The Adler appeal:

Our key takeaways from the landmark Court of Appeal judgment setting aside the Adler restructuring plan, and what it means for future restructuring plans

The Court of Appeal has handed down its much-awaited judgment on the appeal of Adler's restructuring plan under Part 26A of the Companies Act 2006 that was sanctioned by the High Court last year after a contested hearing in which the plan faced strong opposition from a dissenting ad-hoc group of holders of Adler's €800 million 2029 senior unsecured notes (the **AHG**).

In a landmark judgment marking the first appeal of a restructuring plan in the UK, the Court of Appeal unanimously allowed the AHG's appeal and set aside the High Court's order sanctioning Adler's restructuring plan.

The Court of Appeal found that the terms of the restructuring plan deviated from the pari passu principle of insolvency law without justification and that the High Court should not have exercised its discretion to permit the use of the cross-class cram down mechanism to impose the plan on the dissenting class of holders of the 2029 Notes.

The Adler case itself has an unusual set of facts including that the purpose of the restructuring plan was to implement a solvent wind down rather than a continuation of the business as a going concern, so some of the aspects of the judgment are likely to have limited broader application in practice. However, the commentary from the Court of Appeal on a number of issues common to restructurings more generally will certainly have an impact on restructuring plans in the future.

Key takeaways

The judgment has significant implications, not just for Adler and its creditors, but also for future restructurings involving Part 26A restructuring plans. The key takeaways from the judgment are:

The *Pari Passu* Principle

A restructuring plan in which a solvent "wind down" is proposed as an alternative to insolvency proceedings should be consistent with the fundamental principle of *pari passu* distribution which would apply in insolvency proceedings, unless there is a good reason or proper basis to depart from it.

By preserving the staggered maturity profile and associated temporal subordination of the different series of its senior unsecured notes, which would not have applied in a formal insolvency context, Adler's restructuring plan departed in a material respect and without justification from the *pari passu* principle. By contrast, the one-year maturity extension of the 2024 Notes was necessary to facilitate the implementation of the restructuring plan and the business plan formulated by Adler's management team and therefore, the priority ranking given to the holders of the 2024 Notes for this additional accommodation was found to be an appropriate and justified reason for departing from the *pari passu* principle.

Although the judgment does not specify exhaustive criteria for what constitutes a "justified departure" from the *pari passu* principle, examples include the provision of new money funding or other financial accommodation or the continuation of supplies of goods and services which are essential for the beneficial continuation of the company's business under the restructuring plan.

Cross-Class Cram Down

The established principles developed from scheme of arrangement case law considering the fairness of imposing a compromise or arrangement to minority dissenting creditors or members within a class, such as the "rationality test" which considers whether an intelligent and honest person could reasonably approve the scheme or plan, require modification in the context of the court exercising its discretion in relation to cross-class cram down.

Reiterating his reasoning in Virgin Active[1], Snowden L.J. noted that satisfaction of the statutory conditions for cross-class cram down does not give rise to a presumption in favour of sanction. The court must still consider whether to exercise its discretion in light of all relevant circumstances. For further analysis of the use of cross-class cram down in the Virgin Active decision (where A&O advised the plan companies) please see our previous bulletin.

The overall percentage of creditors or the number of assenting classes approving the plan is not a relevant factor for the consideration of the exercise of cross-class cram down as there is necessarily more that divides the members of the dissenting class from members of other classes than unites them by virtue of the existence of the separate classes, which depends on an assessment of the similarity of their rights.

Instead, when deciding if a proposed plan is fair to a dissenting class and the exercise of the cross-class cram down power therefore appropriate, the court is required to consider whether the restructuring plan contemplates a "fair distribution of the restructuring surplus". This involves the court engaging with the commercial issues in the case and assessing whether differences in the treatment of different creditor groups are justified and appropriate in the circumstances (known as the horizontal comparison). As part of this assessment, the court should not confine itself merely to the proposal presented in the restructuring plan but also consider whether alternative restructuring proposals may have been fairer.

Retention of Equity

It is a matter for the "in the money" creditors, as the real economic owners of the company, to decide whether the shareholders should retain equity following the restructuring, irrespective of whether the shareholders provided new value or not. The retention of diluted equity holdings by the existing shareholders in the Adler restructuring was held not to breach the *pari passu* principle as shareholders would not receive any distributions until creditors were fully repaid.

Cancellation of Claims

The court held provisionally that a restructuring plan cannot provide for the compulsory cancellation, transfer or extinguishment of the debt or equity interests for no consideration, which is consistent with the longstanding principle that a scheme of arrangement must require an element of reciprocity. If debt or equity interests held by "out of the money" stakeholders are to be cancelled, transferred or extinguished, those stakeholders should receive a "modest amount" to compensate them. Although the judgment does not prescribe what level of compensation is adequate, Snowden L.J. noted that in his view there was no evidence that this principle had unduly impeded restructuring processes in the past and this is clearly not intended to provide creditors or shareholders with no economic interest any disproportionate commercial negotiating leverage.

