

Pre-pack Administration

Control over pre-packs looks set to tighten further

As we stand looking into the abyss of another financial crisis, the UK government looks set to further tighten the screw to control pre-packaged sales to connected parties. The writing has been on the wall since Theresa Graham's 2014 report on sales to connected parties – although the government hoped it might do enough with the introduction of the pre-pack pool, it reserved the right to take further steps if deemed necessary. With very low uptake on the pre-pack pool and continuing concern over the secrecy of pre-pack sales (and whether they deliver the best returns for creditors), the government

has indeed deemed it necessary to take further action. The government published draft regulations in October 2020¹ which, if implemented, would either require creditor consent for pre-pack sales to connected parties (which for the reasons we set out below, we consider unlikely to be utilised much in practice) or that connected parties get an independent opinion in relation to such sales to justify the terms of the sale – most crucially, the price. This looks set to increase the cost to connected purchasers but perhaps it will, finally, put to rest the long-running criticism of pre-packs.

¹ https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/922230/Draftregulationstext_1.pdf



Key messages



The proposed measures will be mandatory not voluntary. This is a gear shift from the government and may be the price to pay to ensure pre-packs to connected parties remain a useful rescue tool and are not completely prohibited.



The definition of “connected person” will be key for secured lenders and the success of a quick lender-led pre-pack rescue. The current definition of “connected person” appears to conflict with the equivalent term used in the current SIP 16. It is hoped this is an oversight in the draft regulations.



The necessary qualifications for the evaluator are unclear. Is the evaluator the Pre-pack Pool in disguise? To give confidence to the market the evaluator should be suitably qualified and the Regulations are very “light” in this regard. In addition, it is not clear how much input the administrator may have on the choice of evaluator when their input and experience may be very valuable.



It is not obvious transparency will be achieved. For example, will the connected party be required to disclose all evaluator reports, good or bad, to the administrator? If yes, will the administrator be required to disclose all such reports to creditors?



Further guidance is expected, along with a revised SIP 16. We hope to have the opportunity to input on this guidance and the revised SIP 16 at the drafting stage. We expect insolvency professionals to be interested in the interplay between the legislative and non-legislative measures.



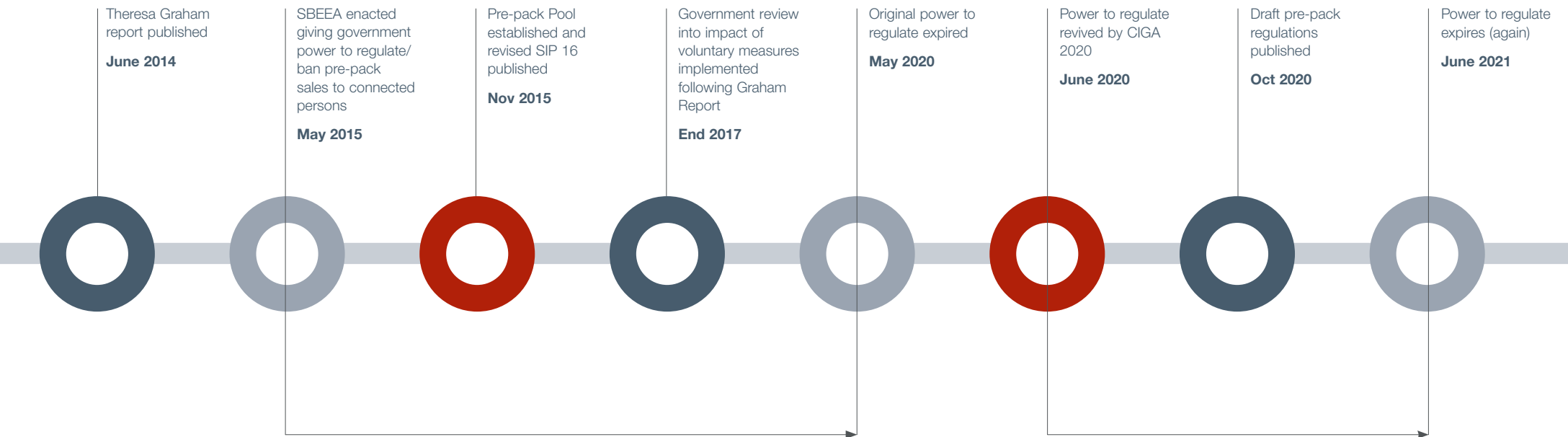
Timing is unclear; will Brexit eat up Parliamentary time (again)?

The Report says that the government will “seek to bring forward regulations as soon as Parliamentary time allows” prior to June 2021. Brexit and the continuation of the coronavirus pandemic may mean we are more likely to see space in the Parliamentary agenda after spring 2021 than winter 2020.



