European Perspective: The West Lothian Question in Voluntary Arrangements

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The Role of Disinterested Creditors in the Approval Process

As the question of Scottish independence resurfaces, the West Lothian question remains embedded, thorn-like, in the side of British politics and democracy 35 years after it was first posed: How is it that Scottish members of Parliament with no apparent interest in a matter applying only to England and Wales are entitled to vote on it?

An identical question arises with voluntary arrangements: Why should a creditor who is to be paid in full have the right to vote on a proposal that compromises the claims and rights of others? The increasing popularity of company voluntary arrangements ("CVAs") gives some urgency to the resolution of this question. In this article, we will look at whether CVAs can be used to differentiate between creditors and the legal issues that arise if they are used to do so. The issues discussed here apply equally to individual voluntary arrangements, but for the sake of convenience, we restrict our discussion to CVAs.

Unlike schemes of arrangement, where creditors must be divided into distinct classes to ensure sufficient protection of their divergent interests, CVAs require the support of only 75 percent in value of the total mass of creditors (and only 50 percent in value of the total mass of creditors unconnected with the debtor) to be passed (Rule 1.19 of the Insolvency Rules). Where a CVA proposes to treat a class of creditors differently from other classes, there is a clear danger that if the differentiated class holds under 25 percent of the voting rights, it will be powerless to prevent other creditors from approving the debtor's proposal.

The small number of provisions of the Insolvency Act 1986 and the associated Rules speak of creditors as a collective. Thus, the debtor's proposal and the notice of the creditors' meeting must be sent out to all creditors, and all of them must be invited to attend the meeting and vote on the proposal. There is no basis for excluding a category of creditors on the grounds that it has no interest in the proposal or that it has no economic interest in the debtor (as is the case with a "scheme of arrangement", a procedure under the Companies Act 1985 enabling a compromise or arrangement between a company and its creditors, its members or any class of them, subject to ratification by the court).

One may perhaps then have inferred that a CVA proposal must provide for all creditors to take the pain (or, if you prefer, the haircut), such that their treatment and recovery rate contemplated by the debtor's proposal must be the same. However, voluntary-arrangement practice soon established that a debtor's proposal could offer creditors a derisory return, or no return at all, and if the creditors voted for it, it was binding. It was a matter for creditor democracy to establish whether the creditors were prepared to accept a debtor's offer of compromise, however commercially repugnant its terms might be. It was then not too big a step for debtors to start differentiating between categories (or classes) of creditors in terms of treatment and recovery under a CVA.

The landmark case of *Re Cancol* (1996 1 BCLC 100) established that a debtor could legitimately offer a different deal under a CVA to those landlords of premises it wished to continue to occupy for its future business and those whose premises it wished to vacate. This line of reasoning has been refined and, in more recent times, has been adopted with considerable success by retail chains overburdened by long-term, onerous, solvency-busting leases. These debtors have used CVAs as a way of retaining leases at profitable sites (perhaps on varied terms) and escaping from unprofitable sites by leaving landlords to claim a dividend calculated in accordance with a specified formula from a pot of money reserved for them. JJB Sports is one of the most high-profile companies to have used a CVA to this effect—and not once, but twice. There has, however, been no challenge made to any of these CVAs. If there had been a landlord disgruntled with differential treatment compared to non-landlord creditors, what could the poor fellow have done about it?

There are only two grounds of challenge: material irregularity and unfair prejudice. Although the terms of a CVA are ostensibly protected by section 6(a) of the Insolvency Act 1986, challenging them as unfairly prejudicial has proved difficult for creditors. As held in *Re a debtor* (No 101 of 1999), the mere existence of differential treatment is not enough to support a finding that a dissentient creditor has been unfairly prejudiced. Further, even if a class of creditors would have been able to vote down a scheme of arrangement, that does not necessarily mean that a CVA proposal can, on the same facts, be successfully challenged as unfairly prejudicial.

In considering whether a CVA is unfairly prejudicial, the court will examine the dissenting creditor's position as against the other creditors (the "horizontal position"). However, it will also place substantial weight upon the return that the creditor might expect in a winding-up of the debtor (the “vertical position”). While the *Powerhouse* ruling (*Prudential Assurance v PRG Powerhouse*, 2007 EWHC 2170) confirms that a CVA will be unfair if the creditor would be in a worse position than in a winding-up, where this is not the case, the courts have been inclined to overlook an imbalance in the recoveries of creditors, swayed by the desire to let stand a CVA proposal approved by creditors.

