Re Houst Limited – SME restructuring plan and cross-class cram down of HMRC

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Case: Re Houst Limited [2022] EWHC 1941 (Ch), Zacaroli J, 22 July 2022

Synopsis: This is the first time the cross-class cram down powers under Part 26A Companies Act have been applied in respect of a dissenting HMRC. An additional feature of the plan was the fact that the priority amongst the creditor classes applicable in the relevant alternative was not reflected in the distributions under the plan (a feature that the court noted would be fatal to a Chapter 11 plan due to non-compliance with the 'absolute priority rule'). The court sanctioned the plan notwithstanding, noting several factors, including in particular the lack of active opposition at the hearing from HMRC (a 'sophisticated creditor'), the proposed capital injection by shareholders (unavailable in the relevant alternative, being a pre-pack administration), the secured creditor's write off of approximately 75% of its claim – thereby enabling the company to continue trading so as to generate more funds to all creditors than available in the relative alternative – as well as unopposed evidence that all creditors would have been worse off in the relevant alternative. The court concluded that the plan presented a fair distribution of the restructuring surplus. This case is also one of the few examples of the use of the restructuring plan in respect of a small to medium sized enterprise (an 'SME') and the first outside of administration. This case is a stark reminder that active participation in the court hearings is important to influencing the court's discretion.

Topics covered: **Restructuring plans, cross-class cram down, HMRC, crown preference, schemes of arrangement, restructuring surplus, order of priority**

Comment

The court's sanction of the restructuring plan resulted in cramming down HMRC's claim, effectively thwarting the Crown preference. Had the plan been proposed pursuant to a scheme of arrangement under Part 26 Companies Act, HMRC could have blocked the entire restructuring proposal, proving again, the power of the cross class cramdown power. Similarly, the restructuring would not have been possible under a CVA as, amongst other things, the provisions of s4(4) IA 1986 prevent the approval of any CVA under which a preferential creditor is treated otherwise than in accordance with the statutory order of priority.

HMRC voted against the plan, expressly on the basis of its policy not to agree to a compromise of its preferential status in any circumstance.

The court gave short shrift to any suggestion that Crown preference should sway its approach to its discretion, commenting on the fact that the evidence showed conclusively that all creditors would be worse off in the relevant alternative and that HMRC (a sophisticated creditor) had not offered evidence to the contrary nor attended either of the hearings. The court found a distinction between voting against a plan and active opposition at the sanction hearing. In this regard, the case indicates that creditors that wish to veto a Part 26A proposal should actively attend hearings and submit evidence in opposition.

In considering whether to exercise his discretion, Zacaroli J also raised a question as to whether it would have been appropriate for the company to start over with a fresh plan proposal and seek to negotiate with HMRC. The court found that, as an SME, the costs and delay would impose a disproportionate burden on the company. Combining this with HMRC not showing any willingness to negotiate, the judge observed that nothing may be gained if required to start again, and in all likelihood, the company would go into administration. Thus, the court adopted a nuanced approach to its discretion, sensitive to the facts of the case.

When deliberating on whether the restructuring surplus distribution was fair, despite there being no absolute priority rule under Part 26A, the court took into account the order of priority in the relevant alternative. The case shows that a deviation from the usual order of priority in insolvency can be justified with good reason.

This case is significant in that it is the first Part 26A restructuring plan to be sanctioned for an SME outside of administration. As identified in the Interim Report on the CIGA 2020, the cost of restructuring plans were perceived as a barrier to use of the procedure with respect to SME's. This case shows that restructuring plans in respect of SMEs are viable in appropriate circumstances. Practitioners may therefore see an increase in SME's using Part 26A restructuring plans now Houst proved that an efficacious outcome is in reach.

The Facts

Houst provides property management services for short-term/holiday lets. It lists properties on websites such as Airbnb and manages logistics and bookings, earning its revenue from a share of the amounts paid by customers when booking the properties. The nature of Houst's business means it had been severely affected by the Covid-19 pandemic, resulting in the company becoming both balance sheet and cash flow insolvent. Three of its creditors presented statutory demands and threatened winding up petitions.

