

## Feature

### KEY POINTS

- ▶ Debtors who have successfully completed an IVA will often face unexpected claims from secured creditors to enforce securities which, though worth next to nothing at the commencement of the IVA, have since become valuable owing to rises in property prices.
- ▶ However, where a secured creditor has voted in favour of an IVA, he may have put his security at risk.
- ▶ Thus, he may be deemed to have made an election to abandon it until such time as the court permits him to revalue it.
- ▶ The terms of certain IVAs may be inconsistent with the continuation of the security.
- ▶ The terms may be construed as constituting an agreement between the debtor and the creditors (including the owner of the security) for the secured debt to be treated as unsecured until it is re-valued. This could interfere with the ability of the secured creditor to obtain possession of the property secured.

Author David Schmitz

# When can an IVA defeat a mortgage?

The aftermath of an IVA can produce surprises. A debtor enters into an IVA. His house is in negative equity. One of the secured creditors values his security at nil and accordingly participates in the IVA as an unsecured creditor. The IVA concludes and the house in the meantime has increased in value. The secured creditor seeks to exercise his security and relies upon the principle that an IVA cannot affect or modify his right to enforce his security, except with his concurrence – Insolvency Act 1986 ('IA 1986') s 258 (4). The debtor, however, believes that because he has fulfilled all of his obligations, the secured creditor ought not to profit from an unexpected windfall. Who wins?

Surprisingly, the answer is often unclear because the authorities have not fully explored the consequences of the creditor: (1) voting for an IVA upon the footing that his debt is unsecured or secured only to a nominal extent; (2) and voting for an IVA, which contains terms that are inconsistent with the continuation of the security

### THE INSOLVENCY RULES 1986

Rule 5.23 (formerly r 5.18) provides that where the claim or part of it is secured, the votes of the creditor will be left out of account for the purpose of determining whether or not the requisite majority of the creditors has passed the resolution for the IVA. If the creditor claims to be secured in part only, it is the part which is said to be secured, and only that part, which is left out of account – *Calor Gas v Piercy* [1994] BCC 69. Other rules relating to bankruptcy are relevant to IVAs because they are frequently incorporated in IVA proposals and because the court will in any event lean in favour of treating IVAs similarly to bankruptcies, see *Whitehead v Household Mortgage Corporation* [2003] 1 All ER 319, 329.

Rule 6.115 provides that a secured creditor may, with the agreement of the trustee or the leave of the court, at any time alter the value which he has put upon his security in his proof of debt. Significantly, however, r 6.115(2) provides that if the creditor has voted in respect of the unsecured balance of his debt, he may re-value his security only with the leave of the court. Rule 6.116 provides that if a secured creditor omits to disclose his security in his proof of debts, he shall surrender his security for the general benefit of creditors, unless the court, on application by him, relieves him from the effect of that rule on the ground that the omission was inadvertent or the result of honest mistake.

Rule 6.119 provides that if a creditor who has valued his security subsequently realises it, the net amount realised shall be substituted for the value previously put on it by the creditor and that amount shall be treated in all respects as an amended valuation made by him. The

In order to avoid unpleasant surprises on either side, an IVA should clearly state whether or not the secured creditors will continue to be able to rely upon their securities.

revaluation upon realisation is automatic, and does not, as in other cases, require the consent of the trustee or of the court.

### THE CASE LAW

There are four relevant reported cases.

*Johnson v Davies* [1999] Ch 117 holds that the documents governing an IVA are to be interpreted in the same way as contractual documents. This is because the debtor makes a proposal (which serves as an offer), the specified majority of the unsecured creditors accept it and any dissenters are deemed 'by a statutory hypothesis' to have accepted it (p 138). An IVA is therefore a contract and interpreted as such.

In *Whitehead* (*supra*) the chargors had granted a charge over their house. The husband proposed an IVA. The chargee's debt was stated to be unsecured to the extent of £25,000 odd, this being less than the 25 per cent of the total indebtedness that would have entitled the chargee to block the IVA. The chargee voted against the IVA, but the IVA nevertheless was approved. During the course of the IVA, the chargee proved for the unsecured portion of its debt and accepted dividends. After the conclusion of the IVA, a subsequent chargee obtained possession of the house, sold it, and accounted to the chargee for the whole of the debt which was owed to the chargee, not merely the part which had been treated as secured.

The chargors claimed that the chargee should retain only the secured part and argued that the portion of the debt which had been treated as unsecured should be regarded as having been satisfied in the IVA.

In construing the IVA documents, the Court of Appeal noted that the IVA proposal:

- ▶ listed the house as an asset and provided, 'In the event of there being a shortfall to secured creditors, such shortfall will constitute a further unsecured liability in the arrangement';
- ▶ also provided, 'It is not proposed that anything in this proposal should affect the rights of any secured creditor to enforce its security'.

The court then refused to imply a contractual term that a creditor who accepted a dividend for part of his debt could not thereafter rely upon his security over that part. To imply such a term was to ignore

both the express provision that the security should be unaffected and the use of the word 'shortfall' which could only have referred to sums which remained owing after the security had been realised (p 330).

