

INSOLVENCY PRE-PACK SALES - WHAT'S THE PROBLEM?

AN ASSESSMENT OF THE CURRENT AND PROPOSED LEGAL RESTRICTIONS ON THE USE OF PRE-PACK SALES

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, unfair to ordinary creditors or, at least, open to abuse. This controversy has provoked the issue of new guidelines for use of pre-packs to be adopted by R3, the representative body of insolvency practitioners (“IP’s”); a hotline for complaints at the Government’s Insolvency Service; and an investigation into the practice by the Department of Business and Enterprise Regulatory Reforms. 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 his obligations to optimise realisations, would advertise the business or assets for sale, provide serious bidders with a sales pack containing such information as he has 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, the IP could demonstrate to interested parties that, subject to the constraints of his situation, he had done what he 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 wait for an improvement in the market, is unlikely to be an attractive option.

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 that 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 2002 - A FURTHER BOOST FOR PRE-PACKS

Before this Act 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 which 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 (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 who (creditors may feel) created the problem to start with!
- **Value:** A pre-pack sale goes through without an open marketing process (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 additional debts leave even more creditors exposed. On the traditional sale process, as soon as the problems become apparent, an insolvency appointment would be 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 **conflict of interest** (IP’s will be brought in to assist directors of an insolvent company but may then take appointment as office holder and even advise the new business).

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 his strategy for the administration and put this before creditors (within three months under the old regime or eight weeks under the post Enterprise Act regime). Case law under the old regime (*re T and D Industries Plc [2002]*) and under the new regime (*re Transbus [2006]*) 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 HMRC [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 which is known by a name so similar so as to suggest an association with the old company. If he does 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, he sends a notice to all creditors of the old company before he acts a director or adopts the prohibited name.
- “Substantial property transactions” (that is transactions in excess of £100,000, or, if between £5,000 and £100,000, exceed 10% of the company’s current asset value) between a company and its director, or a person or company “connected” with him, 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.

- Phoenix trading may also be taken into account in assessing whether a director ought to be disqualified.

Getting proper value: IP’s duties.

- A receiver has a duty to act in good faith, to take reasonable precautions and exercise due diligence (*re Downsvieview Nominees [1993]*). However, the application of this principle to sales can be unclear. He 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 v RBS [2003]*).

Receivers also have a 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 so 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 recently given (*re Lehman Brothers [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 administrator is not performing his functions as quickly or as efficiently as is reasonable or may allege misfeasance.

Protection of new trade creditors: The wrongful trading provisions of 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 which generates low or nil realisations for unsecured creditors, directors may be exposed to an action of this nature.

THE NEW REGULATIONS

Against this background, R3, the body representing IP's, has issued a new statement of insolvency practice. This directs that:

- IP's should make clear who they are advising in the process, recommend independent advice; and
- in the absence of exceptional circumstances, 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.

In an unusual step, the government's Insolvency Service has issued an announcement that they will look to their enforcement powers to clamp down on directors who mis-use the process. They encourage reporting of mis-use of the pre-pack procedure and have 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 IP's 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 Companies Act 2006. In the meantime, it is hoped that the new regulations will be of assistance in encouraging best practice.

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This briefing offers general guidance on insolvency issues. It reflects the law as at February 2009. The circumstances of each case vary and this note should not be relied upon in place of specific legal advice.

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