CVAs after the Debenhams decision

Introduction

In May 2019, the requisite majority of the creditors of Debenhams Retail Ltd voted in favour of a company voluntary arrangement ("CVA") proposed pursuant to s.1 of the Insolvency Act 1986. As has become common, the scheme of arrangement proposed by the CVA only affected the rights of landlords and rating authorities. All other creditors were to be paid in full.

Six of the landlord creditors, who had not voted in favour, issued a claim challenging the CVA on a number of grounds. An expedited trial was ordered, and on 19 September 2019, Norris J handed down judgment in judgment in Discovery (Northampton) Ltd v Debenhams Retail Ltd [2019] EWHC 2303 (Ch). He upheld one of the challenges and dismissed the rest.

The landlords who challenged the CVA were funded by Mike Ashley via Sports Direct – it was said that this was because he wanted to get control of Debenhams. The Judge said he was alive to this, but he did not rely on this unusual feature of the background in reaching his conclusion on any of the challenges. So it is probably best regarded as an interesting, but ultimately irrelevant, aspect of the background.

The terms of the Debenhams CVA

The CVA divided the company's shops into a number of different categories by reference to the financial performance of the business.

Category 1 properties were those where Debenhams was doing well. The only change proposed there was that the rent would be paid monthly rather than quarterly.

In the case of Category 2-4 properties:

The rent was reduced – to 75% of the contractual rent for Category 2, to 65% for Category 3, and to 50% for Category 4, in each case for 5 years.
At end of the 5 years, the rent was to be reviewed to the higher of the reduced rent and the then market rent.
The landlords' right to forfeit triggered by the CVA could not be exercised.
The landlords had a one off right to break. This had to be exercised within 90 days of the "Next Payment Date" – the first date on which rent became payable following the CVA becoming effective subject to 60 days' prior notice, or, at the option of the Company, an additional 30 days (for 90 days' total notice) with full contractual rent to be paid during such 30 day extended notice period.
Both parties had an additional right to break on anniversaries 2, 3, 4 and 5.
Debenhams was to have no liability in respect of dilapidations if a lease expired during the term of the CVA.

In the case of Category 5 properties, rent was payable in full until 24 January 2020 when the leases would terminate.

The CVA was approved by 95% of the company's creditors. More than 75% of the category 1, 2 and 3 landlords voted in favour. Less than 75% of the category 4 and 5 landlords voted in favour.

The grounds of challenge

There were a number of grounds of challenge.

One was that the CVA proposal was defective because it gave insufficient information about potential claims under sections 239 and/or 245 of the 1986 Act. The Judge rejected that challenge.

The only point in his decision on that ground which is of general interest is this. He said that if there had been a defect in the information provided to creditors, he did not think it would have made any difference. So even if there was an "irregularity" it was not a "material" one. He said that the test for materiality was whether "objectively assessed, there is a substantial chance that if the irregularity had not occurred it would have made a material difference to the way in which the creditors would have considered and assessed the terms of the CVA". That accords with previous decisions. In Re Trident Fashions (No 2) [2004] 2 BCLC 35 at [46] Lewison J said there did not have to be more than a 50% chance of a different outcome: "… the right test is whether there was a substantial chance that the creditors would not have approved the CVA in the form in which it was presented".

Another ground of challenge was that the CVA was invalid because it imposed new obligations on the landlords. Norris J made short work of that ground, and rightly so. The CVA altered existing obligations owed to the landlords but did not impose new ones on the landlords.

I will now discuss the remaining grounds of challenge, and the Judge's decision on them. The arguments fell into two categories:

Arguments that the CVA exceeded what is permissible under s.1 of the 1986 Act.
Arguments raised under s.6(1)(a) of the 1986 Act, which allows a creditor to apply to the court for an order revoking the decision approving the CVA if the CVA "unfairly prejudices the interests" of the creditor.

Argument 1: Landlords are not "creditors" in respect of future rent which may never fall due for payment

S.1(1) of the 1986 Act says: "The directors of a company (other than one which is in administration or being wound up) may make a proposal under this Part to the company and to its creditors for a composition in satisfaction of its debts or a scheme of arrangement of its affair (from here on referred to, in either case, as a "voluntary arrangement")."

The landlords argued that they were not "creditors" in respect of the potential right that they had to claim rent from Debenhams in the future, if the leases continued in effect.

The Judge rejected this ground. He agreed with the decisions of Knox J from the mid-1990s, in Doorbar v Alltime Securities Ltd (No.1) [1994] BCC 994 and In Re Cancol Ltd [1995] BCC 1133, that a landlord is a "creditor" in respect of its contingent entitlement to future rent.

