COMMERCIAL TENANT INSOLVENCY

PRE-PACK ADMINISTRATIONS AND CVAs

"GAME ON - LANDLORDS FIGHT BACK"

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CVAS AND PRE-PACK ADMINISTRATION: THE RESCUE CULTURE

1. In this talk, I am going to address two areas of particular concern for commercial landlords arising out of commercial tenant insolvency, namely (i) continued enjoyment of the landlord's premises during the course of administration and the administrators' liability for payment for such use and occupation; and (ii) the issue of CVAs being used unfairly to "strip out" parent guarantees given to landlords.

2. There have been several high profile CVAs and administrations affecting tenants, notably several high street retailers, and these have impacted on landlords in a particular way. The increased number of CVAs and administrations in this recession is a natural consequence of the "rescue culture" at the heart of the insolvency regimes laid down by the Insolvency Act 1986, as amended by the Enterprise Act 2002.

PRE-PACK ADMINISTRATIONS

3. A pre-pack administration is an arrangement under which the sale of all or part of a company's business or assets is negotiated with a purchaser prior to the appointment of an administrator, and the administrator effects the sale immediately on, or shortly after, his or her appointment. The purchaser is often connected with the insolvent company in some form, as where the directors of

the insolvent company form a new company in order to take over the profitable parts of a business.

4. A pre-pack sale has great advantages and is part of the "rescue" culture underlying the changes to the process of administration made by the Enterprise Act 2002. It is no longer necessary to obtain a court order, and an administrator can be appointed out of court. Administration has therefore become a cheaper and less complicated process. Prior to taking an appointment as administrator, the nominated insolvency practitioner must consider whether he or she is able to fulfil one of the statutory purposes, namely (i) to rescue the company as a going concern; (ii) a better realisation of the company assets than would be the case should the company be wound up; (iii) a distribution to either the secured or preferential creditors.

5. The main advantage of a pre-pack administration is the ability of the company to trade up to the point of the administration and thereafter to seamlessly "hand over" the more profitable elements of the business to a purchaser. This enables the preservation of the goodwill of the business and enables the assets of the company to be sold at a higher return which in turn benefits the creditors and ensures the survival of that part of the company's business that can be saved, albeit in the hands of a new entity. The wider advantages, in terms of rescuing viable businesses and preserving jobs, are obvious.

6. However, pre-packs can be controversial and there is a clear danger of the process being abused, particularly as the directors of the company are not only frequently instrumental in the process of putting the company into administration but are also often behind the "new co" set up to purchase the business of the insolvent company. Furthermore, where the circumstances warrant it, the administrator does have power to sell assets without the prior approval of creditors or the permission of the court. The public perception can therefore be that the "same people" are rising "phoenix like" from the ashes, taking the assets from the company and leaving the liabilities behind. This obviously over simplifies the issue, and there is no doubt that used properly for the statutory

purpose or purposes of administration, a pre-pack can be a "win win" situation in the event of a company's insolvency. However, the potential for abuse is recognised by the Association of Business Recovery Professionals in its publication of "Statement of Insolvency Practice 16" which deals specifically with pre-packs and the standards which insolvency practitioners are expected to adhere to. These guidelines address in particular fulfilment of the statutory duties both in the pre-appointment period and in relation to the manner of disposal of the business or assets as well as provision of after the event disclosure to the creditors. An administrator is an insolvency practitioner who must act honourably and fairly as an officer of the court. Administrators must act in the interests of the company's creditors as a whole and even where the objective is to realise property in order to make a distribution to secured or preferential creditors, the administrators have a duty to avoid unnecessarily harming the interests of the creditors as a whole. If they fail to comply with their duties, their conduct can be challenged under paragraphs 74 and 75 of Schedule B1 to the Insolvency Act 1986.

7. There have been several high profile administrations, particularly in the retail sector, such as Blacks, Jessops, Game Station, La Senza and Woolworths, to name just a few. A common feature of such retail administrations is the impact they have on commercial landlords. Pre-packs will often involve a sale of the retail business and "brand". The purchaser (and its funder) will want to take on the leases of profitable stores and close down the weaker branches.

8. The seamless handing over of the profitable stores overnight does not fit well with the structure and drafting of the modern commercial lease. Most will have restrictions on alienation in some form or other and a proviso for re-entry in the event of non payment of rent, other breaches of tenant covenants and insolvency events, such as administration. The purchaser of the business is often granted a licence to occupy premises pending an application for licence to assign. This in itself quite frequently amounts to a breach of a covenant against parting with or sharing possession or occupation of the premises. The "new co" is effectively in occupation without the landlord's permission. However, the

moratorium imposed on the administration prevents landlords from forfeiting a lease, either by taking court proceedings or peaceable re-entry, without either the permission of the administrators or the consent of the court (IA Schedule B1, para 43(4)). A landlord's security, embodied in the proviso for re-entry, no longer carries the day, so far as its enforcement is contrary to the purpose of the administration and where the overall balancing exercise comes out in favour of the administration. As an unsecured creditor, the landlord is unlikely to recover much if anything on a *pari passu* distribution between unsecured creditors and is likely to start looking at recovery under guarantees and or AGAs.

9. The latest blow to landlords is the decision in *Leisure (Norwich) II Ltd v Luminar Lava Ignite Ltd [2012] BCC 497 ("Luminar")* to the effect that rent payable in advance which accrues on a quarter day occurring prior to the administration is not recoverable as an administration expense, even where administrators use the premises during the administration or allow others to use it. Administrators are alive to the benefits that can be achieved in effecting administration the day after a rent quarter day in these circumstances. This is exactly what happened in the *Game* litigation, where the administration was entered into on 26 March 2012, the day after the March quarter day. Effectively, according to *Luminar*, they get the benefit of 3 months' rent free use of premises for the purpose of the administration, unless the landlord can obtain an order for leave to forfeit within that period. It is hardly surprising that the large commercial landlords have decided to fight back, as they have collectively done in the *Game* Litigation.

"GAME ON: LANDLORDS FIGHT BACK"

10. In July of this year, Nicholas Lavender QC sitting as a Deputy High Court judge in *Jervis v Pillar Denton Ltd (Game Station) & ors* [2013] EWHC 2171 (Ch) ("The Game Litigation") gave a group of the major landlords, namely Hammerson, British Land, Land Securities and Intu Properties ("the Game Landlords"), permission to appeal so as to enable them to challenge the principles established in *Goldacre (Offices) Ltd v Nortel Networks UK Ltd* [2010] EWHC 3389 (Ch); [2010] Ch 455 ("Goldacre") and *Leisure (Norwich) II Ltd v*

Luminar Lava Ignite Ltd [2012] BCC 497 before the Court of Appeal on a fast track basis. The judge accepted not only that the Game Landlords had reasonable prospects of success but also considered that there were other compelling reasons why the appeal should be heard as the issue to be decided is one of wider general importance to the landlords and administrators. Further, Game's quarterly rental liability was £12 million, so the outcome of the case has significant financial implications for the parties. The "new Co", Game Retail Ltd, which had been given a licence to occupy many of the stores by the administrators, has indemnified the administrators in respect of any finding that the rent is payable as an administration expense. The appeal is listed to be heard by the Court of Appeal on 12 or 13 February 2014.

