KIRKLAND & ELLIS

English Court Refuses to Approve Two Restructuring Plans "Cramming Down" Tax Authority

16 MAY 2023

At a Glance

"[T]he Court should exercise caution in relation to HMRC debts ... and should not cram down the HMRC unless there are good reasons to do so"

EXTRACT FROM *NASMYTH* SANCTION JUDGMENT, 28 APRIL 2023

"Given its status as a major in the money creditor, and the strong terms in which it has voiced its objection, not only in light of the facts of this particular case but also given its critical public function as the collector of taxes, I think HMRC's views deserve considerable weight."

EXTRACT FROM *GAS* SANCTION JUDGMENT, 16 MAY 2023

- The English Court refused to approve two separate SME restructuring plans in which the debtors had sought to "cram down" the UK tax authority (**HMRC**) as a dissenting class.
- HMRC actively opposed the restructuring plans of Nasmyth Group Ltd (**Nasmyth**) and The Great Annual Savings Company Ltd (**GAS**).
- Although Nasmyth's plan satisfied the statutory requirement that no member of a dissenting class be any worse off under the plan than in the relevant alternative, the Court refused to approve the plan as a matter of discretion. *Nasmyth* is the first UK restructuring plan to be refused approval on discretionary grounds.
- In contrast, the Court found that GAS' plan failed the requisite "no worse off" test and stated that it would have declined to approve the plan as a matter of discretion even if the plan had passed that test.[1]
- The Court held that:
  - the Court should not refuse to "cram down" HMRC as a matter of principle[2], but should exercise caution in relation to HMRC debts (*Nasmyth*);
  - GAS had not discharged the burden of showing that HMRC would not be any worse off the plan, because the Court was not sufficiently persuaded of the robustness of the conclusions in a valuation of GAS' principal asset (its debtor book);
  - the proposed distribution of benefits under both plans was ultimately unfair to HMRC; and
  - Nasmyth's failure to agree "time to pay" arrangements with HMRC (i.e., an agreed instalment plan) for the wider group before proposing the plan tipped the balance against sanctioning the plan and was a "blot" (technical or legal defect) which prevented its plan from taking effect in the manner intended.
- **Fair distribution of benefits**: the Court's judgment in *GAS* provides significant guidance as to relevant factors when considering whether a plan constitutes a fair distribution of post-restructuring benefits – including 1. stakeholders' existing rights, 2. additional contributions to the plan (including if they are taking on additional risk by making new money available) and 3. if any disadvantageous treatment is justified. See page 5.
- **Critical creditors**: In *Nasmyth*, the Court held it would not have been prepared to accept a particular creditor as a "critical supply creditor" (who was to be repaid in full outside the plan, effectively at the expense of HMRC). Particular care is needed in considering whether there are respectable commercial reasons for leaving certain creditors uncompromised by a plan.
- **Background**: The background to Nasmyth's plan is summarised in Annex A; the background to GAS' plan is summarised in Annex B.
- **Post-script**: Following the Court's judgment, Nasmyth reportedly entered administration and, in a "pre-pack" deal, was sold to an affiliate of its existing shareholder. It remains to be seen whether GAS will enter administration following today's judgment.
- **Future compromises**: We expect HMRC to seek reform of restructuring plans, such that it would be impossible to compromise HMRC debts via a restructuring plan without its consent. Pending any such reform, the ability to compromise HMRC in future has not been excluded "as a matter of principle". See page 7.
- For **Key Takeaways**, see next page.

1. This mirrors the Court's approach in *Hurricane Energy*, the first and only other case in which the Court has refused to approve a UK restructuring plan; see our Alert.
2. In *Houst* (2022), the Court did approve an SME restructuring plan which bound HMRC as a dissenting class. However, HMRC did not actively oppose Houst's plan. See our Alert.