The court then went further and held that it should be slow to infer any contractual term which differed from the rules governing bankruptcy. Rule 6.115 permits a creditor to revalue his security. If a creditor can revalue his security, it therefore cannot follow that the creditor waives his security for all time, simply because he has proved in a bankruptcy as an unsecured creditor and has accepted dividends. As with bankruptcy, so with IVAs unless the contract states otherwise.

*Whitehead*, however, was a case where the chargors' case depended upon the fact merely that the creditor had proved in the IVA. It was not a case where the chargor could also claim that the creditor had voted in the IVA as an unsecured creditor.

*Rey v FNCB Ltd* [2006] EWHC 1386 (Ch) concerned an application for permission to appeal the decision of a Circuit Judge who had refused to declare that a charge had ceased to have effect in circumstances where the creditor had voted for an IVA and had valued his security at nil. Mr Justice Lightman refused permission to appeal and noted that as r 6.115 was expressly included in the IVA Proposal, the parties must have intended to keep the charge alive, as otherwise they would not have provided that it could be revalued at any time. The case also provides an example of how an express inclusion of r 6.115 can affect the interpretation of other clauses in the Proposal. Clause 22 provided that:

'on approval of this proposal ... the Creditors shall not be entitled to commence or continue any proceedings, execution or other legal process in respect of the Debts ...'

Because of the inclusion of r 6.115, it was held that while the effect of cl 22 was to preclude proceedings on the debtor's personal obligations to pay his debts, it did not render the securities ineffective.

Note that in this case the chargor was attempting to obtain a declaration that the charge was gone for all time. He was not attempting the less ambitious task of seeking a declaration that the charge was ineffective unless and until it was revalued.

In *Khan v Permayer* [2001] BPIR 95, however, the chargee did lose the benefit of the charge by virtue of his conduct in connection with the chargor's IVA. Two partners in a restaurant business entered into IVAs. The defendant was the holder of a charge over the restaurant and was paid money, after the conclusion of the IVA, in order to obtain the release of the charge.

The claimant sued for recovery of the money as money paid under a mistake, the mistake being that the charge was enforceable whereas it had in fact been waived. The claimant succeeded firstly because the terms of the IVA were inconsistent with the maintenance of the security and because secondly the defendant had voted for the IVA, thus providing that 'concurrence' without which the secured creditor's rights cannot be affected – the IA 1986, s 258 (4).

The features of the IVA were that it:

- made specific provision for the treatment of debts which were described as secured debts;

- made no mention of the defendant continuing to be a secured creditor;
- provided for the defendant to participate as an unsecured creditor; and above all
- provided that the moneys that were to be paid during the IVA (ie to the unsecured creditors) should come from the profits of the restaurant.

This last feature was inconsistent with the survival of the security, because if the security had survived it would have been possible for the defendant to enforce it even during the IVA, and because if he were to have done that, he would have destroyed the source of the very income which was to service the IVA that he had agreed to.

#### **DOES KHAN SUPPORT A BROADER PRINCIPLE – THAT IF A SECURED CREDITOR VOTES FOR AN IVA IN RESPECT OF PART OF HIS DEBT, THEREBY TREATING IT AS UNSECURED, HE SURRENDERS HIS SECURITY OVER THAT PART AS A MATTER OF LAW?**

In *Voluntary Arrangements* (2007) (p 120) His Honour Judge Edward Bailey states that if a secured creditor votes for an IVA in respect of the secured part of his debt he impliedly, if not expressly, surrenders his rights as a secured creditor if he also accepts dividends. *Khan* is cited in support. In *Personal Insolvency* (2008) (para 6.188), however, the same author elaborates the point by stating that the question, surrender or no, is a matter of contract, and that the 'Court will require clear language before interpreting the terms of the arrangement as interfering with a secured creditor's rights'. But is 'clear language' really essential?

While, obviously, there can be no surrender of a security if the IVA provides that the security will continue, it does not follow from this principle or from the authorities that the security will always continue save where continuation is clearly excluded.

A secured creditor who chooses to vote on the IVA proposal (which he is only permitted to do to the extent that he declares his debt to be unsecured) has arguably made an election which will prevent him from acting in a way which is inconsistent with that for which he has voted.

This is especially the case if the IVA proposal would have failed without his support, for then he would have bound even those IVA creditors who had not wanted it. He is to be treated in line with this principle:

'[A] litigant may be shown to have acted positively in the face of the court, making an election and procuring from it an order affecting others apart from himself, in such circumstances that the court has no option but to hold him to his conduct and refuse to start again, on the basis that he has abandoned.'

*Kok Hoong v Leung Chong Kweng Mines Ltd* [1964] AC 993, 1018. The significance of the decisiveness of the creditor's vote is noted in passing in *Whitehead*, p 329.

