

INSOLVENCY

- a brief history of “ guarantee stripping” from the Bible to the case of Prudential Assurance v Powerhouse

by

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Introduction

It seems that in the biblical period a guarantee for another's obligation was entered into by striking hands with the creditor. The Book of Proverbs in Chapter 6 gives a strident warning against anyone who finds himself in this position and compares the guarantor to an animal caught in a trap. He is exhorted to sleep no more until he has got himself out of the guarantee. How this was done without the institution of a CVA for the principal debtor is not clear.

From the biblical period until now, guarantors have sought ways of escaping from their liabilities as guarantees. Landlords and other creditors have sought to ensure that the guarantee liability remains in place and effective for just the occasion for which it was agreed, namely the insolvency of the debtor.

The subject reveals a number of conflicting principles and policies. Suretyship law, being objective, has never, outside the consumer-sphere, differentiated clearly between guarantees given by a parent or friend on the one hand, and guarantees given by commercial entities for reward on the other. In the 18th and 19th centuries, judges felt sympathetic to parents, guardians and friends caught up in guarantees given to financiers and found numerous ways of letting the surety out. However many of the parties who subsequently tried to take advantage of the pro-surety rules and principles turned out to be banks and insurers who had given their bond for reward.

In more modern times, one again finds guarantees by parents, relations and friends on the one hand and suretyship for reward given by banks and insurance companies.

In the particular case of a parent company guarantee, two fundamentally opposed principles are at work. The parent has put a limited amount of capital (possibly as little as £2) into a subsidiary which carries on the relevant business. Under the principle of limited liability, that is all the capital that the parent is meant to risk. On the other hand, sensible parties dealing with the under or low capitalised subsidiary, who have any kind of bargaining position, will try to obtain a parent company guarantee which in effect gets round the limited liability that the parent has sought to institute. If the guarantee remains valid and effective on the insolvency of the subsidiary, then the parent will have failed to limit its liability and both it and its own creditors could find themselves in financial trouble. On the other hand, if a way out of the guarantee is found, whilst this

will confirm the limited liability of the parent, it will disappoint the expectations of the creditor based on freely entered into contractual obligations.

The particular area in which this conflict was played out in the case of *Prudential Assurance Co Limited v PRG Powerhouse Limited* [2007] BCC 500 was in the sphere of the rescue mechanism known as a CVA by which the trading subsidiary tried to avoid the collapse of its business.

CVAs

Before the new rescue procedures introduced by the Insolvency Act 1986, consolidating older legislation together with statutory changes, there was little interest in rescuing businesses, other than where a creditor held floating security and was able to appoint what we now call an Administrative Receiver to run the business with a view to selling it for a beneficial price.

One mechanism used from time-to-time to avoid selling or liquidating the assets was a form of statutory compromise known as a scheme of arrangement under section 425 of the Companies Act 1985, consolidating legislation under a series of Companies Acts and other statutes going back to the 19th century. Schemes of arrangement are now-a-days often used by insurance companies either to deal with insolvency or to deal with a solvent situation where an extremely long run-off is foreseen, unless that can be shortened by the statutory compromise. The scheme process, which involves at least two court applications and complicated documentation, but no statutory stay protecting the assets from creditors, was not found to be of general use in insolvency cases. It was too cumbersome and expensive for small and medium sized debtors and was too reliant on creditor goodwill for most situations.

The Cork Committee on Insolvency, whose recommendations found their way to some extent into the Insolvency Act 1986, suggested a simpler form of proceeding for smaller companies and simpler situations, namely the CVA. This solved two significant complications which attended schemes of arrangement. Firstly, there is no longer any need for a court application, unless a creditor wished to challenge the statutory compromise. Secondly, the case law on schemes of arrangement had long been complicated by the requirement of the debtor to decide whether he needed to have meetings of one or more classes, a topic which gave rise to decades of complicated

and difficult case law. In the new-style CVA, the creditors would all meet together and not be divided into classes.

The Insolvency Act 1986 provided statutory protection for secured creditors and preferential creditors in a CVA and those will be left to one side in this discussion. For practical intents and purposes, a CVA would involve a single meeting of unsecured creditors, but such creditors might have very different rights and interests and yet this would not lead to their being divided into separate classes.