11. In the *Game* litigation it was accepted by all concerned that on the current state of the authorities, as set out in *Goldacre* and *Luminar*, the High Court was effectively bound to treat rent accruing in advance prior to the administration as a debt provable in the insolvency as opposed to an expense of the administration payable in priority, even in cases where the premises were used for the purposes of the administration during the period in respect of which the advance rental liability related.

12. This is an incredibly important issue for commercial landlords and administrators. Most commercial leases provide for rent to be paid quarterly in advance. Administrations are carefully timed to "get the best value for the administration". If the administration in *Game* had commenced on 24 March, as opposed to 26 March, the authorities would dictate that the administrators would be liable to pay the whole quarter's rent as an administration expense. By waiting a matter of days they (and hence the "new co") were effectively off the hook entirely in circumstances where the new co was deriving value from the premises.

13. In *Goldacre (Offices) Ltd v Nortel Networks UK Ltd (in administration)* [2010] EWHC 3389 (Ch); [2010] Ch 455 the issue was not as to rent accruing before the administration, but rather as to the administrators' liability to pay rent falling

due during the period of administration as an “administration expense”. In that case, the landlord had leased commercial premises to a company on two long leases. The company went into administration and the administrators were appointed. Following their appointment, the administrators used part of the premises for the purpose of the more efficient conduct of the administration. Other parts of the premises were sub-let and the landlord was receiving the rent from the sub-tenants directly. The issue was whether the rent for the part occupied by the administrators for the purpose of the administration should in future be paid as an administration expense. HHJ Purle QC held it should, applying the *Lundy Granite* principle. Under that principle, liquidators are held liable to pay rent as a liquidation expense where the liquidators make use of or retain, for the benefit of the liquidation, possession of leasehold premises.

14. However, he went further and held that in circumstances where the administrators were in occupation using the premises for the purposes of the administration on a future quarter day, they would be liable to pay that quarters’ rent in full, as an administration expense, even if they subsequently vacated the premises during the quarter. In other words, in those circumstances, the whole quarter’s rent would rank as an administration expense and the administrators would not be able to seek an apportionment of rent to reflect the period they were no longer using the premises for the benefit of the administration. He did so applying the principle of election embodied in *Powdrill v Watson* [1995] 2 Act 394. HHJ Purle QC said that “*a liquidator electing to hold leasehold premises can do so only on the terms and conditions contained in the lease, and any liability incurred while the lease is being enjoyed or retained for the benefit of the liquidation is payable in full as an administration expense*”.

15. In *Leisure (Norwich) II* Ltd v *Luminar Lava Ignite Ltd (In Administration) [2012] EWHC 951 (Ch) [2012] 4 All ER 894*, HHJ Pelling QC held that the quarter’s rent that fell due before the administration was not treatable as an administration expense, even in circumstances where the administrators thereafter made use of the premises for the purpose of the administration during the period covered by that quarter’s rent.

16. In that case, the landlords applied for orders requiring the administrators of the respondent tenants to pay pre-administration expenses. The tenants, as part of a company group, had been one of the largest nightclub operators in the UK, and had leased four properties from the landlords for that purpose. Rent was payable quarterly in advance on each quarter day. The administrators agreed to sell the majority of the tenants' business and assets to a buyer. The buyer agreed to seek the landlord's consent to the assignment of the leases to it. The issue largely related to the September 2011 quarters' rent. The companies were placed into administration on 28 October 2011. On 31 October 2011, the administrators confirmed an intention to trade the venues until 1 January 2012 even though they were not in a position to pay rent. On 1 November 2011, the landlord sought the administrators' consent to exercise the right to forfeit the lease which was refused on 2 December 2011. By the time of the hearing, the administrators had given leave to forfeit. The only substantive issue related to whether the rent falling due on 29 September 2011 was payable as an administration expense or not.

17. It is now well established that the question of whether a liability is or is not an administration expense, payable in priority to provable debts, is a matter governed by Rule 2.67 of the Insolvency Rules 1986. The court has no discretion to treat something as payable as an administration expense if it is not covered by those rules: see *Toshoku Finance UK Plc* [2002] 1 WLR 671 establishing that proposition in the case of liquidation which has been held to be equally applicable to administrations: see *Newmans LLP v Administrators of Portsmouth City Football Club* [2012] EWHC 3088, per Morgan J at para. 93. This includes (1)(a) "expenses properly incurred by the administrator in performing his functions in the administration of a company" and "(f) any necessary disbursements by the administrator in the course of the administration". It is also well established that if pre-existing contractual liabilities (such as under a lease entered into before the administration) fall within the "*Lundy Granite*" principle, they will be covered by rule 2.67(1)(a) or (f). In other words they will be <u>treated as</u> an expense or disbursement <u>incurred</u> by

the administrators even if the underlying liability was incurred by the company prior to the administration, such as to constitute a provable future debt.

18. The real issue therefore is how far the *Lundy Granite* principle extends. In *Luminar*, HHJ Pelling QC held that it did not apply to rent falling due before the administration. He analysed the cases and held that in none of them were debts falling due before the administration or liquidation held to be covered. He considered his decision to be consistent with the reasoning of HHJ Purle QC in *Goldacre*.

19. In summary, the position following *Goldacre* and *Luminar* is as follows:

    a. Where rent is payable in advance and falls due for payment prior to commencement of the liquidation or administration, then it is provable but not payable as a liquidation or administration expense, even though the liquidator or administrator retains the property for the purposes of the liquidation or administration for the whole or part of the period for which the payment in advance was payable;

    b. Where rent payable in advance becomes due during a period when the liquidator or administrator is retaining the property for the purposes of the liquidation or administration then the whole sum is payable as a liquidation or administration expense even though the liquidator or administrator gives permission to forfeit or vacates before the expiry of the period for which the advance payment is due.

20. In the *Game* litigation, the landlords will challenge both propositions head on. The proposed grounds of appeal are set out in paragraph 19 of the decision granting leave to appeal as follows:

> "1. The Lundy Granite principle [which is the principle being applied and interpreted in Goldacre and Luminar] is concerned with the use of property for the benefit of a liquidation or administration, and requires as a matter of "common sense and ordinary justice" that "the landlord receives the full value of the property. [and there is a reference there to the decision of the *House of Lords*

in *Re Toshoku Finance UK Plc [2002] 1 WLR 671* , quoting at paragraph 23 from Lundy Granite itself.]

2. The touchstone for the application of the principle is the use by a liquidator or administrator of the property for winding-up or administration: Toshoku at [26] citing *Re Oak Pits Colliery Co* .

3. The principle is not concerned (unlike many other heads of expense in Rule 4.67(1)) with debts incurred by the administrator. As Lord Hoffmann pointed out in Toshoku at [27], the liability is plainly not incurred as an expense of the liquidation (or administration), because "the whole of the liability was incurred by the company before the winding-up for the whole term of the lease".

4. Instead, the principle is based on a fiction: " … it would be just and equitable … to treat the rent as if it were an expense of the winding up and to accord it the same priority": Toshuku, at [27].

