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Level of security offered by third party guarantees following Powerhouse

Whilst the Court overturned an attempt to release parent company guarantees using a company voluntary arrangement of the debtor, it left open the possibility for future schemes to do so

Prudential Assurance Company Ltd and others; Luctor Limited and other -and- PRG Powerhouse Limited and others; Anthony Murphy and others [2007] EWHC 1002 Ch

Introduction

The property industry has welcomed a finding in the Powerhouse case that a company voluntary arrangement or CVA, which removed some of the company's landlords' rights to recover arrears from under parent company guarantees, was unfairly prejudicial.

PRG Powerhouse Limited used a CVA, which was approved by a majority of its creditors, to close 35 loss-making stores whilst paying the landlords of those premises only a fraction of its rental obligations - and requiring a release of parent company guarantees given by PRG Group Limited. The landlords issued proceedings, seeking a declaration that the CVA was ineffective to release the guarantees and/or invalid on the basis that it caused unfair prejudice.

The decision of 1 May 2007 was not a victory for landlords in general. The Court ruled that a CVA could deprive landlords of recourse to guarantees. The case is a wake up call for landlords when they receive notice of a proposed CVA. If the CVA is approved, landlords need to consider challenging it and, unless time and money is spent to prove in Court that the particular CVA is unfairly prejudicial, the landlord may lose the benefit of its guarantee. Guidance from the Court suggests that a CVA scheme could be written in a more balanced way, which still deprives landlords of parent company guarantees in relation to a tenant's obligations, yet is not invalid on the basis of unfair prejudice.

The decision that a CVA (or individual voluntary arrangement) may deprive creditors of the company (or individual) of rights not only against the debtor (past and future) but also future rights against third parties, such as guarantors, has implications for all businesses including lenders and suppliers.

Facts of the Case

Powerhouse Retail Ltd (the trading company formed by the amalgamation of the regional electricity boards) was tenant under various electrical store leases. Powerhouse Retail Ltd collapsed in 2003 but its liquidators sold the business to Pacific Retail Group, a New Zealand company (which subsequently changed its name to PRG Group Limited and recently Wall Group Limited) ("**PRG**"). The leases of the company's stores were assigned to a special purpose vehicle, PRG Powerhouse Limited ("**Powerhouse**"). When landlord's consent had been required to assign a lease, it was usually only provided because PRG offered a guarantee.

In 2005, Powerhouse made a declared loss of £19 million and, on 17 February 2006, Powerhouse used a company voluntary arrangement ("**CVA**"), approved by a majority of its creditors, to close 35 loss-making stores whilst paying the landlords of those premises (the "**Closed Premises Landlords**") only a fraction of its rental obligations - and releasing the parent company guarantees given by PRG.

A CVA is a procedure under Part I of the Insolvency Act 1986 (the "**IA 1986**") enabling a company to reach an agreement with its creditors about how its debts are to be repaid. Part VIII of the IA 1986 provides an equivalent procedure for individuals (an individual voluntary arrangement

("**IVA**")). The scheme may provide for full or partial repayment, depending on the amount that the company can reasonably afford. CVAs cannot affect the rights of secured or preferential creditors and can only be proposed by insolvent companies.

A CVA requires the approval of 75% of the voting creditors (by value). If approved, it binds all creditors irrespective of how they voted. The Powerhouse CVA was agreed despite several of the landlords voting against it. The companies' largest creditors were banks and trading suppliers. Generally rent arrears had not accrued for long and since the landlords' contingent claims for future rent were valued at one pound, the Closed Premises Landlords did not have the necessary 25% of the creditors' vote to block the CVA.

Under the CVA, named classes of creditors, including the Closed Premises Landlords, were to be paid a small dividend, funded by PRG, instead of the full amount they were owed. Other creditors, including the landlords of the continuing stores, were to receive payment in full.

The Closed Premises Landlords were to get a percentage - equivalent to 28 pence in every pound - of the total value of any rent arrears already owing and 8-12 months rent (depending on the length of the remaining term of their lease, where this was over 5 years). No further claims (for rent, interest or service charge) were to be permitted against Powerhouse. Powerhouse agreed, if asked by a Closed Premises Landlord, to surrender its lease or to assign the lease to any guarantor, surety or previous tenant. Controversially, the CVA also prevented claims by the Closed Premises Landlords against PRG and released the guarantees.

Judgment of 1 May 2007

The Closed Premises Landlords sought a declaration that the CVA was ineffective and/or invalid. At a preliminary hearing, Mr Justice Etherton was asked to decide:

- Whether the guarantees had been released or could not otherwise be enforced; and
- Whether the CVA unfairly prejudiced the Closed Premises Landlords, under s.6(1)(a) of the IA 1986.

