



Pre-pack administration

COURT CONSIDERS ITS DISCRETION AND PRE-APPOINTMENT COSTS

A recent court decision confirmed that transparent pre-pack sales can be used where they are in the best interests of the creditors as a whole. The court ruled that:

- the applicant must provide sufficient information on the pre-pack to enable the court to see that the procedure is not being obviously abused to the disadvantage of creditors; and
- the proposed administrator's costs in putting together the pre-pack sale may potentially be treated as an expense of the administration.

In the current economic climate, pre-pack administrations are the focus of much attention. The government's BERR (Department for Business, Enterprise & Regulatory Reform, formerly the DTI) Committee Report on the Insolvency Service published on 6 May 2009 stated that prompt, robust and effective action is needed to ensure that pre-pack administrations are transparent and free from abuse.

The BERR Report noted that a combination of a lack of transparency and potentially reduced returns to unsecured creditors following a pre-pack sale caused particular outrage where the existing management buy back the business and continue to trade, clear of the original debts. To maintain public confidence, the report noted that, where there are good reasons for an insolvency practitioner agreeing to a pre-pack, this must be explained clearly and fully. Where there are no good reasons for entering into a pre-pack this must be exposed before the damage is done.

The BERR Report welcomed the introduction of the new Statement of Insolvency Practice 16 (SIP 16), which aims to increase the transparency of pre-packs.

The recent judgment of the High Court in *Kayley Vending Limited* appears in keeping with concerns reflected in SIP 16 and the recent BERR Report. It is also an endorsement of the pre-pack process when properly implemented. In making an administration order ahead of a pre-pack sale the judge reached several important conclusions:

- in exercising its discretion as to the making of an administration order, the court should be alert to the

risk of abuse of the pre-pack procedure given the apparent blessing that may be conferred by making an administration order;

- the applicant must provide sufficient information to enable the court to judge whether the administration and pre-pack are in the best interests of the creditors as a whole. To the extent that it is known or ascertainable at the date of the administration application, it is likely to be appropriate to supply the information to be sent to creditors in accordance with SIP 16 (see box on page 3) in most cases; and
- the insolvency practitioner's costs of negotiating a pre-pack sale, incurred prior to appointment, could be treated as an expense of the administration where incurring these costs benefits the creditors as a whole more than it does any other party.

This case shows the court being more proactive in the exercise of its discretion, looking behind the proposed administrator's statement at the effect of administration and a proposed pre-pack.

The facts

The company in the *Kayley Vending* case supplied cigarette vending machines to pubs. When it encountered financial difficulties, HM Revenue & Customs applied for a winding-up petition. As a result of the outstanding winding-up petition, the directors were unable to make an out-of-court appointment of an administrator.

The directors and insolvency practitioner negotiated with two potential third party purchasers. They were the principal competitors of the company and, as a result (and given the competitive tension), were likely to pay the most for the assets of the business. The insolvency practitioner's evidence, supported by an asset valuer, was that if the company went into liquidation the machines could not be sold in their current locations and so the business would realise a much lower value. On that evidence the judge concluded that there was a reasonable prospect of achieving a better return for the creditors as a whole through administration and the proposed pre-pack. There was nothing to suggest that the administration order should be refused as a matter of discretion. He therefore made the order sought.

Court required evidence properly to exercise its discretion

Where an application is made to court for an administration order, the court has discretion whether to grant it, even if the application is unopposed. The court must therefore not only be sure that the threshold requirements for administration are met (that the company is, or is likely to become, unable to pay its debts and that there is a reasonable likelihood of achieving the purpose of administration) but also that the making of the order is appropriate. The court therefore needs sufficient information to assess the merits of the proposal.

The Insolvency Rules require the applicant for an administration order to lodge certain evidence, but much of this goes to showing the company's inability to pay its debts. The only information specifically required that demonstrates that the administration has a reasonable likelihood of achieving one of the objectives of administration is a statement by the proposed administrator to that effect.