5. The fact that rent payable in advance under a lease cannot generally be apportioned. (due to the Apportionment Act) is not relevant to the question whether payment for the use of leased property should be treated as if it was a debt incurred by the company in administration for the period when the property was used for the purposes of the administration. *Ellis v Rowbotham* itself did not involve a liquidation and did not involve any consideration of the Lundy Granite principle.

6. Put another way, whether or not the rent payable under the lease contract can be apportioned day to day, the amount which is payable pursuant to the fiction that the rent has been incurred as an expense of the administration is only that which is referable to the period when the property is being used beneficially for the purposes of the winding-up.

7. HHJ Purle QC's conclusion was based on the decision of the House of Lords in *Powdrill v Watson* [1995] 2 AC 39, but the issue in that case was the different one of whether an administrator had "adopted" a contract, and so became liable for the liabilities accruing due under it post administration: it did not involve the application of the *Lundy Granite* principle.

21. To my mind the arguments put forward on behalf of the landlords have considerable force but it remains to be seen how the Court of Appeal will approach this question, particularly if there is a concern that, by elevating the claims of such landlords, the general pot available for *pari passu* distribution will decrease. As a matter of principle, the landlords' arguments are compelling. It seems arbitrary to simply look at the date on which rent accrues as an actual debt, given that the future debts due under the lease are themselves provable in any event. The *Lundy Granite* principle is already an exception to the *pari passu* principle, based on a fiction. If the underlying principle is that the administrator should pay for the value he receives, why should he not pay the

landlord for continued use of property, particularly in circumstances where the landlord is precluded from exercising the right to forfeit without consent of the court or the administrator? And equally, why should he pay for value he does not receive? In one of the five *Game* test cases, the administrator used the premises for 5 days, simply to vacate the store. If the administrator objects to the landlord exercising its security, why should he not pay for that privilege as an expense in the administration? The knock on effect if such rent is not an administration expense is that the administrator will find it more difficult to object to applications for leave to forfeit. The balance will more firmly rest in favour of allowing leave applications in such cases because the landlord is not receiving any payment for the continued use of its property in circumstances where, if forfeiture were allowed, it could recover beneficial use.

22. A recent article in the Estates Gazette suggests that the recent Supreme Court ruling in the appeals in the *Nortel and Lehman administrations* [2013] UKSC 52 represents a blow to the Game Landlords[1]. In my view, there is nothing in the judgments of the Supreme Court that should concern the Game landlords as the issues were entirely different. In that case, it was held that the potential liabilities under a financial support direction served by the Pensions Regulator on a "target company" during the course of administration was a provable debt and not an administration expense. This case turned on the meaning given to provable debts in rule 13.12 IR 1986 and the particular statutory scheme of regulation in the pensions' field. It did not concern the *Lundy Granite* principle at all. There was in that case "no question of such a liability resulting from any act or decision taken by or on behalf of the administrator" (para. 105, per Lord Neuberger) and in any event, there was no question of the debt (which would arise out of circumstances arising before the administration, namely the underfunding of the relevant pension scheme) being a liability arising "in the course of" the administration. "In the course of" does not mean "during the period of". (para.99, 106). The expense must be incurred as one of the "natural incidents connected with" the administration. One can readily see that this reasoning has no application to the *Lundy Granite* principle, which rests on the

[1] Egi, Jess Harold (24.07.2013), "Pensions blow to Game landlords"

notion that the property is used by the administrators for the benefit of the administration. The *Goldacre* and *Luminar* decisions were not referred to by the Supreme Court, quite simply because they did not impact on the issues the Supreme Court had to consider.

APPLICATIONS FOR LEAVE: THE LAZARI DECISION

23. Prior to forfeiting by way of proceedings or peaceable re-entry it will be necessary for a landlord to obtain either the consent of the administrator or the leave of the court under IA 1986, Schedule B1, para. 43. This effectively is the statutory moratorium imposed to further the objects of the administration.

24. If the administrator does not consent, the principles that will be applied by the court are set out in *Re Atlantic Computer Systems Ltd* [1992] 505, 542 to which reference should be made in detail if making an application.

25. Those principles were usefully summarised by HHJ Norris QC in *Metro Nominees (Wandsworth)(No. 1) v Rayment (16 October 2006)* as follows:

> "First, it is emphasised by the Court of Appeal that this passage contains guidelines which must be treated as such and must not be regarded as a straightjacket, fettering the exercise of a general discretion. Second, the general rule in the normal case is that if a creditor seeks to exercise a proprietary right that is unlikely to impede the achievement of the purpose for which the administration is being pursued, then leave should normally be given. Third, where that is not the case (so that there is a likelihood that the proprietary right will impede the achievement of the purpose) then the court has to carry out a balancing exercise, balancing the legitimate interest of the lessor and the legitimate interests of the other creditors. Finally, in carrying out that balancing exercise, great importance or weight is normally given to the proprietary interests of the lessor (the underlying principle being that an administration for the benefit of unsecured creditors should

not be conducted at the expense of those who have proprietary rights, save to the extent that this is unavoidable)."

26. The second principle set out above was also applied in *Lazari GP Limited v Jervis* [2012] EWHC 1466 (Ch). In that case there had been a business sale by the administrators very shortly after the commencement of the administration. Under that agreement the buyer had taken the risk of occupation without the landlord's consent, had made only a half hearted application for consent to assign and had not availed itself of the right to use the company's name for the purpose of bringing a claim that consent had been unreasonably delayed or withheld. Therefore under the business sale agreement, it mattered not for the beneficial realisation of the company's property in administration whether or not the lease was forfeit. The buyer had taken the full risk of the exercise of those rights and there would be no adverse consequences for the administration. Leave was given. This is an extremely useful decision for landlords faced with a pre-pack. If, as is quite often the case, the administrators retain no benefit from the premises following a sale, they will find it difficult to justify a refusal of leave.

27. It can be quite difficult to advise on the prospects of any application for leave without understanding what the administrators' position is and the exact nature of the arrangements they have entered into with the "new co" or other purchaser. The burden of proof in any application for leave is on the applicant, but administrators, given their role, should be expected to set out their position openly and promptly. Administrators can be extremely cagey about answering any direct request for information but if they refuse leave to forfeit, they should be pressed to provide a coherent explanation as to how, if at all, the continued retention of the premises is said to be of benefit to the process of administration. A copy of any sale agreement or other such arrangement should be requested, or even applied for by way of disclosure in an appropriate case.

28. Whilst a pre-pack may entirely put the risk onto the buyer such that the continued occupation does not benefit the administration, that is not always the

case, as the case of *Innovate Logistics Ltd (in admin) v Sunberry Properties Ltd* [2009] BCC 164 demonstrates. In that case, under the pre-pack arrangement, the "new co" who occupied the premises under a licence given by the administrators was to perform the company's existing contracts and thus ensure the continued collection of the company's book debts, for the benefit of the administration. The occupation of the "new co", although in admitted breach of lease, did benefit the insolvent company in administration and would further the objects of that administration, necessitating the difficult and fact sensitive "balancing exercise" to be undertaken. In that case the balance came down against granting leave for a mandatory injunction seeking termination of licence.

