Company Voluntary Arrangement (CVA) briefing

Prepared by: Laurence Raeburn-Smith (Head of Retail Policy), 020 7802 0121, lraeburn-smith@bpf.org.uk

The British Property Federation

1. The British Property Federation (BPF) represents the real estate sector – an industry which contributed more than £100bn to the economy in 2018 and supported more than 2 million jobs.

2. We promote the interests of those with a stake in the UK built environment, and our membership comprises a broad range of owners, managers and developers of real estate as well as those who support them. Their investments help drive the UK's economic success; provide essential infrastructure and create great places where people can live, work and relax.

3. This briefing outlines our concerns with the way in which Company Voluntary Arrangements (CVAs) are being used and some apprehensions we have about how they are undermining the property sector's efforts to transform our high streets. We also outline our recommendations for government as to how CVAs can be improved so that they provide for more transparency, oversight and clarity for creditors.

4. We would be delighted to provide further information on any aspect of this paper. Please contact Laurence Raeburn-Smith (Head of Retail Policy) at: lraeburn-smith@bpf.org.uk, or on 020 7802 0121, if you would like to discuss any of the points raised.

What are CVAs?

5. CVAs are an out-of-court insolvency procedure through which a business can compromise both current and future debts owed to unsecured creditors, usually for a period of three-years. In the case of property owners, the terms of a CVA often include a reduction in future rent obligations. CVAs can also be used to write down rent in arrears, compromise dilapidations or exit unprofitable stores (though not strictly break leases).

6. In order to undertake a CVA a firm doesn't need to actually be insolvent but it does need to gain the consent of a least 75% of unsecured creditors by value. Further, no more than 50% of unconnected creditors may vote against the CVA. If approved, the terms of the CVA then bind all creditors, including those dissenting.

7. Unlike many other forms of insolvency, CVAs are often company-led and the existing management remains in place and in control of the business. A CVA must be administered by a licenced insolvency practitioner (IP) but the quasi-law underpinning IP practice on how this is determined – the statement of insolvency practice (SIP) 3.2 – allows for a degree of flexibility over what this entails.

8. CVAs have traditionally been used by small firms yet in recent years many of the UK's largest retail, hospitality and leisure firms have looked to them as a means through which to navigate the structural shift to online and declining footfall. Covid-19 has also resulted in severe financial stress among high street businesses, prompting a wave of CVAs that is expected to continue for months to come.

9. This House of Commons briefing on CVAs provides for further background.

Company Voluntary Arrangement (CVA) briefing

How abuse of the CVA process is impacting high streets, pensions and investor sentiment

10. The UK's insolvency framework is renowned the world over for its flexibility and low cost. However, in recent years this flexibility has allowed for an abuse of the CVA process that has created considerable knock-on effects for the commercial property market and the pensions that underpin it, thereby driving investment out of our high streets and town centres at the very time when it is needed most.

11. The BPF supports a business rescue culture and we recognise that CVAs can be a useful tool for restructuring when used correctly. We are however extremely concerned by the 'Landlord CVAs' that have been undertaken by major high-street firms over the past decade, where there is only one or two compromised classes of creditors but other, largely unaffected creditors approve the CVA.

12. The abuse of CVAs however has impacts that stretch far beyond property owners themselves:

    12.1. **They transfer value from UK pensioners and savers to businesses and shareholders -** as much as 70% of the of the c. 1.5bn sq ft of retail and food and beverage space in the UK is owned by the general public, through charities, local authorities and institutional investors such as pension funds and insurance companies. Of the UK's top 22 High Streets some 60% is owned by the public. It is the public that ultimately bears the cost of CVA abuse and the public's cash that ends up being transferred to the owners of CVA businesses.

    12.2. **They make it riskier to invest in town centres -** our town centres quickly need to adapt to changing social and economic forces but CVAs make it much harder to underwrite the investment that would facilitate this, as it becomes impossible to have any certainty over future rental income.

    12.3. **They undermine property rights, hurting the UK's reputation** - the UK has long benefited from a reputation among international investors for having strong, well-defined property rights and a strong rule of law. CVAs are seriously undermining these as they effectively allow leases to be rewritten (sometimes permanently) in an occupier's favour. Without these international investors in property, it becomes much more difficult to nurture the built environment needed for vibrant town centres.

