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Retail insolvency

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The retail sector in the UK has suffered a number of high-profile casualties in recent months – a development that has parallels in a number of jurisdictions – and many other retailers are taking advice and undertaking measures to steer them through the challenging trading environment they face. Since the global financial crisis, there have been shifts in the market that are unprecedented in recent times. In particular, there has been a seismic shift in consumer attitudes and outlook– driven in large part by technological advances, the influence of social media and retailers' use of customer data – and a seemingly irreversible change in emphasis from "bricks-and-mortar" retailers to online retailers.

In addition, retailers have faced rising costs, including increased import costs as a result of sterling's decline over the past two years and increases to the national minimum wage. In response, many traditional high street and out-of-town retailers are implementing capital investment programmes (including developing and refining their online offerings) and "right-sizing" programmes to rationalise their operations and physical footprint to better suit the needs of a more informed, new generation of shopper. Those that have failed to embrace and adapt to the change described have fallen by the wayside.
Some of the companies that have gone into administration in recent months are Toys "R" Us, Maplin, Kleeneze, Feather & Black and Palmer & Harvey.

This article considers some of the issues commonly encountered by practitioners advising on retail distress, turnaround efforts and insolvencies. In particular, it considers certain preliminary considerations and precautions to bear in mind for distressed retailers, the use by certain retailers of company voluntary arrangements (CVAs) – primarily as a rent-reduction tool – as well as the effect of CVAs on landlords, before concluding with some brief remarks on the effect of administration on third parties. The intention is to give a flavour of the kinds of legal issues commonly encountered in retail cases generally, but it is worth noting that there have been variances in fortunes between different market segments within the retail sector and, indeed, players within those segments.

Preliminary considerations

"It is important for debtor companies to act early once signs of distress emerge"

In retail as in other sectors, it is important for debtor companies to act early once signs of distress emerge; the sooner that problems are recognised and acknowledged, and key stakeholders engaged with a view to exploring solutions, the broader the range of options there will be available to navigate through the period of distress and achieve a return to profitability. For professionals and their clients alike, it is critical that due diligence is carried out on all the company's contractual arrangements in order to assess the range and viability of the options available, particularly in circumstances in which a sale of some or all of the parts of the business is under consideration. As part of that process, it will be necessary to ascertain the realisable value of the retailers' inventory, and to identify the goods that are supplied to the retailer on terms that could have an impact on the continuity of the business, as well asvaluations prepared for the purposes of effecting a turnaround or going concern sale. Examples include goods supplied

- On credit terms (and any scope for amendment of such terms on the occurrence of key trigger events)
- On retention of title terms (by which title remains with the supplier until receipt of payment for those goods and even other amounts owing, thereby allowing the retaking of possession in the event payment is not made when due)
- On terms that allow withdrawal on the occurrence of specified events linked to, for example, the financial standing, trading performance or solvency status of the retailer (as is commonly encountered with market-leading, luxury or branded products)

In addition, it will be necessary to understand the terms on which any in-store devices, information systems, equipment, decor and fittings are licensed or otherwise made available to the retailer and whether they are capable of being withdrawn in the event of financial distress or the commencement of insolvency proceedings in a way that would be detrimental to the continuation of the business as a going concern (for example, contracts with suppliers of payment services devices such as card readers or electronic points of sale).

Many retailers trade in whole or in part through concessions that is, brand or label-focused outlets within large department stores – and, in such cases, it will be important to understand the terms on which the arrangements and related rights and privileges can be terminated and payments due under the relevant agreements withheld.

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It is entirely appropriate for retailers to negotiate with its key stakeholders and consider more formal steps such as the implementation of a CVA (e.g. in order to compromise particular obligations of the company and others in its group) or seeking the appointment of administrators (which will be driven in most cases by directors' concerns around the discharge of their duties and responsibilities). Appointing administrators may facilitate a rescue effort under the protection of the applicable statutory moratorium – and, where relevant,
interim moratorium – on creditor claims, the enforcement of security and attempts to repossess third-party goods in the company's possession. While such an effort might seek the rescue of the company itself, it is much more likely that to be focused on effecting a sale of any profitable parts of the business. It is worth noting, however, that recent case law has established that a practice that had developed with certain retailers filing repeated notices of intention to appoint administrators for the sole purpose of obtaining the benefit of the interim moratorium in each instance until the lapse of its ten business-day period of application, without then appointing administrators, is impermissible. The court held in
that case that no such notice should be filed unless the company or its directors has a fixed and genuine intention to proceed with the appointment (if a qualifying floating charge-holder consents to the appointment and does not proceed to appoint its own choice of administrator; or the period lapses without any such action having been taken).

