

The problem with pre-pack

Jeremy Whiteson assesses the current and proposed legal restrictions on the use of pre-pack sales



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'Pre-pack sales mitigate some of the problems with traditional sale structures: there is certainty on the price to be received and the business is not exposed to a long period in which the IP's staff are incurring big fees to supervise trading and the goodwill is evaporating.'

Whittards of Chelsea, USC, Officers Club, Laurel Pubs, MFI and many other well-known businesses have reportedly been sold through 'pre-pack' insolvency sales over recent months. This will commonly result in little, if any, money being available for ordinary creditors, while the business appears to continue uninterrupted, often with the same management in place. Criticism of the procedure has been widely reported, with many claiming that these 'quickie bankruptcies' are unethical and unfair to ordinary creditors or, at least, open to abuse. This controversy has provoked the issuing of new guidelines for use of pre-packs to be adopted by R3, the representative body of insolvency practitioners (IPs); a hotline for complaints at the government's insolvency service; and an investigation into the practice by the Department for Business, Enterprise and Regulatory Reform. But what exactly are pre-packs? Are they a good or a bad thing? What are the legal limits on their use, and is further reform needed?

Traditional insolvency sales

In the 'traditional' structure an IP appointed over a trading business, mindful of obligations to optimise realisations, would advertise the business or assets for sale, provide serious bidders with a sales pack containing information about the assets, invite best offers by a fixed date and then try to conclude the sales in that period. The IP would usually obtain a valuation of the assets to help assess the level of offers received. Through this structure, IPs could demonstrate to interested parties that, subject to the constraints of their situation, they had done what they could to optimise the position of creditors.

Problems with the traditional approach

This structure is not without criticism.

Expense

While the business is marketed for sale, the IP's staff would run the business and charge for their time at substantial rates, eating into realisations available for creditors.

Damage to the business

A formal insolvency process is very public. Before the sale is concluded, key staff, demotivated by the lack of certainty, as well as frustrated unpaid creditors or disappointed customers, may withdraw their support, making rehabilitation of the business by a buyer much more difficult.

Uncertainty

Once the insolvency process has started, the appointed IP needs to generate realisations, even if the level of offers received is disappointing. If no acceptable offer is received, they may be forced to close the business and sell its assets on a break-up basis. In view of the ongoing costs and damage to the business, trading the business for longer to generate profits or waiting for an improvement in the market are unlikely to be attractive options.

Differences with a pre-pack structure

In view of these difficulties, pre-pack sales have increased in popularity. In this structure, before the IP is appointed, a buyer is identified, an offer accepted in principle, terms of the sale are agreed and a draft contract settled. The IP will often obtain a valuation of the business to help assess the adequacy of this offer. The insolvency appointment is made and a sale contract concluded by the IP

immediately after their appointment. By the time creditors know about the appointment the sale has already been completed.

A variant of pre-packs is also available in voluntary liquidations where a liquidator appointed by members, but not yet approved by creditors, sells assets. This is permitted without court sanction where the goods are 'perishable' or their value is 'likely to diminish if they are not immediately disposed of'.

This mitigates some of the problems with traditional sale structures: there

is certainty on the price to be received and the business is not exposed to a long period in which the IP's staff are incurring big fees to supervise trading and the goodwill is evaporating.

Enterprise Act (EA) 2002: a further boost for pre-packs

Before the EA 2002 came into force in 2003, pre-packs were normally initiated by banks through appointing receivers under their security. From 2003, however, the administration procedure was simplified, allowing inexpensive and quick out-of-court appointments

by a company's directors and shareholders, as well as certain secured creditors. This allowed additional parties to institute a procedure that could be used for pre-packs.

Criticism of pre-packs

Corporate insolvencies, by definition, always leave unpaid and disappointed creditors. Do pre-pack sales make the position worse?

- Consultation: the sale will have gone through without any formal consultation with creditors

Insolvency Act 1986: Restrictions on re-use of company names

216 — Restriction on re-use of company names

- (1) This section applies to a person where a company (the liquidating company) has gone into insolvent liquidation on or after the appointed day and he was a director or shadow director of the company at any time in the period of 12 months ending with the day before it went into liquidation.
- (2) For the purposes of this section, a name is a prohibited name in relation to such a person if:
 - (a) it is a name by which the liquidating company was known at any time in that period of 12 months; or
 - (b) it is a name which is so similar to a name falling within paragraph (a) as to suggest an association with that company.
- (3) Except with leave of the court or in such circumstances as may be prescribed, a person to whom this section applies shall not at any time in the period of five years beginning with the day on which the liquidating company went into liquidation:
 - (a) be a director of any other company that is known by a prohibited name;
 - (b) in any way, whether directly or indirectly, be concerned or take part in the promotion, formation or management of any such company; or
 - (c) in any way, whether directly or indirectly, be concerned or take part in the carrying on of a business carried on (otherwise than by a company) under a prohibited name.
- (4) If a person acts in contravention of this section, he is liable to imprisonment or a fine, or both.

