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# In Practice

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## Football and fashion: no way to treat a creditor?

**KEY POINTS**

- Solvent guarantors should seek to offer compensation to those losing the benefit of the guarantee under the CVA to avoid a successful challenge.
- The compensation offered must reflect the value of the rights proposed to be given up.
- The football creditor rule lives to fight another day.

Company Voluntary Arrangements have become increasingly popular with insolvency professionals as the tool of choice to implement a restructuring.

### INTRODUCTION

Company Voluntary Arrangements ('CVAs') have been used in increasingly diverse and imaginative ways over the last few years. Some proposals have stretched the limits of CVAs almost to breaking point. Some have actually snapped those limits and their validity has been rejected by the court. From the huge complexities of *TXU* and the ground-breaking use of CVAs in pension restructurings in *Dana*, to the more recent mixed outcomes of *Powerhouse, Blacks* and *JJB Sports*, CVAs are becoming the mechanism of preference for insolvency professionals when they need to attempt something unusual or controversial, whether inside or outside another procedure, such as administration.

It would seem that this trend is continuing with two recent CVA proposals that have come before the courts. In the first, HMRC unsuccessfully challenged a CVA proposal for Portsmouth City Football Club where there was a particular focus on the fairness (or otherwise) of the football creditor rule. In the second, landlords successfully challenged the CVA proposal for the Miss Sixty fashion retail chain, which sought to take away their rights under parent company guarantees.

### Can a CVA be challenged?

Once a CVA has been approved by a majority in excess of three-quarters in value of the creditors present and voting, half of whom must be unconnected with the company (IR 1.19), then the Insolvency Act 1986 ('IA 1986') provides only two grounds of challenge to creditors. Section 6(1) allows an application to court if the CVA (a) 'unfairly prejudices the interest of a creditor' or (b) there was some 'material irregularity' at the creditors' or members' meetings convened to approve the CVA. It is the s 6 challenges that the recent cases have addressed.

### The cases

*HMRC v Portsmouth City Football Club Limited (in administration) and others [2010] EWHC 2013 (Ch)*

Portsmouth City FC (the 'Club') follows in a long line of football clubs which have gone into administration including Wimbledon, Leeds, Crystal Palace and Southampton. The Premier League and the Football League require clubs who wish to remain playing in the relevant leagues to abide by these organisations' rules. If a club in the Premier League goes into administration, its membership is suspended and only renewed if the club (i) exits administration by way of a CVA and (ii) pays its debts to so-called 'football creditors' in full or fully secures the repayment. Football creditors are those creditors related to the football industry, for example, other clubs, to whom there are transfer fees outstanding, players' salaries and various football authorities and organisations. This is commonly known as the 'football creditor rule'.

In addition, while a club is suspended, the Premier League may make payments to football creditors out of the revenue which it would otherwise pay to the club. The Premier League may also make a 'parachute payment' to a club if it is relegated, as a form of compensation for the loss of revenue suffered by no longer playing in the Premiership. Again, the proceeds of such a parachute payment will be made mostly to football creditors directly.

As the judge in this case pointed out, the football creditor rule has been criticised in the past, including by a House of Commons Select Committee but it is still in operation. HMRC is bringing another case specifically on the football creditor rule in separate proceedings and the judge declined to express a view on the validity of the rule in the meantime.

### FACTS

HMRC petitioned for the winding up of the Club at the end of 2009. The petition was adjourned in February 2010 and the Club went into administration later that month. The administrators proposed a CVA that would pay out a dividend worth approximately 20 per cent of the unsecured creditors' claims while the football creditors would be paid in full from Premier League funds, not from the Club's estate. The CVA would last for nine months, then the business would be transferred to a new company and the administration would then move into a creditors' voluntary liquidation.

HMRC initially claimed a debt of £17m. It then increased the claim to £35m but without any detailed supporting evidence. Partly because of this, the Chairman of the creditors' meeting convened to approve the CVA proposal valued HMRC's claim for voting purposes at £13m. The CVA was approved by about 78 per cent of the unsecured creditors. HMRC claimed that the CVA proposal unfairly prejudiced it and that there were material irregularities at that meeting.

The court dismissed HMRC's claims of material irregularities, including the challenge to the valuation of its debt and it is beyond the scope of this article to consider the issue further.

HMRC's claim for unfair prejudice was based on three heads:

- The CVA committed the Club to exit the CVA and administration by way of a CVL. A CVL liquidator could not pursue claims under s 127 of the IA 1986 (namely a challenge to any disposal of assets of a company following the presentation of a winding up petition), which HMRC felt would enable certain payments made to football creditors to be recovered for the estate generally.
- The CVA approved past and future payments made to football creditors that

were and would be paid in priority to other unsecured creditors.

- Football creditors had been allowed to vote even though they were to receive payment in full. These votes had swamped the votes of the other unsecured creditors.

