Article

Pre-packaged administration begins to take shape

by Peter Walton

INTRODUCTION

A perusal of *The Times* on January 18, 2010 would suggest to the reader that pre-packaged administration ("pre-pack") is not a universally popular mechanism. Lord Kirkham the chairman of DFS is quoted as saying:

> *"These shameful devices give badly managed businesses a huge cost advantage … I cannot get my head around why such incompetence should be rewarded at the expense of successful companies."*

Bertrand des Pallieres in the context of the Hellas Telecommunications transfer of its centre of main interest to the UK and subsequent pre-pack administration made the following comment:

> *"If nothing is done, London will become a bankruptcy brothel for low-life businesses to come from all over and take advantage of the British system to dump some of their debts and move on."*

Yet practitioners who operate pre-packs are keen to explain their positive characteristics. Peter Sargent, the president of R3 (Association of Business Recovery Professionals), states:

> *"Pre-packs are a very misunderstood insolvency tool, and the benefits – for example, the numbers of jobs saved – are often lost in concerns over the impact on unsecured creditors."*

The purpose of this article is to consider in outline what all the fuss is about and to consider recent legal developments in the area. It will consider in particular whether the reactions of the regulator and profession have gone far enough to counter fully the criticisms levelled at pre-packs.

What is a pre-pack?

In its guidance to the insolvency practitioner profession, R3 (in the text of Statement of Insolvency Practice 16 ("SIP 16")) defines a pre-pack as:

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

The pre-pack is a process which is not mentioned anywhere in the Insolvency Act 1986 ("the Act"). According to the Act, administration is a process under which an administrator is appointed with various statutory purposes in mind (Sched B1, para 3). Upon appointment the administrator should initially consider whether or not rescuing the company as a distinct entity is feasible. Only if this is not reasonably practicable should the administrator then consider acting with the objective of achieving a better result for the company's creditors as a whole than would be achieved in an immediate winding up. If this is not possible the administrator should act to realise property in order to make a distribution to one or more secured or preferential creditors. If either of the first two statutory purposes is pursued, the administrator must act in the interests of the creditors as a whole. If the third statutory purpose is pursued the administrator must act in a way which does not unnecessarily harm the interests of the creditors.

According to the provisions of Schedule B1 of the Act, the administrator must generally put a proposal, aimed at achieving the statutory purpose, to the creditors. If the proposal is approved by the creditors it is then carried out. Of course, with a pre-pack none of this happens (at least not before the company's business has been sold on). The absence of any statutory authority for pre-packs is one significant cause for concern.

MAIN CRITICISMS OF PRE-PACKS

There has been much said and written both in legal journals and in the general media on the mechanics and consequences of pre-packs. The courts have recognised the general unease surrounding them. His Honour Judge Cooke made the following statement in *Re Kayley Vending Limited* [2009] BCC 578 at 583:

> *"A general summary of these concerns would be that the speed and secrecy which give rise to the advantages claimed for pre-packs may too easily lead the directors and the insolvency practitioner to arrive at a solution which is convenient for both of them and their interests (perhaps also satisfying a secured creditor who might be in a position to appoint his own receiver or administrator), but which harms the interests of the general creditors because:*
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> *(i) it may not achieve the best price for the assets;*
>
> *(ii) credit may be incurred inappropriately in the pre-appointment period;*

> *(iii) they are deprived of the opportunity to influence the transaction before it takes place; and*
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> *(iv) having been presented with a fait accompli, they have insufficient information to make it worthwhile investigating and challenging the decisions taken."*

Steps taken to allay these criticisms

The regulator (the Insolvency Service) and the profession (in the form of the insolvency practitioner professional bodies) have reacted to these concerns by making the process more transparent with the introduction of quite rigorous information-giving requirements found in SIP 16 (in force January 1, 2009). SIP 16 requires that where a pre-pack has occurred, the administrator must make certain information available to the company's creditors. The administrator must, inter alia, provide the following information: how the administrator came to be involved, the extent of his or her involvement prior to appointment, a full explanation of any attempt to market the business, any valuations, alternative courses of action which were considered, why a pre-pack was decided upon, whether major creditors were consulted, and full details of the sale including the price and the identity of the buyer.

A report on the first six months' operation of SIP 16 ("the Report") drafted by the Insolvency Service has provided useful information on how common pre-packs are, the characteristics of a typical pre-pack and areas where the profession could improve its compliance rate. The Insolvency Service is continuing to monitor the operation of SIP 16 and is carrying out a consultation with the profession as to how the terms of SIP 16 can be improved.

