November 2018

2018: The year of the CVA

2018 has seen a wave of company voluntary arrangements ("CVAs") hit the market, with high profile companies such as House of Fraser, Carpetright, New Look and Homebase (to name a few) all making use of this restructuring tool. This briefing note explains how a CVA works, provides an overview of current "market" themes, and makes some predictions on the future of CVAs.

EVOLUTION OF THE CVA

- A CVA is a statutory tool under the Insolvency Act 1986, which enables a company to agree a compromise arrangement with its unsecured creditors. A CVA is open to be voted on by all of the company's unsecured creditors. To be approved, of the creditors who vote on the CVA, 75% (in value) must vote in favour, which must include at least 50% (in value) of unconnected creditors. Once approved, the CVA will bind all of the company's unsecured creditors, irrespective of how or whether they voted.

- CVAs are very flexible procedures and can be used to compromise any unsecured debts of a company. However, the current trend in the market has been a sharp increase in the amount of "landlord-only" CVAs. These are CVAs which compromise a company's leasehold liabilities to its landlords (for example by allowing it to pay less rent, or return unprofitable sites), whilst generally leaving other creditors' claims untouched. This type of CVA has been used by companies with large or burdensome property portfolios – typically in the retail, leisure, and casual dining industries.

- The increase in landlord-only CVAs is probably due to a combination of factors. As widely-reported, many companies have been struggling against inflationary pressures, such as increases in the costs of supplies and employment, whilst watching customer footfall and spending decrease. Those companies with significant leasehold portfolios, also have to contend with increases in business rates and high rents (exacerbated by a history of upwards-only rent reviews) under long-term leases. If those lease terms cannot be renegotiated consensually, this perfect storm has led many companies to use a CVA to rationalise their real estate portfolios in order to save their businesses.

- Despite some criticism of CVAs within the real estate community, most recent CVAs have been approved with landlord support. Why would landlords agree to compromise their claims? This question is generally answered by the counterfactual. The CVA proposal will assert that, in the absence of a successful CVA, the company is likely to go into administration or liquidation. A CVA proposal should, therefore, give a better outcome for creditors than in an insolvency scenario. Well-crafted CVAs will provide fair compensation to landlords, calculated by reference to the current market value of their lease(s) and their likely recovery in an alternative insolvency. A CVA is also likely to be one part of a larger restructuring. Lenders and shareholders will be crucial. New funding maybe provided and/or existing facilities retained, but conditional upon a restructuring of the business through a CVA. A landlord will be more inclined to vote in favour of a CVA if other stakeholders are "sharing the pain". The company will need to demonstrate to landlords, and indeed its other stakeholders, that it has a viable business plan going forwards, and that it can comply with its revised leasehold obligations during and following the CVA.

CURRENT THEMES IN LANDLORD-ONLY CVAS

- **Categories of lease and differential treatment**

  The directors of the company will carry out a review of the company's real estate portfolio with their advisors to determine the historical and projected financial performance of each site (e.g. each store or restaurant). This data will be used to split each of the company's leasehold premises into different categories based on each site's financial performance and strategic importance. By way of example: Category A (performing sites); Category B (sites which are underperforming, but could be viable with reduced rent and/or increased capex); and Category C (underperforming sites which the company wishes to exit).

  The CVA will typically propose different treatments for each category. For instance, categories with underperforming sites will commonly have reduced rent payable, whereas categories with better performing sites are likely to be maintained at full rent (with perhaps a shift to monthly payment terms). There are also likely to be break rights afforded to the landlord and the company for the categories with underperforming sites, but not for the categories with performing sites.

- **Dilapidations**

  Dilapidations can be an unknown and potentially substantial liability. Many CVAs therefore compromise dilapidations liabilities for underperforming sites. It is common for a percentage of rent (often 5-10%) to be paid for a period in lieu of all dilapidations liabilities.

- **Business rates**

  Some recent CVAs have compromised the company's liability to pay business rates. As mentioned above, a CVA should produce a better outcome for creditors (in this case, the relevant local authorities) than the likely insolvency alternative. As a result, it is not possible to compromise future rates liabilities indefinitely. However, short periods of compromise have been proposed and accepted in certain CVAs.

- **Other creditors/arrears**

  If the company has larger arrears or amounts prospectively due to non-critical creditors which are having an impact on its financial performance, it may also seek to compromise these liabilities.

- **Upside fund**

  It is common for CVAs to provide for the establishment of an upside fund by the company, in which compromised landlords are entitled to share. These funds are generally intended either to ensure that the compromised landlords are put in a better position than in the alternative insolvency scenario, or otherwise to provide an incentive for the compromised landlords to support the CVA by offering them an opportunity to share in the successful turnaround of the business.

THE FUTURE OF THE CVA

- Whilst there has been some criticism of the growing number of CVAs, particularly from larger, institutional landlords who are seeing their returns fall as a result of them, it seems likely that, unless some of the structural issues in the retail and leisure sectors can be resolved soon, there will be more CVAs in the near future. CVAs could continue to be particularly prevalent in the consumer sectors of retail, leisure, and casual dining, being sectors where companies typically have large real estate portfolios and are increasingly experiencing a simultaneous rise in operating costs and a downfall in trading performance.

- The possibility of legal challenges to future CVAs should not be disregarded. Once a CVA has been approved by the requisite majority of creditors, there is a 28 day statutory challenge period which provides creditors with the opportunity to challenge the CVA as having unfairly prejudiced their interests and/or assert that there has been a material irregularity in relation to the creditors' decision. A number of larger landlords and stakeholders have been vocal about their concerns about the growing trend of landlord-only CVAs and their differential treatment in those CVAs. Whilst the House of Fraser CVA was challenged by a group of landlords, this challenge was settled before it reached a Court hearing. As a result, potential points of issue remain which have not yet been determined by the Courts.

- There have been calls for legislative change. The insolvency and restructuring trade body R3 has also published research this year in support of reforms to improve the effectiveness of CVAs. Given the current pressures on parliamentary time, it seems unlikely that reform in this area will occur in the near future. In the meantime, well-advised companies will ensure that they engage fully and early with landlords and other stakeholders to ensure that CVA proposals are transparent and that their purpose and benefits are fully articulated.

Travers Smith has extensive experience advising on CVAs and has acted on many recent high profile matters including Carpetright, Carluccio's, House of Fraser, Gaucho and Powerleague Fives.

FOR FURTHER INFORMATION, PLEASE CONTACT

10 Snow Hill
London EC1A 2AL
T: +44 (0)20 7295 3000
F: +44 (0)20 7295 3500
www.traverssmith.com

Edward Smith
Partner, Restructuring & Insolvency

E: edward.smith@traverssmith.com
T: +44 (0)20 7295 3482

Peter Hughes
Partner, Restructuring & Insolvency

E: peter.hughes@traverssmith.com
T: +44 (0)20 7295 3377

Natalie Scoones
Senior Associate, Restructuring & Insolvency

E: natalie.scoones@traverssmith.com
T: +44 (0)20 7295 3356

Kirsty Emery
Associate, Restructuring & Insolvency

E: kirsty.emery@traverssmith.com
T: +44 (0)20 7295 3371