217 — Personal liability for debts, following contravention of s216.

- (1) A person is personally responsible for all the relevant debts of a company if at any time:
 - (a) in contravention of s216, he is involved in the management of the company; or
 - (b) as a person who is involved in the management of the company, he acts or is willing to act on instructions given (without the leave of the court) by a person whom he knows at that time to be in contravention in relation to the company of s216.
- (2) Where a person is personally responsible under this section for the relevant debts of a company, he is jointly and severally liable in respect of those debts with the company and any other person who, whether under this section or otherwise, is so liable.
- (3) For the purposes of this section the relevant debts of a company are:
 - (a) in relation to a person who is personally responsible under paragraph (a) of subsection (1), such debts and other liabilities of the company as are incurred at a time when that person was involved in the management of the company; and
 - (b) in relation to a person who is personally responsible under paragraph (b) of that subsection, such debts and other liabilities of the company as are incurred at a time when that person was acting or was willing to act on instructions given as mentioned in that paragraph.
- (4) For the purposes of this section, a person is involved in the management of a company if he is a director of the company or if he is concerned, whether directly or indirectly, or takes part, in the management of the company.
- (5) For the purposes of this section a person who, as a person involved in the management of a company, has at any time acted on instructions given (without the leave of the court) by a person whom he knew at that time to be in contravention in relation to the company of s216 is presumed, unless the contrary is shown, to have been willing at any time thereafter to act on any instructions given by that person.

(although sometimes the IP will have discussed the proposal with key creditors).

- The phoenix syndrome: in many cases, a pre-pack sale will be to a vehicle led by management of the insolvent business – the very people

(although often an IP will obtain a valuation before the sale). How can creditors know that a proper price was obtained?

- Prejudice to trade creditors: negotiation of the sale may take some time. During that period

made and an IP put in control of the process to protect creditors.

Other concerns raised are bank funding (in view of the concerns about the ethics of pre-pack sales, many major banks say that they are unwilling to fund pre-packs and so are encouraging insolvency sales to be conducted through the traditional processes) and conflicts of interest (IPs will be brought in to assist directors of an insolvent company but may then take appointment as office holders and even advise the new business).

The government's insolvency service has issued an announcement that it will use its enforcement powers to clamp down on directors who mis-use the pre-pack process.

who (creditors may feel) created the problem to start with!

- Value: a pre-pack sale goes through without an open marketing process

additional debts leave even more creditors exposed. On the traditional sale process, as soon as the problems become apparent, an insolvency appointment would be

To what extent does the current law address these issues?

Consultation

There are minimal obligations on an IP to consult before the sale. An administrator should make a written proposal of their strategy for the administration and

Insolvency Act 1986: Restrictions on re-use of company names [continued]

Insolvency Rules 1986

4.228 — First excepted case

(1) This Rule applies where:

- (a) a person (the person) was within the period mentioned in s216(1) a director, or shadow director, of an insolvent company that has gone into insolvent liquidation;
- (b) the person acts in all or any of the ways specified in s216(3) in connection with, or for the purposes of, the carrying on (or proposed carrying on) of the whole or substantially the whole of the business of the insolvent company where that business (or substantially the whole of it) is (or is to be) acquired from the insolvent company under arrangements:
 - (i) made by its liquidator; or
 - (ii) made before the insolvent company entered into insolvent liquidation by an office-holder acting in relation to it as administrator, administrative receiver or supervisor of a voluntary arrangement under Part I of the Act.

(2) The person, will not be taken to have contravened s216 if prior to his acting in the circumstances set out in paragraph (1) a notice is, in accordance with the requirements of paragraph (3):

- (a) given by the person, to every creditor of the insolvent company whose name and address:
 - (i) is known by him; or
 - (ii) is ascertainable by him on the making of such enquiries as are reasonable in the circumstances; and
- (b) published in the Gazette.

