

Consultation/Call for evidence on improving the transparency of, and confidence in, pre-packaged sales in administrations (March 2010)

RESPONSE OF INSOLVENCY LAWYERS' ASSOCIATION

INTRODUCTION

This response to the Insolvency Service consultation on improving the transparency of, and confidence in, pre-packaged sales in administrations has been prepared on behalf of the Insolvency Lawyers' Association (the ILA) by its Technical Committee (the Committee). The views set out in this response do not necessarily reflect the views of all the members of the ILA.

The ILA provides a forum for c.320 full-time, associate and overseas members practising insolvency law and the membership comprises a broad representation of regional and City solicitors, barristers and academics. The Committee is responsible for identifying and reporting to members on key developments in case-law and legislative reform in the insolvency marketplace. The Committee welcomes the opportunity to provide comments on the proposals outlined in the Consultation.

GENERAL COMMENTS

In recent times, we have increasingly observed the criticisms of the pre-pack practice in the trade and national press and we welcome the opportunity to contribute to the debate stimulated by the Consultation. However, we are disappointed in the absence of an impact statement, or indeed, any empirical data to identify the extent to which the criticism or lack of confidence identified in the Consultation paper is causally linked to the pre-pack practice.

One of the main real issues is that prepacks always involve a company in financial distress; that means people lose money, some more than others. What evidence there is suggests that pre-packs generally achieve a better (not worse) result on both overall recoveries and in saving businesses and jobs. Junior creditors in a security structure will lose more than senior creditors; unsecureds (including trade) more than secureds; shareholders more than creditors. That's how insolvency works. When those facts of life are experienced in a pre-pack, it is (in all but exceptional cases) because the company is insolvent, not because the solution was a pre-pack.

Anecdotal evidence suggests that criticism of pre-packs is voiced mostly by unsecured creditors, particularly those in middle to lower value cases, especially those involving sales to directors of the insolvent company. Research¹ suggests that unsecured creditors typically receive very low returns from either type of administration sale. Therefore, although the focus of these

¹ The Frisby Report (2007)

creditors' criticism is the pre-pack practice, the real root of creditor dissatisfaction is more likely the insolvency itself, rather than the process which formally recognises that state of affairs, or under which that adverse condition is addressed.

Part of the problem is an impression of unfairness. It is unfair to have extended credit, and for it not to be honoured, but the economy cannot function without credit, nor without the risk it carries. However, different stakeholders think that different aspects of the pre-pack are unfair. Financial creditors focus on the fairness of the valuation, while trade creditors tend to focus on whether it is fair that shareholders/directors can escape their liabilities and carry on trading. There are already checks and balances to ensure that proper valuations are obtained (not least administrators' existing duties, statutory and in case law), and that directors' conduct is investigated.

The same research referred to above also found that overall returns from pre-pack administrations was slightly better than in trading administration sales, and in particular, the employment outcome was markedly better in pre-pack cases. The evidence available does not therefore obviously support a case for restricting the availability of pre-pack administrations on grounds of their financial outcome.

However, we acknowledge that to the extent that pre-packs are perceived (rightly or wrongly) with scepticism, this threatens the integrity of the insolvency profession and, in particular, the usefulness of the pre-pack practice in proper and appropriate cases. We therefore agree that it is appropriate to debate the introduction of measures to address these concerns. However, it is important that, in trying to remove the potential for abuse, any such measures do not price pre-packs beyond the reach of appropriate cases.

It is worth recalling that the paragraph 14 and 22 filings for administrations introduced under the Enterprise Act changes for entry into administration (without a court order), were a response to the view that applications to court, supported by sufficient evidence (especially rule 2.2 reports, which came to be quite sophisticated documents to aid the court and anticipate questions), were too costly and time consuming. A more expedient entry route was felt appropriate, and it affirmed the UK approach to the administration of insolvencies as being under the stewardship of the licensed professionals, rather than the courts (as is the US experience). That stewardship is mostly justified, and the perceptions that the consultation addresses are marginal behaviours rather than typical of the profession.

