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Kirkland Alert

English Court Revokes Regis' Company Voluntary Arrangement on Unfair Prejudice Grounds

21 May 2021

At a Glance

The court ordered the revocation of Regis' company voluntary arrangement on unfair prejudice grounds, specifically, because the company's shareholder had been permitted to vote on the CVA in respect of an intercompany debt claim, whilst that debt was left unimpaired.

A blanket 75% discount on landlords' claims for voting purposes was not justified, but was not a material irregularity given it did not impact the outcome of the vote.

A requirement for landlords exercising a termination right to terminate *all* their leases could potentially have constituted an unfairly prejudicial fetter — but the court held that a modification letter validly removed this constraint.

The revocation of Regis' CVA is of little practical effect, given the CVA had already terminated (upon the company's entry into administration). The judgment dismissed all but one of the applicant landlords' claims of unfair prejudice and/or material irregularity. Although the implications of this case — together with the seminal judgments in New Look and Virgin Active — will need to be considered carefully when structuring future CVAs, it will not diminish the popularity of the CVA as a flexible restructuring tool.

We discussed the implications of these landmark cases in a webinar on 18 May with expert speakers; a recording is here. On 1 June, join expert speakers to discuss the state of the retail market and market implications of these cases; for more information and to register, see here. Our alert on New Look is here and on Virgin Active, here.

Key terms of the CVA

Company	Regis UK Ltd
Proposal Date	October 2018; automatically terminated October 2019 upon the company's entry into administration
Approval	c. 79% (by value, of all unsecured creditors voting)
Terms	Divided creditors into various categories: • "Critical Creditors" — including two major intercompany claims; deemed critical to the company's ongoing trading; to be paid in full. Importantly, the requisite statutory approval threshold was only achieved because these creditors voted in favour of the CVA • Five categories of "Compromised Landlords" — certain of which were substantively unimpaired, certain of which switched to reduced or zero rents (and to be paid 7% of their claims); "break rights" for landlords to take back and re-let their properties • Other "Non-Critical Creditors" — to be paid 7% of their claims

Challenges, court's rulings and key takeaways

Inadequate disclosure

The applicant landlords unsuccessfully argued that inadequate disclosure around (a) antecedent transactions and (b) the statement of affairs and the estimated outcome statement, constituted a material irregularity. Non-disclosure will constitute a material irregularity only if there is a substantial chance that the non-disclosed material would have made a difference to how creditors voted at the meeting.

Challenge	Judgment
The CVA proposal did not adequately disclose antecedent transactions in 2017 and 2018 (which might have been vulnerable to challenge as transactions at an undervalue)	No material irregularity For 2017 transactions, there would in fact have been no sustainable claims under the relevant statutory provisions (given the company's solvency at the time), and more extensive disclosure would have revealed that there was no material prospect of the claims succeeding For 2018 transactions, the CVA proposal ought to have identified the possibility that a particular transaction might give rise to the possibility of a claim as a "transaction at an undervalue". However, failure to disclose this was not a material irregularity, in part because the circumstances demonstrated a potential defence to such a claim. Accordingly, there was no substantial chance that creditors would have assessed the CVA differently had the CVA proposal addressed the possibility of such a claim
The statement of affairs and the estimated outcome statement were materially inaccurate or complete, for various reasons	No material irregularity In particular: • the failure to refer to any recoveries in respect of antecedent transactions was not a material irregularity, given the (at best) doubtful prospect of success of such claims • in the circumstances, it was reasonable to use a shut-down administration as the comparator to the CVA

Unfair prejudice — treatment of intercompany/shareholder claims

The applicant landlords successfully argued it was "unfairly prejudicial" for a claim owed to the company's shareholder to be categorised as a "Critical Creditor" and paid in full. **The court revoked the CVA on this basis** and held that the nominee's report on the CVA proposal was below the standard expected in this regard (in recommending that the CVA proposal be put to the creditors' vote, when the inclusion of the shareholder's claim as a Critical Creditor was unfairly prejudicial to the applicant landlords), as explored further below.

