Hurricane Energy Restructuring Plan: Court Declines to Sanction Plan Cramming Down Shareholders

Authored by Adam Plainer, Solomon Noh, Kay Morley, Alastair Goldrein and Tayyibah Arif

7 July 2021

Dechert LLP

Hurricane Energy Restructuring Plan: Court Declines to Sanction Plan Cramming Down Shareholders

7 July 2021/ Authored by Adam Plainer, Solomon Noh, Kay Morley, Alastair Goldrein and Tayyibah Arif

Background

On 28 June 2021, in the English High Court, Mr. Justice Zacaroli handed down a judgment[1] declining to sanction a restructuring plan proposed by Hurricane Energy PLC which, among other things, sought to cram down the dissenting class of shareholders and hand over the control of the company to its bondholders with a debt-for-equity swap diluting the shareholders down to 5% of their existing shareholding.

Hurricane Energy was the first time that the English court has declined to sanction a restructuring plan (since their introduction almost a year ago in June 2020) following a contested three-day hearing, and only the fourth time that the cross-class cram down mechanism has been used. It follows the judgment[2] relating to the Virgin Active restructuring plans earlier this year which, for the first time, successfully crammed down dissenting landlord classes following a contested five-day sanction hearing, to achieve a balance sheet and operational restructuring. The Hurricane Energy plan can be distinguished from the Virgin Active plans due to the lack of imminent liquidation.

The shareholders' position was also carefully considered in both cases: in *Virgin Active*, the court rejected the arguments from dissenting landlords that the plans were not just and equitable as between the treatment of unsecured creditors and shareholders who retained all their equity (in exchange for provision of new monies); in *Hurricane Energy*, the shareholders successfully challenged the plan on the basis that they were being prematurely deprived of their equity in a company that had the scope for potential future upside.

Given the ability of the new restructuring plan to impose a cross-class cram down, valuations are of critical importance, and valuation disputes are likely to constitute a regular and important component of any restructuring plan challenge. However, whilst recognising the difficult questions of valuations that may arise in the context of contested restructuring plans, in the cases of both *Virgin Active* and *Hurricane Energy*, the English court has indicated that the utility of restructuring plans should not be undermined by lengthy valuation disputes. Accordingly, in circumstances where a company is in imminent financial distress, it would appear that the English court will seek to avoid extensive valuation challenges which, by virtue of the time it may take to determine any such disputes, could undermine the viability of any given restructuring plan and by default, result in the insolvency of the debtor company.

Here we consider the key takeaways from both cases and look at the key issues arising in the High Court's refusal to sanction the Hurricane Energy plan.

[1] *Hurricane Energy* [2021] EWHC 1759 (Ch)

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

The Key Takeaways

Hurricane Energy Plan	Virgin Active Plans
Not a rubber-stamping exercise: The court's sanction of a restructuring plan is not a rubber-stamping exercise and, particularly where cross-class cram down mechanism is engaged, the court will carefully consider the plan company's evidence to ensure that it has discharged its evidential burden as the proponent of the plan.	**Where the relevant alternative is imminent insolvency, the objections of 'out of money' creditors carry little or no weight:** Where the only alternative to a plan is insolvency, the business and assets of the company in essence belongs to those creditors who would receive a distribution in the formal insolvency. Therefore, it is for the 'in the money' creditors to determine how to divide up the 'restructuring surplus'. In this instance, the relevant alternative was not disputed and in light of the urgent liquidity crisis, was imminent entry into administration (followed by an accelerated business sale). As the dissenting landlords would be out of the money, their objections to what the secured creditors had agreed with the plan companies carried little or no weight.
Particular care to be taken where the plan involves immediate and irrevocable deprivation of dissenting class' rights: The court will take particular care in the application of cross-class cram down provision where the members of the dissenting class would be deprived of all but a fraction of their interest in the company.	**The plan can bind 'out of money' creditors without requiring them to even vote on the plan:** Creditors who would be 'out of the money' in the relevant alternative could be bound to a plan that effects a compromise or arrangement of their claims without even being given the opportunity to vote at a class meeting (pursuant to the operation of section 901C(4)). An application to do so would be dealt with at the preliminary stage.
Range of possible outcomes to be considered where the relevant alternative is not imminent insolvency: Where the relevant alternative is not an imminent insolvency process but rather continued trading in the near-to-medium term, the court will look at the range of possible outcomes available to determine whether there is a realistic possibility of the dissenting class being better off in the relevant alternative. In this instance, the court held that the "no worse-off" test was not satisfied.	**Valuation:** • In the absence of competing evidence, it is not unreasonable for the court to rely on the company's valuation evidence. • The potential utility of Part 26A plans should not be undermined by lengthy valuation disputes but alongside this, the protection for dissenting creditors provided by the "no worse off" test (and the court's discretion) must be preserved. • There is no absolute obligation to conduct a market testing process as part of a restructuring and whether it is used in a particular case will depend on whether it is necessary or practicable in the circumstances. In this instance, the "fruits of any market testing process" would have been treated with extreme caution given the unfavourable market conditions for the sale of the gym and leisure business. • Valuations will invariably produce a range of outcomes so that the mere existence of a broad range is not per se unreliable.
Timing for proposing a restructuring plan is key in the absence of a burning platform to avoid premature disenfranchisement of creditor classes: Although the low 'financial difficulty' threshold for a company to be able to propose a restructuring plan may be easily satisfied, careful consideration should be given as to when a company seeks to restructure its capital structure, especially where there is no 'burning platform' and it involves immediate and	**Not inappropriate to use the right tool to achieve desired restructuring:** It is not inappropriate for a company to choose to utilise Part 26A rather than a CVA to achieve the desired result of rescuing the company in the interest of their stakeholders generally.

