WILL COMPANY VOLUNTARY ARRANGEMENTS BECOME THE UK'S MOST POPULAR RESCUE PROCEDURE?

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A Financial Times journalist reporting on the successful approval of a company voluntary arrangement (CVA) by the creditors of **JJB Sports plc** (JJB) in May 2009 referred to CVAs as:

'The previously obscure legal process… tipped to become one of the UK's most popular corporate lifelines.'

To describe the CVA process as 'obscure' is something of an exaggeration, but is there any basis for this prediction? After a couple of false starts in CVAs by **Powerhouse Ltd (Powerhouse) and Stylo plc** (Stylo), a model for the rescue of large retail companies using stand-alone CVAs has been developed. Three recent high-profile cases in the retail sector, involving JJB, **Focus (DIY) Ltd** (Focus) and **Blacks Leisure Group plc** (Blacks), have shown that the CVA procedure can be more useful than administration in rescuing a retail business. JJB and Blacks were both publicly listed companies, and JJB was the first such company to use a stand-alone CVA, without the protection of the administration moratorium, as a rescue procedure.

CVA PROCEDURE

CVAs were introduced by the Insolvency Act 1986 (the 1986 Act) as a mechanism for a company in financial difficulties to make a composition or scheme of arrangement with its creditors. For a long time, it was seen as an adjunct to and exit route from administration, and, accordingly, did not come with an automatic moratorium. The statutory procedure in ss1-7 of the 1986 Act and the related **Insolvency Rules 1986** (the 1986 Rules) has been tweaked on several occasions, including the introduction of an automatic moratorium on the initial court filing, as detailed in s1A and schedule A1 of the 1986 Act. However, this only applies to small companies as defined by s382 of the **Companies Act 2006** (the 2006 Act). For various reasons, the procedure is unpopular and rarely used.

In essence, a CVA allows a debtor company to make a proposal to its creditors to restructure its debts and, provided that a statutory majority of over 75% of creditors by value vote in favour of the CVA, it will have binding effect on all the company's creditors, if not formally challenged. The usefulness of CVAs, which is only now being fully appreciated, lies in their extreme flexibility, relative informality and speed. CVAs have these qualities because, unlike schemes of arrangement, they are not a court-driven process, although it is necessary to file a report and notice at the commencement of the procedure, and a report of the result of the creditors' and members' meetings. There are detailed statutory requirements regarding the information about the company's business that must be included in a CVA proposal to creditors, but this document can be structured to suit the exact needs of the business.

Several issues are important to note in relation to the binding effect of CVAs. CVAs are vulnerable to challenges from creditors, who can apply to the court to have them set aside on the grounds that either they are unfairly prejudicial to one or more of the creditors or members, or there was a material irregularity in the process by which creditor approval was obtained. The law on such challenges is set out in s6 of the 1986 Act, 'challenge of decisions'. There is a limited period of 28 days from the date that the report notifying the result of the creditors' meeting is filed in court in which creditors are entitled to make an application to challenge a CVA. The statutory timetable, from the date of giving notice to the court of the convening of the statutory meeting of the creditors until the expiry of the 28-day period for challenge of the CVA, covers only 45 days, allowing for a 14-day notice period to creditors and three days for the posting of the notices. Of course, the preparation period leading up to the initial filing at court can take as long as necessary and depends on the circumstances of the debtor company or group.

The 1986 Act also requires that a meeting of members is convened to consider the terms of the CVA proposal, but this is a formality as s4A of the Act provides that, in the event of a mismatch between the decisions of the creditors' and members' meetings, the decision of the creditors will prevail. Secured and preferential creditors cannot be bound by a CVA proposal unless their prior agreement is obtained. Section 2 and schedule 2 of the **Insolvency Act 2000** (the 2000 Act) amend s5(2)(b) of the 1986 Act to bind all creditors to the decision of the statutory creditors' meeting, whether or not they had actual notice of the meeting. This amendment brings CVA procedure into line with the scheme of arrangement procedure under the 2006 Act. Unliquidated and contingent creditors can be bound by a CVA and the 'chairman' is entitled to place a nominal value on such claims for voting purposes, unless the creditor provides sufficient evidence showing how its claim is quantified, with its proof of debt. This procedure is detailed in rule 1.17(3) of the 1986 Rules and was referred to in ***Chittenden & ors v Pepper & ors*** **[2006].** There are rules preventing the votes of creditors that are connected with the company from swamping the votes of ordinary unsecured creditors. There is no requirement for a minimum number of creditors to approve the CVA proposal, but there must be a majority of more than three-quarters in value of the creditors, present in person or by proxy, voting on the resolution.