CREDITORS' VOLUNTARY ARRANGEMENTS

What is a CVA?

29. Part I of the Insolvency Act 1986 introduced an entirely new procedure into UK company law, namely the Creditors' Voluntary Arrangement or CVA. It was introduced to deal with the failure of the former company law identified by the Cork Committee Report (*Report of the Review Committee into Insolvency Law and Practice* (1982) (Cmnd 8558 at paras. 400-403) to allow a company (as opposed to an individual) to enter into a binding arrangement with its creditors for the composition of its indebtedness by some relatively simple procedure in order to avoid formal insolvency. This gives the company a chance to trade out of its difficulties or to secure a more equitable distribution to creditors than might have been achieved through other insolvency processes.

30. The assumption underlying CVAs is that the practical aim of the law should be rescue; getting the debtor back on its feet or maximising value for creditors from what is presently available. Rehabilitate the debtor and draw a line in the sand. There is no expectation that anything will be done by the debtor once rescued to compensate creditors further.

31. A CVA does not result from a court order and/or the actions of a secured creditor as in the case of administration or administrative receivership. It is a compromise agreement between a company and its unsecured creditors. The

CVA comprises a set of proposals that are usually put together by a licensed insolvency practitioner appointed as nominee. He will act as the supervisor if the CVA is approved and will collect the assets subject to the CVA and ensure that creditors are paid the agreed dividend.

32. The initiative in setting up a CVA is taken by the directors of the company or, if the company is being wound up, by the liquidator or administrator. It is not however a pre-requisite that the company should be "insolvent" or "unable to pay its debts".

33. The essential element of a CVA is that a 75% majority of a company's unsecured creditors can bind the remainder to the proposed arrangement against the latter's wishes. It is this power that has led to challenges by minority landlord creditors indignant that the CVA procedure has been invoked so as to unilaterally impose upon them a fait accompli that is prejudicial to their interests.

34. The Act contains an inbuilt mechanism to ward against such unfairly prejudicial treatment. By section 6 of IA 1986, a person entitled to vote at either of the meetings or a person who would have been entitled to vote at the creditors' meeting if he had had notice of it, may apply to the Court on one or both of the following grounds, namely that:

    (a) a CVA unfairly prejudices the interests of a creditor, member or contributory of the company;

    (b) that there has been some material irregularity at or in relation to either of the meetings.

    The Court, if satisfied as to either of those grounds, may:

    (i) revoke or suspend any decision approving the CVA; and/or

    (ii) give a direction to any person for the summoning of further meetings to consider any revised proposal.

The ways in which CVAs usually compromise the landlord's claim against the tenant

35. It is unusual for a CVA to include terms that a lease is actually forfeit or surrendered as the effect of such arrangement, if implemented, would be to let former tenants and their guarantors off the hook. Even if there are agreed terms for a surrender of a closed store lease incorporated into the CVA, such agreement is unlikely to comply with s.2 of the Law of Property Miscellaneous Provisions Act 1989. However, if in pursuance of such an agreement the landlord and tenant do actually effect a surrender of the lease, then the obligations of any guarantor would come to an end, although any freestanding obligation undertaken by the guarantor to take a new lease would survive: see *RA Securities Ltd v Mercantile Credit Co Ltd* [1995] 3 All ER 581.

36. However, it is not unusual for CVAs to be drafted on the basis that future contingent claims for rent and damages for non compliance with other covenants are compromised, so in effect releasing the tenant from most, if not all, continuing responsibility under the terms of the lease. In everything but name, therefore, as between the landlord and tenant, the lease no longer exists and it becomes necessary to look at the landlord's rights under the lease as against third parties, such as former tenants and guarantors.

37. As a general rule which applies to all contracts of guarantee, if a creditor releases the principal from his debt or obligations by a valid and binding legal agreement, then the surety will be discharged. There are two reasons for this rule. First, as a matter of basic principle, since the contract is one of guarantee, the surety's obligation being to pay the debt or perform the obligation of another, once that payment or obligation has been released, there is nothing left in respect of which the surety can be liable. Secondly, the effect of the release would deprive the surety of his right to pay off the creditor and sue the principal in the creditor's name.

38. However, it has long been established that this reasoning does not apply in circumstances where (i) the creditor reserves his rights against the surety at the time he releases the principal or (ii) where the original contract provides for the enduring liability of the surety notwithstanding the principal's release since in those circumstances the principal has notice of the surety's continuing liability and his consequent liability to indemnify the surety: see *Greene King v Stanley* [2001] EWCA Civ 1966.

39. It is usually the case that guarantees contain express provision providing for continuation of the guarantee in the event of compromise with or insolvency of the principal debtor. In such cases it is not even necessary for the creditor to go to the length of expressly reserving rights against his surety in dealing with the principal: see *Lombard Natwest Factors Ltd v Loutrouzas* [2003] BPIR 444; *Prudential Assurance Co Ltd v PRG Powerhouse Ltd* [2007] EWHC 1002 (Ch).

Does a CVA release a surety? – a matter of construction

40. The cases demonstrate a considerable reluctance on the part of the courts to construe the terms of a CVA as having the effect of releasing co-debtors and sureties. The true effect of the CVA is a matter of construction of the relevant voluntary arrangement, on usual contractual principles. A release may be implied, as a matter of construction.

41. In *RA Securities Limited v Mercantile Credit Co Ltd* [1994] BCC 598, a landlord under a pre 1995 Act lease sued an original tenant for arrears of rent where the second assignee and current tenant had gone into a CVA. The landlord claimed both pre-arrangement and post-arrangement rent from the original tenant. The first assignee (but not the original tenant) was summoned to the creditors' meeting and was a party to the CVA. Jacob J noted that the CVA "*is not for the benefit of solvent parties who happen to owe debts also owed by the debtor. It would be unfair if a solvent debtor escaped liability as a side-wind of the VA system.*" He recommended that for a CVA effectively to deal with a lease held by assignment, the assignor should be summoned to the creditors'

meeting. And it would seem correct to add that he should be made a party to the CVA. The judge rejected the suggestion of an accord and satisfaction of the entire debt. The landlords were bound by the CVA but they did not voluntarily accept some other performance. Although a CVA takes effect as a contract, there was no accord in truth; just a statutory binding. The original tenant's failure to exercise the option to turn up at the creditors' meeting and argue for some other arrangement did not amount to an accord in the sense of an acceptance.

42. In *Johnson v Davies* [1999] Ch 117*,* the Court of Appeal held that the question of whether a surety is released by the terms of an IVA is to be answered by reference to the terms of the agreement embodied in the IVA, on usual contractual principles. If, on its true construction, the agreement amounted to an accord and satisfaction, then effect would be given to it so as to terminate the surety's liability even if it did not turn up and the landlord voted against the proposal. In this respect the reasoning in *RA Securities Limited V Mercantile Credit Co Ltd* that a mere statutory binding could not affect an accord and satisfaction of a third party's liability was rejected.

