Raising the bar: Virgin Active restructuring plans sanctioned in landmark decision

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On 12 May 2021, Mr Justice Snowden sanctioned Virgin Active's three inter-conditional restructuring plans under Part 26A of the Companies Act 2006. The case has been followed with significant interest in the restructuring community because the restructuring plans included the most extensive cross-class cram down proposal since the introduction of the restructuring plan process last year (*DeepOcean* and *Smile Telecoms* are the only other restructuring plans to utilise the cram-down mechanism). The plans were also the first to seek to compromise lease liabilities and the first to be fully contested. The judgment provides guidance on how the Court will assess the relevant alternative for the "no worse off" test and explains the factors the Court will consider when exercising its discretion to sanction plans where creditor classes have dissented. The Hogan Lovells London Restructuring team, with support from our Sydney, Singapore, Amsterdam, and Milan offices, advised the senior secured lenders on this landmark deal.

Key Points

On the "relevant alternative":

- The Court is not required to satisfy itself that a particular alternative would definitely occur nor is the Court required to conclude that it is more likely than not that a particular alternative outcome would occur – the critical words in the section are what is "most likely" to occur.
- There is no absolute obligation to conduct a market testing process.
- The strength of the evidence is key. To challenge the "no worse off" test, creditors should consider adducing their own valuation evidence.

On Court discretion:

- Where conditions A and B are met, the Court still needs to consider all relevant factors and circumstances that it would ordinarily take into account. The Court cautioned against reading too much into the "fair wind behind it" comment from *DeepOcean*.
- The Court's assessment should be confined to the plan that is before the Court, and not consideration of whether some other or better plan might have been possible had it been done differently.
- Votes of "out of the money" dissenting creditors will carry little or no weight at all in the sanction process.
- It is for the "in the money" creditors to determine how to divide up any value or potential future benefits following the restructuring (i.e. the restructuring surplus). However, where compromised dissenting classes of creditors are in the money then the treatment as between such classes would need to be looked at much more closely.

The restructuring plans

The restructuring plan procedure under Part 26A of the Companies Act 2006 allows businesses that have encountered, or which are likely to encounter, financial difficulties to reach an agreement or compromise with creditors and shareholders. Crucially, whereas a scheme of arrangement under Part 26 of the Companies Act 2006 requires approval by at least 75% in value and a majority in number of each class of creditors or shareholders who vote on the scheme, Part 26A allows for what is being referred to as a "cross-class cram down" which is where the Court sanctions a plan notwithstanding there being dissenting creditor classes if the following conditions are met:

Condition A: none of the members of the dissenting class would be any worse off than they would be in the “relevant alternative” (meaning whatever the Court considers most likely to occur if the plan is not sanctioned); and

Condition B: the plan has been approved by at least one class of creditors or members who would have a genuine economic interest in the company in that relevant alternative.

Virgin Active launched a comprehensive restructuring and recapitalisation to address the severe impact of COVID-19 on Virgin Active’s Europe & Asia Pacific business sub-group. The key element of the restructuring was three inter-conditional restructuring plans for certain English subsidiaries within the Virgin Active group: Virgin Active Limited, Virgin Active Holdings Limited and Virgin Active Health Clubs Limited. Each plan included seven creditor classes: (i) the senior secured lenders; (ii) the UK landlords, categorised in classes A to E based on club profitability; and (iii) a class of other general unsecured property creditors.

Class	Key terms	Voting outcome
Secured Creditors	3-year maturity extension, changes to interest provisions, mandatory prepayment regime amended to permit additional club disposals and retention of proceeds by the company	Consented
Class A landlords	Arrears paid, no reduction in rent	Consented
Class B landlords	100% of arrears written off, no reduction in future rent	Dissented
Class C landlords	100% of arrears written off, 50% reduction in rent until earlier of return to FY19 profitability or three years, break right on 30 days’ notice within first 90 days	Dissented
Class D landlords	100% of arrears written off, 100% rent reduction, rolling break right	Dissented
Class E landlords	100% of arrears written off, 100% rent reduction, rolling break right	Dissented

General property creditors	Full compromise of claims	Dissented

The restructuring plans formed part of a wider restructuring which involved a £45m shareholder injection, a £6m equity contribution (to fund payments to compromised creditors of 120% of their estimated administration return which they are entitled to claim under the terms of the restructuring plans), the capitalisation of c. £185m of inter-company liabilities and certain waivers and deferrals under the arrangements with Virgin Enterprises Limited, the licensor of the Virgin brand.

