The Changing Face of the CVA and Schemes of Arrangement

A Security Agent's Perspective

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The use of company voluntary arrangements and court sanctioned schemes of arrangement as tools to restructure the debts of a company in financial difficulties has continued to increase in popularity in recent times, particularly in the retail sector, as an alternative to formal insolvency procedures, with the aim of generating better financial outcomes for the company in question and its creditors.

However, there have been some interesting developments in recent case law that have clarified the parameters around such arrangements, specifically the recent judgments in the *Debenhams* and *Instant Cash* cases, which may have a significant impact on the future content and structure of such restructuring mechanisms.

As an experienced independent debt administration services provider, GLAS has been involved in various capacities in numerous restructuring transactions and processes, including CVAs and Schemes, as an active participant in the restructuring of the company's financial arrangements, resulting, in some cases, in litigation, including in the *Debenhams* case. The recent legal developments raise key considerations for security agents collaborating with transaction parties to analyse and assist with achieving the goals of the transaction parties aiming to enable companies to continue as a viable going concern outside of a formal insolvency process.

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What is a CVA?

A company voluntary arrangement ("**CVA**") is a tool permitted under Part 1 of the Insolvency Act 1986 and is essentially a contract between a company in financial difficulty and certain of its creditors, which enables a company to restructure and compromise its debts and liabilities, with the aim of generating a better financial return and better prospects for the business than if the company entered into a formal insolvency procedure, such as liquidation.

Unlike other insolvency procedures available, the directors of the company remain in control of the business, which continues to operate under the supervision of an insolvency practitioner, and under the terms of the arrangements agreed between certain of the company's creditors.

A key benefit of a CVA is that, once in effect, a creditor cannot take any step against the company to recover any debts, or enforce any rights against the company that arise from failure to pay those debts in full, which are covered by the terms of the CVA.

There has been a recent increase in the use of CVAs, particularly in the retail sector, as the CVA can offer a mechanism for the company to restructure its rent obligations with landlords as a whole class of creditor, without the need to negotiate with each landlord individually, and has the potential to swiftly and significantly reduce rental outgoings of a company. Additionally, a CVA typically allows greater flexibility than a formal insolvency process, and is often more cost effective to implement, therefore offering a more commercially attractive outcome.

The *Debenhams* case

Discovery (Northampton) Ltd v *Debenhams Retail Limited* [2019] EWHC 2441 (the "***Debenhams* case**") was a recent significant case relating to CVAs, in which GLAS had direct involvement due to its role on the wider transaction.

The Security Agent's transactional role

Given its expertise in complex restructuring matters, GLAS was mandated as successor Facility Agent and successor Security Agent in March 2019 in respect of the existing loans and notes of Debenhams Retail Limited (the "**Company**") and other Debenhams group companies (the "**Group Companies**"), in addition to a subsequent new money facility and transfer of debt obligations of some Group Companies to a new funding vehicle (the "**Restructured Facilities**"). This appointment involved representing financial creditors whose total exposure to Group Companies was in excess of £700,000,000, providing administrative services in respect of the Restructured Facilities and taking a pragmatic approach to facilitating communications amongst lenders in respect of the proposed CVA arrangements.

Summary of the CVA proposals

Following consideration of its financial position and existing debt arrangements, the Company's directors had proposed a CVA in May 2019 mainly to compromise unsustainable retail rental and business rate liabilities. The proposals principally affected the Company's landlords and local authorities, and the proposals were approved by over 90% of the Company's creditors.

The CVA proposal challenge

Despite this overwhelming approval, a minority group of landlords (the "**Applicants**") initiated a challenge to the CVA proposals on several grounds, including specifically relating to the proposals that would impact landlords and the treatment of rental payments due under existing lease arrangements.

At a hearing in September 2019 (the "**September Hearing**"), the main claims asserted by the Applicants (in **bold type**), and the court's findings (in *italics*) , were as follows:

1 – Claims capable of compromise under the terms of a CVA do not include future rents and should not be included in the CVA as these are not correctly characterised as "debt" but as "unearned future rent payments"; therefore the Applicants are not "creditors" for future rent within section 1 of the Insolvency Act 1986 – *the court did not agree with this argument and ruled that future rental payments can be caught within the terms of a CVA*;

2 – the Applicants should be paid rent under the CVA at the full agreed contractual rate, as it would be unfairly prejudicial not to do so, or there is no jurisdiction to reduce rents for any future period when the Company occupies the property – *the court found that the fact that future rents may be reduced as part of the CVA would not be unfairly prejudicial or against the*

requirements of common justice, as it was noted that the purpose of a CVA would be to modify existing obligations, rather than create new ones;

3 – the Applicants are treated less favourably under the terms of the CVA than other unsecured creditors without any proper justification – *the court held that this argument failed as the differential treatment of landlords to other creditors was not inherently unfair and that market pressures and the need for business continuity may necessitate such differential treatment amongst creditors in certain circumstances*;

4 - the CVA proposals did not comply with certain requirements of the Insolvency (England and Wales) Rules 2016 (the "Insolvency Rules") – *the court determined this argument failed on the basis that the proposals put to creditors had sufficiently detailed the Company's efforts to source alternative financing*; and

5 – the right of forfeiture is a proprietary right that cannot be altered by a CVA – *on this point, the court found in favour of the Applicants, noting that Applicants' proprietary rights cannot be abrogated and therefore landlords could not be prevented from forfeiting their leases under the terms of the CVA*.

