When to trust the creditors?

The protection of minorities in restructuring procedures

A lecture delivered by Mr Justice Zacaroli at the 5th International and Comparative Insolvency Law Symposium at Royal Holloway, University of London, on 26th April 2024

1. Democracy, as Winston Churchill once said, is the worst form of government, apart from all those other forms that have been tried from time to time. From the Greek words "demos" (meaning people) and "kratos" (meaning rule), it gives, in the words of John Lennon, power to the people, i.e. in theory, power to all those affected by decisions made by the governing class.
2. It is generally speaking an anathema to our legal process. We require our courts to reach decisions, not merely in order to decide what the law is on a particular topic, or in order to resolve disputes of fact, but also in exercising a broad range of discretions, where the judge is required to take account of – and balance against each other – a range of different interests so as to reach a conclusion as to what she or he believes is in the best interests of all.
3. To this, however, there has long been an important exception. When it comes to determining the fate of a bankrupt individual or insolvent company, the decision rests – to some extent at least – with those who are most directly affected by it: the creditors. Most obviously, this is the case where the insolvent debtor (or one or more of its creditors) proposes some form of scheme of compromise or arrangement so as to avoid the full rigours of bankruptcy.
4. I will start with a brief statutory history of the provisions in this jurisdiction which have vested power in an insolvent debtor's creditors. Prior to 1825, it had long been possible for an individual debtor to escape from a bankruptcy, by reaching an agreement to assign his assets to a trustee in consideration of the creditors agreeing to compromise their debts.
5. This required, however, agreement among all the creditors. The 1825 Bankruptcy included a provision which enabled a compromise to be reached between a bankrupt and his creditors if agreement was reached with 75% of them by value:

> "Every Deed or Instrument made or entered into between a Debtor and his Creditors, or any of them … relating to the Debts or Liabilities of the Debtor … shall be as valid and effectual and binding on all the Creditors [provided that] …a majority in number representing three fourths in value of the creditors of such Debtor whose Debts shall respectively amount to Ten Pounds and upwards shall, before or after the Execution thereof by the Debtor, in Writing assent to or approve of such Deed or Instrument."

6. This introduced for the first time the concept of a majority of the creditors binding the minority, even where the minority had not participated in the process, or had voted against the compromise.

7. Upon the invention and statutory recognition of the company as a separate personality, the s.136 of the Companies Act of 1862 adopted this concept of majority rule in devising the scheme of arrangement:

> "Any Arrangement entered into between a Company about to be wound up voluntarily, or in the course of being wound up voluntarily, and its Creditors, shall be binding on the Company if sanctioned by an Extraordinary Resolution, and on the Creditors if acceded to by Three Fourths in Number and Value of the Creditors, subject to such Right of Appeal as is herein-after mentioned."

8. It remains an astonishing feat of the common law that, despite the enormous development in the world of corporate finance since 1862, including the changes in the way interests are held in a company via myriad forms of debt and equity instruments, and the way the beneficial interest in them is held and traded, the whole of the law of restructuring rests on a few lines in a statute first contained in the 1862 Act.

9. In 1870 – there was an important innovation: the potential for dividing creditors into classes, s.2 of which provided as follows:

> "Where any compromise or arrangement shall be proposed between a company which is in the course of being wound up … and the creditors of such company, or any class of such creditors, it shall be lawful for the Court … to order that a meeting of such creditors or class of creditors shall be summoned … and if a majority in number representing three fourths in value of such creditors or class of creditors present … at such meeting shall agree to any arrangement or compromise, such arrangement or compromise shall, if sanctioned by an order of the Court, be binding on all such creditors or class of creditors, as the case may be…"

10. This was a significant change to the position in bankruptcy, where compositions and arrangements applied to the unsecured creditors as a whole without distinction. As we will see, this remains true today. In the bankruptcy context (by which we mean the insolvency of individuals as opposed to corporations) there has never been the possibility of dividing creditors into separate classes. This likely reflects the fact that the financial affairs of individuals have tended to be much simpler than those of corporations.