    12.4. **They distort competition and favour poorly run businesses -** because CVAs are easy to implement, they are often used as an alternative to genuine shareholder investment and proper structural turnaround. However, the lower running costs that a CVA allows gives those businesses an unfair advantage against their better run or less opportunistic competitors – those who play by the rules.

    12.5. **They undermine consensual negotiations and partnerships** – the avalanche of opportunistic CVAs over the past few years mean property owners are less willing to come to consensual agreements with existing tenants, as they know that such a CVA may compound these compromises further later on. The fact that CVAs can be abused also sours tenant-property owner relationships with suspicion and creates an incentive for occupiers to seek short-term gain through a CVA at the cost of long-term partnerships. This has been particularly problematic over the course of the Covid-19 crisis, given the need for property

owners and tenants to come to agreement on how to manage the £1.5bn worth of rent arrears being accrued each quarter.

How is the CVA process being abused?

13. Broadly, our concerns with CVAs fall under the following headings:

 13.1. **Manipulation of the vote** - the voting procedure is being manipulated in order to target particular classes of creditors. CVAs are often centred on making compromises to debts owed to property owners yet their voting rights are heavily and arbitrarily discounted by the IPs in the firm's employment, often only to ensure the vote passes. This voting discount is decided by the IP themselves in each case which is a clear conflict of interest. This materially affects not just the chances of approval but also the contents of CVAs, as those creditors whose vote is discounted can be more severely compromised without the chance of voting reprisal.

 13.2. **Unaffected creditors are given voting rights -** even more problematic is that those creditors who are not compromised within a CVA are given full voting rights. As an example, the recent Clarks CVA focused compromises onto property owners yet the C & J Clark pension fund was admitted voting rights of nearly £260m (almost a third of the total), thereby making the result a foregone conclusion from the outset.

 13.3. **Lack of oversight -** there is no means of recourse for creditors who feel they have been unjustly treated in a CVA other than to challenge them in the courts. By challenging however creditors threaten the business's recovery (new funding is often made contingent on no challenge being made) and doing so is extremely costly for all parties.

 13.4. **Permanent re-writing of contracts –** CVAs are supposed to provide a temporary respite for a struggling but ultimately viable business to put in place new investment and an effective turnaround strategy. They now however routinely include terms that outlast the CVA's supposed duration, such as indefinite rent concessions or rent reviews at the end of the term. Given CVAs lack court oversight this innovation simply cannot be acceptable, given its impact on investor faith in the lease contract.

 13.5. **Lack of effective restructure** – proposals often do not include an adequate turnaround plan or detail even whether refinancing options have been considered. They simply compromise a company's contractual obligations to unsecured creditors (and can only compromise unsecured creditors) in an effort typically to only cut costs and defer investment decisions. PwC analysis shows that just over half of all retail CVAs have failed, with 51% resulting in another insolvency procedure, 31% completed successfully and 18% still ongoing.

 13.6. **Lack of transparency** – unsecured creditors have few rights to information in CVAs and are frequently given insufficient time to consider proposals. It is in many cases unclear whether the issuing firm is truly even in financial difficulty and creditors regularly have not even been able to read the CVA document in full by the time they are asked to vote on it.

 13.7. **Lack of clarity over the role of the insolvency practitioner –** despite some recent positive changes to the statement of insolvency practice (SIP) 3.2 that underpins IP behaviour on CVAs, they remain a "company-led" process. There are clear conflicts of interest in this role, with the IP in the firm's employment charged with chairing the

creditors hearing, deciding on voting principles and then ultimately overseeing the CVA's implementation. Unlike other forms of insolvency, an IPs duty is not principally to creditors as is often assumed.

14. For those seeking further information on each of these points in turn they are expanded upon in the second half of this briefing.

Recommendations to Government

15. The legislative underpinnings for CVAs are lacking and this is the reason abuse of the process is possible in the first place. Over the past few years, we have been lobbying government to improve the way CVAs work so that they are fairer and the process is more transparent for creditors. Given that the Covid-19 crisis will inevitably result in more companies considering their insolvency options, it is more crucial than ever that government urgently moves to reassure creditors by reviewing CVAs.

