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ARTICLE

Company Voluntary Arrangements: Recent Developments

Shuvra Deb, Member, Ely Place Chambers, London, UK

Over the last twelve months there have been a number of notable challenges to the terms of company voluntary arrangements (CVAs). Cases include those brought by creditors testing the time limits within which they must act and applications seeking clarification of the circumstances in which a CVA can remove third party guarantees as considered by the *Powerhouse* decision in 2007.

Powerhouse applied in Sixty UK but with the opposite outcome: *Mourant & Co Trustees Limited and Mourant Property Trustees Limited v Sixty UK Limited (in administration)* [2010] EWHC 1890 (Ch)

In September 2008 the fashion retailer Sixty UK Limited, trading as Miss Sixty ('Sixty UK') was placed into administration. A creditors' meeting took place in April 2009 at which CVA proposals made by the administrators were approved. Sixty UK operated out of a number of retail units which it had leased, including two leases with an unexpired term of seven and a half years. Sixty UK's Italian parent company Sixty SpA ('Sixty SpA') had given guarantees over each of the leases (the 'Leases').

As a result of financial difficulties, Sixty UK needed to close four of its shops, including both properties subject to the Leases benefiting from the guarantees given by Sixty SpA. Upon such closure, the effect of the CVA terms was to release Sixty SpA from its position as guarantor, leaving the landlords of the two retail units without any of their rights under the guarantees during the remainder of the term of the Leases. The CVA provided for a limited sum to be paid to the landlords of the closed shops, however there was no provision for payment in full. Notably, under the terms of the CVA all external creditors of Sixty UK, with the exception of the landlords, would be paid in full.

The CVA terms provided for payment of GBP 300,000 to the landlords for the surrender of the Leases. It was stated in the proposal that this figure had been calculated on the basis of advice given to Sixty UK and in light of assumptions about the landlords' ability to re-let the premises. The CVA was passed at the creditors' meeting by the requisite majority of votes from unsecured creditors, all of whom were to be paid in full. The landlords were alone in voting against the terms of the CVA. The application, which was heard by Mr Justice Henderson, was brought by the landlords under both sections 6(1)(a) and (b) of the Insolvency Act 1986 ('IA 1986') on grounds that the CVA unfairly prejudiced their interests and contained material irregularities.

The following five core submissions were made with reference to the argument of unfair prejudice:

(i) the CVA left the landlords in a substantially worse position than on the liquidation of Sixty UK; irrespective of the amount the landlords may have received in dividend payments upon the company's liquidation, their contractual rights under the guarantees provided by Sixty SpA would have remained in place;

(ii) it was unfair in principle that the CVA should 'guarantee-strip' in the way it was seeking to do;

(iii) the estimate of Sixty UK's liability to the landlords was based upon unrealistic assumptions, including a view taken on the landlords' ability to re-let the premises in an increasingly difficult market and, in reality, was founded on the maximum figure that Sixty SpA was willing to make available by way of compensation payment for the surrender of the Leases;

(iv) the CVA allowed for at least two other creditors to be treated differently and more favourably without it being shown that there was any proper justification for the inequality; in particular, Ryohin Keikaku Europe Ltd trading as Muji;[1] and

Notes

1 Muji was an original tenant of another closed shop lease. It had assigned its lease to Sixty UK but remained liable to the landlord for all future rents for the remainder of the term. However, Muji had a right of indemnity against Sixty UK in the event that it was called upon by the landlord to pay the rent. The CVA terms did not affect Muji's right to be paid in full by Sixty UK.

(v) there was no enforceable obligation in the CVA terms requiring Sixty SpA to pay compensation to the landlords in return for giving up their contractual rights under the guarantees, nor was there provision for the release of the guarantees being conditional upon receipt of such payment.

Unusually, the hearing of the landlords' application proceeded without attendance of or representation for the Respondents. The applicants accepted that CVA terms were capable of imposing upon landlords a binding release of their rights under a guarantee of a lease. This principle of 'guarantee-stripping' within CVAs had been established in *Prudential Assurance Co Ltd v PRG Powerhouse Ltd* [2007] EWHC 1002 (Ch).

It was held in *Powerhouse* that CVA terms could be structured in such a way irrespective of whether those terms would deprive a creditor landlord of the benefit of a guarantee given by a third party for the debts and other liabilities of a tenant under a lease.

