Corporate Voluntary Arrangements

A typical CVA from early 2018

- Company: national retailer.
- Group of which Company was a part: modestly loss-making.
- Company: modestly profitable at the date of the CVA proposal.
- Profits declining.
- Operating in excess of 600 stores.
- All of the stores rented.
- Rent: the most significant fixed cost faced by the Company.

A typical CVA from early 2018

- Portfolio: “significantly over-rented compared to comparable market rates. As a result, the current rental payments are unsustainable and need to be addressed in order to help ensure the solvency of the Group in the medium to long term.”
- “The CVA gives the Company the ability to rationalise the store portfolio by exiting unprofitable stores, and securing rent reductions where stores are over-rented or can be made viable with a rent reduction.”

A typical CVA from early 2018

- “The Group forecasts that without the CVA it will not generate sufficient cash to meet its future debt service obligations and capital investment funding.”
- “The CVA is required to re-base the property portfolio of the Company to market rents so as to provide a stable platform against which the other identified Turnaround Measures mentioned above can be implemented.”
- “If the CVA or the other Turnaround Measures are not successfully delivered … then the Group may cease to be financially viable.”

What if the CVA is not approved?

- If the Group ceases to be financially viable then the Company is likely to enter administration followed either by
  - (1) Winding-up, or
  - (2) A pre-pack sale.

- “In either scenario, the unsecured creditors of the Company, including the Landlords, could expect to recover significantly less value for their claims, which otherwise the Company would anticipate would be paid if the CVA and the other Turnaround Measures are successful.”

Classes of creditor

- CATEGORY A LANDLORDS
- CATEGORY B LANDLORDS
- CATEGORY C LANDLORDS
- TRADE AND OTHER CREDITORS

CATEGORY A LANDLORDS

- Stores that are currently viable or otherwise strategically important.
- Rents will stay the same: Category A landlords would not be detrimentally affected by the CVA.

CATEGORY B LANDLORDS

- “Stores were the rent is above the market rate or not commensurate with the level of profit generated by the store, but which could become viable with “an appropriate rent reduction”.
- CATEGORY B1 STORES: 20% rent reduction.
- CATEGORY B2 STORES: 40% rent reduction.
- CATEGORY B3 STORES: 60% rent reduction.
- Although the CVA was to be for three years only, the rent at the end of the CVA was to move to the higher of the “Market Rent” or the relevant percentage of the contractual rent.

CATEGORY B LANDLORDS

- Terminal dilapidations liability extinguished and Category B landlords given in substitution 5% of the contractual rent.

- Category B landlords given the right to terminate the leases within a defined period at the start of the CVA.

- “Compromised Lease Fund” of £600,000 for eventual distribution: “To allow the Compromised Landlords to share in the upside of the Company achieving its turnaround.”

CATEGORY C LANDLORDS

- Stores not economically viable even with a rent reduction.
- 60% rent reduction for six months then 100% rent reduction.
- Category C landlords given the right to terminate the leases within a defined period at the start of the CVA.
- Terminal dilapidations liability extinguished and Category C landlords given in substitution 5% of the contractual rent.

TRADE AND OTHER CREDITORS

“The CVA will not seek to compromise the claims of any other creditors, including, without limitation, employees, customers, trade suppliers and any other unsecured creditors. In particular, in order to achieve the Turnaround Measures the Company will need to retain the support of trade and other business suppliers whose continued willingness to work with the Company is critical. The Company has therefore concluded that it would not be in the best interests of the Company and its creditors generally to seek to compromise trade and other unsecured creditors.”

LIKELY VOTING ATTITUDES

- Category A landlords: No rent reduction. Potential for increased solvency reduces risk of future default. In favour.

- Other creditors: Not affected. Potential for increased solvency reduces risk of future default. In favour.

LIKELY VOTING ATTITUDES

- Category B and C landlords. Facing rent reduction. But:

(1) Ability to terminate lease and attempt to re-let in the open market.

(2) If no rent reduction, increased risk of insolvency. Insolvency likely to be met by administration and either pre-pack sale or liquidation. Estimated in the proposal that, for Category B1 landlords, the CVA would represent 76.7p/£; a pre-pack administration would generate 0.09p/£; and administration followed by liquidation would generate 12.07p/£.

