CVAs survive landlords' challenge in UK court

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Debenhams, the UK department store chain, has successfully defended the challenge to its company voluntary arrangement (CVA) in the first test case in the current wave of CVAs.

Kate Stephenson of Kirkland & Ellis explains the case and its implications.

Background

Debenhams was acquired by a creditor-owned SPV via pre-pack administration in April 2019. Shortly after, it proposed a CVA which was approved by creditors in May 2019, by approximately 95 per cent 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.

The English CVA

A CVA is an English insolvency proceeding within which a company can restructure its unsecured liabilities by reaching a compromise with at least 75 per cent by value of those creditors who vote.

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.

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, as 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".

continued on page 11

continued from page 10

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 an English 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.

Debenhams CVA challenge Firms & Faces

The company

Debenhams was represented in court by **Tom Smith QC**, **Richard Fisher** and **Madeleine Jones**, all of South Square. They were instructed by Debenhams' solicitors, Freshfields, led by global restructuring head **Ken Baird** and assisted by **Craig Montgomery**.

The landlord group

The six landlords bringing the claim, part of the Combined Property Control Group (CPC) Group, were represented in court by **Daniel Bayfield QC** and **Ryan Perkins** of South Square.

They were instructed by the solicitors Shoosmiths, led by restructuring partner **Sarah Teal**.

There were two other respondents in the case. **Jim Tucker** and **Ed Boyle** of KPMG were appointed administrators in April, and were represented in the September hearing by **Jeremy Golding QC** and **Andrew Shaw** from South Square, instructed by Travers Smith. Glas Trust Corporation was represented by **Martin Pascoe QC** and **Matthew Abraham** of South Square, instructed by Baker & McKenzie.

The bondholders/new owners

Kirkland & Ellis, led by **Kon Asimacopoulos**, **Sean Lacey**, **Partha Kar** and **Elaine Nolan**, represented bondholders and investors that became Debenhams' majority shareholders following April's pre-pack administration. They were not parties to the court action, but members of the Kirkland team did attend the five-day hearing in September for the full five days.

The RCF lenders/new owners

Trevor Borthwick, **Ian Field** and **Nick Lister** of Allen & Overy advised the RCF lenders/new owners.

UK real estate companies face knock-on from retail CVAs

UK real estate companies now face their own crisis after a shocking series of debt restructurings by their retail chain tenants, and Intu and Hammerson appear to be in the firing line.

Over the last two years the list of retailers using Company Voluntary Arrangements (CVAs) to shut stores and modify leases has included Debenhams, Toys R Us, House of Fraser, New Look and HMV.

Piling on the pain is the continuing uncertainty surrounding Brexit, which saps consumer confidence and increases the costs of imported goods.

Shopping centre giant Intu has UK£4.7 billion in net debt and its shares have shed around two thirds of their value this year. The shares briefly recovered in September following unsubstantiated rumours in the media that Orion Capital Managers was seeking partners to bid for Intu. Two serious attempts by rivals to buy Intu failed last year.

Intu voted against the CVA sought and ultimately won by Arcadia in June after the UK fashion retail empire led by Philip Green appealed to landlords to lower rent and agree to some shop closures.

Intu has warned of falling rental income for the last three years, forcing it to cut debt and sell assets. It suspended its dividend this year and changed management.

Other big UK property companies under pressure include Hammerson, British Land, Land Securities and Capital & Counties, and all are trading at big discounts to asset value.