The careful system of checks and balances which applied in schemes of arrangement were therefore not replicated in the case of CVAs. The division into classes which protected creditors with different rights from being oppressed by creditors who had fundamentally different rights was not present. The requirement for a prior court sanction, making sure that creditors with different interests were not oppressing a minority, also did not apply. The sole remedy for a creditor would now be an application to court to challenge the CVA on the grounds of unfair prejudice.

The Cork Committee thought that the new procedure would be appropriate for small, simple cases. They had obviously failed to take into account the usual “law of unintended consequences”.

Guarantees and Statutory Compromises

Landlords and other holders of guarantees used to be able to sleep soundly at night. Statutory compromises had been around for over 100 years, both in relation to personal and corporate insolvency, but had never given rise to a serious problem.

Going back to our sympathetic judges of the 19th century in relation to guarantees given by parents and friends, one of the very strict rules which guarantors could take advantage of, unless excluded by the contractual documentation, was the rule that a variation in the underlying liability would automatically release the guarantor unless he had agreed to it. The detailed principles in case law are set out in some detail in Chapter 8 of the 5th ed. of Rowlatt on Principal and Surety (1999). Even a binding agreement to give time to pay could have the effect of releasing the entire suretyship liability. Needless to say any well drafted guarantee would exclude the possibility of

release by this method. It is still surprising how many guarantees fail to take this obvious precaution.

One particular form of variation of the principal liability would occur where a debtor entered into a binding composition with his creditors: see Rowlatt, especially at paragraphs 8-25 and 8-27.

However, a release by entering into a composition arises because agreeing to the composition is a *voluntary act of the creditor* to vary the principal, underlying obligation. Therefore, as a matter of principle, no such release will result from a statutory composition, where release results not from any voluntary act of the creditor but from the operation of the statute, at least if the creditor has not voted in favour. The point is concisely and clearly set out in Rowlatt at paragraph 8-22 (and see also paragraph 8-23).

Since CVAs (and the equivalent for individuals, IVA's) are simply updated and simplified versions of previous statutory compositions, such as section 425 of the Companies Act 1985, they ought not to have any different effect. Mr Justice Jacobs so held in *RA Securities Limited v Mercantile Credit Co Limited* [1994] BCC 598. He then unsurprisingly followed that decision himself at first instance in *Johnson v Davies* [1997] 1 WLR 1511. That general approach was endorsed by Lightman J in *March Estates Plc v Gunmark Limited* [1996] 2 EGLR 38.

Unfortunately, this long-established and sensible approach was turned into a nightmare by a dictum of the Court of Appeal in *Johnson v Davies* [1999] BCC 275. The long and well established line of cases which stated that a statutory composition did not release a guarantor because the effect was created by the statute and not the will of the creditor was distinguished on the rather flimsy basis that the draftsman of the Insolvency Act 1986 had introduced wording which was phrased in the form of a deemed consent by each creditor to the statutory compromise. The wording in the case of a CVA in the coda to section 5(2)(b) of the Insolvency Act 1986 states that a creditor is bound into the CVA "as if he were a party" to the CVA.

The case law for over a 100 years prior to *Johnson & Davies* had regarded statutory compromise as a form of statutory contract and treated non-voting, dissenting and indeed every type of person bound by the statutory compromise as if they had consented. No-one had ever suggested that this led to a release of a guarantor. If it

were not for ones innate respect for the Court of Appeal, one would have to use some words such as “absurd” in relation to the dictum in *Johnson v Davies*. The decision to depart from all the previous precedents was not a matter of *ratio* because in that case the terms of the IVA, as construed by the Court of Appeal, did not have the effect of releasing the co-debtors in any event, so that the analysis of the previous case-law was not strictly necessary.

It can only be hoped that an opportunity will arise for the House of Lords to correct this fundamental error.

The landlord’s nightmare needed however only to be temporary: all he had to do to combat *Johnson v Davies* was to dust down his standard form guarantees and make sure that any release pursuant to *Johnson v Davies* was excluded by appropriate wording. The institutional landlords in the Powerhouse case, for example, all had appropriate wording. Nevertheless, for smaller landlords without access to first rate legal advice, or without standard form precedents, this remains a potential trap for the unwary.