## Feature

### Biog box

David Schmitz practises as a Chancery barrister at 10 Old Square, Lincoln's Inn. His cases include *Krasner v Dennison* [2001] Ch 76 (whether a personal pension vests in the trustee in bankruptcy under IA 1986, s 306), *CIBC Mortgages v Pitt* [1994] 1 AC 200 (undue influence and constructive notice thereof) and *Grant v Edwards* [1986] Ch 628 (constructive trusts). He is a qualified mediator with ADR Chambers and has published articles on partners' negligence and on the *Spectrum* case in the *Solicitors' Journal*. The issues that are covered in this article arose in a recent Court of Appeal case which settled.

If this is right, it follows that a secured creditor who votes for an IVA will later, if his vote has been decisive, be able to rely upon his security only to the extent that he has asserted its value and thereby given up some of his voting rights. If he votes as an unsecured creditor for the whole of the debt and thereby values his security at nil, he will not be able later to rely upon it at all. In other words, it is, arguably, for the secured creditor to show that the IVA has preserved his security rather than for the debtor to show that the IVA has done away with it.

If r 6.115 has been included and if the secured creditor wishes to undo his election, he could apply to the court for permission to revalue the security. If other persons were to be prejudiced, the court could refuse to allow a revaluation. Because the court's discretion is unfettered, there is no reason why the court should not consider the position of the debtor if, for example, the security is his home, it was excluded from the IVA, he fulfilled his obligations under the IVA for several years and he suddenly faces an application which was brought on only by an unexpected increase in the value of the property. If r 6.115 has not been included, then either the creditor would be unable to retract his election or alternatively he would have to persuade the court to act in accordance with the rule anyway as in *Whitehead* (though query whether or not the court would imply the rule as opposed to refusing to imply a term which was inconsistent with it).

That said, it could be argued that this is all wrong. Earlier legislation provided that a creditor who voted as an unsecured creditor to the full extent of his debt, would be deemed to have surrendered his security unless the court was satisfied that his failure to value the security had arisen from inadvertence (Bankruptcy Act 1914, Sch 1, para 10).

By contrast, r 5.23 of the 1986 Rules contains no such express provision. (Rule 6.116 (*supra*) does not concern the consequences of a creditor's voting.) On the other hand, an omission like this may be of limited help in construing the current rules.

### WHAT KINDS OF TERMS IN AN IVA WILL BE RELEVANT?

The following would help the creditor:

- a term that the secured creditor's rights are not to be prejudiced (which would generally be decisive);
- a term referring to the negative equity or shortfall;
- a term incorporating rr 6.115 to 6.119 of the Bankruptcy Rules. See *Rey* (*supra*). Such a term would probably be overridden, however, by any term which was inconsistent with the survival of the security.
- a description, in the IVA proposal, of the property as secured. Such a description will not, however, be decisive where the creditor then describes his debt as unsecured. The debtor's offer would not match the creditor's acceptance.

The following would help the debtor:

- a term recognising that the property will be used to generate the income for servicing the IVA;
- a term which secures upon the property the obligations which the debtor is assuming under the IVA.

(Both of these are inconsistent with the continuation of the security, because the rights of the participants in the IVA – ie the rights of the unsecured creditors – would be destroyed if the security were to be exercised. The creditor may argue that the right to enforce the security is merely suspended until the end of the IVA, but query: for while it is commonplace for charges to be postponed in priority, such postponement does not carry with it a suspension of the right to enforce. An arrangement for the survival of a charge and for the mere suspension of the right to enforce it is unusual and should not be lightly inferred.)

- A term expressly excluding of the property from the assets in the IVA. Though not conclusive, such a term is consistent with an intention that the debtor should keep something of the property which would normally be conclusive.

### IF A SECURED CREDITOR HAS VOTED FOR AN IVA AND HAS ATTACHED A LOW OR NIL VALUE TO HIS SECURITY, CAN THE DEBTOR RESIST A POSSESSION ACTION EVEN IF THE SECURITY REMAINS VALID?

The debtor could argue that under the IVA the debtor and his creditors have agreed to treat the debt as unsecured until the creditor applies successfully for leave to revalue his security under r 6.115, (whether incorporated expressly or inferred by the court) and that until then the court should treat the debt, for all purposes, as unsecured or as secured only so far as the creditor abstained from voting. If the debtor is able to pay that part of the debt at a rate which the court finds acceptable under the Administration of Justice Act 1970, a possession order should be refused or suspended.

Against this, the creditor could argue that as a matter of construction of the IVA, r 6.115 only governs relations between the secured and unsecured creditors and is not relevant to an action between a secured creditor and the debtor. Yet again, the position is uncertain.

### HOW CAN UNCERTAINTY BE AVOIDED?

A secured creditor who wishes to reserve the right to enforce a worthless security which may later become valuable should stipulate that the IVA will not prejudice his right to enforce the security to the full extent of his indebtedness and that he is to be free to revalue it at any time with the leave of the supervisor or of the court.

If the terms of the IVA are attractive enough to induce a creditor to give up the prospect of profiting from a later increase in value of the secured property, the debtor should seek to include a provision that upon the conclusion of the IVA, the debtor shall retain the property free of any claims in the IVA or from the secured creditors.

Whatever expectations the parties may have, they should regard the law as uncertain in this area and they should therefore spell out the effects on the creditors' securities which the IVA is to have. ■

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