Key Takeaways

HMRC-RELATED

1 Caution on cramming down HMRC

The Court will not refuse to cram down HMRC as a matter of principle; however, it will exercise caution and will not cram down HMRC unless there are good reasons to do so

2 *Nasmyth* – unfairness

Unfair to cram down HMRC given: size of debt; wider Group liabilities to HMRC (some well overdue); "tiny" share of restructuring surplus for HMRC; attempt by directors and secured creditors to use plan as "convenient opportunity" to eliminate debts to HMRC – improper purpose

3 *GAS* – unfairness

Unfair to cram down HMRC given: better treatment of other (non-critical) creditor classes without satisfactory justification; value-creation under the plan involved the eradication of HMRC's existing debt and effectively prioritising payments to various unsecured creditors at HMRC's expense

4 Failure to agree on "time to pay" was crucial

Nasmyth's failure to agree "time to pay" arrangements with HMRC before proposing the plan was the factor which tipped the balance against sanction

5 Future tax benefits

Future tax payments (following approval of the plan) cannot count towards "no worse off" test, as the obligation to pay future taxes is not an obligation that arises under the plan; focus is on treatment of *existing* debts (*GAS*)

OTHER

1 Fair distribution of benefits

When considering fairness, relevant factors include stakeholders' existing rights, additional contributions (including new money) and if any disadvantageous treatment is justified. May involve comparing the plan with other possible structures (*GAS*)

2 No "invariable rule" requiring opponent to provide competing expert evidence

Court may conclude company has not proved the "no worse off" test even without opposing expert evidence, e.g., if manifest errors/inconsistencies (*GAS*)

3 Views and votes of out-of-the-money creditors

Even out-of-the-money creditors may have a legitimate interest in opposing a restructuring plan; the Court may take their views into account (*Nasmyth*). Failed attempt to disenfranchise out-of-the-money classes from voting on the plan, owing to difficulties giving retail customers proper notice (*GAS*)

4 "Blot" on plan

Absence of agreement on wider group "time to pay" arrangements with HMRC was a "blot" (technical or legal defect) preventing the Court from sanctioning the plan (*Nasmyth*)

5 Scrutiny of "critical creditor" categorisation

Court scrutinised both companies' categorisation of critical creditors (to be repaid in full) and would have rejected categorisation in *Nasmyth*

“No Worse Off” Test

For the Court to sanction a plan which not all classes have approved, it must be satisfied that no member of a dissenting class is any worse off under the plan than it would be in the relevant alternative, among other matters.

The Court concluded that HMRC was “no worse off” under Nasmyth’s plan than it would be in the relevant alternative, whilst GAS’s plan failed the “no worse off” test.

***GAS*:**

- The return to HMRC under GAS’ plan was only marginally better than in the relevant alternative, based on the company’s projections. HMRC did not adduce competing valuation evidence.
- The Court held there is no “invariable rule” that, in the absence of opposing expert evidence, the Court is bound to accept the company’s valuation analysis. If there are manifest errors/inconsistencies in the company’s materials, it is open to the Court to conclude that the company has not discharged the evidential burden of satisfying the “no worse off” test (on the balance of probabilities).
- GAS’ largest asset is its “commission debtor book”, i.e., claims by the company for commission due under brokerage contracts. The Court did not find the valuation evidence of the commission debtor book persuasive. It cited various weaknesses including (a) lack of clarity as to what form of independent analysis had been conducted in respect of certain figures, (b) lack of indication that figures had been checked or subjected to scrutiny and (c) lack of allowance for the possibility that certain figures might be inaccurate or that certain assumptions might be wrong.
- Accordingly, the Court was not satisfied on the evidence that HMRC would be no worse off under the plan: the evidence had too many limitations to justify that conclusion.
- HMRC asserted various claims (e.g., wrongful trading, preference claims, misfeasance claims) which might boost recoveries in the relevant alternative. The Court held that it could not reliably attribute any present value to the alleged claims. Accordingly, the “no worse off” analysis was determined solely by reference to the valuation of the company’s commission debtor book.

***Nasmyth*:**

- During the sanction hearing, Nasmyth’s board resolved to file a notice of intention to place the company into administration if the restructuring plan was not sanctioned. This was alleged to be a “cynical and transparent” decision to “hold a gun to the head of the Court”.
- However, the Court ultimately accepted that the board could see no other alternative if the Court did not sanction the plan. Accordingly, the company had proved (on a balance of probabilities) that the relevant alternative to the plan was insolvent administration.
- The Court accepted that HMRC (and unsecured creditors) would be no worse off under the plan than in the relevant alternative.

