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Insolvency: Pre-packed and ready to go

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The UK's pre-pack process has come in for much criticism – but is it really that bad?

The current financial storm may well be the gravest worldwide recession ever seen. High-profile administrations have catapulted the UK's insolvency processes into the spotlight, with the reforms introduced by the Enterprise Act in 2003 facing intense public scrutiny.

Allegations abound that our processes are 'not fit for purpose' with others lamenting our lack of a Chapter 11-style rescue process. Worse still, dishonest directors are said to be gleefully ditching companies (and their associated debts) and selling assets to their latest shell company. Cries of 'revolving door' administrations and how 'debt dodgers revel in return of the phoenix' circulate in the press.

Background

Administrators must provide a statement of proposals to creditors within 10 weeks of appointment. This sets out what they propose to do with the company and its assets. However; in a pre-pack administration, the business and assets are sold in advance. At the meeting the sale is presented to the creditors as a fait accompli.

Sales prior to the first meeting are not new – the practice was around before the 2003 reforms. So long as they considered it to be in the best interests of the company and its creditors, administrators could take immediate steps to sell assets – before the meeting and without reference to the court. The practice was affirmed more recently by decisions in Transbus and DKLL Solicitors.

The pre-pack process

Waiting until the first creditors' meeting before looking to dispose of the business may not be practical: the company might lose both customers and employees over the intervening period. Goodwill – and therefore value – will suffer.

A pre-pack sale aims to dispose of a business smoothly, keeping employees in place and preserving value. Generally, an insolvency practitioner will work with directors

prior to the administration. The business and assets will be valued and marketed. Commonly this is undertaken in secrecy with a view to a quick sale on or soon after appointment. The result: jobs are saved and there is a better return for the company's creditors.

Yet the perceived lack of transparency and the 'done deal' approach leaves unsecured creditors feeling disenfranchised. Was the business marketed correctly? Was the best price really achieved?

Statement of Insolvency Practice (SIP) 16

SIP 16 is a statement of best practice for licensed insolvency practitioners (IPs). Released on 1 January, 2009, it sets out basic principles and standards of behaviour. Failure to comply may lead to disciplinary action.

The SIP focuses on transparency and disclosure: IPs must maintain records so they can demonstrate that they have considered duties and obligations owed to creditors in the pre-appointment period as well as explain and justify why a pre-packaged sale was undertaken. Detailed information must be disclosed, including:

- the source of the administrator's introduction;
- the extent of involvement pre-appointment;
- marketing activities conducted;
- valuations obtained;
- alternative courses considered;
- why it was not appropriate to sell later on in the administration;
- assets involved in the sale; and
- the identity of the purchaser (including any connection with the directors, shareholders or secured creditors of the company).

The Insolvency Service has set up an enforcement hotline and related email address to monitor conduct.

Is transparency the real issue?

Much of the criticism arising in respect of pre-packs stems from a perceived lack of transparency. It is hoped that SIP 16 will go some way to address this.

However, some critics fail to identify the real issues. Pre-packs are not supposed to provide a lifeline to companies – in fact the very opposite – companies shed their key assets and retain liabilities. The key issue is whether it has achieved the best price for its assets. If a pre-pack sale realises this, so be it.

Do we need Chapter 11?

Although the primary purpose to be considered by our administrators is the rescue of the company as a going concern, in practice this rarely happens. Generally – and

in contrast to the position in the US under Chapter 11 – it is the business which tends to be preserved while the company finishes in liquidation.

As such, the Chapter 11 process is a more debtor-friendly system: a company does not have to be insolvent to file for protection. It affords a breathing space – companies enjoy protection from trade suppliers who are unable to withdraw credit.

Any insolvency regime needs to strike a balancing act between protecting and rescuing a debtor on the one hand and maximising returns for creditors on the other.

Despite recent bad press, statistics from the World Bank suggest our system serves creditors well. In terms of sums recovered in insolvencies, the UK comes 10th out of 127 countries (ahead of the US, Germany, France and Italy). Our processes are also among the quickest (9th out of 175). While pre-pack administrations might not rescue companies, they certainly preserve jobs and keep businesses going.

Undoubtedly our system is undergoing a significant test. However, prudence would suggest that now – in the midst of the crisis – is not a sensible time to implement fundamental changes.

It remains to be seen how SIP 16 will perform. At the very least, with increased transparency and additional information at their disposal, creditors will be better placed to assess what happened in the period leading up to the pre-pack. Issues requiring closer scrutiny may then be addressed: paragraph 74 of Schedule B1 of the Insolvency Act entitles a creditor to apply to the court where an administrator has unfairly harmed their interests; paragraph 75 deals with administrators' misapplication of company property or breaches of duty and misfeasance. Administrators may be ordered to repay, restore or account for money or even to contribute to the company's property.

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