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Author Chris Umfreville

# Taking a DIP into the pool: should the Pre-Pack Pool be extended to CVAs?

## KEY POINTS

- Company voluntary arrangements (CVAs) are a prominent feature of the restructuring landscape in 2018, with an increased media focus.
- R3 has published a wide-ranging research report into the outcomes of CVAs, *Company Voluntary Arrangements: Evaluating Success and Failure* (the 'R3 Report'). This makes a number of recommendations for reform.
- The British Property Federation (BPF) has called for an urgent government review of CVAs and interim measures to address issues and restore confidence.
- Should the remit of the Pre-Pack Pool be extended to CVAs, as the BPF suggests?

- the case for the pre-pack is not unreasonable;
- the case is not unreasonable but there are minor limitations in the evidence provided; or
- the case is not made.

## THE YEAR OF THE CVA

The CVA has without doubt been the dominant theme in the restructuring community in 2018. With a number of well-known high street brands, including Jamie's Italian, Mothercare, New Look and more recently House of Fraser and Homebase, entering into or reported to have considered a CVA, the process has regularly been in the media spotlight.

A common factor in these high-profile cases is an extensive commercial property portfolio, and a desire to reduce leasehold liabilities. It is perhaps not surprising that the BPF has called for a review and suggested immediate reforms to the CVA process to protect its members. Amongst the suggestions advocated by the BPF is the expansion of the Pre-Pack Pool to CVAs. It is worthwhile considering how this might work and the benefits it could offer.

## BPF CONCERNS AND RECOMMENDATIONS

The BPF is concerned with common practices in recent CVAs which mean the process is 'being mis-used... [which] risks undermining the UK's global reputation and deterring much-needed investment into our towns and city centres' (see: [www.bpf.org.uk/media-listing/press-releases/british-property-federation-calls-government-urgent-review-cvas](http://www.bpf.org.uk/media-listing/press-releases/british-property-federation-calls-government-urgent-review-cvas)). It suggests that a number of issues are undermining the CVA process, including:

- a lack of transparency;
- unfair discrimination between different creditors; and
- a lack of regulation to ensure appropriate use and good practice.

The BPF has called on the government to conduct an urgent review of CVAs, but no doubt cognisant of the current parliamentary Brexit-related logjam, has recommended a number of immediate steps to 'restore some confidence in the interim'. The first recommendation is that CVAs affecting more than five 'outlets' are referred to an independent third party for review. It is suggested that the Pre-Pack Pool could be given an extended remit to perform this function. Ian Fletcher, Director of Policy (Real Estate) at the BPF, has suggested this would be a more satisfactory way of seeking a second opinion on a CVA proposal than the only current option of going to court (see: [www.esquireglobalcrossings.com/2018/06/spotlight-on-cvas-the-british-property-federation-gives-squire-patton-boggs-its-views-on-the-recent-spate-of-landlord-cvas/](http://www.esquireglobalcrossings.com/2018/06/spotlight-on-cvas-the-british-property-federation-gives-squire-patton-boggs-its-views-on-the-recent-spate-of-landlord-cvas/)).

## THE PRE-PACK POOL

The Pre-Pack Pool was born out of the 2014 Graham Review into Pre-Pack Administration. Identified as an industry-led reform to address perceived issues with connected-party pre-packs, the Pre-Pack Pool is an independent panel of experienced business people who offer one of three opinions on the proposed transaction:

Referral to the Pre-Pack Pool is at the discretion of the connected-party purchaser, with no prescribed information to be provided. Since its inception on 1 November 2015, use of the Pre-Pack Pool has been limited, and has declined year-on-year (see Annual Review available at [www.prepackpool.co.uk](http://www.prepackpool.co.uk)). The Graham Review also recommended separately that connected party purchasers submit a viability review to the Pre-Pack Pool, though this appears to have been even less popular than referral to the Pool.

The Insolvency Service is currently reviewing the Graham Review reforms, including the Pre-Pack Pool, to determine whether further reform is needed. The viability of the BPF's proposals will depend on the outcome of this review, which is ongoing at the time of writing.

## COMPANY VOLUNTARY ARRANGEMENTS: EVALUATING SUCCESS AND FAILURE

The BPF's call for an urgent review of CVAs followed hot on the heels of the publication by R3 of *Company Voluntary Arrangements: Evaluating Success and Failure*, though does not mention it. A comprehensive report on CVA outcomes, the R3 Report evaluates data from CVAs commenced in 2013 alongside stakeholder interviews and surveys. In doing so, it identifies a number of issues and makes recommendations for reform to the CVA process to improve both operational performance and stakeholder confidence (see: [www.r3.org.uk](http://www.r3.org.uk)).

Extending the Pre-Pack Pool to CVAs was not amongst the recommendations in

the R3 Report, though it was raised during interviews with unsecured creditors (see Section 7.4 of the R3 Report). There is some similarity between a connected-party pre-pack and a CVA. In both cases, the existing management retains control of the business, certain debts are avoided, and unprofitable parts of the business can be closed down. A key difference is the formal involvement of the unsecured creditors in approving a CVA proposal, a stark contrast to a pre-pack.

