VOLUNTARY ARRANGEMENTS; ASSETS AND LIABILITIES

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INTRODUCTION

1. A number of recent cases have highlighted how assets and liabilities should be treated in voluntary arrangements, demonstrating that what may or may not have been adopted as common practice is not necessarily the correct approach. Accordingly, we highlight these issues below, with a focus more on IVAs than CVAs, although the principles tend to be equally applicable across each. We say tend, but it is usually the case that the IVA issues depend upon the precise terms of the appended Standard Conditions (whether R3 or Protocol) whereas CVAs tend to be more bespoke, tailored to the particular needs of the business concerned.

2. The other point to note is that the cases and issues tend to focus on the front-end issues, determining the value of the claims for voting purposes to determine whether the VA has the necessary statutory majority (or, if connected creditors are involved, statutory majorities). Equally as important is the later stage; it is not necessarily the case that the amount for which a particular creditor is entitled to vote at the creditors' meeting is the same amount at which the proof will be admitted for dividend purposes.

LEASES

Ongoing leases; VA terms generally

3. On the whole, leasehold properties tend to be more of an issue as regards the liabilities encompassed within the lease. But, as an asset, if it is sought to retain the lease for the purposes of continuing to trade, there are two important issues to consider.

4. First, the fact of the approval of the voluntary arrangement, being a compromise or arrangement with creditors, is very likely to be an appropriate event for forfeiture purposes. If the lease is sought to be retained for trading purpose, then landlord support is absolutely crucial.

5. Secondly, the way in which this support is achieved is usually by offering money. If a leasehold interest is to be kept for any period of time, either pending sale or for the purpose of the debtor's business, the proposal must set out how the rent and other outgoings are to be paid. In *Thomas v Ken Thomas Limited* [2006] EWCA Civ 1504; [2007] BPIR 959, at para 34, Neuberger LJ (as he then was) stated that rent falling due after the approval of a voluntary arrangement should by no means necessarily be expected to be caught by the terms of the arrangement, even if capable of being caught. His Lordship further stated that in normal situations, it would seem wrong in principle for a tenant to be able to trade under a voluntary arrangement for the benefit of its past creditors at the present and future expense of the landlord. If the tenant were to continue occupying the landlord's property for the purposes of trading under the voluntary arrangement, it should normally expect to pay the full rent to which the landlord was contractually entitled. His Lordship considered that a voluntary arrangement

should so provide and, if it did not, in the absence of special circumstances, the landlord might well be entitled to object to the proposal as unreasonable.

6. To prevent forfeiture, it will also be necessary to make provision for the payment of any arrears of rent or other sums due to the landlord. However, if arrears of rent are included as debts bound by the approved arrangement, then those claims of the landlord will have been compromised and any right to forfeiture in reliance upon them lost; see *Ken Thomas*. A voluntary arrangement deals only with obligations, not remedies, and there is no basis for thinking that, if one right is lost in relation to a particular payment as a result of a voluntary arrangement, then another can remain. If a landlord on the terms of the voluntary arrangement is bound to accept payments in accordance with that voluntary arrangement in substitution for rent, then his right to recover the rent has been replaced by the rights under the voluntary arrangement. Thus, a right to forfeit for non-payment of rent accruing before the approval of the arrangement is lost, because after the approval of the arrangement, no rent is owing.

Landlord's voting rights

7. When the VA is proposed by the tenant debtor, the landlord usually responds with a claim that covers three bases:

   7.1. arrears of rent;

   7.2. future rent due under the terms of the lease; and

   7.3. dilapidations, whether current or due at the end of the lease.

   In this respect, the nominee/chairman is faced with great difficulties in assessing the appropriate value.

8. Whatever rules of thumb or standard practice may have been adopted generally as regards assessment of such claims (in particular as regards allowing a landlord to vote for one or two year's future rent if the premises are not required for the purposes of the VA) some regard has to be had as to the real life situation. A landlord may well be seeking to vote or claim in respect of dilapidations and future rent, but if the reality of the situation is that the landlord wants to repossess the premises in order to redevelop them prior to letting to a new tenant that has been lined up, than it is difficult to see why such a landlord should be entitled to vote, or claim, save for arrears.

9. The classic situation facing a nominee/chairman is that which arose in *Re Newlands (Seaford) Educational Trust (in Administration); Chittenden and Others v Pepper and Others* [2006] EWHC 1511 (Ch); [2006] BPIR 1230. The administrators sought to propose a CVA. The landlords sent proxy forms to vote in the sum of £1.175m against the administrators' proposals and the CVA at the meetings. That sum comprised £0.875m for dilapidations and £0.3m for 2 years future rent. At the first meeting, to consider the administrators' proposals, the chairman valued the landlords' claim at £1, pursuant to r. 2.38(5) of the Insolvency Rules 1986 ("the Rules"). The proposals were approved, with debts totalling nearly £1.2m in favour and debts worth under £10,000 voting against. At the second meeting, to consider the CVA, the chairman valued the landlords' claim at £1, pursuant to r.1.17(3) of the Rules. The proposals were approved, with debts totalling nearly £1.35m in favour and debts worth under £6,500 voting against. The landlords had voted against the proposals and the CVA. The landlords appealed: (i) under r.2.39(4) of the Rules in respect of the amount for which they were permitted to vote at the meeting to consider the administrators' proposals; and (ii) under s.6(1)(b) Insolvency Act 1986 ("the Act") and r.1.17A(3) of the Rules in respect of the amount for which they were permitted to vote at the meeting to consider the CVA. The issues for determination were: (1) whether, for the purposes of voting at the initial proposals meeting, the chairman's decision under r.2.38(5) of the Rules to value the landlord's claims at £1 was open to him and if not what, if any, order to make under r.2.39(4) of the Rules; (2) whether, for the purposes of voting at the creditors' meeting to consider the CVA, the failure of the chairman to value the landlords' claims under r.1.17(3) of the Rules at any sum greater than £1 was open to him and if not; (3)

whether such failure constituted a material irregularity; and if so (4) what, if any, order to make under r.1.17A of the Rules.

10. The Chancellor dismissed the appeals:

10.1. It was not necessary to reach a conclusion on issue (1). On the values of the debts voted, the resolution in favour of the administrators' proposals would have been passed even if the landlords had been permitted to vote to the full value of their debt.

10.2. Both elements of the landlords' claim were unliquidated and unascertained. The claim for future rent was by definition both unliquidated and unascertained. The claim for the dilapidations was both unliquidated and unascertained on either of the two bases on which it might be claimed. Under the leases it would depend on the cost to the landlords of carrying out the repairs required by the leases. A claim for damages for breach of covenant was necessarily unliquidated and unascertained until quantified by judgment.

10.3. The claim of the landlords came within r.1.17(3) of the Rules and not r.1.17A(4).

10.4. The phrase 'unless the chairman agrees' in r.1.17(3) of the Rules should be interpreted in a similar manner to its predecessor, as considered in *Doorbar v Alltime Securities Ltd (No 2); Re A Debtor (No 162 of 1993)* [1996] BPIR 128. Thus the initial question for the chairman was whether he was prepared to put a value on the claim higher than £1, without speculation or investigation. He was obliged to examine such evidence as the creditor put forward and any relevant evidence provided by any other creditor or the debtor. If the totality of that evidence led him to the conclusion that he could safely attribute to the claim a minimum value higher than £1 then he should do so.

10.5. The future rent element of the claim depended on whether the lease was forfeit in the future and remained unlet for a period of 2 years. There was no basis on which either contingency could be given any value. In the case of the dilapidations the schedule prepared in April 2004 did not quantify individual items, so it was not possible to point to items which did not appear to be in dispute and conclude that at least £x should be treated as admitted. But even if it were it would not be relevant to either of the bases on which the landlords' claim could be put. It would be neither a measure of the cost of repairs actually incurred by the landlords for a claim under the leases nor would it indicate the amount if any by which the value of the landlords' reversion was diminished by the want of repair for the purposes of s.18 of the Landlord and Tenant Act 1927.

10.6. The minimum value of the landlords' claim might well have been greater than the sum of £1 attributed to it by r.1.17(3) of the Rules, but there was no basis on which the chairman could have put any higher value on it. There was simply no evidence on which he could conclude with any degree of confidence that the value of the claim was at least £x, let alone the sum of £443,000 which was the minimum required to give rise to any material irregularity. The chairman had no option but refuse to put any higher value on the landlords' claim.

