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The Adler Restructuring Plan Judgment: Is *Pari Passu* Passé?

24 April 2023

What Happened

On 21 April 2023, Mr Justice Leech gave his written reasons for sanctioning the Adler Group's novel and ground-breaking English restructuring plan[1] following a fully contested hearing and cross-examination of witnesses. It is the most significant decision involving a restructuring plan since *Virgin Active*[2] and was opposed by an *ad hoc* group of holders of 2029 Notes (the "**AHG**"). In a lengthy judgment, the Court provided vital insight into its approach to use of its cross-class cram-down power and the circumstances in which a plan can afford differential treatment to otherwise *pari passu* creditors.

Key Takeaways

The key takeaways from the judgment are:

1. The plan did not violate the *pari passu* principle despite providing for differential treatment to otherwise *pari passu* creditors. One of the AHG's arguments was that the plan – which they termed a "liquidation plan" – infringed the *pari passu* principle because it maintained the time subordination of the 2029 Notes and further subordinated it with new money. Crucially however, Leech J found that it was likely creditors would be paid in full under the plan (based on the evidence presented to the Court) and differential treatment in such circumstances was therefore justifiable.

2. Although the holders of the 2029 Notes were subject to additional credit risk under the sanctioned plan relative to other creditors, this was not unfair for the following reasons:

    a. the 2029 Noteholders had, when they acquired the 2029 Notes, already accepted that their instruments would be time subordinated;

    b. if the plan is not successful (ie. because the AHG's valuation was correct) Noteholders (including the holders in the AHG) will be able to accelerate their Notes and the governing intercreditor agreement would provide for *pari passu* recovery;

    c. based on the evidence presented, the Group would need to realise c. £500m less than what was forecast before a creditor would be worse off under the plan than if the plan was not implemented; and

[1] *Re AGPS Bondco Plc* [2023] EWHC 916 (Ch).

[2] *Re Virgin Active Holdings Ltd and others* [2021] EWHC 1246 (Ch).

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d. even though the AHG (made up of a group of 2029 Noteholders) contested the plan a majority of the holders of the 2029 Notes did in fact support the plan (including those without cross-holdings in the 2024 Notes).

3. Due to the opposition from the AHG, the plan sought to use the cross-class cram-down mechanic to bind in the 2029 Noteholders. When presented with conflicting valuation evidence, the Court made it clear that the onus remains on the plan company to demonstrate that the "*no worse off*" test is satisfied on the balance of probabilities. This is consistent with the approach taken in the *Virgin Active* restructuring plan.[3] Ultimately the Court preferred the valuation evidence submitted by the Group and approved the use of cross-class cram-down. The Court did note though a number of times that the valuation and financial analysis undertaken by the relevant experts was inherently uncertain.

4. The Group's use of the *Issuer Substitution Strategy* to engage the jurisdiction of the UK Restructuring plan was valid.

5. Although the plan was sanctioned, Leech J expressed the *greatest concern* in relation to shareholders retaining 77.5% of the equity in the Group without having to advance any additional funds. Ultimately he concluded that the retention of equity was justified, including because those most affected by it – the new money providers – had negotiated their 22.5% participation and had acted in a commercially rational way.

The appeal process is ongoing.

Background

Adler Group S.A. is the main holding company of a German real estate conglomerate. It is focused on providing affordable residential housing. Its portfolio is estimated to be worth around €8bn. In recent years it encountered a number of destabilising events. These have been well publicised and include:

- ratings downgrades;
- regulatory investigations;
- accusations of related party transactions;
- adverse short-seller reports; and
- bondholder activism.

The Adler Group had significant financial debts with maturities in 2024, 2025, January 2026, November 2026, 2027 and 2029, with each series of bonds governed by German law. A subsidiary in the Group, Adler Real Estate AG, has a note maturity date on 27 April 2023 (the "**2023 RE Notes**"). This maturity wall was the principal reason cited by the Group for the urgency of the restructuring plan and truncated court timetable.

[3] *Re Virgin Active Holdings Ltd and others* [2021] EWHC 1246 (Ch).

This confluence of factors led to the Group pursuing a comprehensive financial restructuring. After it failed to obtain the required creditor support to implement the restructuring contractually out of court, it opted to launch a restructuring plan under Part 26A of the Companies Act 2006 despite there being no obvious nexus with England and in preference to other European restructuring procedures, such as the newly enacted German *StaRUG* or the Dutch *Wet Homologatie Onderhands Akkoord*.