The key question was whether treatment of intercompany/shareholder claims could be objectively justified. A common justification for paying a creditor in full is that it is necessary to do so because that creditor's ongoing support for the company is critical to the success of the CVA, and it will not provide that support unless its existing debt is paid.

Challenge	Judgment
The treatment of Regis Corporation and the company's sole shareholder as "Critical Creditors" constituted unfair prejudice	• Regis Corporation held the key to the company's licence/franchise agreements; the debt owed to Regis Corporation was secured; Regis Corporation's support for the CVA was conditional upon its debt not being impaired by the CVA. On balance, there was sufficient justification for the non-impairment of that debt • However, the position was materially different in relation to a c.£600,000 liability owed to the company's sole shareholder. The amount funded from the company to pay allowed CVA claims was only £330,000 — i.e., the proposal envisaged the company paying a sum to its shareholder almost twice as large as the amount that it would pay in order to fund the claims of all impaired creditors under the CVA. But for the CVA, the shareholder would have recovered nothing in respect of that claim. The full repayment of that claim was to be made possible, therefore, only because of a CVA under which impaired creditors would be paid a fraction of their claims (7%) and Compromised Landlords would be entitled only to reduced rent going forward. There was no evidence that any attempt was made to negotiate in this respect

	• Accordingly, the categorisation of the shareholder's claim as a "Critical Creditor" was not justified and the preferential treatment it received was unfairly prejudicial to creditors whose debts were impaired

75% discount of landlords' claims for voting purposes

The court held that applying a blanket 75% discount to landlords' claims in respect of future rent for voting purposes was *not* justified. However, this was not a material irregularity as it had no impact on the outcome of the meeting.

In contrast, in the recent challenge to New Look's CVA, the court concluded that a discount of 25% to landlords' claims in respect of future rent for voting purposes *was* justified, where the claim of each landlord had been estimated by reference to the circumstances of the particular lease (see our *Alert*).

Challenge	Judgment
The discounting of the landlords' claims by 75% for voting purposes constituted a material irregularity or unfair prejudice	• The question whether an appropriate discount has been applied to a creditor's claim for voting purposes *is* one which a court can opine on • There were two important differences from the New Look CVA: 1. in Regis' CVA, landlords' claims were calculated according to the same formula[1], even though there were large variations in the likelihood of premises being re-let. Accordingly, a blanket discount could not be justified in the Regis CVA; and 2. the 75% discount in Regis' CVA was much larger than the 25% discount in New Look's CVA. The court held that — whilst it was difficult to identify precisely what percentage discount would be appropriate — there has to be some adequate justification offered for such a large discount; here, there was none[2]

	• However, as noted, even if there was an irregularity, it was not material, as it had no impact on outcome of the meeting

Fairness of modifications to lease terms

The applicant landlords unsuccessfully argued that various modifications to lease terms were unfairly prejudicial. However, the court held that a requirement for landlords exercising a termination right to terminate *all* their leases could potentially have constituted an unfairly prejudicial fetter, and that the supposed benefit of Regis' profit-share fund[3] was illusory.

Challenge	Judgment
Various modifications (primarily rent reductions) to the lease terms were unfairly prejudicial	• As in New Look, the modifications to lease terms did not amount to unfair prejudice; the critical considerations were that: 1. landlords had the option to terminate the leases instead of being bound by the modifications; and 2. these options provided a more favourable outcome than the relevant comparator (being a shut-down administration in which there would be no material recovery) • The applicant landlords' case included that rents were reduced to below market rent. As in New Look, however, no expert evidence was adduced
Whether the alleged unfair prejudice was sufficiently mitigated by the grant of new termination rights to landlords or the	• The applicant landlords claimed that the termination rights and profit share fund in the CVA were insufficient mitigation for the impairment to their rights under the leases; the court cross-referred to the decision in New Look, in holding that the termination rights *did* mitigate unfairness • Additionally, the applicant landlords claimed that:

availability of a profit-share fund	◦ **termination rights which had to be exercised within 90 days** of the CVA becoming effective were insufficient mitigation, as it would take landlords longer than 90 days to secure a new tenant, and they would not ordinarily want to exercise a termination right before securing a replacement tenant; again, the court held this did not amount to unfair prejudice (given the landlords had the option whether or not to terminate their lease, and these options provided a more favourable outcome than the relevant comparator) ◦ under the original CVA, **landlords of multiple leases** could only exercise their termination right if they did so in respect of *all* their leases; here, the court held that could have led to unfair prejudice, as it could have led to affected landlords being forced to accept a reduction in rent in a particular lease without an unqualified option to terminate that lease: "the requirement to terminate all leases is a fetter on the option to terminate each lease which, in my judgment, removes an essential element in that reasoning"[4] ▪ however, the court held the above issue had been corrected by a **modification** to the CVA; the applicant landlords contended that the modification was ineffective, but the court held otherwise ◦ a **new right for the company to terminate** leases with "Category 5" landlords was inherently unfair in that it failed the "vertical comparator" (i.e., a comparison with what the creditors' position would have been in the event that the CVA was not approved); however, the court did not accept that the vertical comparator test was failed merely because the termination involves the release of the company's liabilities. Whilst in a hypothetical liquidation the landlord would have a right to claim damages, including for loss of future rent, that right would have

been worth less than the recovery which the Category 5 landlords would receive under the CVA

- the **supposed benefit of Regis' profit-share fund was illusory**; the court agreed, because the fund was to be funded by profits in a period in which no profits were actually anticipated. The court held the absence of a real profit-share arrangement is something to weigh in the balance when considering the differential treatment of creditors within the CVA. However, it was unnecessary to decide whether the absence of an effective profit-share arrangement was unfairly prejudicial in this case, given the court had already concluded that the shareholder's treatment as a Critical Creditor constituted unfair prejudice

Breach of duty by the nominees

The applicant landlords alleged that the CVA nominees (individual insolvency practitioners who oversee the CVA proposal) had acted in breach of their duties.

The court held that the "critical focus" in considering whether a nominee has complied with their duties is the nominee's report to the court (which is the nominee's only function under the insolvency legislation). The court ultimately held that any reasonable nominee ought to have taken certain matters into consideration before accepting that the shareholder was properly to be treated as a Critical Creditor. In that "one limited respect", the conduct of the nominee *did* fall below the required standard. However, the court did not make an order to deprive the nominees of their fees.

Revocation of CVA

Even though Regis' CVA had already terminated (automatically upon its entry into administration), the court held it nonetheless had jurisdiction to revoke the CVA. The remedy of revocation is discretionary, not automatic. The court decided to make an order revoking the CVA.

Comment

Regis is the third in a trio of landmark cases in the distressed tenant-landlord context in the past fortnight; see our alerts on New Look here and Virgin Active here. Although the practical effect of the revocation of Regis' CVA is limited, the key takeaways described above — together with those in New Look and Virgin Active — will drive the next wave of potential compromises.

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1. Namely, assuming that each of the premises would be re-let at 85% of the contractual rent after a six month void period and a six month rent-free incentive period.↩

2. The court held that the fact that the same discount had been used in most retail CVAs since 2011 was not relevant to whether it amounted to a material irregularity, as in no case had the reasonableness of the discount used been tested in, or resolved by, a court.↩

3. Namely, 20% of the company's net profits for the next two years, above £250,000, subject to a cap of £200,000.↩

4. *Carraway Guildford (Nominee A) Ltd & others v Regis UK Ltd & others* [2021] EWHC 1294 (Ch) at [181]↩

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Suggested Reading

- 20 May 2021 Award Chambers USA, America's Leading Lawyers for Business 2021
- 19 May 2021 Award China Business Law Awards 2021
- 18 May 2021 In the News Seadrill Partners Restructuring Approved in Texas