had not objected.

Affirmation of views expressed in *Adler* that the Court expects parties to engage early in relation to disputed RPs such that issues before the Court can be narrowed.

Useful reminder that Court’s discretion to sanction RPs/schemes is fact specific – it is important to recognise the limitations of previous cases if looking for principles of broader application.

Background to the Thames Water Plan – Sanctioned at the High Court

Terms of the Part 26A Plan

Super Senior Funding

- > Injection of £1.5 bn in new super senior secured debt plus option of an additional £1.5 bn accordion
- > Class A and Class B creditors given right to participate in super senior funding pro rata to their respective share of debt
- > Pricing of the new super senior was subject to argument before the Court in relation to fairness

Maturity extension and cancellation

- > Existing maturities extended by two years
- > Undrawn facilities cancelled but RCFs automatically rolled
- > Relaxation of covenants

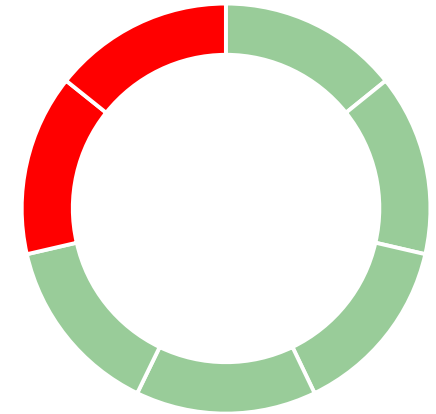
Creditor rights

- > Information rights for creditors (in particular ad hoc groups) in relation to future holistic restructuring (“RP2”)
- > Requirement to enter into lock-up agreement for RP2 with 66^{2/3}% of Super Senior and Class A creditors to access funding beyond June (the “**June Release Condition**”)

Relevant alternative and evidence

- > Plan company argued that the relevant alternative would be special administration (“**SAR**”) of TWUL. Dissenting creditors argued that the relevant alternative was an alternative transaction proposed by the Class B AHG. The High Court ruled that the relevant alternative was a SAR
- > Plan company valuation evidence showed that junior creditors would receive nothing in a SAR. The Class B AHG’s valuation evidence argued that in a SAR the value broke in the subordinated debt and that the Class B would be paid in full. The High Court preferred the Plan Company’s evidence

Classes and Votes on the Plan



- Holders of liquidity facilities
- Holders of interest rate and index-linked hedging facilities
- Holders of cross-currency hedging facilities
- Class A Make-Whole creditors
- Remaining Class A creditors
- Class B creditors (crammed down)
- Subordinated creditor (crammed down)

Refresher on the High Court's initial decision and key takeaways

1

The impact of costs and fees on the decision to sanction: In the *Thames Water* decision, the Court was reassured that these costs would ultimately be borne by creditors in RP2, not the plan company. It concluded that the public interest in approving the plan surpassed that of the SAR.

2

Further clarity on new money arrangements and fairness: The High Court justified propositions regarding new money, including that priority repayment of super senior debt is justified if priced correctly, and new money debt is not unfair just because it dilutes junior creditors. Junior creditors have limited influence when found to be out of the money and can be allocated tiered participation rights. Their equal access to super senior funding is not guaranteed, absent specific commercial justification.