The Report covers information received in relation to 572 companies in administration. As there is no statutory or regulatory requirement for insolvency practitioners to send SIP 16 information to the Insolvency Service, the actual number of pre-packs during the six month period in question could be between 10 and 20 per cent higher. It seems that between one in four and one in three administrations are pre-packs. The Report found that 370 of the 572 administrations complied with SIP 16 which represents a compliance rate of about 65 per cent. The Report found that 81 per cent of pre-pack sales were to parties connected with the insolvent company. The Insolvency Service has written to 180 insolvency practitioners in relation to the 202 non-compliant pre-packs and referred 29 insolvency practitioners to their respective professional bodies.

The most common and most significant areas of non-compliance are highlighted by the Report. In a majority of cases where a valuation of the business had been obtained prior to the pre-pack, insolvency practitioners did not disclose the amounts attributed to either the business as a whole, or to individual classes of asset. In a large minority of cases, no valuations appear to have been sought in relation to certain assets that were subsequently sold for a relatively substantial amount. In a small minority of cases, no effort was made to identify the individuals involved with a purchasing corporate entity.

The Report suggests that there is no initial evidence to suggest that the level of director misconduct in pre-packs (at least those reported under SIP 16 to the Insolvency Service) is any greater than the overall level of misconduct reported by insolvency practitioners generally. Despite this initial finding, it may be too early to dismiss the common complaint that companies are sometimes "fattened up" prior to a pre-pack by inappropriate incurring of credit. It may be that such behaviour is more prevalent in pre-packs where no SIP 16 returns have been made to the Insolvency Service. Compulsory filing of SIP 16 reports to the Insolvency Service may lead to greater confidence in the policing of director misconduct.

COURT'S BLESSING?

An important issue which has been considered in recent times is whether or not the court can be seen as giving its blessing to a pre-pack when making an administration order where the applicants are planning a pre-pack. This is atypical, as the vast majority of pre-packs involve an appointment made out of court. In *Re Kayley Vending Limited* [2009] BCC 578 the court made an administration order. The evidence presented to the court suggested a reasonable prospect of achieving a better result for the creditors than would be achieved on an immediate winding up (the second statutory purpose). The court emphasised that part of its function was to ensure that the procedure was not being obviously abused to the disadvantage of the creditors. If this was the case the court might conclude that it was inappropriate to give the pre-pack the apparent blessing conferred by making the order. The court would look to be provided with the same information required by SIP16 to explain how and why the pre-pack should happen.

The result of *Kayley* suggests that if an administration order is made in circumstances where a pre-pack is intended, the granting of the order would act as a significant protection for the administrator were the company's creditors to mount a subsequent attack on the pre-pack and/or the administrator personally. The apparent blessing of the court would be an enormous comfort for the administrator. The consequence of this would suggest that such an order affords the administrator protection from creditor action akin to a kind of legal "bomb shelter" (something the courts have shied away from in a similar context in *Re T&D Industries* [2000] BCC 956).

This point was further explored in *Re Hellas Telecommunications (Luxembourg) II SCA* [2009] EWHC 3199 (Ch). The court considered two controversial issues. The first involved the court agreeing that the company had successfully moved its centre of main interest to England for the purposes of the EC Regulation on Insolvency Proceedings (1346/2000). The second required consideration of an application for an administration order where a pre-pack was intended. The court, consistently with *Kayley*, decided that in order to consider the matter it would need to see the information which would be required under SIP 16. On the facts the court made the order. There was no real alternative to the pre-pack deal.

In the course of a short judgment, Lewison J observed: "It is not entirely easy to see precisely where in the statutory structure the court is concerned with the merits of the pre-pack sale." There are no provisions in the Act dealing with any matter specific to pre-packs so it is no surprise there is no guidance on how to consider an application for an administration order where a pre-pack is intended.

His Lordship appears wary of allowing the court to be used as a shield from creditor discontent and laid down that the general rule will be that the merits of the deal are something with which the administrator has to deal. Aggrieved creditors will still be able to challenge the decision of the administrator even where the court has made the order. His Lordship identified three possibilities when the court is faced with an application for an administration order with a pre-pack in mind:

1. It may be obvious that the proposed pre-pack is an abuse of the administrator's powers. In such circumstances the court could refuse to make the order or direct the administrator not to complete the pre-pack sale;
2. It may be obvious that the pre-pack is the only real way forward. The court could make the order but an aggrieved creditor could still complain (this was the court's view of the application in question);
3. In the majority of cases the position may not be clear. In such a case the making of the administration order should not be taken as giving the court's blessing to the pre-pack sale.

