



# High Court rules on company voluntary arrangement challenges

MISS SIXTY AND PORTSMOUTH CITY FOOTBALL CLUB

The High Court has in the past month ruled on two challenges to company voluntary arrangements (CVAs) on the grounds of unfair prejudice and material irregularity, reaching a different conclusion in each case. This briefing examines the facts and findings of each case and their possible impact on future CVA structures.

## The Miss Sixty judgment<sup>1</sup>

### Facts

Sixty UK Ltd (Sixty), a fashion retailer, was placed into administration in September 2008. Its administrators proposed a company voluntary arrangement (CVA), which was approved at a creditors' meeting in April 2009. Sixty's liabilities as the tenant of two retail units were guaranteed by its Italian parent company, Sixty SpA. The effect of the CVA was to release Sixty SpA from all liability under these guarantees on payment of a certain sum to the applicant landlords of the units. Under the terms of the CVA all Sixty creditors, with the exception of the landlords of the Sixty stores that were intended to close, would continue to be paid in full. It was also anticipated, but not a term of the CVA itself, that payments to Sixty's associated companies would be deferred.

### Judgment

The applicants challenged the CVA on the grounds of both unfair prejudice and material irregularity. In his judgment, Mr Justice Henderson did not consider the arguments made in relation to material irregularity because it was clear to him from the arguments as to unfair prejudice that 'the CVA is fatally flawed'.

The Sixty administrators did not participate in the hearing; however, the applicant landlords presented

compelling evidence to substantiate the unfairness of the CVA. Mr Justice Henderson applied the principles originally set out in the Powerhouse case:<sup>2</sup>

- any CVA that leaves a creditor in a less advantageous position will be prejudicial to that creditor – the real issue is whether the prejudice is 'unfair';
- the question of unfairness must depend on all the circumstances of the case, including the alternatives available and the practical consequences of a decision to confirm or reject the CVA; and
- there are a number of techniques that may be used to assess the question of unfairness, including the so-called 'vertical' and 'horizontal' comparisons. The vertical comparison compares the position of the creditor in a hypothetical liquidation with what its position would be under the proposed CVA. The importance of the comparison with the liquidation template is that it generally identifies the irreducible minimum below which the return in the CVA cannot go. The horizontal comparison compares the position of the challenging creditor against the position of other creditors. Creditors can be treated differently, but if they are this requires careful scrutiny to ensure that the imbalance in treatment is proportionate and justified.

By applying the principles above, Mr Justice Henderson found that the CVA was unfairly prejudicial to the applicants, in light of the following:

<sup>1</sup> *Mourant & Co Trustees Limited and Mourant Property Trustees Limited v Sixty UK Limited (in administration), Peter Hollis, Nicholas O'Reilly (in their capacity as joint administrators and supervisors of Sixty UK Ltd)* [2010] EWHC 1890 (Ch).

<sup>2</sup> *Prudential Assurance Co Ltd and others v PRG Powerhouse Limited and others* [2007] EWHC 1002 (Ch).

- the applicants would be better off in a hypothetical liquidation of Sixty, as they would have recourse under their guarantee claim. The judge noted that no suggestion had been made that Sixty SpA would have been unable to meet its liabilities as guarantor (vertical comparison);
- there was no sufficient justification as to why the landlords of the closed Sixty stores (which included the applicants) should be the only ones to be affected by the CVA and not any other Sixty creditor (horizontal comparison); and
- the sum proposed to be paid to the applicants in lieu of the ‘guarantee-stripping’ was found inadequate, as it was far lower than the value that the professional report commissioned by the Sixty administrators attributed to that asset.

### Commentary

The CVA challenged in this case sought to rely on the Powerhouse decision, where it was established that a CVA could in principle have the effect of depriving a creditor landlord of a third-party guarantee of the tenant debtor’s liabilities. As was the case in Powerhouse, the court re-affirmed the possibility of ‘guarantee-stripping’; however, it proceeded to find on the facts that the CVA was unfairly prejudicial to the affected landlords. The evidence in this case was compelling in favour of the applicants. It is worth noting that there has not to date been a reported case where the court has had to consider how a CVA may fairly effect such a ‘guarantee-stripping’. It appears that it will be difficult to do this where the solvency of the guarantor is not in issue, even where the compensation being offered is based on fair assumptions (which was not the case here).

Unlike in a scheme of arrangement, all unsecured creditors vote together and form one ‘class’. Therefore, the votes of creditors who will be paid in full and who are not affected by the CVA are still counted for the purposes of obtaining the necessary voting majorities. There are inherent vulnerabilities in a CVA, which is structured in a way that intends to deprive a small group of creditors of their contractual rights (like a guarantee in their favour) and relies on the non-affected creditors’ vote to be approved. Where this is the case, Mr Justice Henderson urged administrators to take the ‘greatest care’ to ensure fairness to the affected creditors when proposing such a CVA.

