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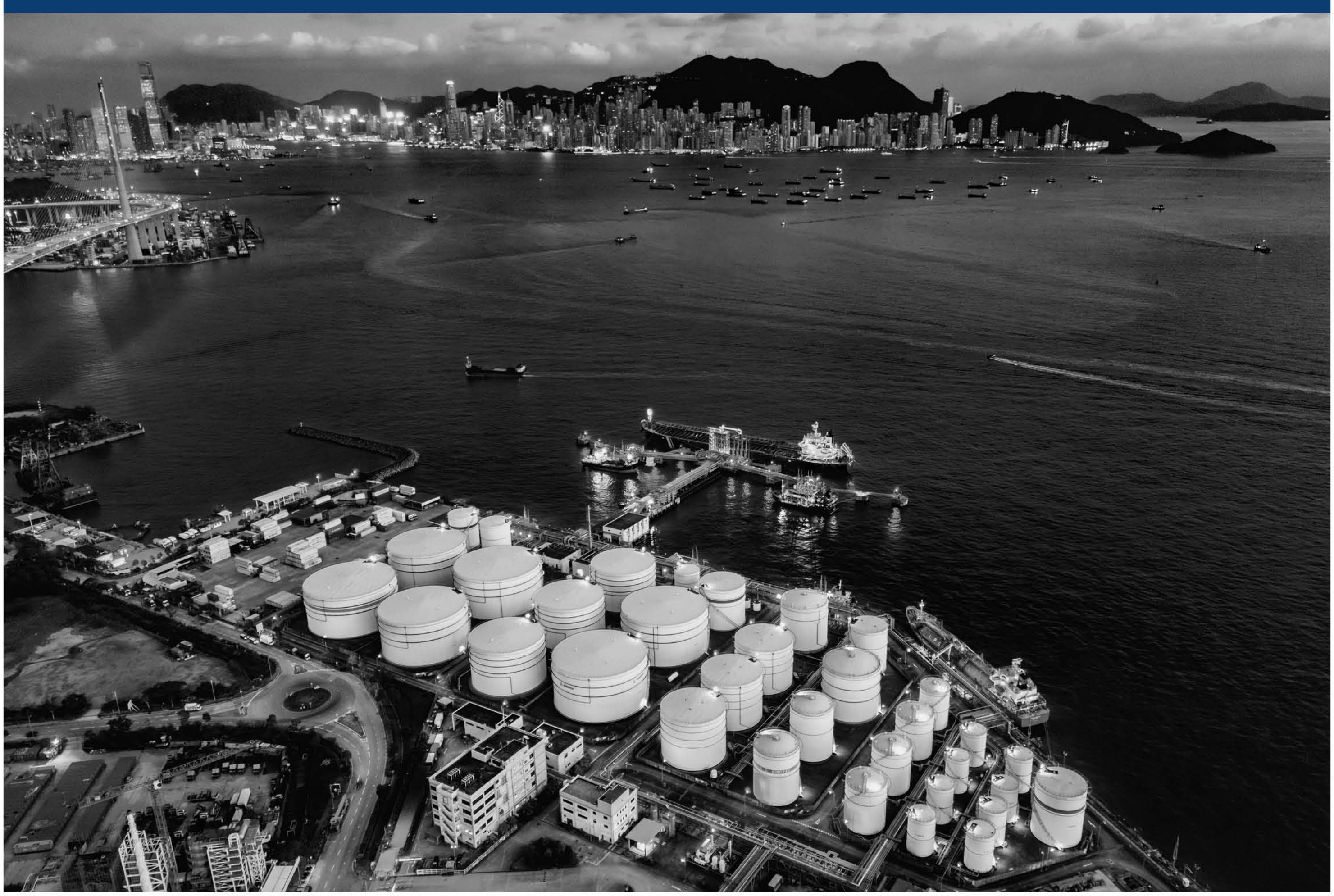
Petrofac Restructuring Plans Overturned, but Significant Questions Left Unanswered



Key Takeaways

Provision of new money

The economics of new money provided under or in connection with a plan that exceed what could otherwise be obtained in the market should be considered a benefit of the restructuring, and allocation of this benefit should be justified. When assessing what terms could be obtained in the "market", the focus should be on the terms that would be available by reference to the post-restructured group, when the risk of investment should be lower following the compromise of the plan company's liabilities. The evidential requirements for demonstrating market terms appear to have become more onerous, and it is unclear (i) what practical implications this may have in future restructurings and (ii) whether they apply to the provision of new money without an equity component.

Treatment of out-of-the-money classes

Virgin Active is no longer good law in this respect. In-the-money classes cannot take (almost) all of the benefits of the restructuring without providing a 'fair share' to out-of-the-money classes. What is "fair" will have to be assessed on a case-by-case basis, and we await guidance on how to satisfy this standard. We anticipate a period of uncertainty and practical challenges as the legal industry works to establish clarity about what is now required.

