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Review

Business Recovery & Insolvency

Landlords rejoice as Court overturns "unfair" CVA

The past eighteen months have seen a marked increase in the use of the Company Voluntary Arrangement ("CVA") by retailers to reduce their lease liabilities and win the release of onerous parent company guarantees, with several high street names going through the process. Although this practice received cautious support from landlords, real concern continues to be voiced over the practice of "guarantee stripping".

The High Court has just handed down a decision which helps set the boundaries on acceptable practice in this area and provides some comfort for landlords that they will not be bulldozed into accepting unacceptable proposals, simply because they are a minority voice in the proceedings.

In the recent decision of the High Court in the matter of *Mourant & Co Trustees Limited & another v Sixty UK Ltd (in liquidation) & others [2010] EWHC 1890 (CH)* the court has built on the principles established in *Prudential Assurance Company Ltd v PRG Powerhouse Limited [2007]* ("Powerhouse") and provided some welcome clarification of the meaning of "unfair prejudice" to a creditor in a CVA.

The decision provides a timely reminder of an IP's obligations to act in the best interests of all creditors when proposing a CVA and to maintain an objective stance when preparing the proposals.

> "...real concern continues to be voiced over the practice of "guarantee stripping"..."

Background

Sixty UK Ltd (the "Company") operated a clothing retail business trading under the brands of "Miss Sixty" and "Energie" from various stores and concessions nationwide. The Company was loss-making and, in April 2008, appointed experts to advise on a potential restructuring and the closure of loss-making stores. Amongst the proposals was the closure of two loss-making retail units based at the Met Shopping Centre in Liverpool. The Company operated from those premises under two ten-year leases entered into in November 2006. The 2008 advice concluded that it would cost not less than £490,000 per store to negotiate a surrender of the leases.

Each of the leases was guaranteed by the Company's ultimate parent company, Sixty SpA, an Italian registered public limited company, which was of good covenant strength and solvent at the time.

In the face of sustained trading losses, the decision was taken in September 2008 to place the Company into administration, with a view to then proposing a CVA to the Company's creditors from behind the protection of the statutory moratorium. The insolvency practitioners who had advised the Company in April were appointed as its administrators.

In March 2009, the administrators presented their CVA proposal to the creditors and this was approved on 02 April 2009. The CVA proposal provided for all of the Company's trading creditors to be paid in full on an ongoing basis, save for the landlords of four premises that were to be closed, including the two retail units in the Met Centre. The CVA sought to take advantage of the Powerhouse decision by using the CVA to release Sixty SpA from its parent company guarantees.

The proposals provided that the landlords of the closed stores would receive a compensatory payment of £300,000, which Sixty SpA would provide, in return for which the Company would

"...the assumptions upon which the compensation payment was based were unrealistic..."

be released from its liabilities under the leases and Sixty SpA would be released from all liability under the guarantees. The figure of £300,000 was said in the proposals to represent 100% of the Company's estimated liability to the landlords on a surrender of the leases, calculated on the basis of valuation advice received and certain specified assumptions.

The court considered carefully the basis of the calculation of the proposed compensation payment and the assumptions upon which that payment was based. The court concluded that, in a depressed and uncertain property market, the assumptions were unrealistic and that the level of compensation proposed was too low. During the course of the proceedings it became apparent that the proposed level of compensation was not reflective of the true value of the landlords' losses but rather was indicative of the maximum amount that Sixty SpA was prepared to pay to obtain a release of its obligations under the guarantees.

Sixty SpA appeared, somewhat cynically, to be basing its approach on the belief that the landlords would be unprepared to incur the additional costs, delay and litigation risk that bringing proceedings in Italy would possibly involve. The offer was therefore calculated on a very commercial basis to provide a lump sum payment that obviated that risk.

The Court found that the assumptions set out in the CVA proposal did not match the assumptions upon which the Supervisor's own valuer had based his preliminary calculations (prepared as part of the report in April 2008) but that the supervisors had picked and chosen which assumptions to adopt, to bring the calculation of the landlord's loss down from approximately £1.2 million to only £300,000. The Court concluded that the level of compensation being offered to the Met Centre landlord bore no relation whatever to the valuation advice obtained.

For example, the supervisor's own valuer had suggested that the following assumptions would be appropriate in assessing the landlord's likely losses – a one year vacancy period, a 3 month rent free incentive, a cash incentive of £275,000 to a new tenant, an incoming tenant paying rent in line with the passing rent of £109K and a dilapidations claim of £40k.

The final CVA proposal only contained three of those assumptions: a one year vacancy period, a 3 month rent free incentive and rent being in line with the current passing rent of £109K. There is no explanation or justification for ignoring the other (significant) assumptions, other than to bring the compensation calculation down in line with the amount that Sixty SpA was prepared to pay.

"there is no single universal test that can be applied to determine whether or not a proposal is unfair"

In his judgment Mr Justice Henderson was very critical of the basis upon which the proposal had been made. He agreed with the landlords' view that the assumptions upon which the compensation payment was based were unrealistic in the circumstances and that the true value of the landlords' loss was far higher than set out in the proposal (alternative valuation advice provided at the trial suggested that a figure £1.2M would have been more appropriate).

Henderson J stressed that, in putting forward the CVA proposals, the insolvency practitioners were under an obligation to maintain an independent stance, to act in good faith and only to propose a CVA if they were satisfied that it would not unfairly prejudice the interests of any creditor, member or contributory of the Company.

This was particularly so in these circumstances, where the CVA was structured so that it was bound to be passed because the position of the vast majority of creditors was either unaffected or improved by the proposal and only another, much smaller, class of creditors would be deprived of valuable contractual rights. In this case the Judge feared that the administrators had lost their sense of objectivity and had sided with the parent company, rather than maintaining a neutral stance and acting at all times in the best interest of the creditors.