In the experience of some of our members, a pre-pack administration is often the only viable option to preserve an insolvent company's business, especially in the middle or the lower value end of the market. Reasons for this include a lack of funds to trade the company in administration, especially following erosion in value of the floating charge and the increase in popularity of invoice discounting and factoring arrangements. In addition, in smaller cases, the risk

to the IP of trading the company in administration (including value destruction, employee redundancies and preferential claims, and the absence of certainty of a sale) is far outweighed by the attraction and certainty that a pre-pack offers. In many cases, a pre-pack sale whether to a connected or third party, is the best commercial option in the interests of the creditors as a whole. If this option is restricted, or made too expensive by, for example, requiring court approval, administration may cease to be an option altogether. If that were to happen, it would result in a higher number of liquidations, lower returns to all creditors and a greater loss of employment. This outcome must be avoided.

There are features in different parts of the market which we consider require distinguishing. The principle zone of complaint has been in relation to sales back to management or connected parties (“phoenixism”). This is much more likely to affect trade creditors and other market participants where the operational business is the pre-pack subject. By contrast, in cases where the pre-pack is effected at a higher level in a group’s capital structure (eg holding company level, where the Opco is “washing its face”, but is unable to throw off sufficient profits to enable the overleveraged Holdco to service its debt), the parties most likely to be affected will be sophisticated financial creditors when a sale of Opco’s shares leaves several layers of debt in the capital structure out of the money.

All prepack cases involve valuations, especially where there is no market testing as well. This applies just as much in the mid market as in the larger cases, but the scope for valuations to diverge (and the extent of any divergence) becomes greater as a function of the size of an enterprise, and the size and complexity of its capital structure. What follows applies in all cases to a greater or lesser extent, but is seen more acutely in larger value cases with several participants in the capital structure. The issue of valuation will be uppermost in the minds of the vendor company directors and security agent for several reasons. First, many of the large restructurings involve multiple layers of debt with sophisticated PE houses and junior creditors (usually CLOs and Funds) who are not shy to challenge. Second, as a result, the directors will be cognisant of their duties to act in the interests of all creditors, not just seniors and will be advised to obtain market testing or at least a quality valuation to ensure value breaks in the senior debt/debt. Third, the senior agent has an obligation to obtain the best price reasonably obtainable and will also not wish to be involved in a situation where it could be sued or criticised. Fourth, in these larger restructurings, no administrator – who will usually come from a Big 4 Firm or known IP boutique practice – will be willing to take an appointment and sell without a valuation (or a minimum of two valuations) or other mechanism – conditional contract – to ensure the right value is being obtained. There is a concern that some of the measures suggested would be overkill in the larger restructuring context.

Although there are already provisions for dissatisfied creditors to challenge prejudicial conduct, or misfeasance, by administrators, such challenges are rare, and successful ones rarer still. We do not take that as a testament of satisfaction, so much as a natural reluctance of creditors to throw good money after bad. In such cases, complaints to RPB's can become a low cost "proxy" for such a challenge, in which the swiftness and rigour of the RPB investigation becomes a yardstick for creditor confidence. RPB's have a role to play in upholding proper professional standards and creditor confidence in the appropriate use of the prepack practice. It is temptingly easy for the perception of abuse to gain traction and take hold as an urban myth, prompting a call to arms for something to be done, lest inertia appears to endorse what are complained of practices. Better empirical data is still required than seems to be available, so that any decisions which follow from the consultation can be seen as a proper response to a real problem, rather than one which is more imagined than real.

Question 1: Do you believe that the current framework governing the operation of pre-pack sales in administration provides a sufficient level of confidence that pre-packs are only being used in appropriate circumstances and with an appropriate degree of transparency?

One of the sources of a perception of inappropriate use of prepacks is that of press reporting, suggesting that pre-packs are a device to leave your creditors behind, and carry on as if nothing had changed. Very rarely do reports make it clear that the business is being or has been sold for its current value. Can press coverage really be expected to be more objective if, say, SIP 16 were made mandatory? If not, the perception problem may remain largely unresolved.

