SLAUGHTER AND MAY

BRIEFING
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Unpacking the pre-pack review

INTRODUCTION

On 16 June, Teresa Graham's long anticipated report on pre-pack administrations was published. It recommends a series of reforms designed to increase transparency and assuage creditor concerns, which it hopes the market will adopt on a voluntary basis.

Background

Pre-packaged administrations (or "pre-packs") are not legislated for in statute, but have developed through market practice and have been sanctioned by the courts. Broadly speaking, "pre-packing" is the practice of arranging the sale of all or part of a company's business before formal insolvency is entered, with the sale to be executed at or soon after the appointment of an administrator. Usually the majority of the company's unsecured creditors will not hear about it until it is a done deal. Pre-packs can be an effective way to rescue a business: when used well they enable viable businesses to stay afloat, preserving value and jobs which would likely be lost in a liquidation or a trading administration. However, public perceptions of pre-packs tend to be negative (not helped by the high incidence of sales to parties connected to the company or business which have failed), and unsecured creditors often feel that they are disadvantaged by the process.

In response to these concerns, and as part of the Government's wider scrutiny of insolvency and company law, the UK Department for Business, Innovation & Skills commissioned Teresa Graham, a senior accountant, to conduct a review into pre-packs. The terms of reference of the review included assessing the long-term impact of pre-pack deals on the wider economy, whether they provide the best value for creditors as a whole, and the usefulness of the pre-pack procedure in the context of business rescue generally. The review gathered evidence from a wide cross-section of interested parties, and also commissioned quantitative research from Wolverhampton University into the use and effect of pre-packs.

THE REPORT'S RECOMMENDATIONS

The review found that pre-packs to connected parties fail more frequently than pre-packs to non-connected parties, and are less likely to yield a return for unsecured creditors. The report therefore makes two recommendations aimed specifically at pre-packs involving sales to connected parties. It also proposes a definition of "connected party" that builds on, but is not identical to, definitions contained in existing legislation, and which is considered further below.

Pre-Pack Pool

The first recommendation is that a pre-pack pool consisting of experienced business people should be established to review pre-pack deals before they go ahead. The report envisages that pool members will be selected from

a range of industries and disciplines, possibly nominated by organisations such as the Institute of Directors, the Confederation of British Industry, and trade representative organisations. The connected party would present the outline to a member of the pool, along with supporting documentation. The pool member would review the documentation and provide a statement, probably to the effect that he or she has not found anything to suggest that the grounds for the pre-pack put forward by the connected party are unreasonable (or words to the contrary). Making an approach to the pool would be voluntary, and a negative response would not prevent the deal proceeding, but whether an approach has been made and the outcome would need to be declared in the Statement of Insolvency Practice (SIP) 16 report which administrators are required to send to creditors. The applicant would bear the costs of the exercise.

Viability Review

The second recommendation is that a connected party should also complete a "viability review" of the new company which will take over the business. This is aimed at addressing concerns that businesses with unviable business models should not be allowed back into the market to fail again, a problem which the review found to be more marked in connected party pre-packs. The connected party should explain how the purchasing entity will survive as a going concern for at least 12 months from the date of the statement and provide a narrative of the things it will do differently to avoid another failure. A short statement is envisaged: something in the region of 500 words. Again, compliance is voluntary, but if a review is not conducted this will need to be made clear in the SIP 16 report. The administrator will not be expected to express a view on the statement (the viability of the new company is not a consideration for administrators, who are concerned with the creditors of the old company).

Connected Parties

The proposed definition of connected party aims to catch a wide range of people who have connections to, or controlling interests in, the company which is the subject of the pre-pack, with an exemption for sales to secured lenders that hold security over the shares of both the old and the new companies as part of their normal business activities (the reference to 'normal business activities' is intended to prevent group companies making secured intra-group loans in order to benefit from the exemption). We assume that this exemption is meant to exclude secured lenders engaging in "credit bids" (where a secured lender writes down or reduces its loan in exchange for an interest in the business or assets of the insolvent company) from the scope of the connected party provisions, although the extent of the carve-out proposed by the report is a little ambiguous – it is to be hoped that this will be clarified before the recommendations are implemented.

