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PRE-PACK ADMINISTRATION: NEW REGULATIONS PROMISE GREATER SCRUTINY BUT WILL THE TRUE COST BE BUSINESS RESCUE?

On 8 October the Insolvency Service published a report on pre-pack sales in administrations, together with draft regulations imposing a mandatory referral to independent scrutiny in the case of pre-packaged sales to connected parties. This article considers the background to the proposed regulations, their content and their potential impact.

BACKGROUND

Pre-packaged administration sales are an effective but controversial component of the business rescue toolkit. In a pre-pack, a sale of the whole, or a substantial part of, the business of a company is negotiated and agreed prior to the appointment of an administrator. The sale will then be completed by the administrator immediately, or very shortly, after Pre-packs can be a cost-effective means of saving viable businesses and protecting jobs. However, as has been well publicised, they have also been subject to widespread criticism and mistrust. Particular concerns surround pre-packs with connected parties, which enable directors or shareholders to continue operating the same business through a new corporate vehicle, free of the liabilities of the original insolvent company.

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THE PRE-PACK POOL

Voluntary measures to address creditors' concerns around pre-packs were adopted in 2015, following the publication of the Graham Review. A key recommendation of this independent review was the creation of the "pre-pack pool" (the Pool). The Pool is an independent body whose members, all experienced business people, will offer an opinion on the purchase of a business or its assets by a connected party in the circumstances of a pre-pack sale.

Referrals to the Pool are voluntary and are made by the purchaser of the business, not the insolvency practitioner. After reviewing the documentation provided, the Pool member will issue one of three opinions:

- That there is nothing found to suggest that the grounds for the proposed sale are unreasonable.
- That evidence provided has been limited in some areas, but otherwise nothing has been found to suggest that the grounds for the proposed sale are unreasonable.
- That there is a lack of evidence to support a statement that the grounds for the proposed sale are reasonable.

The Pool member will not give reasons for their opinion. A negative opinion from the Pool would not prevent a deal going ahead - however, the administrator would have to disclose the opinion in their statement to creditors (post-sale) and give clear reasons as to why it was appropriate to go ahead.

EFFECTIVENESS OF THE VOLUNTARY REGIME

The Insolvency Service has conducted a review into the effectiveness of the voluntary measures relating to pre-packs, the findings of which it published in its report on 8 October (the Report). The value of pre-packs is recognised – as the Report states: "In some cases, a pre-pack deal may be the only option available for the company and a lifeline for employees and the survival of the business." However, concerns remain about whether they are always in the best interests of creditors.

The most striking finding in the Report is the very limited adoption of referrals to the Pool. The proportion of connected party pre-packs referred to the Pool declined from 22% in 2016 to a mere 7% in 2018 and 9% in 2019. Nonetheless, it was generally considered that where the Pool was utilised it functioned well, and the Pool's decision was considered valuable by some creditor groups.

The most common reason given for referrals not being made to the Pool was simply that the purchaser saw no benefit in making a referral. Cost was also mentioned as a factor by a number of respondents – perhaps not just the cost of the Pool opinion itself (£950 + VAT), but rather the professional time and costs involved in assembling all the necessary documents and evidence to present to the Pool.

Overall, the Report concludes that the voluntary measures do not appear to have significantly influenced the behaviour of purchasers or offered the level of transparency and reassurance to creditors which was envisaged. Therefore, although the government does not propose to ban connected party pre-packs, regulations are to be introduced to address the perceived failings of the voluntary regime and provide stakeholders with reassurance that a pre-pack sale is appropriate in the circumstances.

THE PROPOSED REGULATIONS

The proposed regulations (the Regulations) require an independent opinion to be obtained on a pre-pack sale in administration to a connected person. The government has chosen not to mandate a referral to the Pool, although this was suggested by a number of the stakeholders consulted during the review process.

The Regulations lay out the following framework for independent scrutiny:

- An administrator may not make a sale of all or a substantial part of a company's business to a connected party within the first eight weeks of the administration without either the approval of the company's creditors or an independent written opinion.
- The written opinion is to be obtained by the connected party purchaser and provided by them to the administrator. The purchaser may obtain more than one opinion.
- The opinion is to be provided by an "evaluator" who has the requisite knowledge and experience to provide the report and is independent of the connected party purchaser, the company and the administrator.
- The evaluator will provide a written report giving their opinion. The opinion may be either a "case made opinion" – stating that the evaluator is satisfied that the consideration to be provided and the grounds for the disposal are reasonable in the circumstances – or a "case not made opinion" – stating that the evaluator is not satisfied as to the above.
- In either case the evaluator is required to include their reasons for making this statement and a summary of the evidence relied upon.
- The administrator must consider the report, and although a "case not made opinion" does not prevent the administrator from proceeding with the sale, the administrator must provide a statement to creditors setting out the reasons for doing so.

- A copy of the report(s) must be sent to creditors of the company and to Companies House.

The Regulations are to be laid before Parliament before June 2021. The government proposes to work with industry and professional bodies to prepare guidance to accompany the Regulations, and to ensure that SIP 16 is compatible with them.

Tim Carter, Co-Head of restructuring and insolvency at Stevens & Bolton, comments that: "While unsecured creditors may welcome the increased clarity and independent oversight of pre-packs, it will remain to be seen how this will work in practice. A number of questions spring immediately to mind: Will the Pool be mothballed, or will it become the effective source of independent reports for purchasers, given the structure already set up and the expertise in place? Will purchasers "shop around" for favourable reports? This seems unlikely in all except the largest and most high-profile of cases, as the costs of this would be prohibitive.

It goes without saying that the requirement to obtain an independent report will add to the costs and timeline for a pre-pack, which may be unpopular with purchasers. The contents of this proposed independent report also go further than the current Pool reports, as the evaluator is required to give reasons for their opinion.

However, the insolvency profession will generally be pleased that the government does not propose to go as far as banning connected sales; and we await with interest the promised guidance - set to accompany the Regulations – which it is hoped will give more colour on how they are to operate in practice. Whilst the desired transparency no doubt will be welcome, it is equally hoped that in reality this does not prove to be at the expense of business rescue."

KEY CONTACTS

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