In circumstances in which the retailer's proposed solution will result in the redundancy of 20 or more employees at one establishment within a period of 90 days or less, it has a duty to consult collectively with the affected employees' representatives and also notify the Department for Business, Energy and Industrial Strategy (under sections 188 and 193 of Trade Union and Labour Relations (Consolidation) Act 1992). The duty to consult brings into stark contrast the clash between employment law and insolvency law since, often, preparation for pre-planned insolvency proceedings will need to take place in confidence and on an accelerated timescale. There are limited exceptions to the duty to consult, including where there are "special circumstances" where it is not reasonably practicable for an employer collectively to consult in good time. The case law has established, however, that insolvency in itself does not amount to a special circumstance. Accordingly, an employer seeking to establish that it is justified in any given case in failing to consult faces a difficult task. Appropriate advice should be taken in each case as to whether the duty to consult is engaged in the first place (e.g. whether there was at the relevant time a settled intention to make redundancies) and, if so, whether special circumstances exist that justify an employer in failing to consult.

Company voluntary arrangements

A company voluntary arrangement (CVA) is a formal corporate rescue process under the Insolvency Act 1986, which allows a company to compromise claims of unsecured creditors provided that 75 per cent by value of creditors attending a creditors' meeting (in person or by proxy) to consider the terms of the proposal for the CVA vote to approve it. Once approved, it is binding on all the company's unsecured creditors, including those who were eligible to vote but did not in fact receive notice of the proposal or who attended the meeting and voted against the proposal. From the point at which the CVA becomes effective, no unsecured creditor can take any step against the company to recover any debt that falls due within the scope of the CVA. CVAs are commonly described as being akin to a contract between the company and its creditors, which is given statutory effect. Unlike a scheme of arrangement – which has enjoyed something of a renaissance in the past 15 years – the process of approving a CVA does not involve the court, which means that they are usually a much more time – and cost- effective means of compromising liabilities. An important feature of a CVA – much like Chapter 11 of the US Bankruptcy Code – is that its implementation does not involve the displacement of the company's directors, who remain in situ throughout; however, they do involve the oversight of a qualified insolvency practitioner (referred to as the nominee in the early stages, when the CVA is being proposed, and as the supervisor once the CVA has
been approved).

CVAs have not been widely used in all business sectors, principally because it is not possible to bind secured creditors to their terms without their consent, and financing structures that are prevalent in most sectors mean that major creditors normally hold some form of security. The difference in the retail space – which has led to a proliferation in the use of CVAs – is that landlords are often significant creditors but do not typically take security for the obligations owed to them by their tenants (except to the extent that rent deposits are charged in their favour). As such, their claims are normally susceptible to being varied or cancelled by the terms of a CVA. CVAs have recently been implemented by the high street fashion retailers New Look and Select.

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As well as being used to reduce rents payable by the retailer, CVAs are commonly used to effect other amendments to the terms of leases, such as changes to rental periods (e.g. moving to monthly rent periods rather than traditional quarterly rent periods) and specific covenants, and can even, in principle, be used to vary or discharge third-party obligations (such as the guarantee obligations of a parent company). From the perspective of the retailer, particularly one with a large national network of stores and multiple landlords, the principal advantage of going the CVA route is that it allows a “one-size-fits-all” or, more often, the “multi-track” amendment of lease terms rather than necessitating the entry into bilateral negotiations with individual landlords in different locations across a number of regions, which would inevitably result in differing levels of success. A multi-track approach involves the categorisation of landlords under the terms of the CVA according to whether the lease in question relates to profitable, or loss- making but salvageable, stores (rent reductions will be graded commensurately; i.e., low in the case of the former, and with larger reductions in the case of the latter), or those that are heavily loss-making and earmarked for closure (in which case, the CVA will likely provide for the termination of the relevant leases). This is one instance of the flexibility of CVAs as a corporate rescue tool and their potency in the right hands for delivering a successful turnaround.

It is common, in order to incentivise landlords to vote in favour of CVA proposals, to include among their terms “bounce-back” provisions, to the effect that any rent reductions or other amendments to the lease effected by the CVA, once approved, will no longer apply if the CVA is terminated (usually for non-compliance with its terms on the part of the tenant). The rationale is that the landlord’s provable claim will then be maximised in any ensuing terminal insolvency proceedings. It has recently been held that such provisions of a CVA are binding and that a landlord’s claims are not permanently compromised in a subsequent liquidation (for example, because they amount to a penalty or infringe the pari passu rule for distribution of property on insolvency) (with the effect that rents payable in an administration in the intervening period, following termination of the CVA, were payable as expenses of the administration). For this reason, any changes to the lease made by the CVA that are intended by the parties to survive termination of the CVA should be effected by way of a separate deed of variation of the lease, which is not inter-conditional with the CVA. As a matter of practice, it would be prudent to include among the CVA terms an obligation on landlords to execute the relevant deed of variation in a specified form, when possible.