Quick recap on pre-pack scrutiny to date

The independent Theresa Graham 2014 report was part of the (then) government's wider "Trust and Transparency" agenda. Issued in June 2014, the recommendations in the report led to the implementation in November 2015 of a package of voluntary measures for so-called "pre-packaged" sales to connected persons – **voluntary** being the key word here. These measures included the establishment of the Pre-pack Pool and a new Statement of Insolvency Practice 16 (**SIP 16**) which enhanced the marketing, valuation and information requirements in its guidelines for insolvency practitioners undertaking pre-pack sales. The government also gave itself the back-up power to regulate further, presumably if it deemed the voluntary measures were not sufficient to address the issues identified by the Graham report (see section 129 of the Small Business Enterprise and Employment Act 2015). It seems, by the government's standards, that these voluntary measures have not had the desired effect*. The back-up power to legislate further lasted for 5 years, expiring in May 2020. However, according to the government's "Pre-pack sales in administration report" (published October 2020) (the **Report**), concerns surrounding the transparency of pre-pack sales to connected persons were, once again, raised during the recent Parliamentary debates on the Corporate Insolvency and Governance Act 2020. This resulted in the "revival" of the government's power to legislate on pre-packs, such power will expire (again) at the end of June 2021. Assuming "Parliamentary time permits" it seems inevitable some form of mandatory measures will be enacted.



What is a pre-pack?

A pre-pack is a sale of all or substantially all of a business from a company which has entered administration. The sale is effected by an independent insolvency practitioner who has been appointed to the disposing company and usually happens very shortly, sometimes immediately, after their appointment (with the sale having been negotiated in advance). It is a useful way of rescuing the business of a company that is in financial difficulty. One of the key benefits is that it can be done quickly – before key counterparties (such as suppliers, employees and customers) know that the business is in financial difficulty. Once the pre-pack is complete, these counterparties can often be persuaded that there is no need to terminate contracts, even if they have a right to do so, because the resulting company should now be on a firmer financial footing. It is therefore a useful business rescue tool, particularly for companies with a fragile customer base or the value of which resides in the talent of its employees whose retention is therefore important.

What is the concern around pre-packs?

Because the sale usually happens very quickly, there is not time to consult with creditors before it completes. Businesses are often not openly marketed due to concerns that this would have a negative impact on the business operations, given the stigma of impending insolvency proceedings. This leads to a concern that perhaps the business is not being sold for the best possible price. These concerns are particularly present where the sale is to an individual or organisation who is connected to the seller (for example a new company owned by the same shareholders or governed by the same directors) – which is the case in around half of all pre-packs.

What has the government previously done to regulate pre-packs?

The government introduced, in 2015, voluntary measures designed to address some of the concerns around pre-packs. A “pre-pack pool” was established. This was essentially a committee of experienced business individuals who would review information submitted in respect of a proposed pre-pack to a connected party and give, within 48 hours:

- an opinion that the proposed sale was not unreasonable based on the information provided (if such information was sufficient to form this view);
- a qualified opinion – suggesting that some evidence was limited but there was still nothing to suggest that the pre-pack sale was unreasonable; or
- a negative opinion that there was insufficient evidence to support a statement that the pre-pack was reasonable.

The pool charged a fee of GBP950 +VAT.

The government also introduced a new Statement of Insolvency Practice 16 (**SIP 16**) whereby administrators are required to ensure, among other things, that:

- creditors are provided with sufficient information such that a reasonable and informed third party would conclude that the pre-packaged sale was appropriate and that the administrator had acted with due regard for the creditors’ interests. In a connected party transaction it was expected that the level of detail would need to be greater;
- the business is marketed in line with a defined set of six principles of good marketing;
- they keep a detailed record of the reasoning behind both the decision to undertake a pre-packaged sale and all alternatives considered;
- guidance is given to the selling company that any valuations should be of an independent nature and performed by valuers and/or advisors, carrying adequate professional indemnity insurance.

What is the government now proposing? The government has published draft regulations, which, if implemented, would become mandatory rather than voluntary (as in the case of the pre-pack pool) in relation to sales to connected parties. An administrator would not be permitted to effect a pre-pack sale of all or substantially all of a company's business or assets to a connected party within the first eight weeks of administration unless they had either received creditor approval or a report on the proposed sale meeting certain requirements (**the Pre-pack Report**).

Who is a connected person for the purposes of invoking the new regulations?

The regulations look to paragraph 60A(3) of Schedule B1 to the Insolvency Act 1986 to define "connected person", this itself reads through into section 435 of the Insolvency Act 1986 with respect to what "associate" means. The definitions are broad and include those you would expect, such as directors or other officers of the company and their family members, and any other employees and their family members. There is one category of connected person, though, that may be relevant to secured lenders. A company is considered to be an associate of another company where the same person has control of both – control for these purposes is defined as an entitlement to exercise or control the exercise of one third or more of the voting power at a general meeting of the company. Where lenders have taken share security over one third or more of the shares and have the ability to exercise voting rights in respect of those shares and hold the voting rights in over one-third of the shares in the purchasing newco, they would fall within the definition of connected persons and within the ambit of the new regulations for any lender-led pre-pack sale. It is not clear whether this is the intended consequence of the regulations given that SIP 16 makes it clear that secured lenders are outside the scope of connected parties for that purpose. Of course this doesn't prohibit sales to secured lenders by way of a pre-pack but, if they are not excluded from the connected persons definition, then they too will need to go through the process of seeking creditor consent or getting a Pre-pack Report.