16. Our key asks are that:

    16.1. The voting procedure is made fairer to those that the CVA compromises. Government should **implement a statutory requirement that the chairman assess the value of future/contingent claims for voting purposes via a more appropriate formula.** The arbitrary 75% discount often applied to property owner's unascertained claims should be explicitly ruled out.

    16.2. **The voting rules should be reformed so that unaffected groups of creditors cannot get full voting rights.** This would mean firms are unable to target certain types of creditors within proposals and CVAs must be balanced and at least to a degree consensual.

    16.3. **Large CVAs should be mandatorily referred to an independent third-party for review pre-launch.** The Pre-Pack Pool could perform such a function, as it (or rival bodies) now must in the case of pre-packs. The remit of that independent third party would be to check that (a) one class of creditors was not being treated less favourably than others unless that was absolutely necessary for the rescue of the business, (b) if they were so treated then there was a proper mechanism to compensate them out of the future profits of the business (e.g. no dividend should be paid to shareholders until their claims were met in full), and (c) the CVA proposal went no further than was reasonably necessary to avoid formal insolvency.

    16.4. Government should **implement reform so that the terms that bind creditors are limited to the CVA's actual duration** and this should be capped at 3-years.

    16.5. Reform should also be put in place so that **firms undertaking a CVA be required to outline a full and effective turnaround strategy** and where there are wealthy shareholders, they should be encouraged to 'buy-in' to the process by putting in investment themselves.

    16.6. **CVAs should also be reformed so that unsecured creditors have better rights to information.** As a bare minimum, store level EBITDA should be provided to property-owners for the leases that are compromised.

    16.7. **The 14-day notice period of the creditors' meeting should be extended to 28-days** with a provision that allows businesses to apply for a 14-day notice period, if they can prove

they cannot avoid insolvency for 28-days. This would give creditors enough time to consider proposals before being asked to vote on them.

Appendix - What's wrong with CVAs?

Manipulation of the vote

17. The voting procedure is being manipulated in order to target property owners. This widespread practice has gone on for many years. It is not supported by case law and there is no justification for it, other than to cram down the votes of property owners or indeed other classes of creditors that a firm wants to compromise in that particular case.

18. To get a CVA approved it must be voted through by 75% of the unsecured creditors by value. The 75% is based on the weight of claims that the creditor has, but the rules for calculating 'unascertained debt', such as future rent, for voting purposes provide that these claims can be valued at as little as £1 unless the chair – the IP - attributes a higher value to the claim.

19. In practice, the estimated minimum value of property-owner's future contingent claims for voting purposes are typically calculated according to the approach taken in the *Re Park Air Services* case, with the formula used often comprising standard terms across a portfolio of properties. An arbitrary discount of between 25%-75% is then applied, without proper justification.

20. In theory, the property-owner's claim on future rent should run to the end of the lease. The explanation given for this arbitrary discount however is always that it reflects the uncertainty of the property owners' losses. This ignores the property advice the firm will have received, which is used to calculate *Re Park Air Services* discounts before the further discount is then applied anyway.

21. IPs are frequently unwilling to consider evidence put forward by property owners that would allow them to more robustly assess their claim. Further, we have seen evidence that where it would mean property owners are able to affect the outcome of the vote, the arbitrary discount is often reaffirmed to be 'fairly' calculated at 75%, even by IPs who have previously used lower discounting in other CVAs with similar levels of available evidence.

22. In essence, companies should not have it both ways. If the chair has sufficient evidence to calculate the landlords' likely loss on a *Re Park Air Services* basis then he or she should do so and no more. If he or she has no such evidence then it may be justifiable to apply an arbitrary discount to the maximum possible amount of the landlords' loss (the future rent should run to the end of the lease). He or she should not be able to do both.

23. The current rules thereby enable companies to unfairly engineer the weight attached to affected creditors' voting rights, thus resulting in unaffected creditors approving CVAs with affected creditors being powerless. It should be noted that this engineering is company driven and built into the CVA proposal itself. We believe this is fundamentally unfair and requires Government intervention to be solved.