Landlord as creditor

11. It is now clear that, so far as the right to forfeit by way of re-entry or proceedings is concerned, the landlord is not a secured creditor; see *Razzaq v Pala* [1997] BPIR 726 and *Ken Thomas*.

12. There has never been any doubt that a landlord can be bound in respect of arrears of rent due at the date of the creditors' meeting. What has, in the past, proved to be more difficult is the question of whether or not a landlord can be bound in respect of future rent. In *Ken Thomas* it was established beyond doubt that a landlord could be bound in respect of future rent. Albeit that such a position would likely be unfairly prejudicial to the landlord were the premises to be retained for the purposes of the VA. But a degree of uncertainty exists as to the position where, with the landlord's agreement, the tenant remains in occupation of the leasehold premises, pays rent for a period of time after the approval of the arrangement and then defaults on the rent. It is suggested that in such circumstances, the landlord will not be bound in respect of

such rent arrears and that any provision in the proposal to the contrary is likely to be susceptible to a challenge.

13. r. 11.13 of the Rules will apply. If the landlord seeks to prove in the voluntary arrangement for future rent, then the mathematical computation of the claim must bear in mind the provisions of r.11.13 (debt payable at future time) which should specifically be incorporated into the proposal as a specific term of the arrangement, so as to avoid any argument as to whether or not this rule does apply to a voluntary arrangement.

14. It is not uncommon for the landlord and the tenant to agree the future obligations of the tenant during the course of a voluntary arrangement. In *In the Matter of Cotswold Company Ltd* [2009] EWHC 1151 (Ch); [2009] BCLC 371 the tenant vacated the commercial premises some years before the expiry of the term, proposed a CVA and ceased trading. The CVA was approved. In order to attempt to mitigate its loss, by a deed of severance the landlord took a surrender of the lease, excusing the tenant from its obligations under the lease, with a view to the premises being re-let. The landlord submitted a claim in the CVA for pre and post-surrender rent, arguing that on the terms of the deed of severance it was entitled to do so. The tenant argued that the effect of the deed of severance was to extinguish all prior obligations under the lease as at the time of the surrender there had been no reservation of rights regarding the outstanding debt for future rent and future obligations. It was held that, on the terms of the deed of severance, the landlord's rights to claim for future rents had been adequately preserved, especially as its purpose was to enable the landlord to mitigate its loss and there was no commercial reason for the landlord to have given up its future claims completely. The supervisor was directed to allow the landlord's claim.

15. In *Peoples Phone Ltd v Nicolaou* [2011] EWHC 1129 (Ch); [2011] BPIR 1477 the debtor and his son were tenants of restaurant premises. The debtor's IVA was approved in October 2008. Subsequently, by a deed of surrender effected on 9 November 2009, among other things all the tenants' interests under the lease were surrendered, and the landlord and tenants each released each other from all obligations under the lease, whether past, present or future. In February 2010, the landlord submitted a proof of debt to the supervisor, based on arrears of rent up to 9 November 2009. The supervisor rejected the proof, on the basis that the deed of surrender had released all claims against the debtor. The landlord claimed that such release of the arrears of rent as against the debtor had been a mistake and, shortly before the hearing of its appeal against the supervisor's decision, issued rectification proceedings in respect of the deed. The district judge rejected the landlord's application for an adjournment pending the determination of the rectification proceedings and dismissed the landlord's application. His Honour Judge Behrens, sitting as a High Court judge, allowed the landlord's appeal. The rectification proceedings were not bound to fail and, if successful, the landlord would be regarded as a creditor in the IVA entitled to participate in any dividend. The balance between the supervisor's wish to conclude the IVA and the fair determination of the landlord's claim came down heavily in favour of awaiting the outcome of the rectification proceedings.

LITIGATION

Introduction

16. This has to be considered in two contexts:

    16.1. litigation, existing or contemplated, by the debtor, which would be regarded as an arrangement asset; or

    16.2. existing litigation against the debtor, which would be regarded as an arrangement liability.

Litigation as an asset

17. It is not uncommon for a debtor, rightly or wrongly, to say that all his troubles have been caused by the defendant to litigation that he has commenced (or wants to commence) and if only those proceedings can be seen through to their conclusion, all the debts should be paid off.

18. In this respect, there are two issues:

    18.1. who should conduct that litigation; and

    18.2. how should that litigation be funded.

19. Usually, the VA will provide that particular assets are to be held by the debtor on trust for the purposes of the VA, and that the supervisor will hold the assets for the purposes of the VA. That is all well and good as regards asset that will not cost too much to realise, but where there is an open-ended potential cost, such as in the case of litigation, it is important to bear in mid who is entitled to control the litigation, and who is to pay for it.

20. For example, in *Welburn v Dibb Lupton Broomhead* [2002] EWCA Civ 1601; [2003] BPIR 768 the issue was whether a cause of action vested in the debtor as at the approval of the IVA was an arrangement asset. The debtor sought damages against a firm of solicitors, claiming damages for breach of contract or negligence in its conduct of the claim. A preliminary issue arose as to who held the claim after the approval of the IVA, and on what terms. It was held that the claim against the solicitors formed part of the assets included in the IVA and those assets were impressed with a trust. Although the debtor retained nominal legal title to the claim, the benefit of the claim was held on trust by the supervisor for the participating IVA creditors. It was, therefore, for the supervisor to give instructions to the solicitors and no such instructions appeared to have been given.

21. Accordingly, as regards the conduct of the claim, it is important to identify precisely who has control of the proceedings.

22. As regards funding, again it is important to be precise. Whilst each case varies, depending on its own facts, the usual scenario will be that the debtor will continue to fund the proceedings him/itself, subject to an indemnity out of the proceeds of the litigation if successful.

23. In *Simpson v Bowker* [2007] EWCA Civ 772; [2008] BPIR 1114 the Court of Appeal expressed some sympathy with a director of a company subject to a CVA who had spent nearly £475,000 of his own money on litigation by the company in order to achieve a settlement of £675,000, inclusive of £252,000 costs. Out of the settlement sum the director accounted to the supervisor for about £200,000, claiming that the balance was owed to him for the costs of funding the litigation and the subsequent mediation that achieved the settlement, being the total sum of about £475,000. The supervisor applied for directions as to the extent to which the director was entitled to be reimbursed, having regard to the express terms of the CVA. Patten J determined that whilst S's entitlement was not limited to legal costs strictly in the sense of solicitors' and counsel's fees, or to meet awards of costs made against the defendant in the action, it was limited to sums expended on the claim or which were reasonably and necessarily incurred as part of the cost of funding the pursuit of the claim. So, the claim would be limited to either direct expenditure involved in the preparation and conduct of the case (e.g. payment of solicitors' fees), or the cost of funding generated by the need to raise monies necessary to meet the direct costs of the litigation (e.g. borrowing to fund litigation costs).

24. The director's appeal was dismissed, the Court of Appeal holding:

    24.1. The relevant provisions of the CVA had to be construed in a common sense and practical fashion in the light of its underlying purpose, which was to facilitate the pursuit of the claim for £800,000 by the company.

    24.2. The references in the CVA to the 'costs', 'legal costs' and 'funding' the legal action and the claim indicated that there were agreed limits to what the director was entitled to

recover under the CVA. Identifiable legal costs were clearly covered, but there was no provision in the CVA that entitled the director to recover money simply on the ground that he spent it on running the company in order to pursue the claim.

24.3. Whilst the director's stance was understandable, in that he bore the risk and funding of the successful claim but for which the creditors would have received nothing, the legal basis of his entitlement to recovery of expenditure was governed by the terms of the CVA, and not by any general principle of reward for risk and effort. The crucial question was the extent to which he was entitled under the CVA to recover non-legal costs and expenses.

24.4. As for the non-legal costs and expenses, in the absence of an agreed variation to cover particular items beyond legal costs, it was necessary to find a link between the director's costs and expenses and the funding of the claim. The judge had posed the correct question for determining what was recoverable under the terms of the CVA.

Therefore, the express provisions of the CVA did not justify the director's contentions.

