SQUIRE PATTON BOGGS

RETAIL SECTOR INSOLVENCY
USE OF CVAs

Introduction to CVAs

A company voluntary arrangement ("CVA") is a tool available to a company in financial difficulty to restructure its debts. In contrast to other insolvency procedures, the directors remain in control of the business which continues to operate broadly as normal, subject to the supervision of an insolvency practitioner ("the Supervisor").

A CVA is a statutory contract between the company and its creditors, which (in theory at least) produces a better financial return than if the company was placed into formal insolvency. The proposals will be funded either by a lump sum payment or an agreed schedule of payments over an agreed period (usually 3-5 years). If 75% or more in value of the company's creditors vote in favour of the proposals, they become binding upon all of the company's unsecured creditors, including those who (1) voted against the proposals and (2) were eligible to vote but did not receive notice of the meeting.

Once bound by a CVA, a creditor cannot take any step against the company to:

- recover any debt that falls within the scope of the CVA ("CVA Debt"); and
- enforce any rights against the company that arise from failure to pay the CVA Debt in full.

There is generally no moratorium available to a company proposing a CVA unless it is an eligible company (s 1A Insolvency Act 1986).

A CVA allows much greater flexibility than formal insolvency procedures such as administration or liquidation. The company and its creditors effectively agree when and what percentage of the company's debts will be paid in full and final settlement of those debts. Creditors in the same class can, by agreement, be treated differently, if the company can show that there is a benefit in so doing, e.g. a creditor or supplier who is so critical to the business that preferential treatment is necessary to ensure the success of the CVA. Different groups of creditors can also be treated differently e.g. Landlords are often divided between those premises where the company wants to continue to trade and those where the company wants to close. This must be done carefully to minimise the risk of a court challenge by those creditors who are treated differently arguing that they have been unfairly prejudiced (see Unfair Prejudice below). Typically, a CVA will be "sold" to a company's creditors on the basis that the return dividend will be significantly better than in an administration or liquidation. CVA creditors will be offered a number of pence in the pound, which usually compares very favourably with the much lower returns available from administration or liquidation. A CVA may also contain further incentives, such as additional payments if during the lifetime of the CVA the company performs better than was envisaged at the start of the process. Taken together with the certainty of a known return as opposed to the uncertainty and reduced return in a formal insolvency, creditors often feel that commercially they have little choice but to accept the CVA terms proposed.

The Use of CVAs in the Retail Sector

a) Reasons for using CVAs

The use of CVAs for companies with large property portfolios (such as retailers) has increased in recent times, as a CVA offers a mechanism that allows the tenant company (with creditor consent) to restructure its rent obligations on a mass scale, without the need to negotiate with each individual landlord. A successful CVA permits the overheads of the company to be reduced significantly in a very time and cost-effective manner. A CVA can thus be a powerful tool as it can, depending on the terms of the CVA, effect overnight the closure of unprofitable stores, restructuring of property liabilities, reduction in rents and can bind individual landlords and vary lease terms even where that landlord did not approve the CVA.

However, in order to deliver these benefits the CVA must be carefully drafted to ensure it provides a more commercially attractive outcome for the landlord than a formal insolvency and will not be challenged following approval. We explore below CVA proposals which failed because the landlords' position was not fairly considered.

b) Issues with Property CVAs

Tenants:

The retail environment has changed greatly in recent years and a company's need for retail outlets in every high street is outmoded and unnecessary. If a retailer has a large property portfolio, a CVA can be an effective mechanism for the restructuring of the business and compromising the lease liabilities on a large scale. As such, a CVA can be an extremely efficient and cost-effective way of transforming a struggling business.

Advantages:

A CVA has a number of advantages for a tenant. A CVA:

- carries less stigma than other insolvency processes;
- is cheaper, allows greater flexibility, preserves jobs and ongoing contracts;
- allows existing management to remain in place; and
- offers a better return to creditors.

A CVA can therefore be a useful restructuring tool where the underlying business is sound, the management is committed to a return to profitability and continued trading will produce funds sufficient to service both CVA obligations plus ongoing trading commitments.

Disadvantages:

- a CVA does not necessarily address the underlying cause of the company's financial difficulties;
- the fact that existing management remains in place and in control of the company's affairs for the duration of the CVA is often unpalatable to creditors; and
- the minority of creditors have to follow the majority (subject to their ability to challenge the proposal as unfairly prejudicial);
- the failure rate of CVAs is high;
- there is no investigation by the Supervisor as to why the company is in financial difficulties, compared with the formal reports on the directors' conduct required to be submitted in an administration or liquidation;
- if a CVA fails, the company will likely enter administration or liquidation anyway, and return to creditors will be worse than it would have been had a formal insolvency procedure been commenced instead of a CVA; and
- a CVA can only affect the right of a secured creditor to enforce its security if it agrees to be bound.

