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A fair deal?

Mark Parkhouse & Kerry Scott on the criticism of pre-package administrations

IN BRIEF

- Recent criticisms levelled at "pre-packs".
- Whether current protections fully address creditors' concerns.

Insolvency issues are rarely far from the front page of most newspapers these days. In particular, the use of pre-packaged administrations (pre-packs) has been the focus of vigorous recent criticism.

This article considers if the criticisms are justified and whether current provisions, including the Statement of Insolvency Practice 16 "Pre-packaged Sales in Administrations" (SIP 16) (which came into effect in England and Wales on 1 January 2009), will appease creditors' concerns.

Aims of administration

In order to consider pre-packs in context, it is first useful to recap on the aims which are imposed on administrators by legislation (Insolvency Act 1986 (as amended), Sch B1, para 3(1)):

- The prime objective—to rescue the company as a going concern; or
- The second objective—to achieve a better result for the company's creditors as a whole than would otherwise be the case if the company were simply to be wound up (without first being in administration); or
- The third objective—to realise a company's property to make a distribution to one or more secured or preferential creditors.

It is often clear that it will not be possible to rescue a company as a going concern. In such cases, insolvency practitioners have to consider whether selling off all or part of a company's business is the best means to

achieve the second or the third objective.

What is a pre-pack?

In the case of pre-packs, a company facing insolvency finds a purchaser for all or part of its business before an administrator is appointed. The administrator then sells the assets immediately upon, or very shortly after, the company goes into administration. This is done without any necessity for the prior approval of the company's creditors or the permission of the court. The appointment of the administrator and his sale of the company's assets are essentially pre-packaged as a deal before the company goes into administration. An alternative to the pre-pack is a more open-ended administration in which the insolvency practitioner trades the business and looks at alternative means to achieve the statutory aims.

Job protection?

Supporters of pre-packs argue that the procedure helps to preserve all or part of the business of a failing company. They claim this can help save jobs because the business continues trading under new ownership without the risk of the cost cutting measures necessary if the company has to either restructure or sell its business through an open-ended trading administration.

Critics say that, rather than saving jobs, by leaving a company's unsecured creditors out of pocket, pre-packs can result in creditors having to make staff cuts of

their own. Job losses are simply pushed further up the supply chain. This criticism may be an over-refinement: in that in any insolvency there will be losses to creditors and potentially supplier job cuts. There is no evidence that a properly run pre-pack causes more job losses than any other form of insolvency. Arguably, by enabling all or part of a company's business to be kept alive under new ownership, we suggest that pre-packs can and do result in fewer jobs being lost than in a fire sale or protracted restructuring of a company's assets.

Broader criticism

Two of the main criticisms directed specifically at pre-packs, particularly where assets have been sold to a director, are that:

- pre-packs fail to consult the wider market and do not achieve the best possible price for the assets of a company in administration and hence do not realise full value for creditors; and
- the procedure is open to abuse by unscrupulous company directors or investors as a means of "dumping" a company's debts while purchasing profitable assets from the administrator through a new corporate entity.

Failing to achieve proper value?

Creditors have complained that pre-packs fail to achieve full value for a company's assets. They point to the asset values in the last audited balance sheet and they question how the pre-pack can have recovered only a fraction of this value. These concerns often ignore the critical value of time in bringing an insolvent business to market.

The starting point for determining what a business is worth is generally to consider what is the market value of that asset to a willing buyer? In a recession, there are a limited number of potential purchasers who are willing or able to purchase all or part of a troubled business, and to invest further working capital. Current difficulties in obtaining bank finance restrict the market

further. Likely potential purchasers such as competitors, management buy-out teams and third party entrepreneurs may well all be prohibited by the lack of finance. In an ideal world, an administrator could take time to obtain bids from various potential purchasers before selecting the highest bidder. In reality, in a market with few purchasers to choose from, a pre-pack will generally cost less and can actually generate better returns for creditors than efforts to sell or restructure the company's assets as a going concern traded by the administrator.

Time to market has a particularly marked effect on goodwill. Part of the value of a business is often tied up in its brand. When it becomes known that a company is in financial difficulty, its brand suffers irreparable damage as both customers and suppliers lose confidence. As a result, as it becomes wider knowledge that a company has gone into administration, its brand value will significantly decrease. Pre-packs enable all or part of a business to be sold immediately after an administrator has been appointed. This can minimise the damage suffered by the brand and hence the loss in the value of this part of the business.