Litigation as a liability

25. It is usually, though not necessarily, the case that ongoing litigation against the debtor will be compromised by the approval of the VA, the claimant's claim being replaced by the ability to prove within the VA, with the assessment made by the supervisor. However, there are circumstances where such an automatic termination of the proceedings may not be appropriate:

25.1. The claimant may be bringing proceedings in order to claim the benefit of the Third Party (Rights Against Insurers) Act 1930 (for the time being). It is only right that such proceedings should continue to judgment, so that the claimant can use the benefit of the judgement against the insurer.

25.2. The claim may be in relation to proprietary rights, rather than personal rights sounding in money. e.g. arguments as to the beneficial ownership of land, or boundary/adverse possession claims. In those circumstances, a supervisor has no power (and very rarely would ever seek the power) to determine the proprietary disputes.

25.3. Similarly, the claim may be one which is dependent upon the exercise of the Court's discretion in order for it to succeed. For example, the debtor may have been the beneficiary under a will, facing proceedings by a disgruntled relative of the deceased under the Inheritance (Provision for Family and Dependents) Act 1975. It would not be appropriate for the Supervisor to determine such claims.

25.4. The proceedings may have reached such a stage, and be of sushi a nature, that it is hardly worth compromising the claim and leaving it to the Supervisor to determine. One can imagine hotly contested debt proceedings between the claimant and the debtor, each calling the other side liars, so hotly disputed that no matter what the supervisor decided on the determination of the claimant's proof, someone would appeal. Either the claimant (because it was admitted for too low) or the debtor (because it was admitted at too high). If the proceedings had reached the stage that the trial was about to take place then, provided that the debtor was appropriately funded, the usual situation will be to let the proceedings run their course and the value of the claimant's claim be determined by the Court, not the supervisor.

26. An example of the last point is the decision in *Hall and Shivers v van der Heiden* [2010] EWHC 537 (TCC); [2010] BPIR 585, albeit an interim order case on rather extreme (although not uncommon) facts. This involved a building dispute. The claimants claimed damages for breach of contract against the defendant of £100,000. The defendant counterclaimed for £50,000. Very shortly before trial, the defendant apparently sacked his legal team and appointed an insolvency practitioner to act for him. On the last working day before the trial, the defendant issued an application for an interim order, which was granted that day. At the trial, the

claimants' sought permission to continue with the trial. Coulson J had no difficulty granting the claimant's application. The claimants had an overwhelmingly strong case to continue with the trial. The conduct of both the defendant and the insolvency practitioner had been at best cynical, and at worst, wholly unacceptable.

27. It is worthwhile noting a slight change in the R3 Standard Conditions as regards existing litigation. The Second Edition, published in November 2004, provided as follows:

> "5 Existing proceedings against Debtor
>
> 5(1) [Discontinuance of existing proceedings] Legal proceedings against the Debtor in existence at the commencement of the Arrangement in respect of Debts which are subject to the Arrangement shall, unless they are of a type contemplated by Paragraph 4(4), be discontinued by the Creditor as soon after the commencement of the Arrangement as is practicable.
>
> 5(2) [Costs of existing proceedings] Legal costs of a Creditor in proceedings other than bankruptcy referred to in Sub-paragraph (1) shall be a Debt falling within the Arrangement.
>
> 5(3) [Costs of bankruptcy proceedings] Petition costs of a Creditor who presented a bankruptcy petition against the Debtor prior to the commencement of the Arrangement shall be treated as an expense of the Arrangement to rank after the costs of the Nominee but before those of the Supervisor.
>
> 5(4) [Prior distress] Where any person has distrained on the goods or effects of the Debtor in the period of three months prior to the making of the interim order, those goods or effects, or the proceeds of their sale, shall be charged with the Preferential Debts of the Debtor to the extent that the assets of the Arrangement are insufficient for meeting those debts."

28. The Third Edition, published in January 2013, now provide as follows:

> "5 Existing proceedings against Debtor
>
> 5(1) [Discontinuance of existing proceedings] Legal proceedings against the Debtor in existence at the commencement of the Arrangement in respect of Debts which are subject to the Arrangement shall, unless they are of a type contemplated by Paragraph 4(4) or the Supervisor otherwise directs, be discontinued by the Creditor with no order as to costs as soon after the commencement of the Arrangement as is practicable.
>
> 5(2) [Costs of existing proceedings] Legal costs of a Creditor in proceedings other than bankruptcy referred to in Sub-paragraph (1) shall be a Debt falling within the Arrangement.
>
> 5(3) [Costs of bankruptcy proceedings] Petition costs of a Creditor who presented a bankruptcy petition against the Debtor prior to the commencement of the Arrangement shall be treated as an expense of the Arrangement to rank after the costs of the Nominee but before those of the Supervisor.
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> 5(4) [Prior distress] Where any person has distrained on the goods or effects of the Debtor in the period of three months prior to the making of the interim order, those goods or effects, or the proceeds of their sale, shall be charged with the Preferential Debts of the Debtor to the extent that the assets of the Arrangement are insufficient for meeting those debts."

29. These are important because *Alman v Approach Housing Ltd* [2001] BPIR 203, dealing with a company voluntary arrangement (CVA), made it clear that in the absence of an express provision in the terms of the proposal, the approval of a voluntary arrangement does not act as

a stay, preventing a party pursuing legal proceedings against the debtor. This case concerned an employment claim, where the claimant issued a writ claiming damages for wrongful dismissal and for the wrongful detention of chattels. Before the matter came to trial, the defendant company entered into a voluntary arrangement, which was approved. The claimant already had a judgment against the company in respect of another claim and voted in favour of the proposal, which was duly approved with modifications. The supervisor sought to agree the unresolved claim, but without success, whereupon the claimant sought to pursue his claim. Crucially, he recognised that if he obtained a judgment, he could not enforce it against the company. The defendant company issued an application seeking trial of a preliminary issue to the effect that the claimant was prevented by the approved arrangement from taking any further steps in the action. The master held that the arrangement did not have the effect of staying the action and Rimer J upheld that decision on appeal, holding:

29.1. there was no express provision in the terms of the arrangement to prevent the claimant taking proceedings against the company with a view to establishing his debt; and

29.2. although a creditor who could not persuade the supervisor to agree his debt could apply, in the case of a CVA, under s 7(3) of the Act (s 263(3) in the case of an IVA) this did not mean that it was necessary to imply a provision into the arrangement to the effect that a creditor was not entitled to take proceedings with a view to establishing his debt.

30. It follows, therefore, that if it is desired to ensure that a creditor cannot continue with proceedings, even to establish liability, then there must be an express provision in the arrangement providing for this. It is, of course, possible that such a provision could be challenged as unfairly prejudicing the creditor in question, but it has been held that the jurisdiction of the court under s 263(3) is, in effect, all-embracing. Indeed, where there are existing proceedings against a debtor at the time of the proposal, it is all the more important that the proposal should specifically deal with the consequences of approval on those proceedings, e.g. whether or not the proceedings should be stayed and, if continued, who should have conduct of the debtor's defence and at whose expense. This is particularly important as regards proprietary or non-money claims, especially those that might have an impact on the realisation of assets for the benefit of creditors bound by the IVA.

31. The R3 Standard Conditions specifically provide that, as a result of the approval of the IVA, existing proceedings should be discontinued (expressly with no order as to costs in the Third Edition) but that the costs of those proceedings should be a debt in the IVA. Clause 5(2) is potentially unfairly prejudicial, especially if the costs incurred by the claimant are large. The claimant in the proceedings might argue that it does not want its costs order included in the IVA, because it wants to take its chances of enforcement outside IVA (for example, because it genuinely believes that there is family money that will be used to avoid bankruptcy of the debtor). Other creditors may say that they do not want what would otherwise not be an IVA debt included, because their dividend might be diluted. It is suggested that the inclusion of an express term covering the claimant's proceedings would not necessarily prevent unfair prejudice arising.

32. Further, whilst Clause 5(2) deems that the claimant's costs should be a debt for the purposes of the IVA, it is suggested that it does not entitle the claimant creditor to vote on the approval of the Proposal. The potential costs order would not be a debt due at the time of the meeting but as a result of the approval. Alternatively, the prospective costs order is likely to be an unascertained and unliquidated within r 5.21 of the Rules, such that the chairman of the meeting would be entitled to value the debt at only £1 for voting purposes.