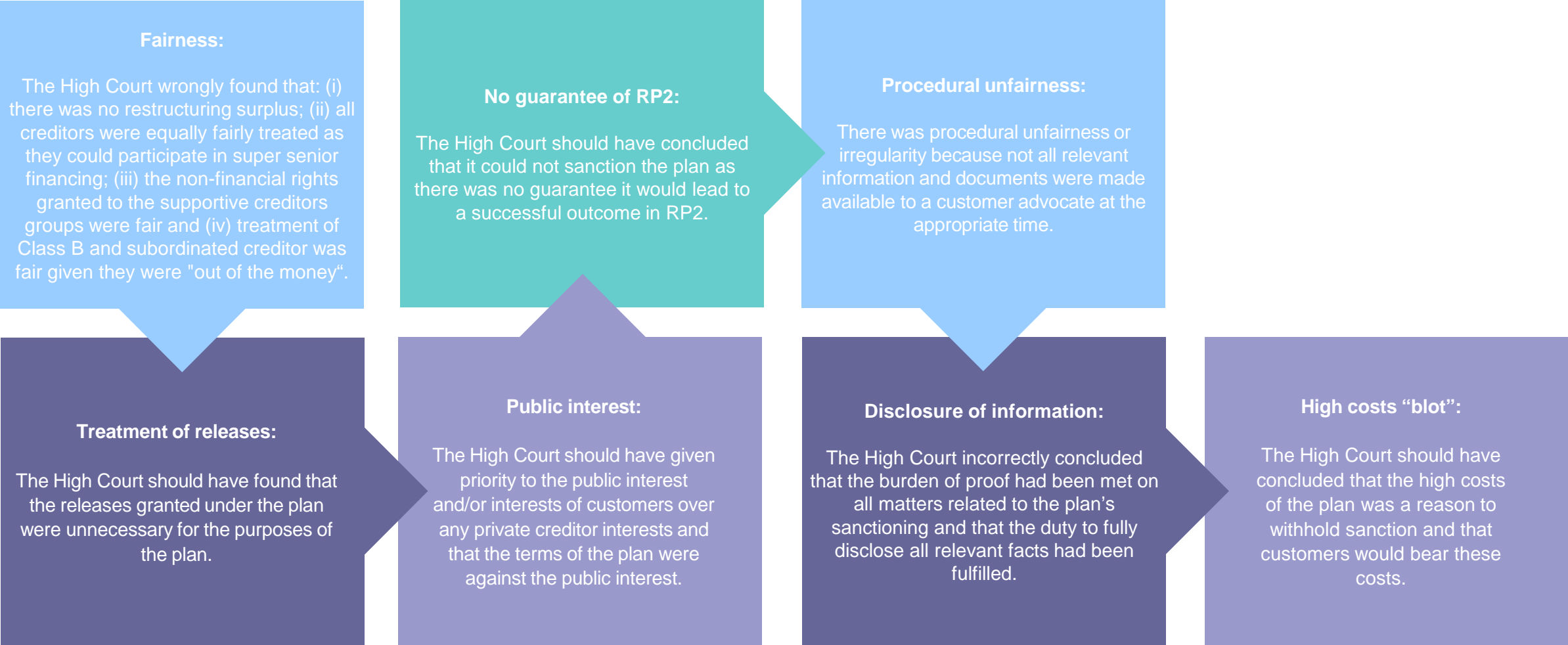
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Disparity of information and control rights were not unfair: The High Court found that certain groups of in the money creditors benefiting from specific rights under the plan was not unfair to excluded (and out of the money) creditors.

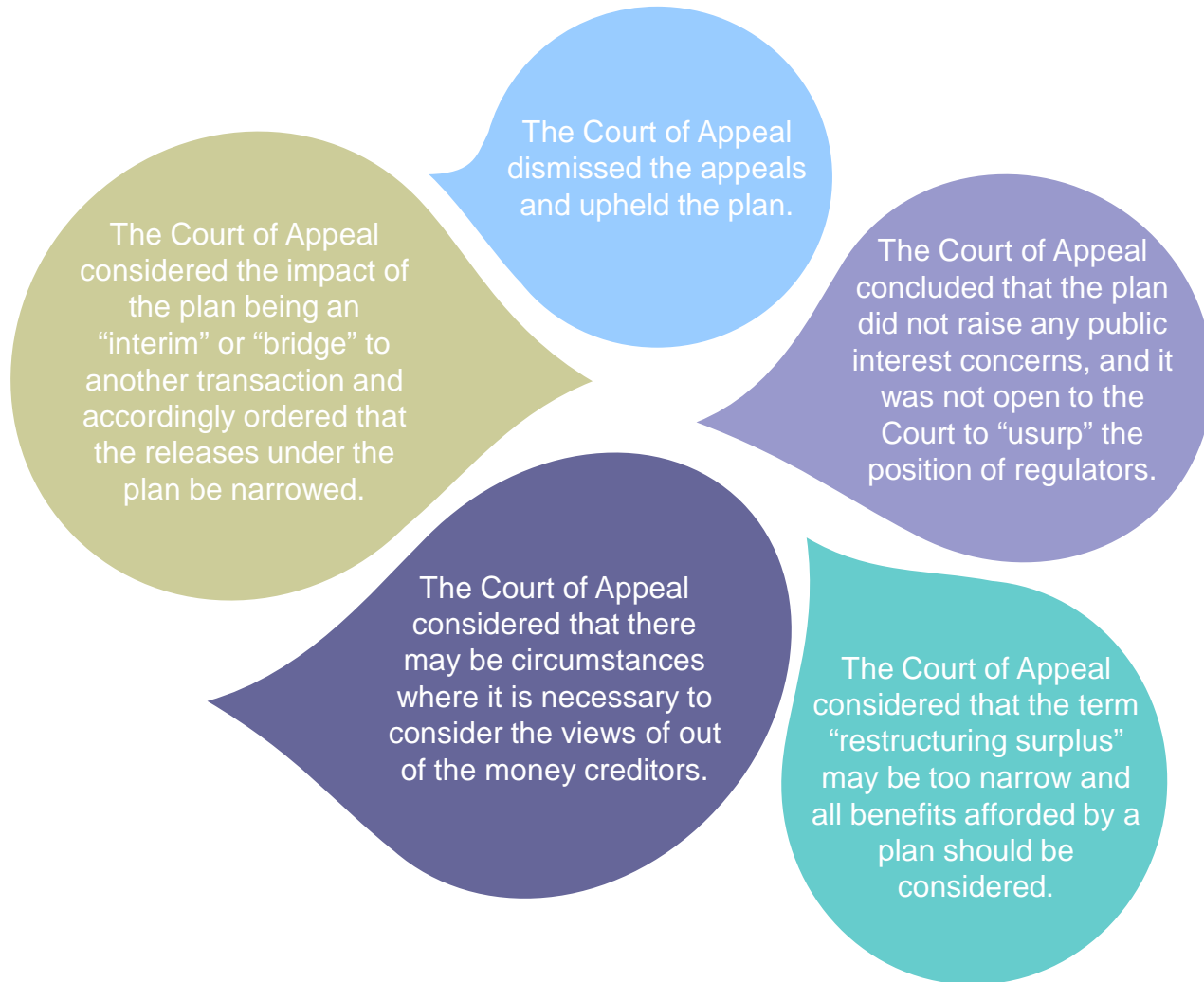
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Allegations of diversion of the restructuring surplus require high level of evidence: The High Court emphasised the need for strong evidence when alleging unfair diversion of restructuring surplus. Showing that these processes have the support of in-the-money creditors and new money providers is not sufficient proof of manipulation. The Court seeks concrete evidence to validate claims of unfair practices in financial restructuring plans, particularly concerning the equity raise's impact on the allocation of funds amongst different creditor tiers.

