U.K. Focus

Football and Fashion: No Way to Treat a Creditor?

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Company voluntary arrangements ("CVAs") have been used in increasingly diverse and imaginative ways over the last few years in the U.K. Some proposals have stretched the limits of CVAs almost to the breaking point. Others have actually exceeded those limits and have been rejected by the courts. From the huge complexities of *TXU* and the groundbreaking 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 attempting something unusual or controversial, whether or not in conjunction with another insolvency procedure, such as administration under the U.K. Insolvency Act 1986, as amended by the Enterprise Act 2002 (the "Insolvency Act").

Judging by two recent CVA proposals that have come before the courts, it would appear that this trend is continuing. In the first, Her Majesty's Revenue and Customs ("HMRC") unsuccessfully challenged a CVA proposal for Portsmouth City Football Club, where there was a particular focus on the fairness of the "football creditor rules." In the second, landlords successfully challenged a CVA proposal for the Miss Sixty fashion retail chain, which sought to abridge their rights under parent-company guarantees.

Company Voluntary Arrangements

If a U.K. company and its creditors can reach agreement on a plan to deal with the company's debts, an appropriate means of implementing such agreement may be a company voluntary arrangement ("CVA"), largely under the U.K. Insolvency Act 1986. Under this process, the debtor makes a proposal to its creditors to repay a certain percentage of their claims over a specified period of time. If more than 75 percent in value of the debtor's creditors taking part in the creditors' meeting to consider the proposal vote in favor of the proposal, then, subject to certain safeguards, the proposal becomes binding on all creditors, including those who voted against it (although secured creditors need to consent specifically to a CVA in order for it to be binding on them).

On What Grounds Can a CVA Be Challenged?

Once a CVA has been approved by more than three-quarters in value of the creditors present and voting, half of whom must be unconnected with the company, the Insolvency Act provides only two bases for challenge by creditors. Section 6(1) provides for court redress if: (a) the CVA "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. The most recent cases have addressed Section 6 challenges.

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 that have gone into administration, including Wimbledon, Leeds, Crystal Palace, and Southampton. The English Premier League and the Football League require clubs that wish to remain playing in the relevant leagues to abide by league rules. If a club in the Premier League is placed into administration, its membership is suspended and may be renewed only if the club: (i) exits administration by way of a CVA; and (ii) pays its debts to "football creditors" in full or fully secures the payment obligation. "Football creditors" are those creditors related to the football industry (*e.g.*, other

clubs, if there are transfer fees outstanding, player salaries, and various football authorities and organizations). This concept is commonly referred to as the "football creditor rules."

In addition, while a club is suspended, the Premier League may make payments to football creditors out of the revenue that it would otherwise pay to the club. The Premier League may also make a "parachute payment" to a club if it is relegated to a lower league, as a form of compensation for the loss of revenue suffered by the relegation. Again, the proceeds of such a parachute payment will be made primarily to football creditors directly.

The football creditor rules have been criticized in the past, including by a House of Commons select committee, but they are still in force. HMRC is bringing another case specifically challenging the football creditor rules, and the judge in *Portsmouth* declined to express a view on the validity of the rules 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 filed for administration later that month. The administrators proposed a CVA that would pay approximately 20 percent of the unsecured creditors' claims, while the football creditors would be paid in full from Premier League funds rather than the Club's estate. The CVA would last for nine months, after which the business would be transferred to a new company and the administration would be converted to a creditors' voluntary liquidation ("CVL").

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

HMRC's claim of unfair prejudice had three components:

- The CVA committed the Club to exit the CVA and administration by way of a CVL. A CVL liquidator could not pursue claims under section 127 of the Insolvency Act (namely, an investigation of any disposal of assets of a company following the presentation of a winding-up petition), which HMRC asserted would make certain payments made to football creditors recoverable by the estate.
- The CVA approved past and future payments to football creditors that would be paid with priority over other unsecured creditors.
- Football creditors had been allowed to vote even though they were to be paid in full. These votes had overwhelmed the votes of other unsecured creditors.

