EVERSHEDS SUTHERLAND

A game-changing moment

Proof of concept for mid-market restructuring plans

After much anticipation, the Houst Limited (**"Houst"**) restructuring plan (**"RP"**) has been sanctioned and the first true SME RP has successfully been implemented. The prevalent view has been that the RP is a fantastic new restructuring tool but that it is not fit for purpose as an SME restructuring tool - it is fair to say that the Houst RP represents a game-changing moment for this game-changing tool.

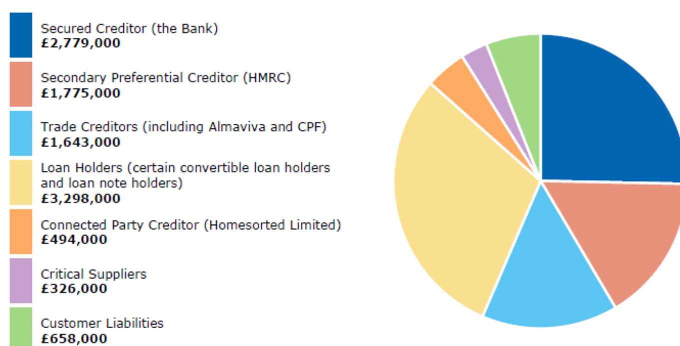
Since the introduction of this new tool in June 2020, the RP, like the scheme of arrangement, has predominately been used to restructure large cap companies. The outlier was the Amicus RP. This was an RP for an SME; however, it was proposed as a restructuring solution for a company in administration which is a different type of proposition and did not change the prevalent view that the RP would be too costly to be used effectively in the SME space. The problem lies in the fact that the RP was borne of the scheme and therefore suffers from the perception that it will remain the preserve of the large cap end of the market which could afford to pay for the benefits of the scheme.

The key interlinked concerns around the RP becoming an effective tool in the mid-market - execution certainty, costs and timings - were aired in the recent government consultation paper (Corporate and Insolvency Governance Act 2020 - Government Interim Report March 2022) and we have previously considered them in-depth (Mid-Market Prospects for the Restructuring Plan). The Houst RP dramatically changes the paradigm as it demonstrates proof of the mid-market concept, landing very much at the bottom end of the mid-market to restructure a company with less than £11 million of outstanding liabilities of which its secured debt represented less than £3 million. The Houst RP means that practitioners will now need to reassess their views as to the true significance of the ability of the RP's cross-class cram down mechanic to preserve and maximise value, despite its increased legal implementation cost.

Background to the Houst RP

Houst is a company specialising in a hosting and management platform for short-term holiday lets worldwide. It became cashflow and balance sheet insolvent as a result of the impact of COVID-19. Prior to the sanctioning of the RP, it could not service its obligations to its secured creditor (the **"Bank"**) and was facing three statutory demands, served on it by its landlord, HMRC and its previous call centre services provider.

The objective of the RP was to return Houst to solvency and for each class of stakeholder to be better off than under the relevant alternative, a pre-pack administration sale after an accelerated marketing process, if the RP were to not go ahead. The two in-the-money creditors were (i) the Bank, estimated to get 27p in the pound under the RP versus 8p in the pound in the relevant alternative; and (ii) HMRC, as secondary preferential creditor, estimated to receive 20p in the pound under the RP versus 15p in the pound in the relevant alternative.



A key aspect of the RP was a variation to Houst's equity structure to allow for a capital injection of a minimum of £500K to generate the new value for stakeholders to receive more than they could otherwise expect to receive in the relevant alternative. The plan provided for the Bank's debt to be reduced to £750K and to be then paid down over 3 years, whilst two separate funds, a secondary preferential creditor payment fund and an unsecured creditor payment fund were set up to fund a dividend to both HMRC and the unsecured creditors, respectively, over a period of 3 years as well.

Classes

The class composition consisted of six classes - the shareholders as one class and five separate classes of creditors. The creditor classes were (i) the Bank (in a single member class); (ii) HMRC as secondary preferred creditor (also in a single member class); (iii) trade creditors; (iv) convertible loan holders and loan noteholders; and (v) a connected company creditor, Homesorted (which had an unsecured debt of c£500K and got no dividend under the RP).

Houst's customers, critical suppliers and employees were all excluded from the RP and there was no compromise proposed in relation to the debts owed to them.

At the convening hearing, Mr Justice Adam Johnson considered whether the shareholders should be divided into two classes (splitting out the existing ordinary shareholders and preferential shareholders). Mr Justice Johnson concluded that although the shareholders' existing rights were not the same, there did not need to be a division of the members class – there was no reason why they could not consult together as to their common interest and a "*degree of pragmatism*"[1] was required in addressing the issue of class composition.

