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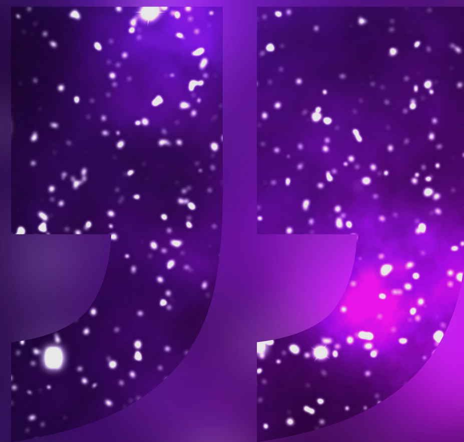

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DEATH ON THE HIGH STREET? THE IMPACT OF CVAS

UK retail is in crisis with many high street brands struggling for survival. Increasing numbers are turning to company voluntary arrangements (CVAs) in a bid to restructure their store rental obligations and save their businesses. But has the pendulum swung too far in favour of retailers? Here Clifford Chance experts explore what lies ahead for landlords, their lenders and the future of retail.

The UK retail sector has hit a perfect storm – almost 2,500 shops, banks and chain restaurants disappeared from the top 500 high streets in 2018, and major retailers such as Marks & Spencer have announced store closures and an end to expansion plans. Much of that retail and banking business has shifted online. Internet shopping now accounts for over 20 per cent of all retail sales and grew at ten times the rate of store sales during 2018. This has led to deep discounting and reduced footfall. Partner Iain White says: "This, coupled with increases in the minimum wage, upward only rental reviews, rising business rates, unfavourable exchange rates, and uncertainty about Brexit and its impact on tariffs, movement of goods and consumer spending, suggests that weaker retailers are going to struggle to survive at least in their current state – and I think 'in their current state' is quite an important caveat here."

Figures from the Centre for Retail Research indicate that the number of retailers entering into administration has risen by 30 per cent since 2015, and a growing number of retailers are now turning to the CVA in a bid to renegotiate with creditors. These include Homebase, Mothercare, Carpetright and New Look. CVAs are increasingly controversial, as Iain White explains: "On the face it, the CVA seems to tick all of the boxes – it can be developed quickly, it can be used to target very specific liabilities such as unsustainable rents, it's flexible enough to do different deals with different creditors and it prevents one disgruntled creditor from holding up a restructuring which would be supported by the majority. Used in the right circumstances they can be a critically important rescue tool. Unfortunately, the CVA is gaining the same sort of reputation as administration pre-packs did a few years ago, with suggestions that it is being used in inappropriate ways."

CVAs may, potentially, be good news for retailers but they create uncertainty in the property market. Properties are often difficult to value with the spectre of CVAs, which has an effect on the ability of landlords to raise finance or sell (and drag values down even further). The question is, though, whether it is CVAs or the wider market that is the problem.

The impact of CVAs on landlords

In December 2018, a group of landlords, including Hammerson and British Land, filed a legal challenge contesting a CVA on the basis of unfair prejudice. It involves the hair-salon chain Regis (which also includes the Supercuts brand). Regis has 223 salons and is seeking rent reductions of between 25 per cent and 100 per cent at 110 sites. "We see more of these challenges coming," says Iain White. "The noise is certainly growing within the landlord community and, as the Regis case demonstrates, the large institutional landlords are right at the heart of the debate."

Jeanette Best, a Senior Associate in Clifford Chance's Restructuring and Insolvency group, says that CVAs are disliked by landlords because "they are often seen as singling out landlords and can be voted through by other unsecured creditors whose terms are left unaffected by the proposal." She adds that the situation is exacerbated because for voting purposes, the value of landlords' claims is often discounted by as much as 75 per cent, which has now become the market standard.

"What recourse do landlords have? They can challenge the CVA, but that is an inherently expensive and uncertain tool, particularly in circumstances where, if the CVA is successfully challenged, insolvency may be the only alternative

and landlords will end up recovering less of what they are owed," she says.

The CVA legislation does spell out what a proposal should contain, but a CVA that targets landlords typically splits leasehold properties into three categories depending on the perceived quality of that property from the retailer's perspective:

- Category 1 – leases that are not going to be affected by the CVA. These are leases of stores in popular locations. If a retailer proposes to compromise the terms of that lease, the landlord might decide, 'I've got a list of 15 people who are willing to pay me what you originally agreed to pay me, perhaps more, and so I'm simply not going to put up with it.'
- Category 2 – leases where the retailer has determined that the market rent – which might have been set many years before – is no longer sustainable for the retailer and should be discounted on some basis.
- Category 3 – leases which the retailer does not think are worthwhile and which will not enable it to a turn a profit.

