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Kirkland Alert

Debenhams' CVA Upheld in Major Test Case

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At A Glance

Debenhams has successfully defended the challenge to its company voluntary arrangement ("CVA") in the first test case in the current wave of CVAs.

In a resounding victory and what will no doubt become the leading case on CVAs, the English court confirmed that CVAs can compromise landlords' claims for future rent, upholding the CVA as valid and enforceable — subject to the removal of provisions waiving landlords' right to forfeiture.

Kirkland advise a committee of Debenhams' bondholders who are now lead shareholders following a debt-for-equity swap via pre-pack administration in April 2019.

Kirkland team members were present during the entirety of the five-day trial at the High Court in London.

Background

Debenhams, one of the largest UK retailers, was acquired by a creditor-owned SPV via pre-pack administration in April 2019. Shortly thereafter, it proposed a CVA which was approved by creditors in May 2019, by approximately 95% by value of creditors voting. Debenhams' CVA compromises rent payable to landlords — across six different categories — and business rates. The CVA was challenged by a group of six related landlords; the challenge was funded by Sports Direct, a former major shareholder of Debenhams. The challenge was brought on five grounds, which are explained below.

For those unfamiliar: a CVA is an English insolvency proceeding within which a company can restructure its unsecured liabilities by reaching a compromise with a majority (75% by value, of those voting) of its creditors. A CVA may be challenged on the grounds that it unfairly prejudices the interests of a creditor (among others) or that there has been a material irregularity. The authorities identify two useful ways of assessing whether a CVA is "unfairly prejudicial":

1. The "**vertical comparator**", which compares the projected outcome of the CVA with the projected outcome of a realistically available alternative process (usually liquidation). This sets a "lower bound" below which a CVA cannot go.
2. The "**horizontal comparator**", which compares the treatment of creditors under the CVA as between each other. Whilst there is no prohibition on differential treatment, any differential treatment must be justified.

Recent years have seen a notable increase in UK retail and casual dining companies using CVAs to deal with burdensome leases and other liabilities.

Kirkland has led this market, advising on a majority of such CVAs including Debenhams and House of Fraser (creditor-side) and Toys"R"Us, Prezzo, Homebase, Paperchase, A.S.Adventure (comprising Snow+Rock, Runners Need and other brands), Travelodge, LA Fitness and Fitness First.

Grounds of challenge and court's judgment

Ground 1: A landlord is not a "creditor" for future rent (within the scope of the Insolvency Act 1986); therefore, its claims cannot be compromised in a CVA.

> **Held:** Future rent is "a pecuniary liability (although not a presently provable debt) to which the company may become subject". Whilst the term of the lease endures, the company is "liable" for the rent, and the fact that in the future the landlord may bring the term to an end by forfeiture does not mean that there is no present "liability". Accordingly, as a matter of jurisdiction, **"future rent" can be included in a CVA.**

Ground 2: A CVA cannot operate to reduce rent payable under leases, because it is automatically unfairly prejudicial to do so, or because there is no jurisdiction to do so (because the CVA imposes "new obligations" (including to make the premises available on new terms), outside the scope of what a CVA can impose, as a matter of jurisdiction).

> **Held:** As a matter of principle, it was not "unfair" that a landlord might receive less than its contracted-for rent in certain circumstances. The court noted unchallenged evidence that valuation advice was that **all stores were "over-rented". A CVA that reduces rent under an existing lease is not automatically "unfair"**; "if the creditor/landlord does not like the variation [under the CVA] he can bring the obligation to an end". **A CVA varies existing obligations: it does not create new ones.**

Ground 3: The right of forfeiture is a proprietary right that cannot be altered by a CVA. (The right of forfeiture is a landlord's unilateral right to terminate a lease in the event of a breach by the tenant. Debenhams' CVA includes provisions to waive landlords' right of forfeiture, which might otherwise have been triggered by the CVA.)

> **Held:** A CVA cannot vary a right of re-entry. The right of re-entry is property belonging to the landlord. On this ground alone, the court agreed with the applicant landlords: varying the right of forfeiture would exceed the power granted by the Insolvency Act. Accordingly, the court ordered that the relevant **provisions which waive landlords' right to forfeit be deleted from the CVA under the severance provisions of the CVA**; however, Debenhams' CVA otherwise remains valid and enforceable.

Ground 4: The Applicants are treated less favourably than other unsecured creditors without any proper justification. (Debenhams' CVA varies rents and business rates, but does not compromise claims of other unsecured creditors like suppliers.)

> **Held: Differential treatment of landlords from suppliers is justified by the need for business continuity** (and itself embodies a principle of "fairness"). The landlords were providing long-term accommodation at above-market rates, whilst suppliers were providing goods and services on an order-by-order basis which, given competitive pressures, were likely to be at market rates. There would have been "unfairness" if landlords were expected to take reductions in rent to below the market value of the premises concerned, but none of the applicants suggested that was the case.

Ground 5: The CVA fails to comply with the content requirement of the Insolvency Rules 2016 (rule 2.3(1)) by not referring to potential antecedent transaction claims in the CVA proposal. (Debenhams had granted security in connection with new money in March 2019, a condition of which was the granting of security in respect of its existing revolving credit facility and notes.) The applicant landlords argued that the CVA should have set out that, if the company were to enter administration or liquidation,

circumstances existed which might give rise to potential claims under section 239 (Preferences) or 245 (Avoidance of certain floating charges) of the Insolvency Act 1986.

> **Held:** Evidence for Debenhams had shown why it had granted security in respect of the RCF and the Notes — it was a non-negotiable condition of the grant of new money. The case that the directors might (in granting security for existing indebtedness in order to obtain new money) have been influenced by a desire to prefer the financial creditors **"did not have legs". The account in the CVA was fair**, alerting the creditors as a whole to the existence of the issue and enabling any creditor to ask further questions before or at the meeting. There was **no evidence to conclude that the prospect of a modest "claw-back" would have influenced compromised creditors** to view the CVA differently.

Impact

This seminal judgment confirms that a CVA can validly compromise landlords' claims for future rent. It offers welcome recognition that companies have legitimate reasons for the differential treatment of landlords and other unsecured creditors, such as suppliers.

This judgment provides major comfort to companies in financial distress with burdensome leasehold estates that a CVA remains a potential route to restructure and compromise their rent obligations.

The market will adjust to reflect the court's ruling that a CVA cannot vary a right of forfeiture (because it is a proprietary right). There may, however, be grounds to say that landlords have waived their right to forfeit, including where they voted in favour of the CVA or treat the lease as continuing post-CVA (including by accepting rent).

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