## DECISION

### The s 127 argument

The court held that a s 127 action could still be pursued following a CVA as HMRC could obtain a compulsory winding up order to run concurrently with a CVL. Therefore, there was no unfair prejudice on that count.

### Past payments

The court also held that the CVA did not approve past payments, ie payments made before administration. The CVA also did not provide that football creditors were to be paid in priority to other creditors. The CVA did assume that football creditors would be paid in full and as a matter of fact, the football creditors would be paid with Premier League money, not money from the Club. If these payments were not made to the football creditors, the Premier League would not pay the money to the Club. It followed that the football creditors may receive a better outcome but not at the expense of other creditors. The court then considered the validity or otherwise of the football creditor rule. It did not make a finding that it was in some way unenforceable or gave the administrators a valuable claim. That being the case, HMRC, and the other unsecured creditors, were not deprived of money which would otherwise flow to them so there was no *unfair* prejudice (emphasis in original) and possibly no prejudice at all.

### The voting issue

On the third head, the court found 'this point [football creditors being able to vote] a little more troublesome than some of the others' but ultimately, the judge concluded that it did not amount to unfair prejudice. The case against admitting the football creditors was that they had no real interest in the CVA. They were to be paid in full from funds falling outside the Club's estate and which were unavailable to other creditors. It was argued that they should not be able to push through a proposal which did not actually affect them. The court held that this was not quite correct; it held that football creditors did have an interest in the CVA being approved. If the CVA was not approved, then players' contracts of employment would come to an end, whereas in a CVA, the contracts would continue. In the circumstances, the court came to the view that the voting rights given to the football creditors did not amount to unfair prejudice. However, more to the point, the court was also of the view that HMRC had been bound into a CVA which 'can only leave them financially better off than in a liquidation'.

## COMMENT

The court noted that HMRC has a policy of voting against all CVA proposals which do not follow a strict *pari passu* approach to the payment of distributions. The court emphasised in its summing up that this was a case which had to turn on the 'commercial realities' not the validity, or otherwise, of the football creditor rule. The court seemed to pay particular attention to the fact that no significant money would flow into the insolvency or any asset value be preserved other than via a CVA. It was not for the court to judge a proposal against a hypothetical deal, only against the actual deal presented or a liquidation scenario and in this case, the court found that HMRC benefited more from the CVA than it would from a liquidation. This also seemed to have helped the court to find that there was no unfair prejudice in allowing the football creditors to vote, although when noting that the football creditors did, in reality, have an interest in the CVA, the judge referred only to employees, not any of the other football creditors, whose claim to an interest might be more nebulous. Perhaps, ultimately, the court was swayed by the line in the CVA proposal which stated that 'creditors are asked to distinguish between their dislike of the Football Creditor Rule and voting for the CVA, which are two separate and distinct matters'.

## MOURANT & CO TRUSTEES LIMITED AND ANOTHER V SIXTY UK LIMITED (IN ADMINISTRATION) AND OTHERS

This case follows in a line of others where administrators or corporate tenants have attempted to compromise landlords through a CVA and in particular take away a landlord's right under a parent company guarantee for a tenant's lease obligations. In *Prudential Assurance Company Ltd & Others v PRG Powerhouse Ltd & Others* [2007] EWHC 1002 (Ch) although the court held that the terms of that CVA proposal were unfairly prejudicial to the landlords, in principle, a CVA could be drafted which released a guarantor from its obligations provided that the creditor was adequately compensated. In *Sixty*, the administrators tried to propose such a CVA.

## FACTS

Sixty, a clothes retailer, sought to close its loss-making stores as part of a plan to restructure its business. Sixty's Italian parent company ('Parentco') had guaranteed its liabilities under the leases of the closing stores. Under the terms of the draft CVA, Sixty (via funds from Parentco) would pay the landlords of the closing stores the surrender value of the leases and Parentco would be released from its obligations as guarantor. All of the other unsecured creditors would be paid in full. A report was commissioned which estimated the surrender value of the leases was about £1m. The situation worsened and Sixty went into administration. The administrators took over the CVA proposal as it stood, although following discussions with Parentco, the total amount to be offered to the landlords of the closed stores was reduced to £600,000. This new amount was a commercial offer from Parentco, unlike the previous amount which was based on valuations, although the CVA wording was not amended to reflect this.

The CVA was approved, although the landlords of the closed stores voted against. They subsequently brought an application to challenge the CVA on the ground that it was unfairly prejudicial.

By the time of the hearing, it was clear that *Sixty* was likely to breach the terms of the CVA. The administrators asked the court to adjourn the hearing until after a new meeting of the

# In Practice

***Biog box***

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creditors was held at which modifications to the CVA proposal would be proposed so that all unsecured creditors would receive equal treatment. The court refused to do so and the administrators declined to take any further role in the proceedings.

