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Houst: English Court Approves SME Restructuring Plan

Binding a Dissenting Preferential Creditor, with Important Implications for Fair Distribution of Post-Restructuring Value

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At a Glance

The English court approved Houst's restructuring plan, binding the English tax authority (HMRC) as a dissenting class – even though stakeholders' treatment under the plan did not follow the priority they would have received in the relevant alternative to the plan (namely, administration).

This is a small case in which the court bound a preferential creditor without its consent – consistent with the court's ability to bind dissenting stakeholders of all classes of seniority (including even secured creditors). HMRC only recently became a preferential creditor, end 2020 – see our *Alert*.

The key threshold for binding a dissenting class requires the class to be "no worse off" under the plan than in the relevant alternative. The court requested further evidence before it was satisfied on this.

- **Fair share of "restructuring surplus":** The court carefully scrutinised the distribution of post-restructuring value under the plan. Key factors in approving the plan notwithstanding its departure from the established order of priority included:
  - the lack of active opposition to the plan – noting the only creditor "disadvantaged" was HMRC, who were a sophisticated creditor;
  - creditors' treatment in the relevant alternative is a "relevant reference point" in determining their appropriate share of post-restructuring value – but a departure from that priority is not fatal;
  - the court placed little if any weight on the votes of consenting junior classes, given they would all be out of the money in the relevant alternative;
  - it may be relevant to take account of the source of benefits to be received under the restructuring; here, the new value generated by the plan came principally from a capital injection from the plan members – so this was not a case where assets that would have been available in the company's administration were being applied in a manner inconsistent with the order of priority in administration; and
  - evidence indicated that all creditors, including HMRC, would be worse off if the court refused sanction.
- **SME:** Houst was an SME; the plan compromised c.£10 million in debt. It follows the restructuring plan of another SME, *Amicus Finance*, in November 2021 – see our *Alert*.
- **Contrast to CVA:** In binding a dissenting preferential creditor (HMRC), Houst's restructuring plan effected what would not have been possible via a company voluntary arrangement (which cannot bind secured or preferential creditors without their consent).

"The present case involves a **clear departure from the order of priority** between creditors that would exist in the relevant alternative"

"The issue facing me is a **binary one**; to sanction the plan, or not. While it would in theory be possible to require the Company to start again and seek to negotiate with HMRC, that is highly undesirable, where the costs and delay in requiring it do so would impose a **disproportionate burden on the Company, a small to medium enterprise**"

"**If I refuse to sanction** the plan, then the evidence indicates that **all creditors, including HMRC, will be worse off.** … I would expect HMRC's interest to be in recovering more, rather than less, tax and, as such, in relation to the binary choice that faces me, **their interests lie in sanctioning the plan**"

Extracts from sanction judgment, 22 July 2022

The convening judgment (Johnson J, 14 June 2022) is here. The sanction judgment (Zacaroli J, 22 July 2022) is here.

Background – Houst's Restructuring Plan

- *Business:* Houst Limited provides property management services for short-term / holiday lets, via an online platform
- *SME*: Houst's total liabilities were c.£10 million
- *Financial difficulties:* both cashflow and balance sheet insolvent, following severe impact from the Covid-19 pandemic. Certain creditors had threatened winding-up petitions and/or served statutory demands
- *Relevant alternative:* pre-pack administration
- *Jurisdiction:* English company
- *Purpose:* to return Houst to solvency and for all stakeholders to receive more than they would in administration alternative
- *HMRC*: voted against the plan, but did not formally oppose it. In correspondence, HMRC stated it would not relinquish its preferential status in order to provide a dividend to unsecured creditors – apparently as a matter of policy

	STAKEHOLDER CLASSES[1]	DEBT	TREATMENT UNDER PLAN	EST. DIVIDEND IN RELEVANT ALTERNATIVE	APPROVED?
1	**Clydesdale Bank**	c.£2.8m **Secured**[2]	£250k payment upfront + further £500k payment over 3 years; remainder released – equivalent to **27p / £**	**7-8p / £**	✓
2	**HMRC**	c.£1.8m - **preferential status** in relevant alternative	Monthly payments – equivalent to **20p / £**[3]	**15p / £**	**X**
3	**Trade creditors**	c.£1.6m	Monthly payments – equivalent to 5p / £[3]	Nil	✓[4]
4	**Convertible loan note holders**	c.£3.3m	Option to (a) swap existing debt for pre-dilution equity or (b) participate in the dividend to unsecured trade creditors	Nil	✓
5	**Connected party creditor**	c.£500k	Zero'd (by consent)	Nil	✓
6	**Members** (ordinary and preferential shareholders, together)	-	Diluted to c.5% of overall equity *(Certain members to advance min.£500k new capital for new pref. shares)*	Nil	✓
		c.£10m			

1. Liabilities owed to customers, certain critical suppliers and employees were specifically excluded from the restructuring plan – to be paid in full, given non-payment would have significant negative impact on company's ability to trade.
2. In the relevant alternative, the bank would receive an estimated £300k from the realisation of fixed charge assets; it would receive zero from the realisation of c.£180k floating charge assets, because it would rank behind HMRC's c.£1.8m claim as secondary preferential creditor. For more on HMRC's preferential status in the insolvency waterfall, see our *Alert*.
3. If the company fails to make the monthly payments, plan administrators have the right to terminate the plan, in which case all creditors' rights would revert to the position prior to the restructuring plan.
4. The vote of a particular non-consenting trade creditor was accepted only in part. Had the vote been accepted in full, the requisite majority would not have been obtained. However, given the unsecured creditor class would have been out-of-the-money in the relevant alternative, the court placed little if any weight on the vote of that class (whether for or against the plan). The court held that the chair acted fairly in refusing to admit the claim for the full amount and, even if the creditor's vote had been wrongly excluded, that would not have been a reason to refuse sanction.