Let us consider then, in light of the BPF's recommendations, whether extending the Pre-Pack Pool to CVAs could prove beneficial to all creditors by evaluating its impact on a number of the issues affecting CVAs highlighted by the R3 Report.

## POSSIBLE BENEFITS

### 1. Decrease in termination rates?

One of the headline findings from the R3 Report was that 65% of CVAs commenced in 2013 were terminated without achieving their intended aims. Whilst the R3 Report identifies that termination does not necessarily equate to failure of the CVA, as there could be better returns than in a pre-pack administration or liquidation, this figure does raise issues. In nearly two thirds of the 2013 CVAs, unsecured creditors did not receive the level of returns they expected when approving the CVA.

Furthermore, the R3 Report found that 7% of all CVAs from 2013 were terminated within six months of commencement. Very early termination of a CVA could be caused by a number of factors, some of which may be beyond the company's control, such as withdrawal of support from key suppliers or customers. However, it is doubtful that all cases were subject to such unexpected events, which calls into question whether the CVA was viable from the outset.

These high termination rates, especially the number of early terminations, risk damaging the reputation of CVAs and the ability to garner creditor support in the future. Referral of the proposal to the Pre-Pack Pool for scrutiny could potentially help weed out unrealistic proposals, thereby

decreasing termination and improving creditor confidence in the process.

### 2. More realistic proposals?

The R3 Report identified that many CVAs may be undermined by the terms of their proposals, contributing to early termination. In particular, many CVAs appear to suffer from the proposed duration, often a default of five years in line with HMRC requirements and standard practice in IVAs, and the level of dividends, with many proposing full repayment.

Over a quarter of all companies entering into CVAs in 2013 were less than five years old. Often the terms of a CVA will place restrictions on management and shareholders, including a ban on pay rises and dividend payments during the CVA. If a company has had to resort to a CVA so soon after incorporation, it is not surprising that it might struggle to continue trading under such strict conditions for a prolonged period. Once the reality of these restrictions sinks in, it is little wonder that management may lose interest in continuing the CVA.

Many CVA proposals are also undermined by the twin issues of over-optimistic financial forecasts and underestimating the impact of a CVA on the availability of working capital. These are identified by both the membership survey and stakeholder interviews in the R3 Report. Such optimism no doubt leads to unrealistic dividend proposals. Consequently, the terms of the CVA are more likely to be breached when reality bites and contributions cannot be made, leading to default and termination of the CVA.

### 3. Improved levels of scrutiny?

The BPF's recommendation of extending the Pre-Pack Pool to CVAs intends to provide an additional level of scrutiny of proposals. In principle, this would allow for an independent review of a CVA proposal, which could address unrealistic or problematic terms, leading to a reduction in the number of terminations. In time, the presence of such a filter could lead to more realistic proposals being put forward at the outset to smooth passage through this

scrutiny, much like it has become standard practice for CVAs to include those terms often required by HMRC.

Some may argue that it is the role of the nominee to scrutinise the proposal's viability. The nominee is only required to report whether the CVA has 'a reasonable prospect of being approved and implemented' and 'be satisfied that it is achievable' (s 2(2) Insolvency Act 1986 & SIP 3.2). In addition, evidence from the 2013 CVAs in the R3 Report suggests that insolvency practitioners (IPs) are not necessarily well-practised in overseeing CVAs. Of the 552 CVAs commenced in 2013, 79 were supervised by IP firms taking only one appointment that year. 140 IP firms took five or fewer appointments. Whilst it is undoubtedly positive that the market is not dominated by a small number of players (conversely, only four IP firms took more than 20 appointments in the calendar year), this experience gap may present a risk in terms of approval of CVAs. Referral to the Pre-Pack Pool could ensure a more consistent level of review.

This may be doing a dis-service to IPs, whose expertise and exposure in other areas of their practice will feed into their review of CVA proposals. It cannot be ignored, however, that there is a perception of a lack of scrutiny by nominees, and even IPs acknowledged in the R3 Report that some form of independent scrutiny could be useful.

### 4. Addressing perceived unfair practices

The treatment of landlords' claims in a CVA compared with other creditors is one of the core issues that the BPF is seeking to address. The BPF believes that CVAs are being used to reduce leasehold liabilities rather than as a complete restructuring exercise. This is one example of perceived unfair practices being employed in CVAs.

Further examples of alleged unfair practices are revealed in the R3 Report stakeholder interviews. These include directors' company cars being deemed essential supplies and retained at the expense of other creditors, existing rents being compromised only for new properties to be leased during the CVA, and the inclusion

## Feature

### Biog box

Chris Umfreville is a Lecturer in Law at Aston University in Birmingham. Chris has written widely in the area of corporate insolvency and rescue. He was also part of the teams that contributed to the Graham Review into Pre-Pack Administrations for the Insolvency Service and produced the recent report *Company Voluntary Arrangements: Evaluating Success and Failure* on behalf of R3 and the ICAEW. Chris is also a Contributing Editor of *Palmer's Company Law*. Email: [c.umfreville@aston.ac.uk](mailto:c.umfreville@aston.ac.uk)

of fictitious debts to alter voting rights. Subjecting the CVA proposal to the Pre-Pack Pool may allow some of these practices to be rooted out, and in turn improve creditor confidence in the process.