Four of the five creditors classes and the members class voted in favour of the RP. HMRC was the only class that voted against the RP, on the basis of its preferential status, stating in correspondence that it "*will not relinquish this status in order to provide a dividend to unsecured creditors*"[2]. It was therefore necessary for the Houst RP to seek to rely on the cross-class cram down mechanism.

Cross-class cram down

The cross-class cram down mechanic allows dissenting classes of creditors or members to be bound to an RP provided that (i) they are no worse off than they would be in the relevant alternative (**"Condition A"**); and (ii) the RP has been approved by 75% of those voting in any class that have a genuine economic interest (**"Condition B"**).

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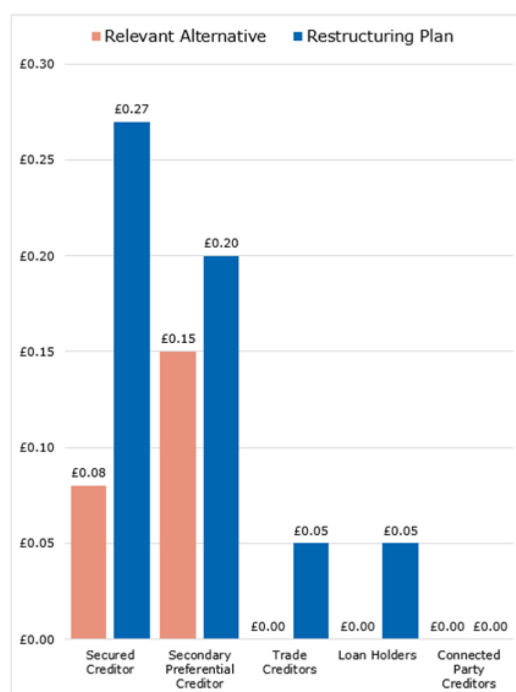
1 *Johnson J, Houst Limited [2022] EWHC 1765 (Ch) [43]*
2 *Zacaroli J, Houst Limited [2022] EWHC 1941 (Ch) [16]*

The estimated outcome statement prepared by Begbies Traynor estimated that in the relevant alternative, HMRC would be likely to receive 15p in the pound; whereas, under the RP, HMRC would receive 20p in the pound. HMRC did not seek to challenge the valuation evidence and, in fact, accepted in correspondence that they would be better off under the RP than in the relevant alternative. Condition A was satisfied as Zacaroli J concluded that while HMRC "*may recover more, or less, in the relevant alternative, [he was] satisfied that it is likely to be no worse off under the plan*"**[3]**.

Condition B was satisfied by the Bank (who had a genuine economic interest in the relevant alternative) having voted in favour of the RP. Zacaroli J considered that "*attempts artificially to create an in-the-money class for the purposes of providing the anchor to activate the cross-class cram down power should be resisted*"**[4]**. The Bank was undoubtedly substantially impaired under the plan and, although it was known to be supportive, it had not signed a lock-up agreement and could have withdrawn its support at any point. The Houst RP confirmed that it did not make "*a difference, as a matter of jurisdiction to exercise the cross-class cram-down power, that there is only one creditor within the class*"**[5]**.

Restructuring Surplus

As a result of Conditions A and B being satisfied, the RP had a "*fair wind*"**[6]** behind it but the Court also needed to be satisfied that it was appropriate to exercise its discretion to sanction the RP. This included the important consideration of whether the RP provided all stakeholders of Houst with "*a fair distribution of the benefits generated of the restructuring*"**[7]**, being the restructuring surplus (the value preserved or created by the RP), and whether the difference in treatment of HMRC under the RP versus the relevant alternative as compared to other stakeholders was justifiable. The Court considered that the Houst RP "*involves a clear departure from the order of priority between creditors that would exist in the relevant alternative*"**[8]** – see the chart below which illustrates the allocation of the restructuring surplus under the Houst RP.



Houst argued that the enhanced dividend to the Bank under the RP was the least that the Bank was prepared to accept to support the restructuring and, notwithstanding the relative priority of HMRC to the trade creditors and loan holders, the RP was a fair distribution of the restructuring surplus as it was important that the trade creditors received some return in the RP in light of Houst's ongoing trading relationship with them and the loan holders were potentially the future funders of Houst.

The justification to alter the order of priority under the RP was considered to be a weak basis for depriving HMRC of the priority they would have had in administration, particularly as Houst was not dependent upon the Bank to be able to continue trading.