The rules provide, however, that this statement 'shall contain... any other matters which, in the opinion of those intending to make the application ... will assist the court in deciding whether to make such an order, so far as lying within the knowledge or belief of the applicant' (Rule 2.4(2)(e)). The judge held that the fact that a pre-pack is proposed, and the value it is likely to achieve, would be appropriate information to provide

under this head. The applicant does not have a free hand in deciding whether to provide this information: if he considers it will assist the court in reaching a decision on one of the threshold issues or in the exercise of its general discretion, he must include it (whether the information is favourable or unfavourable to the application).

The exact information to be disclosed will of course depend on the circumstances. The judge felt it likely, however, that the information required by SIP 16, insofar as known or ascertainable at the date of the application, would fall within this requirement. He noted that providing this would not normally be unduly burdensome or costly as the insolvency practitioner would be gathering it in any event.

Costs of pre-pack negotiations treated as an expense of the administration

Expenses of the administration are paid out of asset realisations before any distribution to holders of floating charges or unsecured creditors. An administrator may recover his remuneration as an expense of the administration but this does not extend to costs incurred prior to appointment. The costs of negotiating a pre-pack, therefore, are essentially a matter between the relevant insolvency practitioner and the party instructing them.

The court, on hearing an administration application, has a wide power to make any other order which it thinks appropriate. The judge used this power to order that the proposed administrator's pre-appointment costs be treated as an expense of the administration (following two earlier unreported cases). He did so on the basis that the balance of benefit arising from incurring those costs was in favour of the creditors as a whole rather than other stakeholders. He drew a distinction between this case, where the pre-pack was to an arm's-length purchaser, and a pre-pack to the management, where management might benefit more than the other creditors and such an order might not be justified. Despite its limited application, this decision sets an important precedent as the first reported case of such an order.

The future: not a practice direction – but likely to be influential

These decisions affect only the minority of administrations where appointment is by the court. Most appointments are out of court by the holder of a qualifying floating charge or the company directors. Court appointments are predominantly made where a petition for compulsory winding up of the company is pending, and so an out-of-court appointment by the company or its directors is not permitted, or a formal court order is desirable (for example for ease of overseas recognition). Furthermore, the judge emphasised that whether his conclusions apply to other court applications will turn on the facts and be at the discretion of the judges hearing them. He was conscious that it was not for him to purport to lay down anything that could be construed as being a practice direction.

The judgment sets out the rationale for the judge's decisions in some detail, however, and seems likely to be influential in future court pre-pack administration appointments. The judge hoped 'that these observations [on the supply of information] will be of some assistance to the profession in at least minimising the possibility that applications will be adjourned for the provision of additional information...'. On allowing negotiation costs to be treated as administration expenses he concluded, 'in my judgment it is appropriate that the court should continue to follow this practice'.

In summary, the area of pre-packs is likely to remain controversial. However, this decision is welcome as it confirms that pre-packs are appropriate in certain circumstances. Further, it goes some way to setting out the scope of those circumstances.

In the matter of *Kayley Vending Limited* [2009] EWHC 904 (Ch)

Statement of Insolvency Practice 16 – Pre-packaged sales in administrations

SIP 16 came into force on 1 January 2009. It sets out reminders to and requirements of insolvency practitioners who advise a company prior to administration, or act as administrator, in relation to pre-packs.

Paragraph 8 states: 'it is in the nature of a pre-packaged sale... 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...'

To this end, paragraph 9 sets out a list of 17 pieces of information which, subject to some exceptions, the administrator must disclose to creditors, including information about:

- the terms of the sale;
- marketing activities undertaken;
- alternative courses of action that the administrator considered, with an explanation of what their possible financial outcomes would have been;
- why it was not possible to trade the business and offer it for sale as a going concern during administration; and
- any connection between the purchaser and the directors or others involved in the company.

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