The Court's Decision

The court dismissed HMRC's claims of material irregularities, including the challenge to the valuation of its debt. It then addressed HMRC's allegations of unfair prejudice.

The Section 127 Issue

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

Past Payments

The court held that the CVA did not approve past payments (*i.e.*, pre-administration payments). It also found that the CVA did not confer greater priority on the claims of football creditors than other creditor claims. Although the CVA did assume that football creditors would be paid in full, the payments were to be made with Premier League money, not money from the Club. In addition, the court noted, had payments to football creditors not been made by the Premier League, the league would not have paid that money to the Club. Thus, football creditors would receive a better outcome, but not at the expense of other creditors.

The court declined to decide whether the football creditor rules were valid. Instead, it determined that HMRC (along with the other unsecured creditors) was not deprived of money to which it would have otherwise been entitled, so that there was no unfair prejudice and possibly no prejudice at all.

The Voting Issue

Addressing the third prong of HMRC's claim of unfair prejudice, the court found "this point [football creditors' being able to vote] a little more troublesome than some of the others," but ultimately concluded that it did not amount to unfair prejudice. HMRC argued that the football creditors should not be allowed to vote because they had no real interest in the CVA—they were to be paid in full from funds outside the Club's estate that were inaccessible to other creditors. The court held that the football creditors did have an interest in having the CVA approved. If the CVA were not approved, it explained, players' employment contracts would end, while the contracts would remain in effect if the CVA were approved. Under the circumstances, the court concluded that the voting rights given to the football creditors did not amount to unfair prejudice.

More to the point, the court also determined that HMRC was bound by the terms of a CVA that "can only leave [HMRC] financially better off than in a liquidation."

Comment

The court noted that HMRC has a policy of voting against all CVA proposals that do not follow a strict *pari passu* approach to the payment of claims. The court emphasized that this case had to turn on "commercial realities" rather than the validity or otherwise of the football creditor rules. It appeared to give particular weight to the fact that, without a CVA, no significant money would flow into the estate, and asset values would not be preserved. According to the court, its role was not to judge a proposal against a hypothetical deal, but to examine the propriety of the actual deal presented against a liquidation scenario.

The same reasoning appears to underpin the court's finding that there was no unfair prejudice in allowing the football creditors to vote. However, in explaining that the football creditors did have an interest in the CVA, the judge referred only to employees, not to any of the other football creditors, whose claims of an interest might be more nebulous. The court may have been swayed by a provision in the CVA proposal stating 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* [2010] EWHC 1890 (Ch)**

This case follows a line of others where administrators or companies have attempted by means of a CVA to abridge the rights of landlords under a parent-company guarantee of a tenant's lease obligations. In *Powerhouse*, for example, although the court held that the terms of a CVA

proposal were unfairly prejudicial to the landlords, in principle, a CVA could be drafted that releases a guarantor from its obligations, provided the creditor is adequately compensated. The administrators tried to propose such a CVA in *Sixty*.

Facts

Miss Sixty ("Sixty"), a clothes retailer, sought to close its unprofitable 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 a proposed CVA, Sixty (using funds provided by 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. An expert report was commissioned that estimated the surrender value of the leases at approximately £1 million.

The situation worsened, and Sixty was placed into administration. The administrators adopted the CVA proposal, although, following discussions with Parentco, the total amount 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 it. They subsequently challenged the CVA in court on grounds 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 a new meeting of creditors could be convened for the purpose of proposing modifications to the CVA that would give equal treatment

to all unsecured creditors. The court refused, and the administrators declined to take any further role in the proceedings.

