CVAs AND THE STRUGGLING HIGH STREET RETAILER: A NEW BATTLEGROUND FOR LANDLORDS?

The Company Voluntary Arrangement ("**CVA**") has become an insolvency procedure of choice for companies experiencing financial distress. 2018 has already seen prominent high street brands such as Mothercare, Carpetright, New Look and House of Fraser implement CVAs in a bid for survival. Given their resurgence, this briefing note explores why CVAs have become so popular amongst high street retailers, the types of objections that landlords might make and how this may impact how landlords transact in the future.

Key issues

- A tenant's proposal under a CVA can include measures which impair the rights of landlords – such as amendments to lease covenants, reduction in future rent or bringing the lease to a premature end – all of which may be implemented without the affected landlords' consent as long as a majority of 75% in value of the tenant's unsecured creditors vote in favour of the proposal.
- The challenge to the House of Fraser CVA is suggestive of a changing climate and greater willingness amongst landlords to challenge what they perceive to be an unfair compromise of their rights.

What is a CVA?

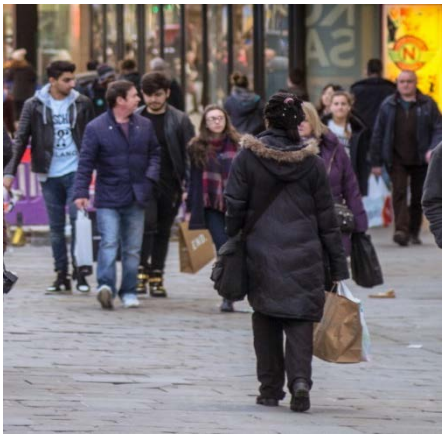
A CVA is an insolvency and rescue procedure under Part 1 of the Insolvency Act 1986. It allows a company in financial distress to enter into a legally binding arrangement with its unsecured creditors to defer or compromise payments with the aim of saving itself from going into an insolvent liquidation.

Proposals are typically made by directors of the distressed company but can also be made by an administrator or liquidator. The proposals are then circulated to shareholders and creditors for their consideration and approval.

How does a CVA come into force?

A CVA proposal will be implemented and bind all unsecured creditors of a company (known and unknown) if approved by at least 75% of the known creditors (in value) who vote on the proposal, as long as those voting against the proposal do not include more than half of the creditors (in value) who are unconnected to the company.

A CVA cannot affect the right of a secured creditor to enforce its security, except with its consent. This effectively means that debts owed to secured creditors cannot be compromised by a CVA and must be dealt with by direct negotiation or paid in full. Landlords are typically unsecured creditors of their tenants and so fall into the category of creditors who will be consulted on, and will be bound by, any CVA proposals that are implemented.



Why are CVAs so popular with retailers?

Where a company in financial difficulty is the tenant of a number of leasehold properties (as is the case with most high street retailers), the CVA offers a mechanism by which it can restructure its rental obligations or change the terms of its leases and thereby improve its financial position. The inherent flexibility of a CVA means that a tenant's proposal can include a wide range of measures, such as a reduction in future rent, a compromise on its dilapidation obligations, amendments to its lease covenants, the inclusion of a break right, changing the frequency of rent payments (e.g. from quarterly in advance to monthly in advance), delaying a landlord's right to forfeiture or even an ability to hand back the keys and be released from any future liability under one or more leases. The fact that a CVA may be implemented without the affected landlords' consent if sufficient support for the proposal is obtained from the company's other unsecured creditors is a further advantage for companies using the CVA procedure.

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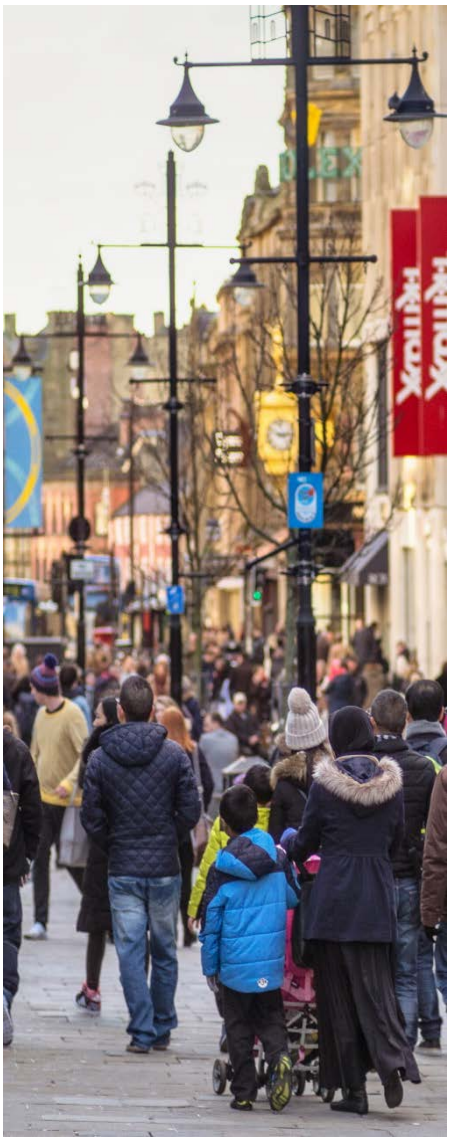
Although each CVA proposal will be tailored to the specific needs of the company in question, recent practice suggests that landlords and leases are commonly split into three different categories under a CVA: (i) Category A (profitable stores) – these leases will generally be left unaltered with current rent levels being maintained, or subject to only minor amendments; (ii) Category B (borderline stores) – these leases will be heavily negotiated and face significant rent reductions; and (iii) Category C (unprofitable stores) – these leases will be terminated and the premises returned to the landlords.