The Group engaged the jurisdiction of the UK Restructuring Plan through the *Issuer Substitution* strategy. This is a relatively well-trodden path accepted by the English courts in restructuring plans and schemes of arrangement. In brief, it involves incorporating an English incorporated company. English NewCo then assumes the group's debt. The English Newco then launches the restructuring plan – in this case, that English Newco was AGPS Bondco Plc. This *Issuer Substitution* and its validity as a matter of German law was one of the points disputed by the AHG (although the Court disagreed and accepted it was valid).

What Did the Restructuring Plan Involve?

The terms of the restructuring plan are complicated but in summary it proposed that:

- Creditors will advance c.€937.4m of new senior secured debt to repay the debt maturing in relation to the 2023 and 2024 Notes. This new money will be granted super-senior first lien ranking. New money providers will receive 22.5% of the equity in the restructured company.

- The maturity dates for the 2024 Notes will be extended to 31 July 2025. The trade-off for these Noteholders agreeing to push out their maturity was that these Noteholders would be given priority over the other Noteholders under a new intercreditor agreement.

- Other series of Notes will:
  - be reinstated at their original contractual maturity;
  - be amended to permit the refinancing and a switch to PIK interest, with an improved coupon; and
  - receive new subordinated security.

- A cash interest payment holiday will be applied to all of the Notes, with interest capitalised until 31 July 2025.

- Shareholders will retain their equity interests subject to dilution by the shares issued to new money providers.

It was common ground that the relevant alternative was a liquidation of the Group. The plan was characterised by the AHG as a "liquidation plan", essentially facilitating a solvent wind-down of the Group. They argued that the Court would be discarding the pari passu principle – a fundamental tenet of corporate insolvency law – if it sanctioned such an extra-judicial liquidation that provided differential treatment equivalent to unfair prejudice under the horizontal fairness test in a company voluntary arrangement challenge.

The Convening Hearing

For readers not familiar with the English restructuring plan it involves two court hearings. Firstly, the convening hearing, and then the sanction hearing. The convening hearing is something of a "gateway step", in which the Court will consider the following:

- whether it has jurisdiction to hear the plan;
- the proposed terms of the plan;
- whether creditor classes are properly formed; and
- the company's eligibility to use the restructuring plan.

At the convening hearing,[4] Mann J was satisfied that the plan could proceed and ordered that meetings be convened for the six classes of creditors (one for each series of Notes). Separate creditor classes were formed for each series of Notes. However, there were certain matters that would usually have been dealt with at the convening hearing that instead were deferred to the sanction hearing. In particular, the AHG disputed the validity of the *Issuer Substitution*, as explained by Mann J in his reasons approving the convening of creditor meetings:

> *This presupposes, for present purposes, that the substitution has been effective. It has been agreed between the parties before me (the company, the steering committee, and the AHG) that bearing in mind the urgency of the matter and the lack of time to deal with it at this stage it is appropriate to put that issue off until the sanction hearing even though it would normally be appropriate to deal with it at this convening hearing. I agree with that decision. The AHG would also apparently wish to take the point that even if the substitution was valid as a matter of German law, what has happened in this case, in which an English company has been incorporated specifically for present purposes and to receive the substitution for the purpose of being able to apply under the Act, is a technique which should not be supported by the English courts, which should not allow the jurisdiction to be exercising these sort of circumstances.*

The other key issue Mann J had to grapple with was the proposed timetable put forth by the Group. The Court noted that *there is an urgency about this matter which requires a very tight timetable.* This was due to the upcoming maturity of the 2023 RE Notes on 27 April 2023 and the need to apply the new money being made available in the plan to this commitment. Ultimately the Group's proposed timetable was endorsed, despite it being acknowledged that the matter involved very substantial issues around German law, Luxembourg law, and extensive valuation evidence. Highlighting the tension present in these matters, Mann J observed:

> *This debate reflects the sort of tensions that will often arise in cases under the new Part 26A regime. On the one hand there will usually be an applicant presenting a case of urgency because that is of the nature of these applications, where a company is facing insolvency, that they are urgent. Delay may well often frustrate the purpose of the scheme, so it has to be got on relatively quickly. On the other hand, the presentation of opposition to the scheme, where it is opposed, will require the presentation, consideration and meeting of evidence which can be quite complex, and this case is*

[4] *Re AGPS Bondco Plc* [2023] EWHC 415 (Ch).

certainly a manifestation of that. The complexity is magnified where matters normally dealt with at a convening application are put off to be dealt with, along with a catalogue of other matters, at the sanction hearing. In these circumstances the court has to strike a balance between the urgency of the company's case and fairness to the opposing creditors in the presentation of theirs. There will often have to be a tight timetable, but it must not be so tight as to operate unfairly as against those who oppose the scheme, particularly bearing in mind the complexity of the evidence with which they might have to deal. Opposing creditors have a legitimate interest in not being required to advance their case with unfair speed.

