Analysis

HMRC v Part 26A: can you cram the Crown?

Speed read

HMRC has had mixed results when opposing certain recent Part 26A restructuring plans. While recent judgments are relatively case specific they do provide some guidance which may impact future restructuring plans. In particular, the court has acknowledged that HMRC have a differentiated status, as recognised by their secondary preferential creditor status in respect of certain debts due since 2020. As a result, companies, lenders and advisers must take care when attempting to cram down HMRC; this is especially the case in SME and mid-market restructurings where HMRC typically accounts for a greater proportion of total debt.

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As the UK economy continues to experience macroeconomic uncertainty following Covid-19, the risk of a recession remains elevated. High inflation and interest rates provide a challenge to businesses in a variety of sectors and the number of companies using insolvency and restructuring processes continues to rise.

The Part 26A restructuring plan (RP) introduced in 2020 has many features of the more widely known Part 26 scheme of arrangement ('scheme'). However, unlike a scheme, the RP can be sanctioned by the court even where there is a dissenting creditor class, using a process known as 'cross-class cram down' (explained below).

Recently, a number of companies have attempted to 'cram down' HMRC using an RP, and HMRC has had mixed results challenging such procedures.

In this article, we discuss the approach of companies, the court and HMRC with reference to relevant case law and we conclude on the key takeaways.

HMRC's secondary preferential claim

'Crown preference' was introduced for insolvencies commencing on or after 1 December 2020, whereby HMRC was given 'secondary preferential creditor' status in respect of certain tax debts. These taxes ('priority taxes') are broadly those collected by a company on behalf of HMRC: VAT, PAYE, employee's NICs, student loan, and construction industry scheme deductions.

In an insolvency, asset realisations are now paid out to creditors in the following order ('the waterfall'):

1. Secured creditors with a fixed charge (in respect of fixed charge realisations).
2. Insolvency practitioners' expenses.
3. Preferential creditors (primarily employee related, for example certain unpaid wages, unpaid pension contributions and holiday pay).
4. Secondary preferential creditors (i.e. priority taxes).
5. Prescribed part up to £800k (including HMRC claims which rank as 'unsecured').
6. Secured creditors with a floating charge (in respect of floating charge net realisations).
7. Non-preferential/unsecured creditors.
8. Shareholders.

The returns to creditors following an RP, do not need to strictly follow the order of priority in the waterfall. This has led to recent resistance from HMRC, given their restored priority status.

Part 26A restructuring plans

The RP was introduced by the Corporate Insolvency and Governance Act 2020. The specific form of an RP can vary and may include amending the terms of a debt facility, resetting covenants, compromising certain debts or implementing a debt for equity swap. Many RPs have been focussed on financial debt, but they have also been used to compromise operational liabilities and amend lease terms in mid-market and SME businesses.

A key difference, compared with schemes, is that RPs can be sanctioned by the court (subject to certain conditions) and bind all creditors, despite a dissenting creditor class who would otherwise cause the failure of the required level of consent for approval (being a 75% majority in value of each 'in-the-money' creditor class). This can be achieved via 'cross-class cram down' (CCCD) provisions.

The following conditions must be met for the court to sanction an RP seeking to utilise CCCD:

- Condition A: 'No worse off', i.e. no members of a dissenting class may be any worse off under the proposed RP than under the relevant alternative; and
- Condition B: the RP must be approved by at least one class who would have a genuine economic interest in the company in the relevant alternative.

In addition, where the prior two conditions are satisfied, the court retains a general discretion not to sanction an RP. Considerations may include:

- whether the allocation of the restructuring surplus is fair or equitable;
- whether the priority of distributions in the relevant alternative is reflected under the RP; and
- the source of the benefits to be distributed.

Definitions

Class: Classes of creditors for the purposes of voting are formed based on each creditor's rights. Each class must be made up of creditors whose rights are 'not so dissimilar as to make it impossible for them to consult together with a view to their common interest'. There may be one creditor in a class if there are no other creditors in a similar position. HMRC's preferential creditor claim status would result in it being the only creditor within its class (in respect of priority taxes).

Cram down: A simple 'cram down' is when a restructuring is binding upon a dissenting creditor or group of creditors, where a sufficient majority of creditors within that class provide their consent (75% in an RP).

Cross-class cram down: A feature of certain restructuring procedures that allows creditors to be bound by a plan, even if the relevant voting threshold is not met within a specific class (or classes).

Relevant alternative: The most likely outcome to occur in relation to the company if the RP is not sanctioned (this may often be an administration or liquidation, but it is not necessarily an insolvency process).

Case law

Certain cases over the last 15 months illustrate how the courts are assessing RP applications and challenges.

Smile Telecoms

In *Smile Telecoms Holdings Ltd* [2022] EWHC 387 (Ch), a creditor objected to the proposed RP in correspondence. This creditor was not represented in court, nor did they bring formal evidence to support their arguments. The court's criticism was stark: 'Put simply, if a creditor or member wishes to oppose a scheme or plan ... they must stop shouting from the spectators' seats and step up to the plate.' Following *Smile*, it is clear that dissenting creditors have to fully engage with the restructuring process for concerns to be sufficiently recognised by the court.