SIP16 would appear to address the accountability problem posed by pre-pack sales (namely the fact that creditors were previously given insufficient information about the pre-pack to assess whether their interests had been harmed by it). Although the latest report² shows only 62% of SIP16 submissions were fully compliant, it also shows that only 7% of cases were sufficiently non-compliant to warrant disciplinary action. When you consider that SIP16 is open to interpretation, and that practice might be said to still be evolving, the fact that the profession has achieved 93% substantive compliance over a relatively short period means that creditors do generally now have information on which to make informed judgments about pre-pack sales.

Additionally, the recent rule changes that introduce the ability to seek creditor approval for an IP's pre-appointment costs, where utilised, will provide further transparency as to the work done towards the pre-pack transaction prior to appointment, but it will take time before we know how this will be received in practice.

It is probably still too soon to make a substantive judgment on the impact of SIP16 and whether it, together with the rule changes, will serve to address the concerns of pre-pack critics and provide "sufficient" confidence.

Meanwhile, we would not be in favour of the introduction of any hasty or costly measures until SIP16, properly monitored and enforced by the regulatory bodies to ensure full compliance, has been allowed to mature and a fact-based assessment of its impact has been conducted. At this stage, resources would be better directed at improving the guidance available to IPs with a view to encouraging a better culture within the profession of proper explanation as distinct from one of tick-box compliance with the SIP16 components, and helping creditors understand what is and, equally, what is not an appropriate use of a pre-pack transaction.

It is worth adding that SIP 16's requirements have already achieved judicial traction in those cases in which the route to the administration order (and closure of a sale shortly thereafter) has been via a court application³, from which it can be seen to have become part of the common law (and lore) of

² Insolvency Service Report on Operation of SIP16 July – Dec 2009

³ Kayley Vending [2009]BCC 578

insolvency practice. Whether that supports the suggestion of formalising its contents in the Insolvency Rules, as has been suggested, or renders it unnecessary, is an open question.

Question 2: If not, what are your main concerns with the way pre-packs are currently executed?

There is to some extent a lack of confidence among some members in the depth of the marketing and valuation exercise conducted by a small number of IPs. What creditors will see is the fait accompli, and where it has been with connected parties, it invites scepticism as to the rigour of the market and value testing. That is where the IP needs to rise properly to the challenge of clearly explaining what has been done, rather than a bland compliance with the provision of the information required by SIP16.

Question 3: Do you believe that pre-packs are presently subject to abuse? If so, how? Please indicate whether you believe it is the actions of directors, insolvency practitioners, secured lenders or any other parties that are contributing to any perceived or actual abuse and to what extent you believe this is a problem.

It is perceived by some that there is a small number of IPs who become too close to the insolvent company's directors to remain impartial. Others may align themselves too readily with a "quick deal" or a senior secured debt solution. However, we are not aware of any actual cases of abuse.

That phoenix's are bad is perhaps the real complaint (and the whole system of licensing IPs came about in response to the abuses in the late 70's and early '80's of the so-called "cowboy liquidators"), not so much that a debtor company has already become an impaired covenant for its creditors by the time an IP is consulted in the first place. But the view of the Company Law Steering Group in 2001 was that not all phoenix's are bad⁴

Question 4: Some of the following options would require a distinction to be drawn between pre-packs and 'conventional' administrations. What do you think should be included in a statutory definition as to what constitutes a pre-pack transaction?