33. Finally, the precise meaning and effect of the new provisions is not clear. Having expressly provided that the proceedings should be discontinued with no order as to costs, the amended Standard Conditions provide that, nonetheless, those costs incurred by the creditor should be recoverable as a debt within the arrangement. It is a little bizarre that the proceedings should be expressly discontinued with no order for costs in the Court order, but the Court's power to decide the incidence of costs is taken away and imposed by the express terms of the IVA. The position is not entirely clear, and the amendment does nothing to solve the issues as to the

extent to which the creditor should be entitled to vote, as regards both the claim and the costs, at the creditors meeting.

SECURED CREDITORS

Introduction

34. This is an issue that has arisen more frequently recently in IVAs, where issues have arisen as to the manner in which a secured creditor's unsecured claim should be calculated for voting purposes, either at the original creditors' meeting or at a meeting convened to consider a variation to the IVA.

Negative equity

35. A difficult issue can arise in negative equity claims: what is the actual effect of approval on a secured creditor who, at the date of the creditors' meeting, has an actual or contingent negative equity claim? For example, debtor's property is worth £60,000 and the secured creditor is owed £70,000, then there is a negative equity, ignoring costs of sale, of £10,000. It is clear that the secured creditor is able to prove in the arrangement for that amount and receive a dividend. Indeed, the secured creditor is entitled to vote. This, of course, is dependent on the creditor giving sufficient information, so that the chairman of the meeting can agree to put upon the debt an estimated minimum value for the purposes of entitlement to vote. This assumes that the debt in question is either unliquidated or unascertained, which would not necessarily be the case in this scenario, because if it is clear that the value of the property is £60,000 and that the mortgage debt is £70,000, then the debt is not, on the face of it, either unliquidated or unascertained. The obligation on the chairman is to leave out of account the whole of the claim that is secured.

36. Supposing then, and following the same example, the arrangement proceeds for its specified duration (say, for example, three years) and during that period of time, dividends are declared and paid. The secured creditor will be entitled to receive a dividend on its unsecured claim of £10,000. This can put the chairman of the meeting in a difficult position, especially in the rare circumstance where the secured creditor seeks to vote on the basis of the value of its unsecured indebtedness. How is the chairman to determine to what extent the value of the secure creditor's vote should be left out of account? Should the valuation of the security be an open market valuation or a forced sale? What if the secured creditor seeks to vote with a reduced value of the security, in order to increase its unsecured indebtedness with a view to influencing the outcome of the creditors' meeting? How should the chairman approach the matter if an unsecured creditor is dissatisfied with the valuation placed upon the security by the secured creditor?

37. The Rules suggest that it is for the secured creditor to value its gross claim, and then identify to what extent such claim is secured. While the Rules do not provide the basis upon which security should be valued, there is an analogy to be drawn with bankruptcy, where a secured creditor has to place a value on its security if it seeks to present a bankruptcy petition against the debtor. In that scenario, the court has said that a forced sale valuation is the appropriate basis. Further, the Rules do not suggest that it is for the chairman to value the security precisely. That suggests that if the secured creditor places a deliberately low value on its security for the purposes of inflating its unsecured claim, then that is a matter for the secured creditor and it is not inappropriate for the chairman to accept that at face value for voting purposes. This is on the basis (as set out below) that, having voted its unsecured indebtedness based upon its (low) valuation of the security, the secured creditor is fixed with that valuation for dividend purposes, unless permitted otherwise in due course. It is possible for another unsecured creditor to argue that the chairman should only allow the secured creditor to vote in accordance with a more appropriate valuation of the security, especially if such change in the valuation might have an effect on the outcome of the meeting (whether approval or rejection). Such an allegation could form the basis of a challenge to the outcome of the meeting on the basis of a material irregularity or unfair prejudice under s 262 of the Act, or an appeal as to the secured creditor's entitlement to vote under r.5.22 of the Rules. The outcome of such a

challenge may well depend upon the extent to which the secured creditor might be fixed with the (low) valuation of its security.

Revaluation of security

38. The potential difficulties that arise are:

38.1. what is the position should the value of the property increase or decrease during the subsistence of the arrangement?

38.2. what is the creditor's position at the end of the arrangement?

39. The rules relating to bankruptcy in the Act and the Rules contain a number of provisions relating to secured creditors and, indeed, creditors' claims generally, but these do not apply expressly to arrangements. However, it should be noted that the provisions of the Rules as regards secured creditors and bankruptcy in rr 6.115 to 6.199 are imported by para 17(5) of the Protocol Standard Conditions by direct reference to the bankruptcy provisions of the Rules. Provisions to the same effect, though not in the same precise terms, are set out in para 39 of the R3 Standard Conditions, but without direct reference to the Rules. In particular, the following are relevant:

" '6.109 Secured creditors

(1) If a secured creditor realises his security, he may prove for the balance of his debt, after deducting the amount realised.

(2) If a secured creditor voluntarily surrenders his security for the general benefit of creditors, he may prove for his whole debt, as if it were unsecured.

6.115 Value of security

(1) A secured creditor may, with the agreement of the trustee or the permission of the court, at any time alter the value which he has, in his proof of debt, put upon his security.

(2) However, if a secured creditor –
(a) being the petitioner, has in the petition put a value on his security, or
(b) has voted in respect of the unsecured balance of his debt, he may re-value his security only with permission of the court.

6.116 Surrender for non-disclosure

(1) If a secured creditor omits to disclose his security in his proof of debt, he shall surrender his security for the general benefit of creditors, unless the court, on application by him, relieves him from the effect of this rule on the ground that the omission was inadvertent or the result of honest mistake.

(2) If the court grants that relief, it may require or allow the creditor's proof of debt to be amended, on such terms as may be just.

6.117 Redemption by trustee

(1) The trustee may at any time give notice to a creditor whose debt is secured that he proposes, at the expiration of 28 days from the date of the notice, to redeem the security at the value put upon it in the creditor's proof.

(2) The creditor then has 21 days (or such longer period as the trustee may allow) in which, if he so wishes, to exercise his right to re-value his security (with the permission of the court, where Rule 6.115(2) applies). If the creditor re-values his security, the trustee may only redeem at the new value.

(3) If the trustee redeems the security, the cost of transferring it is borne by the estate.

(4) A secured creditor may at any time, by a notice in writing, call on the trustee to elect whether he will or will not exercise his power to redeem the security at the value then placed on it; and the trustee then has 3 months in which to exercise the power or determine not to exercise it.

6.118 Test of security's value

(1) Subject as follows, the trustee, if he is dissatisfied with the value which a secured creditor puts on his security (whether in his proof or by way of re-valuation under Rule 6.117), may require any property comprised in the security to be offered for sale.

(2) The terms of sale shall be such as may be agreed, or as the court may direct; and if the sale is by auction, the trustee on behalf of the estate, and the creditor on his own behalf, may appear and bid.

(3) This Rule does not apply if the security has been re-valued and the re-valuation has been approved by the court.

6.119 Realisation of security by creditor

If a creditor who has valued his security subsequently realises it (whether or not at the instance of the trustee) –

(a) the net amount realised shall be substituted for the value previously put by the creditor on the security, and
(b) that amount shall be treated in all respects as an amended valuation made by him."

40. The proposal might be drafted so as to incorporate provisions akin to this and if that is done, and certainly if the secured creditor agrees, then these will govern any situation that might subsequently arise. While it is not unusual for the proposals to contain such provisions, it is unusual for a secured creditor to vote in favour of them. Nonetheless, it can, and does, happen. How is the supervisor to approach the revaluation? It is suggested that the outcome may well depend upon whether or not the revaluation was brought about because of an actual realisation, or whether it is because of a pure revaluation.

41. If, during the continuance of the arrangement, a secured creditor does realise its security, then the supervisor should admit the balance of the debt after deducting the amount realised and, clearly, in the unlikely event of a secured creditor surrendering its security, then that creditor will be able to prove for the whole debt, as if it were unsecured. That would be a straight application of r 6.119 of the Rules, and would apply whether or not the secured creditor has voted for or against the IVA proposal. It is difficult to see how provisions contained in proposals which prohibited a secured creditor from revaluing in the event of a realisation during the continuance of the arrangement could be anything other than unfairly prejudicial if not agreed to by the secured creditor, for that would put the secured creditor in a worse position than in the event of bankruptcy. The terms of the IVA would fail the 'vertical comparison', the comparison between the terms of the IVA and a hypothetical liquidation (or bankruptcy) propounded in *Prudential Assurance Company Ltd v PRG Powerhouse Ltd* [2007] EWHC 1002 (Ch), [2007] Bus LR 1771, [2007] BCC 500, [2007] BPIR 839 and applied in *(1) Mourant & Co Trustees Limited (2) Mourant Property Trustees Limited v (1) Sixty UK Limited (in Administration) (2) Hollis (3) O'Reilly* [2010] EWHC 1890 (Ch), [2010] BPIR 1264; If the matter came before the court, probably on an application for directions under s 263(3) or (4), then a court is likely to order the supervisor to allow a secured creditor who has valued its security to revalue as a result of the realisation.