Powerhouse

As with the position in the Sixty UK litigation, PRG Powerhouse ('Powerhouse') was a subsidiary of its parent company, PRG Group Limited ('PRG'). Powerhouse had a number of leases, several of which were guaranteed or indemnified by PRG. Landlords of the closed shops were to receive 28 pence per pound owed within the CVA in contrast to a zero return in the event of liquidation. All other creditors were to be paid in full. The CVA included terms having the effect of releasing PRG from its liabilities as guarantor of leases held by Powerhouse. At a meeting of all creditors, including those whose rights and obligations remained unaffected, the CVA was approved by the necessary majority.

Henderson J, in deciding the landlords' application in *Sixty UK* applied the following principles from Mr Justice Etherton's judgment in *Powerhouse*:

(1) It was acknowledged that any CVA which left a creditor in a less advantageous position would be prejudicial to the creditor. However, the real test was whether the prejudice operated in such a way as to be 'unfair' (citing *Powerhouse* at [72] of that judgment).

(2) There was no universal test for ascertaining unfairness; the issue of unfairness depended upon all of the circumstances of the case, which included an exploration of the alternatives that were available to the proposed CVA terms and consideration of the practical consequences of affirming or rejecting the CVA ([74]).

(3) When assessing the question of unfairness, a number of techniques may be used, including 'vertical' and 'horizontal' comparisons. A vertical comparison evaluates the creditor's hypothetical position in liquidation as against the outcome of a CVA. The importance of such a comparison is that it quickly identifies the irreducible minimum below which the return in the CVA cannot go (*Sixty UK* at [67]). A horizontal comparison looks at the position of the applicant creditor against the position of other creditors or classes of creditors. Differences in treatment between creditors form relevant factors to be taken into consideration; however, such disparity would not render the CVA automatically unfair if the inconsistency was proportionate and justified ([75]).

Sixty UK

Whilst in *Powerhouse* it was not considered that 'guarantee-stripping' was contrary to section 6 IA 1986, it was held in *Sixty UK* that the CVA was unfairly prejudicial to the landlords; thus, the CVA was revoked and findings were made accordingly.

A vertical comparison showed that the landlords would have been left in a better position in the event that Sixty UK entered liquidation rather than a CVA as the guarantees would remain in place. Further, in the event of a disclaimer of the Leases by a liquidator of Sixty UK the landlords benefited from a contractual right requiring Sixty SpA to step into its shoes and take equivalent leases in its own name. This right was in addition to rights under the guarantees. It was held that these contractual rights were of obvious commercial value to the landlords, and formed an important part of the consideration for the package of incentives negotiated with Sixty SpA in entering into the Leases (*Sixty UK* [75] to [76]).

In the context of the present case, it was unfair in principle to require the landlords to relinquish their right to the guarantees. It was held that 'at 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 the right to enforce the terms of the guarantees. Further, 'in the absence of a compelling justification a landlord should not be forced to accept a sum which is based on numerous assumptions', such as the landlords' ability to re-let the premises. Adopting such a procedure in circumstances where there was no evidence or suggestion that Sixty SpA would have been unable to meet its liabilities, and was in fact solvent, would undermine the basic commercial function of the guarantee. This would force the landlords to accept a commercially inferior substitute in its place (*Sixty UK* [77]). An example of what may constitute 'a compelling justification' was the need to secure the continuation of the company's business by paying essential suppliers or service providers (*Sixty UK* [67]).

Henderson J added at paragraph [78] of the judgment that even if his conclusions were incorrect, the sum of GBP 300,000 was inappropriate as evidence

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had shown that a figure in the region of GBP 1 million was the least that could fairly be regarded as appropriate. The unacceptability of the sum was compounded by the fact that the figure of GBP 300,000 had been reached arbitrarily based on the maximum sum Sixty SpA was willing to pay out.

On a horizontal comparison, it was held that there was no sufficient justification for imposing a compromise of the rights and claims of landlords of the four closed shops, of which two were the applicant landlords. This was particularly so in the face of the position of other creditors in respect of the closed shops whose rights and claims were not compromised as under the CVA they were entitled to payment in full by Sixty UK of their present and future debts on normal trading terms. There was no justification for treating the landlords of the closed shops differently when Sixty UK's own associated companies and Muji were not required to carry any comparable burden (*Sixty UK* [80] to [82]).

The court went further and placed significant criticism upon the conduct of the administrators for putting forward the CVA proposal, the terms of which could not be objectively justified and which essentially permitted Sixty SpA to dictate the terms. Henderson J stated that the administrators had abdicated their responsibilities as office holders, in particular for representing in the proposal that the figure of GBP 300,000 was ascertained from advice received from expert valuers when in fact this 'genuine estimate' had no likeness to the valuation contained in the report which Sixty UK had commissioned (*Sixty UK* [78]; and [88] to [89]).