11. The scheme of arrangement in relation to companies has, in contrast, always permitted – indeed required – creditors to be placed into separate classes. And it is only if each of those classes votes to approve the scheme by the requisite majority (75% by value and more than half in number) that the court has jurisdiction to sanction the scheme.

12. The next big innovation did not arrive for another hundred years, in the insolvency legislation of 1985 and1986. This introduced the voluntary arrangement. The ancestor of this is clearly the 19th century bankruptcy arrangements, not the scheme of arrangement – albeit that they apply both to individuals and to companies.

13. "Voluntary arrangement" is defined as the proposal made by the debtor to "its creditors for a composition in satisfaction of its debts or a scheme of arrangement of its affairs". Accordingly, the legislation provides for a single arrangement between the debtor and all of its creditors, with no possibility of division into classes. The requisite majority for approval by creditors is set at the same 75% by value, as in the other regimes.

14. Another major distinction from the scheme of arrangement is that there is no substantive court involvement in the creation of a voluntary arrangement. This is an area where – in the first instance – trust is undoubtedly placed in the creditors. Instead, creditors are permitted to challenge a voluntary arrangement, after it has been approved by the requisite majority, if it can be shown that there was a material irregularity in its formation, or that it is unfairly prejudicial to a creditor or creditors.

15. Finally, and most recently, the Corporate Insolvency and Governance Act 2020 introduced a variation on the scheme of arrangement, which we have come to call the restructuring plan. The ancestor of this is definitely the scheme of arrangement. It includes the same basic provisions as to classes, and the ability of the majority by value within a class to bind the whole class (albeit that the requirement for more than half by number has been dropped).

16. The big innovation, however, is the ability of the court – when asked to sanction the scheme – to override one or more of the classes that did not approve the plan by the requisite majority (or even opposed it) – the "cross-class cram-down power."

17. To revert to the comparison with national governance for a moment, all of these arrangements have an important feature in common with the most direct form of democracy, the referendum. They each involve – usually at least – a binary decision: to vote for or against the proposal. In the national sphere this carries with it two particular features, some would say disadvantages. First, although the resolution proposed may be binary, the reasons for voting for or against it might be many and varied. But there is no control mechanism for imposing any value judgment on the quality of votes, for example by discounting those that may have been motivated by particular self-interest. Second, and relatedly, once the majority has prevailed, the outcome entirely discounts the views of the minority, however small was the majority in favour of the decision. There is no middle ground which might give some weight to the views of the minority.

18. The second feature has – until recently at least – been reflected in the insolvency field. The choice has been between approving the arrangement proposed by the debtor or rejecting it. And, if approved by the requisite majority, it binds everyone. I will return to this aspect briefly at the end when I discuss restructuring plans.

19. The first feature is one which, on the national stage, is very difficult to combat (even if it is something that it is thought needs combating). People invariably vote in their self-interest. And their self-interests vary enormously. It is one which in the insolvency field, however, the courts have – from the earliest days – sought to develop principles to counterbalance, imposing important checks and balances on the ability of the majority to bind the minority.

20. It is the circumstances when the court will not simply "trust the creditors" that I will explore in this talk.

21. First – why is it that this a question upon which the court is prepared to trust creditors at all, rather than imposing its own view? The answer to this is relatively simple. The decision for a creditor to accept a compromise of its debt, and on what terms, is at heart a commercial one, based on factor such as: the creditor's perception of the debtor's ability to pay, whether now or at some time in the future; how much it values payment of all that it can get, now, over the prospect of waiting but perhaps obtaining more; how much it might be tempted to forego part of its debt in exchange for a share of equity, so as to benefit from any ultimate upside generated by the debtor being saved from bankruptcy; and how benevolent it might feel towards the debtor's predicament.