Despite the apparent attractiveness of CVAs for retailers, and the fact that there are a number of success stories where they have been used, they have a relatively high failure rate (recent examples of unsuccessful CVAs include: Toys “R” Us, BHS and Austin Reed). There are several reasons for this, including that the management who are responsible for the company’s plight remain in the driving seat. The principal reason for the failure of CVAs, though, appears to be where retailers attempt to deploy them in circumstances in which a market for a particular product has fundamentally changed, such that no amount of tinkering around the edges would result in an outcome by which demand for physical stores would ever return to its prior levels. Effecting a financial restructuring through the use of a CVA is likely to be of limited value in circumstances in which an operational restructuring is also required. Another contributing factor which has been seen in the UK market is the emergence of a negative perception of a retailer which enters into a CVA, which, in some cases, has led to the withdrawal of its suppliers’ credit insurance and, therefore, reduced confidence in continuing to trade with the retailer.

CVAs: the landlord's perspective

In all cases, a landlord should seek to engage with the retailer and its advisers at the earliest opportunity when any suggestion of a CVA is made. A company proposing a CVA is required to give only 14 days' notice of the creditors' meeting at which the CVA proposal will be voted on. Since no proposal is set in stone unless and until it is approved by the requisite majority of creditors – and the possible terms of CVAs are an open book, to a large degree – the landlord should take every step it can, if it appears that the company is inexorably heading into a CVA, to carefully consider the proposed CVA terms, to seek to secure the terms most favourable to it, and to extract whatever concessions it is able to prior to the CVAs being put to the company's creditors for approval. Fast, incisive professional advice is critical at this stage, in order that the proposal ultimately presented does not represent a unilateral attempt by the tenant completely to recast its relationship with its landlord, which the landlord is then resigned to accept for fear of the alternative (see below). In this regard, landlords would be well-advised not to approach the CVA in a vacuum, and, as far as possible, approach other landlords (and similarly placed creditors, if relevant) in order to attempt to build a consensus as to preferred terms of the CVA proposal and obtain as much leverage as possible over the tenant to encourage it to reach the preferred compromise position.

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A landlord presented by a retailer with a CVA proposal faces a dilemma: support the CVA and take some of the pain itself; or oppose the CVA and risk the possibility of having to remarket the property, perhaps at a reduced rent (potentially, in competition with the other landlords with exposure to the insolvent tenant). Much will, of course, depend on the location and marketability of the leased property or properties in any given scenario. In recent times, however, it has often been the case that landlords have had little choice, from a commercial perspective; a CVA will represent a more favourable outcome than a terminal insolvency process (on the basis that the tenant continues to pay (albeit reduced) rents, rather than literally "shutting up shop" and paying no rent at all). In light of the spate of retail insolvencies that have occurred and the challenges posed by online sellers more generally, it is frequently the case that there is simply a lack of demand from other retailers with an attractive covenant strength to take up the stores if the present tenant fails, meaning the risk of the properties becoming unoccupied (and the landlord being liable for business rates) is a very real possibility for landlords. A further consideration is that non-institutional landlords operating in isolation, without finding strength in numbers among similarly placed landlords, often perceive opposing (or subsequently challenging) the CVA to be costly and the outcome uncertain. There is a strong public relations-influenced concern from landlords too; invariably, they will recognise the need to be supportive of a proactive recovery attempt by a retailer when the alternative – a terminal insolvency filing – would likely result in widespread redundancies of employees and damaging knock-on effects for suppliers.

Landlords will be well advised, in preparing to vote on the terms of a CVA, to seek to maximise their claims against the tenant as far as permissible, given that the voting threshold for approval of a CVA is purely value-based. While the nominee will normally value the landlord's claim for arrears of rent at its face-value for voting purposes, the starting position for other, unascertained and non-particularised claims, such as for future rent and dilapidations, is likely to be to ascribe nil value to them. To the extent possible, therefore, ahead of voting on a CVA, a landlord should seek to quantify such claims, supported by expert evidence (e.g. as to the likely time it would take to re-let the property and an assessment of the costs of required remedial works), in order to persuade the nominee that its full claim should be valued appropriately, with the effect that the landlord's vote carries more influence in the process relative to others who have not undertaken such diligence.