Work Fees

Work fees remain, in principle, acceptable to compensate creditors for their work to facilitate a restructuring. However, in light of the Court of Appeal's approach in this case, work fees are likely to be subject to increased scrutiny from the courts going forward, particularly where paid in equity. A cautious approach will need to be taken when seeking to negotiate higher fees, both from a fairness and a class perspective.

The Court of Appeal's third judgment on restructuring plans, and its second instance of overturning approval, *Petrofac* has prompted renewed discussion about the merits of using an English restructuring plan for complex financial restructurings. Increased uncertainty around how the English court may approach restructuring plans, including a willingness by the Court of Appeal to cast doubt on the precedent value of principles laid down in earlier restructuring plan cases, will give practitioners pause for thought. Whilst we wait to see if the group will seek leave to appeal to the UK Supreme Court, it is worth considering the implications of the Court of Appeal's decision for the market.

Background

By way of a reminder, the appeal of the complex and heavily negotiated restructuring plans proposed by two Petrofac entities was a result of two JV partners (who were unsecured creditors entitled to receive warrants and a share of £1 million under the plan) seeking to overturn the plan. The appeal proceeded on the basis of two general grounds: (i) the "no worse off" condition (required by statute to be satisfied in order to engage the cross-class cram down jurisdiction) was not satisfied; and (ii) the plan resulted in an unfair allocation of the benefits created or preserved by the plan between all creditors. The appellants were successful on the second ground but not on the first.

The Court of Appeal judgment focuses on three main areas, as set out on the following pages.

Provision of New Money

A key area of consideration for the Court of Appeal was the terms on which new money was to be provided to the group. The main findings of the Court were:

1. If returns to creditors are equivalent to market rates, then the provision of new money should be considered a *cost* of the restructuring. If such financing is obtained on terms which are materially in excess of what would otherwise be obtained in the market, then this should be considered a *benefit* of the restructuring, and the allocation of that benefit will need to be specifically justified. The Court emphasized that the burden of showing either that the returns are equivalent to what could be obtained in the market or that the allocation of any benefits is fair rests on the plan company.

2. The Court of Appeal also concluded that new money returns should be considered by reference to the cost at which new money could be raised *after* approval of a plan and implementation of a restructuring—the logic being that the relative risks should have been removed by the restructuring itself.

3. The fact that the opportunity to participate in the new money is open to all creditors will not cure an issue relating to fairness (although it would address class issues).

In regard to the first point, the Court of Appeal suggested that the evidential burden to demonstrate that the new money pricing is based on market terms could be satisfied via expert evidence or evidence of market testing. This suggestion carries with it practical challenges:

Expert Evidence: Since it is typical for negotiations with creditors aimed at reaching a consensual solution to commence at an early stage of financial distress, deal terms are likely to be largely agreed upon prior to any provider of valuation evidence being substantially progressed in their work, or even engaged. Accordingly, there is a real timing mismatch between (i) when the terms of a restructuring and any new money provision are agreed upon and (ii) when the evidence required to meet the process outlined by the Court of Appeal (including the post-restructuring capital structure) will be available to the company.

Market Testing Process: In contrast to US restructurings where there is a mature and competitive market for DIP financing in Chapter 11 cases, running a market testing process for new money in a European restructuring context is not an established practice. It remains to be seen how the market will adapt to this and whether concerns around 'stalking horse' bids will act as drivers to competitive pricing or as dampeners. Again, timing issues will be a key consideration in any market testing process, particularly regarding when during restructuring discussions such market testing processes should be commenced—noting that 'Plan A' is usually to reach a consensual deal without the need for a restructuring plan.

It is also unclear whether the Court of Appeal has established a general principle requiring this evidential burden to be satisfied in all cases or whether this enhanced evidential burden need only be satisfied in cases where the economic returns on the new money, on their face, appear to be unjustified, outsized or could result in very significant equity upside.

Treatment of out-of-the-money classes

Having concluded that the terms of the new money constituted a ‘benefit’ of the restructuring, the Court of Appeal considered whether the plan achieved a fair allocation of the benefits amongst all creditors. Building on its decision in *Thames Water*, the Court of Appeal emphasised that any determination as to whether or not a plan is fair will need to be assessed on a case-by-case basis. Fairness may require that an out-of-the-money class is offered more than a *de minimis* return under a plan, and being “out-of-the-money” does not necessarily mean that such a class can or should be excluded from the allocation of benefits of a restructuring. More generally, the Court of Appeal made it clear that a plan which satisfies the “no worse off” test is not in and of itself a fair one.

By effectively reversing the principles laid down in *Virgin Active*, the Court of Appeal has moved away from what most of the market considered to be relatively settled law, namely that out-of-the-money classes need only receive a *de minimis* recovery. Instead, the Court of Appeal seems to be taking the position that out-of-the-money classes need to receive some element of the restructuring surplus as compensation for the release of their claims, as this release ultimately contributes to the company’s ability to continue as a going concern.