22. These are matters on which a court is not well suited to opine. The point was elegantly made by in an early case involving an insolvent individual, *Re Cowen* (1867) LR 2 Ch

App 563, a case decided under the Bankruptcy Act 1861. I will come back to this case as an illustration of other points, but the bare facts were as follows. William Foster obtained a judgment against David Cowen. After the judgment was obtained, but before it became enforceable, Cowen entered into a deed of compromise with others of his creditors, amounting to more than 75% by value of all his debts. By s.192 of the Bankruptcy Act 1861, that deed was binding on all creditors. The evidence showed that the debtor's assets were insufficient, once the judgment debt was taken into account, to pay all creditors in full. All creditors were entitled, under the deed, to recover the same pro rata proportion of their debts. But alarm bells were set ringing by the amount of the distribution. Each creditor would get 2 shillings 6 pence in the pound, whereas the debtor's assets were sufficient to pay substantially more. The court was urged to conclude that a deed could only bind the minority if it was reasonable, and it was manifestly not reasonable to pay such a small dividend when the assets could bear a much larger one. The court declined to do so. Turner LJ explained why: how could a court of justice determine what was reasonable for creditors to accept, under all the varied circumstances of arrangements between debtors and their creditors? The court would not, therefore, weigh the extreme niceties of the arrangement, or the probability that the estate of the debtor may be able to pay more than the composition agreed upon.

23. Nevertheless, the court was prepared to assume for itself a vital role – in relation to any arrangement where the majority had the power to bind the minority. Lord Cairns put the point succinctly in *Re Cowen*:

> "The position of the majority of the creditors is a very strong one; that of the minority is very weak, and requires to be carefully guarded by the Court."

24. The first – and most obvious – way in which the court will not trust the majority is if the vote has been achieved through a fraud on the creditors. The classic such fraud was an agreement between the debtor and one of its creditors to provide that creditor with an additional advantage, in order to induce it to approve the deed.

25. That had long been outlawed, even before the power of the majority to bind the minority was introduced. In *Cockshott v Bennett* (1788) 2 Term Rep 763, 100 ER 411, for example, all of the debtor's creditors agreed to enter into a deed accepting 11 shillings in the pound. One of the creditors, however, insisted on receiving a promissory note for the remaining 9 shillings in the pound. That promissory note was kept secret from the other creditors. When the creditor came to sue on the promissory note, the court held it was void. The rationale was as follows. All creditors, gathered for the purpose of arranging

the debtors' affairs, had mutually agreed with the debtor and with each other that the debtor should be released from his debts on the assignment of his assets and acceptance of a lesser sum by all creditors. It was regarded as an essential premise of their agreement to accept a lesser sum that all were in the same boat. The secret deal by the plaintiff, therefore, was a fraud on the creditors.

26. In that case, the consequence was simply to deprive the plaintiff of the additional bargain which it had negotiated for itself. The same principle was later used to undermine the binding effect of a compromise approved by the requisite majority under later bankruptcy legislation. The consent of the majority was vitiated if motivated by such a secret side deal, so that a minority creditor was not bound by the compromise.

27. This was not, however, the only principle in play. The reason that a secret side deal was such a fraud on creditors that it would vitiate the compromise altogether, is that it took place in the context of bankruptcy, and bankruptcy was founded upon the essential premise that all unsecured creditors share rateably in the assets of the debtor.

28. This principle was given voice most eloquently by Malins V.-C. in *McKewan v Sanderson* (1875) LR 20 Eq 65, 72-73. Mr Sanderson was indebted to the London and County Bank for a sum in excess of £7,000. In July 1870 he filed a petition in bankruptcy for a composition of his debts. A meeting of creditors was held on 27 August. Mr Sanderson's proposal was that each creditor would accept 2 shillings 6 pence in the pound. The meeting was attended by a representative of the bank (the largest creditor) who voted against it. The meeting was adjourned to 7 September. In the meantime, Mr Sanderson and his brother met privately with the bank, and persuaded them to accept a guarantee from the brother which would have the effect of limiting the bank's ultimate loss to £2000. In return the bank agreed to forbear from pressing Mr Sanderson into bankruptcy. At the adjourned meeting, the bank not attending, Mr Sanderson's proposal was accepted. In refusing to permit the bank to enforce the guarantee, the Vice Chancellor said:

> "Now I take it to be thoroughly settled, both in Court of Law and Equity, that where there is a bankruptcy, or an arrangement with creditors by composition or insolvency, when insolvency exists as contradistinguished from bankruptcy, it is the duty of all creditors who have once taken part in the proceedings of bankruptcy or composition to stand and share and share alike."

