

A nightmare on the high street - challenges for landlords when a retailer enters into a CVA - Part 2

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The second part of our report considers the recent challenge made by some landlords to the Debenhams' company voluntary arrangement (CVA) that was approved by creditors in May 2019. Here we set out key issues that landlords should consider in deciding whether or not to challenge a CVA, an issue likely to rear its head again with the recent announcement of Mothercare entering administration following its earlier CVA.

CVAs

CVAs allow for viable companies in financial difficulty to agree with their creditors to repay a portion of their debt over a period of time. They are intended to provide a contractual facility through which a company can restructure its liabilities, allowing it to continue to trade for the benefit of the creditors as a whole. It is the directors of a company that propose a CVA and once proposed it must be approved by at least 75% of the company's unsecured creditors.

Are they effective?

The collapse of Debenhams has once again thrown the spotlight onto CVAs and with it, many retail landlords raising concerns over their use and the potentially detrimental impact they can have to them. This is particularly so in circumstances where landlords see the level of rent payable to them during the CVA's lifetime being eroded, whilst other unsecured creditors such as suppliers and employees (who are seen as 'key creditors') are paid in full during the life of the CVA.

The effectiveness of CVAs was considered in a recent research report commissioned by the insolvency and restructuring trade body (R3), with the support of the Institute of Chartered Accountants in England and Wales (ICAEW). This report was conducted by the University of Wolverhampton and their findings indicated that in 552 CVAs in England and Wales entered into during 2013 that they analysed, a whopping 65.2% were terminated without achieving their intended aims.

The report concluded that CVAs biggest strength is its flexibility but noted that improvements were needed and as such provided for several recommendations, including capping CVAs at three years, and introducing both pre-insolvency moratoriums and standard terms and conditions. The statistics for failure for the 2013 CVAs referred to in the report certainly appears to endorse the need for the CVA as a procedure to be overhauled going forward if it is to be maintained as a viable option for companies in financial difficulties. CVAs are often approved on the basis that they purport to offer better returns for unsecured creditors than comparable outcomes via administration or liquidation. However, if the rate of their failure is realistically around 65%, unsecured creditors may need to consider if that approach to approving them is sound, given that failure will most likely result in administration or liquidation in any event.

How and why to challenge CVAs

If landlords consider that their position as unsecured creditors is being prejudiced, unfairly, over and above the general body of unsecured creditors by way of a proposed CVA, there are routes for challenging a CVA even following its approval. If such challenge is successful, the court may (amongst other things) revoke or suspend any decision approving the CVA, give a direction for the summoning of a further meeting to consider any revised CVA proposal.

The Insolvency Act 1986 provides a route for challenging CVAs on the basis that:

- It unfairly prejudices the interests of a creditor, member or contributory of the company/
- There has been some material irregularity at, or, in relation to the meeting of the company, or the decision procedure pursuant to which the CVA was approved.

Case Study: *Discovery (Northampton) Ltd v Debenhams Retail Ltd [19.09.19]*

On 19 September 2019 the High Court substantially rejected a challenge against Debenhams' CVA brought by six landlords and funded by Sports Direct. The decision provides landlords with some judicial insight into the issue of unfair prejudice, in that the court did not on the facts of this case, consider that there was unfair prejudice where landlords were still being paid market rent (if not contractual rent) for the leases under the CVA terms.

The decision helpfully clarifies for landlords that their rights of re-entry cannot be altered by the terms of a CVA proposal. It remains to be seen in light of this element of the decision whether this will lead to fresh applications being made for existing CVAs to be varied where they purport to infringe or exclude such landlord rights.

Background

The landlords had participated in a 'sale and leaseback' transaction in 2010 as part of which they granted shop leases to Debenhams. The leases all had 30-year terms with automatically escalating rent for the first 10 years of the term and thereafter the rent to be reviewed on an 'upwards-only' basis for five-yearly intervals.

Debenhams' directors proposed the CVA to address what they considered unsustainable property costs associated with certain stores, by compromising future liabilities for rent and business rates. The CVA was approved at a creditors' meeting on 9 May 2019 by 94.71% of the company's creditors. Of the landlords who voted on the CVA, 82.1% by value voted in favour of it.