Lord Neuberger MR, Thomas v. Ken Thomas [2006] EWCA Civ 1504

"It strikes me that, at least normally, it would seem wrong in principle that a tenant should be able to trade under a CVA for the benefit of its past creditors, at the present and future expense of its landlord. If the tenant is to continue occupying the landlord's property for the purposes of trading under the CVA (and hopefully trading out of the CVA) he should normally, as it currently appears to me, expect to pay the full rent to which the landlord is contractually entitled … Therefore as at present advised, I consider that a CVA should so provide, or if it does not provide, in the absence of special circumstances the landlord may well be entitled to object to the proposals as unreasonable."

THE STATUTORY SCHEME

Cork Committee report: it was a weakness of the existing regime that a company could not enter into a composition with its creditors unless it obtained the separate consent of every one of those creditors.

Sections 1 to 7B, Insolvency Act 1986.

THE STATUTORY SCHEME

Burford Midland Properties v. Marley Extrusions [1994] BCC 604:

“The object of the legislation is to provide a swift and comparatively informal arrangement whereby the majority of the company's creditors can bind the minority to some arrangement (and there are many) inhibiting the immediate enforcement and/or total enforcement of the debts, thereby avoiding a creditors' free-for-all and giving the company often a period in which it can trade untrammelled by the need for payment of the debts comprised in the arrangement.”

THE STATUTORY SCHEME

Key features:

- No requirement that the company should be “insolvent” or “unable to pay its debts” within the statutory definition of those terms

- Decision by majority rule: a 75% majority of creditors by value can bind the minority creditors to an arrangement against their wishes.

THE STATUTORY SCHEME: Section 1

“The directors of a company (other than one which is in administration or being wound up) may make a proposal under this Part to the company and its creditors for a composition in satisfaction of its debts or a scheme of arrangement of its affairs (from here on referred to, in either case, as a ‘voluntary arrangement’).” (With a company in administration or that is being wound up, the administrator or the liquidator may make the proposal.)

A “composition” is a discharge or reduction of debt. A scheme of arrangement is something less than that, e.g. a moratorium.

THE STATUTORY SCHEME: Section 1

- The CVA is proposed by the directors. In reality, the proposal will be formulated with the help of an insolvency practitioner who will also be the intended nominee.
- The directors give notice of the proposal to the nominee, and submit a document to him setting out the terms of the proposed CVA and a statement of the company's affairs.
- The nominee has 28 days to prepare and submit a report to the court.
- If the nominee forms the view that proposed scheme should go ahead, he reports to the court that a meeting of the company should be summoned and the views of the creditors sought. The court's role is administrative.

THE STATUTORY SCHEME: Section 3

Consideration of the proposal: Where the nominee has reported to the court under section 2(2) that the proposal should be considered at a meeting of the company by the company's creditors, he shall summon a meeting to consider the proposal and seek the creditors' decision on it.

THE STATUTORY SCHEME: Section 4

Section 4(3): “Neither the company nor its creditors may approve any proposal or modification which affects the right of a secured creditor to enforce his security, except with the concurrence of the creditor concerned.”

Section 4(4): restrictions on ability to approve proposals affecting preferential creditors.

Section 4(5):“Subject as above, the meeting of the company and the qualifying decision procedure shall be conducted in accordance with the rules.”

THE STATUTORY SCHEME: Section 4

"While it is true that it was at one time thought that a landlord with a right to forfeiture was to be treated for these purposes as a secure creditor, that is now seen to be wrong: see Razzaq v. Pala [1997] 1 WLR 1336, 1341E–1343D and In re Lomax Leisure [2000] Ch 502, 510B – 517D. It does not seem as if the legislature intended a creditor with a right to forfeit should be treated in a different or better position under a CVA than any other sort of unsecured creditor": Thomas v. Ken Thomas, per Lord Neuberger MR.

THE STATUTORY SCHEME: Insolvency Rules

- Rule 2.34: “The chair of a meeting under this Part must be the nominee or an appointed person.”
- Rule 15.31(2): “A creditor may vote in respect of a debt of an unliquidated or unascertained amount if the convener or chair decides to put upon it an estimated minimum value for the purpose of entitlement to vote and admits the claim for that purpose”.
- Rule 15.31(2): “But in relation to a proposed CVA or IVA, a debt of an unliquidated or unascertained amount is to be valued at £1 for the purposes of voting unless the convener or chair or an appointed person decides to put a higher value on it.”
- Rule 15.34(3): “Each of the following decisions in a proposed CVA is made when three-quarters or more (in value) of those responding vote in favour of it- (a) a decision approving a proposal …”.

THE STATUTORY SCHEME: Insolvency Rules

- Rule 15.34(4): “In a proposed CVA a decision is not made if more than half of the total value of the unconnected creditors vote against it.”