29. Equality was the only principle that could be applied. He hoped that "this will be a lesson to bankers … that where there is once a bankruptcy of a customer, they are not to stipulate

for private advantage to themselves, but must stand with the other creditors and participate equally with them."

30. In light of these and other cases, the principles that emerged from the 19th century bankruptcy cases were summarised in a more recent case *Cadbury Schweppes v Somji* [2000] 1 WLR 615 (CA) as:

> "the fundamental rule that there must be equality between creditors in the distribution of the debtor's assets, and additionally on the equally fundamental rule that there should be complete good faith between the debtor and his creditors, and between the creditors inter se."

31. It is instructive to note, that in virtually all of the cases, the particular vice identified was the lack of good faith – i.e. the fact that one creditor was secretly being preferred in order to obtain their agreement. In one case, however, the lack of equality was itself given as the reason for striking down an arrangement, even though that lack of equality was there on the face of the deed.

32. In *Thompson v Knight* (1866-67) LR 2 Ex 42, the arrangement provided that all creditors would be paid 10s in the pound, payable in instalments. The trustee of the arrangement was given a discretion, however, to pay any creditor whose debt was £20 or less the full amount of their compromise in one go. The court found the arrangement invalid on the simple basis that "it is absolutely essential", that all creditors should be placed on an equal footing.

33. Two clear principles therefore emerging from these cases. First, the court will not trust the majority where its vote was obtained through bad faith – such as a secret inducement – whether the inducement came from the debtor or from a third party. Second, all creditors must be treated equally.

34. To this must be added a third, which comes from the *Re Cowen* case already mentioned. As I have said, in that case there was no question of any secret side deal, or any lack of equality among creditors under the arrangement. The perceived problem was the uncommercial nature of an arrangement which saw creditors receiving a far smaller dividend than the evidence showed the debtor could afford. While that was not – in itself – a reason to undermine the arrangement, it led the court down the path of investigation. Who were these creditors? What motivated them? It transpired that some were related by marriage and others were personal friends of Mr Cowen. Crucially, they each expected that over time their debts would be paid in full, not because there was any agreement to do so, but because of their bonds of family and friendship with the debtor.

35. That was enough, the court held, to mean that the compromise should not be binding on the one truly external creditor, Mr Foster, who had a judgment debt. He was therefore held not to be bound by the compromise, and was permitted to enforce his judgment.

36. The underlying principle is harder to grasp. One of the judges, Turner LJ, introduced a new concept: he considered that the majority vote was not "bona fide for the benefit of all creditors". Lord Cairns considered simply that an arrangement imposed on all creditors by the vote of personal friends who were content, motivated by kindness and generosity, to accept a nominal composition was not entered into in good faith.

37. The concept of a majority voting "in the interests of the class as a whole" reflected a principle derived from partnership and later applied in company cases. For example in *Blisset v Daniel* (1853) 10 Hare 493, the question arose as to the exercise of a power given to a majority of partners to expel one of their number. Page-Wood V-C said it was inserted "…not for the benefit of any particular parties holding two-thirds of the shares, but for the benefit of the whole society and partnership."

38. By 1927, a principle had been articulated that any power of the majority to bind a minority within a class "…must be exercised subject to a general principle, which is applicable to all authorities conferred on majorities of classes enabling them to bind minorities, namely that the power given must be exercised for the purpose of benefitting the class as a whole, and not merely individual members only": see *British America Nickel Corpn Ltd v O'Brien Ltd* [1927] AC 369 (PC) 371, a case concerned with the power of a in majority of debenture holders to modify the terms of the debenture so as to bind the minority.

Schemes of arrangement

39. These principles provide an important underpinning to the scheme of arrangement. Remember that the statutory foundation of this is simple: the creditors are divided into classes, and if a majority in number and 75% by value then court may sanction it so it binds all.

40. First, and most importantly, the essential principle of equal treatment underlay the court's approach to defining the meaning of "class" – a word without any statutory definition.