Landlords:

CVAs can impact significantly upon a landlord's property portfolio and their terms should always be very carefully considered. Landlords should therefore engage with the CVA nominee and legal/professional advisers as soon as they receive proposals**.**

Until a CVA is accepted, a landlord (like any other creditor) is free to pursue any remedies available to it (provided no moratorium has arisen under s1A Insolvency Act 1986). However, once the CVA is approved, the landlord is bound by the terms of CVA provided it was entitled to vote at the creditors' meeting, whether or not they attended or voted or were notified of the meeting.

The landlord may face a dilemma when deciding whether to accept the terms of a CVA. If a reduction in rent is proposed, a landlord may prefer to maintain occupation of the properties concerned rather than have them vacant. However, a landlord who has accepted a significantly reduced rent for the CVA period may find that the tenant eventually succumbs to administration or liquidation in any event and that they have lost the opportunity in the meantime to re-let to a more profitable tenant.

There are a number of issues for landlords to consider when considering a CVA proposal:

- is the CVA binding on them?
- what is the position in the CVA for payment of rent and future rent?
- is the tenant in breach of the terms of the lease allowing the landlord to forfeit the lease prior to a CVA being approved? In the *JJB Sports* case, the CVAs ultimately failed and it may have been better for landlords to take back premises rather than to allow an ailing business to limp on in a CVA;
- what effect will the CVA have on any guarantees?
- if the landlord has a minority vote, is it possible to join with other creditors to increase the voting power to influence the result?; and
- there has been a considerable groundswell that in CVA proposals landlords are unfairly singled out in comparison to other types of creditors. Do the proposals result in a position which would permit challenge on the grounds of unfair prejudice or material irregularity? (see further below).

c) Challenging a CVA

A CVA can be challenged on the basis that:

1. the arrangement **unfairly prejudices** the interests of a creditor, member or contributory of the company; or
2. there has been some **material irregularity** at or in relation to either the meeting of the company or the meeting of the creditors at which the arrangement was approved.

The following may apply to challenge the approval of a CVA:

- a person entitled to vote at either meeting;
- a person who would have been entitled to vote at the creditors' meeting had they had notice of the meeting;
- the nominee; and
- a liquidator or administrator of the company.

Unfair Prejudice

The concepts of prejudice and unfairness are questions of fact and are distinct considerations. The question of fairness turns on whether the CVA offers appropriate compensation for the prejudice suffered by the creditor. The mere fact that one creditor is in a worse position to another creditor is not of itself sufficient to demonstrate unfair prejudice; the court is required to carry out an assessment of the degree of prejudice between creditors having regard to all the circumstances, including the other options available at the time of the arrangement.

The ***Powerhouse*** case (see below) is an example of a case where a claim of unfair prejudice succeeded. There, a CVA proposed to prevent landlords from pursuing the tenant's guarantor, but offered inadequate compensation for the loss of the guarantee. This was held to be unfairly prejudicial to those landlords with guarantees.

Material Irregularity

There are no statutory definitions of "material" or "irregularity". However the phrase has been considered at common law.

In ***Re A Debtor 87 of 1993 No. 2*** *(1995) Times, 7 August* the judge had accepted that a failure to comply with the insolvency rules would amount to an irregularity. In ***Somji v Cadbury Schweppes plc*** *[2001] 1 WLR 615* the Court of Appeal considered what amounted to an irregularity being material and Judge LJ considered that the test under s 276 Insolvency Act 1986 should be *"had the truth been told it would be likely to have made a material difference to the way in which the creditors would have considered and assessed the terms of the proposed IVA"* (the wording about material irregularity is the same for both IVAs and CVAs). In ***Exeter city council v (1) Vivian Murray Bairstow (2) James Patrick Martin (3) Trident Fashions plc*** [2007] EWHC 400 (Ch) the judge, applying these considerations, did declare that there was an irregularity, but did not consider that there was any real prospect that it would have affected the approval of the CVA. He therefore considered that, whilst there was an irregularity, it was not a material irregularity.

An irregularity may arise, for example, from the basis of valuation a nominee places on a landlord's claim, from errors or omissions in the CVA proposal and statement of affairs, the conduct of a meeting, or a breach of a requirement in the Insolvency Act 1986 or Insolvency Rules 1986- assuming that irregularity is material in accordance with the analysis above.

Where the Court is satisfied that either of the grounds for challenge has been made out, it may:

- revoke or suspend any approval given by the meeting;
- give a direction to any person for the summoning of further meeting(s) of the company's creditors and/or members to consider any revised proposal, or, if the challenge was on the basis of a material irregularity, to reconsider the original proposal; or

give supplemental directions as it thinks fit, including directions with respect to things done under the arrangement since it took effect.

d) Using a CVA in Property Scenarios

Landlords must carefully consider and take advice upon the detailed terms of a CVA proposal, as the extent of the compromise of the tenant's liability that a landlord is being asked to accept can be substantial.