Comment

Following the *Powerhouse* decision it was considered possible for CVAs to be used by retail groups to divest themselves of unprofitable premises by removing the benefit of third party guarantees, leaving landlords in the unenviable position of being less than fully compensated for losing long-held contractual rights against a third party in a way which has not traditionally occurred under a typically more landlord-friendly pre-pack administration scenario.

Whilst the court in *Sixty UK* did re-affirm the possibility of guarantee-stripping, it was emphasised that CVA terms should not seek to press landlords into accepting a lower than adequate sum in compensation for the loss of their rights under third party guarantees; such payments should not be valued on an arbitrary set of assumptions. The more uncertain market conditions continue to be, the more difficult it will be to justify the sum being offered in return for the surrender of a lease. Therefore, it is advisable in the circumstances to obtain full valuation reports and to rely on them when considering a proper sum to be paid in compensation.

In-depth analyses of vertical and horizontal comparisons were made in *Sixty UK*. It would be prudent therefore to consider the same prior to agreement of the proposed CVA terms; in particular by comparing the position of affected creditors in situations of hypothetical liquidation or administration (vertical comparison); and by looking at their position as against other creditors' rights and liabilities under the CVA (horizontal comparison).

Henderson J's warning should be heeded when he urged administrators (at [88]) to take the 'greatest care' to ensure fairness to adversely affected creditors 'both in the substance of what is proposed and in the procedure that is adopted.'

Deeds of surrender: *Cotswold Co Ltd, Re* [2009] EWHC 1151 (Ch)

The *Cotswold* decision considered the circumstances in which a commercial landlord can submit a claim within a CVA for payment of future rent and breaches of covenant under a lease which has been surrendered.

A number of years before the lease was due to expire, the tenant vacated the premises and instigated proposals for a CVA. Eventually, the tenant company ceased trading. In order to mitigate the loss of the tenancy, the landlord wished to re-let the premises. In order for this to happen, the landlord and tenant entered into a deed of surrender, the terms of which enabled the landlord to re-let the premises and provided for the tenant to be excused from its obligations under the lease.

The landlord submitted a claim to the supervisor who was willing to admit debts up to the date of the deed of surrender. However, claims in relation to the remainder of the term were refused on the basis that the deed of surrender meant that all claims had been extinguished.

The landlord brought a challenge that was heard by Sher J QC, sitting as Deputy Judge of the High Court. The supervisor submitted that the deed of surrender had not contained any terms that reserved the landlord's right to recover sums under the lease in respect of post-surrender debts and obligations. The landlord argued to the contrary stating that such rights were reserved in the deed.

The court found in favour of the applicant landlord and held that it was still able to bring a claim for payment of future and other liabilities under the lease, notwithstanding its surrender. It was found that the recitals to the deed made specific reference to the CVA encompassing all of the tenant's obligations under the lease. It stated that the landlord's acceptance of the surrender was in order that it could mitigate its losses in the CVA. Moreover, one clause expressly stated that the deed of surrender released the company from liability under the lease 'save in respect of the landlord's right to claim within the CVA.' In addition, the deed

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emphasised that the landlord could claim for the rental stream and the benefit of the tenant's other covenants up to the end of the lease.

Comment

Where a deed of surrender is being prepared or reviewed on behalf of a landlord, such as in the *Cotswold* case, it is important to consider the inclusion of specific and plain reference to the recoverability of future rents, breaches of covenants and other liabilities within a CVA scenario. Where it is not possible to negotiate a specific reference to post-surrender liabilities within the CVA itself then inserting this type of clause into a deed of surrender represents the best available protection for landlords.

Time limits: *Wood v Heart Hospital* [2009] BPIR 1538

In *Wood* the court was asked to give directions in relation to circumstances in which a supervisor should admit a late claim by a creditor who sought to benefit from a distribution, but who had not received notice of the creditors' meeting approving the CVA and was therefore not bound by its terms.

The facts concerned a minor, C, who had a potential claim against the hospital in negligence. If successful the claim was valued at up to GBP 6 million excluding costs. The hospital benefited from insurance up to the value of GBP 5 million.

The applicant supervisor wished to distribute GBP 500,000 to creditors under the terms of the CVA. The issue was whether C was entitled to share in the distribution of funds or whether those funds were held on trust by the supervisor for the creditors bound by the CVA.

The terms of the CVA itself, by condition 21(c) set out that the supervisor had discretion to allow a claim from a creditor who had not received notification of the creditors' meeting. The supervisor's argument was that he should not exercise his discretion under condition 21(c) on the basis that he was bound to act in the best interests of the beneficiaries under the CVA. This duty would be hindered by C's claim as it would delay distribution and could have the potential of significantly diluting the funds available.

