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7 REASONS WHY THE POPULARITY OF CVAS MAY SOON WANE

The first half of 2020 saw a wave of company voluntary arrangements (CVAs) as companies explored their restructuring options against the backdrop of a darkening economic outlook.

> CVAs have proven popular in the casual dining and retail sectors amongst operators who have used the process to change rents with multiple landlords.

For many, the CVA has become the restructuring tool of choice - particularly for those operating in the retail, casual dining and hospitality sectors who rely upon heavy footfall across a large estate of rental premises. To name but a few, All Saints, Travelodge and Poundstretcher are all examples of companies that have successfully launched CVAs this year and as we write this article Pizza Express is reported to be drawing up plans for its CVA.

But, is the CVA all that it is cracked up to be? Originally, this rarely used restructuring tool was conceived to help smaller businesses struggling with their debts to reach a suitable compromise with a small number of creditors. Its use by larger companies in more recent years has thrown a spotlight on how they operate. Here we explore some of the limitations associated with this form of insolvency procedure and why their popularity might soon wane.

1. A compromise for all but a victory for none

A CVA is a consensual process, whereby a company seeks to compromise some of its debts with the agreement of its creditors. The beauty of this process is its flexibility, meaning that the nature of the compromise put to creditors can be adapted to suit the relevant company. Typically, unsecured creditors will agree to suffer some kind of haircut or reduction in the amount of debt owing to them, having accepted that this is a better outcome than if the company were to go into liquidation or administration.

CVAs have proven popular in recent years amongst companies which operate across a large number of leasehold premises, with CVAs used to reduce rents for a period of time, typically up to 36 months in duration. A common approach is to categorise leases into different bands, often using a variation of the traffic light analogy, with each band being treated differently during the life of the CVA depending upon whether they are regarded as a good (green), average (amber) or poor (red) performing site.

For businesses in the casual dining and retail sectors, part of the attraction of launching a CVA is the ability to compromise multiple leases in a single stroke without having to reach bilateral agreements with individual landlords, which can be time-consuming and unpredictable. The CVA can be useful where attempts to negotiate rent cuts with multiple landlords prove unsuccessful (as was the case for New Look recently) as, provided the CVA obtains sufficient creditor support generally, then all landlords can be bound whether they like the compromise or not.

The downside to this approach is that one never really quite knows whether the compromise reached via the CVA represents the best outcome achievable for each individual lease because of the tendency to group landlords into distinct bands. By contrast, in the case of an administration, for example, there is arguably greater potential to negotiate bespoke rent reductions with individual landlords with the possibility (albeit not guaranteed) to cut deeper into a leasehold portfolio than might be achieved via a CVA and therefore achieve greater rent savings.

2. The need to demonstrate that creditors are no worse off than in a liquidation

Another perceived weakness of the CVA is that it does not offer an ability to neatly sidestep particularly onerous or legacy liabilities. Take the alternative of a "pre-pack" administration, for example, which offers the ability for a purchaser of the business out of administration to cherry-pick assets and to leave unwanted liabilities or onerous contracts behind which might otherwise hamper profitability. It might be possible for the debtor company to "exit" some onerous leases or contracts via a CVA, but only by offering a return to the relevant creditors which will most likely need to be demonstrably better than what they would receive under a liquidation or administration.

CVAs require creditor support – which can lead to them being more costly than some other insolvency processes.

The debtor proposing a CVA is acutely aware that, unless it can demonstrate that no creditor is worse off under its CVA than in a liquidation, the CVA will be vulnerable to a court challenge by a disgruntled creditor. Given the inevitable evidentiary difficulties involved in proving the "no worse off" criterion, debtors tend to address this risk by "over-paying" creditors under the CVA. Whilst this over-payment approach reduces the risk of court challenge to the CVA, it inevitably reduces the economic upside for the business of doing the CVA in the first place. Furthermore, secured creditors cannot be bound by the terms of a CVA, whilst critical suppliers and HMRC will often also be left untouched.

