A quick-fix solution in volatile times

Insolvency The final article discusses the concept of pre-packs as an alternative form of administration. By *Simon Hartley* and *Devi Shah*

Recent events have shown that even organisations that have previously been seen as excellent covenants may find themselves in an insolvency procedure.

Although commentators have drawn comparisons with the recession of the 1990s, numerous developments have taken place in company insolvency procedures since then. These changes include the growing number of distressed companies entering administration and the use of pre-packaged business sales, or "pre-packs".

Differences in approach

Landlords may be familiar with the formal insolvency procedures, but not with pre-packs. They are not referred to in insolvency legislation because they constitute a practice, not a legal structure.

Insolvency legislation requires administrators to prepare a proposal stating how they will achieve the administration's aims. Where this may include a sale of the business, it envisages that the company will trade under the protection of a moratorium while the business is marketed. The administrator sends the proposal to creditors within eight weeks of his or her appointment. The creditors then vote on this within 10 weeks of receipt. In practice, however, preserving the value of the business during this period may prove difficult because the company is likely to lose customers and employees and its goodwill may be irreparably damaged.

With a pre-pack, a purchaser is lined up in advance of the administration and the sale can follow immediately upon the administrator's appointment. *Re Transbus International Ltd (in liquidation)* [2004] EWHC 932 (Ch); [2004] 1 WLR 2654 decided that administrators can complete business sales without the sanction of a creditors' meeting or a direction from the court. As with other administrations, the company's unwanted debts, including its leasehold liabilities, may be left behind.

Pre-packs enable a debt-free sale of a business to its existing owners or management. They may continue to operate it as they did before the insolvency, albeit under a different trading name. This has generated criticism because of similarities to "phoenix trading", namely the use of a failed company's name (or similar) by a director who is also a director of the successor in order to acquire goodwill. Phoenix trading confuses creditors, who are left to prove, or cannot recover, debts owed by the failed entity.

Research by the University of Nottingham (*Report on Insolvency Outcomes* 2006) suggests that sales to connected parties are increasing but do not represent a significantly higher percentage of pre-packs than they do of business sales generally. Such sales may be appropriate if, for example, the management is crucial to the business, represents the only buyer in the market or is prepared to pay a fair price in the circumstances. The key issue is often whether the market was properly explored.

Some argue that pre-packs lead administrators to breach their statutory duties or place them in situations in which their duties conflict. However, administrators must be satisfied that the company's rescue is not feasible and the pre-pack will produce the best result for the creditors. Advice from specialist valuers is important in this regard.

Creditors' rights

Although most administrators give reasons for choosing a pre-pack, and provide details of marketing attempts, a perceived lack of transparency imperils the strategy's integrity. This led the Insolvency Service to propose amendments to the Insolvency Rules 1986, with the aim of addressing communication failures. It would allow

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Pre-packs compared

Differences between traditional administration and pre-packs

	Administration	Pre-packs	Liquidation
Objectives	Survival of the company, and the whole or part of its undertaking, as a going concern, or a more advantageous realisation than on a liquidation	In taking the pre-pack option administrators effectively decide the company cannot survive as a going concern and realise the value of the business immediately	Realisation and distribution of the company's assets but not on a going concern basis
Statutory basis	Part II of IA 1986	No separate legal regime	Part IV of IA 1986
Moratorium	Yes, from administration order or filing of the notice of appointment	Yes, but not during the pre-appointment negotiation of the sale	No
Marketing of company assets	Administrator markets the business post appointment in order to obtain the best deal. Legislation envisages any sale being put to the vote at a creditors' meeting	Terms of the business sale are concluded prior to appointment. Administrator may have to rely upon a sale process conducted by those benefiting from the pre-pack. Unsecured creditors may not be aware of the sale	Realisation of remaining assets post appointment, usually with the assistance of valuation and disposal experts
Power to disclaim onerous contracts	No	No	Yes
Exit process	Company voluntary arrangement, compromise, liquidation or dissolution	Liquidation or dissolution	Dissolution

Source: Aggregated from a number of sources, including the Insolvency Act 1986

Note: Since liquidators are often appointed after administration, this process is included

pre-appointment costs to be recovered as administration expenses. Since 25% in value of a company's creditors will be able to challenge fees as being excessive, administrators will have an incentive to explain their actions.

Secured creditors will no doubt have been consulted on the sale and asked to release their charges over the company's assets. Indemnities from secured creditors in respect of a proposed administrator's pre-appointment fees and expenses may cause concern among unsecured creditors that the administrator will act in the secured creditors' interests post-appointment. The proposals may address this issue, but do not require disclosure of connections between the company and its purchaser.

Landlords are able to exercise various rights at a creditors' meeting in their capacity as creditors. These include the replacement of the administrator, the rejection of the proposals or the establishment of a creditors' committee to oversee the activities of the administrator.

Unsecured creditors may feel disenfranchised because they were unable to participate in decision making prior to the sale of the business. As a result, they may want to challenge the pre-pack, and can do so on the basis of procedural irregularity, or by establishing serious and unfair prejudice arising from their treatment compared with that of the other classes of creditor.

The propriety of each pre-pack will depend upon its facts. If one of the grounds is established, the court has the power to undo the administrator's actions and/or discharge the administration.

Challenge to pre-packs

A challenge along these lines was attempted in *Re DKLL Solicitors* v *Commissioners of Revenue & Customs* [2007] EWHC 2067 (Ch); [2008] 1 BCLC 112.

The partners of an insolvent firm applied for an administration order, having arranged for the proposed administrator to sell the business on appointment. HM Revenue & Customs was the major creditor and opposed the administration; it had already presented a winding-up petition. The court held that it could authorise an administrator's proposals, despite the majority creditor's opposition, if it believed that the administration was reasonably likely to achieve the statutory objectives. The administration application was approved.

A better realisation of a company's assets than that arising on a winding up is sufficient grounds for an administration order. The court heard evidence from an experienced insolvency practitioner that the firm's pre-pack arrangements would generate significantly more income than could be raised from liquidation. Reliance was placed upon the expertise and experience of "impartial insolvency practitioners". Unsecured creditors sometimes express concern because proponents of pre-packs have been known to hand-pick the proposed administrator. Nevertheless, the courts appear reluctant to question an administrator's judgment, and clear evidence will be needed to counter an assertion that an administration's objectives can be achieved.

There is some question as to whether preserving employment is a proper objective. The judge considered it appropriate to take into account not only the interests of creditors but also the fact that the pre-pack was likely to save jobs and minimise disruption to the firm's clients. Nottingham's research suggests that pre-packs preserve more jobs, but job preservation is not included in administration's statutory objectives.

Active participation

Following *Re DKLL Solicitors*, challenging pre-packs remains an option, but it may not be the best option for landlords. It is no substitute for active portfolio management, staying alert to arrears and monitoring the financial situation of tenants. Business sales are sometimes completed before landlords are aware of any problem.

If issues are identified sufficiently early, dialogue can be entered into with the management (which may control the business following a future pre-pack), leading to the renegotiation of leases, the taking of rent security deposits or managed exits. The more important the premises of the business being sold, the more leverage landlords will have. Landlords should move quickly to obtain advice, not only to avoid the loss of rights of challenge, but to discuss tactics. The key to reducing the risks to landlords associated with practices such as pre-packs is an active and expeditious participation in the process.

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