- Rule 15.34(5): “For the purposes of paragraph (4)- (a) a creditor is unconnected unless the convener or chair decides that the creditor is connected with the company.”

- Rule 15.35(1): “A decision of the convener or chair under this Chapter is subject to appeal to the court by a creditor, by a contributory, or by the bankrupt or debtor (as applicable).”

THE STATUTORY SCHEME: Section 5

Where the proposal has been approved:

“The voluntary arrangement:

“(a) takes effect as if made by the company at the time the creditors decided to approve the voluntary arrangement, and

“(b) binds every person who in accordance with the rules- (i) was entitled to vote in the qualifying decision procedure by which the creditors’ decision to approve the voluntary arrangement was made, or (ii) would have been so entitled if he had had notice of it, as if he were a party to the voluntary arrangement.”

THE STATUTORY SCHEME: Section 6

CHALLENGE OF DECISIONS

“Subject to this section, an application to the court may be made, by any of the persons specified below, on one or both of the following grounds, namely-

“(a) that a voluntary arrangement which has effect under section 4A unfairly prejudices the interests of a creditor, member or contributory of the company;

“(b) that there has been some material irregularity at or in relation to the meeting of the company, or in relation to the relevant qualifying decision procedure.”

WHO IS A CREDITOR?

Secured creditors: no right vote to the extent secured.

All other creditors: entitled to vote even if, under the terms of the CVA, the debt is going to be paid in full. Hence, in the 2018 CVA, the Category A landlords and the trade creditors had a vote.

WHO IS A CREDITOR?

Re Cancol Limited [1995] BCC 1133:

- Landlord sought a declaration that “a company voluntary arrangement … cannot as a matter of law … bind persons entitled to future or contingently payable debts such as future payments of rent to fall due under an existing lease, but can only bind persons entitled to the benefit of present as opposed to future or contingent liabilities.”

WHO IS A CREDITOR?

Re Cancol Limited [1995] BCC 1133:

No statutory definition of “creditor” in relation to CVAs.

Landlord’s argument: “the word ‘creditor’ has to be given its ‘ordinary meaning’; that is … a person entitled to the benefit of a liability presently due … That does not, of course, cover rent due in the future under an existing lease because … that is a liability which is both future and contingent … The liability in question is an existing one but payment is only due in the future.”

WHO IS A CREDITOR?

Re Cancol Limited [1995] BCC 1133:

Held: “I do not accept that a liability to future rent is incapable of inclusion as a matter of law in a company voluntary arrangement.” The word ‘creditor’ “includes those entitled to a right to a future payment under an existing valid instrument such as a lease.”

A CVA can therefore validly affect future rental liabilities under a lease.

HOW TO VALUE THE CREDITOR'S CLAIM?

- Rule 15.31(1): votes are calculated according to the amount of each creditor's claim.
- Rule 15.31(2): a creditor may vote in respect of a debt of an unliquidated or unascertained amount if the convener or chair decides to put upon it an estimated minimum value for the purposes of entitlement to vote.
- Rule 15.31(3): in relation to a proposed CVA, a debt of an unliquidated or unascertained amount is to be valued at £1 for the purposes of voting unless the convener or chair or an appointed person decides to put a higher value on it.

HOW TO VALUE THE CREDITOR'S CLAIM?

- Re Newlands (Seaford) Educational Trust [2006] EWHC 1511 (Ch): "The [convener] should not speculate. Nor is he obliged to investigate the creditor's claim. But he must examine such evidence … as the creditor puts forward."

- Rule 15.35(1): a decision of the convener or chair under this Chapter is subject to appeal to the court by a creditor.

HOW TO VALUE THE CREDITOR'S CLAIM?

- Doorbar v. Alltime Securities Ltd [1996] 1 WLR 456 (an IVA not a CVA):
- Lease with seven years unexpired.
- Whole of future rent under the lease to be compromised under the CVA.
- Landlord said claim should correspondingly be valued by reference to the whole of the rent that would fall due. Wrong to compromise seven years' liabilities but only allow votes in respect of one year's liability.
- Chair valued the claim at one year's rent on the grounds the landlord would mitigate his losses by forfeiting and reletting within a year: the CVA did not affect the landlord's ability to forfeit on the grounds of insolvency.

HOW TO VALUE THE CREDITOR'S CLAIM?