Fair Share of “Restructuring Surplus”

CONTEXT

- The court considered whether the plan provided a fair distribution of the benefits generated by the restructuring (sometimes termed the “restructuring surplus”)
- This case involved a clear departure from the order of priority between creditors that would exist in the relevant alternative, in which HMRC would rank second to the bank in relation to fixed charge proceeds, but would ultimately receive the largest dividend (c.15p/£) given the limited value of assets subject to the fixed charge
- Although HMRC could expect a higher dividend under the plan than in the relevant alternative, the bank was to receive a significantly higher *increase* on its dividend under the plan

COURT’S EVALUATION AND FINDINGS

- Creditors’ treatment in the relevant alternative (i.e., based on their ranking in the insolvency waterfall) was a “relevant reference point” in determining the appropriate share of the restructuring surplus - but a departure from that priority was not in itself fatal to the success of the plan. The exclusion of the absolute priority rule from the legislation must be taken to be deliberate.
- It may be relevant to take account of the source of benefits to be received under the restructuring (e.g., from assets of the company or from supportive third parties).
- The court placed little if any weight on the votes of consenting junior classes, given they would all be out of the money in the relevant alternative.
- The court was satisfied that:
  - the repayment in full of “**critical creditors**” was justified given the company’s ability to generate additional funds to pay HMRC and other unsecured creditors depended on its continued trading; without paying critical creditors, the company would be unable to trade; and
  - the treatment of the new **shareholders** (who would enjoy the largest part of the benefits of ownership, on the facts) was justified given they were providing the capital injection without which the company would not survive; it was fair for them to share in the potential upside.
- The company’s explanation for the enhanced dividend payable to the **bank** was that it was the product of extensive negotiations and was the least that the bank was prepared to accept in order to support the restructuring. Its explanation for paying any dividend to **unsecured creditors**/convertible loan note holders was that they included creditors with whom the company would need to trade or was likely to look to for potential future funding.
- The court found these explanations offered only a **“weak basis” for depriving HMRC of the priority** they would have in the relevant alternative.
  - The company was not dependent on the bank to be able to continue trading.
  - There was no reason in principle why the plan could not have been achieved with the support of HMRC as the requisite consenting “in-the-money” class – i.e., instead binding the bank as the dissenting class.
- However, the court nonetheless exercised its discretion to sanction the plan, on the basis that:
  - the new value generated by the plan came principally from the capital injection from the members – so this was not a case where assets that would have been available in the company’s administration were being applied in a manner inconsistent with the order of priority in administration;
  - the only creditor who was disadvantaged (by the failure to follow the order of priorities in administration) was HMRC – who were a sophisticated creditor able to look after their own interests and had not actively opposed the plan (or suggested that they would prefer a formal insolvency); and
  - evidence indicated that all creditors, including HMRC, would be worse off if the court refused to sanction the plan.

Other Takeaways

SATISFYING THE "NO WORSE OFF" TEST

- To sanction a plan which not every class has approved, the court must be satisfied that no member of a dissenting class is any worse off under the plan than in the relevant alternative (among other matters).
- The court had expressed concern that HMRC could potentially receive more in the administration alternative (estimated 15p/£ - but inherently uncertain) than under the plan (fixed dividend of 20p/£).
- The court initially indicated it was not willing to sanction the plan absent further evidence as to how estimated recoveries were calculated. The company provided further information (from analysis that had already been conducted); this evidence was provided on paper, avoiding the cost of an additional court hearing.
- Ultimately, the court **was** satisfied that HMRC was likely to be no worse off under the plan.

ABILITY TO BIND DISSENTING CLASS VIA APPROVAL OF CLASS WHICH WOULD HAVE BEEN PREPARED TO ENTER CONSENSUAL DEAL

- The court was asked to bind a dissenting class (HMRC) based upon the consent of a class which would otherwise have been prepared to enter a consensual arrangement to restructure its rights (the bank).
- The permissibility of this had been raised but left open in the case of *Virgin Atlantic* (2020).
- The court in Houst held:
  - 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, particularly where such a class is not impaired by the plan;
  - however, where (as here) the "in-the-money" class of creditors is undoubtedly adversely affected by the company's insolvency and is substantially impaired under the plan, then the mere fact that 100% of that class is prepared to support the plan is not a reason to prevent the cross-class cram-down power being exercised.

USE OF RESTRUCTURING PLANS BY SMEs

- The court was very conscious that the company was an SME, facing difficult cost/benefit issues in pursuing its restructuring, without the ability to provide the extensive documentation and evidence common in larger cases.

"While it would in theory be possible to require the Company to start again and seek to negotiate with HMRC, that is highly undesirable, where the **costs and delay in requiring it do so would impose a disproportionate burden** on the Company, a small to medium enterprise."
Sanction judgment, [44]

- The Insolvency Service recently published a report including suggestions of how restructuring plans could be made less costly and time-consuming for the SME market. For more information, see our *Alert* and paragraph 4.2.5 of the report.
- Houst's example may facilitate the use of restructuring plans by other SMEs – especially given the ability to bind dissenting secured or preferential creditors under a restructuring plan (unlike a CVA).

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