42. The position is slightly different if the secured creditor has voted its unsecured indebtedness. In those circumstances, it would appear that r 6.115(2)(b) of the Rules would apply directly. Being a secured creditor who had voted in respect of the unsecured balance of his debt, the secured creditor could only revalue its security with permission of the court. It is not clear how the court would exercise its discretion, or what matters it might take into account. If there was a material and unexpected change in circumstances, such that the value of the security increased in value, then it would seem unfair not to allow the secured creditor to revalue. But if there was simply a change in value due to the market, the court might not be so willing. That is especially the case where the secured creditor has voted the value of its unsecured indebtedness in favour of the IVA, thereby achieving the requisite majorities for approval, but that if the security had been valued at the revised (higher) sum the requisite majority might not have been achieved. There are a number of potential solutions. The court might not allow the secured creditor to revise the value of its security upwards. Alternatively, it might permit a revaluation upwards, but allow an application to revoke the approval of the IVA on the grounds of material irregularity, if necessary, by allowing an extension of time for such purpose to the dissenting creditor.

43. It is perceived that with a possible rising market in house prices, contrasting with the position in the previous few years or so, the problem might become more real. Also, the answer as to whether or not the secured creditor would automatically be allowed to revalue without a realisation has an impact upon the position of a dissentient creditor who thinks that the secured creditor might have valued its security deliberately on the low side in order to increase the value of its unsecured indebtedness so that it could vote in favour of the IVA. If the secured creditor were automatically able to revalue, then it would seem that there would be likely to have been a material irregularity in the approval of the IVA. But, if, in the absence of a realisation, the secured creditor would be fixed with that valuation, then it might be more difficult for a dissenting creditor to argue that there was a material irregularity in the approval of the IVA.

44. Traditionally, the cases as regards the variation of a secured creditor's rights have all pointed one way: unless the secured creditor has expressly consented to a variation, or extinguishment, of its rights as a secured creditor:

    44.1. there should be flexibility as regards the approach to be adopted as regards a secured creditor's valuation of the security;

    44.2. pending such revaluation, the secured creditor's rights to rely on the extent of its secured indebtedness will be fixed by such valuation, save where permission to vary is granted; and

    44.3. in the event of a realisation, the secured creditor has a right to replace the valuation figure with the realisation figure.

    (See *Khan and another v Mortgage Express* [2000] BPIR 473, *Khan v Permayer* [2001] BPIR 95, *Whitehead v Household Mortgage Corporation plc* [2002] EWCA Civ 1657; [2003] BPIR 1482 and *Webb v (1) Macdonald QC (2) Dakers Green Brett* [2010] EWHC 93 (Ch); [2010] BPIR 503).

45. That was the effect of the decision of HHJ Behrens in Leeds County Court in *Re Linfoot; Linfoot v (1) Adamson (2) Bank of Scotland Plc (3) National Westminster Bank Plc* [2012] EW Misc 16 (CC), [2012] BPIR 1033. The case concerned a proposed variation to an existing IVA, incorporating the R3 Standard Conditions. The secured creditor, BoS, had not voted on the approval of the IVA, having expressly stated that it would rely upon its security. By the time of the creditors' meeting called to consider the proposed variation, the secured property had been repossessed, and BoS had received valuation and marketing advice as to the likely value of its security. It took that valuation into account in valuing its security for the purposes of voting at the variation meeting. The debtor challenged BoS's valuation, asserting that the true value was higher, with the effect that it should only have been admitted to vote for £1, with the consequential effect that the proposed variation would have been approved.

46. The debtor's application was dismissed, HHJ Behrens concluding as follows as regards the treatment of BoS's debt:

> "65. I agree with [Counsel for BoS] and [Counsel for the Supervisor] that Condition 39 is of central importance in determining this appeal. It is for the secured creditor to value the security. In this case BoS valued [the property] at £2,000,000 and supported the valuation with a professional valuation from Colleys. In addition the Supervisor was aware that [the property] had been marketed by Savills for some time but this had not resulted in a sale. He was also aware that the vandalism to [the property] had taken place since the marketing by Savills.
>
> 66. Under condition 39(4) the Supervisor had the right to require a professional valuation by a person agreed between himself and BoS. However, he already had a valuation by a professional valuer.
>
> 67. Apart from the offer dated 20th April 2012 there can be no criticism of the Supervisor's decision to value [the property] at £2,000,000. The crucial question is whether, as at 26th April 2012, it was Wednesbury unreasonable of the Supervisor to accept BoS's valuation in those circumstances and not to have adjourned the meeting to investigate it further. As at 26th April 2006 there were good grounds to be sceptical of the offer. It came from an unidentified source, proof of funding had not been provided even though it had been asked for in the e-mail of 24th April 2012. The offer was in an unusual sum; it was subject to contract and was for a figure more than double the current valuation of [the property]. Both BoS and the Supervisor shared these concerns.
>
> 68. The offer was not raised at the meeting before the votes were counted and although [the Debtor] was legally represented at the meeting there was no application for the meeting to be adjourned. It is not in dispute that [the Debtor] was aware of the offer as copies of it were sent by [the Debtor's solicitors] to the Supervisor on 24th April 2012. Any such adjournment would necessarily have increased the costs of the meeting.
>
> 69. It has not been suggested that the Supervisor's decision was made in bad faith. In my view it cannot possibly be said that the decision was so perverse that no supervisor properly advised could have acted in that way. Nor can it be said that the decision was so absurd that no reasonable person could have acted in that way. I would accordingly dismiss the challenge to the BoS valuation.
>
> 70. I should perhaps add that if I had had to apply the more generous test under Condition 64 I would still have come to the same conclusion. The factors outlined above would, in my view, ignoring the events that happened after the meeting, have justified the decision that was taken."

47. A similar decision was reached by District Judge Musgrave in Birmingham County Court in *National Westminster Bank plc v McNally*[1].The bank served a statutory demand for over £3m, relying upon a valuation of its security of £350,000. In the bankruptcy petition, it relied upon the same valuation. The debtor obtained an interim order, and his proposal for an IVA expressly incorporated the bankruptcy provisions as regards valuing debts. At the creditors' meeting, the bank voted its unsecured indebtedness on the basis of its valuation of £350,000. As a result, the proposal was rejected. The debtor appealed, raising a number of allegations of material irregularity in relation to a number of votes. As regards the bank, the debtor asserted that the bank had been allowed to vote for too high an amount, on the basis that the secured property was worth more. Relying on *Re Power Builders (Surrey) Ltd; Power v Petrus Estates Ltd* [2008] EWHC 2607 (Ch), [2009] 1 BCLC 250, [2009] BPIR 141, the bank sought dismissal of the application, on the basis that if it was correct as to its entitlement to vote, it still held over 25% of the unsecured indebtedness, such that it was pointless for the application to be pursued. The

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[1] The debtor's appeal against the district judge's decision was heard earlier this year by Morgan J, and judgment has been reserved.

bank was successful. It had received genuine valuation advice such that there was no reason for the chairman to look behind the bank's valuation. Interestingly, the district judge also relied upon r 6.115(2) of the Rules, which were applicable because of the direct application of the bankruptcy provisions. This provided that where a petitioner had put a valuation upon his security in his bankruptcy petition, the valuation of that security could not be altered without the permission of the court. As the bank was a petitioner, in the absence of any application to the court, the chairman could not go behind the bank's valuation. The debtor's application was dismissed, the interim order discharged and a bankruptcy order made.

48. Otherwise, at present, there is no direct authority upon whether and, if so to what extent, a voting secured creditor might be entitled to vary the value of its security in the absence of a realisation. Similarly, there is no direct authority on the extent to which a voting secured creditor might be able to revalue its security upon a realisation after the approval of the IVA, especially in circumstances where, if the secured creditor had voted in accordance with the realised value as opposed to the estimated value, the outcome of the meeting might have been different.