Six class meetings were accepted by the court at the convening hearing. The classes consisted of i) Clydesdale Bank as secured creditor ii) HMRC as preferential creditor iii) trade creditors iv) loan holders v) a connected creditor and vi) shareholders.

At the sanction hearing, the court accepted Houst's submission that, should the restructuring plan fail, the relevant alternative was a pre-pack administration (in which case, only two creditors would obtain recovery – Clydesdale Bank and HMRC).

The restructuring plan put forward to the court included:

• A dividend to be paid over time to Clydesdale Bank, HMRC and trade creditors to reduce the company's debt.

• A capital injection by existing shareholders in return for the issue of new shares which would lead to a dilution of existing shares to 5% of existing equity.

• Loan note holders to be given the option to convert their debt into equity or to participate in the dividend to unsecured creditors.

The order of priority under the plan differed from the order in the relevant alternative, resulting in Clydesdale receiving a significant uplift on its dividend (27p/£ vs 7p/£), HMRC receiving an improved dividend at a smaller proportion (20p/£ vs 15p/£) and other unsecured creditors, with no recovery in the relevant alternative, receiving a dividend of 5p/£. HMRC was the only class to reject the plan at the plan meetings and did so on the basis that the plan did not fully reflect their preferential creditor status. Given the reinstatement of HMRC as secondary preferential creditor in 2020, HMRC maintained that under no circumstances would they relinquish this position to provide a dividend to unsecured creditors. In light of this, a cram down of the tax authority was necessary to sanction the plan.

To cram down a dissenting class, the court must consider Condition A and Condition B under s901G CA 2006 and its general discretion. Condition A asks: if the plan was sanctioned, would any members of the dissenting class be any worse off than they would be in the relevant alternative? The court was satisfied HMRC would be no worse off based on the valuation evidence that HMRC would receive 5p/£ more under the plan.

Condition B requires that the plan is approved by 75% of those voting in any class with a genuine economic interest (i.e. that would receive a payment) in the relevant alternative. This was satisfied as Clydesdale Bank, in a class of its own and the only class with a genuine economic interest in a pre-pack administration, had voted in favour. Whilst the court observed that "*attempts artificially to create an in-the-money class for the purposes of providing the anchor to activate the cross-class cram down power should be resisted*", it did not consider that was the case here. Amongst other things, the bank was undoubtedly substantially impaired under the plan and, although it was known to be supportive, it had not signed a lock-up agreement and could have withdrawn its support at any point.

The Explanatory Notes to the statute provide that the court has an absolute discretion over whether to sanction a plan even if the procedural requirements have been met. An example provided is that the court may refuse a plan on the basis that it is not just and equitable. The court in this case chose to exercise discretion similar to that of a scheme of arrangement with some modifications to account for differences between the regimes. The crucial question is whether the plan provides a fair distribution of the restructuring surplus between the classes that have approved and those that have not in reference to the order of priority in the relevant alternative.

Decision

The court sanctioned the plan and applied a cross-class cram down on the balance of interests.

As this case presented a clear departure from the order of priority in the relevant alternative, Zacaroli J took into account that the better treatment of critical creditors was necessary for the company to continue trading, which ultimately resulted in an enhanced dividend for all – including HMRC. The judge also noted that this is not a case where assets that would have been available in the relevant alternative are to be distributed in a manner inconsistent with the order of priority. The value generated was to come from the capital injection of members (and creditors were relinquishing their debt) which would have been unavailable in the pre-pack administration.

While it was acknowledged that HMRC's entitlements are impaired, the tax authority was to receive more than in the alternative and the court noted it had not sought to negotiate with the company or actively oppose the plan. In any event, the court found that, as a 'sophisticated creditor', HMRC is able to look after its own interests. It was also key that the evidence showed that all creditors would be worse off if the court refused to sanction the plan.

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