What level of creditor support would be required?

If an administrator wants to go down the creditor consent route then they would need to seek a decision from the company's creditors on their proposed course of action. They are likely to do so initially using the deemed consent route – whereby the proposals would be deemed to be approved by creditors unless 10% of the creditors object. Creditors who are fully secured do not get to vote and where they are partially secured they will only be able to vote in the amount that is not covered by security. If 10% of creditors object to the proposals under a deemed consent procedure then the administrator would need to seek a decision from creditors using another method, under which a majority in value would need to approve the proposals.

Given that one of the main drivers for effecting a pre-pack is the desire to complete the sale immediately once the company has gone into administration, we consider it rather unlikely that the creditor consent route will be pursued in practice.

What is a Pre-pack Report?

The alternative to creditor approval is for the connected party to the proposed sale to obtain, and provide to the administrator, a report from an "evaluator" (who is not the administrator, nor connected with the administrator or any company connected with the administrator) on the proposed sale. The administrator is obliged to consider the Pre-pack Report and whether the evaluator met the necessary requirements for providing such a report.

The Pre-pack Report will need to include one of the following statements:

- the evaluator is satisfied that the consideration to be provided for the relevant property, and the grounds for the substantial disposal, are reasonable in the circumstances (a "case made" opinion); or
- the evaluator is not satisfied that the consideration to be provided for the relevant property and the grounds for the substantial property disposal are reasonable in the circumstances (a "case not made" opinion).

Does a “case made” opinion completely protect the administrator in implementing a sale?

No. An administrator is still an officer of the court and still needs to ensure that they comply with their duties to act in the best interests of the company’s creditors. Therefore, even where a proposed purchaser provides the administrator with a “case made” opinion in respect of their proposed transaction, if a better, deliverable offer emerges from another prospective purchaser then the administrator would be obliged to accept that better offer and cannot simply rely on the “case made” opinion as justifying a sale at a lower price.

Can the sale proceed if a “case not made” opinion has been received by a purchaser?

Yes, provided a ‘case made’ opinion *has* been received. The regulations do not prevent a connected purchaser from obtaining as many reports as they want in the hope of receiving one that is a “case made” opinion. It may perhaps have been envisaged that all reports would be provided to the administrator and subsequently to creditors but there appears to be no obligation on the connected party to provide all such reports to the administrator and it seems unlikely that a connected party would voluntarily disclose a “case not made” opinion.

It also seems that, even where a connected prospective purchaser seeks but fails to obtain a “case made” opinion, the administrator could still proceed with the sale provided that they obtain creditor approval although, as mentioned above, the delay involved in that exercise may not meet the urgency of the situation which is the driver for a pre-pack.

What qualifications must the evaluator have?

Somewhat unexpectedly, the draft regulations are not prescriptive about the qualifications an evaluator must have. Instead, they leave it up to the evaluator themselves to assess whether they have the requisite knowledge and experience to provide the report, though the administrator also needs to consider whether there is any reason to believe the evaluator does not meet the requirements.

The evaluator will also need to be independent of the selling company, the connected person and the administrator or any company with which the administrator is connected. The evaluator must also be free of any conflict of interest with respect to the proposed sale and must not, in the preceding 12 months, have provided advice in respect of the company or a company connected with the company in connection with or in anticipation of the commencement of an insolvency procedure or any corporate rescue or restructuring. In other words, they must be truly independent of the company, the purchaser, the administrator and the proposed transaction.

A number of people, including those convicted of any offence involving dishonesty or deception, anyone subject to an undischarged bankruptcy order or other debt relief proceedings and anyone disqualified from being a company director, are prohibited from being eligible to provide the Pre-pack Report.

Must the evaluator be an individual or can it be a company?

It appears from the draft regulations that the Pre-pack Report would need to be given by an individual rather than a company. This is somewhat curious. One might have expected that the proposed purchaser would have sought the opinion from a firm of accountants, for instance, but it seems that instead they will need to find an individual who is prepared to give the opinion in their own name. A provider of a Pre-pack Report will need to ensure their or their firm’s professional indemnity insurance will cover their making the report in their own name. It is a requirement under SIP 16 that a ‘valuer’ carries such insurance.

Who will see the Pre-pack Report and what will it cost?

The Pre-pack Report will be commissioned by the connected party to whom the sale is to be made. It will need to be provided to the administrator, who must in turn provide it (or a redacted version) to all creditors of the company unless they are opted out. This is a potentially extremely wide pool of recipients, including those who may be unhappy about the sale and who wish to challenge it, which begs the questions as to who will be prepared to provide the Pre-pack Report and what they will charge for doing so. We suspect that it will be substantially more than the GBP950 +VAT that is the current cost of referring the sale to the pre-pack pool.

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