For consistency, the definition in SIP16 should form the starting point of any statutory definition. We would suggest the following additions:

"An arrangement under which the sale of all or part of a company's business or assets is negotiated **and substantially agreed** with a purchaser prior to the appointment of an administrator, and the administrator effects the sale immediately on, or shortly after*, his appointment"

⁴ see para's 3 & 4 of the CA judgment in *ESS Productions Ltd v Sully* [2005] EWCA 554

*In the interests of certainty, the phrase “or shortly after” should be defined. The Frisby Report recorded instances of pre-pack sales taking place up to 7 days after appointment, but in the majority of cases the sale will take place within hours rather than days after the appointment. Irrespective of the length of gap between appointment and completion of the pre-pack sale, the defining feature of a pre-pack administration is that the sale is substantially negotiated before appointment, and no attempts are made after appointment to pursue any alternative arrangement.

Whether there is a need for a statutory definition is to presuppose that statutory intervention is required in the first place, and that is at the core of the consultation. At present pre-packs offer a commercial solution, within the legitimate commercial margin of appreciation, and used properly, is a useful tool within English insolvency practice. It is not like the US court supervised pre-pack, which is a recognised procedure.

OPTION 1: NO CHANGE

Question 5: Do you believe that the new pre-appointment cost recovery mechanism will have a significant effect on transparency and confidence?

No.

The mechanism for seeking approval of an IP's pre-appointment costs in the amended Insolvency Rules 1986 is an uncertain and potentially costly process. If the spirit of SIP16 is observed, the pre-appointment cost recovery mechanisms may not add much to what creditors will or should already have been told, so that its value in providing greater transparency for creditors may be more imagined than real. In addition, on smaller jobs, where margins are particularly tight, an IP may be reluctant to accept the uncertainty and prefer either to seek his pre-appointment costs elsewhere, or if that is not an option, not to take the job at all. Creditors will always be disenchanted at the discovery of an insolvency of their counterparty, but creditor confidence in the integrity of the process is a function of what they are told about it and the alternatives which were available, rather than a measure of the cost inputs to deliver the outturn they are presented with.

OPTION 2: GIVING STATUTORY FORCE TO SIP16 AND PROVIDING PENALTIES FOR NON-COMPLIANCE

Question 6: Do you believe that by giving statutory force to the SIP 16 disclosure requirements creditors would be given better information about the reasons and justification for the pre-pack?

No. The reference to penalties for “comparable matters in the Insolvency Rules” begs the question what comparable matters are being referred to? We

are not aware of many incidences of enforcement of such matters and imposition of penalties. Unless resources are also allocated to enforce any new statutory offence, enshrining SIP16 in statute would have no greater effect than the current arrangement.

The Insolvency Service latest report showed 62% of submissions are already fully compliant with SIP16, and 93% are by implication substantially compliant. Further guidance and regulatory monitoring should improve these figures further. We do not consider that giving SIP16 statutory force alone would drive better compliance than the prospect of disciplinary action by regulatory bodies.

There is a risk that a statutory equivalent to SIP16 could have the opposite of the intended effect. It would run the risk of less flexibility in what is a fluid commercial situation: it is easier to amend and refine a SIP in response to experience and developments in the market than it is to amend legislation, whether primary or secondary. If SIP16 (currently part of proper professional standards) was made into a statutory code (so that it becomes an issue of legal compliance too), it might also drive more IPs to the caution of requiring court endorsement to their intended actions. As we comment elsewhere, resort to the courts ordinarily adds to costs, potentially diminishing creditor returns.

The absence of empirical evidence that the perception of abuse is borne out, as distinct from the anecdotal, is rarely a solid basis for legislating. That said, if the perceived problem is seen as so endemic that it genuinely requires steps to address it, then a mandatory requirement in the Rules for compliance with the principle of SIP16 is perhaps the lightest touch proposal in the consultation.

Question 7: Do you believe that such a requirement will increase costs and reduce the returns available to (a) secured creditors, and (b) unsecured creditors? If possible, please provide an estimate of the impact on each.

We would not expect compliance with a statutory version to be much more expensive than the current costs of properly complying with SIP16, unless it created the inflexibility and greater caution described above. It is naïve to think that creating an offence for non-compliance (in addition to professional sanctions) will not create a more cautious initial response.

Question 8: Do you believe that it would be appropriate for details of the pre-pack to be filed at Companies House? If not, why not?

