

Introduction

There has been a significant increase in the use of CVAs, in particular in the retail and hospitality sector over the last 12 to 24 months, largely impacting landlord creditors. Consequently, there has been an increase in landlords challenging CVAs.

Landlords (and other creditors) may apply to court to challenge a CVA on the grounds of material irregularity or unfair prejudice.

This guide is intended to highlight those areas that will need to be taken into account when determining whether a landlord should vote in favour (or not) of a CVA and if there are potential grounds for challenge. The case law in this area is always developing and each CVA needs to be considered in context – one size does not fit all!

Unfair Prejudice

The question of fairness depends on the overall effect of the CVA and is a question of fact. If the outcome is unfair, it does not automatically mean that the CVA can be challenged; a landlord's position must also be prejudiced. In addition, what is fair (or unfair) in one case may not be in another.

Material Irregularity

A material irregularity may arise in the context of how a landlord's claim is valued at the CVA meeting or as a result of disclosures given within the CVA document that may have influenced how a creditor voted. As with fairness, just because there has been an irregularity does not mean that this will give grounds to challenge; any irregularity must also be material.

This note is intended as an overview and should not be relied on as legal advice. Should you require legal advice in relation to your specific circumstances, please contact a member of the Restructuring & Insolvency team listed at the end of this note.



Fairness/Unfair Prejudice

In most cases, there will be some level of compromise of payments due under the lease. This may include rent, service charges and insurance premiums. Whether the compromise is fair will require an analysis of the following:

Treatment of pre-CVA arrears:

- Does the CVA provide for payment in full?
- Does the CVA provide for arrears to be compromised? If so, how much discount is applied? Prior to COVID-19, it would have been unusual for arrears to be compromised in a CVA. We have seen a move in the COVID-19 era towards landlord CVAs compromising arrears, but whether this is unfair will be a question of fact.

CVA payments:

Rent:

- **How are leases classified?** Generally, most landlord CVAs will deal with landlords by categorising leases according to the profitability or otherwise of the premises. It is common to see landlords grouped into different categories, such as Category A1, B1, B2, etc. This might result in unfair prejudice between landlord creditors themselves, but a common ground of challenge is that landlords are treated differently to other creditors, such as trade creditors.
- **Are there any changes to payment terms?** It is quite common (and largely now accepted) that moving rent payments from quarterly to monthly does not prejudice the landlord. However, are other payment terms proposed that might result in a prejudicial outcome (e.g. moving from payment in advance to payment in arrears or switching to turnover rent)?

Discounts:

- **How much discount is applied?** More often than not, future rents are discounted by a set percentage. There is no industry standard, but based on recent CVAs, this could range from between 0% and 75%. Is the discount fair in the context of the wider CVA?
- **Assumptions used and the basis of valuation.** Landlords may wish to challenge the methodology used to calculate the appropriate discount (e.g. market rent, rent-free periods, marketing timelines etc). A different methodology or use of assumptions in some cases may result in a materially different outcome for a landlord and they may argue they have been unfairly prejudiced by the methodology used.
- **“Zero’d” rents (i.e. have rents been reduced to nil on some premises)?** Reducing rent to nil is not automatically unfair, but should be considered in the context of the CVA as a whole. The vertical comparator will be particularly important here. What else does the landlord get under the CVA and is this still a better outcome for them than in a relevant alternative (i.e. administration)?

- **Does the discount take the rent below market rent?** This may not necessarily be unfair (contrary to some interpretations, the Debenhams case is not authority for assuming that below market rents are automatically unfair).
- **What is the justification for the level of discount?** For example, is the premises underperforming? Is the level of competition in that area strong/weak? Have there been any changes in the surrounding area that could impact on business (e.g. the closure of flagship stores)?
- **Is the discount based on a turnover test?** If so, is there a base or a floor that rent cannot go below, which is then topped up with an agreed percentage of the tenant’s turnover? Landlords tend to dislike turnover rent, as it introduces substantial uncertainty to their portfolio. However, as a CVA requires “sharing of the pain” and some “give and take”, turnover rents are generally a fair way to structure a CVA. Nonetheless, fairness will turn on the CVA package as a whole. In addition, if there was a “floor” or a base rent, for example, this could provide landlords with an element of certainty.
- **COVID-19 clauses** – are there any further discounts for COVID-19-related closures (i.e. is there a separate rent mechanism for a “Lockdown Period” with further discounts on the CVA rent)? How is such a reduction triggered? Is there a phased return to CVA rent? What rights (if any) are given to the landlord to take back the lease if a COVID-19 provision is engaged?