Release of Third Parties

There are a number of situations in the case of statutory compromises where it may be convenient, and actually proper, to provide for the release of third parties.

Here is an illustration based on an actual case which has nothing to do with landlords.

An insolvent company in a foreign English law based jurisdiction sued a major firm of accountants for negligence and breach of duty. A settlement was reached whereby the accountants or their insurers were prepared to pay a large sum of money to be distributed amongst the insolvent companies’ creditors. However, in return for the payment the accountants wanted to ensure that the creditors could not sue them in other jurisdictions and in that way get round the finality of the settlement made by the company on behalf of its creditors. The particular technique that was used was to have a scheme of arrangement under the foreign jurisdiction’s equivalent of section 425 of the Companies Act 1985 and to make it a term of the scheme that creditors would be obliged, in return for receiving their dividend, not to take any proceedings against the accountants in any jurisdiction at all. Although as scheme of arrangement is a form of statutory contract, it is not subject to the ability that contracts now have under English

law to benefit third parties. Thus, neither a scheme of arrangements nor a CVA, even in England, can be effective in a direct sense in releasing a third party. On the other hand, there is nothing in principle to prevent it being a term of the scheme of arrangement or CVA that every creditor should release or regard themselves as having released a third party. To make this work in a practical sense, the release can be buttressed by provisions which make receipt of the dividend conditional upon executing a Deed of Release. Furthermore, better view is that the scheme or CVA can (despite dicta which may cast some doubt on this) effectively settle the benefit of the obligation to release or not to sue, subject to some potential problems in the case law, on trust for the benefit of the third party, so that it can be enforced even if for example the corporate debtor is unwilling, or unable as a result of dissolution, to do so.

These techniques for protecting third parties in appropriate cases can be very useful, and it would be unfortunate if any doubt were cast upon them. In the case of a scheme of arrangement, the creditors have the protection of being divided, in appropriate cases into different classes and, in every case, the protection of the sanction of the court, which ensures that the scheme is fair and proper. Such protection, as already noted, does not exist in a CVA. Here, the only protection is the challenge on the grounds of unfair prejudice.

Guarantee-stripping

The notion of guarantee-stripping in connection with a voluntary arrangement goes back some way prior to the *Prudential* case. In *Re Primlaks (UK) Limited (No.2)* [1990] BCLC 234, an administration order was made against the company and administrators were appointed. One of the statutory purposes for which the administration order was made was for the approval of a CVA. The CVA provided *inter alia* that guarantees given by certain individuals to the bank creditor (BCCI) should no longer be enforceable by the bank. The bank unsurprisingly applied under section 6 of the Insolvency Act 1986 on the grounds of unfair prejudice to have the voluntary arrangement set aside. The actual reported decision deals with disclosure. It was suggested in that case that the guarantors had no assets (see at page 241(a-b)) so that the loss of guarantees could not seriously prejudice the bank. There was however some material to suggest that the guarantors were not as impecunious as they made out. Their position of American Express Gold card holders was in particular thought to suggest that they had an affluent lifestyle.

Prudential Assurance v Powerhouse

For the purpose of the preliminary issues in this case, a statement of agreed facts was used. The main points are as follows.

PRG Powerhouse Limited (“*Powerhouse*”) was a subsidiary of *PRG Group Limited* (“*PRG*”), a public listed company registered in New Zealand. In about September 2003, *Powerhouse* acquired, with financial support from *PRG*, the assets of the *Powerhouse* business for £17.4 million, including 24 high street stores and 110 superstores. A number of landlords took parent company guarantees or indemnities from *PRG* in respect of *Powerhouse*’s obligations under the leases.

Powerhouse got into financial difficulties and its directors informed the creditors that it needed to close 35 under-performing stores (the “Closed Premises”) and to retain 53 stores which the directors hoped would enable *Powerhouse* to trade profitably. On this basis the directors of *Powerhouse* proposed a CVA. The key features of the CVA were as follows.