The Judge analysed future rent as being a pecuniary liability, although not a presently provable debt, to which the tenant may become subject by reason of the covenant to pay rent in the lease. While the term endures the tenant is liable for the rent, and the fact that in the future the lease may be brought to an end does not mean that there is no present liability.

The Judge's analysis of this issue was persuasive. The matter must, I think, be regarded as settled at the level of the High Court. The contrary would certainly be arguable on appeal, but I think it will be difficult to persuade an appellate court to take a different view.

Argument 2: A CVA cannot remove a landlord's right to forfeit because that is a proprietary right

The argument here was that, in removing any right of the landlords to forfeiture which would arise as a result of the CVA or any CVA related event, the CVA abrogated the landlords' proprietary rights, which is beyond the jurisdiction conferred by s.1 of the 1986 Act.

The Judge agreed with this ground of challenge, and held that the provisions of the CVA that purported to deprive the landlords of the right to forfeit were void. He held that this did not affect the rest of the CVA as the forfeiture provisions could be severed.

The Judge's decision on this point was followed by Zacaroli J in a judgment handed down on 8 October 2019, In The Matter Of Instant Cash Loans Ltd [2019] EWHC 2795 (Ch). Zacaroli J decided that the court does not have jurisdiction under the Companies Act 2006 part 26 to sanction a scheme of arrangement which contained an arrangement that leases held by the company would be surrendered to the relevant landlords.

This is an important issue, which is bound to end up at some point being considered by the Court of Appeal and perhaps the Supreme Court. It is well arguable either way. However, in my view, Norris and Zacaroli JJ were correct.

In Re Lehman Brothers International (Europe) [2010] B.C.C. 272, the Court of Appeal held a part 26 Companies Act 2006 scheme of arrangement cannot affect rights which a person did not hold as a "creditor" but as an owner. Part 26 of the Companies Act 2006 confers on the court a jurisdiction to sanction "a compromise or arrangement …. proposed between a company and (a) its creditors, … or (b) its members …". The Court held, essentially, that only rights to be paid money can be described as rights held by a person as "creditor". A creditor is someone to whom money is or may be owed. An "arrangement" can only affect the rights of persons insofar as they are the rights of a creditor – someone to whom money is owed, or may be owed.

Norris J considered that the logic of that decision applied equally to CVAs, and I think he was right about that. He considered that it meant that a right of forfeiture could not be abrogated by a CVA because the right of re-entry is property belonging to the landlord and not a security right created by the tenant over his own property. Neither its existence nor its exercise is dependent upon the tenant owing the landlord money. A tenant who had paid all his rent to date but has done something such as proposing a CVA which entitles the landlord to re-enter may still have his lease forfeit. Again, I think he was correct.

The decision on this point – if correct – gives rise to a number of issues:

Can a CVA validly vary the terms of the lease so as to give the tenant a right to break the lease? Arguably not, as that is just a different way for the tenant to terminate the legal estate created by the lease and to force the landlord to resume possession.
Can a CVA validly vary the terms of the lease so as to give the landlord a right to break the lease? There does not seem to be any obvious objection to this as it confers an additional right on the landlord and does not interfere with his proprietary rights.
Would a landlord waive the right to forfeit by voting against a CVA? This seems unlikely as voting against a CVA would not be a clear and unequivocal communication of a decision to treat the lease as subsisting – see Greenwood Reversions v World Environment Foundation [2008] EWCA Civ 47. In any event, many commercial leases provide that both proposing and entering into a CVA are events that entitle the landlord to forfeit so if the CVA is approved then that may well give rise to a fresh right to forfeit.
Can a tenant contract out of the right to relief against forfeiture? Some CVAs say that the tenant will not claim relief if the landlord forfeits. It is doubtful if this is enforceable, although the Court could have regard to it when exercising its discretion as to whether to grant relief.
If the landlord forfeits on the grounds of the tenant proposing or entering into the CVA would the Court grant relief? Normally, the Court will grant relief if the harm done by the event which entitles the landlord to forfeit can be undone. In the case of a CVA, the harm is done by the terms of the CVA becoming binding on the landlord and it is difficult to see how that can be undone. The argument the other way is that forfeiture should not be permitted so as to undo the effect of the CVA and so endanger the survival of the tenant company, contrary to the "rescue culture" which is central to the 1986 Act.