Hurricane Energy Plan	Virgin Active Plans
irrevocable removal of shareholder rights (which by their very nature participate in any potential upside) or other junior stakeholder rights.	
Striking a balance between urgency of proceedings and ability of dissenting class to meaningfully challenge a plan: Potential unfairness to dissenting class due to speed of proceedings and resulting difficulties it might face in adducing its own evidence (and testing the company's evidence) must be balanced against the genuine urgency of the proceedings. In this instance, the court found that there were no legitimate grounds for urgency and a restructuring could be undertaken further down the line.	**Timely provision of information:** A company proposing a plan should co-operate in timely provision of information, which can include information over and beyond the explanatory statement so that genuine valuation disputes can be resolved efficiently.
Shareholder rights are fundamentally different: Wider interests of shareholders are fundamentally different to that of debt holders as (in the absence of contractual rights granted to other stakeholders) shareholders alone have the right to share in the potential upside in a company.	**Provision of new money by shareholders is not inherently inappropriate:** There is nothing inherently inappropriate with shareholders providing new money. In this instance, the evidence suggested that the money from the shareholders had been advanced on more commercially favourable terms than otherwise available in the market. Therefore, depending on the circumstances of the case, sponsors with dry powder and a willingness to follow their money may provide a company with new money and remain engaged in any restructuring process.
Shareholders retain right to appoint directors until formal insolvency process: Absent the intervention of a formal insolvency process (or contractual rights under debt or security documentation for other stakeholders), the shareholders retain their collective rights under the constitutional documents of a company, including to appoint and remove directors.	
Engagement of junior stakeholders in restructuring process: Shareholders (and other junior creditor classes) should be effectively engaged in a restructuring process unless they can be definitively shown to be out of the money at the time when the plan is being proposed.	

Court's approach to sanctioning a Part 26A plan

Provided that the financial conditions for entry into a Part 26A plan are satisfied, the starting point for sanctioning a Part 26A plan is the approach taken when sanctioning a Part 26 scheme of arrangement that was summarised by Snowden J in *Re Noble Group*[3] as follows:

***Re Noble Group* Approach**
The court must consider whether:
• the **provisions of the statute** have been complied with;
• the **class was fairly represented** by the meeting, and whether the majority was coercing the minority in order to promote interests that are adverse to the class that they purported to represent;
• the scheme was **a fair scheme which a creditor could reasonably approve**; and
• there is any **"blot" or defect in the scheme**.

The important difference between a Part 26 scheme and a Part 26A plan is that where not all relevant classes vote in favour of the plan, section 901G cross-class cram down mechanism (**CCCD**) is engaged, which provides the court with the discretion to nevertheless sanction such a plan.