- Doorbar v. Alltime Securities Ltd [1996] 1 WLR 456:
- Chair's decision upheld: "while the chairman should not have taken account of any duty to mitigate, nor should he have considered, as he put it in his report, 'the most which would be accepted for future liability,', it was entirely realistic of him to put a minimum value on Alltime's claim by estimating what was likely to happen and making allowance for the possibility that Alltime would exercise its power of re-entry. In my judgment, Alltime's aproach of treating the minimum value of the future rent liability as equal to the whole of that liability was wrong in principle."

HOW TO VALUE THE CREDITOR'S CLAIM?

Re Cotswold Company Limited [2009] L&TR 22 (a CVA)

- Proposal was to sell company's share capital and distribute proceeds of £1.45 million by way of dividend to the unsecured creditors in full and final satisfaction of their claims against the company.
- Landlord submitted claim in the CVA for £572,526.12, being the full amount of rent and service charge that would fall due over the unexpired term. Lease was going to be surrendered.
- Company had vacated the premises and had no intention of paying the rent.

HOW TO VALUE THE CREDITOR'S CLAIM?

Re Cotswold Company Limited [2009] L&TR 22 (a CVA)

- Held: "All that was left to be done was the quantification of the claim in respect of that future rental stream and other future obligations. That quantification involved an assessment of the loss incurred by the Landlord on the footing it was going to release the benefit of the rents and other obligations stretching into the future. A comparison needed to be made between what the Landlord would have been entitled to had the lease continued and what it would be left with after such release. Credit would have to be given for rents that the Landlord could recover by way of mitigation."

HOW TO VALUE THE CREDITOR'S CLAIM?

2018 CVA:

Prescribed method in the proposal: value of landlord's claim for voting purposes is "Total Rent" minus the "Deduction Amount".

"Total Rent" is: the rent, service charge, insurance, and an allowance for dilapidations payable under the lease.

"Deduction Amount" is: a valuer's estimate of the income the landlord could make from re-letting, based on the rent free incentive needed to achieve the same level of rent as had been payable under the lease.

HOW TO VALUE THE CREDITOR'S CLAIM?

2018 CVA Worked example:

- Total rent: £2,840,000
- Deduction amount: £1,880,000
- Balance: £960,000
- "Less NPV Deduction" of £160,000: £800,000
- "75% deduction to reflect the unliquidated nature of claim – test in Rule 15.31(3) Insolvency Rules", so deduct a further £600,000.
- Value of claim for voting purposes £200,000

HOW TO VALUE THE CREDITOR'S CLAIM?

- Rule 15.31(3): "But in relation to a proposed CVA or IVA, a debt of an unliquidated or unascertained amount is to be valued at £1 for the purposes of voting unless the convener or chair or an appointed person decides to put a higher value on it."

- Effect: to diminish the relative voting power of the landlords, and to increase the relative voting power of the other creditors, who are going to vote in favour in any event because their claims are not going to be compromised.

CHALLENGE FOR UNFAIR PREJUDICE: s.6

- No challenge yet to a CVA of this type.
- Support from Cancol and Thomas v. Ken Thomas?

CHALLENGE FOR UNFAIR PREJUDICE: s.6

Re Cancol:

- Company had a number of leases.
- Proposal was to vacate some of them and continue to trade from others.
- Terms of the proposal were that it would pay rent in full for the premises from which it continued to trade; the rent for the premises it was vacating would be compromised in the CVA.
- So differential treatment of different classes of landlords: where premises being used, rent paid in full; where premises not to be used, rent not paid in full.

CHALLENGE FOR UNFAIR PREJUDICE: s.6

Re Cancol:

"The question arises: does it constitute unfair prejudice for those creditors with future rights to be paid in full so long as the asset in question is used to earn the profits envisaged by the voluntary arrangement while those whose assets are no longer so used are left to a dividend in respect of their claim under the arrangement. …"

CHALLENGE FOR UNFAIR PREJUDICE: s.6

Re Cancol:

"… I do not consider that it is unfair within the meaning of the section to make a differentiation between members of the class of creditors with future claims on the basis proposed. The landlord has a right of forfeiture once the rent ceases to be paid in full. The proposals do not deprive him of that, so he is not without a remedy. Of course, it is a much less attractive remedy in terms of static or falling rents than in terms of rent inflation, but I do not consider that the fact that the remedy which the landlord has is not very attractive to him means that it should not be taken into account. Equally, the distinction between the categories of future creditors does seem to me to be a realistic and commercially sensible one, and on that basis I reject the argument that there was here unfair prejudice."