Marketing

The review also found that the marketing conducted prior to pre-pack sales is often insufficient and that more could be done to explain the valuation methodologies used. It therefore recommends that all marketing of businesses which are pre-packed comply with six "principles of good marketing" (in a nutshell, these promote broad, independent marketing campaigns using appropriate media). If marketing is not possible or is likely to harm creditors' interests, the administrator should explain clearly why this is the case. It also recommends that valuations are carried out by a valuer who holds professional indemnity insurance, on the grounds that insurers place stringent checks on those applying for cover, which should give creditors additional comfort. These recommendations apply to all pre-packs, not just those involving connected parties.

COMMENT

In general, the industry response to the report has been positive, although this may be more a reflection of relief that the report does not call for sweeping reforms which might see the baby thrown out with the bath water. Some critics are, however, concerned that unless the recommendations are given statutory force they will lack teeth.

There is likely to be an ongoing debate and controversy about the proposal for the pre-pack pool and how it might work in practice. If it increases transparency and addresses concerns about fairness, and is at the same time cheap and efficient, then it is to be welcomed. However, the key challenge will be ensuring that it functions effectively and fairly. In this respect, a number of practical issues can be identified which will need to be addressed before the proposals are implemented.

The report envisages that pool members will be drawn from a diverse range of professional backgrounds. There may be concerns that, however experienced in their field, pool members may not have the experience necessary to un-pick the details of a complex rescue transaction. Care will need to be taken to ensure that the approach of pool members is well informed, consistent and suitably objective, and that the basis for decisions is transparent.

The report does not propose a mechanism whereby an applicant may challenge a negative statement if they have reason to dispute the basis on which it has been made. Applicants may of course press ahead with the deal in the face of a negative statement, but that will likely be something insolvency practitioners will hope to avoid doing. Equally, if negative statements are ignored too often then the recommendation will prove ineffective. Thought may therefore need to be given as to whether an appeal or review process should be incorporated into the proposal.

The report envisages that panel members will spend no more than half a day reviewing the information submitted to them and reaching their conclusions (and envisages that they will be paid on a fixed fee basis, which is likely to entrench the time allowance). It remains to be seen how practical this will be in complex transactions, where there is a risk that such a review will become a headline exercise. If, as a consequence, connected parties are deterred from making applications to the pool, this may need to be considered further.

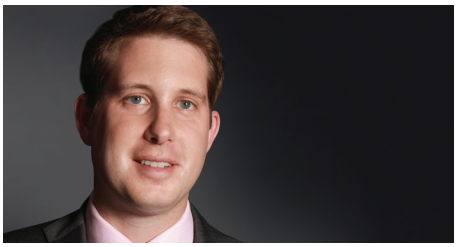
Time is often critical for pre-packaged administrations, and so the system will only function well if pool members are available on an urgent basis. Of course, the success of the proposal also relies on there being sufficient interest in the business community to set up the pool – which, as the report envisages the fees paid will be low, will require a degree of goodwill and community spirit. It is also not yet clear who will take the lead in setting up the pool.

CONCLUSION

Perhaps the most welcome aspect of the report is its conclusion, based on empirical research, that when used well, pre-packs are an effective restructuring tool. The review found that, when like was compared with like, pre-packed businesses were more likely to survive than businesses sold out of trading administrations. As well as highlighting the areas which need improvement, the report notes that pre-packs can help to preserve jobs, can offer significant cost advantages compared to some other restructuring options (particularly if the out-of-court administration procedure is used), and may bring some benefits to the UK economy as a consequence of overseas companies seeking to take advantage of the UK's flexible restructuring and insolvency framework. For the reasons outlined above, the pre-pack pool is probably the most controversial of the proposals.

Compliance with the recommendations will be voluntary, but the Government has indicated that it agrees with the report's conclusions, and that if the recommendations are not successfully implemented on a voluntary basis, legislation may follow. To this end, the Small Business, Enterprise and Employment Bill (which had its first reading in the House of Commons on 25 June) will, if passed, give the Secretary of State the power to make regulations prohibiting or imposing requirements or conditions on sales by administrators to connected parties.

If you would like further information on any of the issues raised in this briefing please contact Ian Johnson, Tom Vickers, Richard de Carle, Nicky Ellis or your usual contact at Slaughter and May.



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