Procedure open to abuse?

The other main criticism is that pre-packs can allow directors to put a company under an insolvency practitioner and then quickly snap up the assets at a bargain price before the creditors can have any say. The directors can in effect buy back the assets from the administrator, free of the company's debts, then continue trading from the ashes of the old company through a new corporate vehicle. This is the "phoenix trading" syndrome which key provisions of the Insolvency Act 1986 were designed specifically to outlaw. It is easy to see why, on the face of it, this potential lack of control by the creditors can cause concerns of possible abuse.

Protections for creditors

The iron fist

It is worth noting that administrators are both officers of the court and licensed insolvency practitioners who are subject to an intense and severe regulatory system. An administrator who colludes in undervalue sales to directors—or indeed to anyone—will find himself foul of a network of laws and regulations that can penalise him, remove him from office, force him to compensate creditors from his own assets, and restrict or remove his insolvency licence and consequently his livelihood.

Transparent reporting

The mesh of regulations governing Insolvency Practitioners includes "Statements of Insolvency Practice" or "SIPs". These define industry standards and provide a code of conduct expected from practitioners. Partially in response to concerns about whether the best value for assets is realised by pre-packs—and partly as a formal statement of existing best practice—the industry introduced SIP 16 earlier this year. This requires, at paras 8 and 9, that administrators provide creditors with a detailed explanation and justification as to why a pre-packaged sale was undertaken, including information with regard to the following:

- (i) why it was not possible to trade the business and offer it for sale as a going concern during the administration, including details of requests made to potential funders to meet working capital requirements;
- (ii) the courses of action which were considered by the administrator as an alternative to the sale, including the potential financial outcomes of such alternatives;
- (iii) any valuations obtained of the company's business or underlying assets and any marketing activities conducted by the company/administrator; and
- (iv) details of the assets involved in the sale, the nature of the transaction, the consideration paid, the terms of payment and any condition of the contract which could materially affect the consideration.

SIP 16 also attempts to reduce the risk of connected parties being able to hide behind a fresh corporate veneer in order to purchase a company's assets. This is to address public scepticism that pre-pack arrangements can be little more than "cosy side deals" between administrators and a company's directors. SIP 16 requires administrators also to disclose: (i) the source of the administrator's initial introduction to the company and the extent of the administrator's involvement prior to being appointed; (ii) the identity of the purchaser including any connection between the purchaser and the directors, shareholders or secured creditors of the company; (iii) the names of any directors or former directors of the company who are involved in the management or ownership of the purchaser; (iv) whether any directors have given guarantees for amounts due from the company to a prior financier, and whether that financier is financing the new business;

and (v) whether any options, buy-back arrangements or similar conditions attached to the pre-pack sale.

Will the protections work?

Insolvency practitioners cannot be licenced until they have passed an extensive suite of examinations on their technical proficiency and have also shown their regulating bodies that they are persons of proper probity to take insolvency appointments. There is a vast body of external sanction that can be applied through the courts or the regulators. However, cynics will observe that the iron fist can only strike if creditors or aggrieved parties first bring an action or file a complaint. Where creditors lack the appetite or resources to make a complaint, improper action may go unreported.

SIP 16 requires transparency and clarity of reporting in pre-pack arrangements. Although the SIP could itself be subverted by false reporting, practitioners will be aware that "big brother" is watching. The government's Insolvency Service recently announced it will request that all practitioners send it copies of their SIP 16 reports to creditors. While the fact remains that a company's assets will have been sold by the time information is provided to creditors, it is suggested that insolvency practitioners are well aware of their duties and the vast majority of them will always act to secure the best results for creditors as a result of their training and ethics and, if necessary, on pain of the sanctions described above.

Insolvency procedures are, by their very nature, attempts to make the best of a bad situation. The use of the pre-pack procedure is an additional tool by which highly regulated professionals can seek to make the best returns for creditors. In the current market, pre-packs often represent a quick—and possibly the only—means of realising any real value for creditors. However, it is true that the procedure could be open to abuse by the unscrupulous.

Preventing an abuse of the pre-pack procedure relies largely on strict self-regulation within the insolvency profession, rather than a comprehensive legislative framework. SIP 16 is undoubtedly a step in the right direction in terms of ensuring greater accountability to creditors. It remains to be seen whether, taken together with the existing governing framework, it is enough to placate the pre-pack critics. NLJ

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