43. In other words it is necessary to examine the terms of the IVA to decide whether the parties to it had intended that rights against a surety be reserved or not. Historically the question of whether a release of a co-debtor released the other depended on whether the agreement represented a release (which would automatically release the co-debtor) or merely an agreement not to sue (which would not). That distinction was held to be artificial in *Watts v. Aldington*, The Times, 16 December 1993 and was rejected. The true inquiry is as to whether the intention of the parties was to reserve rights against the co-debtor or not. In addressing this question in *Johnson v Davies*, the Court of Appeal held that the Defendants were not released from their obligations under a covenant of indemnity by reason of the terms of an IVA of a co-obligee who was liable, jointly with the defendants, under the same covenant the liability which was the subject of the indemnity. The IVA was inconsistent with any intention to effect an immediate or absolute release of the debts owed by the debtor to his

creditors; the bargain in the IVA did not lead to a release by accord and satisfaction of the joint debt owed by H and the defendants to the claimants, such that that debt could no longer be enforced against the defendants. Although it was necessary in order to give efficacy to the arrangement to imply a term that creditors bound by the proposals would take no steps to enforce their debts against the debtor while he was complying, or had complied, with his obligations thereunder, it was not necessary to imply a term that creditors were bound to take no steps to enforce their debts against his co-debtors. The debtor proposed to pay a percentage of his income to the supervisor, on the true construction of the CVA that did not amount to a release by accord and satisfaction. In *Re Goldspan Limited* 2003 BPIR 93 and following *Johnson v Davies*, Mr Leslie Kosmin QC dismissed robustly a contention that the IVA of one co-debtor released any claim against a solvent co-debtor.

44. The question whether a reservation of rights of a creditor against a guarantor ought to be implied into an agreement between the creditor and the principal debtor releasing the principal debtor may be a question of fact requiring a trial rather than a summary determination-see *Finley v Connell Associates* 1999 WL 477.

45. In *Greene King Plc v Stanley* [2002] BPIR 491, the debtor took a loan from Greene King to finance the purchase of the lease of a public house. The loan was secured on the debtor's parents' house. The pub business failed. The debtor was substantially in arrears with payments under the charge. An IVA was proposed under which a sum of money put up by the debtor was shared between the creditors. The debtor was given more time to pay off the secured loan. The duration of the IVA was 1 year. The creditors were paid out but Greene King was not repaid. It took possession proceedings to enforce its security. The supervisor notified creditors that the IVA had been fully implemented, thereby bringing it to an end. The parents sought to defend the possession claim on grounds that under the general law a creditor (Greene King) could not preserve his rights against a surety on the release of the principal debtor unless there is a term in the contract of surety which entitles it

to do so. The Court of Appeal disagreed. It could see no relevant distinction between the position of a surety and that of a co-debtor. It had long been accepted that, on the release of a co-debtor, the creditor may reserve its rights against the other co-debtors. The release of the principal debtor discharges the surety as the release of the principal debtor interferes with the surety's right to pay off the debt and sue the principal debtor. However, that right takes effect subject to any reservation by the creditor of its rights against the surety at the time of the release. Therefore, it was open to Greene King to release the debtor whilst reserving its rights against the parents. The reservation became part of the IVA when the existence of Greene King's rights against the parents was expressly mentioned in the proposal. A statement in the proposal that "Greene King have a guarantee from my parents secured by a charge on their house" effectively put the creditors on notice of the possibility that Greene King intended to preserve its rights against the parents. Accordingly, the IVA did not have the affect of releasing the parents from their obligations under the charge.

46. Some ambiguity as to the effect of a CVA has been introduced by certain dicta of Lord Neuberger in a more recent case which might be said to lend support to an argument that a guarantor should escape the hook, either wholly or in part, where the tenant's liability under the covenants in the lease is replaced with a liability to pay a dividend.

47. In *Thomas v Ken Thomas Ltd* [2007] 1 EGLR 31, rent plus VAT was payable monthly in advance under a lease dated 13th May 2004. The tenant paid the rent (but not the VAT) up to November 2004. It did not pay the November rent or the VAT on the previous month's rent. From December 2004 it paid the full amount due on a weekly rather than monthly basis. A CVA was approved which dealt, inter alia, with the arrears of rent due in November 2004 and the unpaid VAT element. The proposal, accepted by the requisite majority of the creditors voting (but against the wishes of the landlord) was to pay 23p in the pound. The landlord sought to exercise his right to forfeit in respect of the November 2004 rent and the unpaid VAT element which, by reason of the CVA, he could not sue for in debt.

48. Neuberger LJ held amongst other things that the landlord could not forfeit the lease for past rent which was caught by the terms of the CVA. The reasoning for this essentially was that the debts of the landlord under the lease had been substituted by a different debt under the CVA. As the right to claim rent had gone, so had any remedy related to it, such as the right to forfeit. If that is right, it could perhaps be argued that the effect of the CVA must be to effect an automatic accord and satisfaction by the loss of the original covenant and its substitution for something else. However, if that is right, this brings into question the entire line of cases decided above and it is doubtful that Lord Neuberger intended such a result. Further, in *Watts v Adlington* itself, the party to the action accepted a new obligation (namely payment by a third party) in substitution for its liability by way of a compromise of his primary liability but the co-debtor was not released and remained liable on the original liability. This is perhaps an argument of last resort. The real test, in my view, remains whether, in agreeing to accept a dividend payment the parties intended that a third party guarantor should be released, whatever the analysis of the statutory effect of the compromise as between landlord and tenant.

49. I have also seen it suggested that the guarantor's liability could perhaps be reduced accordingly to the amount of the dividend payable[2]. If there is a total substitution of the liability, the guarantor would be released entirely. His guarantee was in relation to the original obligation. I cannot see how it can extend, without his consent, to an entirely new liability, namely the liability to pay the dividend.

Preservation of rights against third parties not connected with tenant's operation

50. A distinction here can be drawn between the preservation of rights against a third party who is not connected with the current tenant, such as former tenants

[2] Property Insolvency, Levaggi and Elford at 5.78

and their guarantors and those who are, such as the parent company guarantor of the current tenant.

51. In the former category, it is common to find an express reservation of the landlord creditor's rights against such third persons. Whilst the current tenant thereby opens itself up to contingent claims by such persons by way of indemnity, such claims are often compromised for little money as part of the CVA. Therefore the current tenant has little to lose from agreeing to an express reservation provision. This may not be necessary in any event as most guarantees are drawn widely to ensure that they are preserved in the event of the tenant's insolvency or a compromise with the tenant, when they are really needed.

52. Even if the CVA expressly seeks to preserve rights against third parties, that is not necessarily conclusive as to a third party's liability under the terms of his guarantee. Although the landlord and third party guarantors are likely to be parties to the CVA and be bound by it under section 5 of the IA 1986, despite not voting in favour, the effect of the CVA is to create a series of bilateral agreements enforceable as between the company on one hand and its creditors on the other: see Etherton J in *Prudential Assurance Co Ltd v PRG Powerhouse Ltd* [2007] EWHC 1002 (Ch) at para. 51. A tenant's CVA cannot constitute any agreement, binding or otherwise, between the landlord on the one hand and the third party guarantor or former tenant on the other. In other words if, on a true construction of the terms of the relevant guarantee itself, the liabilities of the guarantor come to an end on a release of the tenant's liabilities under the CVA, then the CVA cannot have the effect of altering that so as to provide for enlargement of the AGA beyond its expressed scope.