The landlords' application was based on several grounds including: (i) a fixed amount of compensation, especially when based on estimates and assumptions as to future performance, could not adequately compensate a creditor for loss of rights under an unlimited guarantee; (ii) even if the first point was not true, the amount offered in this case was less than the true surrender value of the leases; (iii) the CVA would also leave them in a worse position than in a liquidation because their rights under the guarantee had been taken away. The guarantee would have been enforceable in a liquidation; and (iv) the CVA stated that it was Parentco's intention to ensure that Sixty made all the payments. Parentco was not bound by the CVA (indeed it was not a creditor) so there was no certainty for the landlords that they would actually be paid.

## DECISION

The court struck down the CVA. It held that a CVA could not remove a creditor's rights under a guarantee unless the creditor agreed. It doubted (although did not rule out the possibility altogether) that a lump sum could ever be adequate compensation for the loss of a right to call on a guarantee, especially where the sums involved were likely to fluctuate and could not be reliably assessed, as is the case on leases.

The court regarded as 'critical' the fact that in a liquidation the landlords would still have had recourse to the guarantees from Parentco. These guarantees would have been an important part of the commercial deal struck at the time the leases were granted and for them (in effect) to be removed unilaterally and without adequate compensation would be 'unreasonable and unfair'. The financial good health of Parentco and relative ease of enforcing the guarantees, even in Italy, was also considered. The court went on to say that even if it were wrong on this point, the amount that was actually offered to the landlords was not even a considered estimate of the value of the release; instead it was an amount offered by Parentco based on what it 'hoped it could get away with'.

## COMMENT

The tight rope that those proposing a CVA need to take is to come up with a proposal that will win the support of the required statutory majorities but which will not be capable of a successful challenge. The administrators in this case do not appear to have tread the tight rope with sufficient preparation or care. The court subjected the administrators to heavy criticism for letting Parentco seemingly dictate the terms offered to the landlords. They probably did not help themselves by their very limited participation in the court hearing. As a result, no real explanation of their action was given to the court and it is possible that judgment might have been less critical if they had done so.

It seems that it should still be possible to construct a CVA in which landlords are offered sufficient compensation and thereby enabling rights under a guarantee from a solvent guarantor to be compromised without causing unfair prejudice. However, given the reasoning in the line of cases to date, it seems that such a compromise could only be achieved if the beneficiaries of the guarantees received the full amount (or virtually the full amount) in return for an effective release of their rights. Where a guarantor is solvent and the guarantee has some real value, it does not seem right that rights under a guarantee can be compromised unilaterally without adequate compensation. Furthermore, if a payment in lieu of the guarantee is to be made, the guarantor should also be bound by the CVA to ensure that the guarantor is under an obligation to make the required payment.

## SUMMARY

Both these cases involve consideration of the role of third parties, the Premier League for *Portsmouth* and Parentco for *Sixty* and an analysis of assets, which are actually available to creditors. In *Portsmouth*, it was held that the funds which the Premier League used to pay the football creditors were never part of the Club's estate. HMRC was therefore not prejudiced by the payments made to them. Indeed, the payments allowed the CVA to be voted through which, it was found, ultimately generated more revenue for HMRC than a liquidation would have done. In no way was it considered that the Premier League was seeking to avoid making any payments that it owed or that the Club was preferring certain creditors. If the football creditor rule is found at some later date to be contrary to public policy or otherwise unfair, then future cases may be decided differently but at present no insolvency officeholder or creditor can require payments from the Premier League (or presumably the Football League) to be made to the estate of the insolvent club; to that extent these funds are simply not available to the general body of creditors.

Following *Sixty* it is clear that an enforceable guarantee from a solvent guarantor will be regarded as an available asset or right of the beneficiary of the guarantee. Solvent guarantors should expect to be required to have their guarantees called or possibly make a substantial lump sum payment. To avoid successful challenges of unfair prejudice, the amount of any offered lump sum payment ought to be calculated on a proper and reasonable basis, ideally with expert, independent advice. That said, where the guarantor is a parent company whose support is needed for the CVA to be successful and allow the insolvent business to continue trading, it will always be a balancing act between establishing the amount that the guarantor is willing to pay (and so can be included in the proposal) against the amount the guaranteed beneficiaries are willing to accept. Guarantors should be advised to err on the more generous side of any offer if they wish to avoid a challenge of unfair prejudice. Officeholders, likewise, in order to avoid criticism, should endeavour to demonstrate their impartiality in dealing with a guarantor, where the CVA proposal purports to release the guarantor from his obligations.

These cases both support the view expressed in a number of recent cases that classes of creditors can be treated differently without that treatment automatically being unfairly prejudicial. The question will turn on an analysis of the assets or rights actually available to a particular class of creditor, not on a more nebulous test of what ought to be available or an attempt to force through a re-negotiation of an earlier commercial deal. ■