

CVAs: THE ROUGH GUIDE

**CAMILLA LAMONT & DAVID HOLLAND
LANDMARK CHAMBERS**

THE BACKGROUND: WHAT'S THE POINT?

1. A company on the brink of insolvency has a choice. It can either:

- (a) go into administration;**
- (b) propose a CVA;**
- (c) go into administration and from there have the administrator propose a CVA; or**
- (d) go into liquidation.**

In this talk we propose to give a “whistle-stop tour” of the Company Voluntary Arrangement (“CVA”) process and consider how it impacts on landlord and tenant law.

2. Part I of the Insolvency Act 1986 introduced an entirely new procedure into UK company law, namely the 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

3. to secure a more equitable distribution to creditors than might have been achieved through other insolvency processes.
4. 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.
5. 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.
6. 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”.
7. 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.

8. In practice however (and unlike the equivalent procedure for individuals) the CVA has proved to be relatively unpopular largely for two reasons. The first is that it cannot be made binding on secured or preferential creditors without their consent. The second was that, until the enactment (in 2000) of section 1A of the Insolvency Act 1986, there were no provisions for obtaining a moratorium while the proposals for the arrangement are being drawn up. Originally the only method by which that could be achieved was if a proposal for a voluntary arrangement was combined with an application to the court for the appointment of an administrator.

THE PROCEDURE

9. In the case of a company, a proposal for a CVA may be made by (i) the directors of a company which is not in administration or wound up or, (ii) where the company is in administration or is being wound up, the administrator or the liquidator (as the case may be). A proposal must provide for a nominee to act in relation to the CVA either as a trustee or otherwise to supervise its implementation (section 1 (2) IA 1986). The nominee must be a qualified insolvency practitioner (section 253 IA 1986).

10. In general terms, the provisions of the IA 1986 relating to company insolvency now apply also to limited liability partnerships, see Regulation 5 of the Limited Liability Partnership's Regulations 2001 (SI 2001 No. 1090).

11. Where the directors of a small company as specified in the Companies' legislation (section 247(3) Companies Act 1985; section 382(3) Companies Act 2006) intend to make

a proposal for a CVA, they may seek a moratorium on claims by creditors (Schedule A1, IA86). Small company CVA proposals are rarely encountered in practice and I will say no more about them.

12. The nominee will require from the person intending to make the proposal:

- (a) the terms of the proposed CVA;
- (b) a statement of the company's affairs (section 2 (3) IA 1986).

The directors' proposal of a CVA shall provide a short explanation why, in their opinion, a CVA is desirable and give reasons why the creditors may be expected to concur with such an arrangement (The Insolvency Rules 1986 rule 1.3(1)-references hereafter to "Rule" are to these rules).

13. Within 28 days after he is given notice of the proposal for a CVA, the nominee has to submit a report to the court stating whether in his opinion:

- (a) the proposed CVA has a reasonable prospect of being approved and implemented;
- (b) meetings of the company and of its creditors should be summoned to consider the proposal; and
- (c) if such meetings should be summoned; their date, time and place.

However, it is important to note that the court has no role (at least at this stage) in approving the CVA or scrutinizing its terms. If the nominee considers that the CVA proposal should not be taken

further, then he can submit a negative report. However nothing turns on the filing of such a report and the company can seek another opinion from another nominee.

14. Meetings of the company and of the creditors are then summoned. Every creditor of the company of whose claim and address the person summoning the meeting is aware is summoned to the creditors' meeting (section 3(3) IA86). Meetings of the company and its creditors should be summoned to consider the Directors' proposal not less than 14, nor more than 28, days from the filing at Court of the nominee's report (Rule 1.9(1)).

15. These meetings are to decide whether to approve the proposed CVA, with or without modifications. Proposals which affect the rights of secured creditors to enforce security may not be approved without the secured creditors' agreement. Likewise, the position of preferential creditors is protected. A proposed CVA is approved if the creditors' meeting votes in favour.

