UK pre-packs endorsed... but "clean-up" recommended

The pre-pack is among the armoury of tools that makes the UK an attractive restructuring jurisdiction. A recent independent review has endorsed pre-packs, but also recommended some improvements, explains Glen Flannery

GLEN FLANNERY
Partner, Nabarro LLP's Restructuring & Insolvency group, London

Share your views!

Overview

On 16 June 2014, the British Government published the findings and recommendations of an independent review of pre-pack administrations ("**pre-packs**") carried out by Teresa Graham CBE*.

Graham's review was commissioned by Vince Cable, the Secretary of State for Business, Innovation and Skills, to address continued disquiet about the merits of pre-packs, particularly among some unsecured creditor groups.

Despite identifying some shortcomings that could be improved upon, Graham concluded that pre-packs "*definitely have a place in the insolvency arena*" and that to outlaw them to sub-optimal areas of behaviour would be akin to "*throwing the baby out with the bathwater*".

Therefore, instead of a ban on pre-packs, which had been sought by some opponents of the technique, Graham has recommended a "*clean-up*" involving "*major improvements on how they are administered*". She has proposed that this be achieved through a package of six measures.

Two of these measures are directed at pre-packs involving sales to parties connected to the insolvent company ("**connected party purchasers**"), which are typically more controversial than sales to unconnected parties. Before they enter into a pre-pack, Graham wants connected party purchasers voluntarily to:

- approach a "*pre-pack pool*" of independent and experienced business people, to obtain an opinion on the proposed pre-pack; and
- prepare a "*viability review*", stating how the purchaser will survive for at least 12 months from the date of the review and what the purchaser will do differently to the insolvent company to avoid a further failure.

The other measures are intended to improve:

- pre-sale marketing;
- pre-sale valuations;
- disclosure of information to creditors after a pre-pack, through an enhanced Statement of Insolvency Practice 16 ("**SIP 16**"); and
- monitoring of compliance with SIP 16.

Graham has invited the insolvency industry to adopt her proposed measures voluntarily, without the need for new legislation, but she has asked that the Government consider legislating if her measures are not adopted or fail to have the desired impact.

Graham's key findings and her proposed measures are summarised in more detail below. Before this, for those readers who may be less familiar with pre-packs, there is a brief explanation of a pre-pack and the current SIP 16.

What is a pre-pack?

Administration is a formal insolvency process available under English law, in which a licenced insolvency practitioner (the administrator) is appointed to an insolvent company with the tiered objective of:

- rescuing the company as a going concern;
- achieving a better result for the company's creditors than in an immediate winding-up; or
- realising the company's property to make a distribution to secured or preferential creditors.

In a pre-pack, a sale of all or part of an insolvent company's business is arranged before the company enters into administration and the sale is executed by the administrator on, or shortly after, his or her appointment as administrator.

The sale is structured in this way to minimise the impact of the formal insolvency process on, and thereby to preserve value in, the business. Where the sale is not pre-arranged in this way, there can be a greater risk of losing key suppliers, customers or employees, upon news of the insolvency breaking.

The sale is arranged by the company, the prospective administrator, and the purchaser. Where there is a secured creditor, it may rely on its security to drive the process. Alternatively it may adopt a more passive role, but still be consulted to obtain a release of its security on completion of the sale.

Unsecured creditors are treated differently. Typically, they do not have a voice in whether a pre-pack should be entered into and they only find out about the pre-pack after it has been executed. This leads some to distrust the process, even though they might benefit financially from (a) an increased return to creditors in the insolvency process, and (b) for those whose goods or services are required by the on-going business, the option of dealing with the continuing business.

A pre-pack is not a creature of statute – it is a technique that has been developed by practitioners to

help achieve business rescue and maximise realisations through a business sale where the debtor cannot be rescued as a going concern.

In recent years, approximately a quarter of all administrations in the UK have involved a pre-pack. Examples include the sales of the businesses of Blacks Leisure and Dreams Plc.

Statement of Insolvency Practice 16 (SIP 16)

SIP 16 was introduced in January 2009 and updated in November 2013. It requires an administrator who executes a pre-pack to provide creditors, within seven days of the pre-pack, with an explanation of why the pre-pack was undertaken (a "**SIP 16 statement**").

A SIP 16 statement should include information on matters such as the alternatives considered, the marketing undertaken, asset valuations obtained, the purchaser, any connection between the purchaser and the insolvent company, and the consideration for the sale.