It is quite clear from this that the courts will usually refuse to take part in providing any great comfort to the pre-pack administrator. At either end of the spectrum it may intervene or give a clear indication of its view. It may be that the proposed pre-pack is a clear abuse of process or at the other end it may be that it is the only feasible possibility available to the company. In the majority of cases, even where the court makes the order, the administrator will be left alone to defend the decision to pre-pack if the decision is attacked by creditors. The order will not therefore usually constitute a "bomb shelter" for the pre-pack administrator to hide in.

PRE-APPOINTMENT FEES

One significant issue in relation to pre-packs which has been bubbling under the surface for several years is the matter of how the pre-pack administrator gets paid for all the pre-appointment work. The issue is largely resolved by the recent amendments to the Insolvency Rules (SI 1986/1925 – amendments in force April 6, 2010) but possibly not in a way which will encourage discontented unsecured creditors.

In the summer of 2007, the Insolvency Service carried out a limited survey of insolvency practitioners requesting information on how they were being paid for their pre-appointment work. The evidence suggested that some practitioners relied upon Insolvency Rule 2.67(1)(c) (which appears to limit a claim for expenses to the costs of putting into effect the formal mechanism for applying for an administration order); some distressed companies spent company funds on pre-appointment fees at a time when it is apparent the company was insolvent; some were paid out under a form of indemnity provided by the holder of a qualifying floating charge; some practitioners, who could not recover their pre-appointment expenses in full, took this factor into account when setting their fees for post-appointment work.

The issue as to whether or not pre-appointment fees could count as an administration expense was considered as an additional issue in *Kayley*. On the facts the court ordered that the pre-appointment fees should be treated as an expense of the administration under the discretionary power found in paragraph 13 of Schedule B1 of the Act. This power could only be exercised where the company entered the pre-pack administration by way of an administration order. The court made the point that pre-appointment costs would not automatically be regarded as administration expenses under Insolvency Rule 2.67.

The discretion under para 13 would only be exercised by the court where it is satisfied that the balance of benefit arising from the incurring of pre-appointment costs is in favour of the creditors rather than the management of the company as potential purchasers of the business. On the facts the pre-pack sale was being made to an outsider third party not to anyone connected to the management of the company.

There appear to be two main consequences of the decision, in relation to expenses, for the typical out-of-court pre-pack where the company's management buys the business. The first is that administrators cannot automatically claim the costs leading to their appointment as expenses under Rule 2.67. If it is the company who initially instructs them, the costs will remain as unsecured debt in the administration. If the directors or secured creditor are the instructing client, the administrator must look to them for payment. The second consequence is that if the pre-pack involves a sale to the company's management team, the pre-appointment costs cannot constitute an expense of the administration. This would be the case whether the appointment was made out-of-court or by the court.

Amendments in relation to payment of pre-appointment fees

Changes in force on April 6, 2010 amend Insolvency Rules 2.33 and 2.67. The above analysis of pre-appointment fees will therefore only apply to pre-packs carried out prior to this date. The effect of the new regime is broadly that administrators will be able to claim their pre-appointment fees as administration expenses but only if they obtain the consent of the company's creditors. This looks, at first blush, to give the creditors the whip hand but as will be seen below, this newly bestowed power may be illusory in almost all pre-packs.

Under the new rules, pre-appointment fees will qualify as expenses if (i) they are contained within the proposal provided to creditors and (ii) they are subsequently approved by:

1. The creditors' committee – if none exists or its approval is withheld, then the power to approve the costs is exercised by:
2. A resolution of the creditors – unless para 52(1)(b) applies in which case;
3. Each secured creditor must approve the fees (and at least 50% of preferential creditors voting where a payment is to be made to preferential creditors).
4. If no approval is given under these provisions or if the amount approved is regarded as insufficient by the administrator, he or she may apply to the court for determination.

The likely consequence of these new rules in the majority of pre-packs is that:

1. In a pre-pack it is highly unlikely that a creditors' committee will exist;
2. As only about 1 per cent of unsecured debt is ever recovered in pre-packs (according to the Sixth Report of the House of Commons Business and Enterprise Select Committee – HC198), it is very unlikely that any payment to unsecured creditors will occur. In such circumstances paragraph 52(1)(b) will apply and so the unsecured creditors will not get to vote on the pre-appointment costs;
3. It will therefore nearly always be the secured creditors who get to make the decision on the pre-appointment fees (with the possible caveat that not all preferential creditors have been paid although as any preferential debt will nearly always consist of limited claims of employees and they are likely to have been paid in full prior to the administration this class of creditor is again unlikely to exist to any great extent).
4. Due to the above it is unlikely that the court will be called upon for its adjudication.

