Client Alert | Financial Restructuring & Insolvency

CVAs: A 2018 Revival

January 2018

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With miserable Christmas trading figures exacerbating an already challenging climate for UK retailers, a growing number of companies are turning to company voluntary arrangements ("CVAs") as a possible source of respite. Most commonly used by retailers and other UK companies to impose improved lease terms on their landlords, CVAs look set to come back into fashion.

Market Backdrop

The exponential growth of online shopping, continued Brexit uncertainty and a drop in overall discretionary consumer spending[1] appear to be creating a perfect storm for "bricks and mortar" retailers. With the odd notable exception, the UK retail market remains a very difficult place to operate at present. Retailers are discovering that a number of their high street sites are simply no longer viable to operate; certainly not at current rents and lease terms. 2017 saw the first increase for 5 years in the number of UK retailers falling into administration, with the number of larger retailers in administration also up from the previous year[2].

Largescale CVAs for retailers have been relatively uncommon over the past few years, and retailers that have attempted them, such as BHS, have not always had a happy ending, But given current market conditions, and the fact that reduced footfall is requiring retailers to find ways of cutting costs in order to stay afloat, it will be important for distressed companies, investors and landlords all to remind themselves about CVAs, how they operate, and their impact on stakeholders.

CVAs – a Refresher

A CVA is a compromise or arrangement between a company and its creditors, given effect under the Insolvency Act 1986. Although not the most common restructuring tool in the UK, they are often considered when a company has a large number of lease liabilities which it needs to restructure.

CVAs are voted on and bind all unsecured creditors of a company (with the exception of secured creditors who do not consent). They are supervised by an insolvency practitioner, but there are no costly court hearings (as are required by a scheme of arrangement), and the CVA is seen as more "acceptable" by many (although perhaps not by landlords) than a formal administration or liquidation process.

The directors of the company, along with their advisers, will draw up a proposal for the restructuring to be given effect by the CVA (commonly a resetting of lease terms), by reference to independent valuation evidence so as to ensure fairness. All creditors then vote together to elect to approve or reject the proposal – there is no concept of different "classes of creditors", as there is in a scheme of arrangement. However, different groups of creditors can be treated differently under a CVA. Often, CVAs will categorise creditors, such as landlords, into several different groups.

[1] British Retail Consortium-KPMG Retail Sales Monitor figures recorded a decline in non-food retail sales of 2.1% over the 12 months to October 2017.

[2] The Telegraph, 8 January 2018: "Retail casualties rise for the first time in five years".

Different Treatment

There is no hard and fast rule as to how creditors must be treated in a CVA, and each proposal will be tailored to the specific needs of the company in question. But based on recent practice, landlords and leases are commonly split into 3 different categories under a CVA. At its most straightforward, the category split could look like this:

- Group A – profitable stores – leases left intact, at current rents, or subject only to minor amendment.
- Group B – marginal stores – have substantial renegotiation of the leases, including sizeable rent reductions.
- Group C – unprofitable stores – these will be closed, and the premised returned to the landlords, albeit preferably with some agreement in terms of compensation/retention of rent by the landlords.

A structure along these lines, with a "green/amber/red" approach to the lease portfolio, is contemplated under the CVA currently awaiting approval by the creditors of Byron Hamburgers Limited ("Byron"). As part of a proposed restructuring to facilitate new investment in the Byron business, the 76 leasehold sites occupied by Byron have been split into 3 categories. The majority, 51, are Category 1 sites where the leases are proposed to be maintained at current rents. 5 Category 2 leases are considered viable, but at a reduced rent, with landlords taking a c.33% haircut. The final 20 Category 3 sites have a proposed 45% haircut, which is only guaranteed for 6 months. That 6 month period is intended to buy Byron time to agree a longer term outcome for any future trading of the Byron business from those leases.

CVA voting

Unlike for schemes of arrangement or voting among lenders and bondholders in capital restructurings, the company will not commonly seek to "lock up" or otherwise seek comfort from creditors that the voting threshold will be achieved before launching the CVA: the first landlords are likely to be aware of a proposal is when it is formally launched by the company.

In order for the CVA to be successful, it must be approved by a majority in number and 75% by value[3] of the creditors voting at the creditors' meeting to consider the CVA proposal. That approval binds all creditors of the company in the CVA. Provided that the company adheres to the terms of the CVA, the arrangements with landlords are amended to reflect the terms of the CVA, and there is no ability for landlords to forfeit leases or take proceedings against the company on the basis of the previous lease terms. Any other recourse that the landlord may have had, such as to a rent deposit or against a guarantor, is also subject to the terms of the CVA.

Although in the past it was common to hold physical meetings for creditors to vote on a CVA proposal, more recently (and particularly with recent legislative amendments to facilitate electronic voting) the practice tends to be for votes to be solicited by email or online, so that in practice the company is likely to know well in advance whether it is going to achieve the necessary thresholds.