Insurance/service charges:

- CVAs often provide for these to be paid in full.
- Fairness considerations will be relevant where these are discounted (see above).

Dilapidations:

- Is there a discount on dilapidations claims?
- How is such a reduction calculated and is there a variation in the reduction for certain landlord acts (e.g. lower dilapidations value if a landlord serves a notice to quit or a higher value if a landlord enters into a deed of surrender)?

Termination/conclusion of the CVA:

- **What happens when the CVA terminates?** The CVA may include provisions restoring the landlord’s claim for full contractual rent.
- **What happens at the end of the CVA?** Is rent adjusted based on market rent or does it return to contractual rent? There is still uncertainty about whether a CVA can permanently amend the terms of a lease (because a CVA is contractual in nature). Ongoing challenge cases may resolve this, but it is currently undetermined.

Each provision should be considered in the context of the CVA as a whole – what is the landlord losing as a consequence of the relevant provision and is this fair when considered in the context of what is offered to the landlord in return to the extent that the landlord is prejudiced? This is a delicate balancing exercise and issues should not be considered in isolation.

Addressing Fairness

The position should be considered in the round and assessed on a case-by-case basis, applying both the horizontal and vertical comparator tests (see below). CVAs have evolved rapidly in recent years, and the terms and structure have changed to try to address and avoid landlord challenges. Below are provisions that have become more commonplace, although as the case law develops, there is likely to be further changes to CVA structures and proposals.

If the landlord is being asked to accept a rent reduction, what is the landlord being offered in compensation in return for sharing the pain? Is there an upside for landlords? Is there sufficient give and take in the CVA? Can the landlord take the premises back?

Upside Sharing

It is common to see CVA terms that offer:

- **A profit share mechanism** whereby there will be an increased return to landlords if certain profits/turnover thresholds are met. For example, if turnover reaches X%, landlords will be entitled to Y% to compensate them for accepting rent reductions.
- **An equity stake in the business.** This could be simply through the fact of the CVA, or it could enable landlords to receive a share in the equity value of the company upon a future sale.

Such mechanisms may balance the “investment” landlords are making in the company by accepting a rent reduction. However, the company is not obliged to offer a profit share or equity stake, nor is there a set formula to determine whether the offered amount addresses “unfairness”.

Ability to Take Back Possession

Does the landlord have the ability to recover the premises? It is helpful to consider:

- When can they do so (i.e. is it a rolling right, or a right that must be exercised by a set time, such as three months)? It is common for a landlord to be given three months from the start of the CVA to decide whether to break the lease. Anything shorter might be considered unfair, but anything longer could create commercial uncertainty for the tenant.
- Will the landlord have an opportunity to break the lease at any other point?
- What is the impact of exercising that right on other claims in the CVA?

- How does taking back possession or being bound by the terms of the CVA compare to the likely outcome if the CVA is not approved?
- Do any break clauses operate for both landlords and tenants?

It is common for a CVA to give the landlord an ability to break the lease earlier than perhaps might be the case under the lease. This is to allow the landlord an opportunity to consider whether to accept the discounted rent and other terms proposed under the terms of the CVA or take back the premises.

Assessing Fairness

This will involve both a horizontal and vertical analysis.

Assessing **horizontal fairness** involves an analysis of the treatment of other creditors and whether (if treated differently) this is justified. In relation to the level of discount of payments due to other creditors, what is the extent of the differential treatment? Is this commercially justified? Has sufficient information been provided to assess any differential treatment?

Vertical fairness requires an assessment as to whether the creditor is in a worse position as a result of the CVA, as compared to its estimated outcome in a relevant alternative scenario (e.g. if the company went into administration or liquidation). For example:

- How does any reduction/compromise in rent or dilapidations compare to the outcome in an administration/liquidation?
- What is the likelihood of the landlord receiving a better return (e.g. how many months of rent in an administration/liquidation would be required to break even)?

There is not a “one size fits all” approach to assessing fairness.



