ISSUE 124

TECHNICAL BULLETIN

The Current State of Retail CVAs

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THE CURRENT STATE OF RETAIL CVAS

In May, Mr Justice Zacaroli handed down two judgments in challenges to retail Company Voluntary Arrangements ('CVA') which were intended by the applicant landlords to halt what was felt to be the increasing march of retailers to restructuring their businesses at the expense of commercial landlords. Landlords had wanted the Court to look at retail CVAs and identify the unfairness or irregularities in them, thereby reducing their appeal or extent. However, what the judgments have done, arguably, is to reinforce the applicability and utility of CVAs for retailers and given companies using them significant latitude when dealing with landlords and lease liabilities.

The challenges to the CVAs in New Look Retailers Ltd and Regis UK Ltd had significant overlap in terms of the objections raised by the landlords and together now provide a clear and helpful analysis of the limits of retail CVAs and the approach of the Courts to issues of unfair prejudice and material irregularity.

New Look Retailers Ltd ('New Look')

In the New Look challenge, the landlords attacked the CVA on two bases -

1. a jurisdictional complaint that CVAs of this nature (where creditors, particularly landlords, are separated into numerous categories and treated differently due to their value to the company) were not anticipated by government when it created CVAs in the mid-1980s and do not fall within the provisions of section 1 of the Insolvency Act 1986 ("**IA 1986**"); and

2. the terms of the CVA and the way in which votes were calculated and cast created unfair prejudice or material unfairness.

The jurisdictional arguments can be summarised as –

1. an assertion that a CVA which treats creditors differently is, in fact, numerous separate arrangements with each class of creditor and not one arrangement as required by section 1 of IA 1986;

2. there was insufficient 'give and take' to amount to an arrangement; and

3. rights given to New Look in the CVA improperly sought to interfere with the proprietary rights of the landlords concerned. Each of these arguments was dismissed by Zacaroli J.

As to the 'multiple arrangements' point, the Judge did not accept the landlords' position that 'arrangement' for the purposes of section1 of IA 1986 meant the same thing as 'arrangement' within section 895 of Companies Act 2006. A CVA is not, therefore, limited to "an arrangement in which the rights of all creditors are such that they can consult together with a view to their common interest". Indeed, section 4 of IA 1986 acknowledges that a CVA may involve different treatment of secured and preferential creditors. Further, CVAs may legitimately provide for different treatment of unsecured creditors, indeed when CVAs were created, it marked an important change from traditional insolvency regimes by, in part, expressly providing for the potential for differential treatment whilst requiring all creditors to vote as one class.

Whilst the Judge recognised that 'give and take' was a necessary requirement of a CVA, the suggestion that the CVA did not have sufficient 'give' from the company was rejected. The CVA provided rights to the landlords at least as advantageous as those they would have in the relevant comparator which is sufficient. As to the termination rights argument, the judge dismissed this swiftly in circumstances where whilst the CVA took rent on some lease to nil, this was not the same as requiring the landlord to surrender the lease and, as such, was not an interference with the landlord's proprietary rights as claimed.

As to unfairness, the landlords complained about –

1. modifications to leases, particularly rent;

2. the differential treatment amongst creditors and

3. the fact that the CVA was approved using votes of unimpaired creditors.

The Judge dismissed these complaints in their entirety. As a matter of principle, he rejected the suggestion that CVAs could not reduce future rent (as Norris J had done in the Debenhams CVA challenge). Further, he held that there was no bottom line for rent reductions of 'market rent', fairness in respect of the level of rent imposed by a CVA would be a question to be determined having regard to all the circumstances. Further still, he rejected the landlords' suggestion that a CVA could only interfere with a landlord's rights to the minimum extent necessary to achieve the objectives of the CVA. This was simply no part of the test to be applied. Significantly, Zacaroli J addressed the complaints that modifications to leases were unfair by confirming that so long as landlords were provided with termination rights which were as beneficial as the relevant insolvency comparator, that was sufficient to address any perceived unfair modifications. Landlords were being offered a choice as to whether to terminate and accept better than would be on offer in the comparator insolvency or continue the lease on the modified terms offered. Such a choice was not unfair. As to arguments that termination meant foregoing future rent, the Judge observed that the reason that landlords would not receive future rent was due to New Look's inability to pay it and not simply as a result of terms of the CVA.

As for differential treatment amongst creditors, this was justified in the New Look CVA and, as such, not unfairly prejudicial. It is not inherently unfair if a CVA is approved using the votes of unimpaired creditors and creditors receiving differential treatment, but if the majority is achieved by the votes of unimpaired creditors this will be a highly relevant factor in determining whether there is unfair prejudice, and it will not be enough that the vertical comparator is met and differential treatment is justified, the extent of 'vote swamping' will be relevant. In New Look the approval of the CVA by the votes of unimpaired creditors was found not to be unfair in circumstances where the creditors concerned had released some of their security to allow unsecured creditors, including the landlords, to receive a distribution and were treated differently precisely because they were secured and, as such, had different rights.