POWERHOUSE

In early 2006 the directors of Powerhouse, which ran a chain of high street outlets and superstores selling electrical goods, proposed a CVA, having informed its creditors of its intention to close almost half of its stores, which were unprofitable. Powerhouse would retain about 50 stores and operate as a slimmed-down business that they hoped could trade profitably. Powerhouse's parent company had given guarantees to the landlords of many of the stores. The terms of the CVA are reported in ***Prudential Assurance Company Ltd & ors v PRG Powerhouse Ltd & ors*** **[2007]** and its main terms were as follows. The majority of creditors would not be affected by the CVA, which would only bind scheme-fund creditors, a group made up of the employees, landlords and local authorities who were creditors of the closed stores. These creditors would participate in a fund providing them with a dividend of 28% of the value of their claims against the company. Crucially, the proposal also stated that the liabilities of the parent company under the guarantees given to the landlords of the closed stores would be released.

The CVA proposal was approved by the necessary statutory majority at a meeting of all Powerhouse's creditors held in February 2006. Subsequently, the landlords who lost the benefit of their guarantees from the parent company applied to court to challenge the validity of the CVA. The main issue was whether the CVA could be effective in releasing Powerhouse's parent from the guarantees given to the landlords. The court decided that the CVA could as a matter of contract effectively remove the benefit of the parent company's guarantees by creating a binding obligation on the landlords not to claim under the guarantees. However, the court decided as a second main issue that the removal of the right to claim under the guarantees constituted unfair prejudice since it left the landlord creditors in a worse position than they would have been in if Powerhouse had gone into liquidation. The landlord creditors would also be worse off than the remaining body of the creditors, all of whom were to be paid in full but whose votes nonetheless swamped the votes of the landlord creditors.

STYLO

In February 2009 Stylo plc, an alternative investment market-listed company that owned the Barratts and Priceless chains of shoe shops, was the next high-profile retailer to try to restructure its operations using CVAs. The two operating subsidiaries were first placed into administration and the CVAs were proposed by the administrators. The proposals were quite complicated and the landlord creditors considered them too one-sided. Many of the landlord creditors decided that they would rather not have a tenant at all than agree to the proposals, which included a variation of the passing rent based on a small percentage of the turnover of each store. After rejection of the CVAs by the creditors, the profitable stores were sold to a new company formed by the existing management. The lesson for restructuring professionals was that a more transparent approach, which did not involve varying the passing rent and other terms of the leases, was needed to persuade the landlord creditors to vote in favour of the proposal.

JJB

In April 2009 a different approach was taken by JJB, which proposed a CVA designed to save 250 stores and 12,000 jobs. It was successful and has become the model for subsequent CVAs in the retail sector. As with most retail restructurings, the main problem was the unprofitable stores. JJB's proposal included closing 140 stores but a fund of £10m was made available for the landlord creditors of these premises, equating to a payment of approximately six months rent. JJB also made a significant compromise in bearing the substantial costs of the business rates of the unprofitable stores. The landlords of the open stores were offered the passing rent on a monthly basis for a period, after which the standard contractual quarterly payments would be reinstated. No leases were 'torn up' by the CVA and it was left to individual landlords to decide whether they wished to accept a surrender, consent to an assignment or forfeit the lease. All other creditors were paid to term. The landlords as a group recognised that there was a substantial risk that JJB would go into administration, which would have meant that they received no payments of rent or business rates for the closed stores. The landlords appreciated being consulted in a transparent process and being offered a genuine compromise.

