Second time lucky: pre-pack reform in the UK

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Speed read

- On 8 October 2020, the Insolvency Service published the outcome of its review of industry reforms to pre-pack sales in administration and made recommendations which will impact the way in which pre-pack sales to connected parties in particular operate in the UK in the future.
- The Insolvency Service has proposed the adoption of new legislation which will prohibit sales by companies in administration to connected parties within eight weeks of the start of the administration **unless** either the proposed sale is approved by the company's creditors as part of the approval of the administrator's proposals or an independent report has been obtained by the connected party purchaser.
- Draft regulations have been published and the Government intends to lay these before Parliament as soon as Parliamentary time permits but there is no specific timeframe at the moment (although the power under the Insolvency Act 1986 ("**IA86**") to bring in the regulations will expire in June 2021).
- Whilst the creditor approval route seems difficult to operate in the context of accelerated sales, a requirement for mandatory independent reporting provides an extra layer of scrutiny and protection for creditors, and should go some way to addressing concerns around connected party pre-packs.
- Whether the measures go far enough to satisfy the harshest opponents of pre-packs remains to be seen; we will need to wait for further guidance and for market practice to develop before a proper assessment can be made and some of the key questions raised by the proposals can be answered.

Pre-packs: still dividing opinion

A pre-packaged administration sale or "pre-pack" is a sale of the business and assets of a company by its administrator, shortly after (often on the day of) his or her appointment, to a purchaser selected and on terms agreed prior to the company entering into administration. The Insolvency Service reports that pre-packs represent around 29% of all administration sales in the UK.

Critics of pre-packs have been calling for increased scrutiny, and in some cases prohibition, of the process for some time. Criticism focusses on a lack of transparency and a perception of lower returns to unsecured creditors, largely because of more limited marketing of the assets being sold. Pre-packs to connected parties[1] – particularly those to existing shareholders or management – where the business has been bought back but liabilities left behind in the insolvent company, have been one of the main areas of focus for critics. However, supporters see pre-packs as a valuable rescue tool for struggling businesses where their speed of

[1] A connected party pre-pack is a pre-pack where the administrators sell the assets of the company to a person "connected" with that company. These represent a significant proportion of the pre-packs undertaken in the UK – according to the IS Review, 260 of the 473 pre-packs effected in 2019 were to connected parties.

implementation avoids the uncertainty that might otherwise arise from trading the company in administration, ultimately preserving value, jobs, and relationships with suppliers and customers. So who is right?

Faced with calls for reform, the Government commissioned an independent review in 2014, led by Teresa Graham (the "**Graham Review**"). The Graham Review concluded that whilst pre-packs were a useful tool there were concerns around a lack of transparency, particularly for unsecured creditors. Following the Graham Review, voluntary measures were introduced for the implementation of pre-pack sales. This included six principles of good marketing with which the administrator was expected to comply (or to explain non-compliance in the SIP 16 report), a strengthening of the information to be provided to creditors in the SIP 16 report, the establishment of the Pre-Pack Pool (the "**Pool**"), and a 12 month "viability review" to be provided by connected party purchasers.

One of the recommendations in the Graham Review was that if the voluntary measures were not adhered to, the Government should consider legislation. Accordingly a power was introduced allowing the Government to regulate or ban sales in administration to connected persons, including via a pre-pack sale. The power expired in May 2020 before being used but was reintroduced with an extended deadline of 30 June 2021 by the Corporate Insolvency and Governance Act 2020 ("**CIGA**").

In 2017, the Government began a review of the impact of the voluntary measures introduced following the Graham Review, to determine whether it should use the power to regulate or ban connected party sales in administration. The results of this review were published by the Insolvency Service on 8 October 2020 (the "**IS Review**").

The IS Review concluded that pre-packs are a "*valuable part of the insolvency framework*" and so does not propose banning pre-packs. It also acknowledged an increase in the number of businesses being marketed and the quality of that marketing following the Graham Review. However, connected party sales in administration remain an area of concern, particularly in light of the potential increase in connected party pre-packs as a consequence of the COVID-19 crisis. Concerns were also expressed during the debates on CIGA that the new rescue measures introduced by CIGA might be less effective if pre-packs increased. The IS Review reiterates the importance of the recommendations set out in the Graham Review and proposes certain additional measures, the most important of which being a prohibition on pre-packs to connected persons during the first eight weeks of a company's administration without an independent report or creditors' approval.