The material irregularity challenge focussed on alleged non-disclosure and the 25% discount on the landlords' votes which, it was said, fettered the nominees' duty to put an estimated minimum value on the claims; involved an element of double counting in that the formula for calculating the value of the votes from landlords already contained a deduction to reflect re-letting possibilities; was a 'one-way bet' as it did not make provision for the prospect of the formula used resulting in an under-estimate of the landlords' claims; was arbitrary; and was unfair as no similar discount was applied to other, non-landlord creditors' votes.

The voting complaint was addressed very simply by the Judge – where the discount applied to all landlords (those who voted for and those who voted against), it made no material difference to the outcome of the vote and, as such, could not be said to be a material irregularity. In addition, it was important to have in mind that the nominees' role was to put an estimated minimum value on votes and, as such, a 25% discount for uncertainty was not irregular. Finally, there was simply no basis to apply the same discount to non-landlord creditors.

As for the disclosure point, the Judge accepted that a CVA must comply with the statutory disclosure requirements within the Insolvency Rules (England and Wales) 2016 but must also provide creditors with sufficient information for them to make a reasonable judgment on whether to approve the CVA. What amounts to sufficient information will be fact specific. The Judge considered the complaints of the landlords but concluded that had the information been disclosed, it was not likely to have had any difference to the creditors' assessment of the proposal and, as such, was not material.

Regis UK Ltd ('Regis')

In the Regis CVA challenge, the jurisdictional point was not raised (having been the subject of a previous failed application by the landlords to amend their claim to include such a complaint). Instead, this challenge focussed on

1. an alleged failure to adequately disclose to creditors details of certain transactions entered into by the Company in 2017 and 2018 which might have been subject to possible challenge by a liquidator or administrator;

2. the alleged inaccuracy of the Statement of Affairs and/or Estimated Outcome Statement in

    (i) wrongly treating debts to two creditors and a debenture granted in favour of one of the creditors as valid;

    (ii) wrongly identifying a shut-down administration as the realistic alternative to a CVA; and

    (iii) failing to include any value for recoveries in respect of possible Antecedent Transactions.

3. the admission for voting of two creditors of the Company whose debts were challenged as being unlawful distributions, unlawful returns of capital or arising from transactions which amounted to a breach of duty on the part of the Company's directors;

4. unfair modifications to leases; the inappropriate application of a 75% discount to the landlords claims for voting purposes; and

5. allegedly incorrect treatment of two creditors as being critical creditors.

The modifications to leases complaint was rejected for the reasons set out by the Judge in the New Look challenge. In addition, the Judge identified that the failure by the landlords to adduce expert evidence of market rent prevented a finding that the modifications took the rent below market rent and rejected the landlords' assertion that the 90-day termination window was insufficient so as to undermine the fairness of the termination option.

Zacaroli J dismissed the landlords' criticisms of the disclosure within the CVA proposal of possible antecedent transactions in 2017 and 2018 involving the company. The 2017 claims were not sustainable given the company's solvency at that time; any further disclosure would have had to include disclosure that the claims lacked obvious merit. The purpose of requiring disclosure of such transactions was to inform creditors of claims which would be lost by virtue of a CVA. Here, the 2017 transactions did not give rise to sustainable claims. Further, whilst the specific sections of IA 1986 were not cross-referenced to the individual transactions, this was not required where the substance rather than the form of the disclosure was the key issue.

As for the 2018 transactions, the Judge determined that any failure to identify challenges under IA 1986 to these transactions did not amount to a material irregularity where the facts of the case presented a viable defence to such claims and therefore rendered the possible claims of doubtful merit, a matter which would have had to have been disclosed to the creditors. The Judge was also content that the CVA proposal provided sufficient disclosure as to the company's trading history and the various transactions to allow the creditors to form a view as to whether to support the proposal.

The Judge also dismissed the landlords' criticism of the Statement of Affairs and Estimated Outcome Statement. The nature of the allegations against the company's directors and the third parties and the lack of practical utility of the challenge to the CVA made it inappropriate to determine the validity of the debts owed to two creditors. Zacaroli J agreed with the nominees that a Statement of Affairs ought not to refer to antecedent transaction claims given that they are not assets of a company pre-CVA and concluded that in circumstances where neither insolvency expert witness considered that values could properly be attributed to such claims, the reference to the same in the Estimated Outcome Statement was not materially irregular.

The Judge preferred the conclusions of the nominees' expert, who supported the view taken by the nominees at the time, that a shut-down administration was the most realistic alternative to a CVA. In doing so, he rejected the landlords' suggestions.