24. This also means the argument that property-owners vote CVAs through, so there is no problem, does not stand. The manipulation of the vote often means that even if all affected landlords voted against the proposal, they would in many cases still not be able to block the CVA. They

would however still have to endure being castigated in the media for attempting to vote down proposals.

25. It is wrong to target particular creditors in this way and this is a clear abuse of the CVA process. This should be a key aspect of a Government review into CVAs. We believe Government should implement a statutory requirement that the chairman assess the value of future/contingent claims for voting purposes via a more appropriate formula and that the arbitrary 75% discount often applied to property owner's unascertained claims should also be explicitly ruled out.

Unaffected creditors are given voting rights

26. In addition and in compliment to the aforementioned issues with vote discounting, we are also concerned that particular groups of creditors can be singled out for compromises within CVA proposals and that unaffected creditors are able to vote them through.

27. The CVA proposal documents put forward by major retailers in recently years frequently outline that their sole purpose is to compromise property owner creditors and only property owner creditors. The recent Pizza Hut CVA is a good example of this. Other trade creditors are then left unimpaired even though they could reasonably be compromised and it would be of benefit to the turnaround for them to be. They can however vote fully in line with the uncompromised debt owed to them. Quite simply this means there is nothing voluntary or consensual about a CVA.

28. If CVAs were to be designed so as to best support business recovery and so that they could truly deliver the best outcome for creditors, all those creditors with insurmountable debts owed would be in line for compromises. Further, those less able to shoulder concessions would be protected. Instead, a tyranny of the majority exists in which those with large debts owed can rest assured their debt won't be touched by a proposal, so long as their vote can be relied upon to enforce compromises elsewhere.

29. The voting procedure should therefore be reformed so that rather than being given voting rights in line with debt owed, rights should vary in line with the scale of compromises being imposed. If this where the case, CVAs could still be used to enforce compromises where a handful of creditors are unreasonably obstructing a turnaround proposal but it wouldn't be possible to target whole groups of creditors, as is the case now.

Lack of oversight

30. A CVA has too many important implications to be left exclusively to the IP in question. CVAs affect thousands of employees, the future of our town centres, local authorities' business rates revenue, wider trade creditors, pension funds, property owners and the real estate investment market which is fundamental to the economy.

31. In many cases, IPs even abdicate this responsibility and claim that CVAs are a "company-led process" and it is not for them to assess fairness or scrutinise the terms of the proposal, or indeed, the financial information upon which CVAs are based. This is deeply concerning. As an

out of court process, creditors rely on the IP to be the "honest broker" and provide independent oversight of the CVA in the interests of creditors, as is the case in other insolvency situations.

32. In spite of this, there is also no useful means of recourse for creditors other than to the challenge CVAs through the courts. This is extremely expensive and to some extent means threatening the business rescue itself. A challenge (whatever the outcome and whether or not it goes to court) will threaten the refinancing that the company has secured and will frequently involve considerable time burdens and costs that the company cannot afford. Challenging CVAs often means the challenging landlord's reputation is dragged through the mud in the media as well. There needs to be a means through which unsecured creditors can gain confidence from an independent body that a CVA was fair without having to use the judicial system and threaten business recovery.

33. We suggest that government should make it mandatory that an independent second opinion on large CVAs is always sought pre-launch, like it has recently done for pre-packs, to ensure they are being conducted fairly and are partnered with a proper restructuring. This could be a task for an existing body called the Pre-Pack Pool. It would not cost Government money, as the services for the Pre-Pack Pool are paid for as part of the insolvency process and it is not a Government body but a group of mainly retired accountants and insolvency practitioners, who are experts in picking through these deals. The remit of that independent third party would be to check that (a) one class of creditors was not being treated less favourably than others unless that was absolutely necessary for the rescue of the business, (b) if they were so treated then there was a proper mechanism to compensate them out of the future profits of the business (e.g. no dividend should be paid to shareholders until their claims were met in full), and (c) the CVA proposal went no further than was reasonably necessary to avoid formal insolvency.

The permanent re-writing of contracts

34. A trend that we have seen for years but which has rapidly accelerated in the past year is the implementation of terms that outlast a CVA's supposed duration.

