Case:
Mourant & Co Trustees Limited & Anor v Sixty UK Limited (in administration) & Ors [2010] EWHC 1890 (Ch) (Henderson J, 6-7 July 2010)

Synopsis:
An application under s.6(1) IA 1986 by landlords to revoke approval of a CVA on the grounds of unfair prejudice succeeded. Under the terms of the CVA, the landlords of closed retail stores were to lose the benefit of third party guarantees without adequate compensation or sufficient justification.

Topics covered: CVA; challenge; s.6 IA 1986; unfair prejudice; material irregularity; "guarantee stripping"

The Facts

Sixty UK Limited ("Sixty) was an English registered company whose ultimate parent, Sixty SpA, was an Italian registered public limited company. Sixty carried on the business of wholesale and retail sale of fashion garments in 11 retail shops and 14 concessions in department stores. Two of the retail shops were neighbouring units in a shopping centre in Liverpool, whose landlords were the applicants. The units were demised under two 10-year leases dated 3 November 2006 for a minimum annual rent of £100,000. Sixty SpA was guarantor under both leases. In order to procure the grant of the leases with parental guarantees, the landlords had offered Sixty substantial incentives, including a 12-month rent free period and other benefits, totalling at least £566,000 in value.

Sixty had traded at a loss since 2005, and had been supported financially by Sixty SpA. By the end of 2007, Sixty SpA no longer wished to continue funding the losses. Administrators were appointed to Sixty in September 2008 and they entered into discussions with Sixty SpA and the landlords of the loss-making stores, which culminated in the CVA proposal that was the subject of the application.

The CVA provided that Sixty SpA would defer repayment of an intercompany debt of approximately £15 million, and four loss-making stores would close. The landlords of the closed store leases that were not guaranteed would receive 21% of the amount that the company allegedly estimated that it would be liable to pay on the surrender of the leases. Those closed store landlords that held guarantees from Sixty SpA were to be paid 100% of the amount that the company allegedly estimated as the surrender premium (calculated as £300,000) in return for releasing Sixty SpA from the guarantees. In this way, the CVA sought to take advantage of the obiter remarks in *Prudential Assurance Co Ltd v PRG Powerhouse Ltd [2007] EWHC 1002 (Ch)* , which members will recall suggested that a CVA could be lawfully structured in a manner that would deprive a creditor landlord of a third party guarantee for the liabilities of the insolvent tenant if enforcing the guarantee would give rise to a right of recourse by the third party against the debtor company. All other creditors were to be paid in full.

The CVA estimated that on a liquidation, the dividend for unsecured creditors would be no more than 13p in the £1.

At a meeting held to consider the CVA proposal on 2 April 2009, it was passed by a majority exceeding 75%. The only creditors at the meeting who voted against the proposal were the applicant landlords.
The landlords submitted that the CVA was unfairly prejudicial to them as creditors of Sixty because:

1. The CVA would leave them in a worse position than on a liquidation because, regardless of the quantum of the liquidation dividend, a liquidation would leave their guarantee rights against a solvent parent intact.

2. It was unfair in principle to deprive them of their guarantees, which were intended to protect them in case of Sixty's insolvency, in return for a compensation payment based on uncertain and untested assumptions in a very difficult market.
3. The £300,000 estimate of the surrender premium was unrealistic and should be at least £1.2 million.
4. The compensation should not be fixed but should be adjudicated by independent adjudication.
5. The CVA treated the applicant landlords differently from at least one other creditor that was in a similar position with no justification for such differential treatment.
6. The CVA created no enforceable obligation on Sixty SpA to make any of the compensation payments in return for which the applicants were obliged to give up their guarantees, nor did it make the release of the guarantees conditional upon the receipt of such payments.

The Decision

The Judge considered that the CVA was fatally flawed and must be set aside.

Henderson J noted the principles on unfair prejudice summarised by Etherton J (as he then was) in *Powerhouse* as follows:

(a) Any CVA which leaves a creditor in a less advantageous position than before the CVA will be prejudicial to the creditor. The real issue is generally whether the prejudice is "unfair".
(b) There is no single and universal test for judging unfairness in this context, and the question must depend on all the circumstances of the case, including in particular the alternatives available and the practical consequences of a decision to confirm or reject the arrangement.
(c) In assessing the question of unfairness, a number of techniques may be used, including what may be described as "vertical" and "horizontal" comparisons. A vertical comparison is a comparison between the position that a creditor would occupy and the benefits it would enjoy in a hypothetical liquidation, as compared with its position under the CVA. The importance of this comparison is that it generally identifies the irreducible minimum below which the return in the CVA cannot go. As David Richards J said in *Re T&N Limited [2004] EWHC 2361 (Ch)* at para 82 of his judgment:

"*I find it very difficult to envisage a case where the court would sanction a scheme of arrangement, or not interfere with a CVA, which was an alternative to a winding up but which was likely to result in creditors, or some of them, receiving less than they would in a winding up of the company*…"

(d) A horizontal comparison, on the other hand, is a comparison between the position of the applicant and the position of other creditors, or classes of creditors. The fact that a CVA involves differential treatment of creditors is a relevant factor which calls for careful scrutiny, although it will not automatically render a CVA unfairly prejudicial: see *Re a Debtor (No.101 of 1999) [2001] 1 BCLC 54* (Ferris J). In considering the question of differential treatment, it is necessary to ask whether the imbalance in treatment is disproportionate, and also whether the differential treatment may be justified, for example by the need to secure the continuation of the company's business by paying essential suppliers or service providers.