CHALLENGE FOR UNFAIR PREJUDICE: s.6

Re Cancol:

- But in Cancol, the distinction was between landlords whose premises were going to be used, who would get the rent in full, and landlords whose premises were not going to be used, who would not get the rent in full.
- That is significantly different from the typical 2018 situation where Category A and B landlords are both going to have their properties used, but one category is going to get the rent in full while the other gets less than the rent in full.
- And it is key to this design of CVA that the company is able to keep the profitable premises; but needs to leave in the right to forfeit; so needs to ensure the landlord will have no reason to forfeit.

CHALLENGE FOR UNFAIR PREJUDICE: s.6

Thomas v. Ken Thomas:

"It strikes me that, at least normally, it would seem wrong in principle that a tenant should be able to trade under a CVA for the benefit of its past creditors, at the present and future expense of its landlord. If the tenant is to continue occupying the landlord's property for the purposes of trading under the CVA (and hopefully trading out of the CVA) he should normally, as it currently appears to me, expect to pay the full rent to which the landlord is contractually entitled—see by analogy, in the administration context, In re Atlantic Computer Systems plc [1992] Ch 505, 542–543 and, in a liquidation context, In re ABC Coupler & Engineering Co Ltd (No.3) [1970] 1 WLR 702. Therefore as at present advised, I consider that a CVA should so provide, or if it does not provide, in the absence of special circumstances the landlord may well be entitled to object to the proposals as unreasonable."

CHALLENGE FOR UNFAIR PREJUDICE: s.6

Thomas v. Ken Thomas:

But Thomas was not a section 6 case.

CHALLENGE FOR UNFAIR PREJUDICE: s.6

Prudential v. PRG Powerhouse [2007] EWHC 1002 (Ch):

Unfairness is to be assessed by comparative analysis:

(1) VERTICAL COMPARISON

(2) HORIZONTAL COMPARISION

CHALLENGE FOR UNFAIR PREJUDICE: s.6

VERTICAL COMPARISON

- Compare the creditor's position under the CVA with what his position would have been on a winding up.
- Re T&N Ltd [2004] EWHC 2361 (Ch): "I find it very difficult to envisage a case where the court would sanction a scheme of arrangement, or not interfere with a CVA, which was an alternative to a winding up but which was likely to result in creditors, or some of them receiving less than they would in a winding up of the company …".

CHALLENGE FOR UNFAIR PREJUDICE: s.6

VERTICAL COMPARISON

- So even though insolvency is not a pre-requisite of a CVA, a fully solvent company would find it difficult to use a CVA to achieve rent reductions on part of its portfolio. If solvent, the return on the CVA is likely to be worse than on a liquidation.
- That is why, in the typical 2018 CVA, the proposal is at pains to point out that all the landlords, of whatever category, would be better off under the CVA that on a winding up or pre-pack administration.

CHALLENGE FOR UNFAIR PREJUDICE: s.6

HORIZONTAL COMPARISON

- Comparison between the position of different classes or creditor.
- Doorbar: “Unfair prejudice … is a reference to the degree of prejudice to one creditor or class of creditors as compared with other creditors or class of creditors. It involves an assessment of any imbalance between possible prejudices to one or the other … The concept of unfair prejudice is aimed at disproportionate prejudice on one side or the other.”

CHALLENGE FOR UNFAIR PREJUDICE: s.6

HORIZONTAL COMPARISON

Prudential v. PRG Powerhouse [2007] EWHC 1002 (Ch): "… the fact that a CVA involves differential treatment of creditors will not necessarily be sufficient to establish unfair prejudice … Differential treatment may also be necessary to secure the continuation of the company's business which underlies the voluntary arrangement, for example where it is necessary to pay suppliers in full in order to ensure that the company can continue to trade …".

CHALLENGE FOR UNFAIR PREJUDICE: s.6

HORIZONTAL COMPARISON

- So the differential treatment of the trade creditors from the landlords can probably be justified.
- Unfair prejudice can only therefore come out of the differential treatment of the different classes of landlord. But: (1) there is a rationale for it; (2) where the Category B or C landlords do not like the deal on offer, they are not forced by the CVA to take it – they can instead forfeit. That is why a typical 2018 CVA will preserve an affected landlord's right to forfeit. It means the landlord is not forced to take the deal but can exit instead. That was a key factor in the Doorbar for rejecting unfair prejudice.

CHALLENGE FOR UNFAIR PREJUDICE: s.6

So:

- Vertical comparison unlikely to support unfair prejudice allegation.
- Horizontal comparison between landlords and trade creditors unlikely to support unfair prejudice allegation. Horizontal comparison between classes of landlord receiving differential treatments likely to be justified.
- However: highly fact sensitive inquiry.