Proprietary Rights and Guarantees

Proprietary Rights

Whilst a CVA cannot interfere with proprietary rights, it can compromise monetary/other obligations upon which the right to forfeit is based (i.e. amending the terms of the tenant's covenants, which may give rise to the right to forfeit).

Does the CVA oblige the landlord to take back possession or restrict the enforcement of a proprietary right (i.e. is there a forced surrender or a removal of a right to forfeiture based on the fact of the CVA)? Understanding the wider picture and operation of all of the provisions together will help determine whether the provisions could be said to interfere with a proprietary right.

It is important to understand how the CVA works and, therefore, whether what the landlord is being asked to accept is an interference with a proprietary right. This might not be clear-cut. Case law has determined that a landlord cannot be forced to accept a surrender. However, the tenant may be able to serve a notice to quit, the effect of which is to reduce rents to nil (but not to terminate the lease). This is unlikely to be an interference with a proprietary right because the legal estate remains intact. In addition, incentivising a landlord to accept a surrender (for example by paying higher dilapidations amounts if a surrender is accepted) may not be an interference with proprietary rights.

Treatment of Guarantees

Does the CVA purport to remove recourse to a tenant's guarantor? If so, is there any compensation offered for this loss of rights?



Material Irregularity

Voting

A common ground of challenge is the basis upon which the landlord's vote is valued for the purposes of voting and whether, as a consequence, there is a material irregularity.

Landlords claims often involve arrears (liquidated claims) and future rent/dilapidations claims (unliquidated claims).

The starting point is the Insolvency Rules 2016, which provides that an unliquidated claim can be valued at £1 for voting purposes. However, the CVA will usually set out a formula for determining the value of a landlord's claim for voting purposes, taking into account the potential for the landlord to re-let the property, accelerated receipts and a discount on future rent/service charges to reflect the unliquidated nature that places a higher value on such claims (i.e. above £1).

Points to consider:

- How does the formula work?
- What percentage discount has been applied to claims for future rent/service charges?
- What assumptions have been used to determine the landlord's ability to re-let?
- What discount has been applied for accelerated receipt?
- Have the correct figures/estimates been used in calculating the claim?
- How are dilapidations claims dealt with?
- Can the landlord provide additional evidence to support a higher value?
- Has the nominee taken that into account when placing a value on the vote?

There may be an opportunity for the landlord to increase their claim (and, therefore, their voting power) if the basis of calculation is incorrect (i.e. incorrect square footage). The landlord could also attempt to challenge the CVA on the basis of material irregularity, if, as a consequence of how the formula is applied and works in practice, the landlord suffers material prejudice (i.e. the outcome from the CVA would have been different).

Disclosure

The CVA is required to include/disclose certain information. Failure to disclose or provide sufficient information could provide a ground for challenge. Recent CVA challenges have included challenges around the level of disclosure given in respect of:

- *Antecedent transactions (i.e. preferences and transactions at an undervalue)*. Have some creditors been paid off in advance of the CVA (thereby diluting the cash available under the CVA and putting these creditors in a better position)?
- *Treatment of connected parties*. Landlords would expect connected parties to share the pain and/or inject more capital into the business. If a connected party has been treated “better” than a landlord, that landlord would want to have enough information available to enable them to understand why this is the case.
- *Justification for differential treatment*. Differential treatment may be commercially justifiable, for example, if critical suppliers have threatened to cease supply if they are not paid. However, the CVA must contain sufficient information to enable creditors to form a view on this and assess whether they have been unfairly prejudiced, when compared with creditors who have been paid and/or connected parties.



Undetermined Areas of Challenge

There are a number of typical CVA clauses that are still to be tested in the courts. These include the below:

- Is a CVA that compromises only the claims of a landlord (where all other creditors are paid in full) a “single arrangement” within the meaning of the Insolvency Act 1986? Landlords are attempting to raise an argument that such a CVA is not a “single arrangement” and, therefore, cannot be a CVA and fit within those provisions of the Insolvency Act (instead arguing that the much more onerous (and expensive) schemes of arrangement are used instead).
- Can unimpaired creditors (typically trade creditors) vote on a CVA that binds impaired creditors (typically landlords)? Landlords are arguing that voting of unimpaired creditors dilutes the voting power of the landlords and, therefore, decreases their ability to vote down a CVA.
- Market rent – is a CVA that reduces rent below market rent fair (see above)?
- Can a CVA permanently change the lease terms?

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