41. In the famous test propounded by Bowen LJ in *Sovereign Life Assurance Company v Dodd* [1892] 2 QB 573, a class was made up of those creditors whose rights against the

company were not so dissimilar as to make it impossible for them to consult together with a view to their common interest.

42. In more recent cases, this is paraphrased as "there is more to unite than to divide the members of the class". The first limit on trusting creditors' decision in a scheme of arrangement, therefore, is where they have not been divided into classes where the members of each class have sufficiently similar rights.

43. This has been construed as so fundamental that the correct constitution of classes is regarded as a matter of jurisdiction. Unless the members of each class have sufficiently similar rights to each other, the court has no power to sanction it at all.

44. The second limitation, which concerns when the court is prepared to trust the majority within each class, assuming it is properly constituted, limitation is underpinned by the comments of Lord Cairns in *Re Cowen*. Thus, in *Re Alabama, New Orleans, Texas and Pacific Junction Railway Co* [1891] 1 CH 213, Lindley LJ formulated a three part test that – in essence – continues to be applied today:

(1) Is the majority acting bona fide?

(2) Is the minority being overridden by a majority having interests of their own clashing with those of the minority whom they seek to coerce? and

(3) Is the scheme one which a person, being a member of the class acting in his own interests, could reasonably support?

45. The first part outlaws the sort of secret side deals which constitute a fraud on creditors. The second reflects the thinking in *Re Cowen* itself, and develops the concept of creditors voting in the interests of the class as a whole. In the case of larger corporations, it is less likely that creditors would be motivated to help the insolvent company by family loyalty or friendly feelings. In any event, there is no real opportunity to interrogate creditors to discover their subjective motivations for approving a scheme. The second part of the test therefore focuses on such outwardly visible factors that might objectively cause a creditor to vote with the majority in approving a scheme. As Bowen LJ put it in the *Alabama* case, while it is open to each member of a class "to do that which is best for himself", it is for the court to see what is just and reasonable for the whole class, and it would no doubt be influenced if it turned out that the majority "…was composed of persons who had not really the interests of the class at stake".

46. Here, the courts have developed a distinction between, on the one hand, differences between creditors' rights against the company, and, on the other hand, differences in their interests (i.e. something less than rights against the company) which might influence their

vote. This is a highly important distinction, in that if creditors in the same class have differences in rights, then the scheme cannot be sanctioned, whereas if the differences go only to their interests, then the court retains a discretion to sanction the scheme.

47. The difference was well put by Lord Millett sitting in the Final Court of Appeal in Hong Kong in *Re UDL Holdings Ltd* [2001] HKCFA 19. A simple example helps to explain it. 100 creditors have claims against the company. 50 of them also have a claim against a third party under a guarantee. The scheme merely offers them the same deal: a payment of 50% of their debt. Their rights against the company are the same: the right of guarantee held by 50 creditors is against a third party, not the company, so they are all properly put in the same class. But when the court comes to ask whether it should trust the majority in the class, it will want to be assured that the difference in interests of the creditors with the benefit of the guarantee meant that their vote was representative of the interests of the class as a whole.

48. It is worth noting, however, that it is a very rare case indeed where the court refuses to sanction a scheme, once satisfied that the classes are properly constituted on the grounds that the majority was influenced by having different interests.

49. Where the court does find a significant – and decisive – element within the majority who had their own special interest for voting for the scheme, the question of what to do was addressed by Hildyard J in *Re Lehman Brothers International (Europe) (No.10)* [2018] EWHC 1980 (Ch). There were two possibilities: altogether ignore the special interest creditor – so that the scheme would fail; or treat it as a matter of discretion. He decided it was the latter. An important consideration was how the rest of the class, who did not share that special interest, voted. If a majority of them approved the scheme, then that was likely to be a powerful factor pointing towards sanction. And the reason for that is that which underlines the third part of the test: trusting the judgment of the reasonable member of the class.

50. This third element in the test marks the extent to which the court is prepared to go in contradicting the creditors, by considering the reasonableness, in some abstract sense, of the scheme.

