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A "palliative" approach to insolvency in the retail world?

Howard Morris, 31 July 2017

The retail sector is in the midst of a deeply disruptive shift as online shopping increasingly puts its long-term future in peril. **Howard Morris**, head of the business restructuring and insolvency group at Morrison & Foerster in London, argues that instead of liquidating speedily, retailers should take a leaf out of the insurance industry's book and continue to make profits as they are run down slowly.

The *Financial Times* recently ran an article by Andrew Wrigglesworth, "Will the death of US retail be the next big short?" Online shopping is disrupting traditional retail. It isn't just another recession or adjustment or market correction - the familiar retailer with outlets in many malls seems to be done.

Multi-site retailers are in the path of the disruptive storm of online purchasing. Pivoting to a digital platform is time-consuming, costly and immensely challenging for a company weighed down with a traditional retail structure of stores and supply chain facing the digital giants who enjoy scale of market and resources.

Disruption isn't bad. It is the very stuff of capitalism and that one might disrupt or be disrupted is the risk taking that justifies profit. And the phenomenon isn't new; in the agricultural, the industrial and now the technological revolutions, industries established for decades and centuries have been disrupted and disappeared. The difference now is that disruption is happening so quickly that the effects are all the more dramatic and, secondly, we now care more about the actual and potential societal effects of disruption.

The end of retail or large parts of it as we know it will have huge consequences for employees and investors, for suppliers and ancillary businesses.

Until now, we tackled retail insolvencies with a company voluntary arrangement (CVA) or scheme of arrangement, both of which enable a deal reducing the company's debts so long as a majority of creditors agree and over the objections of a minority representing up to a quarter of the debts owed. The retailer could also shuck off its non-performing shops, get creditors to accept less than they are owed and concentrate the business in the remaining best performing stores.

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But now for some retailers, the number of good sites will keep shrinking until there is nothing left. A deal with landlords and the creditors isn't going to be more than a short-term fix. Meanwhile the winnowing of traditional shopping centres drives down the value of landlords' estates.

The 'rescue culture' in insolvency law isn't new

The idea I want to explore is using the law and techniques developed for insolvent companies to do two things: enable disrupted businesses to continue trading for far longer than would otherwise be the case and in so doing make a profit and, secondly, enable people to keep their jobs for longer, while the inevitable end of the company's life is managed and so reducing the social impact of the end of the company's life.

Instead of falling off an economic cliff edge, the company will be managed to its inevitable end. You may say that second goal is alien to insolvency law. Not at all. Increasingly in developed countries and in the UK since 1985, we've been focused on the "rescue culture". Governments have realised that in saving a business there is a social felicity as well as an economic gain. In the case of disrupted industries there may be no way of saving the business, but palliative care can make the passing so much better.

Learning from the insurance world

In the 80s and 90s the insurance industry realised that many people had suffered harm while at work, but were not yet ill and might not become ill for some time. For example workers exposed to asbestos, while not yet sick, were going to become so and this meant that insurance companies that at the time seemed comfortably solvent would, eventually and unavoidably, fail as the claims began to roll in.

Insolvency law, to stop directors simply gambling on the future of their company, requires them to put creditors first as the company approaches insolvency and to do everything possible to minimise loss to creditors once they know an insolvent liquidation can't be avoided - even if it is years in the future. Those duties, sensible to protect creditors, put a vice-like grip on the ability of a company facing financial difficulty doing anything much other than dramatically restructuring or closing down. A restructuring makes sense and will only get support if the business has a viable future. Many disrupted businesses simply don't have a viable long-term future and the risks of breach of duty by directors and the ability of the courts to unwind transactions entered into by an insolvent company mean that the end shouldn't be delayed.

But for those insurance companies with an unexpected deluge of claims on the horizon, a sudden end wouldn't benefit their claimants, the current and the future, those already ill and those who would later become ill. Liquidation presented costs and complications that had the legal profession hunting for another solution. The answer was to put the insurers' assets into schemes of arrangements and provide a mechanism for all present and future creditors to make their claims and to share in the proceeds of running off the insurer's business. In that way, the assets of the insurer, its investments, could be carefully nurtured to provide the best return and the stringencies and imposts of liquidation, avoided.

What would a palliative insolvency solution look like for retailers?

With that structure in mind let's turn again to the multi-site retailer. It leases stores in malls up and down the country. It is life limited. It isn't going to survive long term, rents go up with each review, and revenue falls as footfall in the malls slip and the anchor tenants retreat but it has a loyal core of customers for its products, which are not all generic.