Only the Scheme Fund Creditors were to be affected by the terms of the CVA. The Scheme Fund Creditors were the employees, landlords, local authorities and others who were creditors in respect of the Close Premises. For these creditors, *PRG* agreed to provide a fund equal to the lesser of £1.5 million and the sum required to pay a dividend to Scheme Fund Creditors of 28p in the Pound on claims valued pursuant to the CVA’s Valuation Mechanism.

The CVA contained provisions designed to release all the Scheme Fund Creditors’ claims against *PRG* related to Closed Premises (i.e. the guarantee and indemnity claims). *PRG* was making the £1.5 million maximum fund available in consideration for the release.

The rent was wholly or mainly paid up-to-date prior to the start of the CVA. The directors represented to the creditors that in the CVA the likely dividend to Scheme Fund Creditors was to be 28p in the £Pound. Other creditors, i.e. the creditors of stores which were not to be closed, were not to be affected by the CVA and would be paid in full through the ongoing trading of *Powerhouse*. The directors represented to the creditors that in a liquidation of *Powerhouse*, the dividend to all unsecured creditors would be nil. *PRG* was said to have security over the assets. The directors further represented to the creditors that *Powerhouse*’s future viability depended upon the CVA

being entered into and *PRG* being released. The directors further represented that the CVA was “desirable in the interests of all creditors”.

PRG provided the £1.5 million to the CVA supervisors to hold on trust but if the CVA failed, the money was to be held on trust for *PRG* and returnable to *PRG* on demand.

At the CVA meeting of all the creditors of *Powerhouse*, the majority (i.e. creditors of stores which were staying in business) unsurprisingly voted through the proposals, since the majority were not affected by them, other than in a positive way.

As far as the Close Premises Landlords were concerned, they expected to receive 28p in the Pound from the CVA as opposed to nil in the liquidation. On the other hand, if the release of the guarantees and indemnities was effective, they would receive nothing from *PRG*, whereas in a liquidation their guarantee and indemnity claims would persist.

In fact the CVA, despite being voted through, failed miserably in that within a few months, and by the time of the court hearing, *Powerhouse* had gone into administration and ceased carrying on business.

The Issues

Without setting out the preliminary issues in full, the questions were whether the CVA had the effect of releasing the guarantees or indemnities, directly or indirectly, and if so, whether that was unfairly prejudicial to the Closed Premises Landlords.

As already explained, there is little doubt that, whilst a statutory composition, as a form of statutory contract, could not directly release a third party, it could be drafted in such a way that an indirect release would result.

However, before looking at that more closely, it should be noted that the (mistaken) dictum in *Johnson v Davies* did not apply in this case because it was “ousted by express provision in the guarantee retaining the viability of the assuery notwithstanding dealings between the creditor and the principal debtor.” (paragraph 41).

The judge could not realistically be expected to disapprove of the Court of Appeal dictum in *Johnson v Davies*. He therefore dealt with the matter on the assumption that the dictum in *Johnson v Davies* was correct.

Mr Justice Etherton came to the unsurprising conclusion that the CVA did not have the direct effect of releasing the third party parent guarantor in a direct way: -

“51. The hypothetical agreement resulting from approval of CVA is not, therefore, one between creditors as to rights and obligations between themselves in a capacity other than as creditors of the company. In relation to the guarantees, *PRG*’s obligations are those to the debtor arising out of a contract made by itself as principal on its own behalf. There is nothing in IA or IR which makes the CVA binding and enforceable as between *PRG* and the guaranteed landlords in respect of such obligations.”

On the other hand, the wording, despite arguable deficiencies of drafting, of the CVA was sufficient to make it clear, according to Etherton J, that as between *Powerhouse* and its creditors the creditors were not entitled to enforce the guarantees or indemnities against *PRG*:-

“69. On the other hand, the obligations in cl.3.14 to treat the guarantees as having been released carries with it, in my judgement, the necessary and obvious implication that the guaranteed landlords will not sue *PRG* on the guarantees.”