49. Analogous situations relating to surrender for non-disclosure and redemption by the trustee are unlikely to arise with an arrangement. Questions as to the test of a security's value may well arise and could be dealt with on an application by the supervisor under s. 262(4) of the Act.

50. It is also worth noting r 11.9 relating to declaration and payment of dividend, which again would appear to have no application to IVAs as these Rules are expressed to relate only to winding-up and bankruptcy. Briefly, the Rule provides for a situation where a creditor revalues its security where a dividend has been declared. If the revaluation results in a reduction of his unsecured claim ranking for dividend, the creditor should forthwith repay to the office-holder for the credit of the insolvent estate any amount received by him as dividend in excess of that to which he would be entitled, having regard to the revaluation of the security. If the revaluation results in an increase of his unsecured claim, the creditor is entitled to receive from the office-holder, out of any money for the time being available for the repayment of a further dividend, before any such further dividend is paid, any dividend or dividends that he has failed to receive, having regard to the revaluation of the security. However, the creditor is not entitled to disturb any dividend declared (whether or not distributed) before the date of the revaluation.

51. In principle, there would appear to be no reason why such provisions cannot be applied to an arrangement, although it is unlikely that the supervisor could force the secured creditor to repay a dividend in excess of that which he would be entitled to, having regard to the revaluation of the security, unless such a provision had been expressly written in to the proposal. This underlines the importance of nominees thinking through the position of secured creditors to ascertain whether or not the sort of considerations that have been discussed above are likely to arise. It is suggested that, on the face of it, the incorporation of these provisions would not offend s 258(4) as they do not affect the right of a secured creditor to enforce its security, but rather relate to the creditor's unsecured claim and questions of revaluation.

52. It is all well and good when the security is valid and it is known how much is secured by the security, even if the value of the property subject to the security is not known. However, the recent decision in *Singh v Singh* (ChD, Proudman J, 8 February 2013) whilst highlighting the approach to be taken by the court in considering whether the IVA proposal was serious and viable when considering whether to make an interim order also demonstrates the difficulties facing a chairman of the creditors' meeting in such a scenario.

53. The facts in *Singh* were not uncommon; after disputed litigation, the victor sought to use bankruptcy proceedings to recover the fruits of the litigation, only to be faced with an IVA proposal in an attempt to stymie the bankruptcy. Following a property dispute, the creditor obtained a judgment and costs, and served a statutory demand and bankruptcy petition in respect of the sums due thereunder. In response, the debtor proposed an IVA and applied for the usual interim order. However there were issues about the validity of various securities granted over the debtor's properties, in that:

    53.1. the largest creditor held charges over the debtor's properties, but also had some unsecured debt; and

53.2. the second largest creditor disputed the validity of the largest creditor's charges which, if they were valid, would significantly reduce his own recovery prospects.

54. At the hearing of the bankruptcy petition, the district judge determined that the creditor held more than 25% of the voting rights of the unsecured creditors, and, as he proposed to vote against the proposal, the IVA would not be approved. Further, it was held that a post-bankruptcy IVA could be considered by a trustee in bankruptcy having investigated the validity of the largest creditor's charges. The district judge made a bankruptcy order, impliedly dismissing the application for an interim order. The debtor appealed, arguing that the district judge had erroneously concluded that the creditor held more than 25% of the unsecured creditors' votes and that it was appropriate for the trustee in bankruptcy to deal with the validity of the charges. Essentially, it was argued that the district judge failed properly to have regard to the test under s 255 of the Act when considering whether to grant an interim order, namely whether the proposal was serous and viable.

55. Proudman J recognised that the position with the charges was factually and legally complex, and that there were various possible analyses which would have varying effects on the financial position of the creditors. Some outcomes would mean that the proposal would not be approved, but some that it could. Overall, the position was borderline. The district judge had failed properly to take into account all these possibilities, and thus had failed to engage in the test as to whether the Court should exercise its discretion to make an interim order, on the basis that the proposal was serous and viable. In automatically considering that the IVA was doomed to fail, meant that the district judge did not properly consider the test and the exercise of the discretion at all. Basically, it was for the creditors to determine how they wanted to have the validity of the charges investigated. If they wanted it to be done by a trustee in bankruptcy, they could vote against the proposal. But, by making the bankruptcy order, the district judge has excluded the creditors from being able to make that decision for themselves, possibly causing them prejudice. Accordingly, the appeal was allowed, an interim order granted, and the case remitted to the County Court for consideration of the nominee's report.

56. So, rather sensibly, Proudman J held that on the whole it is for the creditors, not the Court, to decide what is in the best interests of the creditors and, if at all possible, they should be permitted to decide the best route of achieving their interests. But, one would be forgiven for having a little sympathy for the chairman of the creditors' meeting, having regard to his role in determining the validity and quantum of the various creditors' votes. How should he go about valuing the largest creditor's security for the purposes of determining the extent to which, if any, it has an entitlement to vote as an unsecured creditor? Does he go through a valuation exercise, or allow it to vote but marked objected to? But how much does it vote for: a small amount, on the basis of its security, or a large amount, on the basis that it is unsecured? How does he go about valuing the extent of the second largest creditor's unsecured vote, faced with an issue as to the validity of prior securities? Could the largest creditor achieve the outcome of the meeting that it wished by artificially reducing the value of its security (thereby creating a large amount of unsecured debt for itself, inflating the value of the second largest creditor's security and minimising its unsecured debt) either to achieve a 25% blocking vote or 75% approval vote? Very tricky. It is easy to see how in those circumstances the interests of the general body of unsecured creditors might be ignored because of the effect of the manoeuvrings of secured creditors, the very sort of creditors who are not supposed to be affected by the approval of an IVA.

PAYMENT PROTECTION INSURANCE MIS-SELLING CLAIMS

57. There has been much recent debate about the status of payment protection insurance (PPI) mis-selling claims and whether or not the proceeds of such a claim should be made available to the supervisor for the benefit of the creditors. The usual scenario is that the PPI was mis-sold prior to the approval of an IVA, commonly in relation to a loan or other liability for which a creditor is proving in the IVA.

58. On 10 April 2012, the Insolvency Service issued guidance as to PPI mis-selling claims and bankruptcy,[2] providing information for individuals who might have been mis-sold payment protection insurance but have yet to make a claim. It expressed the view that if a PPI policy had been mis-sold before the date of an individual's bankruptcy, any claim relating to the alleged mis-selling of the policy was owned by the official receiver or trustee of the bankruptcy estate, not the individual to whom the policy was sold. This is on the basis, presumably, of the mis-selling claim being an existing cause of action as at the date of the bankruptcy order, which would therefore form part of the bankruptcy estate under ss 283 and 436 of the Act. Insofar as the claim is regarded as a cause of action, then that is clearly correct.

59. It is likely that, generally speaking, the same view would be taken as regards the status of such a PPI mis-selling claim were the debtor to enter into an IVA, rather than be made bankrupt. The claim would be an existing cause of action as at the approval of the IVA. It would then be necessary to construe the terms of the IVA to determine whether the claim is an asset to be made available to the creditors. Generally speaking, an IVA on R3 Standard Conditions provides that all the debtor's assets should be arrangement assets (under paragraph 26 of the R3 Standard Conditions, which provides that arrangement assets shall comprise all property, other than excluded assets, belonging to or vested in the debtor at the date of commencement of the IVA that would form part of the debtor's estate in a bankruptcy) and it is unlikely that the PPI claim will, historically, have been excluded. That being the case, it is likely that were the lender concerned also to be a creditor in the IVA, then the two claims will be set off against each other.

60. The position may be different in respect of Protocol-Compliant IVAs. While there is no general definition of what should be regarded as arrangement assets, as a general rule such IVAs are usually based on income contributions and the available equity in the matrimonial home, rather than making available the entirety of the debtor's assets save for excluded assets (whether generally or specifically defined). In those circumstances, the PPI claim will not be an IVA asset. Further, there is a good argument for saying that the PPI claim, whether pre- or post-realisation, cannot fall within the definition of 'after-acquired assets' under paragraphs 1(f) and 14 of the Protocol Standard Conditions. Paragraph 1(f) refers to an after-acquired asset as an asset acquired or received after approval of the IVA, before its completion, and which could have been an arrangement asset had it belonged to or been vested in the debtor at the start of the arrangement stating " 'after acquired assets' means any asset, windfall or inheritance with a value of more than £500, other than excluded assets that the debtor acquires or receives between the date the arrangement started and the date it ends or is completed, if the asset could have been an asset of the arrangement had it belonged to or been vested in the debtor at the start of the arrangement". If the PPI claim was vested in the debtor at the commencement of the IVA it cannot be an asset acquired or received by the debtor after the commencement of the IVA, as he already owned it at that time.