An ad hoc group of four landlords opposed the restructuring plans at both the convening and sanction hearings.

The convening hearing

At the convening hearing, the landlords criticised the adequacy of the Explanatory Statement and argued that they required additional information to make an informed judgment on the merits of the restructuring plans. Snowden J found that the proposed Explanatory Statement was in an appropriate form and that certain information requested by the landlords (such as the entity priority model which calculated creditor returns in the relevant alternative) did not need to be included. Snowden J, however, did order the plan companies to provide certain additional information to the landlords (including the business plan, the cashflow forecasts and the historical financial information on a site-by-site basis for 2019). This represents a greater level of disclosure than has been seen on schemes and restructuring plans so far and may set the new bar for information provision. Snowden J reminded the creditors that specific disclosure orders could be requested if they felt disclosure had been inadequate and that this was the appropriate route rather than making a complaint about inadequate disclosure at sanction.

The challenge

The essence of the landlords' case at the sanction hearing was that: (i) there was insufficient evidence to show that the "no worse off" test under section 901G of the Companies Act 2006 had been satisfied; and (ii) the Court should not use its discretion to sanction the plans because the treatment of the landlords under the plans was not just and equitable.

In this case, the landlords raised no issues on class composition or jurisdiction and there was no dispute that Condition B was satisfied by the approval of the restructuring plans by the secured creditors and by the class A landlords. The two issues for the Court to determine were therefore: (i) whether the "no worse off" test (Condition A) was satisfied; and (ii) whether the Court should exercise its discretion to sanction the restructuring plans.

"No worse off" test

Snowden J broke down the approach to the "no worse off" test as follows: (i) he first identified what would be most likely to occur in relation to the plan companies if the plans were not sanctioned; (ii) he then determined what would be the outcome or consequences of that alternative for the members of the dissenting classes (primarily, but not exclusively in terms of the anticipated returns on their claims); and (iii) finally he compared that outcome and those

consequences with the outcome and consequences for the members of the dissenting classes if the plans were sanctioned. The Court was able to satisfy itself on the evidence on each of these three points. The "no worse off" test is always going to be highly fact specific, but we make the following observations from the Court's approach in Virgin Active.

- **"most likely" alternative:** The conclusion on the evidence in this case was that the liquidity crisis faced by the plan companies was so acute that not only was administration the most likely outcome if the plans were not sanctioned, it was almost certain to happen. Snowden J emphasised that the Court is not required to satisfy itself that a particular alternative would definitely occur nor is the Court required to conclude that it is more likely than not that a particular alternative outcome would occur. The critical words in the section are what is "most likely" to occur.

- **M&A process:** The landlords argued that the estimated outcome for creditors under the relevant alternative was inherently unreliable because the returns were based on a "desktop" valuation and were not tested by any form of sales or marketing process. Snowden J stated that there was no absolute obligation to conduct a market testing process as part of a restructuring and that it was not unreasonable in the circumstances, including the current COVID-19 environment, for the plan companies to follow the advice of their advisers, who had not recommend such a process.

- **Disclosure:** Snowden J dismissed the arguments advanced by the landlords that they had been unfairly disadvantaged in their ability to challenge the plan companies, namely by being unable to conduct their own marketing process or producing their own valuations, by the uncooperative attitude of Virgin Active and their advisers to the provision of information. Snowden J found that the landlords had been provided with an enormous volume of information and documents, and that while some of the documents were provided later than the landlords might have hoped, this was not sufficient for him to place less weight on the evidence of the plan companies. If the landlords were dissatisfied with the disclosure given, it was open to them to make an application to the Court but they had failed to do so.

- **Evidence, evidence, evidence:** The strength of the written and witness evidence is key. Snowden J indicated that he had valuation evidence and analysis of the relevant alternative from the plan companies (the landlord group had made some high level calculations but had not produced a valuation of their own) and that it was appropriate and procedurally fair for him to proceed on the basis of the evidence before him.

General discretion

A key question that Snowden J had to address was whether, in all the circumstances, the Court should exercise its discretion to sanction the restructuring plans? Acknowledging that the statute gives little guidance on the factors that are relevant when the Court is exercising its discretion to sanction a restructuring plan, Snowden J's starting point was the judgment in *DeepOcean*. The following key principles as to how the Court will approach a request to exercise discretion to cram down dissenting classes can be distilled from the decision in Virgin Active.