It should be noted by budding guarantee-strippers that it did not follow that these clauses would ever in fact be enforced. By the time of the court challenge, *Powerhouse* was in administration and the administrators were in charge of the company. Unless the administrators were going to use the terms of the CVA as a form of “greenmail”, to extract value from the landlords, it would be difficult to see why the administrators would either want to or try to enforce the terms of the CVA so as to prevent the landlords from enforcing the guarantees against *PRG*. *PRG* itself could not plead the terms of the CVA in its own defence or rely upon any breach of the statutory contract as between the landlords and the tenant *Powerhouse*. Furthermore, at some future point, long before the end of the leases, or the expiry of the guarantees, *Powerhouse* was likely to go into liquidation and subsequently be dissolved, so there would in fact be no person capable of enforcing the terms of the CVA except perhaps the Crown, who are hardly likely to do so. As a mechanism for indirect guarantee-stripping, therefore, a CVA in relation to an insolvent company has very serious shortcomings, unless the insolvent company survives as a going concern.

Unfair Prejudice

Stripped down to the basics, the Closed Premises Landlords were getting the same dividend as other unsecured creditors of Closed Premises and nothing in respect of their guarantee claims against what, at the time of the CVA, appeared to be a solvent parent company. Of course, if the parent were not released from the guarantees and indemnities in relation to the Closed Premises it may or may not be able to remain solvent – in the event it ceased to be listed on the Stock Exchange and proposed its own New Zealand CVA. Nevertheless, there was no evidence to suggest that the guarantees and indemnities were worthless at the time of the CVA and that therefore they should receive no separate value for their release.

A first instance Chancery Judge can normally be expected to spot unfair prejudice when he sees it, although explaining in legal terms what constitutes unfair prejudice, so as to be able to make predictions about future cases, is a more difficult task. In particular there is “no single and universal test” and “it is necessary to consider all the circumstances”: paragraph 74.

Unfairness has to be looked at by comparative analysis from a number of different angles. Etherton J helpfully names these as a “vertical comparison”, that is the comparison with the position on winding up or bankruptcy, and “horizontal comparison”, i.e. with other creditors or classes of creditors. Another helpful guide in the case of CVA as a comparison with the position if there had been a formal scheme or arrangement under section 425 of the Companies Act 1985, in which different classes of creditors would have been required meet and vote separately.

A simple test which derives from the original Cork Committee report which led to the introduction of CVA's (at paragraph 378) suggest that an IVA or CVA proposed by a debtor is justifiable if it confers on creditors “at least the same advantages as court proceedings would provide.” (paragraph 79 of the judgment).

Authority for the comparison with section 425 schemes can be found in *Re T&N Limited* [2005] 2 BCLC 488.

Although the comparison with liquidation or bankruptcy seems straightforward enough, there are exceptions even here. For example if the voluntary arrangements engages in the long-established sport of “stuffing the Revenue”, that may take the case out of the

ordinary: see *Re A debtor (No. 101 of 1999)* discussed at paragraphs 83-85 of the judgment.

With regard to the “horizontal” comparison, it is clear that a CVA can sometimes properly involve differential treatment for different creditors, even though such differential treatment *prima facie* calls for enquiry (paragraph 88) and in special cases differential treatment may be necessary to ensure fairness: see the *Sea Voyager* case discussed at paragraph 89 of the judgment.

Just as in the case of a scheme of arrangement it is proper for a company to exclude from the scheme and to pay in full (despite insolvency) creditors necessary for the continuation of the business, this may also justify differential treatment in a case with a CVA: see paragraph 90–91 of the judgment.

As a matter of common sense, the question of fairness must be similar both in the case of a scheme of arrangement and a CVA, just like the procedural differences: paragraph 92. This was put in a delightful way by David Richards J in the *T&N* case where he states that the “reasonable and honest manner” is a “welcome guest” in a CVA as well as in a scheme. For a scheme to be sanctioned by the court it must be such that a reasonable and honest man could regard it as being in his interests. Nevertheless, this approach has to be taken with “caution”: paragraph 95.