Grounds of Appeal



Overview of the Court of Appeal decision



- > Overall, the decision does not markedly change existing jurisprudence.
- > It clarifies that treatment of out of the money creditors should be done on a case-by-case basis and there is no “hard-edged rule” to ignore out of the money creditors when considering fairness.
- > Nonetheless, on the facts, the plan was not unfair to the dissenting out of the money creditors.
- > The decision includes certain guidance for “amend and extend”, bridge or interim transactions.
- > The release provisions were modified to exclude potential claims by any special administrator or insolvency office holder against the directors and advisers of the respective group companies concerning the plan. This was considered appropriate in the context of an “interim” transaction to cater for the fact RP2 might fail.
- > The Court did not accept that they had a mandate to rule that a SAR was a better outcome and therefore not sanction the plan on that basis but rather focused on the merits of the plan itself.

Fairness

It is well established that the Court will give little weight to out of the money creditors' personal objections to plans, however recent cases have suggested that the Court must still look at the plan holistically to decide fairness, by considering if benefits are being fairly distributed between classes (including the out of the money classes). This decision clarifies the position, confirming that a horizontal comparison must involve a review of what such classes are obtaining.

The Court dismissed arguments that there is a "hard-edged rule" meaning that any consideration out of the money creditors receive is only required to be *de-minimis* and favoured a broader view of the position set out in *Adler*, noting that a dissenting class being out of the money will not always be a sufficient justification to exclude them from any benefit under the plan.


The Court's approach shows that, while out of the money classes cannot exercise a veto on a plan, their treatment will still need to feature in the Court's fairness assessment – the extent to which will be determined on a case-by-case basis. This potentially strengthens the prospect of similar arguments being made regarding the requirement of a horizontal fairness exercise being conducted between out of the money creditors and shareholders retaining equity.

The Court formed the view that, in particular in the context of an interim plan, the use of the term "restructuring surplus" may be misleading and it is better to refer to benefits generated or preserved by a plan. In this case, the Court determined that the benefit was the chance for a future RP2 and was satisfied that the continued payment of interest and participation in the new debt were sufficient benefits afforded to the out of the money Class B creditors in consideration for the impact of the plan.


The Court of Appeal also accepted that difference of treatment between different creditors can be justified and, in this case, certain specific rights in relation to RP2 for the supportive creditor groups did not create unfairness such that the plan could not be sanctioned.