53. An original tenant under an "old tenancy" will be liable on the covenants in the lease. If the lease continues, as it often will under the terms of a CVA, there is unlikely to be any mileage in respect of such arguments for the original tenant.

54. However, the position with former tenants and guarantors in respect of "new tenancies" is different. This is because of the restrictions on continuing liability imposed by the 1995 Act. AGAs take different forms. By necessity, they cannot be drafted so as to extend the liability of the former tenant or guarantor beyond the next assignment for such liability would not be an AGA at all. To comply with this requirement, AGAs are often drafted in terms which expressly provide that the liabilities thereunder are not to extend beyond "*the release of the assignee at law*" or similar phrase. For example in *Shaw v Doleman* the covenant in the AGA was to be "*throughout the period during which the Assignee is bound by the tenant covenants in the Lease.*"

55. However, this type of vague drafting opens up a possible argument that the release of the assignee from all liability under the lease as part of a CVA, itself discharges the former tenant/ guarantors' liability under the terms of the AGA, even though the continuance of the third party's liability whilst the lease continues and has not been assigned is not precluded by the 1995 Act, even if the assignee is released by the terms of a CVA. The CVA cannot expressly preserve the liability of the AGA beyond the date on which it would, on its own terms, cease to impose liability on the assignor. This is unlikely to have been the intention of the parties for it is precisely in the event of the assignee's insolvency that the landlord will want to preserve the right to sue former tenants and guarantors.

56. The outcome of such a dispute will depend on the true construction of the AGA in question, which is likely to involve a detailed examination of the entirety of the AGA and fall to be decided on finer points of contractual interpretation. The decision in *Shaw v Doleman* is likely to be of some comfort to landlords, but the case can be distinguished in the event of a CVA. There would be some force in the commercial argument that the landlord cannot have intended to have taken such a weak guarantee. It is precisely in the event of the tenant's insolvency that the AGA is likely to be resorted to. However, the ratio of the decision in *Shaw v Doleman* was that the terms of the AGA had to be construed against the backdrop of the statutory provisions as to the effect of a disclaimer. The

Cheshire Cat lease essentially came to the rescue of the landlord in that case. There is no such Alice in Wonderland trickery built into the CVA which is treated as a consensual arrangement (albeit one imposed by statute on the minority and subject to challenge on the grounds of unfair prejudice).

57. It is therefore important for landlords to ensure that guarantees and AGAs are drafted in terms which, whilst not falling foul of the anti avoidance provisions in the 1995 Act, protect the landlord in the event of a release of the assignee as part of the CVA. Ideally this should be expressly provided for.

GUARANTEE STRIPPING

58. Whilst a CVA will usually contain express provisions preserving the creditor's ability to pursue third parties, the position is different if that third party is connected with the tenant. Parent companies are usually "the driving force" behind the CVA of a subsidiary. In particular the parent will more often than not be providing the funding by which claims will be compromised with the aim of keeping the subsidiary alive as a going concern. It is perhaps not surprising that parent companies have sought to use the CVA as a means of "guarantee stripping", namely to compromise for little value a guarantee that would otherwise be enforceable in full against them. The legality of guarantee stripping was considered in the *Powerhouse* litigation. The result is that whilst it is technically possible to do this, a CVA which did would, in practice, be extremely vulnerable to a section 6 challenge on the grounds of unfair prejudice. That, however, may be little comfort to landlords who face an expensive and uphill battle after the event to set aside an otherwise enforceable CVA. The tactical considerations and the danger of the CVA being used cynically to put pressure on landlords was fully explored in the *Sixty* CVA litigation which I shall consider below.

Powerhouse

59. The Powerhouse litigation is the collective name given to two test cases heard before Etherton J in the High Court as trials of preliminary issues, namely *Prudential Assurance Co Ltd v PRG Powerhouse Ltd & Ors*; *Luctor Ltd v PRG Powerhouse Ltd And Ors* [2007] EWHC 1002 (Ch); [2007] Bus.L.R.1771.

60. The litigation concerned the question as to whether the tenant company's CVA which purported to provide for a release of the parent company's guarantees to creditor landlords was effective in circumstances where the majority of creditors who voted for the proposal were unaffected by it. In other words, could Powerhouse's CVA be used as a mechanism for stripping out guarantees given by its parent company, PRG Group Ltd?

61. The tenant company was the UK's third largest electrical retailer before it ran into financial trouble. Its directors proposed to close 35 of its underperforming stores but to continue trading out of its more profitable sites which numbered 53. The claimants in each case were landlords of the closed stores who in turn had the benefit of guarantees given by Powerhouse's parent company, PRG Group Ltd ("PRG"). Those guarantees had been framed so that PRG's liability was not to be affected by insolvency on the part of Powerhouse. Therefore, as Etherton J put it, under the terms of the guarantees "PRG assumed the risk of Powerhouse's insolvency". In fact, the tenant had only acquired the business as a going concern in 2003 with the assistance of PRG and, on assignment of the various leases, the claimant landlords had required parent guarantees in these terms as a condition of giving consent.

62. The tenant company proposed a CVA under which the claims against it arising from the store closures would be compromised but all other claims would be settled in full. The creditors whose rights were to be affected, which included the claimant landlords, would receive under the arrangement a dividend of 28 pence in the pound. The proposed CVA also sought to release the parent company's guarantees in respect of the closed stores as follows:

- Clause 3.12 of the CVA provided that payment of the dividend immediately operated to release all liability of the parent company under any guarantee.

- Clause 3.14 of the CVA provided that the guarantees were treated as released.

63. Perhaps unsurprisingly, Powerhouse did not face much difficulty in getting the proposed CVA approved by the majority of its creditors, who were not affected at all and indeed stood to have their claims settled in full under the arrangement or obtain a dividend of 28 pence in the pound when they would have received nothing on liquidation. The landlord creditors with the benefit of the parent company guarantees were in the minority. Likewise it is not difficult to see why the landlords of the closed stores were up in arms and sought to challenge the validity of the CVA in court. As Etherton J noted, the landlords, who stood to gain the most from an insolvent liquidation stood to lose the most from the CVA.

64. The preliminary issues before Etherton J were as follows:

- Whether any of those guarantees or indemnities had been released by reason of the CVA under section 5(2) of the Insolvency Act 1986 ("the IA 1986");
- Whether, if not, any of the claimants were precluded from otherwise enforcing any of the guarantees or indemnities against the parent company by reason of the CVA; and
- If the CVA did operate to release PRG Group Ltd from its liabilities under the guarantees whether the CVA unfairly prejudiced the claimants' interests for the purposes of section 6(1) of the IA 1986.