The Sanction Hearing

The AHG mounted a vigorous opposition to the plan in what amounted to a "mini trial" involving voluminous evidence and cross-examination of key experts and witnesses.

We have set out below the key issues considered at the hearing.

Cross-Class Cram-Down

To recap, a key feature of the UK restructuring plan is the ability to access the Court's "cross-class cram-down" power under section 901G of the Companies Act 2006. This allows a restructuring plan to be imposed on a dissenting class of creditors if the following conditions are met:

- Condition A – or the *No Worse Off* test: the dissenting class would not be any worse off than they would be in the event of the relevant alternative (being whatever the Court considers would be most likely to occur in relation to the company if the plans were not sanctioned).

- Condition B - the *Genuine Economic Interest* test: the plan has been agreed by 75% in value of a class of creditors who would receive a payment, or have a genuine economic interest in the company, in the event of the relevant alternative.

The 2029 Noteholder class did not meet the required 75% approval threshold (although a majority - c. 62% - did vote in favour of the plan). This meant the Group needed to use the cross-class cram-down power to impose the terms of the restructuring plan on these Noteholders.

In addition to the statutory conditions, Snowden J in *Virgin Active* held that the Court had an additional question to answer at the sanction hearing, namely whether, in all the circumstances, to exercise its discretion to sanction the plan. In this case, the principal issue between the parties was whether Condition A – the *No Worse Off* test was satisfied and if it was, whether the Court ought to exercise its discretion to sanction the plan. There was no dispute that Condition B was satisfied. It was also accepted that the relevant alternative, if the plan was not sanctioned, would be an insolvency of the Group. In considering whether Condition A was satisfied, Leech J referred to the following guidance given by Snowden J in *Virgin Active*:

1. What would be most likely to occur in relation to the company if the plan was not sanctioned? In considering this the Court is not required to satisfy itself that a particular alternative would definitely occur. The Court is only required to select the alternative that is "most likely" to occur.

2. What would be the outcome or consequences for dissenting classes if the plan was not sanctioned?

3. The outcome for the dissenting classes if the plan was not sanctioned should then be compared to the outcomes if the plan is sanctioned.[5]

The judgment considers in depth the relevant legal principles and includes extensive analysis of the valuation evidence put forward by the parties. In line with the guidance given in *Virgin Active,* the Court found that on the balance of probabilities the Group is more likely to realise the sums put forward by the Group's valuation evidence than what was presented by the AHG. Leech J did recognise that the evidence, which centred around future forecasts of property prices in the German real estate market, was inherently uncertain. However, he also cited with approval Trower J's statements in *Deep Ocean*[6] that "*where the evidence appears on its face to reflect a rational and considered view of the Company's board, the court will require sufficient reason for doubting that evidence*". Leech J also accepted that it will be ambitious for the Group to pay the 2029 Noteholders in full. Those matters aside, Leech J stressed that it is not necessary for the Court to be satisfied that under the plan the 2029 Noteholders will be paid in full, only that they will be better off under the plan.

Did the plan depart from the pari passu principle?

The *pari passu* rule is a fundamental principle of English insolvency law and, as a matter of public policy, generally cannot be deviated from. It provides that all unsecured creditors must share equally any available assets of the company in proportion to the debts due to each creditor.

The AHG argued that the plan, if sanctioned, would violate this sacred principle, and that it was therefore inherently unfair. Accordingly, on their case the plan could not be sanctioned. Their argument focused on the fact that the plan preserved the existing maturity dates of the Notes (with the exception of the 2024 Notes, which were extended by a year). The AHG argued that if the plan were sanctioned, as holders of the latest maturing series of notes they would rank last in payment (due to their temporal subordination) and be further subordinated due to the c. €937.5m new money being injected and interest accrual on the other reinstated notes. By contrast, in a formal liquidation all of the senior unsecured Notes would rank *pari passu*. The AHG argued that the courts have only departed from the *pari passu* principle where it was necessary to rescue the company as a going concern and that this was not the case here as the plan was effectively a liquidation.

In response, the Group argued that the existing maturity dates (apart from the 2024 Notes) should be preserved, citing the fact that (i) the existing maturity dates reflect commercial reality, in that creditors accepted Notes with different maturity dates which carried a greater commercial risk (and such risk was no doubt reflected in the prices paid and coupon offered); and (ii) the plan is supported by creditors with later-dated Notes, in particular including creditors that hold the 2029 Notes without any cross-holdings of the 2024 Notes.