The business could be sold in a fire sale or through a pre-pack insolvency sale but that would leave behind some creditors including many employees. Yet, the business has the capability to continue to generate profit if it is run down carefully and if it does a deal with its creditors to pay them a portion of what the continuing business generates, they would get more than in a liquidation.

The deal with creditors would adjust running costs over time and in doing so keep more of the staff in work for a longer period, during which they can be trained and supported to find new jobs. This structure offers a better outcome for all than would be case if the company went into liquidation.

Scheme of arrangement

The idea is to use a scheme of arrangement, or CVA, to provide retailers with the opportunity to achieve the following:

- Surrender the hopeless leases;
- For the other shop leases, to introduce a formula adjusting rents in line with revenue and allowing the landlord to take back a property when an agreed threshold is passed. With many malls and high streets facing a critical decline in demand, landlords should see the attraction of keeping properties tenanted and a rent paid based on the shop's revenue;
- Work with unions and other employee representatives to consider alternatives to what would otherwise be inevitable redundancies (by considering viable alternatives such as natural staff attrition, the use of seasonal and other temporary workers and redeployment) and to manage redundancy processes more gradually than in liquidation. With time on their side, retailers would look for some measure of governmental support, to help with staff re-training to enhance redeployment opportunities.
- If there is a direct benefit pension scheme, probably with a deficit, the trustees and the Pensions Regulator will see the benefits of the continued operation of the scheme in a careful, long-term run-down process as will the Pension Protection Fund, who would have to step in on an insolvency event.

Management team

The business would be run by a management team with suitable oversight by the supervisor of the scheme of arrangement or CVA. All new creditors would be paid in the ordinary course of business, and the business would be run on for profit according to a measured business plan.

The business plan, which would almost certainly call for some new investment on which a return must be achieved, would require regular review. The current shareholders and financial creditors, the bondholders and the company's banks, will have to accept a haircut and their willingness to accept a loss will only be on the basis that the structure offers them a better outcome than would otherwise be the case. If benchmarks are not met then the scheme/CVA supervisor could flip the assets and business into a liquidation.

Better managing the social impact

The vision is that while the business shrinks paying its post-scheme/CVA debts as they fall due, the impact of disruption is reduced. No longer will the company struggle to maintain or increase its market share against that overwhelming disruptive wave, but instead focus on its remaining customers. Capex and investment is cut back as there is a conscious realisation that custom is in decline. The number of stores reduces as the business downsizes and at some point, much later than would otherwise be the case, the business closes and go into a solvent liquidation, paying in full all its post-scheme/CVA creditors.

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By that point it should have accumulated money to meet redundancy costs of those staff who haven't retired or moved to new jobs.

An investor can make money from this proposition. Pre-scheme/CVA management would have opted for the scheme or CVA as a means of meeting their duties as directors, as an alternative to insolvency. A new investor would buy into the proposition that the pre-scheme/CVA liabilities would be met out of the schemes/CVA's returns, and the business plan would provide for the investor to take on a business with liabilities that can be managed to accord with its size and market.

Business always carries a measure of risk and trying to ameliorate the effects of industry disruption adds another, perhaps, forbidding, layer to tackle. There are obviously costs associated with introducing a scheme and the threat of holdout creditors who try to skew the deal to get more for themselves. Consumer, supplier and lender confidence are most especially fragile in retail. A generic retailer, with a weak brand, will struggle to persuade those essential groups that the decline in sales won't continue in an uncontrollable cascade after the scheme/CVA. Lenders and suppliers will need to be persuaded of the financial substance of the continuing business, that there is a viable future albeit limited in time, so a history of default won't help. Customers must be reassured that the closure stickers aren't suddenly going up. But there will be cases where a prudent scheme proposed in good time - that being a critical requirement - will be able to have a significant impact.

Better this approach, some will say, than the pre-pack sale of the good parts of a business to its former owners leaving unsecured creditors, including employees and the pension scheme, with an insignificant return. One can picture investors encouraging life limited companies to adopt this approach while there is yet time.

California has introduced new forms of companies that enable and encourage impact investing. Their objects and the duties of the directors aren't just focused on generating profit but on achieving a social impact, doing good. The idea of using techniques refined for insolvent companies can have a benign effect in industries that are about to be overwhelmed by technological and consumer change.

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