CADWALADER

CVA and Its Prominence in Restructuring the Retail Sector


By **Duncan Hubbard**
Partner | Real Estate


By **Livia Li**
Associate | Real Estate

The use of company voluntary arrangements ("CVA") in the UK has risen in the last few years, especially in the retail sector where many companies are struggling with the current landscape of increased competition from online retailers and a depressed sentiment in the economy. It has been reported in the *Financial Times* that since 2016, the number of retailers opting for CVAs has in fact doubled, with prominent retailers such as Carpetright, Mothercare, Homebase and, most recently, Debenhams all taking the same strategy.

The use of CVA has led to some critique around its use (and potential abuse), given that it is not a formal insolvency process and yet it binds all the unsecured creditors of the said company. It also raises concerns for landlords in particular where companies whose rent encompass a large portion of its ongoing costs are said to use this procedure to reduce/renegotiate rents with landlords.

In fact, the British Property Foundation has called the Government to conduct an urgent review of CVA regime, citing that the lack of transparency and unfair discrimination between different creditors result in the CVA regime being misused.

In this article, we discuss and explore the general procedure involved in a CVA and some of the key issues which are relevant for the property sector.

What is a CVA?

In summary, a CVA is a procedure undertaken between a company ("Company") and its creditors under Part I of the *Insolvency Act 1986* ("IA 1986"). A CVA is implemented under the supervision of a licensed insolvency practitioner (also known as a "Nominee" when they first make the application, then as a "Supervisor" when implementing the approved CVA). CVA is an informal procedure which aimed to assist the Company and its unsecured creditors to come to a binding agreement, and therefore avoid the need to go down the path of terminal insolvency proceedings. One of the key distinctions of CVA compared to other insolvency procedures (such as administration, liquidation) is that any approved CVA binds all unsecured creditors of the Company. Secured creditors, although notified, do not get to vote and their rights as secured creditors are not affected.

The general steps of a CVA would include the following:

1. the persons proposing a CVA (this could be a director, or if the Company is already in administration or liquidation, the administrator or liquidator, as applicable) sets out the proposal to the Nominee;
2. the Nominee then has 28 days to submit a report to the court and to also submit its opinion as to whether the proposal should be considered by the Company's creditors or members (in reality, however, most Nominees are involved way before the notification and would be assisting with putting together a proposal);
3. the proposal must also include a statement of the Company's affairs, which should contain information such as the Company's creditors, debts, other liabilities and assets;
4. the Nominee then seeks approval by carrying out the "decision procedures" set out in Part 15 of *the Insolvency (England and Wales) Rules 2016* ("IR 2016") from the creditors. Notice is to be provided to all creditors, although only unsecured creditors will get to vote; approval by creditors is achieved if at least 75% in value of the Company's creditors who respond approve the proposal. If there are "connected" creditors, then a second round of voting is required where only "unconnected" creditors are allowed to vote and at least 50 per cent of "unconnected" creditors voting by value must vote in favour before the CVA is approved;
5. members may also vote on the CVA as well, with the approval threshold being 50%; however, lack of approval from the members will not invalidate a CVA otherwise approved by the creditors; and
6. once approved, a CVA *binds all unsecured creditors* (*i.e.*, this includes any person who did vote, or is not aware of the CVA).

CVA and Its Use in a Commercial Property Context

In the context of CVAs proposed by retail companies, these entities tend to be tenants of a large number of leasehold properties and, therefore, a large proportion of their ongoing outlays are rent. Due to the fact that CVAs provide a lot of flexibility (given that the proposal in the CVA can propose virtually any change, provided it is not unfairly prejudicial to certain creditors nor consists of material irregularity, which can then lead to the CVA to be challenged) and, unlike administration, do not necessarily compel the Company to pay its debts on a strictly parri passu basis, CVAs are therefore often used in the retail industry for struggling retailers to renegotiate their lease terms.

Although there is a written lease, and therefore a contractual commitment to pay rent, if the CVA proposal is to either reduce the rent or terminate the lease, it is binding on all unsecured creditors and, therefore, if approved, the landlord will have to accept the new terms. In the context of rent, this would include all rent in arrears, and also the tenant's liability for all other sums that are due or that will become due under the lease (*i.e.*, future rent) *Re Cancol [1995] BCC 1133*. In determining the future rent, the current standard practice is to provide an estimate of the market value, and in coming to this calculation, certain assumptions can be made about when the next break clause is, and the timing and likelihood of the landlord re-letting the property.

With respect to contingent liabilities, the accepted view is that contingent creditors are also subject to the CVA and, therefore, the contingent liability would form part of the debt pool to which the votes may be cast.

Rental Guarantees and Rent Deposits

It is important for landlords, when taking rental guarantees and deposits, to consider the implications of these instruments if the tenant undergoes a CVA. A rental guarantee is usually given by a parent of a tenant to guarantee the rent payment for a certain period of time. Since the underlying liability (otherwise known as the principal debt) of the tenant's obligations to pay rent may be changed under an approved CVA, the guarantor may be released from the guarantee as the guaranteed obligation has changed. Therefore, a rental guarantee needs to be drafted carefully so as to ensure it is unaffected by the compromise of the principal debt, and therefore not affected by the terms of the CVA.

With respect to rental deposits, depending on how the guarantee is drafted and constructed, rental deposits can be seen as security for the rent in favour of the landlord. Given that the secured creditor's debt is not affected by the CVA, it is worth structuring in a way to ensure it is considered security and therefore not easily altered by a CVA.

Challenges by Landlords

Once a CVA is approved by the requisite majority of creditors, a creditor may only challenge the CVA on grounds of (i) unfair prejudice or (ii) material irregularity.

Whether the CVA is unfairly prejudicial is a question of fact, and it depends, firstly, whether the proposal is prejudicial to certain creditors, and, secondly, whether such prejudice is also unfair. In determining this, the courts would look at the following:

- whether the creditor in question is treated less favourably than other creditors in a similar position without justification;
- whether the creditor is in a worse position under the CVA than if the Company went into administration or liquidation.

For example, a CVA which implemented compensation for landlords of premises that had to be discarded (and therefore leases terminated) but retained full rent for some landlords whose premises continued was held to be prejudicial, but it was not unfair. *Re Cancol Ltd [1995] B.C.C. 1133.*

The Position for Lenders

For lenders who have provided property financing with respect to retail properties, issues arising with respect to the underlying retail tenants (depending on the size of the lease as a proportion to the overall rental income) may be a material concern, as this ultimately affects the ability of the borrower to meet ongoing financial covenants and, ultimately, debt service. The usual position in a loan agreement puts the focus on the Borrower/Obligors by looking at their solvency and also the financial performance of the Obligors as a whole with respect to financial covenants, such as debt yield, which more or less puts an assumption that the rental income agreed in the leases will be honoured by the tenants and legally enforceable. Loan agreements rarely have a direct link to the financial capability and financial performance of the underlying tenants. A well-constructed loan agreement which has a focus on major tenants would include robust information reporting, which requires the Borrower to notify the Lender of material changes regarding certain “key tenants” to the lender, and any insolvency or similar action (such as initiation of a CVA) may trigger draw stop and/or event of default. Given the change in the retail industry and the increasing trend for retailers to adopt CVAs, it may in turn change the traditional property financing terms for lenders who provide financing in the industry. This may be the inclusion of additional early warning triggers such as changes to the financial covenant thresholds, increasing the need to have buffers, increase in reporting, and perhaps even a closer examination of the underlying financial condition of the tenants (such as reviewing their financial performance and tightening of rent collateral required for material leases).