Fair Distribution of Benefits / “Restructuring Surplus”

The Court retains discretion as to whether to sanction a restructuring plan, even if the statutory conditions are satisfied. Whether the plan provides for a fair distribution of the benefits of the restructuring – sometimes termed the “restructuring surplus” – is one factor relevant to the Court’s discretion. The Court held it would be unfair to sanction Nasmyth and GAS’ restructuring plans in all the circumstances (even if GAS’ plan *had* satisfied the “no worse off” test).

The Court in *GAS* provided significant insight into its analysis:

- the relatively strong overall support for the plan was of little assistance in assessing fairness; little if any weight should be given to the views of out-of-the-money creditors, whether they voted in favour of or objected to the plan;
- it is more pertinent to ask whether the plan provides a fair distribution of the benefits between consenting and non-consenting classes, notwithstanding that their interests are different;
- when considering what constitutes a fair distribution of the benefits, it is useful to have in mind (a) the existing rights of the creditors and how they would be treated in the relevant alternative, (b) what additional contributions they are making to the success of the plan – and in particular whether they are taking on additional risk by making new money available, and (c) if they are disadvantaged under the plan as compared to the relevant alternative, then whether the difference in treatment is justified. This may involve comparing the plan with other possible alternative structures – to the effect that “things could and should have been done differently”;
- in *GAS*, the secured creditor and HMRC were the parties with the most significant economic interest in the company. No new money was being advanced. Instead, the company’s vision of providing a “solid platform for future growth and value creation” was premised on the “eradication of legacy debt built up with HMRC” – yet the primary beneficiaries were intended to be the secured creditor and the existing shareholders/connected party creditors. The prospect of future success was “only made possible by the intended compromise of HMRC”; although there was risk for the secured creditor, it was not the risk of losing any *new money;*
- although existing shareholdings would be reduced under the plan, the intention was for currect shareholders to be “resurrected” to a position of full ownership once preference shares were redeemed. Although this was supported by the secured creditor, it was strongly opposed by HMRC (as the other main in-the-money creditor). The Court held HMRC’s views should be matters of real weight in the exercise of its discretion; and
- whilst there is nothing inherently objectionable in a plan proposing a different order of priorities than would apply in the relevant alternative, no sufficiently good reason had been given for the structure proposed – especially the treatment of other unsecured creditors who were being prioritised at HMRC’s expense, “for reasons which are not clear or which are unconvincing”. Accordingly, the benefits from potential future value growth were allocated disproportionately, rendering the distribution of benefits unfair.

The Court in *Nasmyth* addressed this issue in much less detail. However, it specifically held that the plan – which was predicated on the basis that HMRC would agree “time to pay” arrangements with the wider group – would involve HMRC contributing to the “restructuring surplus”, whilst HMRC’s own share of the restructuring surplus was “tiny” (both by comparison with the junior secured creditor (lending new money under the plan) and in absolute terms.

Special Status of HMRC Debts

The Court in *Nasmyth* recognised that HMRC debts have a special status:

- companies have a statutory obligation to deduct and pay PAYE and NICs to HMRC on behalf of their employees and VAT is a throughput tax paid by third parties and for which companies are also obliged to account to HMRC; Nasmyth and GAS had failed to comply with these obligations;
- Parliament has recognised the importance of HMRC debts by legislating for some debts to be treated as secondary preferential debts (see our Alert) – and Nasmyth and GAS were asking the Court to approve the cram-down of such preferential debts;
  - This would not be possible in a company voluntary arrangement (which cannot bind a preferential creditor without its consent) or a scheme of arrangement (in which HMRC would be likely to constitute a separate class and therefore have a right of veto over the scheme)
- tax debts are involuntary, in the sense that HMRC had not chosen to trade with the relevant companies;
- collection of tax is easily open to abuse; and
- if the Court approved Nasmyth's plan, it would give a "green light" to companies to use restructuring plans to cram down their unpaid tax bills – and where a company has been trading at the expense of HMRC, a restructuring plan could easily be used as an "instrument of abuse".

These considerations clearly influenced the Court's judgment in *Nasmyth* that it should exercise caution in relation to HMRC debts and should not cram down HMRC unless there are good reasons to do so.