65. The answer to the first preliminary issue was "no". However, the learned judge accepted that there was nothing new in the principle that a CVA could directly and adversely affect the rights of a third party guarantor. In *Johnson v Davies* the Court of Appeal confirmed that payment of a dividend to a creditor pursuant

to a CVA can automatically operate, as a matter of general law, so as to discharge the liability of a third party co-debtor or surety. Nevertheless, Powerhouse was not such a case, because the general rule was capable of being ousted by express provision in the guarantee retaining the liability of the surety notwithstanding dealings between the creditor and the principle debtor. In *Lombard Natwest Factors Ltd v Koutrouzas* [2003] BPIR 444 it had been held that a surety was not released by an IVA of a co-surety when the guarantee expressly provided that the guarantee would not be affected by indulgence granted to a co-surety. The Powerhouse guarantees all contained express provisions to that effect and so effectively PRG Group Ltd had taken the risk of Powerhouse's insolvency. Therefore as a matter of general law the guarantees would not "fall in" with the primary debt. He held that a CVA was a hypothetical bilateral agreement between each creditor and the company and that it was the company and the creditor, and not any third party, which had the benefit of and could enforce the rights and obligations under the CVA. Accordingly, sections 1(1) and 5 of the IA 1986 did not operate directly to release the parent company's liability under the guarantees.

66. On the second issue however, Etherton J held that clause 3.14 of the CVA (which provided that the parent guarantees were to be treated as having been released) was effective as between the company and the claimant landlords. Therefore clause 3.14 was in principle enforceable by the company as an obligation on the claimant landlords not to claim against the parent company under the guarantees.

67. The learned judge described the claimants' concession, that it is legally possible for a CVA to provide that a creditor cannot take steps to enforce an obligation of a third party to the creditor which would give rise to a right of recourse by the third party against the debtor company (such as payment by a guarantor who can then claim contribution from the debtor), as "plainly right". He held that there was no difference in substance between an obligation of a creditor not to enforce a contract with a third party, on the one hand, and an obligation of the

creditor to deal with the third party as if the creditor's contract with the third party did not exist, on the other hand.

68. Therefore although the CVA could not actually effect a release of the guarantee, it could in practical terms do so because the tenant company could enforce the obligation not to claim on the parent company's guarantees by injunction. This is the worrying element of the *Powerhouse* decision that may leave landlords feeling anxious about the real value of a parent guarantee in the event of a tenant's insolvency even where the guarantee is drafted in terms which expressly puts the risk of insolvency on the parent company guarantor.

69. As a matter of construction however, he held that the wording of the CVA in Powerhouse did not protect the tenant from any right of recourse PRG would have against it in respect of any claim brought by a landlord of closed premises under a guarantee. Therefore Powerhouse had a real financial interest in ensuring that the claimant landlords did not take action against PRG.

70. However, on the third issue (much to the relief of many commercial landlords), he held that the CVA could be challenged on grounds that it was unfairly prejudicial under section 6 of the IA 1986. Etherton J held in no uncertain terms that the CVA unfairly prejudiced the interests of the claimant landlords under section 6 of the IA 1986. It is this element of the decision that has allowed many commercial landlords to breathe a sigh of relief (for now) and has been hailed as a majority victory for landlords.

71. This finding involved an examination of the way in which the court considers an allegation of unfair prejudice. A number of points were made clear.

72. The first point is that the issue whether a CVA unfairly prejudices the interests of a creditor under section 6 of the IA 1986 is to be judged on the information available at the time the CVA was approved.

73. Secondly, establishing “prejudice” will usually be fairly straightforward. It was held that any CVA which leaves the creditor in a less advantageous position than before the CVA – looking at both the present and future – will be prejudicial. It is however, the additional need to show that the prejudice is “unfair” that raises difficulty. As Etherton J stated at paragraph 74:

> “It is common ground that there is no single and universal test for judging unfairness in this context. The cases show that it is necessary to consider all the circumstances, including in particular, the alternatives available and the practical consequences of a decision to confirm or reject the arrangement.”

74. The concept of “comparative analysis from a number of different angles” features heavily in Etherton J’s judgment. He identified three such different types of comparison:

- “Vertical” comparison with the position on winding up;
- “Horizontal” comparison with other creditors or classes of creditors;
- Comparison with the position if, instead of a CVA, there had been a formal scheme of arrangement under section 425 of the Companies Act 1985 on which the different classes of creditors would have been required to meet and vote separately.

75. On the vertical comparison, if a CVA would be likely to result in a creditor or group of creditors receiving less than they would in a liquidation, then the court would be unlikely to sanction it.

76. The horizontal comparison involves a comparison of the position of different classes of creditor. The concept of unfair prejudice is aimed at disproportionate prejudice on one side or the other. However, the mere existence of differential treatment is not enough to support a finding that that the dissentient creditor has been unfairly prejudiced. In some circumstances, differential treatment may be necessary to ensure fairness or to secure the continuation of the company’s

business which underlies the CVA, for example, where it is necessary to pay suppliers in full in order to ensure that the company can continue to trade.

77. In relation to the third aspect Etherton J also held that, depending on the circumstances, a comparison with what the position would have been on a scheme of arrangement under section 425 of the 1985 Act may be of assistance on the issue of unfair prejudice in a CVA. However, he also agreed that caution must be exercised in carrying out that comparison. The fact that a particular class of creditors could and might have blocked a scheme under section 425 of the CA 1985, whilst relevant and potentially important, does not necessarily mean that they have been unfairly prejudiced within section 6 of the 1986 Act.

78. Applying these tests, Etherton J was very firmly of the view that this CVA was unfairly prejudicial.

Sixty

79. The issue arose again in relation to the *Sixty* CVA. In *Mourant & Co Trustees Ltd & anor v Sixty UK Ltd* [2010] EWHC 1890 (Ch), landlords of two retail units at the Met Quarter shopping centre in Liverpool applied under section 6(1) of the IA 1986 for a revocation of a CVA proposed by the administrators of the tenant, Sixty (UK) Ltd ("*Sixty*") on the grounds of unfair prejudice.

80. In that case these two landlords of closed stores had the benefit of guarantees given by the tenant's ultimate Italian parent company, Sixty SpA. There was no suggestion that Sixty SpA would be unable to meet its obligations under these guarantees.

81. The effect of the CVA, as approved by the 75% majority of creditors, was to release Sixty SpA from all liability under the guarantees upon payment of a sum of £300,000 which was said to represent 100% of Sixty's estimated liability to the landlords on a surrender of the lease. Ostensibly therefore, the guarantors

were to receive full compensation. The CVA also provided for two other stores occupied by *Sixty* to close and for their landlords to receive a dividend of 21% of the estimated liability. Those landlords did not have the benefit of any parent guarantee. All other creditors were to be paid in full. Another feature of the CVA was that another landlord creditor's right to pursue an original tenant, Muji, was preserved and the CVA did not seek to compromise any claim Muji might have against *Sixty* to be indemnified.

82. It was accepted by the landlords that, as established in *Powerhouse*, a voluntary arrangement made between a tenant and its creditors, including landlords with the benefit of third party guarantees is possible of imposing on the landlords a binding release of their rights under such guarantees, even though the guarantor is neither the company which is proposing the arrangement, nor a party to it. Furthermore, it was accepted that a CVA could have that effect even though the relevant guarantees contain provisions designed to prevent the release of the principal debtor from affecting the creditor's rights under the guarantee.

