Linklaters

May 2011

A guide to “Pre-Pack” sales.

1 What is a “Pre-Pack” sale?

A “Pre-Pack” is not a special type of insolvency procedure and no reference is made to “Pre-Pack” sales in English insolvency legislation. It is simply a term used to describe:

> a sale of the business or assets of an insolvent company (which could include the sale of shares in its subsidiaries);

> by an insolvency officeholder (typically an administrator);

> where the preparatory work (identifying the purchaser and negotiating the terms of the sale) takes place **before** the appointment of the insolvency officeholder; and

> the sale is then concluded almost immediately after the appointment of the insolvency officeholder **without** the sanction of either the court or creditors, and often with limited formal marketing of the business or assets being sold.

It is the fact that the preparatory work takes place before the appointment of the insolvency officeholder which distinguishes a “Pre-Pack” from any other sale by an insolvency officeholder. It is the rapid conclusion of the sale, the absence of court or unsecured creditor involvement and the fact that many “Pre-Pack” sales are to the insolvent company’s previous shareholders or directors, which have together generated much of the current debate surrounding “Pre-Packs”.

Although concerns regarding the use of “Pre-Packs” have been expressed, research relied on by the UK Government has shown that, in over 80% of “Pre-Pack” sales, returns to unsecured creditors, while low, were nevertheless marginally better than returns to unsecured creditors in non “Pre-Pack” sales.

2 When would a “Pre-Pack” sale process be used?

There are three main commercial reasons for considering a “Pre-Pack” sale:

> **Lack of liquidity**: If there is insufficient funding available for the company to continue trading while looking for alternative potential purchasers, an administrator may have no real choice but to pursue an immediate “Pre-Pack” sale strategy. This often results in a sale to the

Contents

1 What is a “Pre-Pack” sale? ... 1
2 When would a “Pre-Pack” sale process be used? ... 1
3 How common are “Pre-Pack” sales? ... 2
4 A typical “Pre-Pack” sale process ... 2
5 How long does a “Pre-Pack” sale process take? ... 4
6 Potential purchasers in a “Pre-Pack” sale ... 4
7 Why can “Pre-Pack” sales be controversial? ... 5
8 Improving the image of “Pre-packs” – SIP 16 ... 5
9 Potential liability for the administrator in relation to a “Pre-Pack” sale ... 6
10 One final point – terminology ... 6

company's existing shareholders, directors or secured creditors, as they are normally best placed to act quickly, not needing to conduct an extensive, and time-consuming, due diligence exercise.

> **Preserving the value of the business**: If administration has become inevitable, a rapid "Pre-Pack" sale may be necessary in order to limit the potentially detrimental impact of an insolvency procedure on a business, allowing the sale to be completed before suppliers, customers and employees become aware that the company has gone into administration. This scenario is most likely to arise where a business relies on skilled staff who might be tempted to seek employment elsewhere amid the uncertainty surrounding any formal insolvency process.

> **Transferring control of the business and economic upside**: A company's secured creditors might suggest that a "Pre-Pack" sale strategy should be adopted, where the company is facing insolvency, but those secured creditors want to acquire its business (typically using a special purpose company or "SPV" owned and financed by those secured creditors), retaining it under their control until market conditions improve and thereby ensuring that they receive any future economic upside arising from the business.

Lenders have an advantage if bidding for the business because the acquisition price paid for the business is effectively round-tripped (assuming that those creditors funding the SPV have security over any amounts paid by the SPV to the administrator of the selling company), so the secured creditors are often in a position to significantly outbid other potential purchasers. They may therefore argue that, as they would be willing to pay more than the business was currently worth (as long as the amount which they paid was used to repay their secured debt) conducting an extensive sale process would be an expensive and, in all probability, pointless exercise.

Where such reasons exist, an administrator has to strike a balance (taking into account the nature of the company's business and the availability of liquidity) between the need to preserve value by conducting a quick "Pre-Pack" sale and the potential benefits of a wider marketing process which could attract more potential purchasers.

3 How common are "Pre-Pack" sales?

To put the popularity of "Pre-Pack" sales into context, figures released by the Insolvency Service estimate that almost 1 in every 3 administrations involve a "Pre-Pack" sale by the administrator.

4 A typical "Pre-Pack" sale process

> **Who sells?** The company's business (potentially including shares in its subsidiaries) will be sold by an insolvency office holder (typically an

administrator, but possibly an administrative receiver or a liquidator), rather than by the company's directors.

- **When are the sale documents negotiated?** Agreement of the purchase price, the negotiation of the business sale agreement, the completion of any due diligence and obtaining any necessary consents or clearances will normally be completed before the proposed administrators are appointed. The latter will, however, need to approve the terms of that business sale agreement, including the purchase price, as it is they who will be selling the business.