No. The intention of SIP16 was to improve transparency to unsecured creditors and stakeholders involved in the administration. These creditors already receive the SIP16 information. What creditors complain of is a lack of timely engagement with them by the IP, but a filing at Companies House engages with the world at large (including trade competitors), not the

stakeholders directly affected and so this would be no answer to the call for timely disclosure. Additionally, the administrator must also file a copy of his proposals at Companies House. Filing additional SIP16 details (or their statutory equivalent) at Companies House might be of interest to other third parties, but we do not see what SIP16 related purpose would be furthered by it. It would seem to add more red tape and cost for no additional benefit.

Question 9: Do you believe that it would be appropriate for a statutory offence to be created in circumstances where the pre-pack disclosure requirements are not adequately met?

No. The existing arrangements would appear to be adequate. See above.

OPTION 3: RESTRICT EXIT FROM PRE-PACK ADMINISTRATIONS TO COMPULSORY LIQUIDATION TO ACHIEVE SCRUTINY BY THE OFFICIAL RECEIVER

Question 10: Do you believe that confidence in pre-packs would be improved by requiring companies whose business and assets had been sold through a pre-pack to exit administration via compulsory liquidation? What would be the possible costs and benefits?

We do not consider that this option is economically viable, or even beneficial for creditor returns. The point of preventing an administrator from taking office as liquidator arises if liquidation inevitably followed administration. That could remove the advantage of the relatively recent Enterprise Act amendments allowing distributions in an administration. They were seen as a means of reducing the costs of two procedures to facilitate a distribution to creditors. If there have been material breaches by the administrators in the discharge of their duties, there are ways of challenging that conduct (see general comments at the start). If the costs of the liquidation have to be ring-fenced within the administration, then it could make many small value pre-pack administrations uneconomic. Equally, if this proposal is not to be funded by carving out administration assets, in the current economic climate of public spending cuts, it seems unlikely that the Official Receiver would be adequately resourced to undertake these reviews.

We do, however, consider that there is merit in considering the proposal already put forward by other members of the insolvency profession of preventing an administrator in pre-pack cases (or indeed any administration where the business is sold before the creditors' meeting) from taking appointment as liquidator in any subsequent liquidation, absent creditor consent or approval of the court. The administrator conducting a pre-pack case would know that his and the directors' conduct is likely to be reviewed by an independent IP in a subsequent liquidation, and creditors would also have the comfort of an impartial second opinion. It may be necessary to restrict the administrator's power to distribute in administration so as to ensure that, in cases where there are funds to distribute, a liquidation becomes necessary. This proposal would likely add to the costs of the two procedures, but not by as much as requiring a change of IP between pre- and post- administration

appointment work (see option 4 below). It also has the merit of a track record of working well in the context of administrative receivership. It would not, however, provide a review of cases where there are no funds available for a liquidation. Perhaps more research could be done on what percentage of cases fall into this category.

The connected party pre-pack seems to be the focus of most scepticism, and therefore the most likely to merit a second opinion. In such cases, there is merit in examining a requirement that the company may not exit administration via dissolution without a specific resolution at a creditors' meeting, or that the administrator may not become the liquidator in such cases. The prospect of independent review ought to influence the way in which prepack deals with connected parties are done, but how it is funded remains at large.

OPTION 4: REQUIRE DIFFERENT IPs TO UNDERTAKE PRE- AND POST-ADMINISTRATION APPOINTMENT WORK

Question 11: Do you believe that an insolvency practitioner providing advice to a company on the potential for a pre-pack has an inherent conflict of interest when accepting a formal appointment as administrator with a view to subsequently executing a pre-pack sale?

No more so than the analogous situation of a solicitor providing advice to a client in respect of a potential dispute and subsequently accepting instructions to represent the client in legal proceedings. Provided the Ethical Code for Insolvency Practitioners is adhered to, any inherent conflict is manageable.