The Judge considered that the terms of the Sixty CVA were very similar to the CVA in *Powerhouse*, which failed because both the vertical and horizontal comparisons caused unfair prejudice to the landlords who were to lose their guarantees, while other creditors were paid in full, which could not be justified.

On a liquidation, which was the vertical comparison (as in Powerhouse), the applicant landlords would still have had the benefit of the guarantees. That is why the guarantees were taken in the first place. The guarantees would have been enforceable against Sixty SpA, which had a strong balance sheet.

The Judge accepted the applicant's submission that, in the context of commercial and financial turmoil, it was unreasonable and unfair in principle to require the applicants to give up their guarantees for a sum of money in lieu. It was too difficult, if not impossible, to determine what sum would fairly compensate the landlord for the loss of such rights. The Judge upheld the landlord's challenge to the £300,000 compensation assigned to their claim in the CVA. The expert evidence (of both landlords and of Sixty itself) showed that a figure in the region of £1 million was the least that could fairly be regarded as appropriate. He further held that the £300,000 was, contrary to the explanation in the CVA, not a genuine estimate of the value of the applicants' claim, but was instead dictated to the administrators by Sixty SpA, being the maximum amount they were prepared to pay.

On a horizontal comparison, the CVA only imposed a compromise of the rights and claims of the landlords of the four closed stores. It did not compromise the rights and claims of other creditors in respect of the closed stores, nor did it compromise the rights and claims of any other creditors (including associated company creditors), all of whom were entitled under the CVA to payment in full by Sixty. The only justification offered for this horizontal prejudicial treatment was that the closed stores were loss-making, which the Judge held was not adequate.

In addition, the Judge agreed that the different treatment of the applicant landlords and the landlords of a Trafford Centre store, which had the benefit of a covenant from an original tenant, could not be justified. The Trafford Centre landlord was paid in full by the original tenant, which in turn was entitled to prove in full in the CVA for the rent it had to pay after Sixty's default. In this way, the Trafford Centre landlord had the equivalent of a guarantee (in the form of the original tenant) and was therefore in an almost identical position to the applicant landlords. But unlike the applicant landlords, the Trafford Centre landlord's claim was not compromised by the CVA. The Judge found no justification for the difference in treatment.

The Judge also appeared to be swayed by the argument that if the arrangement had been proposed as part of a scheme of arrangement, rather than a CVA, the landlords would have formed a separate class and could have vetoed any such scheme. In this case, the CVA was passed by the votes of the unsecured creditors, who stood to lose nothing from the CVA and whose votes inevitably swamped those of the guaranteed landlords.

Comment

The Judge's disdain for the conduct of the administrators in this case is clear. He summed up:

"*This is, in my view, a CVA that should never have seen the light of day….[T]he evident purpose of the CVA was to compel [the guaranteed 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 itself buy time and subject the applicants to all the uncertainties of litigation. It is 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*."

The Judge went on to emphasize the duty of office holders to maintain an independent stance and only to propose a CVA if they are satisfied that it will not unfairly prejudice the interests of any creditor, member or contributory of the company. Particular care is required 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* decision.

It probably did not help the administrators case that they applied to adjourn the proceedings at the eleventh hour on grounds that they would be issuing revised proposals that would deal with the issue. When this application was refused, they withdrew from the proceedings and so their version of events was not heard. The Judge took the unprecedented step of referring the administrators to their licensing bodies on the grounds of a prima facie case of misconduct.

Henderson J gave a particularly valuable insight into the *Powerhouse* issue when he said:
"I *do not say that it is necessarily impossible to propose a fair CVA of this type but the greatest care is needed to ensure fairness to the [minority creditors who are to be deprived of valuable contractual rights], both in the substance of what is proposed and in the procedure that is adopted*."
It remains to be seen whether a future attempt to propose a guarantee-stripping CVA will be successful. However, the Judge's comments and summary of the principles affecting unfair prejudice in this case are useful, and were relied on by Mann J in the subsequent unfair prejudice challenge to a CVA in *HMRC v Portsmouth City Football Club Limited (in administration) & Ors [2010] EWHC 2013 (Ch)*. In that case, Mann J concluded that the rules of the Football League, which provide that football creditors must be paid in full in a CVA, and commercial reality, were sufficient justification for the disparity of treatment of HMRC. Mann J did not review the validity of the football creditor rules; these are the subject of a separate legal challenge.

The following conclusions can be drawn:

- Where a CVA is being proposed that contains guarantee-stripping provisions affecting a minority of creditors, and where other creditors are being paid in full or given better terms, then, in order for the CVA not to be unfairly prejudicial to the guarantee-stripped minority creditors, they must be fairly compensated for the loss of their guarantees.
- The appropriate compensation payment may need to be independently assessed.
- Release of the guarantees should be conditional upon payment of the compensation.
- In a difficult market, it may not be possible to fairly assess what is an adequate level of compensation.

It would appear, therefore, that CVAs of this kind may require a more consensual approach in future.