Pratt's Journal of Bankruptcy Law

VOLUME 7 NUMBER 5 JULY/AUGUST 2011

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ISSN 1931-6992

Unwrapping English Pre-Packaged Administrations: A Guide to "Pre-Packs"

ALASTAIR GOLDREIN

This article examines pre-packs, summarizes their advantages and disadvantages, and considers the extent to which the concerns associated with the process are warranted.

It has become crucial in the current economic climate to maximize value and minimize losses for creditors. Thus, this recession has seen an increase in "pre-packs" (short for pre-packaged sales) in English administrations. Through a pre-pack, a debtor may avoid a firesale of its business and assets and deliver a better return to its stakeholders. Pre-packs, however, have been viewed with a degree of suspicion given the possibility that a debtor's existing management may utilize a pre-pack to strip the company of its valuable assets, leaving behind debts and liabilities. This article examines pre-packs generally, summarizes their advantages and disadvantages, and considers the extent to which the concerns associated with the process are warranted.

WHAT IS A PRE-PACK AND HOW ARE THEY USED?

Although the English Insolvency Act 1986 (the "Insolvency Act") does not expressly authorize the use of pre-packs, English courts have

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Published by A.S. Pratt in the July/August 2011 issue of *Pratt's Journal of Bankruptcy Law.*
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permitted a debtor to implement a pre-pack in certain circumstances. The essence of a pre-pack is that the negotiations for the sale of some or all of the debtor's business and assets occur prior to the formal appointment of an administrator (or liquidator), with the sale becoming effective immediately upon or soon after the appointment. Essential to the strategy is a swift and seamless transfer of the business to the incoming purchaser. This provides a clear "business as usual" message to the market, preserves enterprise value and avoids detriment to the business during a period of insolvency. Pre-packs have often been used by the pre-existing sponsors of the business, who establish and finance a purchase vehicle with a view to preserving the best assets, free from the liabilities.

The debtor, the prospective administrator and the secured creditors typically draw up a shortlist of potentially interested parties who are approached on a confidential basis with a view to establishing their level of interest. Occasionally, this limited marketing process may be avoided under certain circumstances, including where a secured creditor is interested in acquiring the company or its assets. Under those circumstances, the prospective administrator, who is required to act in the best interest of all creditors, will typically satisfy himself as to the fairness and reasonableness of a proposal by obtaining an independent valuation from a third party.

Unsecured creditors are usually disenfranchised in an English pre-pack in that they are not given an opportunity to consider or vote on the proposed sale of the debtor or its assets. Secured creditors, however, must be involved in the process given the need to obtain a release of any liens to facilitate the sale.

WHY USE THEM?

The key drivers for adopting a pre-pack strategy are usually a combination of an absence of funding, preservation of goodwill (particularly in relation to suppliers), employee retention and a reduction of liabilities. A pre-pack is typically implemented where there is a perception that the company is worth more to its stakeholders as a going concern rather than as a debtor in an insolvency proceeding. Often a pre-pack is the only viable option of selling a business as a going concern, particularly where the

company does not have access to sufficient funding to enable it to continue trading. A pre-pack provides a swift and efficient means of effectuating the sale of a business without the considerable costs that are frequently accumulated in an administration. Thus, a pre-pack often has the added advantage of enhancing the prospects of a better return to creditors.

WHAT IS THE DOWNSIDE?

Transparency

In a conventional administration, creditors are usually entitled to consider and vote on the administrator's proposals. In a pre-pack, unsecured creditors generally do not have the ability to consider or vote on the proposal. Indeed, unsecured creditors often become aware of the sale only after its terms have been finalized. A secured creditor, however, is usually actively involved in the pre-pack process given that it must consent to the release of the security held by it over the assets being transferred. SIP 16 (see below) addresses some of the concerns arising from the lack of transparency.

Proceeds of Sale Not Maximized

Because of the speed with which a pre-pack may be implemented, the marketing process of the business/assets may be relatively clandestine in comparison to the process in a traditional administration, leading to concerns that the potential maximum value of the business being sold is not achieved.[1] As mentioned previously, in circumstances where the secured creditors are the purchaser, the marketing process may be dispensed with altogether and the administrator will utilize an independent valuation to determine the value of the business.

Phoenix Companies

In the event that the business is sold to a company controlled by some or all of the previous shareholders and management, creditors will inevitably be suspicious that the process has been used as a way of jettisoning

the liabilities of the previous company — a practice prohibited by the Insolvency Act.