However, on balance, the RP was not a case where assets that would have been available in the administration of Houst were being applied "*in a manner inconsistent with the order of priorities applicable in that administration*"**[9]**. The new value in the RP was principally generated from the capital injection of members. The Court considered that HMRC are a sophisticated creditor, able to

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3 *Zacaroli J, Houst Limited [2022] EWHC 1941 (Ch) [15]*
4 *Zacaroli J, Houst Limited [2022] EWHC 1941 (Ch) [20]*
5 *Zacaroli J, Houst Limited [2022] EWHC 1941 (Ch) [20]*
6 *Trower J, DeepOcean 1 UK Ltd [2021] EWHC 138 (Ch) [48]*
7 *Zacaroli J, Houst Limited [2022] EWHC 1941 (Ch) [29]*
8 *Zacaroli J, Houst Limited [2022] EWHC 1941 (Ch) [33]*
9 *Zacaroli J, Houst Limited [2022] EWHC 1941 (Ch) [40]*

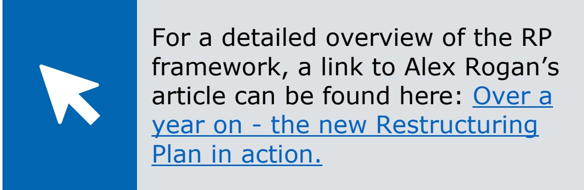
look after their own interests and noted that they had not attended the sanction hearing to oppose the plan or presented any arguments against sanctioning the RP. If Zacaroli J refused to sanction the RP, the evidence showed that all creditors (including HMRC) would be worse off. In the absence of any active challenge by HMRC, the Court concluded that it presumed HMRC would prefer to recover more rather than less tax and their interests lay in sanctioning the plan.

Concluding thoughts

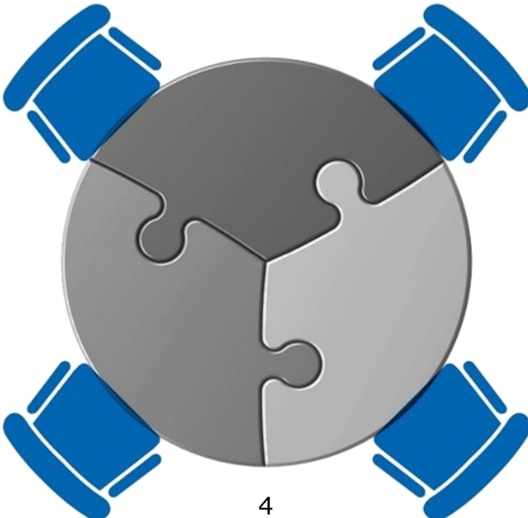
The sanctioning of the Houst RP is significant, not only because it is the first SME company to use the tool outside of administration, which is ground breaking in itself, but also because it crammed down HMRC and demonstrated the flexible nature of the tool regarding its ability to allocate the restructuring surplus in a commercially justifiable manner which does not adhere to the absolute priority rule. As noted in the judgment, given that consideration was given by the UK government to including a modified form of the absolute priority rule in RPs, its exclusion must be taken to be deliberate and a departure from that priority is not in itself fatal to the success of an RP.

Houst did not provide the most compelling reasons for the allocation of its restructuring surplus; nevertheless, it was still sanctioned, showing that the RP is a very effective restructuring tool and, if a dissenting creditor does not actively oppose, then the Court will be slow to impose its view of the substantive fairness of the plan on stakeholders to the detriment of all. Interestingly, Houst also followed the path of Virgin Active and did not conduct a marketing process. A marketing process is a costly endeavour for a distressed business and the Houst RP is helpful for confirming that it is a fact-specific question as to whether this is the best way of establishing value.

There is no doubt that the Houst RP represents a massive leap forward in demonstrating the ability of the RP to maximise stakeholder value even at the bottom end of the market where the legal costs of this process are likely to represent a more significant percentage of a company's total liabilities. No doubt there will be road bumps going forward if practitioners push the parameters of the RP too far too fast but what does seem clear is the direction of travel has now been established. The pre-pack and the CVA will undoubtedly still have their place but the RP will now need to be carefully considered rather than dismissed as an esoteric top of the market option which is too expensive. The RP is not perfect but it is developing rapidly at a point of real need in light of an unprecedented situation created by the Covid-19 pandemic whereby a large number of otherwise good businesses will need to restructure their overly leveraged balance sheets to survive. Practitioners should now be more confident in considering the RP across the mid-market space as a restructuring tool that in the right circumstances can maximise value more effectively than the pre-pack and the CVA, the established mid-market restructuring tools.



For a detailed overview of the RP framework, a link to Alex Rogan's article can be found here: Over a year on - the new Restructuring Plan in action.



How Eversheds Sutherland can assist

Should you require advice on RPs or any other restructuring and insolvency matters, Eversheds Sutherland can leverage its market-leading strength and depth of experience in these areas to assist. For more information or guidance, please get in touch with your usual Eversheds Sutherland contact, or one of the individuals below.

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