The overall debt due to a landlord (which is likely to include rent arrears, liability for dilapidations and unpaid insurance rents) will determine the value of its vote in the approval of the CVA. Landlords should thus aim to get their claim admitted for as high a value as possible, to include future/unascertained debts as appropriate. The higher the admitted claim, the more influence the landlord will have in the process.

A landlord can be critical to the success of a CVA regardless of the size of its vote and thus may be able to exert considerable influence in improving the terms of the CVA. A landlord's position will depend on whether the company wants to continue trading from the landlord's property or close it down and vacate it.

Unless otherwise excluded, the landlord will retain a right to forfeiture in respect of rents due under the CVA. It is therefore important for the landlord to ensure this right is not removed by the CVA to ensure that, whilst rent arrears may be compromised, the landlord has options available if there is further default during the CVA.

3. CVA Examples and Case Law

The use of the CVA to effect a mass release of lease liabilities came to prominence in 2006 with the ***Powerhouse*** CVA proposal. This proposed a release of existing lease liabilities and also sought to bind landlords to accept the release of a parent company guarantee. The proposal failed following a creditor challenge on the grounds that the guaranteed landlords had been unfairly treated (see ***Prudential Assurance Co ltd & ors (2) Luctor Ltd & others v (1) PRG Powerhouse ltd & ors (2) Anthony Murphy & others*** [2007] EWHC 1002 (Ch)) but on its drafting, rather on a rejection of the principle that a CVA could compromise a third party liability.

The ***Stylo Shoes*** proposal followed, which again failed due to the complexity and uncertainty of the proposed return to the affected landlords. The Company proposed that it be permitted to continue to trade from the stores on a turnover basis for an indefinite period of time. This was an unattractive proposition both to landlords of profitable stores (since they would be able to re-let the stores to more profitable new tenants) and to landlords of unprofitable stores (since if the turnover failed to reach certain minimum thresholds, they would receive nothing). As a result, the CVA proposal was overwhelmingly rejected by creditors.

The ***JJB Sports*** CVA proposal saw more success. Whilst the company ultimately entered administration, the CVA of *JJB Sports* was praised at the time for its clarity of terms and the certainty of return for creditors. This received almost unanimous support from the creditors voting for the proposal, the key terms of which were:

- the compromise of claims of landlords of approximately 140 closed retail stores and certain related contingent claims (such as claims of former tenants and guarantors), but with JJB retaining the obligation to pay business rates for these stores;
- the right of those landlords to make a claim against a total aggregate fund of £10 million, with payments from that fund in two instalments in late 2009 and early 2010;
- a concession arrangement for the terms of leases of the 250 open retail stores providing that rent would be paid on a monthly, rather than a quarterly, basis for a 12-month period from the next quarter date; and
- the CVA proposal did not seek to compromise the claims of any other creditors.

The ***Focus Do It All, Discover Leisure*** and ***Blacks*** CVAs came next. These proposed a lump sum payment from a parent company or investor or further funding from a financier contingent upon the CVA proposal being approved. That sum would then be applied to make a single lump sum payment to the affected landlords in return for a complete release of both the tenant and guarantor liabilities. The amount payable to each landlord was to be calculated according to a fixed formula, which would take into account rents, unexpired term, rateable value, profit and dilapidations. The method of termination of the lease was left flexible as some landlords preferred the lease to continue (to avoid rates liability), whilst some preferred to effect a surrender to preserve an existing sub-tenancy.

The ***Miss Sixty*** CVAs mark the boundaries of what constitutes an acceptable CVA proposal and a reminder of the nominee's/supervisor's duties when putting together a CVA proposal. The case also helpfully outlines what constitutes unfair prejudice to an affected landlord in a CVA proposal.

In ***Miss Sixty*** the company proposed a CVA with a view to extricating itself from only two leases in its entire portfolio. The payment offered to the affected landlords did not reflect the market value of the landlords' claims, particularly in circumstances where the parent company guarantor remained able to meet its obligations under its guarantee. The court was highly critical of the terms of the proposal and the conduct of the nominees, forming the view that the nominees had allowed their judgment to become clouded by the commercial wishes of the parent company, which clearly wished to achieve a release of its liabilities as cheaply as possible, at the expense of their duties to the body of creditors as a whole. Consequently, the proposals failed.

Watch This Space

The most recent large-scale retail CVA to be proposed was by the nursery retailer ***Mamas and Papas***. The CVA asked landlords to agree to a reduction in rent at certain of their UK sites and was approved in September 2014. It shows that a reduction of payments due to landlords continue to be a key focus in retail CVAs.