- **The duties of the administrator**: Prospective administrators need to satisfy themselves that:

  - the decision to go down the "Pre-Pack" sale route can be commercially justified;

  - the "Pre-Pack" sale option provides the company's creditors with the best price reasonably obtainable for the business, given its current situation; and

  - the proposed "Pre-Pack" therefore protects, rather than erodes, value.

  The difficulty which administrators face is that the nature of the "Pre-Pack" sale often means that there will only be a very limited marketing process to support their judgment.

- **Obtaining valuation evidence**: In seeking to get comfortable with the agreed purchase price, the administrators will take into account any recent attempts to sell the business. If the business has not recently been exposed to the market, a potential administrator would ideally like to see the business marketed. If this is not practical, an administrator may instead consider:

  - seeking desktop valuations from independent valuers; and

  - obtaining advice from experts in the relevant sector in relation to recent M&A activity, the most appropriate marketing strategies for businesses in that sector and the possibility of there being a 'special purchaser' willing to pay a premium for the business.

- **Appointment of the administrators**: Once the business sale agreement has been finalised and any due diligence has been completed, the proposed administrators will be appointed, either following an application to court or using the out-of-court appointment procedure. Our Guide to administration contains further detail on the administration process.

- **No court approval**: A "Pre-Pack" sale does not require court approval. Courts have historically taken the view that the question of whether a "Pre-Pack" sale is justified, and the commercial terms of any such sale, are both a matter for the administrators' commercial judgement and

that it is not the court's role to second-guess or validate that judgement. If, however, the administrators are appointed by the court, rather than using the out-of-court route, there is recent case law suggesting that the court may, in deciding whether or not to make the administration order, take into account the merits of any proposed "Pre-Pack" sale.

> **Sale of the business**: The administrators will, following their appointment, execute the business sale agreement. The gap between their appointment and the completion of the sale of the business could only be a matter of hours, given that every step in the process is normally finalised prior to the administrators' appointment. The sale proceeds, after deducting the administrators' costs, are typically used to repay secured creditors, with, in many cases, little or nothing being left to satisfy the claims of the selling company's unsecured creditors.

> **Subsequent steps**: Those creditors whose claims remain unsatisfied will typically require an explanation for the proposed "Pre-Pack" sale and may, if they have concerns surrounding the circumstances of the sale, seek a review of the administrators' conduct. The selling company will almost inevitably be dissolved once any such review has been completed.

5 How long does a "Pre-Pack" sale process take?

While the gap between the appointment of the administrator and the subsequent sale of the business can be a matter of hours, the length of the process running up to the sale will largely depend on (i) how long it takes to negotiate the sale price and documentation, (ii) how long it takes the administrators to get comfortable with the process and (iii) what consents and approvals are required for the proposed sale. The length of the preparation process could be impacted by the need, for example, to obtain merger control clearances (where the "Pre-Pack" sale involves a sale to a competitor) or a specific clearance from the Pensions Regulator (where the selling company has a defined benefit pension scheme).

6 Potential purchasers in a "Pre-Pack" sale

Statistically, most "Pre-Pack" sales are to a purchaser with existing links to the business being sold. Figures released by the Insolvency Service indicate that over 70% of all "Pre-Pack" sales are to connected parties, such as current or former management or shareholders.

"Pre-Pack" sales are also frequently used by competitors or specialist investors who follow sectors closely and are able to act swiftly. Such purchasers should understand the business and the issues facing it and will therefore often be able to proceed relatively rapidly without carrying out extensive due diligence.

A "Pre-Pack" sale may also, as noted above, involve a sale of the business to a SPV owned and financed by the company's existing secured creditors.

7 Why can "Pre-Pack" sales be controversial?

There are two major criticisms of "Pre-Pack" sales. The first, a technical argument which has become much less of an issue as case law and practice have developed, is that conducting a "Pre-Pack" sale is incompatible with an administrator's statutory duties. The second is a sentiment, particularly noticeable in press reports about "Pre-Packs", that the "Pre-Pack" sale process lacks transparency, is open to abuse by unscrupulous officeholders, and, if not unlawful, is at least morally wrong.

Concerns relating to transparency arise from the fact that unsecured creditors have little or no input in, or even knowledge of, the "Pre-Pack" sale process. They are often simply presented with a done deal, which will often result in them not receiving any payment. Such creditors may suspect that they might possibly have received some repayment, had the administrators decided to market the business more extensively, instead of going down the "Pre-Pack" route.

The negative impression caused by the lack of transparency surrounding "Pre-Packs" has been increased by the fact that it is, as noted above, often the company's current or former shareholders or management who buy the business, leaving behind much of the company's unsecured debt (a process sometimes referred to as a "Phoenix Pre-Pack"). The Government has announced its intention to improve the transparency of such "Phoenix Pre-Packs" and to enable creditors, in certain circumstances, to raise concerns before the "Phoenix Pre-Pack" sale takes place by requiring administrators to notify creditors where no open marketing of the assets has taken place.