Houst

In *Houst Ltd* [2022] EWHC 1941 (Ch), Houst was the first RP to propose a compromise of HMRC priority taxes. The RP was proposed by Houst to enable it to continue trading, and it involved the injection of new capital from the existing shareholders.

The RP proposed that: HMRC, as secondary preferential creditor, would receive 20p/£ (v 15p/£ under the RA); the secured creditor would receive a higher return than HMRC at 27p/£ (vs. 7p/£ in the RA); and unsecured creditors would receive 5p/£ (v £nil in the RA). The RA would have resulted in the secured creditor receiving a lower recovery than preferential creditors due to the low value of the fixed charge assets and the fact that the secured creditor's claim over floating charged assets would rank behind HMRC. As such, the RP subverted the relative returns under the RA, and it did not respect the 'absolute priority' rule (a principle of bankruptcy requiring senior creditor claims to be paid in full ahead of more junior claims).

HMRC did not actively engage with the RP, nor did it oppose the RP at either the convening or sanction hearings. However, it took a principled approach when voting against the RP, referring to its status as a secondary preferential creditor when explaining their position: 'with the reinstatement of HMRC as a secondary preferential creditor ... this is a position we are not willing to compromise on and will insist this be honoured in all circumstances, regardless of whether this disadvantages unsecured creditors.'

All other classes of creditors voted in favour of the RP and, as both CCCD conditions had been met, the court had the discretion to sanction the RP.

The court sanctioned the RP, giving the following reasons:

- Although the distribution of benefits under the RP differed from the RA (HMRC received less than the secured creditor in the RP versus more than the secured creditor in the RA), deviations from the RA waterfall or the absolute priority rule are not fatal for an RP. Overall, HMRC was still better off under the RP than the RA.
- The differentiated treatment of certain creditors under the RP was justified by the 'source of the benefits to be received under the restructuring'. The value generated by the RP was principally derived from the new money injected by shareholders, rather than representing assets otherwise available under the RA. As a result, it was not required that these assets should be distributed in line with the RA waterfall.
- HMRC as a 'sophisticated creditor able to look after their own interests' did not prepare any opposing evidence to the court (their initial objection, via email to Houst, was a general policy decision not to relinquish their preferential status) and HMRC was not represented at the sanction hearing – a key factor highlighted in *Smile*.

Nasmyth

In *Nasmyth Group Ltd* [2023] EWHC 988 (Ch), the Nasmyth RP was the first time the court declined to sanction an RP, despite both CCCD conditions being met. All classes voted in favour other than HMRC.

The RP would have seen both senior and junior secured creditors repaid in full (vs 100p/£ and 55p/£ in the RA), with HMRC recovering only £10,000, i.e. 5p/£ (vs £nil in the RA). HMRC argued that, despite receiving a higher return under the RP, the allocation of nearly the entire restructuring surplus to the senior and junior secured creditors was unfair.

Nasmyth highlighted the court's approach to HMRC debts, and its acknowledgement of their differing nature:

- The court will not necessarily refuse to sanction an RP as 'a matter of principle [just] because HMRC will be crammed down';
- Parliament has acknowledged the elevated importance of HMRC debt by legislating for the reinstatement of secondary preferential claims; and
- HMRC is an involuntary creditor, as there is no active decision by HMRC to trade with taxpayers.

Consequently, the court cautioned that an RP 'should not cram down the HMRC unless there are good reasons to do so'.

Despite not accepting all of HMRC's arguments, the court used its discretion not to sanction the RP, providing the following justifications:

- Although HMRC would be out of the money in the RA, HMRC retained a genuine interest as it would remain one of the largest creditors of the group and the success of the RP depended on HMRC agreeing time to pay (TTP) arrangements with group companies.
- HMRC's share of the restructuring surplus would be 'both tiny by comparison with [the junior creditor] and in absolute terms'.
- Critically, Nasmyth had failed to negotiate TTP arrangements with HMRC for its subsidiaries' debts prior to the RP launch, with no clear explanations evidenced. The success of the RP was dependent on the group being able to agree such arrangements. As such, the court viewed this as a 'roadblock' to the success of the RP and argued the RP had been proposed for purposes unintended by Part 26A, being 'a convenient opportunity to eliminate debts which the Company owed to HMRC for a nominal figure and to use the Plan to put pressure on HMRC to agree new TTP terms'.

