

RECENT ENGLISH HIGH COURT DECISION HIGHLIGHTS SUBORDINATED LENDER RISKS IN ENGLISH RESTRUCTURINGS

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To Our Clients and Friends:

A recent English High Court decision has underlined the weak position of many subordinated lenders in English financial restructurings. In the IMO Car Wash decision, the English court upheld a restructuring plan that had not been approved by subordinated creditors on the basis that subordinated creditors may be excluded from the plan if the senior debt exceeds the value of the company as a going concern. Although the decision does not provide specific guidance as to the appropriate method for determining the value of a company, it demonstrates that in the current market, subordinated lenders may need to engage in valuation fights to receive any recovery in English restructurings, particularly those of highly-leveraged companies with complex capital structures, and provides some lessons as to the use of expert valuation evidence.

Under English law, a company facing insolvency may use a scheme of arrangement to effect a restructuring plan that binds its creditors. If a scheme of arrangement is approved by a majority in number who represent at least 75% in value of the creditors (or of each class of creditors, if relevant) who vote at the meeting to approve the scheme, the scheme then binds all of the parties to the scheme. The company has discretion to determine who will be a party to a proposed scheme, so long as all creditors whose rights will be altered by the proposed scheme are included. Accordingly, English courts have held that a company may exclude creditors if their rights will not be altered by the scheme, either because those rights are left untouched or because the excluded creditors lack an economic interest in the company.

In the IMO Car Wash case, the mezzanine lenders argued that the proposed scheme approved by the senior lenders was unfair because it gave the mezzanine lenders no interest in the restructured company, despite the value of the company's assets being, in their view, greater than the value of the senior debt. In arriving at his decision, the judge accepted the senior lenders' lower valuation of the company on a going concern basis, finding that the mezzanine lenders' higher valuation was based on a statistical analysis of possible outcomes rather than a true estimate of the probable value of the company. He thus held that the holders of IMO's mezzanine debt had no economic interest in the company and no right to object to the proposed scheme of arrangement. He also emphasized that in the scheme the

senior lenders would effectively receive what they were entitled to under the intercreditor agreement agreed between the parties.

In his decision, the judge showed an understanding of business valuation methodologies, but concluded the mezzanine lenders had failed to present a credible alternative valuation. Some lessons as to the use of expert valuation evidence can be drawn from the judgment. First, the mezzanine lenders do not appear to have retained independent valuation experts at the negotiation stage, weakening their basis for challenging the senior lenders' position in the early stages. Second, while the experts for the senior lenders had engaged in several valuation exercises, the mezzanine lenders limited themselves to a single statistical model (the Monte Carlo method), which the judge found incomplete and unpersuasive. Finally, the judge had evident concerns as to the quality and credibility of the mezzanine lenders' report and its supporting materials. In sum, although the judgment might have been more instructive as to valuation methods had the gulf between the competing reports not been so wide, it provides a reminder of the importance of thorough and convincingly-reasoned independent valuation evidence.

The decision, which was widely anticipated, follows several recent controversial pre-packaged English administrations in which mezzanine lenders found themselves similarly effectively excluded from bankruptcy procedures because in the current market environment a distressed company's value can often be shown to break at the senior debt level. If market conditions improve, subordinated debt holders may be able to counter this trend by demonstrating that they continue to have a genuine economic interest in the company, if properly and thoroughly valued. The current difficulties for subordinated creditors, however, may chill mezzanine lending in the U.K. after the credit markets otherwise begin to thaw.

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