4.229 — Second excepted case

(1) Where a person to whom s216 applies as having been a director or shadow director of the liquidating company applies for leave of the court under that section not later than seven days from the date on which the company went into liquidation, he may, during the period specified in paragraph (2) below, act in any of the ways mentioned in s216(3), notwithstanding that he has not the leave of the court under that section.

4.230 — Third excepted case

The court's leave under s216(3) is not required where the company there referred to, though known by a prohibited name within the meaning of the section:

- (a) has been known by that name for the whole of the period of 12 months ending with the day before the liquidating company went into liquidation, and
- (b) has not at any time in those 12 months been dormant within the meaning of s252(5) of the Companies Act.

put this before creditors (within three months under the old regime or eight weeks under the post-EA 2002 regime). Case law under the old regime (*Re T and D Industries Plc* [2000]) and under the new regime (*Re Transbus International Ltd* [2004]) makes clear that a sale prior to the approval of proposals by creditors, and in the absence of a court order, is permissible. The courts have even supported a pre-pack solution where HMRC, as majority creditor, opposed the proposed sale (*DKLL Solicitors v Revenue and Customs* [2007]).

Phoenix companies

There are existing controls in this area.

- A director or shadow director of a company going into liquidation may not, for five years, carry on business or be a director of a company that is known by a name so similar as to suggest an association with the old company. If they do so, the director is personally liable for the debts of the new company. There are exceptions where the director obtains leave of the court, or, having bought the business from an IP, sends a notice to all creditors of the old company before acting as a director or adopting the prohibited name. (Further details are set out in the Insolvency Act boxout, p21-22.)
- 'Substantial property transactions' (transactions in excess of £100,000, or, if between £5,000 and £100,000, exceeding 10% of the company's current asset value) between a company and its director, or a person or company connected with the director, are prohibited without shareholder approval. This restriction has recently been relaxed for sales by administrators (and has always had an exception for sales by liquidators), but still applies to receivership sales. (Further details are set out in boxout, right.)
- Phoenix trading may also be taken into account in assessing whether a director ought to be disqualified.

Getting proper value: an IP's duties

- A receiver has a duty to act in good faith, to take reasonable precautions and to exercise due diligence (*Downsview Nominees Ltd v First*

City Corp Ltd [1993]). However, the application of this principle to sales can be unclear. An IP has a duty to take reasonable care in obtaining the best price, but need not pursue planning applications or secure pre-lets before sales to maximise the price (*Silven Properties Ltd & anor v Royal Bank of Scotland Plc & ors* [2003]).

Receivers also have latitude as to the time and method of sale, so a sale of a portfolio as a whole will be acceptable even if with re-marketing a higher price could have been obtained by selling properties individually (*Bell v Long* [2008]).

- A creditor or member of a company in administration may apply to court claiming that the administrator has acted or is acting so unfairly as to harm the interests of the applicant, alone or in common with other creditors. Limited judicial guidance as to the meaning of 'unfair harm' was

Bell v Long
[2008] EWHC 1273 (Ch)
DKLL Solicitors v HM Revenue and Customs
[2007] EWHC 2067 (Ch)
Downsview Nominees Ltd v First City Corp Ltd
[1993] AC 295
Re Lehman Brothers International (Europe) (in administration)
[2008] EWHC 2869 (Ch)
Silven Properties Ltd & anor v Royal Bank of Scotland Plc & ors
[2003] EWCA Civ 1409
Re T and D Industries Plc
[2000] 1 WLR 646
Re Transbus International Ltd
[2004] EWHC 932 (Ch)

recently given (*Re Lehman Brothers International (Europe)* [2008]). The administrator is not required to dedicate a disproportionate amount of time to the interests of particular creditors. A disappointed creditor or member may also claim that the

Companies Act 2006: Substantial Property Transactions

190. Substantial property transactions: requirement of members' approval

(1) A company may not enter into an arrangement under which:

- a director of the company or of its holding company, or a person connected with such a director, acquires or is to acquire from the company (directly or indirectly) a substantial non-cash asset; or
- the company acquires or is to acquire a substantial non-cash asset (directly or indirectly) from such a director or a person so connected,

unless the arrangement has been approved by a resolution of the members of the company or is conditional on such approval being obtained.

191. Meaning of 'substantial'

(2) An asset is a substantial asset in relation to a company if its value:

- exceeds 10% of the company's asset value and is more than £5,000; or
- exceeds £100,000.