16. Every creditor who has notice of the creditors' meeting is entitled to vote. Votes are calculated according to the amount of the creditor's debt as at the date of the meeting or the date of the company's liquidation or when the company entered administration. A creditor may vote in respect of a debt for an unliquidated amount or any debt whose value is not ascertained and for the purposes of voting (but not otherwise) his debt shall be valued at £1 unless the chairman of the meeting (who is the nominee or liquidator or administrator) agrees to put a higher value on it (Rule 1.17).

17. The Chairman is to ascertain the entitlement of persons wishing to vote and can admit or reject their claims accordingly (Rule 1.17A). The Chairman may admit or reject a claim in whole or in part. The Chairman's decision is subject to appeal to the Court by any creditor or member of the company (Rule 1.17A(3)).

18. There has been some controversy in the case law as to the position of a landlord with a claim for future rent. The most recent case is IN RE NEWLANDS (SEAFORD) EDUCATIONAL TRUST [2006] EWHC 1511 (Ch). In that case a proposed CVA provided for the company to pay rent on its leasehold property if the CVA was approved, but on the basis that the landlord would not be a creditor who would receive any payment under the CVA proposal in relation to its arrears. The landlord wished to be admitted to vote against the proposed CVA. The landlord had two claims; 2 years' future rent and £875,000 for dilapidations. The landlord produced a letter from agents opining that it would be likely that it would take 2 years or potentially longer to identify a tenant. The schedule of dilapidations was lengthy but was over two years old and did not identify the remedial cost on an item by item basis. The chairman refused to value the landlord's claim at more than £1 and the proposal was approved. The landlord appealed.

19. Rule 1.17(3) provides:

“A creditor may vote in respect of a debt for an unliquidated amount or any debt whose value is not ascertained and for the purposes of voting (but not otherwise) his debt shall be valued at £1 unless the chairman agrees to put a higher value on it.”

Rule 1.17A(4) provides:

“If the Chairman is in doubt whether a claim should be admitted or rejected, he shall mark it as objected to and allow votes cast in respect of it, subject to such votes being subsequently declared invalid if the objection to the claim is sustained.”

Having referred to previous authority, Sir Andrew Morritt C said that the proper test was as follows:

“...the claim is for an amount which is unliquidated and/or unascertained. In each case the chairman is an insolvency practitioner whose function is to decide the value of the debt for voting purposes at a meeting of creditors. Accordingly, it appears to me that the phrase “unless the chairman agrees” should be interpreted in a similar manner. Thus the initial question for the chairman is whether he is prepared to put a value on the claim higher than £1...value” but the context [is] one of an unliquidated or unascertained claim for which a minimum value is now prescribed by the rule. Thus the comparator implicit in the word “higher” is the minimum value of £1. The chairman should not speculate. Nor is he obliged to investigate the creditor’s claim. But he must examine such evidence, and I do not use that word in any technical sense, as the creditor puts forward and any relevant evidence provided by any other creditor or the debtor. If the totality of that evidence leads him to the conclusion that he can safely attribute to the claim a minimum value higher than £1 then he should do so.”

20. Thus the starting point is a value of £1. Only if the Chairman can be satisfied on any “evidence” put forward at the meeting by the creditor that the debt can safely be given a higher value, ought he to do so. In this case the judge held that the evidence before the chairman did not compel him to conclude that. The future rent element of the claim depended on whether the lease was forfeit in the future and remained unlet for a period of 2 years. He did not see any basis on which either contingency could be given any value. Likewise in the case of the dilapidations the schedule prepared in April 2004 (over two years before the meeting) did not quantify individual items. Accordingly it was not possible to point to items which did not appear to be in dispute and conclude that at least £x should be treated as admitted. But even if one could do that it would still not be relevant to either of the bases on which the Landlords’ claim can be put; it would be neither a measure of the cost of repairs actually incurred by the Landlords for a claim under the Leases nor would it indicate the amount if any by which the value of the Landlords’ reversion was diminished by the want of repair for the purposes of section 18 of the Landlord and Tenant Act 1927. The landlord’s appeal failed.