Great Annual Savings Company

The judgment in *Great Annual Savings Company Ltd* [2023] EWHC 1141 (Ch) provided further insight into what constitutes acceptable treatment of HMRC debt. Here, the RP was approved by its creditor classes other than HMRC and one class of energy suppliers. The court did not sanction the RP as it could not be proven that CCCD Condition A was met, i.e. that HMRC was 'no worse off' under the RP. In determining whether HMRC was 'no worse off', the following key points were made:

- Although HMRC appeared no worse off (at face value they were to receive 9.1p/£ under the RP vs. 4.7p/£ under the RA), HMRC challenged the expected realisations of book debts under the RA. The court was not convinced by the valuations of GAS's book debts used in the RA; although presented within an independent valuation report, the valuers had not scrutinised management's conservative views on the realisable value of the book debts.
- Although HMRC did not provide its own evidence, the court made it clear that the burden of proof is on the company, and in this case GAS has not 'discharged their burden of showing that HMRC would not be any worse off'.

Despite Condition A not being satisfied, the judge confirmed he would have, in any case, used his discretion not to sanction the RP as it involved 'a serious imbalance in the way the anticipated benefits of the restructuring are to be allocated'. Broadly, this referred to a number of out of the money creditors under the RA who would have benefitted under the RP at HMRC's expense.

The unfairness of the RP was not altered by the fact that the company attempted to engage with HMRC prior to proposing the RP: 'my concern is not assuaged by the fact ... that the Company had sought to communicate openly with HMRC about the Plan, but HMRC had declined to engage'.

Fitness First

In *Fitness First Clubs Ltd* [2023] EWHC 1699 (Ch), the company proposed to keep HMRC whole and only extend the HMRC repayment profile over five months.

HMRC voted in favour of the RP. Clearly HMRC is willing to accept an amendment to its rights if it views it as fair and such an approach results in one fewer creditor objections for the company to deal with.

Prezzo

After successfully challenging both the Nasmyth and GAS RPs, *Prezzo Investco Ltd* [2023] EWHC 1679 (Ch) saw a return to HMRC's objections being dismissed and its debts being subjected to CCCD.

In this case, there was consensus that the RP satisfied Conditions A and B. HMRC's opposition related to the court's discretionary powers not to sanction the RP, and they argued:

- insufficient weight was given to HMRC's secondary preferential debt and such amounts should be treated as critical;
- the company had been trading to the detriment of HMRC. While planning the RP they ceased payments to HMRC, despite continuing to collect PAYE, NICs and VAT and paying other creditors deemed to be critical;
- despite Prezzo amending the RP to increase HMRC's recovery by £2m, it was being subjected to a substantial write-off, whereas the secured lenders were being kept whole;
- the £2m payment to HMRC which was to be funded by the secured lenders and shareholders was insufficient to justify the retention of its claims in full and its capture of all future upside; and
- sanction of the RP would be a precedent for other companies to avoid HMRC debt and use RPs 'abusively'.

The court did not accept HMRC's objection and sanctioned the RP, citing the following:

- HMRC was to receive the majority of the restructuring surplus following the inclusion of the additional £2m payment;
- HMRC was due to receive a material repayment within 30 days of sanction (unlike in *Nasmyth*, where the proposed RP recovery was not material);
- the company had communicated with HMRC regarding the RP and provided them with extensive information;
- HMRC had not engaged in negotiations with the company; and
- the company's selection of 'critical creditors' was reasonable and it was appropriate that HMRC was deemed not to be critical to the preservation of the business and ability to trade.

Cram down and cross-class cram down of HMRC is not in itself a reason for the court to refuse to sanction an RP. However, the courts will 'exercise caution in relation to HMRC debts' and will 'not cram down unless there are good reasons to do so'

Where does this leave us?

The 'accepted' treatment of HMRC debt under RPs will continue to develop and will always be case specific. However, there are a number of lessons from recent case law:

1. Cram down and cross-class cram down of HMRC is not in itself a reason for the court to refuse to sanction an RP. However, the courts will 'exercise caution in relation to HMRC debts' and will 'not cram down unless there are good reasons to do so'.
2. The court must be satisfied that there are sufficient explanations to justify any unequal distribution of the restructuring surplus or deviation from the relative returns in the RA.
3. HMRC is viewed as a sophisticated creditor and therefore will likely need to formally challenge an RP if it disagrees. Expert evidence is not necessarily required in every case but, at a minimum, court representation appears to be key.
4. RA reports provided by the company must be robust. Even where creditors are shown to be no worse off under the RA (based on company evidence), there is a risk that valuations will be challenged. Assumptions should therefore be supported and independently verified.
5. Unsuccessful attempts to engage with HMRC do not provide debtors carte-blanche to treat HMRC as they wish. Genuine attempts to engage with HMRC would be considered by the court (with the absence of such engagement proving fatal in *Nasmyth*). However, any lack of engagement from HMRC does not negate the requirement for all stakeholders to be treated fairly.

Given HMRC's approach to opposing certain recent RPs, companies should consider how HMRC is likely to view any RP proposal and assess the risk of opposition. This is particularly relevant for SMEs where HMRC will likely be a relatively large creditor and where additional legal costs from a challenge may jeopardise the net benefit of an RP. ■

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