If a landlord is not minded to support a CVA from the outset, then it is free to take a range of actions prior to the CVA becoming effective (noting that there is no moratorium applicable to a CVA, except in the case of certain small companies or a company that is already in administration). In these cases, it is critical that decisive action is taken quickly. If relevant breaches of the lease have occurred,

the landlord could seek to forfeit the lease; issue a claim for recovery of the debt owed; exercise the Commercial Rent Arrears Recovery enforcement procedure under the Tribunals, Courts and Enforcement Act 2007
(which has replaced the common law remedy of distress, in the case of commercial premises, but is limited to arrears of principal rent); or, if the landlord considers that the tenant is insolvent, make a statutory demand for outstanding rent and proceed to petition to wind up the retailer if the amounts owed remain unpaid at the expiry of the three- week period for payment. Given the gravity of these other options – and since the time for a consensual deal for the rescheduling of payments will likely have passed, it is usually the case that a landlord will be ill-advised to take such steps unless it has a willing replacement tenant lined up and ready to step into the shoes of the defaulting retailer. A further option open to the landlord is to draw down from a rent deposit in order to recover arrears of rent or other sums owing under the lease, although this will, of course, offer little comfort in circumstances in which there is no assurance against future breaches of the lease by the tenant.

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A CVA, once approved, can be challenged on limited statutory grounds by the making of a court application within 28 days of its approval being reported to the court (or, for a creditor that did not receive notice of the creditors' meeting, within 28 days of its becoming aware of the approval of the CVA): where the CVA is unfairly prejudicial to a particular creditor's interests; or where there is a material irregularity in the process of approval of the CVA.
If the application succeeds, the court has the power to revoke or suspend the CVA or to order that the CVA proposal (or a revised proposal) be put to the company or its creditors for reconsideration.

Administration

As noted above, the moratorium applicable in administration severely restricts the range of actions available to a landlord against its tenant, including the ability to forfeit the lease by peaceable re-entry. Similarly, the moratorium prohibits the seizure of goods leased to the company or supplied to it on retention of title terms. In all such cases, it is not possible for the landlord or creditor to proceed in accordance with its rights apart from the administration without the consent of the landlord or the permission of the court, and the appropriateness of the assertion or reservations of rights should be considered at the earliest opportunity.

Landlords can nevertheless draw some comfort from the fact that, irrespective of when rent is due under the lease, they are entitled to payment of rent as an expense of the administration – i.e. payment on a priority basis – for so long as the administrators cause the company to continue to occupy the premises for the purposes of the administration (in which case, the rent is treated as accruing from day to day).

However, any rent owed at the time of the administrators' appointment will be an unsecured debt in the administration of the tenant.

Since landlords are prevented from forfeiting the lease in the case of administration, they will be unable to forfeit in the event that the administrator grants a licence to occupy the leased premises (invariably a breach of the terms of the lease) in favour of any buyer of the business pending the buyer obtaining the landlord's consent to assignment of the lease. This can place the landlord in a difficult position and, while it is still open to it to seek the permission of the court to forfeit, it may well take the pragmatic view that the buyer, as a paying party that is already in occupation, is best placed to step into the shoes of the tenant going forward, thereby avoiding the need to carry out any fit- out works and remarket the property.

From the perspective of a consumer, the appointment of administrators will normally represent the end of his or her relationship with the retailer. If and to the extent that he or she has paid deposits to the retailer for goods yet to be supplied and to which title has yet to pass, in circumstances in which the deposits are not held on trust by the retailer for its benefit, it is likely that they will be an unsecured creditor in the amount of the deposit and will receive very little or nothing by way of distribution on their claim. Customers with unredeemed gift cards or vouchers issued by the retailer will also be unsecured creditors.

Although this is the strict position, there are a number of high-profile retail administrations in which – partly in response to public pressure or in a pre-emptive attempt to head off criticism in popular media – administrators have agreed that the retailer will continue to accept gift cards for a limited period during which the business has been traded post-administration.

A final point to bear in mind is that retailers offering their own credit terms to customers (e.g. through store cards) or store-branded credit cards are likely to be regulated by the Financial Conduct Authority. In such cases, it will be necessary for any appointment of administrators to be made with the consent of the Financial Conduct Authority, in the case of an out-of-court appointment (or, in the case of an application to court for an administration order, and the Financial Conduct Authority will have the right to be heard and make representations on the application).

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