Government Reforms to Pre-pack Sales to a Connected Party in Administration

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Synopsis

Pre-pack sales have always been controversial in some circles. On 8 October 2020, the UK Government published draft regulations on connected party pre-pack sales in administration. With the cold economic headwinds brought about by COVID-19, the need for business rescue tools that are fair, transparent and value-preserving has become ever more pressing. In this article, we discuss the legislative proposals that have been tabled regarding pre-packs, and our thoughts on how the new regulations will work in practice. In summary, we consider the proposals to be broadly sensible and proportionate, striking a reasonable balance between creditor protection and the need for an efficient and effective corporate rescue tool.

UK pre-pack administrations

'Pre-pack' is not a term defined in the administration provisions of the Insolvency Act 1986 ('IA 86'). It was developed by practice. As a working definition, a pre-pack administration is where:

(i) a company goes into administration;

(ii) most or all of the assets of that company (typically the business or shares in a company holding a group's business) are sold by the administrator as soon as the company enters administration, or immediately thereafter (i.e. a Day 1 sale); and

(iii) the terms of that sale were negotiated and agreed *before* the company entered administration.

Pre-pack sales, in particular to a connected party (e.g. an existing manager or shareholder), have over the years attracted a fair bit of criticism. While secured creditors are typically engaged in the run up to the pre-pack sale as their cooperation is necessary for the release of security, unsecured creditors are often left in the dark. The first they hear is that the company has gone into administration. Unknown to them, in the majority of complained about cases, the directors or shareholders have bought the business back and are trading on with unsecured debts left behind – typically recovering only a small dividend (if any). These concerns more often arise in the SME market rather than among companies with larger capital structures, primarily due to the greater likelihood of less creditor oversight and participation in the negotiation process for SMEs.

The Graham Review

These concerns about pre-packs have been voiced for many years. As a result, in 2013 the Government commissioned Professor Theresa Graham to conduct a review into pre-packs and to consider potential regulation. In 2014, the Graham Review concluded that pre-pack administrations were a useful tool for struggling businesses, however there were clear concerns around the transparency of the process, particularly for unsecured creditors. A separate concern identified that pre-packs allow fundamentally unviable businesses to return to the marketplace after a pre-pack, free of existing company debts, only to see them fail again.

The Graham Review recommended several voluntary measures to address these concerns, including:

(a) the creation of a group of experienced professionals who could be consulted in advance on the appropriateness of a proposed pre-pack sale, known as 'the Pre-pack Pool';

(b) six principles of good marketing to be complied with and reported on in the SIP16 report sent to the creditors by the administrators after the pre-pack sale, including a broad outreach to potential purchasers and the use of appropriate media in the marketing process; and

(c) an option for a connected party purchaser to conduct a 'viability review' on the new company's survival prospects for the 12 months following the administration purchase.

In case these voluntary measures proved ineffective, the IA 86 was also amended to give the Government legislative power to regulate pre-pack sales to connected parties. This power to legislate was subject to a sunset provision that saw it expire at the end of May 2020. There was no such legislation by May 2020 and the power expired. However, the Corporate Insolvency and Governance Act 2020 has revived the power until June 2021.

Legislative proposals

The Government has now concluded that concerns remain around pre-pack administrations to connected parties. It noted that, while there had been some improvements to the marketing of pre-packs, there was low use of the Pre-pack Pool and continued concerns around transactions under market value. According to the Pre-pack Pool's Annual Review for 2019, only 21 out of 260 connected party pre-packs were referred to the Pool for assessment. At a referral rate of just 8%, this was the lowest since the Pool's inception in November 2015.

In response, the Government has detailed its draft regulations. Where an administrator wishes to dispose of all or a substantial part of a company's assets within the first eight weeks of the administration to one or more connected persons, the administrator may only do so with either (i) creditor approval, or (ii) an independent written opinion by an 'evaluator' commissioned by the connected party purchaser.

The written opinion should include:

(a) a statement as to whether the evaluator is or is not 'satisfied that the consideration to be provided for the relevant property and the grounds for the substantial disposal are reasonable in the circumstances';

(b) the evaluator's reasons for coming to their opinion;

(c) the consideration that will be paid; and

(d) the identity of the connected person and their connection to the company.

There is no requirement for the evaluator to be an insolvency practitioner. However, the evaluator must not be the administrator or one of their associates, nor may they be connected to the company or the connected party purchaser(s) themselves. They cannot be any individual who has provided insolvency or restructuring advice to the company in the 12 months preceding the report, thereby excluding any incumbent financial adviser. In order to be qualified to make the report, the evaluator must believe that they have the requisite knowledge and experience to do so.

Where an opinion does not recommend the disposal, an administrator can still choose to proceed with the sale regardless, but they must provide a statement setting out their reasons for doing so.

Tracking through the draft regulations and the related legislation, it is the unsecured creditors who will need to give their consent to the transaction. The draft regulations state that creditor consent must be obtained in accordance with the procedure set out in paragraph 51 Schedule B1 IA 86. This consent mechanism is further governed by rule 15.4 of the Insolvency (England and Wales) Rules 2016, which rules that any wholly secured debt has nil value for voting purposes. In practice, it is unlikely that companies would go down the route of seeking creditor approval given time constraints.