51. The words from *Re Cowen* again echo down the ages: a court of justice is not well equipped to decide the commerciality of a proposal. That is even more so today, with the increased complexity of many of the restructuring proposals that come before the courts under the guise of a scheme of arrangement. As David Richards J said in Telewest [2004] EWHC 1466 (Ch):

> "In commercial matters members or creditors are much better judges of their own interests than the courts … The court will be slow to differ from the meeting."

52. I mentioned at the outset the binary nature of this direct form of democracy: creditors have a choice whether to approve, or not approve, the scheme. The courts have long taken the view that when it comes to sanction, and applying the discretionary three-part test, it must itself not look beyond that binary choice. The courts have resisted arguments from dissenting creditors that some other scheme would have been more fair to one group of creditors or another. They have consistently said that the only question for the judge is whether this scheme – i.e. the one the company is currently proposing – satisfies the statutory test, and is one which a reasonable member of each class, having regard to their own interests, might sensibly vote for. If so, it is sanctioned; If not, it fails, and the company would have to start again.

53. As Snowden J put it in *Re KCA Deutag UK Finance Plc* [2020] EWHC 2977 (Ch):

> "'fairness" has a specific and limited meaning. The court simply has to be satisfied that the scheme is one that an intelligent and honest man, acting in respect of this interests, might reasonably approve. It does not mean that the court is required to form a view of whether the scheme is, in some general sense, or even in the court's own opinion, the "fairest" or "best" scheme."

54. I turn to consider the voluntary arrangement – introduced in 1986. First, a word about its structure. I have already noted that the process must involve all the creditors – by which I really mean all the unsecured creditors, because it is built into the regime that an arrangement cannot affect the rights of secured, or preferential, creditors without their actual consent. There is no provision for division into classes, or separate voluntary arrangements to deal with separate groups of creditors. It is a single arrangement is binding on all unsecured creditors if 75% by value of them vote in favour of it.

55. There is no real doubt, I think, that the extension of this procedure to companies was intended to be used where the company's debt structure was relatively simple, for example to capture the company that was incorporated to take over the business of a sole trader or the like.

56. It was soon established that – in the context of challenges based on material irregularity or unfair prejudice – the court would be guided by the same underlying principles of good faith and equality of treatment that underpinned the 19th century bankruptcy cases. As Lord Justice Walker put it in Somji v Cadbury Schweppes (above), it was unlikely that

parliament had intended to jettison the "intellectual freight" in the pre-1986 law, particularly the proportionate treatment of unsecured creditors, which has been a feature of bankruptcy law since its earliest days.

57. One aspect of that old law is incorporated directly into the legislation. To cater for the problem that those most closely connected with a debtor may be motivated by factors not shared with the general body of creditors, the rules impose an additional threshold for approval. The arrangement will not be approved unless – in addition to obtaining approval from a majority of 75% of all creditors – at least half of those creditors who are unconnected with the debtor vote in favour.

58. An example of the application of the principles of good faith and equality continuing to apply in practice is provided by *Gertner v CFL Finance Ltd* [2018] EWCA Civ 1781. Mr Gertner was facing a bankruptcy petition based on a debt owed to CFL of over £11 million. He presented a proposal for a voluntary arrangement. He identified creditors of over £582 million. Most of that (£547 million) was owed to Kaupthing Bank, pursuant to a guarantee of the debts of a company in the Gertner family called Crosslet Vale. The proposal involved a one-off payment by a third party of just under half a million pounds.

59. After payment of a small amount of preferential debt owed to the revenue, this would have resulted in a payment to each creditor of 0.07 pence in the pound. The proposal was approved by more than 75% by value of creditors. Kaupthing's vote was enough in itself to achieve that. Kaupthing had, however, by this time entered into a settlement agreement with Cosslett Vale and others, including Mr Gertner and an entity called Laser Trust (which was also the entity paying just under half a million pounds into the IVA to fund the distribution to creditors). This involved a payment to Kaupthing of £6 million from Laser Trust. Kaupthing agreed not to sue Cosslett Vale or Gertner, but without constituting a release of the debt due under the facility agreement.