Though utilitarianism may motivate the court to overlook an unevenness of treatment under a CVA, it is not hard to understand the court’s reluctance when a CVA is approved by the weight of votes of those creditors who have nothing to lose by the CVA and who are in the happy position of saying: “It’s not my money at risk, so why not vote yes?”

The court considered this very situation in *HMRC v Portsmouth City Football Club (in administration)* [2010] EWHC 2013 (Ch), where Her Majesty’s Revenue and Customs (“HMRC”) objected to the participation in the vote of “football creditors” who, pursuant to Premier League and Football League rules, have to be paid in full under a CVA if the Premier League or Football League is to renew the membership of a football club that is subject to an insolvency procedure. Football creditors are creditors related to the football industry (*e.g.*, other clubs, if there are transfer fees outstanding; player salaries; and various football authorities and organisations). Whether you love or hate HMRC, it deserves a medal for its determination to overturn CVAs that it sees as disadvantageous to its interests, even though its history of success has—how shall we put it?—not been crowned with glory. Not one to give up without a jolly good fight, HMRC challenged the football club’s CVA on both material irregularity and unfair-prejudice grounds.

By making an analogy between a CVA and a scheme of arrangement, HMRC initially invoked “material irregularity” as a means of challenging the football creditors’ exercise of voting rights. However, Mr Justice Mann rejected this argument, ruling that, as the provisions for voting in CVAs do not require, or indeed allow for, separate classes of creditors, there could not be any irregularity. This decision makes clear that “irregularity” refers only to a digression from the statutory provisions and not a complaint of inherent unfairness.

Minority creditors are therefore left to interpose an unfair-prejudice argument if they wish to challenge the participation of West Lothian creditors in the yes vote. This line of argument was similarly rejected in *Portsmouth*, albeit on a factual basis. The judge held that the football creditors did in fact have an interest in the CVA’s being approved. If the CVA were not approved and a liquidation followed, the court concluded, their contracts of employment would come to an end. In contrast, were the football clubs to continue operating after approval of the CVA, then the balance of the football creditors’ existing contracts would be honoured.

Notwithstanding his factual ruling vis-à-vis the football-creditor athletes, the judge did note that:

> [I]f it were the case that these creditors had no real interest in the CVA at all then there might be something in it. Why should those with no interest in the CVA at all, and who were being paid outside it, be entitled to force unwilling creditors into a CVA which is not approved by a requisite majority of that smaller class?

Interestingly, the judge did not apply this line of analysis to the non-employee football creditors, such as rival clubs owed transfer fees by the insolvent club.

Although the battle is lost, the war might yet be won by the launch of a separate campaign. HMRC has brought proceedings against the Premier League to challenge the validity of the football-creditor rule.

Although the West Lothian question has thus far arisen only in the idiosyncratic world of football insolvency, it is not inconceivable that West Lothian creditors may appear in a more typical commercial context—for example, where a creditor is able to recover in full outside a CVA (such as by way of a third-party guarantee that will not be discharged by the CVA). It is apparent that there is friction between the freedom which the Insolvency Act gives to a debtor to craft its proposal in whatever way it wishes (subject to certain safeguards) and what we might grandiosely call "the laws of

Company Voluntary Arrangements

If a UK 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 UK 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 favour 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).

natural justice”. The authors’ view is that the courts have correctly interpreted the statutory regime for voluntary arrangements. In applying English insolvency law, the courts appear to have resolved the West Lothian question in favour of the Scottish MPs. Whether that result was intended by the UK Parliament is another matter. In any case, we can see that the result, however commercially convenient, does lead to unfairness and an abuse of creditor democracy. The football-creditor rule also rankles. It is not hard to see the force of the argument that it breaches the golden rule of English insolvency law that all unsecured creditors must be treated equally. We await the outcome of HMRC’s proceedings with great interest, in the hope that it will rule on the validity of the football-creditor rule once and for all and throw light on how to resolve the West Lothian question with respect to voluntary arrangements.

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