Retail CVAs:

Trends and future direction

The face of the UK's high streets and shopping centres continues to change rapidly as consumers, shopping and leisure habits change and evolve.

In this latest article in our "future of consumer" series, we look at the continued use of company voluntary arrangements (CVAs) by retailers (and restaurant owners) to reduce their exposure to landlords under their leases and ask what are the trends and the future direction of this restructuring procedure.

A large number of bricks and mortar retailers continue to face significant headwinds in their businesses, including:

- reduced discretionary spending by consumers;
- increased business rates;
- increased level of online purchases affecting footfall as well as sales; and
- a gradual shift, in particular in high streets, away from retail towards leisure.

Whilst this is not all doom and gloom for those retailers that have a balanced digital and physical presence and are making use of that balanced presence to increasingly utilise their retail footprint to deliver new consumer experiences and to support their online offering (collections, returns, touching and trying), it is certainly not a good time to be a commercial retail landlord and the prevalence of retailers proposing (increasingly aggressive) CVAs only serves to make matters worse for them.

We are approaching the tenth anniversary of this firm advising JJB Sports PLC on the first major retail CVA and in the last 12 months there has been a high volume of CVAs in the retail and casual dining spaces from Toys "R" Us, Byron Hamburgers, Carpetright, Jamie's Italian, New Look, Select/Genus, Prezzo, Carluccios,

Gaucho, Gourmet Burger Kitchen, House of Fraser, and Homebase. Given the well-reported discontent of landlords and other retailers with CVAs, it is perhaps surprising on the face of it that there have been very few cases seeking to unpick the CVA architecture – the only challenge being from a group of landlords to the House of Fraser CVA which was ultimately dropped before the group collapsed into administration. As CVAs appear to be a reality of the high street, we discuss below some of the key legal issues and future direction for this restructuring tool.

What is a CVA?

A CVA is a consensual agreement between a company and its creditors. The aim of a CVA is to offer some or all creditors a compromise which allows the company to avoid administration or liquidation and, in doing so, producing a better outcome for all creditors.

A licensed insolvency practitioner will be engaged by the company to formulate the CVA proposal in parallel with the directors, which will be filed at Court before being distributed to creditors. To be approved, 75% of creditors by value (and at least 50% of unconnected creditors) must vote in favour of the proposal. If the CVA is approved, it becomes binding on all creditors, whether or not they voted in favour of the proposal.

Creditors vote as a whole, rather than by class, so even if the CVA only compromises the rights of one group of creditors – such as landlords – all creditors are able to vote for the purposes of assessing whether the requisite majority is obtained. A CVA cannot bind secured or preferential creditors without their consent so it is rare to see a CVA for financial creditors (although Steinhoff has stated that it intends to propose multiple CVAs to restructure its unsecured financial liabilities).

Basic legal structure

CVAs are a general restructuring tool. The CVA statutory framework contains no specific provisions relating to compromising leases and there is no prescribed format for a leasehold CVA. Market practice has been to follow the basic legal structure of the first JJB Sports CVA with innovations limited to incremental changes.

The basic structure of most leasehold CVAs is:

- preventing creditor action as a result of the CVA (a form of moratorium);
- moving all rent from quarterly to monthly payment;
- dividing leases into categories, typically three categories labelled "red", "amber" and "green", based on certain criteria (such as profitability or whether the store is overrented);
- changing the amount of rent and dilapidations payable going forward;
- giving the tenant the ability to exit certain stores (usually "red" leases) by reducing rent and dilapidations to zero after a specified period (the tenant remains liable for rates following such exit);
- giving tenants the option to remain in stores that it would otherwise exit (usually "amber" leases) if trading improves; and
- generally, all other unsecured creditors and landlords of the "green" stores are paid in full.

This approach works at a legal level because of the ability of a CVA to act as a statutory contract that can amend lease terms and also because of its ability to single out groups of creditors (here, landlords of stores who share similar characteristics) where there is a good reason for doing so.

