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The Changing Landscape of Retail CVAs – Are Landlords Taking Back Control?

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There has been an influx of company voluntary arrangements ("CVAs") in recent times, as retailers fight to rescue their UK high street stores. Retail CVAs accounts for the highest proportion of CVAs at 19%. As more and more CVAs are approved, we consider some of the recent trends seen in the retail sector which showcase the flexibility of a CVA and reflect the demands of landlords whose support is vital to the continuing viability of a business.

What is a CVA?

A CVA is a rescue procedure whereby a company in financial distress and its creditors enter into an agreement to compromise the debts and liabilities of the company. 2018 was coined the "year of the retail CVA", as Toys "R" Us, Prezzo, House of Fraser and Homebase (to name a few) all fell victim to the troubles of the UK high street.

In order for a CVA to be approved, a retailer must secure at least 75% creditor approval and as landlords make up a large percentage of unsecured creditors, their support is usually necessary for approval and the ultimate success of a CVA. However, securing landlord support can be a difficult scale to balance.

Typically, a retail CVA will treat landlord claims differently depending on a stores' financial performance and/or the strategic importance of the premises. So, for example, landlords of performing sites that are key to the future success of the business will be paid rent in full; underperforming sites (which could be commercially viable) will be paid a reduced rent and underperforming sites which are not viable will be closed.

The flexibility of a CVA allows unsecured creditor claims to be compromised in any number of ways to best support the future success of the business. There is no longer a "one size fits all" approach, with CVAs becoming more sophisticated than might historically have been the case. The terms of a CVA can be tailored not just to a class of creditor (i.e. landlords) but also to reflect the past performance and expected future trading of individual stores. The Paperchase CVA, for example, separated landlords into six different categories and rent was compromised on different terms depending on the category.

Sharing the pain and the gain

Improved returns on improved performance: upside sharing

Debenhams, one of the latest stores to propose a CVA, sought to reduce rents in 105 of its stores (some by 50%) and still the proposal received overwhelming landlord support. Why? Perhaps because recent proposals have seen a move towards risk sharing between the company and landlords.

In the Debenhams CVA, for example, the compromised leases included mutual landlord and tenant break clauses enabling either the landlord or tenant to terminate a lease early. It is also understood that the proposal included a £25 million ring fenced fund that will be available to creditors, whose claims were compromised as part of the CVA, if the business sees growth in the future.

A compromised creditor fund capped at £3 million, was also included as part of the Homebase proposal.

The prospect of sharing in the gain, if business improves, is perhaps the best way to secure support. It makes sense, why should creditors who are asked to support a business during a distressed trading period not then share in the upside if trading improves?

Upside sharing is not completely new. We have seen previous examples of this in the Paperchase CVA.

Under the Paperchase proposal landlords will receive a guaranteed base rental income of between 35% to 80% (payable regardless of sales) which is then “topped up” based on the performance of individual stores. If turnover improves, the return to the landlord improves.

Where a retailer’s sales are seasonal, a turnover CVA rent gives a business the headroom it needs to trade profitably outside of its peak session by reducing rent to a sustainable all year base rent. A top up rent therefore allows a landlord to share in the seasonal spike in trading performance.

The Arcadia CVA (approved on 12 June) offered landlords a 20% stake in the company.

Whilst landlords take the pain in the form of compromised rents, on the flip side “upside sharing” means that their support is rewarded by a higher return if the CVA does what is hoped, and the business is turned around, becoming profitable once more.

Squeezing landlords too much?

There are no restrictions on what a company can propose in a CVA save that its terms must not unfairly prejudice unsecured creditors. This allows a company to propose terms specific to the needs of the business to enable it to survive. However, not all recent CVAs have included a share of the gain as well as the pain.

The Regis CVA is an example of a CVA where landlords felt more pain than gain. Some of the landlords of the chain’s hair salons saw their rent reduced by 100%, receiving a nil return under the CVA. It is perhaps not surprising that the Regis CVA is currently being challenged.

Similarly the House of Fraser CVA, which sought to apply an arbitrary 75% rent reduction on those stores remaining open, was also challenged by landlords on the basis of unfair prejudice. The legal challenge was settled on confidential terms outside court for a reported £1 million.

Preserving a landlord’s claim on failure

In addition to “upside sharing” we expect to see CVAs (and landlords requiring a CVA) to include a provision entitling the landlord to claim the full amount of rent due if the CVA fails.

The BHS CVA proposal included such a provision, enabling landlords to claim for the full (not just the compromised) rent when the CVA terminated and BHS went into liquidation.

Landlords being asked to support a CVA should consider whether a similar provision exists. If not, and the CVA fails, a landlord may only be able to claim for the compromised rent.

What other trends do we expect to see?

Business rates

Business rates apply annually and are payable to the local council in which the property is located.

Homebase was the first to compromise rates as part of its proposal and more recently the Paperchase CVA also applied a discount to rates.

A CVA can only compromise rates until the end of the current business rates year. After that, they return to their previous level but if a struggling retailer is considering a CVA after 31 March, the ability to compromise business rates could be invaluable.

Foreign leases

While the UK remains part of the EU, businesses, which operate in the EU, may be able to take advantage of the fact that UK insolvency procedures are automatically recognised in other EU member states. This enabled the terms of foreign leases to be compromised as part of the Homebase CVA.

This may not be an option for much longer, but for the bigger retailers having the ability to compromise the rents of foreign leases may also be a valuable tool when looking to restructure through a CVA.

Changes to landlord behaviour outside of insolvency

Landlords are also feeling the impact of CVAs outside of any direct formal insolvencies or financial distress of their tenants.

Next announced last year that it would incorporate a “CVA clause” into its own leases to benefit from a rent reduction if its neighbouring retailer received a reduction in rent through entering a CVA.

It has also been reported that Next have sought significant rent reductions on lease renewals.

Conclusion

One of the main issues that retailers face is that they are tied into long and expensive leases. Competition from online retailers has meant that these rents are becoming more and more difficult to sustain and CVAs are becoming a popular way for companies to restructure and avoid insolvency.

Landlords often hold a large percentage of the voting power and gaining their support is key to obtaining approval of a CVA.

Many landlords have been hesitant to agree to terms in a CVA that compromise their position but recent proposals seem to strike the right balance between reducing costs; giving a distressed business the headroom it needs to turn the business around but offering a share in the gain for landlords (turnover rents, compromised creditor funds and shares in the future business) in return for their support.

Whilst landlords will inevitably be out of pocket, the alternative to a CVA is often liquidation, which will likely see a landlord recover pence in the pound in respect of unpaid rent, an empty property (and liability for business rates) and uncertainty over future rental income.

It is clear that retail CVAs are becoming increasingly more sophisticated and allow a company to restructure its business to reflect the strength of business locally as well as nationally. Landlords are also much more savvy when it comes to CVAs and it is likely that we will see landlords requiring upside sharing as part of future CVA proposals. The question is: will other major unsecured creditors jump on board and require similar terms in return for their continued support?

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