In contrast, the Court in *GAS* did not specifically address this issue, though it did cite HMRC's critical public function as the collector of taxes as a major reason that HMRC's views deserved considerable weight.

Ability to compromise HMRC in future not excluded "as a matter of principle"

The Court in *Nasmyth* made clear that it will not refuse to cram-down HMRC as a matter of principle. HMRC debts are not trust monies and non-payment of HMRC debts is not to be treated as a "moral stain" or evidence of director misconduct.

We expect HMRC to seek reform of restructuring plans to provide that HMRC cannot be compromised via a restructuring plan without its consent[1].

As noted, the Court will exercise caution in relation to HMRC debts and should not cram down HMRC unless there are good reasons to do so. Pending potential reform, it seems from *Nasmyth* and *GAS* that the following factors would facilitate a future potential cram-down of HMRC in a restructuring plan:

1. other stakeholders contributing substantial new value in connection with the restructuring;
2. considering granting HMRC a greater share of post-restructuring benefits (e.g., than unsecured creditors who are not contributing new value in connection with the restructuring);
3. compromising HMRC's unsecured claims only (e.g., for corporation tax) and not its secondary preferential claims (e.g., for VAT, PAYE and employee NICs);
4. HMRC being an "out of the money" creditor i.e. value breaking within debt secured by fixed charges (NB HMRC's preferential claims rank ahead of the proceeds of floating charge assets);
5. avoiding a "haircut" on HMRC and instead repaying in full over time – as is being proposed in Fitness First's ongoing restructuring plan;
6. HMRC claims representing a relatively small proportion of debt to be compromised under the plan – such that HMRC is not one of the parties with the most significant economic interest in the company;
7. seeking to agree "time to pay" arrangements with HMRC in respect of any tax debts outside the plan (e.g., owed by other group entities); the absence of such an agreement was the tipping factor in *Nasmyth*;
8. "playing it straight" – i.e., the company has not deliberately continued to trade at the expense of HMRC and has not deliberately failed to disclose relevant matters to HMRC;
9. HMRC debts not being long overdue (in *Nasmyth*, certain of the group's HMRC debts dated back to January 2020); and
10. taking care not to categorise non-essential creditors as critical creditors or to grant an unfair share of the restructuring surplus to connected parties (as with the shareholder directors in *GAS*).

Cramming down a non-UK tax authority would raise slightly different issues, given such debts are unlikely to have preferential status in insolvency, among other matters.

1. As is expressly provided by statute for company voluntary arrangements: s.4(4), Insolvency Act 1986.

Other Takeaways

INTERESTS OF OUT-OF-THE-MONEY CLASSES

- The Court in *Nasmyth* held that:
  - HMRC had a genuine economic interest in the relevant alternative (despite the nil return envisaged for HMRC in that scenario), because it would remain one of the largest creditors of the wider group and the success of the plan depended upon HMRC agreeing "time to pay" arrangements with the group;
  - an earlier case (*Virgin Active*) in which the Court held that it is for "in the money" stakeholders to determine how to divide the "restructuring surplus" should not be seen as a rigid rule; and
  - even "out of the money" stakeholders could have a legitimate interest in opposing a restructuring plan (in *Nasmyth*, such claims involved former employees who had no economic interest in the administration alternative). The Court was entitled to take such views into account when deciding whether to approve the plan as a matter of its discretion (although ultimately, these concerns did not impact the Court's decision).
- In *GAS*, the Court followed the more convential approach, attaching little if any weight to (a) the out-of-the-money creditors who voted in favour of the plan or (b) the views of out-of-the-money objectors (four energy suppliers having opposed the plan, in addition to HMRC).

CRITICISM OF CATEGORISATION OF CRITICAL CREDITORS

- As noted, the Court scrutinised the categorisation of critical creditors, who were to be repaid in full. This is a question of fairness.
- *Nasmyth*: the Court held that:
  - the key test is whether relevant creditors are "essential";
  - the Court can be satisfied creditors are essential if the directors had "respectable commercial reasons" for classifying them as such;
  - the Court should generally accept the reasons given by the company unless it is "plain and obvious" that the creditors are not essential to the future operation of the plan company, the company's reasons do not make sense, or there is evidence to the contrary; and
  - the Court would not have been prepared to accept that a former employee (whose claim related to severance pay and not future services) was a critical supply creditor.
- *GAS*: the Court accepted that the categorisation of certain critical creditors appeared "questionable" on their face, but this issue alone would not cause it to decline to sanction the plan. Such matters were primarily for assessment by management.