It is noteworthy, in this regard, that a significant number of businesses which implement CVAs find themselves forced to return to the negotiating table within a relatively short time in order to seek a further restructuring of their financial indebtedness, having failed to make deep enough cuts the first time around. If a further restructuring is not possible, the debtor ends up filing for insolvency. All of which is good news for professional advisers who thrive on multiple restructurings and insolvencies, of course, but a pretty dismal outcome for the other stakeholders.

Given the above, it is of little surprise that this year has also seen a large number of businesses being sold by way of pre-pack administration – recent examples being the Ask Italian and Zizzi restaurant chains, following the likes of Everest, Go Outdoors, TM Lewin, Bensons for Beds, Oak Furnitureland, Le Pain Quotidien, Monsoon Accessorize and Quiz earlier this year.

3. The challenges associated with voting a CVA through

There remains the problem of getting a CVA through in the first place. A decision to approve any CVA proposal will be made when a majority of at least three-quarters (in value) of those responding vote in favour of it. However this is subject to the condition that not more than half the total value of "unconnected" creditors (in terms of the value of claims admitted for voting) vote against it.

The voting thresholds can be difficult to reach where approval of any CVA is heavily dependent on approval by landlord creditors, as landlords tend to be the category of creditors who are most likely to be significantly impacted by the CVA (at least as evidenced by the most recent CVAs). Some institutional landlords harbour an inherent dislike of the CVA procedure because of the loss of control around lease amendments and therefore often vote against any proposal.

As CVAs have become more common, so the response of landlords to them has become more co-ordinated. Obtaining landlord support can sometimes come at a high price, as it might involve offering a sweetheart deal to a recalcitrant landlord or re-categorising some leases in order to get a CVA vote across the line, both of which can make the CVA more expensive than originally anticipated.

Even if a CVA is approved at the creditor and member meetings, there is then the risk of challenge within 28 days of approval either on the basis of material irregularity or unfair prejudice. Unfair prejudice claims are typically brought where the CVA fails either on the "vertical test" (which compares the anticipated CVA outcome versus the projected outcome on the most likely alternative scenario – usually a liquidation or administration) or on the "horizontal test". The horizontal test compares the treatment of creditors under the CVA as between each other. Whilst there is no prohibition on differential treatment as such, it must be justified on the basis of fairness. The CVA launched by Steinhoff Europe AG in 2018 is a good example of a recent CVA whose implementation was significantly delayed as a result of one such creditor challenge. Given how long it can take to implement a CVA, many companies who launch them are often put into administration pending the approval of the CVA proposal in order to benefit from the automatic stay on proceedings in administration.

A CVA may offer respite to pursue a company rescue, but sometimes the company ultimately ends up in administration or liquidation down the line.

4. Unforeseen outcomes where the landlords who break are the ones you want to keep

A common feature of a number of recent CVAs – particularly those launched by retailers and casual dining businesses – has been an attempt to move away from a contractual rent model and towards a turnover rent model. For tenants proposing a CVA, this has been particularly attractive because it offers an ability to share risk and reward with their landlord. But in order to meet the fairness test mentioned above, compromised landlords are typically offered enhanced break rights in return, with an ability to terminate the lease within a specified period following approval of the CVA if they dislike the compromise presented to them.

The drawback to this approach is that it can result in some unforeseen outcomes, with the potential to lose some of the (more profitable) sites which the company was planning to keep - whilst retaining those which are less valued. Whilst the risk of landlords opting to break a lease might be perceived to be low in the current climate, companies shouldn't enter these arrangements blind to this possibility.

5. CVAs may be part of the solution but are rarely a complete answer to a company's financial problems

At best, a CVA offers a route to restructure a company's indebtedness and to provide some breathing space to get through a difficult time. However, a CVA alone is unlikely to restore a company's fortunes unless matched with some other support and a credible restructuring plan. A common feature of many CVAs has been that they are conditional upon a shareholder or other stakeholder injecting new funding into the relevant business (as was seen in the Travelodge CVA, for example). Divestments are often required during the term of the CVA. In short, a company can look very different at the end of a CVA to how it appeared when the CVA commenced.