35. When a CVA ends creditors expect its operative terms to conclude as well. Indeed, a CVA is after all supposed to be a simple, short term means through which a struggling but ultimately viable business can get the respite from creditors needed in order to put in place refinancing and an effective turnaround. It is not supposed to be used as means to circumvent contract law and give the business an advantage over its competition permanently.

36. CVAs now routinely though impalement rent reviews upon their termination, and in many cases, CVA proposals even kindly spell out the outcome of those reviews for landlord creditors. CVAs proposed by Clarks, New Look, Wasabi, Gusto restaurants and Bakers + Baristas within the past 6-months are all good examples.

37. As an out of court procedure without impartial oversight, this legislative loophole is completely unjust and government must end the exploitation of it urgently. If it is allowed to continue and it becomes as normalised as we fear the consequences for the reputation of the lease contract is in jeopardy.

38. Furthermore, there are cases where even the stated duration of CVAs is so long that creditors are in effect left waiting in perpetuity for the company to decide when it wishes to oblige by its original contractual obligations.

39. Most CVAs are typically stated to last between 3-5 years. This is however far too long to bind creditors and we frequently see firms attempting such long CVAs tend to fail anyway. In these cases, directors typically do not implement the necessary changes quickly enough or it is apparent that the long duration has been chosen because radical enough refinancing was not possible to find in the first place so as to ensure the long-term success of the business.

40. There are even cases in which the duration of the CVA is left unspecified. As an example the recent Genus UK (trading as Select) CVA didn't even include an end date and merely stated that, '*it is intended that the CVA will be concluded as soon as reasonably practicable.'*

41. Some excellent research undertaken by the IP trade body R3 also concluded that a 5 year CVA term is generally too long and that they should be capped at 3 years. We agree and urge Government to implement this.

Lack of effective restructure

42. CVAs do not require firms, or indeed their IPs, to adequately assess why they are failing. This is a key reason why so many companies entering them eventually end up in administration anyway. The aforementioned R3 research for instance found that of the 552 CVAs commenced in 2013 65% were terminated without achieving their intended aims.

43. Successful CVAs have tended to be a proper restructuring exercise of the business in distress, whereby refinancing is sought and an effective turnaround plan is proposed and implemented alongside the CVA. In these cases, the firm will look at all the aspects of the business and ask: Is the consumer offer up to scratch? Does it have the right marketing channels? Does it have the right management? Is the debt being restructured? Is new equity being invested, particularly by existing shareholder? Is it most effectively restructuring the property estate and leases?

44. However, many firms undertaking CVAs focus only on compromising creditors and cutting costs. As a result, these CVAs tend to simply keep the business in distress afloat for a short period, without making the necessary changes to turn its fortunes around. Most CVA packs we see actually point to issues such as over expansion, poor product, poor marketing, ill-though through logistics plans, IT failures and over leverage, while at the same time outlining no means through which to address these failings.

45. This is also a significant frustration for other well-run businesses that see their competitors simply benefiting from the restructuring of costs achieved through a CVA. It is a complaint that our members hear frequently from retailer occupiers. It should be noted too that as CVAs provide for cost reductions in specific locations, they impact upon competition on a local level in a way in which other forms of insolvency usually do not, often therefore allowing for local monopoly advantage. CVAs must move on from simply being cost cutting exercises if this is to be in any way justified.

46. If CVAs are to work effectively, they should be proper restructuring exercises that look at all aspects of the business, including whether the firm has the most appropriate management. Wealthy owners should also be incentivised to offer support for their own businesses before requiring creditors to bail them out through a CVA.

47. We believe firms undertaking a CVA should therfore be required by government to outline a full and effective turnaround strategy and where there are wealthy shareholders, they should be

encouraged to 'buy-in' to the process by putting in investment themselves.

Lack of transparency

Lack of rights to information

48. Unsecured creditors have little rights to information. A CVA proposal document typically runs in excess of 200 pages, yet, there is almost always a lack of quality financial information regarding the company's financial status, the basis for future funding to support a successful restructuring and the assessment of profitability applied to the properties in its property portfolio. All of this information is available to the company, and often made available to secured creditors, but is not given to the unsecured creditors being asked to vote and support turnaround.