61. However, the position in respect of Protocol-Compliant IVAs is probably covered by paragraph 17(6) of the Protocol Standard Conditions. This provides that where any creditor agrees, for whatever reason, to make a repayment to the debtor during the continuance of the arrangement, then that payment shall be used solely in reduction of that creditor's claim in the first instance. It further provides that if such repayment results in the creditor's claim being entirely extinguished (after the application of set off) any surplus will be treated as an after-acquired asset and offered to the supervisor for the benefit of the arrangement.

62. Generally, it is not necessarily the case that a debtor will seek compensation by way of pursuing a cause of action against (usually) the bank who sold the PPI product. Compensation may also be sought from the Financial Ombudsman Service. The Ombudsman's decision is reached independently, but is not necessarily dependent on whether a cause of action (properly so called) has arisen. The determination is whether the consumer has been treated fairly and, if not, what redress should be ordered. Such redress can take the form of compensation if the consumer has suffered loss. There are two schools of thought in this respect. One view could be that the compensation claim is attached to a species of property

[2] Payment protection insurance (PPI) mis-selling claims and bankruptcy, accessible at http://www.bis.gov.uk/insolvency/news/news-stories/2012/Apr/PPI-mis-selling-claims-and-bankruptcy.

(the cause of action) and so should all to be dealt with in exactly the same way as that cause of action. An alternative view, based on the fact that the Ombudsman's decision is discretionary and is not necessarily dependent on there being a cause of action, renders the claim for compensation a mere hope, rather than an asset, which would remain personal to the debtor.

63. An answer to this issue was provided in *Ward v Official Receiver* [2012] BPIR 1073, a decision of District Judge Khan in Manchester County Court. The debtor had taken out PPI policies prior to making himself bankrupt on his own petition in February 2009. The lender paid the proceeds of the PPI mis-selling claim to the Official Receiver, as trustee in bankruptcy. The debtor sought an order that the proceeds be paid to him by the Official Receiver. The district judge dismissed the application, on two bases. First, the payment from the lender to the Official Receiver fell within the definition of 'property' within s 436 of the Act because it represented an interest incidental to property. The right to complain to the Ombudsman arose out of the ownership of the policy and therefore the payment received as a result of such complaint was an interest incidental to that property (see also, for example, the two recent bankruptcy cases, *Young and Others v Hamilton and Others* [2010] NICh 11, [2010] BPIR 1468 and *Young v Official Receiver* [2010] EWHC 1591 (Ch), [2010] BPIR 1477, where claims that were ancillary to the ownership of land vested in the trustee in bankruptcy along with the land). Secondly, the circumstances under which the PPI policy was sold to the debtor conferred a cause of action upon him and that cause of action could be viewed as 'property' encompassed within the estate in accordance with the meaning of s 436.

64. Therefore, it appears that the right to complain to, and obtain an order for redress from, the Ombudsman would be treated as an asset owned by the debtor as at the commencement of the arrangement, rather than an asset arising upon the exercise of the Ombudsman's discretion. On that basis, albeit dependent upon the precise terms of the IVA, it is rather more likely that the payment consequent upon a complaint to the Ombudsman will be treated as an arrangement asset from the outset, rather than an after-acquired asset.

65. The same can be said to be true of the interest accruing upon such a claim (which can be large if the claim is particularly historic). Some IVA providers have a policy of allowing the debtor to keep the interest, while the capital sum is made available for the IVA creditors, whatever the terms of the IVA. This would appear to be misguided. The claim for interest attaches to the PPI mis-selling claim itself, and so the person who is entitled to receive the benefit of the PPI mis-selling claim is entitled to the interest too. If the PPI mis-selling proceeds are an arrangement asset, then there does not seem to be any reason why the debtor should be entitled to the interest.

66. There are two perennial problems that arise in relation to the realisation of the PPI mis-selling claim: first, how the costs of recovery (commonly payable to a claims management company) should be accounted for and, secondly, how the income tax payable on the interest should be paid. The answer lies very much upon trust principles, on the basis that, since the PPI mis-selling claim is an arrangement asset vested in the debtor, he holds it on trust for the supervisor, who holds the proceeds on trust for the purposes of the IVA. As a general principle, a trustee is, subject to the terms of the trust, entitled to be indemnified out of the trust property in respect of liabilities, costs and expenses properly incurred by him in connection with the performance of his duties and the exercise of his powers and discretions as trustee. On the basis that the general principle that a trustee should not lose out personally from taking on the onerous and burdensome task of being a trustee, it seems only fair that insofar as the debtor is exposed to a liability for costs in relation to recovering the asset that he holds on trust, then that liability should be subject to an indemnity in his favour out of the trust assets (subject to reasonableness). Accordingly, in the vast majority of cases, there should never be an issue as regards whether the recovery costs should be treated as an expense of the IVA, because they are not incurred by the supervisor for the purposes of the IVA. In most cases, the supervisor, as beneficiary under the trust of the arrangement assets held by the debtor, should be entitled to receive the proceeds of the PPI mis-selling claim net of reasonable costs.

67. The same principle would apply as regards the tax payable on the interest. If a trustee should not lose out personally from taking on the onerous and burdensome task of being a trustee, it seems only fair that insofar as the debtor is exposed to a liability for tax in relation to the asset

that he holds on trust, then that liability should be subject to an indemnity in his favour out of the trust asset. Accordingly, the supervisor, as beneficiary under the trust, should be entitled to receive the proceeds of the PPI mis-selling claim net of tax. Further, in IVAs based upon the R3 Standard Conditions, paragraph 82 (tax liabilities arising on realisations) expressly provides that taxation liabilities of the debtor arising on the sale or other realisation of any asset subject to the arrangement shall, insofar as those proceeds are sufficient, be discharged out of the sale proceeds of the asset in question. Thus the terms of the IVA will provide that the income tax liability that would fall on the debtor in respect of the interest on the PPI mis-selling claim, being an arrangement asset, should be paid out of the proceeds of the claim itself.

68. Many of these issues referred to above are now dealt with in the Guidance Note on Payment Protection Insurance Mis-selling issued by R3, the RPBs and The Debt Resolution Forum on 19 April 2013. In summary, the Guidance provides as follows:

68.1. Where a PPI policy has been sold to a bankrupt prior to the date of the bankruptcy the mis-selling claim vests in the trustee in bankruptcy because the mis-selling took place prior to bankruptcy; discharge makes no difference.

68.2. It is vital that supervisors check the terms of the proposal in each and every case before instituting PPI misspelling claims or demanding the proceeds of such claims, in particular to determine whether the IVA is either:

68.2.1. An “all asset” IVA, on the basis that all the debtor’s assets are subject to the IVA terms except those specifically excluded in accordance with r.5.3(2)(a)(iii) of the Rules. An IVA governed by R3 Standard Conditions, or Protocol Standard Conditions with an “all assets clause”, are examples of such cases. Where such terms apply a mis-selling claim is an asset of the IVA estate.

68.2.2. A defined asset” IVA which as the name suggests, specifies the assets to be included within the IVA. Unless the IVA terms specify that the PPI mis-selling claims form part of the IVA estate they are not usually included as an asset. An IVA governed by Protocol Standard Conditions might be an example of such a case.

68.3. It is unlikely that the proceeds of such claims would be available as ‘after acquired assets’ in accordance with the clauses in the R3 and Protocol Standard Conditions however, as these refer to assets that are acquired during the course of the arrangement, not claims existing prior to the commencement of the IVA.

68.4. Where the proceeds of a PPI mis-selling claim are not caught by the terms of the IVA as an asset they might be captured by clauses dealing with additional income in the hands of the debtor, which would depend upon the precise terms of the IVA proposal. A debtor can utilise those funds as contributions to the IVA or in early settlement of the IVA.