Once bound by a CVA, a landlord cannot take steps against the company to recover any debt that falls within the scope of the CVA (e.g. rent that has been commuted), or to enforce rights against the company that would have arisen from the company's failure to pay the debt in question in full had it not been compromised by the CVA (e.g. to charge interest on arrears or to forfeit the relevant lease).



What remedies are available to landlords who feel that they have been unfairly treated by a CVA?

Section 6 of the Insolvency Act 1986 allows a creditor to challenge a CVA on two grounds: (i) unfair prejudice and (ii) material irregularity.

The concepts of both 'unfairness' and 'prejudice' are questions of fact and are distinct considerations. The likelihood of a creditor claim being successful is usually dependent on whether any prejudice suffered by a creditor is deemed to be 'unfair'. Though there is no single universal test for judging whether a proposal is unfair to a particular creditor, a judge will usually be guided by comparisons between the creditors' position under the CVA and the position they would find themselves in had an alternative insolvency procedure been explored (for example, a liquidation) (known as a *vertical comparison*) and the position of the applicant creditor as against other similar creditors under the CVA (known as a *horizontal comparison*).

Material irregularity is also a question of fact and relates to the conduct of the CVA; the convening of meetings; the value attributed to a creditor's claim and the process by which such a decision is made.

If a petitioner successfully challenges a CVA under any one of the above grounds, the court can at its discretion take any of the following steps: (i) revoke or suspend the creditors' approval of the CVA; (ii) direct the company to issue a revised CVA proposal; or (iii) order the creditors' meeting to be re-run.

Why do landlords vote in favour of CVAs?

The first answer to this question is a commercial one.

CVAs are promoted on the basis that they offer a landlord more than they would otherwise receive if the tenant were to enter a more terminal insolvency process, such as a liquidation. There is also the risk that if the tenant were to go into liquidation, the liquidator would disclaim the lease as an onerous asset and all of the obligations in the lease – including the obligations to pay rent and service charge and to repair and reinstate the premises at the end of the term – would then cease. In these circumstances the landlord would be left with a vacant asset: as well as needing to spend time and money finding a new tenant (with the inevitable demands for rent-free periods and contributions to fit-out costs that this brings), the landlord may also need to meet significant void costs for the premises, such as payment of insurance costs and business rates, until a new tenant is found. Given the growth in online retailing and the increasingly competitive market within which retailers now operate, a landlord may face significant difficulty when attempting to re-let premises.

Against this backdrop, landlords may be persuaded to vote in favour of a CVA by the fact that at least some stores will be kept open, at least some of the premises will remain occupied and they will receive at least some rent, which in all cases is better than the alternative. Given that CVAs are a relatively informal insolvency procedure and do not require extensive court involvement (unless there are formal challenges) they are also thought to be cheaper than more formal insolvency procedures, meaning that there will potentially be more funds available to creditors.

Landlords may be further persuaded to support a CVA for public relations/reputational reasons. Landlords may conclude that they need to be supportive of a recovery attempt by a retailer, especially when the alternative is likely to be a terminal insolvency filing resulting in widespread redundancies of employees and damaging knock-on effects for suppliers. The desire to avoid the negative publicity that a landlord would almost certainly receive if it was perceived to have contributed to such an outcome may be sufficient reason for some landlords to vote in favour of a proposal irrespective of how unfavourable it may seem.

The second answer is that landlords do not always vote in favour of CVAs.