Mr Justice Henderson proceeded to make some disparaging comments about the conduct of the Sixty administrators because, from the evidence adduced, it appeared that they had sided with the Sixty group of companies and did not act in accordance with their duties towards creditors. This meant that the applicant landlords were required to protect their position by embarking on lengthy and expensive proceedings to set the CVA aside. Sceptics of the self-regulatory regime governing the actions of officeholders will no doubt use Mr Justice Henderson’s comments in the continuing debate about the appropriateness of the existing regulatory framework.

### The Portsmouth City Football Club judgment<sup>3</sup>

#### Facts

Portsmouth City Football Club (PCFC) was placed into administration in February 2010. The case was set against the backdrop of the special regime that governs football clubs operating under the rules of the Premier League and Football League (together, the League).

If a club goes into administration and during the administration period, the League has discretion to pay ‘football creditors’ (which include footballers and other clubs) directly, from monies that would otherwise be payable by it to the club (creating a de facto preferential type of debts). The rules also dictate that the club must exit administration via a CVA. If a club company goes into liquidation, its right to play and player registrations are cancelled – leading to material value erosion.

PCFC’s creditors approved the proposed CVA in June 2010. Its terms included a proposal that the CVA, lasting several months, would be followed by a creditors’ voluntary liquidation (CVL). The football creditors would be paid in full by the League by a direct deduction from PCFC’s entitled payments.

HM Revenue and Customs (HMRC), one of the non-football creditors of PCFC, challenged the CVA on the grounds of unfair prejudice and material irregularity, on several bases. These included unfairness due to the proposed exit via a CVL and the payment in full of the

<sup>3</sup> *HMRC v Portsmouth City Football Club Limited (in administration) and others* [2010] EWHC 2013 (Ch).

football creditors, as well as material irregularity due to the fact that football creditors were allowed to vote despite receiving payment in full and because certain information relating to potential recoveries was not disclosed in the CVA proposal.

### Judgment

Mr Justice Mann dismissed HMRC's application. It is important to note that particular emphasis was attributed to the commercial realities against which the CVA had been proposed. These factors included:

- the existence of the League rules and their expected impact on PCFC's future if the CVA did not go ahead. By applying the vertical comparison test, a possible liquidation would probably put HMRC in a worse position than the CVA, due to the value erosion effect caused by applying the League rules (HMRC has begun separate proceedings against the League challenging the validity of the rules);
- the sole potential purchaser of PCFC had indicated that it would withdraw its offer if the matter was not resolved in favour of the CVA. There was no reason to suppose that another purchaser could realistically be found and, as a result, a rejection of the CVA would effectively jeopardise PCFC's survival and its status in the Championship; and
- the omission of certain information from the CVA would have been unlikely to have made a difference to the attitude and voting intentions of the creditors.

Mr Justice Mann reached the same conclusions as Mr Justice Henderson in the Miss Sixty case that it was not unfair prejudice if the 75 per cent majority in favour of the CVA was reached as a result of votes by creditors who were being paid in full if the CVA was successful. Mr Justice Mann did note that he 'found this point a little more troublesome' but he concluded that the football creditors had a real interest in the outcome of the CVA and, as such, including their votes did not amount to unfair prejudice.

### Commentary

In this case, the court focused on the element of the principles set out in the Powerhouse case that requires an examination of the available alternatives and the practical consequences of a decision to confirm or reject a CVA as the main criterion that determined the issue of unfairness. By adopting a pragmatic approach and in

the context of the strict confines of the League rules, the court allowed the CVA to go ahead, thereby giving PCFC a palpable survival plan. The court was in this case satisfied that there were sufficient grounds of proportionality and commercial necessity that dictated the terms of the proposed CVA.

### What do these cases mean for future CVAs?

Any CVA challenge on the grounds of unfairness will always by definition be highly fact-specific.

With particular regard to a CVA that aims to deprive creditors of contractual rights they have against third parties, the Miss Sixty judgment has made it clear that any company proposing such a CVA will have a high hurdle to clear, particularly where the third party is solvent, to ensure that the arrangement is proportionate and sufficiently justified by the commercial circumstances of the case. Further, this judgment will probably help re-ignite a debate about administrators' misconduct and the adequacy of the existing regulatory framework when it comes to dealing with and preventing such behaviour.

The PCFC judgment is a reminder that the English judiciary remains commercially focused and pragmatic. However, it should be borne in mind that this case involved a debtor subject to special rules on an insolvency and that the outcome might have been different had the issue of validity of these rules been resolved before its determination.

For further information please contact

Catherine Balmond  
T +44 20 7716 4177  
E [catherine.balmond@freshfields.com](mailto:catherine.balmond@freshfields.com)

Olga Galazoula  
T +44 20 7716 4876  
E [olga.galazoula@freshfields.com](mailto:olga.galazoula@freshfields.com)

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