The following directions were given by Registrar Jaques:

(i) there was a relationship of trustee and beneficiary between the supervisor and the existing creditors bound by the CVA terms; as such the supervisor's duty was to act in their best interests;[2]

(ii) C was out of time to make a claim under section 6 IA 1986 seeking an order to set aside the terms of the CVA on the grounds of either unfair prejudice or material irregularity and in the circumstances that period could not be extended by the court;[3] and

(iii) the admission of C's claim would prejudice existing creditors bound by the CVA terms by deferring payment of, and diluting, the dividend payable to them; the supervisor's discretion under condition 21(c) could only be exercised where to do so would not prejudice the claims of existing creditors; and the delay arising out of allowing C's claim would be significant as it was likely to be almost three years before the negligence claim would be concluded and in any event, there was no guarantee that C would succeed in establishing that he was a creditor of the hospital.

In addition, it was held that the admission of C's claim may have the effect of defeating his entitlement to claim against the insurers as the CVA terms would require C to forego his right to take remedial action against the hospital as regards pre-existing claims.

The supervisor was therefore directed to distribute the funds of the CVA in accordance with its terms amongst the existing beneficiaries.

Tucker v Gold Fields Mining LLC [2009] EWCA Civ 173; [2010] BCC 544

In *Tucker* the Court of Appeal considered the joint supervisors' appeal against the decision of Sir Andrew Morritt C. on the interpretation of a late claims provision in a CVA. The relevant clause, paragraph 23.5 provided that the 'claims date' would be 45 days after the CVA had been approved at a creditors' meeting. A creditor lodging a claim after the claims date would not be considered for distribution, unless the supervisors or the court were able to determine that the failure to lodge the claim earlier was not due to the creditor's wilful

Notes

2 Applying the judgment of Peter Gibson LJ in Re N T Gallagher & Son Ltd [2002] EWCA Civ 404 at [54]: *'Where a CVA or IVA provides for moneys or other assets to be paid to or transferred or held for the benefit of CVA or IVA creditors, this will create a trust of those moneys or assets for those creditors.'* At para. 1542 of *Wood*.

3 Section 6(3)(b) IA 1986 sets out that any challenge to CVA terms must be made within 28 days beginning the day on which the applicant becomes aware that the creditors' meeting approving the CVA has taken place.

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default or lack of reasonable diligence. Alternatively, the creditor would be required to show that whilst they did not have notice of the creditors' meeting approving the CVA, they had lodged their claim within 28 days of becoming aware that the meeting had taken place.

Morritt C. construed the CVA in such a way as to remove the differential treatment between the late claims by creditors who had received notice and those who had not. Consideration of late claims would be permissible in respect of all creditors where the delay had not resulted from their wilful default or lack of reasonable diligence, irrespective of whether the claim had been lodged within 28 days of the creditor becoming aware of the creditors' meeting.

The Court of Appeal upheld the decision. Lord Justice Mummery held that the interpretation which the supervisors sought to give to the CVA terms gave rise to striking and surprising disparities in the treatment of CVA creditors with notice of the creditors' meeting and those without such notice. Mummery LJ noted that this disparity was 'not required by the general objective of the CVA, nor by the scheme, structure and the language' of the relevant paragraph of the CVA itself.[4] It was held 'that the imposition of a harsher regime on those who were unaware of the creditors' meeting approving the CVA was difficult to understand or justify by reference to any purpose that had been advanced for drawing the mutually exclusive distinction on which the supervisors' case was based.'[5]

Comment

Tucker demonstrates that in appropriate circumstances the court will take a pragmatic approach to the interpretation of a CVA in order to reduce unfairness and to ensure that each clause fits comfortably within the overall structure of the CVA.

Conclusions

The most significant development in recent case law challenging the interpretation of CVA terms is the *Sixty UK* case in which the findings in *Powerhouse* as regards the possibility of guarantee-stripping were affirmed. However, it was significantly qualified as to when CVA terms could make it possible for a creditor landlord to be stripped of the right to rely on a third party guarantee to a lease. The judgment has had the effect of emphasising the need for detailed scrutiny of vertical comparisons, such as liquidation, and horizontal comparisons where the applicant creditor's position is compared with that of other creditors in the CVA. Moreover, administrators have been urged to take the 'greatest care' to ensure fairness to adversely affected creditors of a CVA. This judgment therefore leaves open the possibility of further challenges to CVA terms when they are unfavourable to smaller groups of creditors, often where the CVA is passed due to the requisite voting majority being obtained in spite of objection from smaller creditors. *Sixty UK* may be just the start of things to come.

Notes

4 *Tucker* at para [47].
5 *Ibid.*

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International Corporate Rescue

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