It was held that the plan did not depart from the *pari passu* principle despite preserving the existing maturity dates. Leech J based his conclusion on his finding of fact on the valuation evidence that if the plan is implemented it is likely that creditors will be paid in full. That being the case, there was no infringement of the principle. However, if the evidence of the AHG had been

[5] *Re Virgin Active Holdings Ltd* [2021] EWHC 1246 (Ch) per Snowden J at 106 to 108.

[6] *Re Deep Ocean 1 UK Ltd* [2021] EWHC 138 (Ch).

accepted, and the most likely outcome was a significant shortfall, then the Court may have found that this was unfair and refused to sanction the plan. Ultimately Leech J accepted the evidence put forward by the Group. We note that in reaching this conclusion Leech J was again careful to acknowledge the uncertainty around his findings on valuation:

> *I readily accept that the exercise in which all of the valuation and financial experts were engaged was inherently uncertain…I also accept that I do not have a crystal ball and that I cannot be certain that the 2029 Plan Creditors will be paid in full or even that they will recover on a pari passu basis if the Plan Company defaults.*

In sanctioning the plan, Leech J also noted the following:

1. In maintaining the time subordination of the various Notes (other than the 2024s), the plan reflects the commercial risks which the 2029 Noteholders assumed when they purchased the 2029 Notes and the plan did not involve a significant change to those risks.

2. If the plan fails the Notes will be accelerated. In this scenario the AHG (and other 2029 Noteholders) will recover more than if the Group enters an insolvency process.

3. Even if the Group's valuation evidence is wrong it will not miss the relevant alternative "by much". The Group would have to realise c.£500m less than was forecast before it is in danger of producing a worse outcome than it would be if it entered insolvency now.

4. It was submitted by the Group that if the plan is successful everyone will be better off. This is reflected by the support from creditors who ultimately are the best judges. As such management of the Group ought to be given the opportunity to implement the plan.

5. A majority of the 2029 Noteholders did approve the plan and weight ought to be given to their views.

6. The plan in these terms was the only plan that commended a significant measure of agreement between the Group and its creditors. Indeed, the plan was the product of detailed and lengthy negotiations between stakeholders. Leech J did note though that this on its own was a weak reason to sanction the plan.

Other fairness issues

The Court also considered other fairness issues:

Overall support

Unlike in a part 26 Scheme of Arrangement, while overall creditor support was a factor to be taken into account, the Court accepted the AHG's argument that it is less relevant in a case of exercise of the cross-class cram-down power.

Fair distribution of benefits

It was not the Court's role to determine whether the plan was the best available or whether there was a fairer one. This was consistent with the approach taken in *Re Amicus Finance plc*. [7]

Court could interfere with the existing priority as between creditors

Citing with approval Zacaroli J's analysis of the fairness of stripping HMRC of its statutory priority in the *Houst* restructuring plan,[8] the Court was content there was precedent for changing the payment priority where the Court was faced with a binary decision to sanction or not sanction the plan in circumstances where that plan provided a better result for all creditors (including those whose priority was being changed) and that party was a sophisticated counterparty who had full notice of the plan.

Cross-holdings

Many of the creditors who held 2029 Notes also held other Notes in other classes, including members of the plan-supporting Steerco. The Court considered the extent to which those creditors who only held 2029 Notes had supported the plan (of which there was evidence) and applied the "special interest" test laid out by Hildyard J in *Lehman Brothers International (Europe)*[9] namely, whether the majority had a "special interest" different from and adverse to the interests of other creditors. For a special interest to undermine the representative nature of a vote the Court must be satisfied not only that the special interest was adverse to the interest of the whole, but that it was also the predominant motivation for the creditor voting as it did, and that there was a strong causative link between the special interests and the creditor's decision to support the restructuring.

Jurisdiction and invalid issuer substitution

As addressed above, despite being a German business and having German law governed debt, the Group availed itself of the favourable jurisdictional entry requirements to use a Restructuring Plan in England to implement their financial restructuring. The Group created the necessary jurisdictional nexus through the "Issuer Substitution Strategy" explained above. The AHG argued that this substitution was not valid, arguing that it was not permitted under German law. However, the Court found that the issuer substitution was valid and effective and that the Court had jurisdiction to sanction the plan. This is consistent with the Court's previous approach on these matters.

[7] [2022] Bus LR 86.

[8] [2022] EWHC 1941 (Ch).

[9] [2019] BCC 115.

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