The judgment therefore raises important questions about how to determine the amount that should be given to out-of-the-money classes and what constitutes a fair allocation of restructuring benefits. It remains to be seen how the lower courts will address these questions, and, unless the UK Supreme Court considers the issue, upcoming first instance judgments will be important in providing further guidance. In the meantime, it seems that out-of-the-money classes may have more leverage in restructuring plans than was previously thought to be the case.

The Court of Appeal also made it clear that the Court would expect the plan company to make a genuine attempt to negotiate with all of its creditors, especially if asking the Court to approve exercise of the cross-class cram down power. This approach is also consistent with the draft new Practice Statement recently submitted for consultation in the context of schemes of arrangements and restructuring plans. It is easy to see how this requirement may prove challenging for plan companies with dispersed creditors that hold *de minimis* or out-of-the money claims.

Work Fees

By way of background, the Work Fee payable to the ad hoc group of creditors (the “**AHG**”) was set at 2.5% of the AHG’s aggregate holding of the senior secured debt, equalling US$7.1 million and payable in cash if the Plans were not approved. If the Plans were approved, the Work Fee would be paid in equity in the restructured group. After agreeing the percentage equity allocations based on an initial valuation, the company commissioned a further valuation report in connection with the plans, which concluded that the post-restructuring enterprise value of the group would be much higher than initially thought, between US$1.5 billion and U$1.85 billion. Based on those anticipated outcomes, the ordinary shares to be issued to the AHG in respect of the Work Fee were expected to be worth between US$24.1 million and US$29.9 million.

The Work Fee payable to the AHG was not a point taken by the appellants and did not form part of their grounds of appeal. Nevertheless, the Court of Appeal spent considerable time in its judgment considering the merits of the Work Fee and whether it was justifiable in the circumstances.

The Court was very concerned about (i) the differential between the cash amount of the Work Fee and the equity value of the Work Fee and (ii) the fact that the equity based Work Fee was not adjusted to take into account a subsequent increase in the expected post-restructuring equity value. The Court questioned whether, in these circumstances, the Work Fee could really be said to be compensating the AHG members for time spent on the restructuring or the inconvenience of being restricted for a period of time.

Market participants should be aware that fees payable to creditors, particularly those with an equity component, are likely to be scrutinised by the courts in all cases on the basis of fairness considerations. A cautious approach is advisable when negotiating higher fees, and this should be borne in mind at all stages of the restructuring process, as even fees agreed in the context of a likely consensual restructuring could be reviewed if a restructuring plan is later pursued in order to implement that transaction.

It is also worth noting that the Court of Appeal did not have the opportunity to comment on the extent to which work fees might fracture the class in a scheme or restructuring plan. However, we expect this point to become an area of focus in the future.

Where Next?

The uncertainties created by recent English case law will require parties and their advisors to think carefully about the best forum and process for implementing a given restructuring (absent a fully consensual deal) and to weigh the relative costs and predictability of outcomes of the Restructuring Plan when compared to alternatives in the US and Europe.

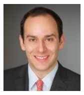
Unless and until further guidance is forthcoming from the UK Supreme Court, as regards English processes, defaulting to the tools used prior to the restructuring plan legislation coming into force, such as using contractual release provisions in inter-creditor agreements, will also be at the forefront of minds as the industry seeks greater implementation certainty for complex restructurings.

Post-script

In the first judgment following the Court of Appeal's decision in *Petrofac*, the High Court, on 9 July 2025, approved the 13 restructuring plans put forward by Independent Builders Merchant Group. Under these plans, the unsecured creditors—who were otherwise out-of-the-money—were allocated 14.4% of the overall benefits arising from the restructuring. This represented a markedly greater share than their pro rata entitlement based on their original claims. In granting approval, the judge decided the distribution of benefits was fair, highlighting in particular that the unsecured creditors stood to receive much more than they would have recovered in a formal insolvency process.

It is worth noting that, in response to the *Petrofac* judgment, at the sanction hearing, the plan companies produced a "Plan Benefits Report" focusing specifically on the allocation of the benefits of the restructuring – something that is likely to become standard in restructuring plan cases going forward.

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to: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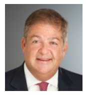
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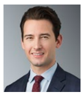
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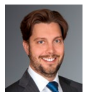
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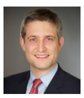
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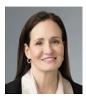
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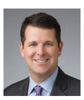
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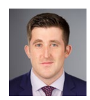
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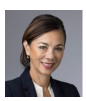
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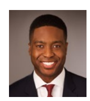
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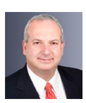
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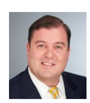
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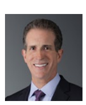
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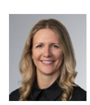
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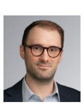
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