As we have seen in the recent high-profile example of the House of Fraser CVA, landlords do not always support a retailer's restructuring proposal. In House of Fraser's CVA, certain landlords decided that the CVA left them worse off than available alternatives for rescuing the business and argued that the CVA unfairly prejudiced them when compared to other unsecured creditors of the company. The problem faced by landlords in such circumstances (as was faced in the case of House of Fraser) is that although they may disapprove of the terms of the CVA and refuse to vote in support, they are part of a much bigger picture and represent just one category of unsecured creditor. If a sufficient number of other unsecured creditors vote in favour so that the company is able to secure a majority (in value) of 75%, the CVA will be implemented, effectively cramming-down the landlords. In situations where the main function of a CVA is to introduce variations to the company's lease obligations and reduce its liability to its landlords without significantly impacting other unsecured creditors, the likelihood is that a company will

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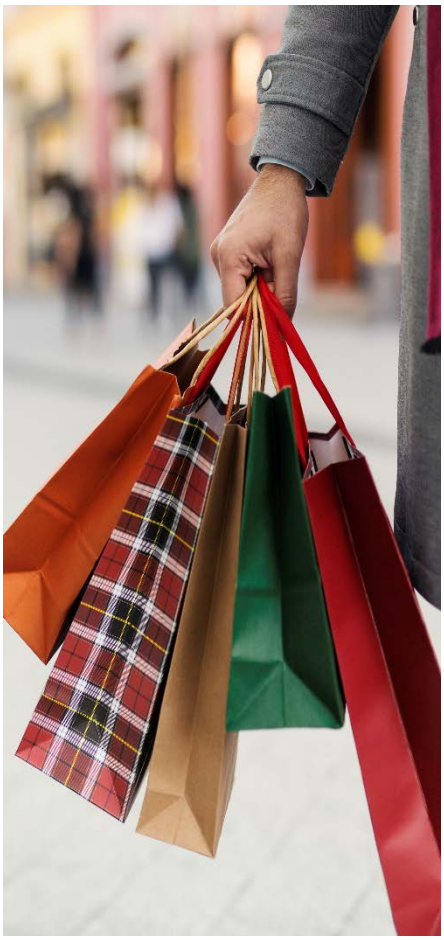
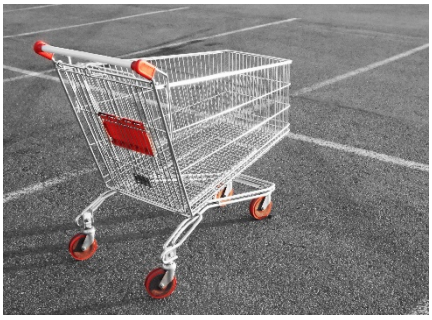


reach the necessary threshold to implement the CVA as it is in the interests of the other unsecured creditors who are not landlords to push through the proposal.

The position of landlords is further frustrated by the procedure through which the value of a creditor's debt and consequently their voting power is determined. Whilst ascertained arrears are given actual value, unascertained or unliquidated sums (e.g. future rent and dilapidations) carry a value of £1 for voting purposes unless the meeting chair agrees a higher value. In practice, the chair is likely to heavily discount a landlord's unliquidated and unascertained claim rather than merely offer them a nominal amount of £1. Consequently, most landlords have limited voting rights compared to other creditors and, even when acting together, may be unable to reach the requisite 25% threshold to prevent a CVA from being implemented.



The House of Fraser CVA and the landlord challenge

This year has seen a particularly robust response from landlords, some of whom believe that their rights are being unfairly compromised by CVAs proposed by tenant companies. The House of Fraser CVA is a particularly good example of this, with landlords challenging the proposal on the grounds of both unfair prejudice and material irregularity.

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In respect of their unfair prejudice challenge, the petitioners argued (amongst other things) that the CVA proposal was unfair as: (i) the landlords were worse off under the CVA than they would have been if an alternative route to rescuing the business was explored and (ii) the landlords were being treated far worse under the CVA than all of the other unsecured creditors of the company.

In relation to the material irregularity challenge, the petitioners argued that there was a failure to accurately value the landlords' likely recovery in an administration, consequently inducing them to vote in favour of the CVA on a false premise. One group of petitioners were also aggrieved by the chairman's decision to discount the value of their claim (for voting purposes) by 75%.

Although the challenges raised by the landlords were not tested in court (as prior settlement was reached between the parties) and details of the settlement itself have not been publicly disclosed, the legal challenge to the House of Fraser CVA signals a greater willingness amongst landlords to contest what they perceive to be an unfair compromise of their rights through the CVA procedure.