8 Improving the image of "Pre-packs" – SIP 16

In January 2009, partly in response to criticisms and in recognition of the increasing role "Pre-Pack" sales are playing in insolvencies, R3 (a body representing insolvency practitioners) released a Statement of Insolvency Practice – SIP 16 (Pre-Packaged Sales in Administrations). Although currently non-binding in nature, SIP 16 contains best practice guidance for insolvency practitioners, requiring them to be able to explain to the company's creditors why a "Pre-Pack" sale was entered into.

Paragraph 9 of SIP 16 suggests that, in order to allow creditors to satisfy themselves that the administrator acted properly and with due regard for their interests, the creditors should be provided with details of:

- why it was necessary to sell the business immediately, rather than to trade the business and then to offer it for sale as a going concern during the administration process;
- any marketing activities conducted by the company and/or the administrator;
- any valuations obtained for the business or the underlying assets;
- the alternative courses of action considered by the administrator, with an explanation of possible financial outcomes; and

> the identity of the purchaser and the consideration, terms of payment and any condition of the contract that could materially affect it.

Although SIP 16 does not impose any specific timescale within which this information should be disclosed to creditors, the Insolvency Service has made it clear that it would normally expect the information to be sent to creditors within a fortnight of the completion of the sale, other than in exceptional cases.

9 Potential liability for the administrator in relation to a "Pre-Pack" sale

Administrators may face potential liability if they sell the business for less than its proper value. Administrators' actions could also be challenged by creditors under paragraphs 74 and 75 of Schedule B1 of the Insolvency Act 1986. Paragraph 74 enables creditors to challenge the actions or proposed actions of administrators where they unfairly harm the creditors' interests, while paragraph 75 gives the court the power to examine the administrators' conduct, on the application of (among others) a creditor, where such conduct may have breached a fiduciary or other duty in relation to the company or where the administrators may have been guilty of misfeasance.

An administrator may also face being removed from office by a court exercising its powers under paragraph 88 of Schedule B1, where creditors have concerns about a "Pre-Pack" sale and want an independent insolvency practitioner to conduct a review of the circumstances surrounding the sale and the valuation arrived at. Having this right may, however, be of little comfort where the "Pre-pack" sale has already been completed.

Finally, the circumstances surrounding a "Pre-Pack" sale could also result in an administrator being reported to their authorising body. For example, during 2010, 15 insolvency practitioners were reported by the Insolvency Service to their authorising bodies.

10 One final point – terminology

Care should be used in relation to the term "Pre-Pack". In a UK context, the term is generally used to refer to a pre-agreed business sale by an insolvency practitioner which does not require prior court and/or creditor sanction. In other jurisdictions, the term "Pre-Pack" may instead be used to describe a fast tracked implementation of a restructuring plan which is agreed by the debtor and its creditors prior to the insolvency filing, but which is then sanctioned by the court on an expedited basis.

Linklaters

Contacts

For further information please contact:

Jo Windsor
Partner

(+44) 20 7456 4436

jo.windsor@linklaters.com

Rebecca Jarvis
Partner

(+44) 20 7456 4466

rebecca.jarvis@linklaters.com

or your usual Linklaters LLP contact.

One Silk Street

London EC2Y 8HQ

Authors: Jo Windsor and Rebecca Jarvis

This publication is intended merely to highlight issues and not to be comprehensive, nor to provide legal advice. Should you have any questions on issues reported here or on other areas of law, please contact one of your regular contacts, or contact the editors.

© Linklaters LLP. All Rights reserved 2010

Linklaters LLP is a limited liability partnership registered in England and Wales with registered number OC326345. The term partner in relation to Linklaters LLP is used to refer to a member of Linklaters LLP or an employee or consultant of Linklaters LLP or any of its affiliated firms or entities with equivalent standing and qualifications. A list of the names of the members of Linklaters LLP together with a list of those non-members who are designated as partners and their professional qualifications is open to inspection at its registered office, One Silk Street, London EC2Y 8HQ or on www.linklaters.com and such persons are either solicitors, registered foreign lawyers or European lawyers.
Please refer to www.linklaters.com/regulation for important information on our regulatory position.

We currently hold your contact details, which we use to send you newsletters such as this and for other marketing and business communications.

We use your contact details for our own internal purposes only. This information is available to our offices worldwide and to those of our associated firms.

If any of your details are incorrect or have recently changed, or if you no longer wish to receive this newsletter or other marketing communications, please let us know by emailing us at marketing.database@linklaters.com.