(3) For this purpose a company's 'asset value' at any time is:

- the value of the company's net assets determined by reference to its most recent statutory accounts; or
- if no statutory accounts have been prepared, the amount of the company's called-up share capital.

(4) A company's 'statutory accounts' means its annual accounts prepared in accordance with Part 15, and its 'most recent' statutory accounts means those in relation to which the time for sending them out to members (see s424) is most recent.

(5) Whether an asset is a substantial asset shall be determined as at the time the arrangement is entered into.

administrator is not performing their functions as quickly or as efficiently as is reasonable, or may allege misfeasance.

Protection of new trade creditors

The wrongful trading provisions of the Insolvency Act 1986 allow actions by liquidators against directors of insolvent companies if they know or ought to know that the company cannot avoid insolvent liquidation and thereafter fail to take steps to protect creditors. Where creditors are prejudiced by ongoing discussions about a pre-pack sale that generates low or nil realisations for unsecured creditors, directors may be exposed to an action of this nature.

New regulations

Against this background, R3, the body representing IPs, has issued a new

statement of insolvency practice. This directs that:

- IPs should make clear who they are advising in the process and recommend independent advice.
- In the absence of exceptional circumstances, IPs should make disclosure of facts concerning the pre-pack sale to creditors. Disclosure should include the extent of any marketing, valuations obtained, alternative courses considered, the connection between the purchaser and the seller, and terms of the sale. (See boxout below for further details)

In an unusual step, the government’s insolvency service has issued an announcement that it will use its enforcement powers to clamp down on directors who mis-use the pre-pack

process. It encourages reporting of mis-use of the pre-pack procedure and has set up a hotline to gather complaints.

Are the new regulations sufficient?

The main concern for creditors should be the value of realisations. Many advisers are convinced that pre-packs often maximise realisations. Transparency will, hopefully, encourage IPs to take extra care, but communication will still take place after the sale. The extent of the IP’s duties, however, in structuring the sale are far from clear. Thought should be given to codifying these in a manner similar to the codification of directors’ duties recently undertaken with the Companies Act 2006. In the meantime, it is hoped that the new regulations will be of assistance in encouraging best practice. ■

Statement of Insolvency 16 (E&W)

Pre-packaged sales in administrations

5. Practitioners should be clear about the nature and extent of their role and their relationship with the directors in the pre-appointment period. Where they are instructed to advise the company, they should make it clear that their role is to advise the company and not to advise the directors on their personal position. The directors should be encouraged to take independent advice. This is particularly important if there is a possibility of the directors acquiring an interest in the assets in the pre-packaged sale.
9. The following information should be disclosed to creditors in all cases where there is a pre-packaged sale, as far as the administrator is aware after making appropriate enquiries:
 - the source of the administrator’s initial introduction;
 - the extent of the administrator’s involvement prior to appointment;
 - any marketing activities conducted by the company and/or the administrator;
 - any valuations obtained of the business or the underlying assets;
 - the alternative courses of action that were considered by the administrator, with an explanation of possible financial outcomes;
 - why it was not appropriate to trade the business, and offer it for sale as a going concern, during the administration;
 - details of requests made to potential funders to fund working capital requirements;
 - whether efforts were made to consult with major creditors;
 - the date of the transaction;
 - details of the assets involved and the nature of the transaction;
 - the consideration for the transaction, terms of payment, and any condition of the contract that could materially affect the consideration;
 - if the sale is part of a wider transaction, a description of the other aspects of the transaction;
 - the identity of the purchaser;
 - any connection between the purchaser and the directors, shareholders or secured creditors of the company;
 - the names of any directors, or former directors, of the company who are involved in the management or ownership of the purchaser, or of any other entity into which any of the assets are transferred;
 - whether any directors had given guarantees for amounts due from the company to a prior financier, and whether that financier is financing the new business; and
 - any options, buy-back arrangements or similar conditions attached to the contract of sale.
10. This information should be provided in all cases unless there are exceptional circumstances, and if this is the case, the reason why the information is not provided should be stated. If the sale is to a connected party it is unlikely that considerations of commercial confidentiality would outweigh the need for creditors to be provided with this information.
11. Unless it is impracticable to do so, this information should be provided with the first notification to creditors. In any case where a pre-packaged sale has been undertaken, the administrator should hold the initial creditors’ meeting as soon as possible after his appointment. Where no initial creditors’ meeting is to be held and it is impracticable to provide the information in the first notification to creditors it should be provided in the statement of proposals of the administrator which should be sent as soon as practicable after his appointment.