"BLOT" ON THE PLAN

- A "blot" is a technical or legal defect in a plan (or scheme) such that its terms are rendered inoperative or ineffective. The Court is unlikely to approve such an arrangement.
- *Nasmyth*: the group's subsidiaries owed HMRC c.£2.6m (on top of the c.£446k owed by the plan company itself). The plan company did not form part of the wider group's "VAT group". Evidence for the plan company accepted that the survival of the group as a going concern was subject to the subsidiaries agreeing "time to pay" arrangements with HMRC. Counsel for HMRC submitted that this meant the plan would be inoperable if HMRC were not prepared to agree terms with the Group.
- The Court held that the failure to agree new "time to pay" arrangements was a roadblock which prevented the plan from taking effect in the manner in which the plan company and its creditors intended: "in the absence of a clear commitment from HMRC to give the Group time to pay its debts, I do not see how the Plan can take effect".
- We are not aware of any other case in which the English Court has refused to sanction a creditor scheme of arrangement or restructuring plan owing to such a "blot".
- *GAS*: the plan purported to prohibit HMRC from issuing legal proceedings against current and former directors. HMRC was concerned that this prohibition prevented it from conducting its statutory enforcement role. However, the Court considered this a "minor issue, principally of drafting" which was not a blot and would not of itself cause it to decline sanction.

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Other Takeaways (cont.)

REMINDER OF NEED FOR SUBSTANTIVE COMPROMISE

- The Court in *GAS* raised the issue of whether the company's original proposal – which sought to compromise contingent creditors' claims in full in return for £1 – amounted to a "compromise or arrangement" as required by statute.
- Accordingly, GAS amended its plan to improve terms for that class, creating a designated payment fund for such creditors.
- Existing case law in the context of schemes of arrangement establishes that there must be an element of give and take; a scheme cannot simply expropriate rights. It has not yet been necessary to determine conclusively whether this "give and take" requirement applies equally in the context of restructuring plans. The Court has been prepared to sanction plans in which fairly *de minimis* payments are made to out-of-the-money classes.

VALUATION OF POTENTIAL CLAIMS IN RELEVANT ALTERNATIVE

- In *Nasmyth*, HMRC argued that in an administration, administrators might be able to bring antecedent claims against directors for wrongful trading or breach of duty – though HMRC did not put forward any evidence to support such claims.
- The Court held that there must be some evidence of directors' misconduct before the Court can attribute any weight to this factor (in determining whether a dissenting class would be better off in an administration alternative).
- In *GAS*, HMRC went further, alleging that certain specific payments could be characterised as a preference (i.e., also subject to potential clawback in insolvency proceedings) and alleging fact-specific potential claims for misfeasance/breach of directors' duty.
- The Court held that there were real difficulties in seeking to evaluate such potential claims, given obvious limitations (e.g., the Court has had no disclosure). The Court could therefore not reliably attribute any present value to the alleged claims, for the purpose of the "no worse off" test – even though there might well be proper grounds for bringing such claims.

DISENFRANCHISEMENT OF OUT-OF-THE-MONEY CLASSES; NOTICE

- GAS' restructuring involved thousands of customer creditors, with over 6,000 missing contact details. All such creditors were "out of the money" and most had not interacted with GAS for 5 years.
- GAS originally sought an order under s.901C(4) of the Companies Act 2006 to exclude certain out-of-the-money creditors from voting on the restructuring plan altogether.
- However, we understand the Court would have required notice to such creditors to be issued in a manner compliant with the Civil Procedure Rules (i.e., in writing unless such parties had previously indicated they were willing to accept notice by electronic means).
- Given practical difficulties in delivering notice in this manner to a very large number of creditors for whom it did not have mailing addresses, GAS elected not to pursue such an order.
- Accordingly, Smile Telecoms (advised by Kirkland) remains the only company to have made a successful application to exclude out-of-the-money classes from voting on a restructuring plan; see our Alert.