Therefore, this last point highlights the one important ground on which the Applicants were successful in relation to the forfeiture of leases – i.e. a landlord's right to terminate a lease before its stated termination date due to a breach of the lease terms by the tenant, allowing the landlord to re-enter the property.

Norris J therefore determined that the CVA was still valid and remained enforceable, but would be subject to certain amendments/ deletions to sever the proposed forfeiture provisions from the remaining proposals in the CVA.

The further *Debenhams* proceedings

In February 2020, a further hearing was held before Norris J to deal with matters reserved at the September Hearing, and to deal with an application by the Applicants to challenge and vary the order made by the court at the September Hearing.

Norris J confirmed the findings in the September Hearing regarding the severance of the forfeiture provisions, upholding the decision that the CVA was valid and could proceed, albeit that the proposed forfeiture arrangements would need to be deleted from the CVA, as it is not possible to interfere with the forfeiture rights of landlords.

The judge also dismissed an application by certain of the landlord Applicants pursuant to the Insolvency Rules in connection with a request for the court to review the order made at the September Hearing in light of arguments on certain points of law that were not advanced by the relevant parties at the September Hearing, and made determinations as to costs.

However, leave to appeal the judge's decision of all matters raised at this hearing was granted, potentially leaving the door open for further future challenges by the parties on these points.

The Security Agent's role in litigation

In acting as Security Agent, it was necessary for GLAS to be joined to the litigation proceedings in the *Debenhams* case as a Respondent, in order for it to be bound by any court order delivered for the benefit of the secured parties and relevant financial creditors. As an active party to the proceedings, the Security Agent was involved at the forefront of the litigation process, which enables the Security Agent to add value by:

1. formulating and understanding all of the key legal and commercial issues, in collaboration with the instructing creditor group, and where necessary, the company;
2. taking proactive steps to appoint independent counsel to work with GLAS' internal legal team to advise on matters relating specifically to the Security Agent's role, preparing submissions in court of arguments in support of the relevant creditors' position and attending court hearings; and
3. seamlessly working alongside creditors and the company and their respective counsel in order to adopt and support the arguments in the creditors'/Company's position papers and skeleton arguments for trial in opposition to the CVA Challenge.

The *Instant Cash* decision

Shortly after the September Hearing, an analogous decision to that of Norris J's in the *Debenhams* case was handed down by Zacaroli J in October 2019 in In the matter of Instant Cash Loans Ltd [2019] EWHC 2795 (the "***Instant Cash***" case).

The *Instant Cash* case related to a scheme of arrangement under Part 26 of the Companies Act 2006, being a court sanctioned arrangement between a company (the "**Scheme Company**") and its creditors to achieve a compromise of the Scheme Company's existing debts (a "**Scheme**").

The court in this case had to determine whether the proposed Scheme, which amongst other things, purported to effect a surrender of leases between the Scheme Company and its creditors with the effect of replacing the liability to pay rent with a claim for damages by the relevant landlord, was valid.

The court determined that the provisions purporting to unilaterally and automatically terminate the lease arrangements between the Scheme Company and its landlords by surrender by the tenant was void, as this interfered with the proprietary rights of the landlord, and did not relate to a contractual right between the Scheme Company creditor and a debtor. The court made the distinction, as in the *Debenhams* case, that the Scheme can only deal with rights between a debtor and a creditor, not with proprietary rights, such as those arising from lease arrangements between a company and its landlord.

The court also found that a lease cannot be terminated by the will of the tenant alone, and that the surrender of the lease in this case was considered to be an unnecessary additional consideration, as it was ancillary to the compromise of a pecuniary liability, and not necessary to ensure the effectiveness of the compromise of debt effected by the Scheme. As such, the court found the surrender provisions in the proposed Scheme were out of the scope and jurisdiction of the court under a scheme of arrangement pursuant to the relevant provisions of the Companies Act 2006.

Therefore, the court determined that it could sanction the proposed Scheme, provided that the lease surrender provisions were removed. The approach of the courts in this case shares significant similarities with the decision in the *Debenhams* case, that whilst it is possible to vary contractual provisions as between a debtor and creditor, it is not possible to unilaterally interfere with the proprietary rights of a landlord.

A new way forward for CVAs and schemes of arrangement?

The *Debenhams* and *Instant Cash* litigation produced two judgments in quick succession on different restructuring procedures where the court has sought to clarify and confirm aspects of the law in respect of creditors' (and specifically landlords') rights. These decisions may well have far reaching consequences for the scope and content of future CVAs and Schemes, given the potential implications on the ability of creditors to dictate or determine arrangements in respect of forfeiture or surrender of leases, which is often a key consideration for the creditor group in the decision to implement a debt restructuring using these methods.

Given the role played by the Security Agent on behalf of the secured parties in these transactions, it will be essential to continue to follow these developments in order to be ready to anticipate future challenges or issues arising where CVAs or Schemes are contemplated.

Postscript

On 9 April 2020, the directors of Debenhams appointed FRP Advisory as administrators over Debenhams Retail Limited and Debenhams Properties Limited with the aim of protecting the UK businesses from creditors, and potential liquidation, due to the current COVID-19 pandemic.