Question 12: If so, do you believe that such a conflict extends to circumstances where the insolvency practitioner has had an ongoing prior relationship with the company in the context of undertaking review work for a secured lender?

The Ethical Code is intended to provide adequate protection against such a conflict of interests. If the secured lender's security has been either taken or enhanced since the IP's appointment then the potential for conflict requires greater scrutiny, perhaps even more so where the sale is effected by the same IP as administrator to a business financed by the same lender, as can be the case in sales to connected parties. The IP will recognise that the decision is one which requires a clear explanation of its merits relative to the alternatives, and what they were.

Question 13: Do you believe that a requirement for a different insolvency practitioner to accept appointment as administrator would improve confidence that pre-packs are only used in appropriate circumstances?

No. We consider that this proposal would have the opposite effect. It would divide responsibility and accountability between the two IPs and at the same time increase costs because the incoming IP would need to duplicate a

significant amount of the out-going IP's work in order to satisfy himself that the pre-pack was the most appropriate option.

If part of the perception is an antipathy to IPs in general, then it is unlikely to be diminished by insisting upon more of the same.

It could also, perversely, introduce a conflict of interest for the pre-appointment administrator to advise against administration even where it would normally be the most appropriate procedure. The pre-appointment IP would be incentivised to advise the company to use an insolvency procedure where he could take the appointment, e.g. CVA or liquidation. This could result in inappropriate CVA proposals or more liquidations instead.

Question 14: Do you believe the requirement to use two separate insolvency practitioners would increase costs and delay therefore reducing the returns available to (a) secured creditors, and (b) unsecured creditors? If so, please provide an estimate of the impact on each.

Yes. We are unable to provide a meaningful estimate. It is always case specific, and the costs impact on smaller estates is always proportionately greater than in the larger ones.

Question 15: Do you believe the requirement to use two separate insolvency practitioners would reduce the number of business sales effected through a pre-pack sale? If so, please provide an estimation of the impact.

We are unable to express a firm view on this question. However, it is certain that costs would increase because of it, and that is likely to make at least some potential administrations uneconomic. So we consider it likely that this proposal would reduce the number of pre-pack sales. Where a second opinion causes delay in transferring an already fragile business into better capitalised hands, or propose abandonment of that route, the benefits of greater early scrutiny may buy confidence and transparency, but at a cost to the business and, ultimately, its creditors.

OPTION 5: REQUIRE THE APPROVAL OF THE COURT OF CREDITORS, OR BOTH, FOR THE APPROVAL OF ALL PRE-PACK SALES TO CONNECTED PARTIES

Question 16: Is it desirable that unsecured creditors, who may not stand to receive any dividend from the proceedings, be given an opportunity to influence the proposed pre-pack sale where the business is being purchased by a connected party? If so, why?

No. If a pre-pack sale to a connected party is the best deal then, this should be the judgment of the IP, in whom the regime has entrusted these powers and corresponding duties. If it is not an appropriate deal, then there are already avenues of redress for breach of duty and regulatory comebacks.

Further, Parliament has only recently abolished the requirement for shareholder consent for substantial property transactions with directors (formerly s320 Companies Act 1985; see now s193 CA 2006). This proposal would re-introduce a similar provision and a veto power for stakeholders with little or no economic interest. It could destroy the value of the pre-pack entirely. Delay rarely adds value, only uncertainty. .

Question 17: Should approval for such a sale initially be sought from unsecured creditors with a recourse to the court, or from the court in the first instance? If you believe unsecured creditors should be given the opportunity to approve in the first instance, what percentage in value of their claims should be required for approval to be obtained?

We are not in favour of either option. We do not consider that unsecured creditors should be given a right of veto over a pre-pack sale that a suitably qualified IP, acting within the Ethical Code and in compliance with his duties as administrator, believes in his professional opinion is the best commercial deal available in the interests of creditors as a whole. See the answer to Q16.