Perhaps the most interesting feature of the JJB CVA was that it was implemented on a stand-alone basis, which required the company to keep in close negotiation with its bankers. As a listed company, it was also necessary to maintain a dialogue with the UK Listing Authority to avoid the risk of a share suspension. The Financial Services Authority (FSA) agreed that the CVA proposal could be treated as a reconstruction under the FSA's listing rules (LR). The CVA document was required to be sent as a circular to shareholders under LR13.3 and included a working capital statement under LR9.5.12. JJB appointed Lazard Ltd (Lazard), the investment bank, as its sponsor and Lazard made a sponsor's declaration in relation to the CVA proposal. Despite the successful implementation of the JJB CVA, there was more than a hint of discontent in a press release of the British Property Federation, which stated that:

> *'While this CVA has covered landlords' empty rates payments, it has not taken any bite out of shareholders' or other creditors' pockets. Landlords have borne all the pain and, when you consider that many of our pension funds are invested with them, it is clear this is not fair.'*

Focus and Blacks

Subsequent retail CVAs have very much used the JJB model based on transparency and the offer of funds (usually six months rent and payment of rates on the closed stores) to achieve the compromise required to gain creditors' support. **Focus and Blacks** held their CVA creditors' meetings in August 2009 and November 2009 respectively. Focus had closed 38 stores that were costing the business an estimated £12m per year. Its CVA proposal followed the JJB model by proposing monthly payments on its retained stores (reverting to quarterly payments later) at the passing rent, together with a fund out of which the landlords of the closed stores would receive about six months rent and the company would pay the business rates. This rescue saved a business with 180 stores and about 4,700 employees. The creditors of Blacks approved a similar deal that included a fund providing the landlords of closed stores with six months rent and payment of business rates. Two smaller retail businesses, the Flannels Group Ltd and Suits You Ltd, also followed JJB's example with CVAs approved in December 2009 and February 2010 respectively.

CVA or Administration?

In contrast, **Borders (UK) Ltd**, the book retailer, collapsed into administration with many stores closed and Clintons Cards plc, the greetings card retailer, which had put its subsidiary, **Birthdays Retail Ltd**, into administration, bought back the profitable stores from the administrators. The landlords of the closed stores received no payment of rent or other sums due in relation to the closed stores in either case. Administration is particularly useful for selling a business with assets and for preserving employment but its great disadvantage is that it often destroys the value of the business However, it is widely acknowledged that this comes about because of the nature of the administration process rather than the way that it is used by insolvency practitioners.

In contrast to administration, a CVA can preserve the profitable part of a business, including jobs and stakeholder value. A CVA allows differentiation between groups of unsecured creditors and can reduce pressure on the business' cash flow by temporarily varying problematic contractual terms, such as quarterly lease payments and compromising contingent liabilities, including future rent. Despite the supposed advantage of the administration moratorium, the prospect of achieving a solvent restructuring is sometimes greater using a stand-alone CVA than a CVA within administration. Unlike a CVA within administration, a stand-alone CVA is a debtor-in-possession procedure that allows the directors to retain control of the business. In practical terms, this is crucial in enabling the company to avoid a suspension of its shares and gives the restructuring a better public image. Another advantage of stand-alone CVAs is that they do not require the business and assets to be marketed. CVAs also ensure that no steps are taken by trade creditors to enforce their legal rights against the company and its assets because they continue to be paid during the process. Professional fees for undertaking a stand-alone CVA are often lower than those for an administration.

Are CVAs the corporate lifeline of the future?

As to the future of CVAs, following the Insolvency Service's consultation begun in April 2009, both main political parties are said to be looking into an extension of the moratorium to all companies entering CVAs and also a 'debtor in possession' funding mechanism similar to that which applies to great advantage in **Chapter 11 of the US Bankruptcy Code**. So, all in all, perhaps there is something in the *Financial Times*' tip about CVAs.

References

Chittenden & ors v Pepper & ors [2006] EWHC 151

Prudential Assurance Company Ltd & ors v PRG Powerhouse Ltd & ors [2007] EWHC 1002 (Ch)