Argument 3: It is fundamentally unfair for a CVA to enable the company to occupy property at less than the contractual rent for the benefit of the creditors as a whole

The argument here took its inspiration from Thomas v Ken Thomas Ltd [2007] L&TR 21 where Neuberger LJ observed, obiter, that:

"There is no doubt but that the rent, which accrued due but was not paid, before the CVA was proposed in this case, would be expected to be caught, at least in its capacity as a debt, within the CVA. As at present advised, it appears to me that the rent falling due after the CVA should by no means necessarily be expected to be caught by the terms of the CVA, even if it is capable of being so caught … It strikes me that, at least normally, it would seem wrong in principle that a tenant should be able to trade under a CVA for the benefit of its past creditors, at the present and future expense of its landlord. If the tenant is to continue occupying the landlord's property for the purposes of trading

under the CVA (and hopefully trading out of the CVA) he should normally, as it currently appears to me, expect to pay the full rent to which the landlord is contractually entitled— see by analogy, in the administration context, Atlantic Computer Systems Plc, Re [1993] Ch. 505 542(g)– 543(b) and, in a liquidation context, ABC Coupler & Engineering Co Ltd, Re (No.3) [1970] 1 W.L.R. 702 . Therefore as at present advised, I consider that a CVA should so provide, or if it does not provide, in the absence of special circumstances the landlord may well be entitled to object to the proposals as unreasonable."

The landlords in Debenhams built on that and argued that a company which makes beneficial use of premises let to it for the benefit of the company's creditors as a whole must pay the full contractual rent referable to that period of occupation.

They relied on the well known "salvage principle" – that if a liquidator or administrator causes a tenant company to use the property demised by a lease for the benefit of the winding up or administration, then the rent under the lease must be paid in full as an expense of the insolvency procedure for the period of beneficial occupation. The principle was most recently examined in relation to the Game administration in Jervis v Pillar Denton [2015] Ch 87. The Court there held that the rent only needs to be paid for the period during which the property is used, regardless of the dates on which the rent falls due for payment under the lease.

No-one argued in Jervis or in any other case that the salvage principle means that only a market rent should be paid, rather than the contractual rent. In Goldacre (Offices) Ltd v Nortel Networks UK Ltd [2010] Ch 455, a company in administration occupied only about 13% of a very large complex of buildings. The Court held that the rent was payable in full as an expense of the administration. In Jervis no-one argued that aspect of the decision was wrong. In Jervis at [82] Lewison LJ said that the principle was that the landlord should receive the full value of the property and: "Where the property is held under the terms of a lease the full value will be taken to be the rate of rent reserved by the lease."

Norris J rejected the argument based on the salvage principle and the Ken Thomas case, because he thought it was fair for the rent payable to be reduced provided it was not reduced to a figure lower than what he called "the market rent". He said:

"Would it not be "unfair" for the suppliers to be unable to receive the market price for their goods in order that the landlord should receive a 100% premium over the market price for his supply? What would be "unfair" about a scheme the object of which was to ensure that everybody got the market price for what they supplied? As a matter of principle I would not have thought it "unfair" that a landlord might receive less than his contracted-for rent in such circumstances."

and later

"Here common justice and "basic fairness" require that the landlord should receive at least the market value of the property he is providing. He should not subsidise other creditors but nor should they be compelled to overcompensate him."

I have considerable difficulty with this part of the judgment. First, it seems to me to be unfair for the rent freely agreed between two commercial parties to be reduced, contrary to the terms of the lease, just because if a new lease was granted to a new tenant the rent would be lower. If the tenant had wanted to take a lease where the rent could be reduced if the market rent fell, the tenant would very likely have had to pay a higher rent to begin with or a premium.

Second, the landlords appear to have accepted that there would be no unfairness in the reduction in the rent if the landlords could have terminated the leases immediately. The unfairness, they contended, was that if a landlord served notice breaking the lease, they then had to put up with a period of 60 days during which a reduced rent would be payable.

Norris J rejected this, saying that: "… a contractual rent should be interfered with to the minimum extent necessary in the circumstances, the modification being limited to what is necessary to achieve the purpose of the CVA. If those principles are observed the fact that under the exit arrangements in a CVA a varied rent is payable during the notice period does not, in my judgment, make the arrangement "unfair"."

However, I question whether the landlords should have accepted that a right to break forthwith would have avoided any unfairness. It is necessary to consider the practical realities of breaking a lease and letting to a new tenant at market rent:

Finding a new tenant takes time, often a long time.
In the meantime, the landlord has to pay the rates and insurance.
The landlord will have to pay a property agent to find a new tenant.
The landlord will very likely have to spend money on the property to put it in lettable condition, and the CVA barred any dilapidations claim.
When a tenant is found, the landlord will have to negotiate the terms of the new lease, taking more time and involving legal costs.
The new tenant will be bound to insist on a rent free period of some months for fitting out the premises.