Challenge to a CVA

Once approved by creditors, the only challenge to the CVA is an application to court within 28 days of the creditors' meeting on the basis of "unfair prejudice" or "material irregularity". Both types of challenge are rare. Material irregularity connotes some type of "procedural" error – e.g. no notice of the meeting having been given to a number of substantial creditors. It is not usually sufficient that a single creditor did not receive notice.

"Unfair prejudice" is the more substantive form of challenge, and, if a challenge is brought on this ground, the court will consider whether any creditor or group of creditors has been unfairly prejudiced by the CVA. It is a high threshold to meet, as courts are generally supportive of a restructuring that has been agreed by a requisite number of the company's creditors.

Courts will typically consider any unfair prejudice application by considering the CVA proposal on both a "horizontal" and "vertical" basis. "Horizontal" meaning that landlords must be treated fairly as amongst themselves (i.e. landlords with equivalent quality of leases should receive equivalent treatment), and "vertical" meaning that the landlords must receive a better return than they would have done if the company had immediately been placed in administration (intended to save a

[3] Note that this does not require an absolute majority of 75%; rather 75% of those who vote on the proposal. It should be noted also that, to the extent there are "connected" creditors – e.g. directors, shareholders, intra-group companies – an additional threshold must be met; 50% by value of the "unconnected" creditors voting on the CVA must also vote in favour.

business) or liquidation (the death knell for a company). Given the usual outcome for creditors on a retail insolvency, and provided the company and its advisers have taken care to establish a level playing field as between individual landlords, this should be relatively straightforward to achieve.

Parties contemplating a CVA should also be aware that all unsecured creditors receive a vote in the process, even if their own liabilities are not being restructured. So creditors such as HMRC and the Pension Protection Fund (the "**PPF**") need to be factored in to the voting: they may well have their own requirements (not necessarily purely commercial) that may form conditions to any support of the CVA.

Practical Examples

Travelodge

While Travelodge's restructuring took place back in 2012, it remains a relevant example of a "good" CVA, which attracted overwhelming support from creditors, and has been in used in part as a template for more recent examples.

3 inter-connected CVAs allowed Travelodge to exit unviable leases and achieve rent reductions on marginal sites. 97% of CVA creditors, including 96% of landlords voted in favour. The liquidation analysis on Travelodge showed a return to creditors of 23.4p in the £ in the CVA, as against a likely 0.2p in the £ in an administration or liquidation.

Some of the tools that Travelodge used to get such a substantial level of support from its landlords were:

- A "clawback" clause which allowed the landlords to share in the business restructuring if it was successful and Travelodge returned to profitability (which it did)
- An assurance that Travelodge would pay business rates on exited leases until replacement occupiers were found
- An option for landlords to extend their lease terms (which has not previously been offered in a CVA)

Toys "R" Us

A more recent example is the CVA implemented by the Toys "R" Us' UK business in December 2017, following the US business entering US Chapter 11 proceedings in the months prior. This CVA was again approved with overwhelming creditor support (around 98% across all creditors, including landlords).

The Toys "R" Us CVA was designed to implement a wholesale right-sizing of the UK business, by way of rent reductions and/or reducing the size of the Toys "R" Us store footprints under a number of its leases, and the termination of leases of heavily loss-making stores. The valuation analysis run by the company's financial advisers showed a return in a CVA for landlords having rents reduced of between 76.2p and 91.3p in the £ (9.4p in the £ for the terminated lease landlords), compared to between 6.8p and 12p in the £ (and 3.8p in the £ for terminated landlords) in administration.

Similar to the Travelodge CVA, Toys "R" Us provided for a "compromised lease fund" whereby compromised landlords will receive a return reflecting any upside in the three years following approval of the CVA.

As was widely reported in the press ahead of the CVA being approved, the PPF – which potentially held a blocking voting stake in the CVA – raised certain last-minute objections to the CVA on the basis of Toys "R" Us' pension fund deficit. Last-minute negotiations and certain longer-term concessions by Toys "R" Us (to address the deficit) eventually led to the PPF voting in favour and the CVA being approved.

Conclusion

Although a CVA will not be relevant in all circumstances, UK retailers in particular, as well as other UK businesses with large lease portfolios such as hotel businesses and car park operators, may well be advised to consider a CVA as a potential option to right-size their leases and help with liquidity and overall profitability. Already in 2018 Byron has launched a CVA, and there is increasing speculation that large retailers such as House of Fraser and New Look may follow suit.

Corporates, landlords and lenders could all benefit from taking a look at their own businesses and customers and consider whether a CVA may be a potential solution (for a company) or a potential problem (for a landlord).

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