49. Proper disclosure to creditors from whom the company is seeking support for a CVA is required to ensure the CVA in question really is the most appropriate course of action, it has been structured in a fair and appropriate manner and the firm truly is nearing insolvency.

50. As a bare minimum, store level EBITDA should be provided to property-owners for the leases that are compromised. Without that, property owners are simply unable to assess whether they are being treated fairly. In light of the ruling in the challenge to the Debenhams CVA that firms must ensure property owners receive market rent under CVAs, companies should also be required to disclose any market rental valuations that they have obtained and are relying on for the purposes of calculating discounted rent under the CVA. If proposing a move to a turnover rent mechanism, firms should further be providing the reasoning as to how the turnover percentages on offer equate to 'market rent'.

51. Recent experience justifies property owners' suspicion of CVAs and their need for information. On multiple occasions our members have encountered situations where the company has compromised future rent through a CVA, given the creditor a break right, and on exercise of that break right offered to pay a higher rent than that which was originally payable under the lease pre-CVA. As an example, a large high-street CVA in 2020 place a member of ours in a category where the base rent was cut from £122K per annum to £24.5K per annum, upon approval of the CVA the property owner then gave notice to break as they were entitled too. Just six-months later that same property owner has just agreed a base rent with the same company at £80K whilst keeping the turnover provision. Should the retailer hit the lowest forecast turnover the property owner will get paid more rent than the pre-CVA rent. Whilst a positive outcome for the owner in this case, the frequency of this sort of outcome seriously undermines the confidence that property-owners have in the system as it calls into question the representations made by the firm in the CVA proposal as to the profitability and market value of the property in the first place.

52. In addition, the simple fact that so many CVAs fail, despite IPs testifying in each case that they think they have a real chance of success when proposed, suggests that either IPs and firms frequently make poor judgements on CVAs or perverse incentives are at play. In order to overcome these issues, unsecured creditors must be given sight of all relevant information to see whether a CVA is appropriate for themselves.

Lack of time to consider proposals

53. Unsecured creditors, especially smaller ones who may be unfamiliar with CVAs, are not given adequate time to consider proposals.

54. The IP is required to prepare a prospectus on the CVA and host a creditors meeting. However, the meeting is usually at the end of the process and by that time it is too late for creditors to affect change. This problem is exaggerated further by the fact that CVAs are nowadays often being used to restructure very large, complex companies, such as Debenhams or the Arcadia Group, and proposal documents mirror this in their scope and detail. As an example, the recent Pizza Hut CVA ran to 423 pages.

55. The 14-days after launch creditors get to consider proposals, decide how they will vote and propose amendments is simply not enough. CVAs affecting property owners should always be discussed with them at a CVA's inception like they are with a firm's secured creditors and the time period between launch and the creditors meeting should be extended to 28-days for large high-street CVAs.

56. An effective turnaround will almost always need property owners to work in partnership with firms and CVAs are currently working against this by giving the impression that unsecured creditors are being taken advantage of by an expedited process.

Lack of effective engagement

57. In an attempt to overcome this problem, we have sought over the past few years to facilitate pre-launch engagement by hosting meetings on prospective CVAs with IPs under non-disclosure agreements.

58. Some IPs working on CVAs for major retailers still though do not engage with us, or even individual property owners effected, or seem to believe that one can be a substitute for the other. Even those IPs we consider to be relatively good at engaging often only bring proposals to property owners a matter of days before launch, even though we know they work on these proposals for months in advance. As property owners have little rights to information, we are also often asked to engage on CVAs without being given the requisite material to assess them effectively.

59. This is a concern that our members share about CVA engagement too. We have heard countless testimonies that in individual one-to-one meetings there is usually a reluctance to provide information, such as store level trading data, to property owners even though that same information will be shared with secured creditors, such as banks. IPs and firms will also often only engage adequately with institutional property owners with which they have a prior relationship, or whom 'hold the vote' (in the rare occasions that this is the case).

60. We hope that government will move with urgency to address these problems and restore property owner faith in the UK insolvency framework.