SQUIRE PATTON BOGGS

Treatment of Creditors in a Company Voluntary Arrangement (CVA)

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When drafting a CVA, one of the key considerations is ensuring that no creditor is unfairly prejudiced. Both unfair prejudice and material irregularity are grounds on which a CVA can be challenged following its approval.

CVAs have typically been used to restructure companies with large lease portfolios, particularly where properties in the portfolio are over-rented and/or underperforming. This, in turn, led to a spate of CVA challenges by landlords, most notably, the challenge brought by landlords to the *New Look* and *Regis* CVAs.

The findings in *New Look* and *Regis* are most useful in the context of CVAs that seek to modify lease terms where the key to mitigating the perceived unfairness to landlords is whether the CVA allows a landlord to terminate its lease.

The following are the key drafting points to note from those cases:

- **Modification of lease terms** – It is not inherently unfair to modify any (non-proprietary) lease terms, and it is for a landlord to assess at the outset whether it thinks the modified term is acceptable to it, not the court. That is, assuming that the CVA gives the landlord a right to terminate the lease and, therefore, a choice as to whether to continue the lease or terminate it.
- **Market rent** – It is not inherently unfair if a CVA reduces rent below market rent, including during the notice termination period, provided the vertical comparator test is met.
- **Turnover rent** – Switching from contractual rent to turnover rent is likely to be increasingly more common. It is not inherently unfair for a CVA to propose turnover rents, provided, again, that the vertical comparator test is met and the landlord is given a right to terminate.
- **Nil rent provisions** – An option to terminate is also key here. If a landlord has the option to terminate (and, therefore, a choice of whether to accept this modification) a provision that releases the company from all of its obligations, including an obligation to pay rent, is not inherently unfair.
- **Company's right to terminate** – If the company is granted a new right to terminate, the effect of which (usually) reduces rent to nil, then, again, if the landlord has a right to terminate, such a provision is not inherently unfair.
- **90 days' notice periods** – Even if a landlord cannot find a new tenant or re-let within the initial termination period, that is not to say that a landlord should be given a longer period or that this period is unfair if what is offered to a landlord meets the vertical comparator test.
- **Rolling right to terminate** – When offering a right to terminate, it does not need to be a rolling right. There may be reason not to do so, such as business continuity. A landlord has to assess at the outset whether it is willing to continue the lease in the absence of such a provision.
- **Multiple leases** – Given the focus on the importance of termination rights, we would expect future CVAs to give landlords the option of selecting which of its properties it wishes to take back, rather than, as has been the case, an option to terminate all or none.
- **Profit share fund** – There is not a requirement to include a profit share fund, but it may address the question of fairness when considering the horizontal comparator test.
- **Termination rights** – For the most part, giving a landlord the opportunity and choice to decide whether to terminate the lease balances the perceived unfairness of the proposed rent reductions and lease modifications, provided that, on exercising the right to terminate, the landlord would be no worse off than in the relevant comparator.

Aside from balancing the terms of the proposal to achieve fairness to creditors on the one hand, and the success of the CVA on the other, another key consideration is how a landlord's claim should be valued and treated for voting purposes – often another area of challenge.

The below sets out the key findings from *New Look* and *Regis* about how the landlord's claim can be dealt with.

Voting

Discounting of Landlord Claims for Voting Purposes

It is usual for a landlord's claim for voting to be valued on the basis of a formula that applies certain assumptions, for example, in relation to re-letting and void periods. It is also usual for a discount to be applied to the claim, usually between 25% and 75%, to arrive at the "estimated minimum value" of the landlord's claim.

In *New Look*, a 25% blanket discount was justified; in *Regis*, a 75% discount was not. The primary difference was that in *New Look*, each of the landlord's claims had been estimated according to the specific circumstances of the lease before the discount was applied, unlike in *Regis*. Therefore, there is likely to be a move away from a broad brush formula to a more focused one, to justify the percentage discount – something that we have seen in "newer" CVAs.

New Look confirms there is not a hard-and-fast rule when it comes to what an appropriate discount is, save that, the bigger the discount, the more that it will need to be justified. The fact that the same discount has been used in other CVAs is irrelevant. It is also likely to be irrelevant, as it was in *Regis*, that the British Property Federation did not object to the discount or that the chair's decision was not appealed.

That said, if a different discount is applied, it will apply to all claims, and therefore makes no material difference to the outcome of the meeting. Similarly, if, despite applying a different formula, there would have been no impact on the outcome of the meeting, any irregularity in the way that the landlord's claims have been valued is unlikely to be a material irregularity or unfairly prejudicial.

What is clear is this:

- A landlord's claim is treated for voting purposes as unliquidated and unascertained
- The starting point is that the claim for future rent is valued at £1 unless the chair decides to put a higher value on it
- The duty of the chair is to consider the available evidence and, if that evidence leads to the conclusion that they can safely attribute to the claim an estimated minimum value, they must do so

Using a formula to calculate claims is acceptable, provided that if a landlord thinks its claim should be valued at a higher amount and produces evidence to support its position, the chair should consider that and value the landlord's claim accordingly.

Counting the Unimpaired Creditor Votes

One of the primary grounds of challenge in *New Look* was that unimpaired creditor claims should not be counted towards the vote. The decision confirms that unimpaired creditor claims should be counted, but if the CVA is approved as a consequence of the votes of unimpaired creditors voting in favour, that will be a highly relevant factor in determining whether there is unfair prejudice.

For Insolvency Practitioners they should count unimpaired creditor votes and those from creditors who are treated differently under the terms of the CVA, but if the CVA is approved because "a large swath" of unimpaired creditors vote in favour, this may give rise to a challenge based on unfair prejudice.

If the CVA is approved by the votes of unimpaired creditors, the court will consider all of the circumstances to determine whether there is unfair prejudice (it is not enough that differential treatment is justified and the vertical comparator test met), including (but not limited to):

- The circumstances that would be taken into account in exercising the discretion to sanction a scheme
- The circumstances that would be taken into account when exercising the discretion to cram down a class in a Part 26A plan
- Whether there is a fair allocation of the assets available within the CVA between the compromised creditors and other subgroups of creditors
- The nature and extent of any different treatment, the justification for that treatment and its impact on the outcome of the meeting
- The extent to which others in the same position as the objecting creditors approved the CVA

More recently, the factors set out above were applied by the court in *Mizen*[1], where the court considered the position of compromised guarantee creditors where the proposal was approved based on the votes of creditors who would receive payment in full. In that case, the court determined that the guarantee creditors had been unfairly prejudiced as a consequence. Although each case will be determined on its own facts, it is clear that unimpaired creditor voting may, in the right circumstances, give a valid ground for challenge on the basis of unfair prejudice.

Contacts

John Alderton
Partner, Leeds
M +44 788 505 8896
E john.alderton@squirepb.com

Monika Lorenzo-Perez
Partner, London
M +44 778 572 0439
E monika.lorenzo-perez@squirepb.com

Devinder Singh
Partner, Birmingham
M +44 772 139 9625
E devinder.singh@squirepb.com

Russ Hill
Partner, Birmingham
M +44 792 160 0409
E russ.hill@squirepb.com

Charlotte Møller
Partner, London
M +44 788 180 4970
E charlotte.moller@squirepb.com

1 Newlon Housing Trust (1) Peabody Construction Limited v Mizen Design/Build Limited and others [2023] EWHC 127 (Ch)