Etherton J had no difficulty in conclusion in deciding that the CVA was unfairly prejudicial. On the question of the “horizontal” comparison, it was clear that the guaranteed landlords received 28p in the Pound whether or not they had the benefit of the guarantees, so that guaranteed landlords were to receive nothing extra for the loss of the benefit of the guarantees, which appeared to have real value both in themselves and as a potential lever in negotiations with *PRG*. In terms of the “vertical” comparison, the CVA was plainly unfairly prejudicial in that the Closed Premises Landlords with the benefits of the guarantees would have their guarantee rights in a liquidation of *Powerhouse* whereas in the CVA they would not. This was combined with the horizontal comparison that in a winding up the other creditors of Closed Premises would get nothing. The combined effect of these two factors was that the guaranteed landlords of Closed Premises were the group of unsecured creditors that would suffer least in an insolvent liquidation but would suffer most under the terms of the CVA. Etherton J described this as “an illogical and seemingly unfair result” and pointed out that it could not have been achieved under a section 425 scheme of arrangement since

the guaranteed landlords would have been in a separate class and be able to veto the scheme. In the present CVA the creditors of the Continuing Premises who stood to lose nothing from the CVA and had everything to gain from it “inevitably swamped those with of the guaranteed landlords who were significantly disadvantaged by it.” (paragraph 108). It was obvious from the terms of the Cork Committee report that such a result was completely outside the contemplation and intention of the Court Committee: paragraph 109.

Consequences of the *Powerhouse* Decision

No case I am aware of has produced such a flood of email “updates” to swamp my Inbox and no doubt that of others engaged in the fields of insolvency and property law. The finding of unfair prejudice created a massive sigh of relief amongst institutional landlords. In some commentaries this was mitigated by the belated realisation that schemes and CVA’s had the ability to create indirect releases of third party obligations such as guarantees.

One consequence of the decision is that there is speculation as to the circumstances in which “guarantee-stripping” would not be held to be unfairly prejudicial. It may for example be the case that if the CVA provided for a proper mechanism to value guarantees on a present day basis and if such values were paid in full through moneys provided by the guarantor, this could mitigate all or some of the unfair prejudice in a particular case. There would still be the question of whether it was fair to force landlords to accept a substitute for freely entered into commercial obligations on the part of the parent or other guarantor, designed to protect the landlord on the insolvency of the tenant, in precisely the situation for which the protection had been sought. The policy of reliance upon reasonable expectations would come into direct conflict with the policy of rescuing businesses. It may well be the case that a CVA in many cases cannot work for an insolvent tenant unless something is done to liquidate and discharge guarantor liabilities which would sooner or later rebound on the tenant. It is equally clear however that, at a minimum, the landlords would have to receive adequate compensation for the loss of their rights.

It is also questionable whether a compulsory exchange of guarantee liabilities for present value should take place in a CVA relating to the tenant, when it is in reality a

compromise of the liabilities of the parent guarantor. Thus in the *Powerhouse* case, an argument not directly addressed or ruled upon in the judgment was whether it was appropriate at all for the liabilities of the parent, *PRG*, to be dealt with in a CVA relating to *Powerhouse*, rather than a CVA relating to *PRG*. The *Powerhouse* CVA tried to have the best of both worlds: assume that *PRG* was fully solvent, notwithstanding the contingent guarantee liabilities, and yet have the advantage of a statutory compromise designed to protect insolvent debtors. It is suggested that this is a doubtful procedure: either a parent guarantor is solvent, in which case it cannot use either its own or its subsidiaries' CVA as a way of short-changing its creditors or making them accept one type of right for another, or, it is actually or potential insolvent, in which case the question of the parent guarantor's liability should be dealt with in its own CVA proceedings, so that its own creditors as a whole can make a judgment in relation to the proposals. Thus in a future case, even if proper value is offered in exchange for the parent guarantee rights, in a CVA on the tenant, it is still open to the landlords to raise an objection as to the appropriateness of the procedure as a matter of principle.

From the point of view of landlords, there are several urgent tasks to be done, if they have not already been undertaken. Firstly, I would have thought that no landlord or landlord's legal adviser can sleep soundly at night unless they have reviewed their guarantee documentation to make sure that it deals adequately with the erroneous dictum in *Johnson v Davies* on the assumption that that dictum is correct.

Secondly, whilst there is no foolproof method of drafting against the event of a CVA being proposed in respect of a tenant, there are a number of tweaks of drafting which can be tried, and in some cases have been undertaken, to try and make express provisions for the threat of a CVA or IVA and try to give give landlords the best possible potential advantages and protections.

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