Equally, there is a long line of authorities where the courts have refrained from second-guessing the IP's commercial decision, from *T&D Industries plc [2000] 1 WLR 646* in which Lord Neuberger held that commercial decisions are the responsibility of the practitioner and the court is not a "bomb shelter" in this regard. In *Re Transbus International Ltd [2004] 1 WLR 2654*, Lawrence Collins J reaffirmed Lord Neuberger's pre-Enterprise Act 2002 view, and considered that the Act reflected a conscious policy to reduce the involvement of the court in administrations. The English judiciary is not trained and resourced to make such commercial decisions and we believe that it would be counter productive to require them to do so.

In approving a sale, the court would have to consider valuation issues and perhaps to hear expert evidence, at which stage the company could be dead, assuming that the pre-pack was justified in the first case. Either of these options would introduce a delay into the process that is likely to destroy most of the value of a pre-pack transaction.

Question 18: Would the prior approval of the court or creditors for the proposed sale improve confidence that pre-packs are only used in appropriate circumstances?

To the uninformed creditor, we accept that a requirement for court approval might give the perception of greater propriety, and therefore artificially improve confidence. However, this misinformed confidence would not be a

good reason to introduce the proposal for the reasons stated above. Where SIP16 obliges the IP to have early engagement with the creditors, this suggestion moves them behind the court, and substitutes its view for those of creditors themselves, whose participation is correspondingly diminished.

An increased confidence in the sale might be desirable, but in many cases it would be at the price of the sale actually happening (and the rescue of a business and workforce), and in all cases will add time and cost to the process (see question 19 below).

Question 19: Do you believe the requirement to obtain court or creditor approval would increase costs and delay therefore reducing the returns available to (a) secured creditors, and (b) unsecured creditors? If so, please provide an estimate of the impact on each.

Yes. Very roughly, we estimate that the cost of a court hearing, including the preparation of a supporting report (not dissimilar to the old r.2.2 reports that were abolished as cumbersome and too expensive by the Enterprise Act 2002) could be in excess of £10,000 even in fairly straightforward modest cases.

This would at the very least reduce the return to unsecured creditors, and in other cases could rule out administration as too expensive.

Question 20: Do you believe the requirement to obtain court or creditor approval would reduce the number of business sales effected through a pre-pack sale? If so, please provide an estimation of the impact.

Yes. Not only would the court application introduce an additional cost barrier, but also potential bidders may require a wasted costs assurance that their costs will be reimbursed if court approval is not forthcoming before they enter the bidding process.

Question 21: Do you believe that any provision requiring the prior approval of the court or creditors for business sales to connected parties should be extended to apply to such sales out of all formal insolvency procedures (i.e. not restricted solely to administration)? If so, why?

Guidance for transactions with directors and connected parties is contained in SIP13. This question should be considered more widely in the context of that SIP.

Question 22: Do you believe that a requirement to obtain court or creditor approval for a pre-pack business sale to a connected party should be combined with the attachment of personal liability to directors

and connected parties who purchase a business without obtaining the requisite approval?

No. As far as providing a disincentive to directors is concerned, there are already deterrents contained in the Insolvency Act 1986 that enable directors behaving badly to be pursued for personal liability. This measure is unlikely to provide any greater deterrent than the existing provisions to a director who is determined to behave inappropriately.

In addition, such a measure as is proposed here would be likely to provide only a false sense of security for creditors (even if they knew about it). In the majority of cases, directors do not have sufficient personal wealth to be of much value to the creditors of NewCo.

Question 23: Do you believe that it would be appropriate for pre-pack business sales to connected parties executed without the requisite approval to be rendered void?

We do consider that a provision rendering such transactions automatically void would be too inflexible, because, for example, third parties acting in good faith may have altered their position as a consequence of the offending pre-pack sale. At the very least, the court should have a discretion in respect of the transaction. Some deals are struck on the basis of no challenge or better offer within, say, 21 days, but where would external finance for such deals come from? In the lower end of the mid-market, it would extinguish the only real market for a going concern sale. Supply creditors may not like the loss to their sales ledger, but they like even less the loss of future custom as well.