60. Relevantly for my purposes, the issue before the court of appeal was whether the fact of the settlement agreement with Kaupthing constituted a material irregularity so as to cause the voluntary arrangement to fail. The court decided it did. It relied on the "good faith" principle. One of the issues was the extent to which – if at all – the settlement agreement had been revealed to the nominee, or to creditors by the time of the meeting. But – as Patten LJ noted – the real thrust of CFL's objection did not depend on non-disclosure. The objection was that the settlement agreement provided a significant inducement to Kaupthing to vote in favour of the arrangement which was not shared with other creditors.

61. This, the court held, was a breach of the good faith principle as laid out in the old bankruptcy cases. That was so even though Kaupthing was not obliged by the settlement agreement to vote in favour of the proposal, and even though there was no question of a breach of the *pari passu* principle, as the payment to Kaupthing came from a third party and so did not diminish the assets of Mr Gertner available to pay his other creditors.

62. As Lord Justice Patten put it:

> "The objection to the [settlement agreement] is that it provided Kaupthing with a collateral advantage not available to other creditors which placed it in a position of conflict with the interests of the other creditors. That was in my view a breach of the good faith principle which disqualified Kaupthing from voting on the proposal to the potential detriment of CFL and the remaining creditors."

63. Note that this case was about collateral advantage. What about where the arrangement itself provides for differential treatment? As I said – the CVA was originally intended to be used in simple case, but the ingenuity of restructuring professionals meant that it began to be used in ever more complex circumstances; circumstances which involved differing groups of creditors which would have been appropriate for a scheme, but where the requisite majorities for the separate classes in a scheme were unlikely to be achieved.

64. A particularly controversial context is the retail sector, where a company operates from many different locations, held by it on lease from multiple landlords. The creditors of such companies often comprise three distinct groups: ordinary unsecured creditors; finance creditors; and landlords.

65. The essential question raised is: how, and when, can you trust the creditors who vote *en bloc* when the nature of the deal being offered differs – sometimes enormously – between different groups of them?

66. This happened in a case that came before me a few years ago: *Lazari Properties 2 Ltd v New Look Retailers and others* [2021] EWHC 1209 (Ch). New Look operated a retail clothing business from a number of premises which it leased from a number of different landlords. A major issue in the case was the ability of a CVA to compromise landlords' claims for rent (but that is beyond the scope of this talk). What matters for present purposes is that most of the landlords' claims for unpaid rent were substantially impaired under the arrangement. They were asked to take a significant haircut. There was also a group of finance creditors – noteholders under bond issues. These were all secured creditors, but the value of the security was less than their debt, so they also had significant unsecured claims.

67. There were then the ordinary unsecured creditors, which the company regarded as essential to its ongoing business. They were to be paid, under the CVA, their outstanding debts in full. That was necessary, otherwise it was thought they would not support the business, and the anticipated profit – from which a dividend would be paid – would not materialise.

68. One of the grounds of the landlords' objections to the CVA was that it was unfairly prejudicial for the vote of the unimpaired creditors to have been swung by creditors who had substantially different treatment. In essence – the majority should not be trusted because they had such different rights and interests.

69. Over the course of many cases, the court has developed two useful tests in the context of CVAs: the so-called vertical and horizontal tests.

70. Under the vertical test , the court looks at what would happen in the alternative to a CVA. It is unfair for any creditor to be worse off than they would be in that alternative.

71. The horizontal test compares the outcome across different creditor groups. This involves asking, first, is the differential treatment justified? The most common justification relates to critical suppliers. Where the success of the CVA depends on the company trading successfully – e.g. to generate profits to pay creditors – and where the ongoing support of suppliers is critical to the success of the business, then paying their past debts in full can be justified as being in the interests of all.

72. But it is not enough just to ask if the differential treatment was justified. It still needs to be asked whether the majority can be trusted if it was obtained with the votes of creditors whose claims who had a materially better outcome under the CVA, noting that their rights were so different that they could not have formed the same class under a scheme.

73. On the facts in *New Look* that did not arise in relation to the critical creditors, who were being paid in full, since even if their votes were ignored, the requisite majority was still obtained.