"It's fair to say that there is a growing unease in the property industry about the use of CVAs," says Real Estate Partner, Ian Painter. "There's a feeling amongst landlords that CVAs allow a tenant to try to rescue its business at the expense of the landlord's business. These leases were entered into between two willing parties in good faith, and there's an argument that unwinding them in this way undermines the UK legal system and the historic tradition of the sanctity of contract. Very often the leases being targeted by CVAs were just bad business decisions on the tenant's part."

He adds that retail tenants will often benefit from the security of tenure provisions of the Landlord & Tenant Act 1954, meaning that when they reach the end of the lease they can, if they wish, take a new lease and the landlord can only object on limited grounds. "The landlord is generally locked in but, if a store is underperforming, a tenant can use a CVA and has the ability to effectively rip up the lease or pay a reduced rent. It does feel very much like a one-way street in favour of tenants," he says.

He also notes that when landlords enter into leases with retail tenants, they will often provide incentives up-front such as a rent-free period, a financial payment, or a contribution to fit-out. None of these are taken into account in the CVA proposal, which typically focuses solely on future rental obligations, and so none of this money comes back to the landlord if a CVA is implemented.

Jeanette Best says that another common complaint from landlords is that CVAs are proposed and agreed without proper involvement and engagement from landlords. There is a perceived lack of transparency that manifests itself in two ways: one is the quality of the information that the landlords receive and secondly, when they receive it. "It's not always obvious to a landlord why a store will require a rent reduction or why it is earmarked for closure when a store down the road on similar terms and in a similar catchment area is fine. Big institutional landlords can sometimes push for that information but smaller landlords struggle," she says. And she adds that in terms of timing, "landlords are normally fairly late to the party." Whilst bondholders and secured lenders have often been involved in restructuring discussions for some months prior to the CVA being launched and have had access to more information, "landlords get hit with a proposal and have fourteen days to say yes or no with little information."

Landlords also argue that they get inadequate information about how the retailer expects the business to perform following the proposed restructuring. "They typically receive limited information about the new business plan and future viability, which makes it very difficult to properly assess the CVA," says Best.

The British Property Federation (BPF), the trade body that represents UK landlords, has called on the government to conduct an urgent review into the abuse of CVAs. It claims that CVAs have moved from being a legitimate restructuring tool, to something that is used solely to reduce rental liabilities and terminate lease agreements. Its view is that CVAs risk undermining the UK's reputation as a safe haven for real estate investments and also deter much-needed investment in the UK's high streets.

The impact of CVAs on property lenders

Andrew Carnegie says that property lenders can be in an even more difficult position than landlords regarding CVAs. “The property lender is a further step removed, has no ability to control anything, may not have been told what is going on and the loan documentation will probably not even refer to information about CVAs.”

He adds that the property lender is “worried about the value of the asset, particularly if an anchor tenant has a CVA, worried about cash flow, worried about whether the loan will be repaid and worried about alternative use.”

Do CVAs offer any advantages?

Jeanette Best is keen to highlight that a CVA is flexible, can be implemented relatively quickly and can be cheaper than other forms of restructuring, because there’s limited court involvement. In some circumstances, a CVA can be the difference between enabling a company to continue trading and the start of a significantly more destructive insolvency process.

Some CVAs have proven successful. Budget hotel chain Travelodge, for example, entered into a CVA in 2012 that involved the closure of 49 of its 500 hotels and a rent reduction on 109. Travelodge recovered and is planning to open 100 new hotels by 2024. However, a number of retailers that have entered into a CVA subsequently go into administration, for example, JJB Sports, which arranged two CVAs before collapsing with debts of £150 million to suppliers and landlords in 2012.

“A CVA is not going to fix a fundamentally flawed business model,” says Jeanette Best. “It’s supposed to be a tool to help restructuring but if the business model is flawed or you’re in an industry facing significant challenges such as retail, then it is not a magic bullet.”

Iain White agrees and believes that perhaps the answer lies in “more holistic solutions which involve both a CVA and steps to right-size the retailer’s balance sheet, rather than the sequential approach we have seen in recent years.”

What’s next?

