KIRKLAND & ELLIS
Kirkland Alert

Latest Retail CVA Technology: Foreign Leases, Business Rates and Turnover Rents in Focus

22 March 2019

At a Glance

2018 proved a record year for CVAs. Kirkland advised on the CVAs of Toys "R" Us, Prezzo, House of Fraser and Homebase in 2018 alone. We expect 2019 to follow a similar trend, based on the number of engagements already underway, including the approval of Paperchase's CVA on 22 March. This *Alert* provides an overview of the latest technology on retail CVAs.

Although CVAs are able to compromise all unsecured liabilities of a company, the recent wave of CVAs has largely been focused on rent obligations. Kirkland recently advised on the first large-scale CVA to compromise business rate liabilities and lease liabilities for certain non-UK properties. The CVA also compromised certain other legacy liabilities which have been left untouched by other major CVAs. We are also advising Paperchase on the first CVA of the current cycle involving a change to turnover rents.

We expect additional new CVA technology to develop in response to evolving market conditions and the needs of companies and their landlords.

Kirkland recently advised on the first large-scale CVA to compromise business rates.

Kirkland advised Homebase on a series of firsts in its recent CVA, placing the company in a stable position to focus on its turnaround. The CVA was approved with an overwhelming majority of more than 95 percent of creditors by value. Kirkland also advised Paperchase on its CVA, which was approved on 22 March 2019.

Kirkland has acted on a number of other leading CVAs over recent years including Prezzo, Toys ‘R’ Us, Tragus, House of Fraser, Travelodge, LA Fitness and Fitness First.

The Homebase and Paperchase CVAs are at the cutting edge of developments in the evolving CVA landscape.

Although CVAs are able to compromise all unsecured liabilities of a company, the recent wave of CVAs has largely been focused on rent obligations. The latest wave goes beyond this, compromising business rate liabilities and lease liabilities for certain non-UK properties, and certain other legacy liabilities which have been left untouched by other major CVAs. The Paperchase CVA utilises turnover rents to better align rents payable with the company's own cash generation. Here are the key takeaways:

1. Business Rates

- The Homebase CVA is the first large-scale CVA to compromise business rates.
- The latest Budget announced £900 million in business rates relief for small businesses; to qualify, business premises must have a rateable value of £51,000 or less. This means larger retailers will be excluded, even though the retail sector as a whole is struggling; the Budget does not address the underlying imbalance between brick-and-mortar retailers and online competitors. Pressure looks set to increase from April, as retailers will likely face a further business rates hike of more than £180 million (based on the latest consumer price index measure), making the ability to compromise rates within CVAs even more important.
- As business rates apply annually, a CVA can only compromise rates until the end of the current business rates year. Rates automatically return to their previous level

thereafter.

- Even this temporary respite offers distressed companies the potential to strengthen their financial position within a CVA. From a strategic point of view, a CVA launched at the start of the rates year (1 April) could capture a greater discount across the full 12 months invoiced.

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About business rates

- Business rates are charged on most non-domestic properties. Such rates are payable to the local council in which the relevant premises are located, under a legislative framework which differs from country to country (even within the UK).
- Rates are set based on the “rateable value” of the property, set by the Valuation Office Agency. A property’s rateable value represents the rent for which the property could have been let on a certain date set in law. The most recent revaluation took effect in April 2017 (based on rateable values from April 2015); the next business rates valuation is expected in 2021.
- Local councils send business rates bills in February or March each year for the following tax year. Most councils request 10 equal monthly instalments.

Treatment of business rates

- The Homebase CVA provides for a discount to be applied on certain business rates until the end of the current business rates year, i.e., until 31 March 2019.
- The CVA had 11 different categories.
- Across the Category 2-Category 5 premises, there was a reduction in current year business rates, at a level commensurate with the level of rent reduction to which each category of lease is subject. (This represents a 25 to 45 percent reduction for properties in Categories 2-4; business rates for properties in Category 5 were paid in full for four months and are now subject to a 90 percent reduction for the rest of the current business rates year.)
- The CVA offered a better return to the rating authority creditors than an administration where, following a short trading period, empty stores would be

exempt from business rates. For the purpose of assessing the outcome in an administration, it was assumed that following the administrator vacating the store, the landlord would apply for a "three month void period," during which the rates council would receive zero on an empty site.

- The discount for rates was matched to the discount for rent on the equivalent property in order to minimise the risk of a successful challenge (on the grounds of unfair prejudice).

> **Underpinned by a considered turnaround plan, CVAs can be a powerful tool able to be employed at short notice to avoid the impact of a full-blown insolvency.**

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2. Cross-border CVA

- Our latest wave of CVAs includes the first material CVA to compromise leases in respect of properties located outside the UK.
- This innovation is possible based on a new provision in the recast European Insolvency Regulation, which only recently became effective. It applies to insolvency proceedings commenced on or after 26 June 2017.
- The relevant provision can help avoid the need for separate, secondary insolvency proceedings and facilitates efficient resolution of cross-border restructurings.

3. Turnover Rents

- Paperchase's CVA is the first CVA of this cycle to implement turnover rents. Turnover rents involve setting a base rent (which is payable irrespective of sales) **plus** top-up payments based on the performance of individual stores. Turnover rents are becoming more popular in commercial leases generally, given the state of the retail market.
- A move to turnover rents via a CVA can offer a great advantage for retailers to manage seasonal variations in trading. Landlords tend to appreciate the possibility of "upside sharing".

Paperchase's move to Turnover Rents

- Paperchase's CVA is the first CVA of this cycle to implement a turnover rent component, with roughly half of landlords moved to a new turnover rent. The affected stores broadly fall into the "amber" category (i.e., those stores which are underperforming, but will be commercially viable if rents are reduced).
- The turnover rent mechanic sees a reduction of the pre-CVA contractual rent payments (with increasing haircuts to match the relevant categories) plus top-up payments calculated based on contractual rent divided by turnover for each store.
- These top ups are paid quarterly and are then subject to annual adjustments, according to store trading performance.
- The benefits of turnover rents are clear in this case and include:
    1. equitable risk sharing between landlords and tenants, which offers the possibility of making up the haircut in base rent;
    2. reducing the impact of mismatch between seasonality of income for the company and rental payments;
    3. reducing pressure on cashflow generally (which is further assisted by a move from quarterly to monthly rent payments, via the CVA); and
    4. satisfying a growing preference among landlords for turnover rents.

While CVAs may not be an appropriate rescue mechanism in certain cases, underpinned by a considered turnaround plan, they can be a powerful tool able to be employed at short notice to avoid the impact of a full-blown insolvency.

If you have any questions about the matters addressed in this *Alert*, please contact the following authors or your regular Kirkland contact.

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Related Services

Practices

- Restructuring

Suggested Reading

- 22 May 2019 Speaking Engagement American Bankruptcy Institute's New York City Bankruptcy Conference
- 11 April 2019 - 14 April 2019 Speaking Engagement American Bankruptcy Institute’s 2019 Annual Spring Meeting
- 27 March 2019 - 29 March 2019 Speaking Engagement ABA Section of Environment, Energy, and Resources' 48th Spring Conference