83. Henderson J allowed the challenge to the CVA. His judgment is in emphatic terms, concluding that it was clear that the application "must succeed". Indeed, he stated that this was a CVA that was "fatally flawed" and "should never have seen the light of day".

84. Applying all of the comparison techniques employed in *Powerhouse*, the judge held that the CVA was unfairly prejudicial to the landlords.

85. On a vertical analysis, it was clear that on a winding up, the landlords would have had the right to enforce the guarantees in full against Sixty SpA for the length of the unexpired term. They also would have had the right to require the parent guarantor to take a new lease for the unexpired term. These contractual rights were of obvious commercial value to the landlord and formed an important part of the consideration for the package of incentives negotiated with the Sixty Group. There was no evidence that the guarantees would be

particularly difficult or time consuming to enforce, even though the parent was Italian. Sixty SpA was a substantial public company with a strong balance sheet and with a reputation to lose. Italy was a member state of the EU and bound by Council Regulation (EC) 44/2001 on jurisdiction and the recognition and enforcements of judgments in civil and commercial matters. The judge indicated that it would require "strong evidence" to persuade the court in such circumstances that the guarantees were of significantly less commercial value than an equivalent guarantee given by a UK company.

86. Henderson J also indicated that it was "unreasonable and unfair" to ask the landlords to give up their guarantees. In times of commercial and financial turmoil, the ability to enforce the terms of the existing leases against the guarantor for a further seven and a half years was a most valuable right and "there was no sufficient justification for requiring the guaranteed landlords to accept a sum of money in lieu". There is an indication that it would rarely be appropriate to require the landlord to accept a sum of money in lieu of such rights. The judge said that in a time of market uncertainty it will be difficult, if not impossible, to determine what sum will fairly compensate the landlord for the loss of such rights, and in the absence of a compelling justification a landlord should not be forced to accept a sum which is based on numerous assumptions which may or may not prove to be well founded. To adopt such procedure, in circumstances where the solvency of the guarantor is not in question would be "*to undermine the basic commercial function of the guarantee, and to force the landlord to accept a commercially inferior substitute for it*".

87. In any event, even if that approach were wrong, the judge went on to find that the value of £300,000 assigned to the claims was grossly inadequate. After hearing expert evidence, it was held that a sum in the region of £1million was the least that could fairly be regarded as appropriate. The judge held that the figure of £300,000 was not a genuine estimate of value but was rather a figure which could not be objectively justified and which was dictated to the administrators by Sixty SpA simply because they knew that the unaffected majority would accept the proposal. The figure proposed by Sixty SpA was

based on a "*cynical calculation by it of what it hoped it could get away with*" *in light of the fact that they knew that the landlords would face lengthy and expensive court proceedings before the CVA could be overturned"*. In so doing the administrators came in for heavy criticism in that they had acted in dereliction of their duty to put forward proposals which they must consider fair to all of the creditors and the company itself.

88. The CVA was also unfair on a horizontal comparison by reference to the treatment of Sixty's associated companies on the one hand and the landlords of all closed stores on the other. Not only were the majority of creditors to be paid in full, but two of Sixty's own associates were entitled to the payment of debts due to them by Sixty in full and without deferment whilst landlords of closed stores were required to accept a dividend of 21% of the estimated surrender liability under their leases. Further the preferential treatment given to Muji, whose claim to an indemnity was not compromised was formulated because of the known risk of Muji derailing the CVA. Parity of treatment would have required Muji to be released from its contractual liability to the landlord and for the landlord to be compensated by cash payment of equivalent value. The true complaint was held not to be the fact that Muji as a creditor was treated unfairly well in comparison with the applicants, but rather that the failure to grapple with Muji's position as a quasi-guarantor led to the Trafford Centre landlord being favourably treated in comparison with the applicants. It was not required to give up a quasi guarantee, whereas the applicants were.

89. The judge concluded with some strong words. The purpose of the CVA was to compel the applicant landlords to give up their rights for a fraction of their fair value, and to improve the group's negotiating position by forcing the applicants either to accept the CVA (which was bound to be passed by the votes of the creditors who stood to be paid in full) or to embark on lengthy and expensive proceedings to set it aside, which would by itself buy time and subject the applicants to all the uncertainties of litigation. It was clear from the documents belatedly disclosed by the respondents that cynical calculations of this nature were never far from the minds of the Sixty Group. He went on,

> "I wish to emphasise that it is the duty of administrators or other office holders, in such circumstances, to maintain an independent stance, to act in good faith, and only to propose a CVA if they are satisfied that it will not unfairly prejudice the interests of any other creditor, member or contributory of the company. The need for a responsible and professional attitude is even more pronounced where the CVA is structured in such a way that it is bound to be passed by the votes of creditors whose position is either unaffected or improved, and where another much smaller class of creditors is to be deprived of valuable contractual rights in reliance on the Powerhouse principle. I do not say that it is necessarily impossible to propose a fair CVA of this type, but the greatest of care is needed to ensure fairness to the latter class, both in the substance of what is proposed and in the procedure that is adopted"

90. Henderson J took such a dim view of the administrators' conduct that he stated that he was satisfied that there was a prima facie case of misconduct on their part which ought to be considered by the professional bodies to which they were answerable. He therefore directed that copies of his judgment should be sent to the appropriate bodies by which they were licensed to act as insolvency practitioners.

Anything to worry about?

91. The robust approach adopted in the *Sixty* case will give landlords further comfort after *Powerhouse*. The possibility of guarantee stripping opened up in *Powerhouse* will be judiciously monitored, albeit after the event. Whilst the possibility of a fair CVA being proposed which includes an element of asset stripping was clearly left open, in reality it will be very difficult for guarantee stripping to be justified on the critical vertical analysis as in a winding up the landlord would be able to enforce the guarantee in full. Further, there is a suggestion in Henderson J's judgment that it would be unfair per se to ask a guarantor to accept money in lieu of a contractual guarantee. It is possible that

guarantees of little worth could be compromised fairly, for example, if there were real difficulties with enforcement and or a very short unexpired term. In these types of cases, a landlord might actually be prepared to accept the terms of a compromise, if it results in a better outcome than that achievable on a winding up.

92. There remains the practical difficulty that the onus lies on the landlord to challenge the CVA by expensive and time consuming litigation. However, attempts by insolvency practitioners to use a CVA tactically would expose them to the type of criticism seen in *Sixty*. When faced with a proposed CVA which a client considers to be unfair or designed to apply unwarranted pressure, a mere forwarding the judgment in the *Sixty* case to the insolvency practitioner with the juicier passages highlighted might well have the desired effect before the CVA is even put to a vote.

93. Given the possible vulnerability of parent company guarantees in the event that the tenant proposes a CVA, landlords may seek to protect themselves in other ways. For example, they may seek to insist on the parent company (or a special purpose vehicle set up for the purpose with no other creditors) taking the lease instead of the tenant, taking rent deposits (perhaps with regular top up provisions), or requiring greater tenant covenant strength in the first place. One way of avoiding the whole issue is to require security, which cannot be overridden by the CVA by reason of section 4(3) of the IA 1986.

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30 September 2013

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