It is therefore conceivable that in nearly all pre-packs, the decision to approve the pre-appointment fees of the administrator will fall to be made by the secured creditors. It is clear that the pre-pack itself is unlikely to be feasible if it does not already have the support of secured creditors and so the agreement to the pre-appointment fees constituting expenses of the administration is likely to be a straightforward matter for the administrator. If this analysis is correct the approval of fees in this way is likely to exacerbate feelings that unsecured creditors are disenfranchised.

Two problems may be identified from the Rules. First, the court has recognised in the context of employment protection legislation that a pre-pack administration is an insolvency proceeding instituted with a view to the liquidation of the assets (*Oakland v Wellswood* [2009] IRLR 250). In an "expenses" context the courts have recognised a close correlation between expenses in administration with expenses in liquidation (*Goldacre v Nortel Networks* [2009] EWHC 3389 (Ch)). It is arguable therefore that it would be more logical to use the precedent for approval of liquidators' remuneration rather than invent a new scheme specifically for pre-packs. This would give the unsecured creditors the right to fix remuneration (or the creditors' committee if there is one). The decision would not be dominated by the wishes of the secured creditors.

Second, under the new Insolvency Rules for pre-pack administration expenses, it is unlikely but still possible that the court will be called upon to approve the remuneration. The court has stated in *Re Kayley* that it would not approve pre-pack fees as expenses unless it is satisfied that the balance of benefit arising from incurring pre-appointment costs is in favour of the creditors rather than the management of the company as potential purchasers of the business. In a typical management buy-out pre-pack it seems the court will not approve the pre-pack fees as an expense. The new Rules would therefore appear to be out of step with judicial assessment of such fees.

PROBLEMS OF CONFLICTS OF DUTY

The decision in *Clydesdale Financial Services Ltd v Smailes* [2009] B.C.C. 810 involved a pre-pack administration sale of a solicitors' practice which had practised as an LLP. The court ordered the removal of the administrators and the appointment of replacement administrators. A majority of the creditors supported this move. The court expressly stated that there was no imputation against the integrity of the administrators who were removed. The principal issue was that on the evidence available to the court, there was a significant issue raised by the majority of creditors as to whether or not the sale of the business was at a significant undervalue. The administrators do not appear to have fully complied with SIP 16 in terms of providing full information about the sale. A further issue involved the terms upon which the main participator in the LLP was subsequently employed by the purchaser. Although not a typical management buy-out pre-pack, the main participator in the LLP was subsequently employed by the purchaser on attractive terms.

The court found that the terms of the pre-pack sale constituted a legitimate matter for an independent review.

The review required an independent administrator to be appointed. The court considered the alternative of a creditors' voluntary liquidation with an independent insolvency practitioner acting as a liquidator but appears to have been swayed by the consequential delay this option would cause and also the majority creditors' wish for a replacement administrator.

One obvious question to ask is: would full compliance with SIP 16 have avoided this result? The answer is not entirely clear. It seems arguable that if full disclosure of all the pre-appointment negotiations and terms of the sale had been given to the LLP's creditors, there may not have been any need for the independent review and by definition no need to replace the administrators. Even if fuller details had been provided to the creditors, the appointment of an independent insolvency practitioner may still have been seen as necessary by the court if there was still a substantial issue as to whether or not the sale had been at an undervalue.

A view recently expressed by the Association of British Insurers suggests that creditors perceive a lack of independence in management buy-out pre-packs: "We do not believe that insolvency practitioners can fully and properly discharge their duty to act independently in the interests of creditors, when they have already been engaged by the distressed company to achieve a pre-agreed outcome (particularly where that outcome is a sale of parts of the business to the existing owners)."

Creditor discontent with pre-packs is unlikely to disappear even where SIP16 is fully satisfied. The provision of detailed information about the lead-up to the pre-pack, valuations, identity of purchasers and the involvement of the insolvency practitioner (under the new rules in relation to remuneration) may provoke more creditor discontent rather than less. The fuller information provided may actually increase the incidence of creditors applying to the courts for an independent review of the deal.

CREDITORS DISENFRANCHISED FROM DECISION MAKING

The Cork Committee (Cmnd 8558, 1982), whose views might be regarded as a little "old hat" by some nowadays, identified a number of characteristics essential to insolvency regulation. In particular, (at para 917) the Committee was: "in no doubt that the machinery should be such as to allow, and indeed encourage, those creditors who have a genuine interest to involve themselves in all types of insolvent administration." The problem with the pre-1986 regime was that creditors were often excluded from decision making. It is a hallmark of a sound insolvency legal system that it encourages creditor participation. It is clear that pre-packs do the exact opposite of this. The express statutory right to vote on an administrator's proposal is usurped and replaced by a non-statutory entitlement under SIP 16 to receive historical information.