The Court affirmed that third parties (such as PRG) could not enforce rights conferred by a CVA. However, the Closed Premises Landlords would have been obliged to treat the guarantees as having been released as Powerhouse could have enforced that obligation. If the Closed Premises Landlords had called on the guarantees, PRG would have had rights of subrogation to recoup its losses from Powerhouse. Due to this contingent claim of PRG, Powerhouse had a legitimate, enforceable interest in the release.

Unfair prejudice is judged on the information available at the time the CVA was approved. The Court found that the guarantees had value at the time the CVA was approved. Further, the Court could not take into account the fact that Powerhouse had remained insolvent and had since entered into an administration procedure.

Prejudice was easily established in that the Closed Premises Landlords were deprived of rights available had there been no CVA. Unfairness was more difficult to assess: the Court said there was no single and universal test. Mr Justice Etherton looked at:

- A "vertical comparison" with the position on a winding up of Powerhouse; and
- A "horizontal comparison" with the position of the other creditors.

One aspect of the "horizontal comparison" was a consideration of the position had there been a formal scheme of arrangement under s.425 of the Companies Act 1985: a compromise or arrangement between a company and its creditors or members, on which different classes of

creditors would have been required to meet and vote separately. The Court confirmed that this might be of assistance on the issue of unfair prejudice, although caution must be exercised. This supports the argument that the interests of different classes of creditors, such as the Closed Premises Landlords, should be considered when a CVA is proposed.

Mr Justice Etherton appeared to take issue with there being no general sharing of the burden of Powerhouse's financial problems. However, the Court did confirm that sometimes this may be acceptable, as it was in the case of *SEA Assets Limited -v- Perusahaan Perseroan (Persero) PT Perusahaan Penerbangen Garuda Indonesia* [2001] EWCA Civ 1696, in which it was necessary to pay suppliers in full for the company to continue to trade.

One consideration seems to have been legitimate expectation. The Closed Premises Landlords were the unsecured creditors that would suffer least, if at all, on an insolvent liquidation of Powerhouse because they could call on parent company guarantees, yet they were the ones most prejudiced by the CVA.

It was accepted by both sides that the guarantees had value (despite the guarantor being outside the jurisdiction) but no value was provided for their release. They were not factored into the calculation of the dividend payable to the Closed Premises Landlords.

Mr Justice Etherton was, "in no doubt that the CVA in the present case is unfairly prejudicial" and, therefore, the CVA was invalid.

Comment

Whilst this decision has been welcomed by the property industry, it is not a victory for landlords in general. The case is a wake up call for landlords when they receive notice of a proposed CVA or IVA. All creditors should note that the decision confirms that a CVA (or IVA) may rewrite the commercial contract between debtor and creditor, even to the extent of advantaging the debtor in future dealings. Further, a CVA (or IVA) may deprive the creditor of recourse against third parties, including guarantees, indemnities, and warranties, even in respect of future claims.

The Court upheld the use of a CVA (or IVA) to deprive creditors from recourse to guarantees. The precise drafting was carefully considered by the Court and will be crucial in each case.

Whilst businesses and insolvency practitioners may now be more circumspect about proposing CVAs releasing guarantees given by solvent third parties, bullish directors and nominee supervisors can rely on the *Powerhouse* case to legitimise similar schemes in the future. Creditors with third party guarantees often do not participate but they now need to be involved in the process. If a CVA is approved, those creditors need to consider challenging it and, unless time and money is spent to prove in Court that the particular CVA (or IVA) is unfairly prejudicial, they may lose the benefit of their guarantees.

Powerhouse argued that opportunities may arise for the Closed Premises Landlords as a result of them obtaining early possession, for example to re-let the premises at a higher rent where the market had risen. Mr Justice Etherton did not rule on this point, as there was no evidence before the Court as to any such opportunities. In future, if it could be established that landlords were likely to suffer less than other creditors, a release of guarantees may not be unfair.

The guidance from the Court provided in this case means that a CVA (or IVA) scheme could be written in a more balanced way, which still deprives creditors of guarantees but is not unfairly prejudicial.

Landlords are an important constituency and the Court will ensure that they are not treated disproportionately unfairly. Just because something has been endorsed in a CVA (or IVA) and

passed by the majority of creditors it does not mean that it is unchallengeable. In that sense, the position of landlords has been clarified and the case ensures that their rights cannot be ridden roughshod over. If a CVA (or IVA) is unfair, landlords can take it back to Court and have it set aside.

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