- **"a fair ~~wind~~ breeze behind it":** Snowden J held that framing the test in the negative (i.e. provided conditions A and B were satisfied, the plans should be sanctioned unless the Court thought that the plans were not just and equitable) read too much into Trower J's comments in *DeepOcean* that: (i) a plan company that satisfies conditions A and B in section 910 G "will have a fair wind behind it"; and (ii) that "all other things being equal, satisfaction of conditions A and B is capable of justifying an override of the views of a dissenting class." The words "all other things being equal" are important. Where conditions A and B are met, the Court still needs to consider all relevant factors and circumstances that it would ordinarily take into account.

- **Treatment of "out of the money" creditors and the restructuring surplus:** The landlords argued that it would be contrary to basic principles of insolvency law if the restructuring surplus went entirely to the existing shareholders to the exclusion of the unsecured creditors and that the favourable treatment of the existing shareholders could not be justified solely by their provision of new money under the plans. Snowden J was not persuaded by this, concluding that there is nothing to indicate that the legislature intended a different approach to the position of creditors who are "out of the money" in relation to Part 26A restructuring plans than the established approach in relation to Part 26 schemes. That is, where the only alternative to a scheme is a formal insolvency, the business and assets of the company in essence belong to those creditors who would receive a distribution in the formal insolvency. This conclusion is supported by the drafting of the legislation: although section 901C(3) provides that every creditor whose rights are affected by a plan must be permitted to participate in a class meeting, section 901C(4) provides that this does not apply to a class of creditors if the Court is satisfied that no member of that class "has a genuine economic interest in the company."

  It is therefore for the "in the money" creditors to determine how to divide up any value or potential future benefits following the restructuring (i.e. the restructuring surplus). In effect there was no basis for the landlords to complain when the secured creditors (who would derive sole benefit from the assets in the relevant alternative) had supported the plans under which, in return for the provision of new money, the shareholders would obtain potential benefits from the restructuring by the retention of their equity. Snowden J cautioned that where compromised dissenting creditors were in the money (for example when there is little or no secured debt) then the treatment of the dissenting creditor classes as between themselves and in relation to the equity would need to be looked at much more closely.

- **Votes of dissenting classes:** The Court should not have the same reluctance to differ from the vote at a class meeting when considering whether to exercise the power

to cram down as it would have when considering whether to sanction a scheme of arrangement under Part 26. The votes of out of the money dissenting creditors carry little or no weight in the decision at sanction, particularly where no reasons for dissenting were given.

- **The "horizontal comparator":** As for the application of the horizontal comparator (adopted from fairness challenges in the context of CVAs), the landlords objected to what they saw as the favourable treatment given to the shareholders who were not required to surrender any of their equity in the group and will therefore share in the potential restructuring surplus. Snowden J made clarificatory comments on the horizontal comparison in plans, distinguishing between a waiver of existing liabilities which would be worthless in a formal insolvency, and the provision of new monies which will, if the plans are sanctioned, be made available to finance future operations and which will be at risk from those continuing operations.

- **The plan before the Court:** The Court's assessment should be confined to the plan that is before the Court, and not consideration of whether some other or better plan might have been possible had it been done differently. Snowden J had limited sympathy for the criticism of the events leading up to the plan and in particular allegations that the plans had been designed by the shareholders (for their benefit, rather than the companies') and with an absence of market testing to establish whether there may have been better alternatives.

- **Other discretionary factors:** Finally, Snowden J stated that the other discretionary factors the Court will consider in deciding whether to sanction a plan include the fair representation of creditors at the meetings, the voting outcomes, whether there was a technical or legal defect ("blot") on the plans and whether the plans were likely to have substantial effect in relevant jurisdictions outside England & Wales.

Conclusion

The Virgin Active restructuring plans are a powerful example of the versatility of a Part 26A plan for restructuring liabilities across all levels in the capital structure and should pave the way for companies to consider holistic balance sheet restructurings using this process in the future. Snowden J's detailed judgment will be the leading authority on cram downs and is certainly welcome in providing guidance on the Court's approach to the "no worse off" test and the factors that the Court will consider in exercising its discretion when faced with a request to cram down dissenting classes.

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