Decision

Justice Henderson examined the earlier Powerhouse decision and cited with approval sections of Justice Atherton's decision in that case in assessing whether a proposal amounted to unfair prejudice of a creditors' position. Justice Henderson followed Justice Atherton's earlier line that there is no single universal test that can be applied to determine whether or not a proposal is unfair: there are, however, a number of techniques that can be used to assess the impact of a proposal on a creditors position. The judge focused on two approaches: the "vertical" approach and the "horizontal" approach.

The Vertical Approach

In the vertical approach, the position of the creditor is compared with the position it would find itself in were the company simply to be placed into liquidation. It is established case law that for a CVA proposal to succeed, the proposal ought to place the creditor in a better position than it would have been had the company simply been liquidated. In this instance, the rights of the landlords under the parent company guarantees would have been unaffected by a liquidation of Sixty UK Ltd and it would therefore have had full recourse against the parent company for all of its losses under the leases, including the rights to require the parent company to take a lease for the remainder of the term. The loss of this valuable right in return for an unsatisfactory financial lump sum payment was held by the court to be unfairly prejudicial.

The Horizontal Approach

An examination of the creditors' position on a "horizontal" basis involves comparing the position of the creditor against the position of other creditors or classes of creditors who are also able to prove within the CVA.

In this instance the position of the landlords of the units was compared with the position of the landlord of another store, where Sixty UK Ltd operated as assignee from Muji Ltd. Muji Ltd were liable as original tenant under the lease for all of the liabilities under that lease and therefore stood in a quasi-guarantor position. The CVA allowed Muji to claim in full for any losses they may suffer as a result of the closure of that store and this in turn meant that the landlord of that store retained the benefit of the Muji "guarantee". This position differed significantly from the position of the Met Centre landlord, as it was effectively being stripped of the benefit of its parent company guarantee. The Court concluded that there was no justification for treating the Met Centre landlord differently from Muji's landlord and that the CVA was also unfairly prejudicial on a horizontal basis.

Lessons for Insolvency Practitioners

1. If, as here, the CVA proposal is clearly only prejudicial to the position of a small minority of creditors, then the IP must be very careful to ensure that the compromise being offered to that minority is fully justified.

2. If proposing a CVA that will only affect a small minority of creditors, the IP should ensure that there are no creditors who could be said to fall within the same class but who are being treated differently for no apparent reason. This is critical to ensuring a CVA is not deemed unfair on the "horizontal" basis. In this case, the CVA failed to address the potential impact of the Muji claim and the differential treatment that the landlord of the Muji store received was not justifiable, rendering the provision unfairly prejudicial to the Met Centre Landlord.

3. Make sure that any assumptions upon which compromise payments are based are objective, realistic and fully justified. The compensation payments to the affected landlords in this case were not based on proper valuation advice but were instead reflective only of how much Sixty SpA were willing to pay.

4. An office holder should always remember their duty to remain impartial when putting together a CVA proposal – "It is not for the officeholders to advocate the interests of one group of creditors as against another group, nor to engage in brinkmanship, or attempt to extract ransom payments…in order to extract a better proposal for the first group… They [should] simply put forward proposals which… they must consider to be fair to all the creditors of the company and to the company itself". (Warren J in Sisu Capital Fund Limited v Tucker [2005], cited with approval by Henderson J in this case.).

5. Any compensation to be paid under the CVA must beat what the creditor would expect to receive in a liquidation, to avoid being unfair on the "vertical" assessment basis. The difficulty here is that the parent company guarantees would be unaffected by a liquidation, so any offer of compensation for a release of that parent company guarantee would have to be significant to persuade the landlord that it was appropriate to give up their contractual rights against the parent. In this instance, that meant considering the level of compensation that would otherwise be payable on a Re Park Air Services basis if the lease were disclaimed by a liquidator, taking into account the likelihood of the landlord mitigating its claim by re-letting the premises and all the relevant factors that might impact on achieving such a re-letting.

"Make sure that any assumptions upon which compromise payments are based are objective, realistic and fully justified."

Conclusion

The evident purpose of the CVA was to compel the affected landlords to give up their rights under the parent company guarantees for a fraction of their fair value and the CVA was proposed solely to improve Sixty UK Ltd's negotiating position, in circumstances where it knew the majority of creditors would be bound to pass the CVA proposal, as only a very few of the Company's creditors were adversely affected by the terms of that proposal.

The court also concluded that, having considered the Powerhouse decision in detail, it is possible to propose a fair CVA of this type but the greatest care is needed to ensure fairness to the smallest class of affected creditors, "both in the substance of what is proposed and in the procedure that is adopted" (paragraph 88 of the judgment).

It is incumbent on the office holders proposing the CVA to maintain an independent stance and to act in good faith when proposing such a CVA.

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Comment

Following the successful use of the CVA by companies such as JJB Sports, Focus DoitAll and Blacks to reduce their rent role exposure and release parent company guarantees, this case provides a useful marker of the acceptable boundaries of any such proposal. Any insolvency practitioners considering making such a proposal have received a strong indication from the court that they will be expected to act at all times in the best interests of all of the creditors, and must not allow their judgment to become clouded by the commercial considerations of the parent company that is providing the ultimate funding behind the application.

This case provides some cautious support for the continued use of a CVA to release parent company guarantees and provides useful clarification on when a proposal may truly be seen to be "unfairly prejudicial" to a creditor. It also underscores that the basis of assessment of compensation in any such case must be properly justifiable on an objective basis, if the proposal is to stand any chance of avoiding a successful "unfair prejudice" challenge by the affected landlords.

HOW HAMMONDS CAN HELP

We would be pleased to discuss with you in more detail any of the matters raised in this article.

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