74. More difficult was the claim of the secured noteholders. Without their votes the majority was not obtained. Their debts were left intact by the CVA. However, under a subsequent – but interdependent scheme – their debt was wholly extinguished – to be replaced by equity and warrants. Crucially, at the time of the vote in respect of the CVA their debts were intact, so they could vote for the estimated unsecured portion of their debt.

75. On the facts, the court was prepared to trust the majority's vote, notwithstanding it was bolstered by the votes of secured noteholders, for five reasons.

76. First, there is no question of the Noteholders receiving any benefit from any assets of New Look which were or should have been available for unsecured creditors. The benefits they received were referable to their security interest. This was not a case where a creditor used its voting influence to extract a greater share of assets that were otherwise to be shared between unsecured creditors.
77. Second, it is precisely because the Noteholders agreed to release their security in the scheme that any assets were made available for other creditors, so as to permit New Look to continue trading. Also, the amount of the dividend to unsecured creditors was increased because the available assets did not have to be shared with the Noteholders as a result of the release of the unsecured portion of their debt.
78. Third, the treatment of the Noteholders' unsecured claim was materially worse than everybody else: it was extinguished.
79. Fourth, even looking at the benefits conferred on the Noteholders as a whole, it could not be said that they were materially better than those conferred on the Compromised Landlords. The Noteholders went from the top of the priority waterfall in an insolvency of New Look (secured creditors with security sufficient to cover at least a substantial part of their debt) to the bottom of the priority waterfall (as holders of equity and subordinated debt in the Parent).
80. Fifth, while the statutory majority would not have been achieved without the Noteholders' vote, the court could take comfort in concluding that the allocation of assets within the CVA was reasonable, from the fact that a majority of Compromised Landlords nevertheless voted in favour of it. More than 80% by value of Compromised Landlords voted at the meeting and, of these, more than 57% voted in favour.
81. That brings me – but only briefly - to the most recent innovation: restructuring plans. We still have all the same questions as with a scheme, because we have the same class and majority vote structure. We can fall back on trusting to the commercial judgment of the creditors, provided we are satisfied they were put in the right classes and the majority fairly represented the class.
82. But the cross-class cram-down power, involves a significant departure. The creditors have spoken, and one or more groups does not like the outcome. That blocking group will often be a minority (but enough to prevent a 75% majority voting in favour), although it could be a majority of a particular class, or even 100% of a class.

83. The court cannot fall back on trusting that the majority was properly constituted and fairly voted in the interests of the class, where it is being asked to pit the interests of one class against another.

84. The entirely new question is when should the court do so? And on what basis, applying what principles? The statute provides no guidance.

85. There is reason for optimism, however, that the court will develop (and are in the process of developing) the principles to apply. It is important to note that we have been somewhere similar before, with the 19th century judges developing principles to flesh out the skeletal statutory provisions so as to regulate the control of majorities, and to determine what is meant by class, and when it is appropriate to sanction a scheme of arrangement.

86. We can see the same process starting again for restructuring plan. What have we learned so far?

87. First, that there is parallel with the approach to complex company voluntary arrangements such as the *New Look* case, so the two "useful comparators – vertical and horizontal" – are a good starting point. If the outcome for the dissenting class is worse than in the relevant alternative, then that will be a reason to refuse to trust the majorities in the approving classes. And beyond that, there needs to be a proper justification for the differential treatment.

88. Second – as happened with CVAs - we are moving away from the binary question of "this scheme or no scheme", because in order to assess whether the plan is fair to all it necessarily involves asking whether an alternative distribution of value – another plan – would be better for all.

89. Third – well, watch this space. We are no longer in the territory of the question posed by this talk: when to trust the creditors? Rather we are necessarily picking up the challenge thrown down in the 19th Century in *Re Cowen*: how could a court of justice determine what was reasonable for creditors to accept under all the varied circumstances of arrangements between debtors and their creditors.

90. With the guidance from the eminent academics, such as the chair of our session today, Professor Paterson, who are thinking deeply about this topic, I am confident that judges will devise the life-belt necessary to avoid the watery grave this picture implies.