> (i) that the subsequent administration (which, in any event, will almost certainly result in no distribution to unsecured creditors) was relevant;
>
> (ii) that the directors could or would have traded the business after rejection of the CVA;
>
> (iii) that a trading administration was possible (given the need for significant funding which was unlikely be obtained); and
>
> (iv) that the court ought to consider the realistic alternative to a CVA as if a marketing exercise had been carried out in parallel by the company in the build up to the creditors' vote when, in fact, no such exercise was undertaken.

Zacaroli J also dismissed the landlords' criticism of the 75% voting discount as being a material irregularity. Fundamentally, as was explained in New Look challenge, a voting discount that applied to all landlord creditors, even if irregular, had no impact on the outcome of the creditors meeting, as it applied to all voting landlords equally, and, as such, was not material. Further, whilst a blanket discount across all categories of landlord was not justified in this CVA and a 75% discount could not be justified by reference to similar treatment in previous retail CVA, given the lack of materiality, the landlords' complaints could not give rise to a material irregularity.

Zacaroli J dismissed the landlords' complaints that the single largest connected creditor had been wrongly treated as critical. The Company's basis for doing so was objectively justifiable and, as such, no unfair prejudice resulted.

However, the Judge considered that there was insufficient evidence to objectively justify treatment of a second creditor as critical, rendering the treatment of that creditor unfairly prejudicial to the remaining unsecured creditors. As a result, the Judge revoked the CVA. In addition, he considered that in recommending in the report that the CVA proposal be put to a meeting of creditors, the nominee's conduct, "in this one limited respect" fell below the standard required of a nominee, given the unfairly prejudicial treatment of the second creditor as a critical creditor.

Significantly, and somewhat unusually, the Regis challenge included allegations against the nominees for breach of duty (based on each and every complaint of the CVA more generally) and a claim for repayment by them of their fees upon revocation of the CVA. The Judge refused to make such an order, despite concluding the CVA ought to be revoked. He identified that it was not appropriate to make such an order in the absence of bad faith or fraud (which had not been alleged in this challenge) and in circumstances where the services provided by the nominees could not be (and were not) described as being without value. Only where the conduct of a nominee was "particularly egregious" would a court consider making an order that nominees repay their fees.

Whilst the challenge was therefore successful as against the company on one ground and led to revocation of the CVA, Zacaroli J has since confirmed in a supplemental judgment that as between the landlords and the nominees, the landlords had failed and the nominees had succeeded. As such, the landlords were ordered to pay a substantial proportion of the nominees' legal costs.

Conclusion

These decisions have established important guiding principles for CVAs:

1. CVAs dividing creditors into several classes, where impaired and unimpaired creditors vote together, are not outside of the scope of section 1 of IA 1986;

2. the vertical comparator remains significant, if landlords are given termination rights which are no worse than what they would receive in the relevant insolvency comparator, modifications to leases will not be unfair;

3. discounts applied to landlords' claims were not automatically unfair, whilst some (such as the 75% blanket discount employed in older retail CVAs) might be difficult to justify, given the obligation on nominees to estimate the minimum value of a claim, a discount was an appropriate way to achieve this and would not be materially irregular if applied to all landlords such as to have no impact on the outcome of the vote;

4. CVA proposals are required to disclose sufficient information to allow creditors to make a reasonable judgment on the proposals but unless likely to cause a change of voting, will not be materially irregular; and

5. whether directors of a company could or should have taken steps to put in place an alternative to a CVA does not impact on the assessment of the nominee of the most appropriate insolvency comparator which is to be assessed as at the point of the CVA failing.

In addition, these expensive challenges from the applicant landlords' point of view have arguably worsened the landlords' position going forward by

1. affirming that future rent can be reduced in a CVA;

2. confirming that there is no underlying principle that impairments to creditors (including modifications to leases) must be limited to the extent necessary to achieve the objectives of the CVA;

3. dismissing the suggestion that rent reductions must not be below market rent;

4. identifying that a reduction of rent to nil was not prohibited under a CVA and did not infringe on a landlord's proprietary right; and

5. allowing the continued use of discounted voting for landlords, reducing their voting power. All this is, of course, in addition to the finding that so long as landlords receive termination rights equivalent to their rights in an insolvency, companies are free to modify leases as they choose it seems.

All of this may change, of course, if the New Look challenge succeeds on appeal (permission having been granted by Zacaroli J to the landlords to appeal).

As for nominees, their position is a little clearer. The extent of their duty has not changed from previous decisions but unless their actions can be said to be particularly egregious, it is unlikely that they will be required to repay fees unless guilty of bad faith or fraud

The R3 Technical Team would like to thank Matthew Weaver, Barrister, Radcliffe Chambers, for this analysis on the current state of retail CVAs.

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