[3] *Re Noble Group Ltd* [2018] EWHC 3092 (Ch)

Where CCCD is engaged, the following two threshold conditions must be met, of which Condition A involves three steps:

Threshold conditions for section 901G cross-class cram down mechanism

Condition A	Court must be satisfied that none of the members of the dissenting class(es) would be **any worse off** if the plan is sanctioned than they would in the event of the **relevant alternative**
Condition B	Plan must have been approved by **75% in value of a class of creditors (or members) voting** at the meeting who would receive a payment or have a **genuine economic interest** in the company, in the event of the **relevant alternative**

3 steps

Step 1

Identifying what would be **most likely to occur** in relation to the company if the plan is not sanctioned

Step 2

Determining what would be the outcome or consequences of that for the dissenting class(es)

Step 3

Comparing that outcome with the outcome and consequences for the dissenting class(es) if the plan is sanctioned

"Relevant alternative" is "whatever the court considers would **be most likely to occur** in relation to the company if the compromise or arrangement was not sanctioned"

Court is not required to be satisfied that a particular alternative would definitely occur, merely (where there are possible alternatives) which one is **most likely to occur**

Similar to the exercise of identifying the appropriate comparator for class purposes in the context of Part 26 Scheme; and the vertical comparator for the purposes of an unfair prejudice challenge to a CVA[1]

Relevant question is **what is the relevant alternative now** if the plan is not sanctioned (not what the company or its directors could have done in the past)?[1]

Phrase **"any worse off"** is a broad concept which encompasses **the impact of the restructuring plan on all incidents of the liability** to the creditor concerned, including the timing and the security of any covenant to pay (in addition to being primarily assessed by reference to anticipated returns on their claims)

As it applies to shareholders, it is necessary to take into account all incidents of their rights as shareholders?

Step 2 is **inherently uncertain** and involves the court considering a hypothetical counterfactual that may be subject to contingencies and will be based on assumptions which are themselves uncertain

[1] Referred to in the *Virgin Active* judgment

Exercise of the court's discretion to sanction the plan

The starting point is the approach to sanction adopted in relation to Part 26 schemes but where the case involves the application of the CCCD power, important modifications are required. In particular, the reluctance of a court to depart from the outcome of a properly convened meeting of a class of creditors cannot have the same place. Refer to the judgments in *Virgin Active*[4] and *DeepOcean*[5] for further guidance on how the court will exercise such discretion.

4 *Re Virgin Active Holdings Ltd* [2021] EWHC 1246 (Ch)

5 *Re Deep Ocean 1 UK Ltd* [2021] EWHC 38 (Ch)

Hurricane Energy - Summary

1) Key Terms of the Proposal and Background

Hurricane Energy PLC (**HE**), an AIM-listed company that is part of an oil extraction group, proposed the plan (**HE Plan**), the key terms of which involved the extension of maturity date of the US$230 million unsecured bonds (**Bonds**) from June 2022 to 31 December 2024 and a reduction of US$50 million in capital amount due under the Bonds to US$180 million in exchange for a 95% of diluted equity to be issued to the Bondholders and increase in cash coupon.

If sanctioned, the company expected to undertake an extended wind-down enabling it to continue oil production until early 2024. It also projected that this would allow sufficient cash generation to enable full repayment of the Bonds with a small surplus to generate some value in the equity, although this was expected to be "less than a meaningful return".

Previously, at the convening hearing stage, the company had proposed holding a meeting of a single class of Bondholders to vote on the plan. The court decided that the shareholders' rights were "affected by" the plan and therefore, an additional meeting of shareholders should also be convened. Accordingly, the Bondholders' meeting approved the plan with 100% votes of those attending and shareholders' meeting

2) HE Plan – Key Issues

The critical question in this case was whether the shareholders were out of the money, both in terms of determining whether they would be any worse off under the plan than in the relevant alternative (condition A) and in the exercise of the court's discretion. The court held that condition A for CCCD was not satisfied and in any case, it would not have exercised its discretion to sanction the HE Plan.

CCCD Threshold Conditions

There was no doubt that Condition B was satisfied as the Bondholder class had approved the HE Plan and they would clearly receive a payment in the relevant alternative.

Condition B

There was no doubt that Condition B was satisfied as the Bondholder class had approved the HE Plan and they would clearly receive a payment in the relevant alternative.

Condition A

The court considered the three steps for Condition A.

For **step 1**, if the HE Plan was not sanctioned, it was common ground that, in the short to medium term, the company will most likely continue trading profitably. The relevant alternative did not involve an immediate insolvency process and it was in the best interests of all stakeholders that the company continue producing oil and trading profitably, and was forecast to do so up to and beyond the maturity of the Bonds.

For **step 3**, it was common ground that the HE Plan was not anticipated to provide any "meaningful return" to shareholders and if such return was generated, the current shareholders' interest in it would be limited to 5%.

The real debate was around **step 2** that, in the absence of the HE Plan, would the shareholders be better off (taking into account all the incidents of their rights as shareholders) than having a 5% stake in equity that promised no meaningful return?