“Landlords are in a difficult position,” says Iain White. “CVAs are a statutory process so there is no ability for a landlord to contract out, and if they vote against them, then the tenant may go into administration or collapse and then they get even less. The House of Fraser collapse demonstrates that landlords also have to be very conscious of the reputational and PR impact of not supporting a CVA intended to rescue an ailing business.”

One alternative is, if the lease allows it, for the landlord to forfeit that lease when a CVA is proposed. However, as Ian Painter points out, it takes a brave landlord to do it. “You end up taking your space back, so you have void costs, you have to find a new tenant and you have to pay business rates in the meantime.”

Another recourse is a legal challenge on the basis of unfair prejudice (such as Hammerson and British Land’s case against Regis) or material irregularity. “Pretty much all CVAs have some form of prejudice but the question is, is that prejudice unfair to a particular party?” says Jeanette Best. “There is some guidance as to what might constitute an unfair prejudice by reference to what is called the horizontal and vertical test; the vertical test is where you look at what that same creditor might have received on a winding-up and compare it with what is being proposed under the CVA – in broad terms – if the proposal under the CVA is going to give that creditor less than it would receive in a winding-up that is unfair prejudice,” she says. A horizontal basis looks at how some creditors are treated vis-à-vis other creditors. “The mere existence of a differential treatment between creditors is not enough to give rise to an unfair prejudice claim, particularly if there are reasons why you can justify that difference in treatment – for example, the location of properties,” she adds.

The alternative is to bring a challenge based on material irregularity. For example, in July 2018, a group of landlords filed a legal challenge to House of Fraser’s CVA, arguing that the company didn’t list all of the costs that would be applicable in the CVA versus an

insolvency. However, a legal challenge can be expensive and, without a CVA, the retailer may collapse.

Andrew Carnegie says that, in the future, we may see a more collaborative approach between landlords and tenants: "There may be a move towards turnover rents and to landlords not relying as much on a long lease and rent that goes up every five years. I think we are much more likely to see landlords and tenants working together so the landlord can manage the property more actively and that the leases are shorter. Interestingly, the stationery chain Paperchase launched a CVA in February this year, which links future rents to turnover as part of its restructuring plans."

And Ian Painter adds: "I think the rise of CVAs is damaging the trust between landlords and tenants. The terms that landlords are being offered are getting weaker and weaker with every CVA, and the ability of an unsecured creditor that is unaffected by the CVA to vote on the proposal needs to be reviewed."

He adds, "we're all hopeful that the Regis case will provide some much-needed guidance on what retailers can and cannot do."

The use of CVAs is not likely to end any time soon and their use is not limited to the retail sector. A growing number of "casual dining" restaurants including celebrity chef Jamie Oliver's Jamie's Italian, burger chain Byron, Giraffe, Ed's Easy Diner and Prezzo have used CVAs as the sector faces an increasingly tough market. Ian Painter says: "In theory, with any business that is real estate-heavy such as care homes, hospitality, student accommodation and serviced offices, there is the possibility of using the CVA as a restructuring tool." And Andrew Carnegie adds: "The high street is very challenging and that poses problems for all of us as citizens. The high street is the focus of towns and cities across the UK and retail employs over three million people. I think a big responsibility now falls on local authorities and central government."

What is a CVA?

A CVA is an arrangement under the Insolvency Act 1986 between a company and its unsecured creditors, under which it agrees to pay back its debts over a set period. CVAs were introduced in 1985 after a long and in-depth review of British insolvency law and practice, and were intended to be simpler than the alternative restructuring arrangement that was available at the time.

How does it work?

- In order for a CVA to be approved and to become effective, it must be approved by 75 per cent by value of the creditors who vote. In turn, they must constitute a majority of the creditors who are unconnected to the company.
- It must also be approved by a majority by value of the company's shareholders but, if it is not, the creditors' vote will prevail.
- There is no requirement to divide creditors into classes. All creditors vote together as one, similarly to shareholders.
- There is no requirement for a majority in number of creditors to support the CVA, the 75% by value test is sufficient.
- Once the proposal has been approved at the creditors' meeting and provided there is no challenge, the CVA will be effective against all unsecured creditors including those who voted against it and including those who didn't vote in respect of it at all.
- Any challenge to the CVA needs to be brought within 28 days of the CVA becoming effective before the court, or, if later, the aggrieved creditor becoming aware of its effectiveness.
- CVAs may be proposed by directors of the company but may also be proposed by an administrator or a liquidator if the company is in an insolvency process.
- A CVA will be supervised by an independent third party and nominee, who must be a licensed insolvency practitioner.

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