FURTHER QUESTIONS TO INFORM IMPACT ASSESSMENT

Question 24: To what extent do you believe that pre-packs provide a positive contribution to the wider economy by allowing economically viable parts of insolvent companies to continue trading? How would you quantify such a contribution? Please provide any evidence you may have to support your comments.

We are unable to quantify their contribution, but the experience of some of our members demonstrates anecdotally that pre-packs do provide a positive contribution to the wider economy. Our experience shows that some pre-pack cases would not be economically viable as a trading administration and so without the pre-pack mechanism as an option, the business would instead be liquidated, resulting in a lower return to creditors and higher unemployment.

Although the Frisby Report suggests that businesses sold using pre-pack sales, particularly those to connected parties, had a greater rate of recidivism, even if NewCo does not avoid a second insolvency, while it still trades, it is still providing employment to employees who might otherwise be claiming state benefits, and it is still placing orders to suppliers, thereby contributing to the wider economy.

Question 25: To what extent do you believe that pre-packs create market distortions by allowing companies to ‘dump debts’ and continue trading to the detriment of competitors? How would you quantify this? Please provide any evidence you may have to support your comments.

It is the business that can, potentially, “dump debts”, not the company, which retains its liabilities (but is usually unable to pay them). We note, however, that a trading administration sale also allows businesses to “dump debts”. To the extent that this practice is objectionable, it is a problem associated with all insolvency sales and is not confined to pre-pack sales.

Dr Frisby has identified that pre-packs can capture a going concern premium, but that it benefits the secured creditors and is not enjoyed by the unsecured creditors. Creditor confidence at the unsecured level might be raised by an extension to the prescribed part, for example. The difficulty we see is that the perceived “abuse” is that a pre-pack results in reduced values for the business and its assets, but the evidence mildly suggests otherwise. Extending the prescribed part does not add a penny piece to the distributable estate, and the perception of value lost or not attained as a causal consequence of the procedure adopted by the IP is not borne out. As mentioned at the outset, part of the perception problem is not necessarily a demonstrable loss of value attained, so much as the distaste that the same management team emerges with essentially the same business free from its debts.

Question 26: To what extent do you believe that pre-packs create job losses ‘upstream’ by allowing companies to ‘dump debts’ and continue trading to the detriment of suppliers who then experience knock-on financial difficulties? How would you quantify this? Please provide any evidence you may have to support your comments.

Again, this problem is not a function of a pre-pack sale. It is a function of any insolvency sale.

Question 27: To what extent do you believe that any economic value preserved by a pre-pack sale (e.g. employees, customers, suppliers) would otherwise transfer to alternative ventures (e.g. competitors) if a pre-pack sale was not undertaken? Please provide any evidence you may have to support your comments.

We are unable to answer this question, but we would comment that the alternative ventures referred to in the question may not be based in the UK.

Question 28: Do you believe that any of the options identified would have a significant impact on the behaviour of secured lenders? If so,

what do you think this is likely to be? If possible, please provide an estimation of the impact.

To the extent that any of the options increase costs (and many of them do), that in turn reduce the returns to secured creditors, lenders will reduce their lending.

It should also be remembered that secured lenders, despite their structural priority through security, often provide the liquidity in a work out which can affect their positions adversely, but provides the means by which the trade suppliers are kept whole.

Question 29: Which of the five proposed options would be your preferred solution(s), and why?

Option 1. For reasons, see our answers above.

Question 30: Are there any alternative measures that you believe ought to be considered?

See answer to Q10, where we suggest that consideration be given to preventing administrators presiding over pre-pack sales from taking appointment as a subsequent liquidator without creditor consent or court approval. This does not provide a complete answer to the criticism levelled at pre-packs but it could provide a cost effective and proportionate response.

Question 31: Please provide an indication (if not obvious) as to the nature of your involvement in, or exposure to, pre-pack transactions and the approximate incidence of that involvement or exposure if relevant.

See Introduction.

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Insolvency Lawyers' Association