The court held that the burden lies on the company proposing the plan and therefore, it cannot be right that the shareholders, as the dissenting class, must identify one strategy (or combinations of strategy) that the company is most likely to adopt nor, in the absence of a legitimate ground for urgency, is it necessary to arrive at a definitive present value for the future income stream.

In contrast to the relevant alternative being an immediate liquidation (where the question is whether the shareholders could expect a meaningful return in the liquidation), in this instance, the analysis was not the same. As the company will continue trading for at least a further year, the resulting outcome for the shareholders will depend in part upon what happens in the intervening period. In such a situation, the possible courses of action open to the company over the next year and beyond should be considered in determining whether there is a realistic possibility that the financial outcome for shareholders will be better than that offered under the HE Plan.

In this regard, the court held that there were two principal areas of uncertainty: (i) quantum of revenue generated from oil production in the future, which itself depended on two variables: (a) rate of oil production and (b) the future price of oil; and (ii) steps that the new board may take to assist in repayment of the Bonds. The court accepted that such steps included a range of possibilities such as repayment of bonds by funding the shortfall either from a third party or by raising money from existing shareholders or via a rights issue, an asset sale, seeking a joint venture partner or buying back the bonds at a discounted price in the market.

Therefore, the court held that it did not need to be satisfied that the most likely outcome from the relevant alternative is that there will be a return to the shareholders at some point in the future but rather the fact that there is “a <u>realistic prospect</u> (based on one, other or a range of the possibilities outlined above, including through refinancing any shortfall) that the Company will be able to discharge its obligations to the Bondholders, <u>leaving assets with at least potential for exploitation</u>, is enough to refute the contention that the shareholders will be no better off under the relevant alternative than under the Plan”.

Urgency

Although the court held the sanction hearing and handed down the judgment on an expedited basis, it found that there were no legitimate grounds for urgency. First, it did not consider that the plan was essential for the purposes of the extension of a bareboat charter (**Charter Extension**) (which was considered urgently necessary for the company to continue extracting oil and trading profitably). Secondly, it held that absent the intervention of a formal insolvency process, the shareholders retained the right to appoint directors and therefore, the imminent replacement of the board or the ad hoc committee of Bondholders’ desire to avoid such replacement was not a legitimate ground for urgency.

Exercise of Discretion

Although it was not necessary for the court to exercise its discretion, it provided *obiter* guidance by summarising the circumstances that pointed against the exercise of its discretion to sanction the plan as follows:

i. The company was profitable and anticipated to remain profitable for at least the next year;

ii. Profitable oil production was likely to be economically viable until early 2024 and there were reasonable grounds to believe that the Charter Extension could be agreed to enable it to do so, and it was in the interests of all stakeholders that this happened;

iii. Despite the projected shortfall between available cash and Bond repayment amount at maturity in July 2022, there was a reasonable possibility that measures could be taken (such as refinancing) to bridge the funding gap;

iv. The question posed by the company (and Bondholders) of whether the company could generate sufficient cash from trading alone to repay the Bonds in full at maturity was too narrow and ignored the possibility of such measures being taken;

v. The plan would remove, immediately and irrevocably, all but a fraction of the current shareholders’ equity in the company;

vi. In considering whether the plan fairly allocated value between the different stakeholders, it was not sufficient to just consider the present value of a future revenue stream from oil production to the exclusion of any potential upside that may be generated from future trading combined with steps that a new board may take to address the repayment of the Bonds in 2022;

vii. The option of continued trading beyond 2022 would be preserved beyond Bonds' maturity date in 2022 such that it was reasonable to believe that a restructuring could be undertaken at a later stage, which reinforced that shareholders should not immediately be deprived of anything other than a de minimis interest in the equity;

viii. The possibility of a different deal was not a relevant alternative – however, the interests of all stakeholders were aligned in ensuring the company continues to produce oil until the point it ceases to be economically viable; and

ix. There was no sufficient ground for urgency, which meant that it was imperative that the Bonds are restructured now. AHC's desire to obtain control of the company was not a good reason to deprive the shareholders now, of all but a fraction of their equity in the company rather than waiting to see if actual performance over the coming months improves the outlook for the shareholders.

Key Contacts

Adam Plainer
Partner
London
+44 20 7184 7555
adam.plainer@dechert.com

Solomon Noh
Partner
London
+44 20 7184 7337
solomon.noh@dechert.com

Kay Morley
Partner
London
+44 20 7184 7556
kay.morley@dechert.com

Alastair Goldrein
Partner
London
+44 20 7184 7456
alastair.goldrein@dechert.com

Tayyibah Arif
Counsel
London
+44 20 7184 7377
tayyibah.arif@dechert.com