SIP 16 is a regulatory requirement rather than a legal requirement. Failure to comply with SIP 16 can result in disciplinary action against an administrator by his or her regulatory/professional body.

A legal claim may be brought against an administrator if he or she executes a pre-pack in a manner that is inconsistent with a proper discharge of his or her functions and duties.

Graham's key findings

Graham analysed information from a variety of sources, including those affected by or otherwise involved in pre-packs (e.g. suppliers, landlords, insolvency practitioners, lawyers, and accountants) and reports issued in the administrations of a random sample of 499 companies who had executed pre-packs in 2010.

Advantages of pre-packs

Graham identified the following positives about pre-packs:

- Pre-packs preserve jobs. This benefits other creditors by reducing claims against the insolvent company.
- Pre-packs are cheaper than alternative upstream restructuring procedures, such as schemes of arrangement which have more court and creditor involvement.
- Deferred consideration is largely paid, such that creditors are not unduly harmed by the presence of deferred consideration in a pre-pack.
- A purchaser is more likely to succeed where it has purchased a business in a pre-pack, rather than after a period of trading in an administration. The odds of failure were 2.4 times higher in a purchase after a period of trading in an administration than in a pre-pack purchase.
- Pre-packs even bring some limited benefit to the overall UK economy ("UK plc") from overseas companies relocating to the UK to take advantage of the pre-pack, i.e. forum shopping to the UK.

Disadvantages of pre-packs

Graham also identified the following shortcomings:

- Pre-packs lack transparency. Inherently, unsecured creditors generally do not find out about the pre-pack until after the event. This leaves them feeling disenfranchised, particularly where the purchaser is a connected party purchaser.
- Marketing of businesses is insufficient. For more than a third of the companies surveyed there was no clear evidence as to when marketing was carried out and for how long. Too often only limited marketing was

> **"GRAHAM CONCLUDED THAT PRE-PACKS "DEFINITELY HAVE A PLACE IN THE INSOLVENCY ARENA" AND THAT TO OUTLAW THEM TO SUB-OPTIMAL AREAS OF BEHAVIOUR WOULD BE AKIN TO "THROWING THE BABY OUT WITH THE BATHWATER"**

PRE-PACK SALES TO CONNECTED PARTY PURCHASERS TYPICALLY ATTRACT A HIGHER LEVEL OF CRITICISM THAN THOSE TO UNCONNECTED PARTIES BECAUSE OF THE PERCEPTION THAT IT IS THE SAME DIRECTORS "DRIVING THE SAME ROLLS ROYCE THROUGH THE FACTORY GATES"

undertaken and the evidence showed that where no marketing was carried out, returns to creditors were lower.

- Explanations of valuations are insufficient. Although an independent valuation was conducted in the majority of cases surveyed (91%), many were simply desk-top valuations and the valuation did not include all of the available assets, e.g. intellectual property or goodwill.
- There is insufficient attention to the viability of the purchaser. This is a particular concern for both transferring and new suppliers, but it is not a primary concern of the administrator because his/her duties are owed principally to the creditors of the insolvent seller.
- The regulation of pre-packs and the monitoring of that regulation could be better. In particular, more could be done with SIP 16 to discourage bad practices.

Of the 499 pre-packs surveyed by Graham, almost two thirds involved connected party purchasers. Pre-pack sales to connected party purchasers typically attract a higher level of criticism than pre-pack sales to unconnected parties because of the perception that it is the same directors "*driving the same Rolls Royce through the factory gates*".

The evidence showed that 29% of connected party purchasers subsequently failed within three years of the pre-pack, compared to only 16% of unconnected party purchasers.

To address these issues, Graham has focused two of her six measures on pre-packs involving connected party purchasers.

Graham's recommendations

Graham has recommended the following measures to improve pre-packs.

1. Pre-pack pool

On a voluntary basis, before entering into a pre-pack, a connected party purchaser should approach a "*pre-pack pool*". The pool member should be given details of the proposed deal and asked to provide an opinion on it, for a fee to be paid by the connected party purchaser.

The pool member should be an experienced businessperson, selected from a wide range of industries and disciplines and possibly nominated by an organisation such as the Confederation of British Industry (the CBI).

Graham envisages a small secretariat being established to administer the pool and that cases be allocated on a strict rotation basis. If the pool member issues a negative statement the pre-pack can still proceed, but the negative statement should be disclosed in the SIP 16 statement.