Directors

A director involved in the pre-pack runs the risk of being accused of (i) failing to act in the best interests of creditors and (ii) other offenses under the Insolvency Act (e.g., engaging in an undervalue transaction). This risk will be heightened if the director subsequently acquires an interest in the assets of the business following the sale.

Pre-Appointment Expenses

On April 6, 2010, the Insolvency (Amendment) Rules 2010 (the "New Rules") were introduced. Under the New Rules, an administrator may recover pre-appointment costs, including the costs associated with the negotiation of a pre-pack, as an expense of the administration. Nevertheless, there is some uncertainty as to the extent to which an insolvency practitioner and its advisors can recover their pre-appointment costs under the New Rules.

STATEMENT OF INSOLVENCY PRACTICE 16

In anticipation of an increased use in pre-packs, the "Statement of Insolvency Practice 16: Pre-packaged sales in Administrations" ("SIP 16"), a guidance note for insolvency practitioners on pre-packs in administrations, became effective on January 1, 2009. SIP 16's purpose is to set out basic principles and essential processes which insolvency practitioners should follow when considering a pre-pack. It is considered a restriction on previous abuse of the process and sets forth new transparency and disclosure requirements. Although not legally binding, an insolvency practitioner will face regulatory or disciplinary action if he/she fails to comply with SIP 16.

Paragraph 8 of SIP 16 states that "it is in the nature of a pre-packaged sale in an administration that unsecured creditors are not given the opportunity to consider the sale of the business or assets before it takes place. It is important, therefore, that they are provided with a detailed explanation

and justification of why a pre-packaged sale was undertaken." Thus, SIP 16 provides that creditors should be supplied with details of the marketing efforts undertaken, the identity of the buyer, any connection between the buyer and the insolvent company, the terms of sale of the business, and a justification for the decision to implement a pre-pack.

CHALLENGING PRE-PACKS

Creditors can bring an action against an administrator under Schedule B1 to the Insolvency Act. These provisions address those situations where an administrator (i) causes unfair harm to the interests of a creditor, or (ii) fails to perform his functions sufficiently, quickly and efficiently. Absent fraud and/or gross negligence, however, the English courts have been reluctant to interfere with the actions and decisions of an administrator. Creditors can complain of an administrator's action, including the use of a pre-pack, on a "hotline" recently launched by the English Insolvency Service.

COMBINING A SCHEME OF ARRANGEMENT AND A PRE-PACK

A pre-pack may be combined with a scheme of arrangement, which is akin to a plan under Chapter 11 of the United States Bankruptcy Code in that, among other things, it is a contractual arrangement entered into between a company and its creditors (or class of creditors) and/or shareholders. Like a plan under Chapter 11, a scheme is binding on non-consenting creditors. In the case of *IMO Carwash*, the administrator proposed (i) a scheme pursuant to which non-consenting senior lenders (accounting for around fifteen percent of the senior debt) were compelled to "rollover" into the new company, and (ii) a pre-pack, pursuant to which the group was transferred to the senior lender-owned newco at the "best price reasonably obtainable."

AN ADMINISTRATOR: A MAN WHO KNOWS THE PRICE OF EVERYTHING AND THE VALUE OF NOTHING?

In England, there is no statutory method of valuation in restructurings. The valuation of the business being sold will often represent the most con-

tentious aspect of a pre-pack. By way of example, in the aforementioned case of *IMO Carwash*, the subordinated creditors were left with no value for their debt claims and unsuccessfully challenged the valuation and pre-pack. In that case, the English courts assessed valuation on the basis of the company's current value, rather than a future value when market conditions and financial performance have improved. The court's view was that the correct approach to valuation would require "some real world judgments as to what is likely to happen…rather than a range to which other ranges are applied in a series of random calculations to come up with some mechanistic probability calculation."

CONCLUSION

Critics complain that pre-packs do not allow either the directors of the distressed business or the creditors sufficient time to consider (or thwart) the sale of the business. Speed, however, remains the indispensable ingredient of a pre-pack. It is the swiftness of the process that reduces the potential damage of protracted insolvency proceedings, and the associated job losses and damage to the goodwill of the business. As such, pre-packs represent a critical instrument in the restructuring toolkit. Despite the unfavourable press coverage attracted by the process, it is to be hoped that the guidance contained in SIP 16 will go some way towards eradicating the criticism associated with the use of pre-packs given the role they play in preserving economic activity.

NOTE

[1] Research undertaken by Dr. Sandra Frisby of the University of Nottingham in 2007 supports the view that unsecured creditors lose out (albeit marginally) in a pre-pack sale, and secured creditors achieve substantially better recoveries in a pre-pack.