Only after that would rent become payable again.

So even if the contractual rent is below the rent that could be obtained on a new letting, a landlord will be reluctant to determine the lease. Therefore I question whether a right to determine the lease, even immediately, really avoids the unfairness of reducing the contractual rent.

Third, ascertaining the market rent can often be far from straightforward; it is often a source of considerable controversy under rent review clauses and s.34 of the 1954 Act. Presumably a landlord who challenged a rent reduction as taking the rent below market rent could then be embroiled in a full-blown valuation dispute with expert valuers on both sides.

Fourth, all modern rent review clauses direct that the rent is to be reviewed to that payable after the expiry of a fitting out period. It has been held in the county court that this is not the case under s.34. There can be a substantial difference between the rent

payable after the expiry of a fitting out period and the rent that would be payable without a fitting out period. How is the market rent to be assessed for the purpose of Norris J's test?

Fifth, the market rent often depends on the duration of the lease. The market rent under a 5 year lease may be different to one under a 15 year lease. By reference to what assumed term is the market rent to be assessed, applying Norris J's test?

Argument 4: the landlords were treated less favourably than other unsecured creditors without any proper justification

There is no doubt that differential treatment of creditors may be justified if necessary to save the company. In a cases concerning insolvent football clubs, it has been held fair for the football players to be paid in full, unlike other creditors, as otherwise the club would be ejected from the relevant league and would be unable to go on.

My view is that it is necessary, if this sort of differential treatment is to be fair, for the CVA to provide for the CVA to provide a mechanism for the loss suffered by the compromised creditors to be valued, and for the company to agree to pay the amount of the loss suffered by compromised creditors out of any profits it makes, in priority to any dividends or share buy-backs or other payment of any kind to the shareholders. I can see no justification for the company's business being carried on for the benefit of the shareholders until the compromised creditors have been compensated in full for the loss suffered by them. However, this issue was not considered in the Debenhams judgment. It appears from press reports that the CVA does provide for a £25 million fund out of which compromised creditors can be paid, and it may be that the landlords were satisfied with that part of the CVA.

The argument in the Debenhams case was that the evidence did not justify treating the landlords differently to the trade creditors. The Judge disagreed. He accepted the evidence adduced by the company that compromising trade creditors would likely lead to suppliers refusing to supply goods and services needed to keep the business running, or only being willing to supply goods providing such supply on onerous credit terms. This would have also posed a significant "contagion risk" whereby other suppliers whose claims were not themselves being compromised would have become concerned about supplying the company in the future, tighter credit terms badly affecting the company's cash flow position. Difficulties with supplies would lead to poor customer experience and brand damage that in turn would further impact the group's trading performance, cash flows and prospects of survival.

One line of attack on that was that the company had not tried to distinguish between suppliers who really were essential and those who were not, such as a minicab firm, a firm of accountants, and a firm of solicitors. Norris J was dismissive of that argument, saying that the company was: "entitled to look at the matter in the round having regard to the likely reaction of the 1,600 suppliers of goods and services, rather than to single out a small number of individual suppliers for separate treatment where such separate treatment would make a wholly immaterial contribution to the outcome."

Another attack was that the supposed contagion risk was illogical because everybody knew that Debenhams was insolvent and that they were at risk in trading with it. But the Judge accepted the company's evidence that the relevant market was not driven by logic but by rumour, and that fear of non-payment would like translate into cancellation, a revision to credit terms, or a refusal to accept an order,

He concluded on the basis of that evidence that differential treatment of landlords (providing long-term accommodation at above market rates) from suppliers (providing goods and services on an order-by-order basis which, given competitive pressures, are likely to be at market rates) was justified by the need for business continuity. He repeated the point he had made earlier that he thought it fair for the rent to be reduced to market value.

This issue – whether payment of some creditors in full is necessary to secure the survival of the business – is one that must turn on the evidence adduced. In the Debenhams case, the Judge was satisfied by the evidence that the differential treatment of creditors was necessary for the survival of the business. That being so, and there being no challenge to the arrangements for the payment to the landlords of the loss suffered by them, the Judge's decision on this point may have been justifiable. However, it is clear that he was heavily influenced by his view that it was fair to reduce the rent provided it did not fall below the market rent. That part of his judgment I do have difficulties with, as explained above.

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