### A VIABLE PROPOSITION?

There is little doubt that, in theory, extending the Pre-Pack Pool to CVA proposals could address a number of the issues currently undermining CVA implementation. Chief amongst these issues is creditor confidence. Creditors may perceive that a CVA is being proposed for the benefit of a company's management, its shareholders, or even the IP who could be appointed in a subsequent procedure should the CVA be terminated. It could also allow for a more thorough review of the terms of the CVA, ensuring that the length is suitable and proposed dividends achievable.

Whether the Pre-Pack Pool could achieve this is dependent on a couple of big issues being addressed. The first is the future of the Pre-Pack Pool itself. The impact of the Pre-Pack Pool has been underwhelming in the three years since its introduction, with only 11% of eligible transactions being referred in 2017 (down from only 28% the previous year). With the Graham Review reforms currently under review, it would only be viable to extend the Pre-Pack Pool to CVAs if referral of Pre-Packs is made compulsory (something this author has called for elsewhere). In such a scenario, referral of CVAs would also have to be compulsory, to avoid the issues currently affecting the Pre-Pack Pool. If the Pre-Pack Pool is disbanded, subsequent creation of a similar body for review of CVAs appears unlikely.

Extending the Pre-Pack Pool to CVAs raises further issues as to what the Pre-Pack Pool would be considering. The two key issues to address are fairness and viability of the proposals. Fairness arguably can be addressed following guidance from the Powerhouse and Sixty UK cases (see *Prudential Assurance Co Ltd*

*v PRG Powerhouse Ltd* [2007] BPIR 839 and *Mourant v Sixty UK Ltd* [2010] BPIR 1264). The question of viability could prove more difficult, however. The test applied to a CVA would need to be more rigorous than that employed for a Pre-Pack, given the differences between the processes and creditor outcomes. This would likely increase the time needed for scrutiny and in turn the cost of that scrutiny. Whether there would be an appetite for further costs in the approval process remains to be seen.

### A COMPLETE PANACEA?

Extending the Pre-Pack Pool to CVAs has the potential to address a number of the issues identified in the R3 Report. However, it would not address all of the problems that can undermine a CVA. It is also questionable if the Pre-Pack Pool is the most suitable means of addressing some of the issues. For example, a revised SIP would be more appropriate for reducing the length of CVAs.

The viability of a proposed CVA is obviously a key issue, however many factors which undermine implementation arise post-commencement. These include management failing to make the necessary changes to turn the company around, key suppliers and customers deserting the company due to it being in an insolvency process, and even issues of employees seeking new work in fear of their employment being terminated along with the CVA. The Pre-Pack Pool would have no control over the impact of these factors.

There are also concerns about the quality of information provided when a CVA is proposed. Whilst subjecting a proposal to an additional level of scrutiny may result in improvement, referral to the Pre-Pack Pool will only increase the already time-pressured approval process. The introduction, and use, of a more accessible moratorium may allow the formulation of more viable turnaround plans free from immediate creditor pressure. The R3 Report found a

marked increase in the implementation of CVAs following some form of moratorium. The government's proposal to replace the Schedule A1 Insolvency Act 1986 provisions with a wider-reaching 28-day moratorium provides grounds for optimism in this regard (see [www.gov.uk/government/consultations/insolvency-and-corporate-governance](http://www.gov.uk/government/consultations/insolvency-and-corporate-governance)).

### CONCLUSION

As is often the case, there is no simple solution for the reform of CVAs. Expanding the remit of the Pre-Pack Pool to consider the fairness and viability of CVAs could address a number of the issues dogging the process. Creditor confidence and public perception of this recently maligned procedure need to be improved. Scrutiny of CVA proposals by the Pre-Pack Pool will not in itself address all of the issues, and may require wider reforms to be effective.

The CVA is not a controversial process, as many media outlets have suggested, but it does require reform to improve outcomes. Whatever reforms are introduced, CVAs will still be susceptible to early termination. With terminated CVAs capable of providing better returns to creditors than alternative insolvency procedures, alongside other benefits, it is clear that some level of reform is needed to restore confidence in the CVA. Whether referral to the Pre-Pack Pool should be included remains subject to debate. ■

### Further reading

- Company Voluntary Arrangements: Evaluating Success and Failure (available at [https://www.r3.org.uk/media/documents/policy/policy\\_papers/corporate\\_insolvency/R3\\_ICAEW\\_CVA\\_Report\\_May\\_2018.pdf](https://www.r3.org.uk/media/documents/policy/policy_papers/corporate_insolvency/R3_ICAEW_CVA_Report_May_2018.pdf))
- Company voluntary arrangements: landlord issues and remedies (2018) 2 CRI 60
- CVAs: landlord pain for shareholder gain? (2018) 2 CRI 119