This proposal is aimed at achieving some independent scrutiny of the pre-pack deal before it is executed, but without news breaking more widely in a way that could damage the business before it is sold.

This measure is aimed solely at sales to connected party purchasers.

2. Viability report

On a voluntary basis, a connected party purchaser should prepare a "*viability review*", explaining how the purchaser will survive for at least 12 months thereafter and what the purchaser will do differently with the insolvent company to avoid a further failure.

The viability report should be attached to the SIP 16 statement. The administrator will not be expected to comment or express an opinion on the review. Where a viability review is not provided, the administrator should state that he or she asked for one but it was not provided.

This measure is aimed solely at sales to connected party purchasers.

3. Marketing

All marketing of businesses prior to a pre-pack should comply with six principles of good marketing and any deviation from these principles should be brought to the attention of creditors in the revised SIP 16 statement.

Graham proposes the following marketing principles:

- Broadcast rather than narrowcast. The business should be marketed as widely as possible, proportionately to the nature and size of the company.
- Justify the media used. The SIP 16 statement should fully explain the reasons for the marketing and media strategy adopted.
- Ensure independence. The insolvency practitioner should satisfy himself or herself as to the adequacy of the marketing that has been undertaken and not simply rely on marketing conducted prior to their instruction as a proxy to avoid further marketing.
- Publicise rather than simply publish. Marketing should be undertaken for an appropriate length of time, sufficient for the insolvency practitioner to satisfy himself or herself that the best deal has been sought.
- Connectivity. Online marketing should be used alongside other media by default. Where the internet has not been used to market, the administrator should justify why it has not been used.
- Comply or explain. The administrator must fully explain his or her marketing strategy and how it achieved the best outcome for all creditors, particularly where the sale is to a connected party purchaser.

4. Valuation

SIP 16 should be amended to require valuations to be carried out by valuers who hold professional indemnity insurance. Where this is not the case, the administrator should explain his or her reasons for choosing a valuer without such insurance.

Graham believes that insurers place their own stringent checks on those who apply for cover, so creditors should be more satisfied that a valuation from an insured valuer will represent a fair value.

5. Revised SIP 16

The Joint Insolvency Committee (made up of representatives of the

recognised professional bodies who licence and regulate insolvency practitioners) should consider adopting a reinforced version of SIP 16 at the earliest opportunity.

Graham sees SIP 16 as a vehicle for delivering her package of measures and she has prepared a re-draft of the 2013 version of SIP 16 to take into account her recommendations.

6. Monitoring SIP 16

The monitoring of SIP 16 statements should be picked up by the recognised professional bodies, in place of the Government's Insolvency Service. Graham considers them better placed to scrutinise compliance with SIP 16, given the level of their practical experience.

Views on Graham's recommendations

Graham's proposals have received mixed reactions from across the insolvency industry and those affected by insolvency.

R3, the main trade body for insolvency professionals in the UK, has stated that it supports Graham's conclusion that there is a place for pre-packs in the UK's insolvency framework and that it is keen to see the recommendations developed.

The British Property Federation, which represents the views of landlords, has welcomed the recommendations to encourage transparency, but expressed concern about the lack of a statutory obligation which could result in the recommendations not being fully adopted.

The British Government has welcomed Graham's report and committed to work with industry and business to fully implement her recommendations, to improve transparency and confidence in a valuable business rescue tool.

In addition, in a new bill which may soon become law (the Small Business, Enterprise and Employment Bill 2014) the Government has included a power to introduce secondary legislation prohibiting or imposing conditions on pre-pack sales to connected party purchasers. This power may be exercised if Graham's recommendations are not adopted or are not effective enough in practice.

It remains to be seen how Graham's proposals will be implemented in practice (there is still a lot of detail to flesh out) and the impact that they will have on business rescue and outcomes for creditors.

For the moment, British insolvency practitioners who handle cross-border work will be pleased that Graham's recommendations do not seek to outlaw the pre-pack, which will help the UK to maintain its status as a favourable restructuring jurisdiction. ■

**For those who would like to read more, Graham's full report can be found at: https://www.gov.uk/government/publications/graham-review-into-pre-pack-administration.*

GRAHAM'S PROPOSALS HAVE RECEIVED MIXED REACTIONS FROM ACROSS THE INSOLVENCY INDUSTRY AND THOSE AFFECTED BY INSOLVENCY