

Teresa Graham report on pre-packed administration sales – impact on the industry

A review of pre-pack administrations by Teresa Graham, commissioned by the Government, was released on Monday 16 June 2014.

The report has largely been well received and trade bodies have been largely complimentary of Graham's recommendations, with the president of R3 stating that the recommendations are "innovative, measured, and worth exploring".

One of the report's criticisms of the current pre-pack regime is that there is no legal requirement for an insolvency practitioner to look at the future viability of the new business that emerges from a pre-pack sale, with an insolvency practitioner's only responsibility being to the creditors of the "old business". The report suggests that more can be done to demonstrate the potential viability of the new business/company emerging from a pre-pack. It may be that turnaround professionals are well placed to fill this void.

What is a pre-pack?

Pre-packing is the practice of arranging the sale of all or part of a company's business and undertaking before formal insolvency is entered, with the sale to be executed at or soon after the appointment of an administrator. As a general rule, unsecured creditors of the company are usually unaware of the sale until the deal is concluded.

The Graham report was commissioned by the Secretary of State for Business Innovation and Skills, Vince Cable. Pre-packs have long since been the focus of negative attention from industry regulators and also from creditors of insolvent companies, who can be somewhat disillusioned by the pre-pack process.

One of the main criticisms of pre-pack sales is the lack of transparency that accompanies them. Whilst any insolvency professional will tell you that secrecy is often a necessary part of a pre-pack administration sale, in order to secure the ongoing viability of the business without risking employee, creditor and customer confidence, the report concludes that more can be done to improve the process.

The Report

The positives....

The report makes several positive observations about pre-packs, including the following:

- by preserving employment, there is a reduces risk of preferential and unsecured creditor claims against the insolvent company (which benefits the general body of creditors);
- they are cheaper than other upstream procedures, such as schemes of arrangement, as they are outside the court process with no involvement (o limited involvement) from unsecured creditors; and
- they are demonstrative of the flexible nature of restructuring, insolvency and company law in the UK, which in itself is attractive to overseas companies and therefore beneficial to the economy.

The negatives....

The report highlights the following criticism of pre-packs:

- the lack of transparency disenfranchises creditors, particularly where the purchase is being made by a connected party;
- insufficient marketing is done to maximise the return to creditors;
- explanation of the valuation methodology for pre-pack sales needs to be improved (the report highlights the fact that the valuation attached to a business is often exactly the same final purchase price); and

- there is a lack of consideration of the viability of the new company and there is no legal requirement for insolvency practitioner to examine this as part of the pre-pack sale process. The ongoing viability of a business is obviously a concern to ongoing suppliers, as well as new ones.

The Graham report recognises that pre-packs are a useful tool and has dismissed any ban on pre-pack administration sales as being counterproductive.

The report makes six key recommendations with a view to providing better regulation, consistency and transparency.

An executive summary of Graham's six key recommendations are contained in section 4 of the report as follows:

Key recommendation 1

Pre-pack pool. On a voluntary basis, connected parties approach a "pre-pack pool" before the sale and disclose details of the deal, for the pool member to opine on.

Key recommendation 2

Viability Review on a voluntary basis, the connected party completes a "viability review" on a new company.

Recommendation 3

SIP 16 – the Joint Insolvency Committee considers, at the earliest opportunity, the redrafted SIP 16 in annex A.

Recommendation 4

Marketing – that all marketing of business that pre-pack comply with six principles of good marketing and that any deviation from these principles be brought to creditors' attention.

Recommendation 5

Valuations – SIP16 to be amended to the effect that valuations must be carried out by a valuer who holds professional indemnity insurance.

Recommendation 6

SIP16 – that the Insolvency Service withdraws from monitoring SIP16 statements and that monitoring be picked up by the Recognised Professional Bodies.

Key recommendations 1 and 2 relate to pre-pack sales to connected party purchasers.

Pre-pack Pool

Graham's report recommends the creation of an independent pool of experienced business people to scrutinise connected party pre-pack deals. It is envisaged that a member of the pool will spend no longer than half a day reviewing a specific pre-pack proposal. The report suggests the following:

1. Pool membership will be experienced business persons who have been selected from a wide range of industries and disciplines and potentially nominated by organisations such as the CBI.
2. A small secretariat should be established to administer the pool and cases will be allocated on a strict rotation basis.

3. Negative statements from the pool will not prevent a pre-pack going ahead, however the negative statement would need to be disclosed in a SIP16 statement.
4. Connected party purchasers would approach the pre-pack pool in advance of the pre-pack (on a voluntary basis), disclosing details of the proposed deal to enable the pool member to offer an opinion on the proposals for a fee. The fee would be paid by the connected party purchaser.
5. The pre-pack pool process will be low cost. The fee would be paid upfront by the connected party purchaser, which would fund the administrative costs associated with maintaining the pre-pack pool, as well as funding the cost of the specific review.

Naturally, with the speed upon which pre-pack sales are generally proposed and concluded, we have to ask ourselves:

- Who is best placed to make up the pool?
- Will the pool be set up on a regional or national basis?
- Who would be responsible for creating the pool and/or assessing if the proposed pool members are sufficiently experienced to act?
- What criteria will be applied to a pool member's review, i.e. what will be the key considerations of the pool in order to 'sign off' on a proposed pre-pack sale?
- Pre-packs invariably move fast and, in lieu of a permanent dedicated pool, how would the pool member be engaged at short notice?
- Would half a day be sufficient time for a pool member to fully get to grips with the workings of a particular business?

Whilst Graham's report envisages a "slick and fast" process, it dismisses the idea that it "has to happen on a Friday and go live on Monday". The report suggests that the pool would essentially serve as a check that sufficient work has been carried out by connected parties to justify a new company's existence.

Whilst the report suggests that pool members will not undertake an audit of the business of a company, it is not currently clear on the level of information that will need to be disclosed to the panel in order to consider the proposed pre-pack sale.

It is also difficult to see how anything short of a full time dedicated pre-pack pool would work in practice. Engaging a member from the pool who can afford to set aside half a day to consider a pre-pack proposal at short notice could potentially prove problematic and may lead to undesirable delays.

Any pool would be best served by knowledgeable and experienced practitioners, with a working knowledge of the insolvency process, who could offer a practical and measured view when considering any pre-pack proposal. I am of the view that business turnaround professionals would be ideally placed to perform these reviews.

In addition, as an approach to the pool would be entirely voluntary, it is difficult to assess whether any such arrangement would be widely utilised.

Viability Report

The Report recommends an arrangement whereby, again on a purely voluntary basis, a connected party purchaser would draw up 'viability review' statement on the proposed new company, detailing how the company will survive for a period of at least 12 months. The report suggests the following:

1. The statement would be drawn up by the connected party prior to the administration.
2. The statement would be attached to the SIP16 statement sent to all creditors by the administrator within 7 days of sale.

3. The administrator will not be expected to comment or express an opinion on the viability review. If the purchaser chooses not to complete a viability review, the administrator must state that they have asked the purchaser for the review but that it had not been completed.
4. In the event that the new company fails, the statement would be made available to the new company's insolvency office-holder to consider when determining whether recovery action could be taken against the director.
5. There would be no prescribed form to the statement but proposed form wording has been provided.

Again, the voluntary nature of this proposal makes it difficult to assess what the likely level of uptake would be by connected party purchasers, however Graham states within her report "I hope that the market will come to expect the review's completion in connected party pre-packs, thereby ensuring a meaningful take-up of the proposal."