What is a "connected person"?

The draft regulations use the term "connected person" as defined in paragraph 60(A)(3) IA86. A "connected person" is:

- **a relevant person in relation to the company**: A "relevant person" is (a) a director or other officer, or shadow director, of the company; (b) a non-employee associate of such person; or (c) a non-employee associate of the company. A "non-employee associate" is a person who is an associate of another person other than by virtue of one of them employing the other. The definition of "associate" is detailed, and should be considered on a case by case basis, but effectively captures the spouse or relative of an individual (or that individual's spouse) and companies with common control (or where one company controls the other); or
- **a company connected with the company**: the purchaser company is connected to the seller company if any "relevant person" of one is or has been a "relevant person" of the other.

So the definition squarely catches a situation where administrators sell the assets of an insolvent company to a newco which has the same director(s) as the insolvent company. This often arises in pre-packs to financial buyers or existing lenders as existing management are the people that know the business best and are well placed to deal with the transition.

What has the Insolvency Service proposed?

The Government has proposed certain legislative and non-legislative measures, as well as an increased focus on some of the recommendations made by the Graham Review.

Draft regulations (which will be known as the "Administration (Restrictions on Disposal etc. to Connected Persons) Regulations 2020" when in force) have been published, and the Government intends to lay these before Parliament as soon as parliamentary time allows (bearing in mind the June 2021 deadline to use the power). Under the regulations, an administrator cannot make a "substantial disposal" to a "connected person" until either:

- he or she has obtained the approval of creditors as part of the process of obtaining approval of the administrator's proposals; or
- the relevant connected person has obtained an independent report.

See the next page for more detail on the key terms of the draft regulations.

The IS Review also considered the effectiveness of the voluntary measures recommended by the Graham Review and concluded that although there has been improvement in the marketing of businesses, it will work with regulators to (a) ensure greater adherence to the Graham Review's principles of good marketing (and to ensure full explanations from the administrator where these have not been complied with); (b) ensure increased compliance with the reporting requirements under SIP16 and (c) understand why viability statements are not being prepared (as recommended by the Graham Review) and how this can be improved going forward.

The Pre-Pack Pool

The existing regime has a similar concept to the proposed independent report in the form of opinions from the Pool, but the key difference is that an opinion from the Pool is not mandatory, whereas the new independent report will be: an administrator cannot sell to a connected party without either waiting eight weeks or obtaining the report (or creditor approval).

The IS Review considered the success (or otherwise) of the Pool. The Pool, which was a key Graham Review recommendation, is a body of experienced businesspeople whom connected parties can approach (on a voluntary basis) to provide an independent opinion on a proposed pre-pack. A negative opinion from the Pool does not prevent the implementation of the pre-pack, but does require an administrator to explain in his or her report to creditors why he or she felt it appropriate to go ahead with the sale notwithstanding that negative opinion.

The IS Review found that, despite the number of connected party pre-packs continuing to increase year-on-year, referrals to the Pool have been low: 22% of eligible transactions were referred in 2016, 11% in 2017, and 9% in 2019. When asked why referrals were not made, the most common response from insolvency practitioners was that the purchaser saw no benefit in making the referral. Despite the low referral rates, the IS Review found that there is general agreement that the *operation* of the Pool has worked well, with stakeholders welcoming the independent scrutiny.

The IS Review is not explicit as to the future of the Pool. It is possible that the Pool (or members of it) will be considered suitable as a provider of the independent report. We await further guidance on this but we would query whether the Pool in its current form is going to be suitable (e.g. members of the Pool are currently allocated pre-packs on a random basis, which seems inconsistent with the selection criteria set out in the draft regulations, and the Pool charges a fixed fee for an opinion which may not be reflective of the work required).