The Court's decision can be seen as an evolution towards a more holistic fairness review rather than dismissing out of the money creditors. Therefore, in future plans, it seems it will be necessary to have a broader look at all the benefits under the plan and how they are allocated between different parties and while differences in treatment may not lead to unfairness, they will likely need to be justifiable.


Releases




The plan originally provided for wide releases from Plan Creditors, the Plan Company and TWUL including in favour of third parties such as officers and advisers (as has been common for some time in schemes and plans).



The Court of Appeal was not satisfied that the release by the Plan Company or TWUL against their own officers and advisers satisfied the test of being “*necessary in order to give effect to the arrangement proposed for the disposition of debts and liabilities of the company to its own creditors*” per *Re Lehman Bros (no 2)*.




The Court of Appeal therefore varied the plan to carve out such claims brought by a future insolvency practitioner.




It remains to be seen if releases of advisers and officers remain standard in “holistic” restructurings and/or non-contested plans and schemes.


Special Administration and Public Interest Issues




The Court of Appeal rejected the argument that they needed to consider whether a SAR would be better than the plan for the public interest. The Court stated that such issues were for the Secretary of State and Ofwat to determine. The Court's role was to consider the Plan on its own merits and its effect on creditors under the terms of Part 26A. This was notwithstanding that the relevant alternative to the plan was a SAR.



The Court placed a high degree of importance on the role of government and regulators in relation to when and if a SAR should occur. In addition, on the facts, the Court was not convinced by the arguments that a SAR would be a cheaper or better alternative.



The Court of Appeal was also not convinced that there had been any procedural unfairness caused by Thames Water not instructing a customer advocate, noting that this would likely be appropriate where the creditors whose rights are affected by a plan or scheme are unable to represent themselves before the Court which was not the case here.



Customer advocates therefore would seem to be limited to schemes or plans involving large numbers of individual creditors who are in fact party to the arrangement or compromise themselves rather than being necessary in any scheme or plan involving any company with a potential public interest element.

Other points to note

The Court of Appeal considered if the High Court was right to conclude that there were no “blots” on the plan. They considered that the concept covered circumstances where either a plan contains or includes (i) a technical defect so that it is unworkable or incapable of achieving what was intended; or (ii) a step which is illegal, ultra vires, or in breach of some other obligation owed by the company (even where the obligation is owed to non-creditor third parties).

The Court of Appeal was satisfied that the costs of the new Super Senior Funding was not a blot on the plan and that the High Court was correct in saying that the costs would ultimately be borne by the Class A creditors.

The Court of Appeal similarly rejected arguments that the company had provided insufficient evidence or information for the plan to be sanctioned.

The Court also rejected the argument that it could not sanction the plan on the basis that they could not be certain RP2 would be successful. It suggested that a Court only had to form the view that it was not sanctioning a plan in vain which was certain to fail for other reasons. On this finding, the fact that a plan or scheme is a bridge to a potential but uncertain future event (including another transaction where terms are not yet known) is not a bar to sanction.

The Court of Appeal decided they did not need to form a view on the correct valuation of the plan company to sanction the plan.

The Court of Appeal touched on the relevance of excluding a class of creditors from voting under s. 901C(4) of the Companies Act 2006 but did not specifically address how it would impact treatment of out of the money creditors compared to their reading of s. 901G.

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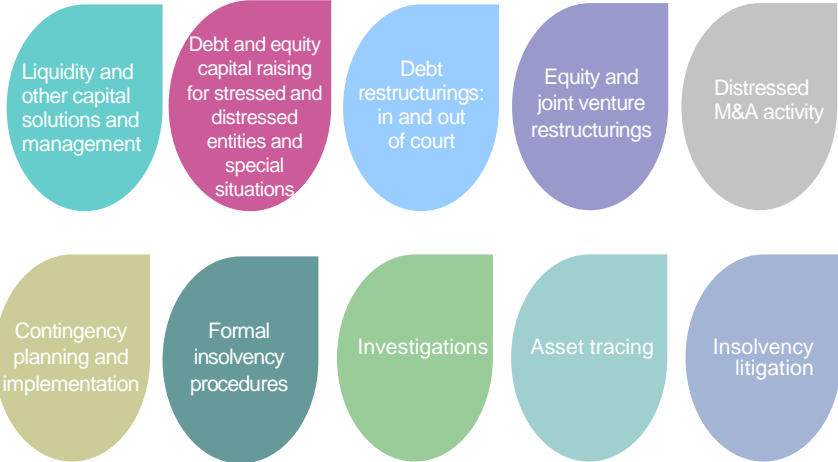


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