In objecting to the CVA, the landlords argued that:

- A fixed amount of compensation, especially when based on estimates and assumptions as to future performance, could not adequately compensate a creditor for the loss of rights under an unlimited guarantee.
- Even if this were not the case, the amount offered was less than the true surrender value of the leases.
- The CVA would leave them in a worse position than in a liquidation because their rights under the guarantee had been taken away, whereas the guarantee would be enforceable in a liquidation.
- The CVA provided that it was Parentco's intention to ensure that Sixty made all payments, but because Parentco was not bound by the CVA (indeed, it was not a creditor), there could be no certainty that the landlords would actually be paid.

The Court's Decision

The court struck down the CVA. It held that a CVA could not abridge a creditor's rights under a guarantee without the creditor's consent. The court expressed skepticism (although it 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 in connection with leases.

The court regarded as "critical" the fact that, in a liquidation, the landlords would still have had recourse to the Parentco guarantees. These guarantees, the court explained, would have been an important part of the commercial deal struck at the time the leases were granted, and it would be "unreasonable and unfair" to effectively void them unilaterally without adequate compensation.

The court also considered the good financial health of Parentco and the relative ease of enforcing the guarantees, even in Italy. According to the court, even if it were wrong on this point, the amount actually offered to the landlords in the CVA 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 difficulty confronted by proponents of a CVA is to come up with a proposal that will win the support of the required statutory majorities but withstand challenge. The administrators in *Sixty* do not appear to have undertaken this challenge with sufficient preparation or care. The court criticized the administrators heavily for permitting Parentco to dictate the terms offered to the landlords. Moreover, the administrators' limited participation in the court hearing could not have assisted their cause. As a result, no real explanation of their actions was given to the court. The judgment might have been less critical if they had done so.

It should be possible to devise a CVA under which landlords are offered sufficient compensation, such that rights under a lease guarantee from a solvent guarantor are compromised without causing unfair prejudice. However, given the reasoning in court rulings to date, it would appear that such a compromise could be reached only if the beneficiaries of the guarantees received the full amount (or virtually the full amount) in return for an effective release of their rights. If a guarantor is solvent and the guarantee has real value, it would be difficult to justify any unilateral abridgment of rights under a guarantee 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 required payment is made.

Summary

Both rulings discussed above involve consideration of the role of third parties—the Premier League in *Portsmouth* and Parentco in *Sixty*—and an examination of the assets available to creditors. In *Portsmouth*, the court held that funds allocated to pay the football creditors were never part of the Club's estate, and HMRC was therefore not prejudiced by the payments. Indeed, the payments were instrumental in securing creditor approval of the CVA, which, the court found, generated more revenue for HMRC than a liquidation. The court did not find 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 rules are ultimately found to be contrary to public policy or otherwise unfair, future cases may be decided differently. At present, however, no insolvency officeholder (*e.g.*, an official receiver, trustee, or liquidator in relation to insolvency cases) or creditor can require payments from the Premier League (or presumably the Football League) to the estate of the insolvent club. To the extent this is the case, such funds are simply not available to the general body of creditors.

Judging from *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 that their guarantees will be enforced or that they may be called upon to make a substantial lump-sum payment. To withstand a challenge on grounds of unfair prejudice, the amount of any offered lump-sum payment should have an appropriate and reasonable basis, ideally accompanied by expert, independent advice. That said, where the guarantor is a parent

company whose support is needed for the CVA to be successful and for the insolvent business to continue operating, the process will likely entail balancing the amount that the guarantor is willing to pay (and so can be included in the proposal) against the amount the guaranteed beneficiary is willing to accept. Guarantors would be well advised to err on the generous side of any offer if they wish to avoid a challenge of unfair prejudice. Likewise, in order to avoid criticism, officeholders should endeavor to demonstrate their impartiality in dealing with a guarantor, if a CVA proposal purports to release the guarantor from its obligations.

Both of these rulings support the view expressed in a number of recent cases that treating classes of creditors differently will not automatically cause the treatment to be deemed unfairly prejudicial. The question will turn on an analysis of the assets or rights actually available to a particular class of creditors, not on a more nebulous test of what ought to be available or an attempt to force through a renegotiation of an earlier commercial deal.

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