Also, the adverse publicity that might bring down the business during the consent solicitation process would undermine the point of most pre-packs. If an independent opinion is obtained, after the sale, that opinion will be made available to the creditors and a copy will need to be filed at Companies House, although commercially sensitive information can be redacted.

Commentary

It is reassuring to see that the Government recognises pre-packs can be a value-preserving rescue tool for businesses, noting in its report that 29% of administrations happen in this way. For sales to unconnected persons, nothing will change from these Government proposals. For sales to connected persons, it is also encouraging that the Government has not imposed a blanket ban on such sales.

Unlike in US Chapter 11s, the idea of a trading administration has not taken off in the United Kingdom in the way that some had hoped. Accordingly, when a company enters administration, there is a real risk of value destruction as suppliers and customers lose confidence in the company and employees look to leave. This has been somewhat softened by the so-called 'light touch administrations' as for Debenhams, but that is comparatively novel and remains the exception not the rule. Accordingly, pre-packs remain a valuable and important tool to transfer the business swiftly to a stronger recapitalised structure, without the downsides and value destruction of a drawn-out administration.

While the introduction of a new moratorium and the *ipso facto* provisions in the Corporate Insolvency and Governance Act 2020 are a positive step to promote rescue culture, market attitude will take time to change. In the meantime, pre-packs continue to be important. In light of this, the proposed regulations seem like a reasonable balance between addressing the concerns surrounding transparency and valuation for pre-packs to connected persons, and not unnecessarily removing a valuable business rescue tool.

The proposed legislation does not give extensive guidance as to who would be an appropriate evaluator. The only criteria are that they must be independent and believe they have the requisite knowledge and experience to provide the report. However, it is apparent that there are considerable overlaps between the functions of an independent evaluator and the Pre-pack Pool.

As the directors of the Pre-pack Pool have openly acknowledged in their 2019 Annual Review, the Pool is unlikely to survive in its current form given its low utilisation. However, the professionals sitting in the Pre-pack Pool may be sensible candidates for the role of evaluator under the proposed regulations. It remains to be seen how this will evolve.

An administrator is not bound to accept the evaluator's opinion. However, it is difficult to see how, as an officer of the court, an administrator could be comfortable effecting a pre-pack sale in the face of a negative opinion. After all, to act in the best interests of creditors as a whole, the administrator needs to be satisfied that the terms of the pre-pack are likely to be the best possible in the circumstances. Failing that, the administrator is exposed to potential claims for misfeasance or causing harm to the interests of the creditors, and might see the appointment terminated with the administrator's ability and conduct called into question.

Finally, the treatment of certain secured creditors also remains to be clarified. The Graham Report devised its own definition of 'connected party' and had deliberately excluded from the definition secured lenders who, as part of their normal business activities, have voting rights over one third or more of the shares in the insolvent and the new company. The purpose of this carve-out from the statutory definition under s. 249 and s. 435 IA 86 is to avoid tripping up restructurings of larger companies, where a lender may have voting rights associated with their debt.

Although a footnote to the Government's statement on the proposed regulations suggests that they have the same carve-out in mind when they speak about 'connected party', that intention has not been reflected in the published draft regulations themselves. It is hoped that this will be addressed in the long-form legislation, making it clear that a pre-pack sale to such lenders falls outside the ambit of the regulations.

As a general note, while the concept of 'connected party' has been long-standing in insolvency law, it is complex and can catch parties who might not ordinarily be considered to be connected to the company. A further complication is that the draft regulations separately define 'connected' and 'connected persons'. When it comes to the independence of an evaluator, the word 'connected' has the meaning given to it in s. 249 IA 86. In this sense, a person is connected with a company if he is (a) a director or shadow director of the company or an associate of such director or shadow director; or (b) an associate of the company. When the regulations refer to 'connected persons', it draws on the definition in paragraph 60(A)(3) of Schedule B1 IA 86. That definition encompasses (a) a relevant person in relation to the company; or (b) a company connected with the company. IA 86 further defines both 'relevant person' and 'associate' but, notably, the paragraph 60 definition does not include employee associates. Given this somewhat labyrinthine mechanism, potential purchasers in a pre-pack should conduct a thorough analysis of its association with the company, to avoid falling foul of the rules inadvertently.

Conclusion

It is reassuring that the Government is introducing a legislative framework that supports pre-pack sales without imposing any additional burdens on pre-pack sales to unconnected persons – while also placing additional scrutiny on those made to connected parties where there have been more concerns. There is nothing inherently problematic with a connected party pre-pack sale when done on an arm's-length basis. In fact, connected parties are sometimes in the best place to appreciate the value in the business, given their familiarity with its operations. Therefore, so long as they pay the right price, a pre-pack to a connected person may be the best outcome for creditors. Lastly, regarding timing, it is unclear when the regulations will be made in light of a packed parliamentary schedule (not least with Brexit and COVID-19), so watch this space.