Powerhouse – CVA found to be unfairly prejudicial to the interests of landlords

Introduction

The High Court[1] yesterday handed down judgment in the trial of two preliminary issues in the (well publicised) applications by two groups of landlords challenging the validity of a company voluntary arrangement proposed by their tenant, the electrical retailer PRG Powerhouse Limited (**"Powerhouse"**) (the **"CVA"**). The preliminary issues were argued on the basis of an agreed statement of facts.

The first preliminary issue considered was whether the CVA was, on its terms, effective to release Powerhouse's solvent parent company, the New Zealand registered PRG Group Limited (**"PRG"**), from liability under guarantees given by PRG to the landlords.

The landlords also sought to challenge the CVA (which had been approved by a meeting of the Company's creditors) on the grounds that it was unfairly prejudicial to them as creditors. This constituted the second preliminary issue.

The decision and its importance

The Court held that, on a true construction of the terms of the CVA and of the guarantees given by PRG, the landlords were obliged to Powerhouse to treat the guarantees as having been released and that (subject to the second preliminary issue) there was nothing to stop Powerhouse from enforcing that obligation.

However, the Court went on to find that the CVA unfairly prejudiced the interests of the landlords as creditors.

This judgment is clearly of general importance in the commercial property market. However, it is also of relevance in the context of guarantees more generally and, so far as concerns costs, to (nominees and) supervisors of (proposed) voluntary arrangements which are the subject of creditor challenge.

1 Prudential Assurance Company Ltd and Others and Luctor Limited and Others (Applicants) and PRG Powerhouse Limited and Others and Anthony Murphy and Others (Respondents) [2007] EWHC 1002 Ch (Etherton J).

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Background to the CVA

Powerhouse encountered financial difficulties and its directors informed creditors that they needed to close certain underperforming stores (retaining others which it was hoped would trade profitably) (the **"Closed Stores"**). The directors proposed the CVA pursuant to which, in summary:

- the landlords of the Closed Stores (two groups of which were applicants in this case) would lose the benefit of any guarantees or indemnities given by PRG in their favour (the **"Guarantees"**) and would have their rights to future rent under the leases of the Closed Stores compromised by receipt of a dividend of approximately 28p in the pound. This dividend was calculated on the basis of a valuation which took account of the outstanding length of the leases but not of the existence of the Guarantees;
- in consideration for this release of the Guarantees PRG would provide certain funding to creditors through the mechanism of the CVA; and
- the rights and obligations of all other creditors would be unaffected by the CVA (that is, it was proposed that they would be paid in full).

The CVA was approved at a meeting of the Powerhouse's creditors on 17 February 2006.

However, administrators were appointed in respect of Powerhouse on 1 August 2006 and it ceased trading[2]. The CVA was not terminated as a consequence.

The first preliminary issue

The Court considered the proper meaning and legal effect of those clauses in the CVA which related to the Guarantees[3].

The Court concluded that a clause purporting to have a direct and binding effect on the substantive rights and obligations of the landlords and PRG (respectively) under the Guarantees was not enforceable. This was because it fell outside the definition of *"an arrangement of [the Company's] affairs"* within s1(1) Insolvency Act 1986 and hence could not form part of a CVA. The offending clause provided that payment of the dividend to a landlord would immediately and automatically operate to release all liability of PRG under the Guarantees.

However, the Court went on to conclude that a clause providing that the Guarantees *"shall ... be treated as having been released"* was enforceable by Powerhouse (as opposed to directly enforceable by PRG) as an obligation of the landlords not to claim against PRG under the Guarantees. Further, such an obligation carried with it the *"necessary and obvious implication"* that the landlords would not sue PRG on the Guarantees.

2 The Court was informed that the Administrators agreed to be bound by its decisions on the preliminary issues.

3 The relevant clauses are not set out in this summary but should be considered in detail (see paragraph 40 of the Judgment in this regard).

The second preliminary issue

The Court considered whether the CVA was unfairly prejudicial to the interests of the landlords as creditors of Powerhouse4. The Court noted that there is no single and universal test for judging unfairness in this context, it being necessary to consider all the circumstances including the alternatives available and the practical consequences of a decision to confirm or reject the CVA.

The Court's starting point was to compare the landlords' position in the CVA with that on a winding up (a "vertical comparison"). It noted that this comparison will always be *"highly material"* but not always conclusive as to unfair prejudice.

The Court also compared the landlords' position as against the position of other creditors or classes of creditors (a "horizontal comparison"). However, the fact that a CVA involves differential treatment of creditors is a relevant factor but will not necessarily be sufficient to establish unfair prejudice (indeed, depending on the circumstances, differential treatment may be necessary to ensure fairness or to secure the continuation of the company's business).

The Court stated that comparison with the position in a scheme of arrangement[5] (in which creditors would have been separated into different classes) may be, depending on the circumstances, of assistance on the issue of unfair prejudice in a CVA. The Court cited case law which drew attention to the similarity of the underlying test of fairness for both CVAs and schemes of arrangement and noted that the Cork Committee[6] did not envisage that a CVA would be imposed in circumstances in which a scheme of arrangement could have been successfully challenged on the ground of unfair prejudice.

However, the Court cautioned that the fact that a particular class of creditors could and might have blocked the scheme of arrangement, while relevant and potentially important to the issue of unfair prejudice in the context of a CVA, does not necessarily mean that creditors have been unfairly prejudiced.

In relation to the second preliminary issue the Court concluded that it was in no doubt that the CVA was unfairly prejudicial to the landlords.

The Court found that the Guarantees had a real value to the landlords (PRG being in a position to discharge its obligations thereunder) and also could have been used by the landlords as a potential lever in any commercial negotiations with PRG. A comparison of the treatment of the landlords as against that of other creditors (who were being paid in full) supported the conclusion that the former were unfairly prejudiced. On a winding-up the landlords constituted the class of creditors which would have suffered the least (as they would have been able to rely upon the Guarantees) but they were the class most prejudiced by the CVA (with the Guarantees being unenforceable and the dividend of 28p in the pound placing no value upon them).

4 s6 Insolvency Act 1986.

5 Pursuant to s425 Companies Act 1985.

6 The report by the Cork Committee on Insolvency Law and Practice presented to Parliament in June 1982.

There was no evidence before the Court that the landlords would have benefited from obtaining early possession of the Closed Premises, such as the possibility of re-letting at higher rents.

The Court compared the result of the CVA to that which would have been achieved under a scheme of arrangement. It was common ground that the landlords would have formed a separate class and voting as such would have vetoed any scheme. The only reason that they were unable to veto the CVA was that all creditors formed a single class such that the votes of the other creditors (who would be paid in full) swamped those of the landlords. The Court referred to the Cork Committee and commented that such a result was *"wholly outside the contemplation and intention of the Committee"*.

Costs

The Court awarded the applicant landlords 75% of their costs of the trial of the preliminary issues (to be taxed if not agreed). This award was made against both PRG and the supervisors of the CVA. In making its award against the latter, the Court took into account that they were respondents to the application and had made "common cause" (and shared legal representation) with PRG. A payment on account was ordered.

Appeal

Permission to appeal was not given by the High Court.

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