IS SIP 16 THE SOLUTION TO ALL THESE PROBLEMS?

The House of Commons Business and Enterprise Select Committee examined the widespread concerns over pre-packs and recognised that SIP16 was a "first step" in addressing creditors' concerns. This suggests that the balance is not yet right. It is likely that SIP 16 will continue to develop and indeed the Insolvency Service is currently surveying the profession to see how it can be improved. Assuming that pre-packs are here to stay – what else is needed?

Looking at the main complaints levelled at pre-packs and assuming full compliance with SIP 16, the following points may be made. SIP 16 deals with the provision of information about how and why the pre-pack was entered. Compliance with SIP 16 would therefore permit creditors to assess whether or not the best price for the company's assets has been achieved. SIP 16 may develop to allow the Insolvency Service to continue to police allegations that credit has been incurred inappropriately in the pre-appointment period. So far, so good.

SIP 16 does not deal with creditors' inability to influence the decision to pre-pack, although through the provision of information, it may assist creditors in deciding whether or not to bring an action against the pre-pack administrator. SIP 16 (and the new rules on expenses) do not prevent creditors feeling that the result benefits the administrator and the participators in the company (at least where there is a connected sale) at the expense of the unsecured creditors.

The Cork Committee stated (at para 191) that the basic objective of insolvency law is "to support the maintenance of commercial morality and encourage the fulfilment of financial obligations." If such a basic objective is to be achieved, "it is essential that proper investigation will be made in every case in which it is warranted" (para 194). The perception that no truly independent insolvency practitioner gets to investigate the pre-pack and the events leading up to it remains a complaint not addressed by SIP 16.

CONCLUSION

The overwhelming criticism of pre-packs made by unsecured creditors is that they have no say in the decision to pre-pack and have nobody looking out for their interests. Despite the statutory duty on administrators to act in the interests of the creditors as a whole (or at least not to act in a way which unnecessarily harms their interests), unsecured creditors remain unconvinced. The way a pre-pack often operates looks very much like an old-style administrative receivership (where the receiver owes a primary duty to the appointing debenture holder). Whether or not this is a valid criticism of the way some pre-packs are carried out, the perception is established. This perceived lack of objectivity is arguably the biggest problem with pre-packs.

The courts have shown an understandable reluctance to "rubber stamp" proposed pre-pack deals and it would be unrealistic to require the court to assess each and every out-of-court administration. The question therefore moves on to whether or not it would be feasible to build into the pre-pack procedure a requirement for some independent assessment by a different insolvency practitioner.

The obvious solution to this concern would be to follow the lead given by the court in *Clydesdale*. If no-one is perceived to be looking out for the interests of unsecured creditors, why not introduce the requirement of an independent review into the pre-pack mechanism? This may be seen as only necessary where there is a management buy-out pre-pack but could be used in all pre-packs. Unsecured creditors should feel significant comfort if an independent insolvency practitioner is appointed to assess the pre-pack and its surrounding circumstances.

Two possibilities may be considered. First, it may be possible to require the appointment of an independent insolvency practitioner prior to execution of the deal whose consent is necessary before the pre-pack can be executed. This would prevent inappropriate pre-packs being executed.

A second option would be to require some after-the-event inspection of the pre-pack. This could be achieved by requiring that following the pre-pack the company would need to enter a creditors' voluntary liquidation with an independent liquidator charged with reviewing the pre-pack. Creditors would have some say in the liquidation even if they had no say in the pre-pack. Creditors' interests would be considered by someone who ostensibly is acting in their interests and seen to be so doing.

The obvious problem with either solution is that they would both cost money. Both would require money being set aside to pay the costs and expenses of the independent insolvency practitioner. Unsecured creditors may baulk at the suggestion that two insolvency practitioners should be paid to deal with the one insolvent company. This is a reasonable concern but not much different to what happens when a liquidation follows on from a receivership (where an independent liquidator must be appointed). The unsecured creditors, who are unlikely to see much if any of their money anyway, may see the positive side of such a system. They might argue that it is their money which is being used to pay for the pre-pack as things stand. If money had to be set aside to pay the costs of an independent insolvency practitioner, such a requirement is unlikely to affect greatly any final dividend payable to unsecured creditors.

If independent scrutiny became the norm, it may be that the incidence of pre-packs will reduce. Secured lenders, pre-pack administrators and management teams would perhaps be more cautious about entering into such an arrangement.

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