21. In practice In Re Newlands is a call to landlords properly to document a claim if they wish to be admitted to vote for more than £1 in relation to future rent or dilapidations. So far as future rent is concerned, evidence as to the state of the market, whether the leasehold property has been exposed to the market and, if so, with what response and a detailed appraisal of the letting prospects should be provided. A claim for dilapidations should be backed up by a fully itemised schedule and, if appropriate, a section 18

22. valuation, all in compliance with the Property Litigation Association draft protocol on dilapidations.

23. At the creditors' meeting, for any resolution to pass approving any proposal or modification there must be a majority in excess of three quarters in value of the creditors present in person or by proxy and voting on the resolution (Rule 1.19).

THE EFFECTS

24. Where a decision approving a CVA is made, by section 5 of the IA 1986 it takes effect as if made by the company at the Creditor's meeting and binds every person who in accordance with the rules:

- (a) was entitled to vote at that meeting (whether or not he was present or represented at it); or**
- (b) would have been so entitled if he had had notice of it as if he were a party to the CVA.**

25. Thus where a CVA proposal is approved by the creditors (subject to any challenge in court) the CVA varies the rights of creditors according to its terms. So a creditor who swaps a right to 100p in the £ for 28p in the £ under the CVA can claim only the 28p in the £.

26. However, by sections 4 (3) and 4(4) of the IA 1986, no CVA can affect the rights of secured or preferential creditors without their consent. Secured claims do not count in voting (Rule 1.19(3)).

FORFEITURE

27. There has also been some controversy in the case law as to whether a landlord's right to forfeit was to be treated as security for this purpose. In the first instance cases of RE NAEEM [1990] 1 WLR 48 and MARCH ESTATES V GUNMARK [1996] 2 BCLC 1 Hoffmann and Lightman JJ had both held that it was. However, the Court of Appeal has recently disagreed.

28. 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.

29. Neuberger LJ held that:

- (i) The rent which accrued due but was not paid before the CVA was proposed would be expected to be caught in its capacity as a debt within the CVA.

- (ii) However, rent falling due after the CVA should not normally be caught by the terms of the CVA (even if it was technically capable of being so caught). It was wrong in principle that a tenant should be able to trade under a CVA for the benefit of its past creditors, at the present and future expense of its landlord. If the tenant is to continue occupying the landlord's property for the purposes of trading under the CVA (and hopefully trading out of the CVA) it should normally expect to pay the full rent to which the landlord is contractually entitled. He drew an analogy with cases concerning administration (Re Atlantic Computer Systems plc [1992] Ch 505, at pp 542(g)–543(b) and liquidation (Re ABC Coupler & Engineering Co Ltd (No 3) [1970] 1 WLR 702). Therefore a CVA should provide for the payment in full of future rent, or if it does not provide, in the absence of special circumstances the landlord would be entitled to object to the proposals as unreasonable.
- (iii) The landlord could not forfeit the lease for past rent which was caught by the terms of the CVA.

30. He advanced a number of reasons for the third proposition and as to why he was differing from the two first instance decisions.

- (i) A CVA, as is clear from the terms of sections 1 to 5 of the 1986 Act, is concerned with obligations, not remedies. There is nothing in Part I of the 1986 Act that relates to the manner of enforcement of any rights whether claiming in debt or exercising a forfeiture. There was therefore no warrant

for holding that, if one right is lost in relation to a particular payment as a result of a CVA, another right can remain.