68.5. Where the IVA is subject neither to R3 Standard Conditions nor Protocol Standard Conditions, or those conditions are modified, the supervisor must be guided by the terms set out in that particular proposal.

68.6. Set off depends upon:
68.6.1. the nature of both the original debt and the mis-sold PPI proceeds;
68.6.2. the identity of the parties; and
68.6.3. the terms of the IVA.

68.7. Where there have been mutual dealings prior to the commencement of the insolvency process set off will apply in a bankruptcy or an IVA where R3 Standard Conditions apply unless the supervisor is satisfied that the creditor has waived set-off). Where Protocol Standard Conditions apply clause 17(6) is open to a number of possible interpretations, so, pending clarification by the Court, legal advice will be appropriate where proportionate to do so, and any decision-making process should be fully documented.

68.8. In open cases, an office holder has a duty to realise the assets of the estate, but does not have an obligation to pursue a PPI mis-selling claim if there would be no substantial benefit to the estate after accounting for likely costs, so there is an obligation to consider whether or not any potential claims exist and the likely costs of pursing them.

68.9. If at all possible IVAs should not be kept open beyond the planned duration. Where R3 or Protocol Standard Conditions apply the supervisor's powers survive the concluding formalities of the IVA. It follows that where the debtor has provided all the information necessary to pursue a PPI mis-selling claim, the office holder is satisfied that due provision has been made for his fees and the application of the proceeds has been agreed, there is no need to delay issuing the Completion Certificate.

68.10. R3 Standard Conditions provide for the supervisor to charge fees when acting as a trustee, but there is no such provision where Protocol Standard conditions apply. Where no provision is made for fees supervisors will either need to seek a variation to the proposal prior to closure of the case, or reach some agreement with individual creditors or the Court, to charge a post-closure fee to those creditors.

68.11. In closed cases, a former supervisor in an IVA does not have a duty to seek out PPI misspelling claims in closed cases although, depending on the terms of the IVA, there may be a power to do so. The former supervisor should consider whether the terms of the IVA are such that the compensation is a trust asset which should be claimed by him/her acting as trustee for the benefit of the IVA creditors.

68.12. In new cases debtors should be asked at an early stage about possible claims in connection with PPI mis-selling and appropriate enquiries made. IVA proposals or Nominees' reports should explain how potential PPI mis-selling claims are to be dealt with.

68.13. Any statutory interest is subject to tax at the debtor's marginal rate applicable at the date of receipt of the compensation. This liability to tax is the debtor's but on the principle that the debtor should not be out of pocket, office holders should discharge out of the proceeds of realisation or indemnify the debtor against such liability, if it has not already been deducted by the payor.

68.14. In bankruptcy the trustee in bankruptcy's ability to charge fees and recover costs will depend upon a creditors' resolution, the provisions of the Act and Rules and SIP 9.

68.15. In IVAs, provision for the supervisor to charge fees and recover costs will be set out in the proposal. Any cases where the provisions are inadequate, a variation may be approved.

68.16. In IVA cases where there is no provision for fees to be drawn after the closure of the case, supervisors might reach agreement with individual creditors to charge a fee and recover costs after closure, with only those creditors agreeing suffering a deduction.

68.17. Where the basis of the remuneration has been fixed as a percentage of realisations, these fees can only be properly charged on actual receipts into the estate, net of any deductions for set-off, although it is open to creditors to agree otherwise.

68.18. It is for the office holder to determine whether or not it is appropriate to instruct a claims management company to pursue potential PPI mis-selling claims which fall within the arrangement, and any reasonable cost should be treated as an expense of the realisation. Any commission for the introduction of a debtor to a PPI mis-selling claims company this should be disclosed and treated as an asset of the estate in accordance with the Code of Ethics for Insolvency Practitioners.

68.19. If there are any limitation issues pursuant to the application of the Limitation Act 1980, it is recommended that legal advice is sought.

AFTER-ACQUIRED ASSETS

69. Finally, a short note on after-acquired assets. In bankruptcy, after-acquired assets that devolve on the bankrupt prior to discharge may be claimed by the trustee. It is therefore logical for such a provision to be made in the proposal for a voluntary arrangement. The debtor should make available, from the after-acquired assets that devolve on him during the arrangement, sufficient after-acquired assets to pay all the creditors in full with interest applicable. The proposal should specifically require the debtor to notify the supervisor of after-acquired assets and of the obligation to make them available. After-acquired assets that would be excluded in bankruptcy may properly be excluded from a voluntary arrangement. The Standard Conditions for a Protocol-compliant IVA provide that the supervisor may claim any after-acquired assets as an asset of the arrangement.

70. Some difficulties arise in relation to the application of Paragraph 17(6) of the Protocol Standard Conditions, in particular in relation to a "defined asset" IVA. This has particular application where, during the life of the IVA, it transpires that as at the commencement of the IVA the debtor had a claim against a creditor, for an example a PPI mis-selling claim or a claim to have the interest on a loan recalculated because, for one reason or another, the lender was disentitled to apply interest for a particular period during the life of the loan. Because the asset is not an arrangement asset, it can only become so if it is an after-acquired asset. But the claim is outside the definition of "after-acquired assets" and so cannot be claimed as such. On the surface, the debtor is free to keep the proceeds, subject to the application of Paragraph 17(6) of the Protocol Standard Conditions, where applicable.

71. Paragraph 17(6) of the Protocol Standard Conditions provides as follows:

> "Where any creditor agrees, for whatever reason, to make a repayment to the debtor during the continuance of the arrangement, then that payment shall be used solely in reduction of that creditor's claim in the first instance. If such repayment results in the creditor's claim being entirely extinguished (after the application of set off) any surplus will be treated as an after acquired asset and offered to the Supervisor for the benefit of the arrangement."

By Paragraph 1(f) of the Protocol Standard Conditions, "after acquired assets" means:

> "any asset, windfall or inheritance with a value of more than £500, other than excluded assets that you acquire or receive between the date the arrangement starts and the date it ends or is completed, if this asset could have been an asset of the arrangement had it belonged to or been vested in you at the start of the arrangement".

72. On its face, this has the curious effect of rendering the proceeds of a pre-IVA claim to be an after-acquired asset, even though it plainly is not an after-acquired asset within the meaning of Paragraph 1(f) of the Protocol Standard Conditions, because it was in existence at the date of the approval of the IVA. Therefore, it would appear the proceeds should be made available to the IVA creditors.

73. But, a number of issues arise:

73.1. It only applies, on its face, to cases where the debt to the creditor has been extinguished and replaced with a liability of the creditor to the debtor. Where the loan has been discharged pre-IVA, the PPI mis-selling claim or interest refund is not being made by a creditor, but is a compensation payment from a third party. In those circumstances, the debtor would seem entitled to keep the asset, it being outside the scope of the "defined asserts" that are arrangement assets.

73.2. "After-acquired assets" is expressly defined in Paragraph 1(f) of the Protocol Standard Conditions as "other than excluded assets". It is perfectly possible that, in the Proposal,

73.3. the borrower has defined the assets to be made available to his creditors as surplus income and equity in the matrimonial home, with all other assets excluded. As, by Paragraph 2 of the Protocol Standard Conditions, the express terms of the proposal as approved override the Protocol Standard Conditions, can the operation of Paragraph 17(6) can "unexclude" what was expressly an excluded asset in the approved proposal?

73.4. The position as regards refunds of less than £500 is not clear. Paragraph 1(f) of the Protocol Standard Conditions only renders assets with a value of more than £500 as an after-acquired asset. Thus, for example, it is far from clear whether an interest refund of £450 is:

73.4.1. an after-acquired asset because Paragraph 17(6) of the Protocol Standard Conditions says that it should be; or

73.4.2. is not an after-acquired asset, because it is not worth more than £500.

73.5. The provision plainly does not apply to any IVA that has terminated, because it states that the repayment (or "the [agreement] ... to make [the] repayment" has to be made "during the continuance" of the IVA.

74. These are not easy questions to answer generally, because, in the most part, they will depend upon the exact wording used in the terms of the approved proposal, as opposed to the Protocol Standard Conditions. Indeed, the likelihood is that historic proposals were prepared, modified and approved without any thought at all as to how their provisions might apply in circumstances such as this. More recently prepared proposals, prepared since the flurry of PPI mis-selling claims, are likely to be a little more sophisticated, even if they don't expressly cover interest over-charging cases.

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