[1]Virgin Active Holdings Limited [2021] EWHC 1246 (Ch)

Guidance on Procedural Issues

Timetable – Although the English courts adopt a pragmatic and commercial view and are keen to be accommodating to the urgency frequently associated with financially distressed businesses seeking to restructure their debts, Snowden L.J. drew a clear distinction with foreseeable events such as maturity dates and made it clear that the court would not tolerate its willingness to accommodate being taking for granted or abused. Parties and their advisers must ensure adequate timetables that allow for the proper conduct of proceedings, particularly where there are actual or anticipated disputes between stakeholders.

Disclosure of information and co-operation – The company proposing the plan must provide fulsome disclosure in the explanatory statement and must make available to dissenting stakeholders material information relating to valuations undertaken in a timely manner to enable expert evidence to be prepared in a rigorous manner and cross-examination to take place. The court expects parties and their advisers to be proactive and sensible in agreeing process matters and to co-operate with each other in narrowing the issues for adjudication at the sanction hearing to prevent undue delay and expense.

Stay Pending Appeal – Although there is no obligation for dissenting stakeholders to apply for a stay of a sanction order pending the hearing of an appeal or other interim relief, Snowden L.J. in this case noted his surprise that no such relief was sought by the AHG, in the context of the challenges posed by the acute pressures of time and the complex question of what the effect would be of setting aside the High Court sanction order after the restructuring had been completed for a significant period of time.

Issuer Substitution – Adler used a newly incorporated English company which was substituted for the original Luxembourg incorporated issuer as a substitute issuer of the German law governed senior unsecured notes in order to engage the jurisdiction of the English court for the restructuring plan. Although the AHG challenged this under separate German law proceedings, this was not a ground of challenge in the appeal. Snowden L.J. did not express a view on the appropriateness of this structure but made it clear that the judgment did not address the issue and therefore should not be taken as an endorsement of the technique for future cases. We note that the use of the issuer substitution, co-issuer and deed of contribution techniques has become increasingly common in recent years but these remain largely untested in the context of disputed schemes of arrangement and restructuring plans.

Background

The Adler Group is a real estate group specialising in the purchase, management and development of high-yield multi-family residential properties in Germany. The group had been struggling with financial difficulties due to various factors impacting the real estate market in Germany such as rising inflation, supply chain disruptions caused by the war in Ukraine and the impacts of the COVID-19 pandemic. Following months of negotiations between Adler and its creditors (including a group of bondholders that entered into direct negotiations with the Adler Group and its advisers and signed up to a lock-up agreement), Adler announced its restructuring plan in January 2023. The plan was sanctioned by Leech J. of the English High Court on 12 April 2023 following a contested hearing over a number of days in which the AHG disputed Adler's valuation evidence and also argued that the plan deviated from the *pari passu* principle of insolvency law.

The restructuring plan

The restructuring plan provided for the amendment of the terms and conditions of the senior unsecured notes with a view to allow the Adler Group to incur new money funding and grant security over its assets to refinance certain of its indebtedness, improve liquidity and facilitate an orderly solvent wind-down of its assets. The amendments included the extension of the maturity of the 2024 Notes by one year, the suspension of interest payments for two years and capitalisation of interest thereafter and the variation of the negative pledge and debt incurrence covenants in the senior unsecured notes. The 2024 Notes received differential treatment under the restructuring by receiving second ranking security in exchange for a one-year maturity extension with all other senior unsecured notes, including the 2029 Notes, receiving third ranking security. Importantly, the staggered maturity dates of the Notes (apart from the one-year extension of the maturity of the 2024 Notes) was preserved, which was one of the principal points of contention for the AHG as they argued the 2029 Notes would be materially prejudiced by being paid last in the company's proposed solvent wind-down plan.

AHG Appeal

The AHG requested permission to appeal following the sanction of the restructuring plan. While Leech J. initially denied the permission to appeal, the Court of Appeal granted leave on 29 June 2023. The appeal hearing was conducted over three days in October 2023.

The road ahead for Adler

As a consequence of the Court of Appeal judgment, the High Court sanction order which, among other matters, authorised the amendments of Adler's senior unsecured notes has been set aside. However, the practical implications of the judgment for Adler and its creditors remain to be seen given the complex cross-border aspects of this restructuring which was completed in April 2023. In a press statement issued shortly after the Court of Appeal judgment was handed down, Adler stated that, while it respects the Court of Appeal's decision, the decision has "no impact on the Adler Group or the effective amendments to the bond terms". Adler's view appears to be that the restructuring and the amended terms and conditions of the senior unsecured notes, which are governed by German law, remain valid and in effect. As the Court of Appeal judgment also does not go any further than to set aside the sanction order, future developments in this unprecedented situation will be observed with great interest in the restructuring market.

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