Some practical steps landlords may take to mitigate how CVAs impact them

Part 1 of the Insolvency Act 1986 is a mandatory statutory provision and so, unlike the security of tenure provisions of the Landlord and Tenant Act 1954, there is no option for landlords to "contract out" of the CVA regime. However, in addition to making a formal legal challenge, there are some other practical steps that landlords may take to mitigate the impact of a CVA on their business:

1. *Broaden the landlord's forfeiture rights*: Landlords may include provisions in their leases which enable them to exercise their right of re-entry upon the tenant making a proposal to enter into a voluntary arrangement with its creditors. Leases typically enable a landlord to

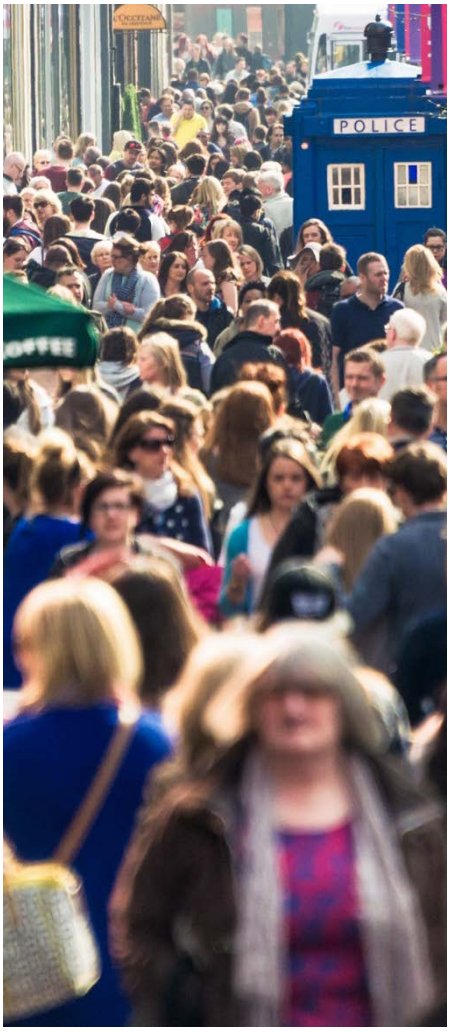
forfeit if the tenant enters into a voluntary arrangement with its creditors, such as a CVA, but this right is capable of being compromised by the CVA itself. From a landlord's perspective, if the lease can be forfeited before the CVA takes effect then this may help the landlord to avoid finding itself in a situation where it is prevented from forfeiting a lease and is obliged to accept a reduced rent for the entire period provided for under the CVA, although this would be subject to the court's equitable discretion to award relief from forfeiture in the usual way.

2. *Act together with other creditors in a similar position*: Landlords who do not have the requisite percentage (25%) to vote against a CVA proposal may attempt to actively seek out and act jointly with other creditors/landlords who are equally unsatisfied with the proposal in order to reach the necessary threshold to modify or reject the company's proposal.

3. *Consider whether they can improve their standing before a CVA is implemented*: Many tenants will approach their landlords in the run up to a CVA and will ask the landlords to consider providing concessions to the tenant, such as a reduced rent or an ability to pay rent in instalments. Landlords may consider agreeing such an arrangement with a distressed tenant where this would potentially have the effect of improving their position under a CVA and makes it less likely that the CVA will include a proposal by the tenant to close that particular store. For example, by agreeing a concession before the implementation of a CVA, a landlord's lease may be placed in a higher/preferred category under the CVA and therefore receive better treatment.

4. *Require earlier and better access to information and a seat at the negotiating table*: Landlords may consider introducing clauses into their lease documents (such as information covenants and financial covenants) to make them more akin to finance arrangements, thereby providing landlords with negotiating leverage much earlier than currently arises.

5. *Make a claim against a former tenant*: In circumstances where a landlord is left with empty premises following a CVA, for instance where the landlord elects to forfeit the lease, consideration may be given by landlords to whether any former tenants would be liable to accept a new lease of the premises on the terms of the previous lease. This may be the case where the lease is an "old lease" that was entered into before the Landlord and Tenant (Covenants) Act 1995 came into effect, or where a "new lease" has previously been assigned and the outgoing tenant provided an authorised guarantee agreement to the landlord. In both cases, landlords should seek legal advice to ensure that all of the requisite formalities are complied with and that any rights to bring a claim against a former tenant are not inadvertently lost.



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What does the future hold for CVAs?

Given the general attitude of the Government towards the real estate sector and the growing public consensus that the high street needs to be preserved

and protected, not to mention other competing priorities such as Brexit, legislative change on the issue of CVAs seems unlikely any time soon. In light of this, together with the difficult economic climate within which most high street retailers now operate and the growing popularity of the CVA, it is seemingly a question of when and not if we will see the next formal challenge by landlords to a CVA proposed by a tenant company.

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