Annex A – Nasmyth's Restructuring Plan

- *Business:* SME – manufacture/sale of machinery plant tools / aerospace industry products
- *Plan company:* Nasmyth Group Ltd, incorporated in England & Wales
- *Purpose of the plan:* to facilitate the continuation of lending into the group (from existing secured creditor) and compromise certain liabilities in order to restore the company to solvency
- *Financial difficulties:* arising from Covid-19 pandemic and its effect on the civil aviation industry; in default
- *Relevant alternative:* administration
  - Following the Court's refusal to approve the restructuring plan, the company undertook a pre-pack administration sale, as noted

	CREDITOR CLASSES	TREATMENT UNDER PLAN	EST. DIVIDEND IN RELEVANT ALTERNATIVE	APPROVED?
1	**Senior secured creditor** owed c.£13.3m	Waive existing default / 3-month stay on enforcement action; no haircut	Repaid in full	✓
2	**Junior secured creditor** owed c.£7.5m	5 year term-out; amendments including 3-month stay on enforcement action To make c.£9m new money available (including c.£8m already committed but draw-stopped)	55p/£	✓
3	**HMRC as preferential creditor** owed c.£210k	Compromised in full for payment of £10k – 4.8%	Nil	X
4	**Unsecured creditors** including HMRC in respect of c.£236k non-preferential claims[1], hedging liabilities and certain claims of former employees	Compromised in full for pro rata share of £10k – 0.09%	Nil	✓[2]
5	**Intercompany creditors** owed c.£3.5m	Compromised in full for no consideration (with express consent)	Nil	✓
OUTSIDE PLAN	**Critical supply creditors**	Paid in full	Nil	N/A
	Members	Not impacted under plan, but to transfer shares to a company associated with the existing shareholder for £1, if plan sanctioned	Nil	N/A

1. HMRC was also owed c.£2.6m by group subsidiaries.
2. The vote in this class was disputed given the inclusion/valuation of claims of two former employees, both of whom actively opposed the plan and appeared at the sanction hearing.

Annex B – GAS' Restructuring Plan

- *Business:* SME – broker of energy supply contracts between energy suppliers and business users
- *Plan company:* The Great Annual Savings Company Ltd, incorporated in England & Wales
- *Purpose of the plan:* remove significant levels of secured debt and manage other liabilities; improve balance sheet and liquidity
- *Financial difficulties:* arising from Covid-19 pandemic and higher energy prices; HMRC issued winding-up petition; landlord issued claim for unpaid rent arrears
- *Relevant alternative:* administration (and liquidation of parent company)
- *Application to exclude out-of-the-money classes from voting:* GAS originally sought an order under s.901C(4) of the Companies Act 2006 to exclude certain out-of-the-money creditors from voting on the Restructuring Plan. However, given practical difficulties, GAS elected not to pursue such an order. See further page 9.

	CREDITOR CLASSES	TREATMENT UNDER PLAN	EST. DIVIDEND IN RELEVANT ALTERNATIVE	APPROVED?
1	**Secured Creditor**	Debt for equity swap (£18.8m; write-off of accrued interest), with potential to recover principal in full if preference shares redeemed	0.6 – 5.2%	✓
2	**Secondary Preferential Creditor** i.e. HMRC	Compromised in full for payment of £600,000 = 9.1%	0 – 4.7%	X
3	**Head Office Premises Plan Creditor**	Contractual terms varied; granted termination right	2%	✓
4	**Rating Authority Plan Creditor**	Compromised in full for payment of £6,000 = 2%	1.3%	✓
5	**Energy Suppliers** (3 separate classes)	Varied: 100%; 10%; nil	Nil	✓ X X
6	**Plan Creditors** (3 separate classes)	Varied: 100%; 10%; 2%	Nil	✓ ✓ ✓
7	**Five other classes**, including certain connected parties	Varied; company also altered terms for certain classes, in part given the Court expressed concern that **compromising certain creditors for £1 might not constitute a proper "compromise or arrangement"**	Nil	✓✓✓✓✓
	15 classes in total			
OUTSIDE PLAN	**Employees**	Paid in full	Not disclosed	N/A
	Non-energy Suppliers	Paid in full	Nil	N/A