- (ii) The notion that the landlord can forfeit a lease for a debt under the lease that had been replaced by a different debt under the CVA was inconsistent with the rescue culture embodied in the 1986 Act.
- (iii) The conclusion was consistent with the wording of both section 5(2) of the IA 1986 and of the CVA in that case. In respect of the single payment of rent that was caught by the CVA, the landlord was bound to accept payments in accordance with the CVA in substitution for the rent. In other words, his right to recover the rent has been replaced by his rights under the CVA. So his right to forfeit for the rent, just as much as his right to sue for the rent, has gone because there is no rent owing; it has been substituted by the sums due under the CVA.
- (iv) The 1986 Act makes it clear what sort of creditors are to be excluded from the class of creditors who are to be bound by the CVA, namely secure creditors, and, to the extent described in section 4(4), preferential creditors. Although it was true that it was, at one time, thought that a landlord with a right to forfeiture was to be treated for these purposes as a secure creditor, that is now seen to be wrong: see Razzaq v Pala [1997] 1 WLR 1336, at pp 1341(e)–1343(d) and Re Lomax Leisure Ltd [2000] Ch 502†, at pp 510(b)–517(d). The legislature did not intend a creditor with a right to forfeit to be treated in a different or better position under a CVA than any other sort of unsecured creditor.

31. Thus, although the forfeiture proceedings had been properly commenced before the approval of the CVA, at the date of the hearing, after its approval, there was no right to forfeit for the past arrears subject to the CVA.

CHALLENGE

32. 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.***

PROBLEMS

33. What can go wrong? Apart from the power set out immediately above, there is no power in the Insolvency Act 1986 to vary a CVA once approved although a CVA may contain a mechanism for variation. In the absence of a mechanism for variation in the CVA, it is open to certain of the parties to a CVA to agree a variation if they can do so without affecting the rights of others (see RAJA V RUBIN [2002] CH 274)

34. If, despite the CVA, the debtor still fails to trade out and goes into liquidation, monies received by the supervisors prior to the liquidation remain subject to the trusts of the CVA. The CVA had to be construed practically. Breaches did not of themselves terminate the CVA (WELSBY V BRELEC INSTALLATIONS [2001] BCC 421).
35. Where, in an IVA, an individual failed right from the start to disclose the existence of property abroad, the court would not declare that the debtor had complied with its obligations under the IVA, nor would the court declare that the debtor had no outstanding liability under the IVA (STANLEY V PHILLIPS [2003] EWHC 720 (Ch)).

THIRD PARTIES

36. The voluntary arrangement, duly approved, takes effect as a statutory contract between the individual or the company and the creditors who are bound by the CVA. That gives rise to two related questions: How are CVAs construed? What impact does the CVA have on third parties, such as sureties or assignors of a term of a lease who may be liable on the default of the current tenant?
37. CVAs are construed as if they are commercial contracts. It is appropriate to look at the factual context. Where necessary to do so, terms may be implied.
38. On the latter question, 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.

39. In JOHNSON V DAVIES [1999] Ch 117 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 affect 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.

40. 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 than a summary determination-see FINLEY V CONNELL ASSOCIATES 1999 WL 477.

41. In GREEN KING PLC V STANLEY [2002] BPIR 491, the debtor took a loan from Green 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 Green King was not repaid. It took possession proceedings to enforce their 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 (Green 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 Green King to release the debtor whilst reserving its rights against the parents. The reservation became part of the IVA when the existence of Green King's rights against the parents was expressly mentioned in the proposal. A statement in the proposal that "Green King have a guarantee from my parents secured by a charge on their house" affectively put the creditors on notice of the possibility that Green 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.

POWERHOUSE

42. The Powerhouse litigation is the collective name given to two test cases heard before Etherton J in the High Court last year 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.

43. 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?

44. 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.

45. 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.

46. 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.

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

- (i) 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");

- (ii) 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
- (iii) 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.

48. 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.

49. 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.

50. 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.

51. 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.

52. 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.

53. 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.

54. 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.

55. 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.

56. 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.”

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:

- (i) “Vertical” comparison with the position on winding up;
- (ii) “Horizontal” comparison with other creditors or classes of creditors;
- (iii) 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.

57. 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.

58. 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.

59. 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.

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

61. 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.

CAMILLA LAMONT & DAVID HOLLAND

LANDMARK CHAMBERS

1ST DECEMBER 2008