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Client Alert
Commentary

Latham & Watkins Restructuring & Special Situations Practice

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Holding Water: Thames Water Restructuring Plan Sanctioned

The English court has sanctioned the group's interim financing plan, but the opposing creditor group's appeal will be heard on an expedited basis.

The last 12 months have been turbulent for Thames Water. Following the court's refusal to convene creditor meetings for the "alternative" Class B restructuring plan, the fate of the company's proposed interim financing now seems clear. The Court of Appeal will hear the Class B creditors' appeal of the sanction in the coming weeks. This will produce a binary outcome for the company: either the appeal will fail, in which case the company will continue with its own equity-raising timetable and propose a second "recapitalisation" restructuring plan (RP) by next September; or the appeal will succeed, in which case it would appear that the company will have insufficient time to raise interim financing to prevent its collapse into special administration before the end of March.

Key Takeaways

Mr Justice Leech's decision to sanction the company's plan was based on the following findings:

- **Class B Alternative Plan**: The plan was undeliverable within the company's narrow liquidity runway. It also lacked the critical and necessary support of the Class A creditors, and it was doubtful that the new money commitments under the Class B Alternative Plan were binding and fully underwritten. If the company's plan was not sanctioned, the Class B creditors were mistaken in claiming that the Class A creditors would automatically support the Class B Alternative Plan in order to avoid special administration when they were far more likely to pursue their own plan.

- **Relevant alternative**: Because the Class B Alternative Plan was found to be undeliverable, the correct relevant alternative was a special administration (as the company and Class A creditors had argued) and not the Class B Alternative Plan.

- **No worse off**: Based on the company's valuation evidence, which the court preferred, the Class B creditors would be no worse off under the company's plan than the relevant alternative of special administration, in which the Class B creditors would have no economic interest.

- **Horizontal comparison**: As they were out of the money, the Class B creditors could not rely on the horizontal comparison test to assist them. This requires the court to compare the position of competing creditor classes under a plan from the perspective of overall fairness, and is often characterised as the fair apportionment between creditors of the "restructuring surplus". Arguably, this concept has limited currency in the context of an RP that provides only for interim financing as opposed to a recapitalisation of the company's balance sheet. In any event, the judge declined to depart from the established *Virgin Active* line of authority that little or no weight should be given to opposition from out-of-the-money creditors, noting that the Class B creditors had been offered proportionate participation rights in the super senior financing alongside the Class A creditors.

- **Class A creditor "control rights"**: Under the plan, the company's access to part of the super senior financing was conditional upon satisfaction of certain milestones in the equity-raising process. These included the support of a critical mass of the super senior and Class A creditors for a recapitalisation plan by 30 June 2025. The Class B creditors argued unsuccessfully that this had the effect of "diverting value" away from the Class B creditors by artificially truncating the equity-raising process. They argued separately that the company's approach offended competition law. The court agreed with the Class A creditors that the control rights were no more than reasonable "downside protection" and reflective of their position as in-the-money creditors entitled to a degree of oversight of the company's equity-raising process.

- **Third-party releases**: The plan included releases given by creditors in favour of directors, officers, and advisers of the company, as well as other group companies. Although wide in nature, the court found that the releases were permissible provided that they were restricted in scope to the interim financing transaction and not the management or affairs of the company generally. Any releases under a future recapitalisation restructuring plan (RP2) would be a matter for creditors and the court to decide at the time.

Expedited Appeal Grounds

In sanctioning the plan, the judge concluded that he "ought to give the company an opportunity to finish the jigsaw and put RP2 in place". The window for seizing that opportunity has been narrowed by the upcoming appeal, which will be heard and decided ahead of 24 March, when the company expects to exhaust its remaining liquidity. The judge restricted the Class B creditors' appeal to the following grounds:

- **Valuation evidence**: The Class B creditors contended they would be worse off under the company plan than under either the Class B Alternative Plan or a special administration. Indeed, their valuation evidence suggested that they would receive a full recovery in each of the company plan, the Class B Alternative Plan, and a special administration.

- **Fairness of the Class A creditor "control rights"**: The Class B creditors argued that their exclusion from the control rights (other than in their minority capacity as potential providers of the new money) gave the Class A creditors disproportionate and, therefore, unfair control of the equity-raising process.

- **Third-party releases**: In the context of an interim financing alone, the Class B creditors considered the proposed wide releases unnecessary and inappropriate to the implementation of the company plan.

Water Under the Bridge?

The subsequent dismissal by the same judge of the Class B creditors' application to convene creditor meetings for the Class B Alternative Plan because there was "no reasonable probability that those meetings would serve any useful purpose" strongly indicates the lower court's tolerance for such tactics.

It should come as no surprise that contractually-senior creditors (Class A holding c.£16bn of debt) should have a proportionately greater sway over the company's plan than contractually-subordinated creditors (Class B holding c.£1bn of debt) in circumstances where:

- the Class B debt appears to be clearly underwater (the court allowed some weight to be given to the relative trading discounts of the Class A and Class B debt in forming its view on valuation); and
- no plan can be implemented without substantial Class A support.

The court cautioned that any successful Class B Alternative Plan that was unacceptable to Class A creditors would necessarily entail a "cram up" of a dissenting Class A creditor class, which it would be unlikely to sanction. Without pre-judging the scope of the future RP2 that will seek to deliver a recapitalisation of the group, it seems equally unlikely that the Class B creditors would be able to challenge successfully RP2 in circumstances where — as the market expects and the court articulated — the Class A creditors will be asked to take a "significant haircut".

While there may be future opportunities for the court to revisit questions of fairness with respect to the division of the restructuring surplus between creditor classes that are in-the-money and out-of-the-money, this case seems an unlikely candidate given its factual matrix.

Prospective equity investors may be forgiven for looking askance at a process that has led to three competing and simultaneous restructuring plans, with substantial time and cost lavished upon each, for what is in effect very expensive bridge financing. Assuming that the appeal is dismissed, the main course of RP2 cannot come soon enough.

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