How can a CVA be challenged?

Once it has been approved by creditors, the two options for dissatisfied creditors to challenge the proposal are that there has been a material irregularity or that the proposal is unfairly prejudicial. Such a challenge requires an application to court which must be made within a specified period.

Material irregularity is largely a question of some failure to comply with the process. Examples include a failure to disclose relevant facts to creditors, flaws in the giving of notice to creditors and the conduct of the decision procedure.

To have a CVA set aside on the grounds of unfair prejudice, a creditor must show that the CVA is not only prejudicial to its interests (most CVAs will, by definition, prejudice creditors – and most will prejudice some more than others) but also that the prejudice suffered by that creditor – or category of creditors – is *unfair*. Courts will consider two grounds of unfairness: "horizontal" and "vertical".

- "Horizontal" fairness is whether a creditor has been treated less favourably compared with other creditors in a comparable position – for example, where two landlords of stores in broadly the same position are required to take different rent reductions. This does not mean that all creditors must be treated the same, only that any difference in treatment must be justifiable; and
- "Vertical" fairness is whether creditors are in a better position than they would be in the event of the company's liquidation or administration.

A classic example of unfair prejudice is seeking to use a CVA to compromise a creditor's claim against a solvent third party guarantor. Clearly, the creditor would be better off in a liquidation where it could simply claim against that solvent guarantor. This guarantee stripping was rejected by the court in *Prudential Assurance Co Ltd v PRG Powerhouse Limited* [2007] EWHC 1002.

Increasingly aggressive terms

Whilst this basic legal structure is relatively settled and has not changed a great deal in the various CVAs seen across the market since 2009, what has changed is that tenants and restructuring advisers have become more aggressive and introduced additional complexity to address particular problems faced by businesses.

Examples of this type of complexity include:

- increasing the number of store categories beyond the red, amber, and green approach; and
- seeking to compromise certain other "non-critical" unsecured creditors such as accrued rates (see the Select/Genus CVA) whilst "critical" unsecured creditors are kept whole.

By introducing these additional elements the risk of challenge increases as, for example, in the event of a challenge the company will have to demonstrate why the finer distinctions that support multiple categories are justifiable on the facts and also how it has assessed those "critical" unsecured creditors who must be kept whole.

Wider restructuring

CVAs have been very successful in reducing rent liabilities for retailers. What they do not do, in isolation, is rightsize a company's debt, inject new capital or effect an operational turnaround.

Commonly therefore CVAs are used in conjunction with other measures targeted at solving the other issues diagnosed by the company and its advisers. These wider measures will be driven by the particular facts and circumstances facing that distressed business.

Attitude of landlords

The landlord community has been vocal in raising concerns (although this can often fall short of voting against CVA proposals) where there is a sense that a CVA has been proposed that will not solve the other material issues preventing a turnaround. There has been little sign of landlords organising themselves proactively once it becomes clear a restructuring in some form will be required (in the way a group of unsecured bondholders would for example) with a view to trying to shape the key elements of the restructuring. This leads to a position where landlords have two unattractive choices, vote for the CVA and be singled out for a haircut or vote against and risk pushing retailers into administration. Arguably, an effect of this is that the company and other, non-landlord, creditors can seek to push through a CVA without landlords having the opportunity to test the restructuring being proposed and, for example, requiring equity or lenders to commit to more aggressive measures to put the retailer in the best position to flourish.

In an effort to fill the landlord vacuum, the British Property Federation has issued a best practice protocol that, in practice, asks very little of companies proposing a CVA. The key plank of the protocol is that the BPF requests a draft of the proposal with three business days to comment. This enables the BPF to read the proposal and flag where the commercial terms are different to what it perceives to be "market".