A CVA is more likely to lead to a full rehabilitation and re-launch of the debtor's business where the stakeholders behind the relevant company are willing to support it with new money through the restructuring that follows. Where there is no appetite for that (which is perhaps more likely in a depressed economic environment such as now, where many investors are fighting fires across a number of portfolio companies) the CVA may at best provide a "softer landing" for the debtor, in the form of an orderly wind-down of the business and realisation of its assets outside of liquidation or administration.

The new "restructuring plan" may offer a viable and more flexible alternative to a CVA.

6. Landlords getting ahead of the curve

A growing trend in recent weeks has been the emergence of landlords proactively taking the initiative and offering some tenants the opportunity to move to a turnover-linked rent agreement. Examples include Crown Estate and West End landlord Capco. When one considers that one of the main objectives of many recent CVAs has been to compromise leases by moving to a turnover-based model, then depending upon how widespread this kind of landlord initiative becomes, it is possible that this might obviate the need for companies to consider going down the CVA route in the first place.

7. Law reform – the new “Restructuring Plan” procedure under Part 26A Companies Act 2006

The new “restructuring plan” procedure was introduced this June (under the Corporate Insolvency and Governance Act 2020). It offers certain key advantages over the existing restructuring tools available to financially distressed companies (including the CVA):

- Unlike a Part 26 Companies Act scheme of arrangement, the “restructuring plan” offers the possibility of a cross-class “cram-down” – i.e. if at least one of the classes of creditor with a legitimate interest voting on the proposal approve it, the court can order that the other classes of creditor are bound by the outcome, even if they voted against the proposal, so long as the debtor can satisfy the “no worse off” test in relation to those dissenting classes of creditor. That is a big improvement on the traditional Part 26 scheme, where a dissenting class of creditor had an effective veto on the proposal
- Unlike a CVA, it is not necessary to invite all creditors to vote on the proposal, so the “restructuring plan” is less vulnerable to challenge on the basis of the “horizontal test” described above and
- Unlike a CVA, it is possible to use a “restructuring plan” to compromise the rights of secured creditors

SUMMARY

When you compare a CVA to the more draconian alternatives of an administration or liquidation, it is easy to see why CVAs continue to prove popular. Going down the path of a pre-pack administration sale, for example, tends to be much more speculative (given the inevitably uncertain outcome of an accelerated administration sale process), puts directors at risk of investigation and can require more work in terms of assigning leases and contracts with counterparties. A liquidation is often the worst possible outcome, potentially jeopardising many more jobs and leaving stakeholders heavily out of pocket. Importantly, management retain control of the company during a CVA (with oversight from the CVA supervisor), where they would typically (and immediately) lose control in the event of a formal insolvency. Whilst a CVA may be a difficult pill to swallow, management, employees, landlords, creditors and suppliers tend to reluctantly accept that the CVA often represents the “least worst” solution, at least in the short term.

But those who embark upon a CVA must acknowledge that they may offer nothing more than a temporary reprieve, whilst postponing the inevitable. A typical CVA will last for three years, giving a company some breathing space with a hope of coming out the other side in better shape. But for some, that stage never arrives. Unless the business enjoys a revival following the implementation of the CVA, there is a risk that a CVA will simply be followed by an administration or liquidation. Carluccio’s, Prezzo, Jamie’s Italian, Mothercare, BHS, Debenhams, House of Fraser, Austin Reed and most recently Chilango (which only completed its CVA in January this year) – these are all examples of administrations which were preceded by a CVA.

It will be interesting to see whether the historically high failure rate of CVAs improves, given the recent rush to use this procedure, or whether the shiny new “restructuring plan” procedure trumps the CVA as the restructuring “weapon of choice” in the future.

KEY CONTACTS

For further information about any of the issues raised in this guide, please contact:

David Steinberg
Partner
T: +44 (0)1483 401206
M: +44 (0)7785 700275
E: david.steinberg@stevens-bolton.com

Matthew Padian
Managing Associate
T: +44 (0)1483 734278
M: +44 (0)7970 721039
E: matthew.padian@stevens-bolton.com

STEVENS&BOLTON

Wey House, Farnham Road
Guildford, Surrey, GU1 4YD
Tel: +44 (0)1483 302264
Fax: +44 (0)1483 302254
DX 2423 Guildford 1
www.stevens-bolton.com

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