The main effects of the CVA on the leases were (amongst others):

- To reduce the rent payable under the leases for the Rent Concession Period.
- To prevent the landlords from exercising any forfeiture rights triggered by the CVA.
- To release Debenhams from any liability under dilapidations claims.
- For some leases to grant the landlord and Debenhams a mutual right to terminate on the second, third, fourth or fifth anniversary of the Next Payment Date, subject to 90 days' prior written notice (Mutual Break Right).
- For other leases to foreshorten the term of the lease.

The challenge

Six of the landlords did not vote in favour of the CVA and instead issued an application to set aside the CVA, based on five allegations:

1. The landlords were not 'creditors' for future rent and as such the CVA could not bind landlords.
2. Reducing the rent payable the CVA is unfairly prejudicial to the landlords, or, the attempt to do so has the effect of changing the terms of the leases.
3. In removing the landlords right to forfeit arising as a result of the CVA abrogates the landlords' proprietary rights.
4. The landlords were treated less favourably than other unsecured creditors without any proper justification.
5. Claims that might be available to Debenhams in administration/liquidation were not disclosed in the CVA - that non-disclosure being a material irregularity.

Decision

In rejecting four of the grounds brought by the landlords, Mr Justice Norris confirmed that:

- Creditors must be given a wide meaning and the term 'debt' extends well beyond one that is so called - Ground 1.
- The flexibility of CVAs means that rents can be reduced without it automatically being unfair - Ground 2.
- Evidence given suggested that all leases were over-rented when compared to current market rents. (That evidence was unchallenged) - Ground 4.
- The court found that there was no material on which to conclude that the prospect of a modest recovery from the claims identified would have resulted in a different result on voting for the CVA - Ground 5.

The challenge to Ground 3 was accepted in that each of the landlords' leases contained a provision entitling them to re-enter in the event that Debenhams entered into a composition with its creditors. However, the CVA purported to prevent any landlord from exercising such a right. The judge agreed that the landlords' right was a property right not capable of being affected by a CVA. As such, the CVA would be modified so that these rights of re-entry were not impacted upon but the CVA would

otherwise continue in the form as approved by creditors.

Lessons learned

Following this decision, if landlords wish to consider challenging a CVA, they should first answer the following questions:

- If landlords are being treated differently to other groups of creditors can such differential treatment be considered unfair or without justification? If so, you must secure valuation evidence in support of that.
- Are proposals being made to remove the landlords' right to forfeit as a CVA term? (similar to Ground 3 above)
- What would the estimated outcome be in alternative insolvency procedures (administration/liquidation)?

Comment

Overall, the judgment is disappointing for landlords despite the application succeeding on one ground. Although the landlords were successful on the removal of their rights to forfeit the leases, this was not enough to overturn the CVA. Instead, the court ordered that the specific provisions restricting the landlords' forfeiture rights be deleted. Subject to any appeal, the effect of this decision is that the Debenhams' CVA has not been overturned and will continue.

Interestingly, in the judgment, the court made the important point that there was no suggestion that the rent being paid to the landlords was being reduced to a level below the market rate. Further, the court was not persuaded that there was a substantial chance that the creditors would have voted differently on the CVA had it contained disclosure of further information relating to the potential for any administrator/liquidator to overturn security granted by Debenhams.

In the current climate, where it may be difficult for landlords to find a new tenant for retail premises, and given the associated costs of re-entering, re-marketing premises and entering into new lease terms with a new tenant, a CVA may still provide a better financial solution for landlords, especially compared to other insolvency procedures such as administration or liquidation. As can be seen from the Debenhams' case, the criteria for establishing a case of unfair prejudice or material irregularity to successfully challenge a CVA are onerous and such claims are not easily made out.

In light of this decision, Landlords may wish to review the terms of any CVAs, which they are currently bound by to ascertain whether any terms purport to remove a landlord's right of re-entry and seek to address any such CVA terms with the CVA Supervisor in the first instance. If payments terms for landlords, even as revised under the terms of a CVA, have been breached, it may be that a landlord's right of re-entry could still be effective, even if the CVA purports to remove that right.

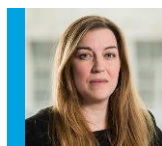
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KEY CONTACTS



Angela Bhaseen
Senior Associate
t +44 161 829 2598
angela.bhaseen@kennedyslaw.com



Laura Smith
Senior Associate
t +44 161 817 2860
laura.smith@kennedyslaw.com

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