This approach however does not give the BPF the ability to analyse properly the wider restructuring and (not surprisingly given the BPF's lack of access to detailed financial information and resources) insist upon the changes to the wider restructuring plan that landlords should request to ensure that they are not bearing a disproportionate burden of the restructuring pain.

Perhaps surprisingly given the number of CVAs and the disquiet in the landlord community, there have been very few challenges before the courts to the terms of a leasehold CVA over the last 10 years, and even these are of limited wider application.

Other stakeholders

The Pension Protection Fund issued a guidance note on 1 June 2018 stating that the PPF's starting point is that the pension scheme must receive an "anti-embarrassment" upside of at least 33% of the company's equity and the PPF expects the company and its advisers to demonstrate that they have addressed 11 core areas of concern in the CVA and wider restructuring. The high profile discussions between the PPF and Toys "R" Us in respect of its proposed CVA indicate that the PPF is willing to use its full commercial leverage when presented with a CVA proposal.

Possible future flashpoints for retail CVAs

1. Store categorisation

Treating categories of stores differently in a CVA proposal is fine from a legal perspective, provided that the categorisation is underpinned by good reasons that, if challenged, could be demonstrated to a Judge.

As the number of landlord categories has expanded and, for example, warehouses and distribution centres are included in the same categories as traditional retail premises, there are more (and likely finer) distinctions that the company may be called upon to justify.

Judgment calls over store categorisation that may be harder to defend in the event of a challenge include non-objective criteria, re-categorising less profitable "flagship" stores because of their importance to the brand, and any re-categorisation of stores to spread a particular landlord's affected portfolio across the various categories.

2. Calculation of landlords' voting rights by reference to the value of their claims

CVAs require that creditors vote by reference to the value of their claim.

In the case of landlords, their claims are largely comprised of future rent and are therefore unliquidated and unascertained. Under the relevant legislation, such claims must be admitted to vote for £1 and will only be given a higher value for voting purposes if the insolvency practitioner chairing the CVA procedure can safely attribute a higher value. It is currently standard practice for the chair to calculate landlords' votes by reference to a formula (taking into account the next break clause and assumptions as to reletting) before applying a 75% discount.

This was an area of focus in the House of Fraser challenge that fell away and may therefore be revisited by landlords in future CVAs. The nature of the relevant insolvency legislation however makes a successful challenge on this basis difficult and there is no current indication that market practice as to the calculation of landlords' claims is changing.

3. Increased co-ordination amongst landlords

It is possible that the landlord community may decide to take a more proactive approach. To do this, a group of landlords with a sufficiently large "voting" stake would have to persuade the company to engage with them early and provide them with financial information – which the company will be reluctant to do if it feels it does not need that group of landlords' support. If provided, this financial information would allow landlords to assess whether the alternative to the CVA is really administration or liquidation – information which they currently are required to take at face value based on the company's proposal.

What next?

It feels like a relatively safe bet to say that leasehold CVAs are here to stay. Over the last ten years they have proved enduringly popular when retailers struggle.

It is also safe to say that many companies proposing CVAs will ultimately collapse into administration or liquidation. Not all businesses can turn around and the previous, and likely upcoming, examples of retailers that fail post-CVA does not show that leasehold CVAs are ineffective. Rather it shows that they must be used judiciously to give retailers the best chance to turn around. When these failures do occur, stakeholders will likely focus more keenly going forward on the wider restructuring proposals to ensure the retailer has a good chance to turn around.

It is also likely that as a broader pool of advisers design variations on the leasehold CVA to respond to specific commercial challenges, we will see increasingly ambitious CVAs. It is important for companies, insolvency practitioners, lenders, bondholders and landlords to understand the legal limits to this technology so they can understand the point at which pushing the envelope gives rise to a vulnerability to a successful creditor challenge.

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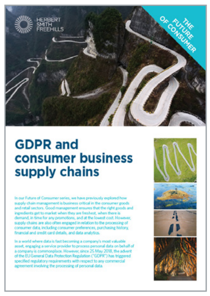

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