Key terms of the Draft regulations

"Substantial disposal"	• A disposal, hiring out or sale, to one or more connected persons, of what is (in the administrator's opinion) all or a substantial part of the company's business or assets effected during the eight week period beginning on the date on which the company enters administration. • Can be in one transaction or a series of transactions.
Creditor approval	• Requirement is satisfied if the administrator refers to the substantial disposal in his or her proposals, and these are approved by the company's creditors in accordance with the usual approval process under paragraph 51(1) or paragraph 52(2) of Schedule B1 to the Insolvency Act 1986 (i.e. by simple majority, within the first ten weeks of the administration unless extended).
The "evaluator"	• Independent report is to be prepared by an "evaluator", which cannot be connected or associated with any of the administrator, the company in administration or the connected person. • A person who has given the company advice in connection with its possible insolvency, corporate rescue or restructuring (within the twelve months prior to the date of the report) also prohibited from being the evaluator. • No particular requirements as to qualification: it is sufficient for the evaluator to believe that they have the requisite knowledge and experience to provide the report.
Content of the report	• The evaluator is required to (i) state the consideration to be provided for the property being disposed of; (ii) identify the connected person to whom the property is being disposed and their connection to the company; and (iii) include a statement as to whether or not the evaluator is satisfied that the proposed consideration and the grounds for the substantial disposal are reasonable in the circumstances (a "case made" opinion or a "case not made" opinion, as relevant). • The administrator may make the substantial disposal whether there is a "case made" or a "case not made" opinion but, if the report contains a "case not made" opinion, the administrator must provide a statement explaining his or her reasons for proceeding notwithstanding the opinion
Distributing the report	• If and once the administrator has completed the disposal, he or she must send all creditors a copy of the report (excluding confidential or

	commercially sensitive information), alongside the statement setting out the administrator's reasons for proceeding with the disposal where there has been a "case not made" opinion. The administrator must also send a copy of the report to Companies House.

Impact on future pre-packs

The confirmation that the Government does not intend to use its power to ban pre-packs, and the recognition of pre-packs as valuable businesses saving tool, is of course welcome news for the restructuring community, and comes at a crucial time as the fall-out from the COVID-19 crisis continues. Our key observations and areas where further clarity or guidance would be welcomed from Government are set out below.

- **Feasibility of creditor approval option:** We consider that the creditor approval route will be difficult to operate in the context of accelerated sales because a key advantage of the pre-pack – being the speed of implementation to minimise damage to a business from a period of trading in insolvency – will be lost if the sale cannot be consummated before the creditor approval process is complete. The independent report therefore appears to be the more realistic option in practice.
- **Secured lenders:** Under the Graham Review "connected parties" excluded secured lenders holding share security (with related voting rights) as part of the lender's normal business activities. This same approach was taken in SIP 16 and in the IS Review. However, the definition of "connected person" in paragraph 60A(3) IA86 (which is the definition used in the draft regulations) does not have the same exclusion for secured lenders and it is unclear from the IS Review whether this is intentional. If not, then we hope the oversight will be addressed in the next draft of the regulations. If intentional, then the creditor approval or independent report process would apply to pre-packs involving secured lenders who may be the "connected party purchaser" in situations where they have control over "oldco" through voting rights in share security and are connected to "newco" through equity holdings.
- **Time and cost:** The independent reporting regime will inevitably add cost to a connected party pre-pack. 20% of those surveyed by the Insolvency Service cited cost as a factor for not making referrals to the Pool (although Pool referral is voluntary). This may act as a deterrent in the SME market but we think this is less likely in deals with larger capital structures. Although the evaluator is appointed by the purchaser, this cost may just reduce the consideration paid and ultimately hit returns to creditors. Preparation time will also need to be factored into the pre-pack planning process, although the independent report may actually provide slightly more flexibility than the existing Pool regime which requires two business days to consider a proposal.
- **The evaluator:** The evaluator is required to be independent, and to believe that he or she has the requisite knowledge and experience to provide the report, but the draft regulations do not otherwise provide much guidance as to how an evaluator should be selected. Insolvency practitioners and financial restructuring advisers would seem to be the obvious place to start (provided they have not previously advised the company) but we will need to wait and see who is willing to provide the reports and how the market develops. Given that third party approval of the choice of evaluator is not required, a purchaser is unlikely to approach someone who they feel will give an unfavourable opinion. As we mention above, it is possible that the Pool (or members of it) could be suitable candidates to provide the independent report but we do not think this is workable with the Pool in its current form.
- **The report itself:** The evaluator is required to report on whether the proposed consideration is reasonable in the circumstances. This raises a number of questions. The evaluator can comment on the robustness of a sales process, for example, but does assessing reasonableness of consideration require the evaluator to make his or her own assessment of value? Will the evaluator need to scrutinise the appropriateness of deferred consideration and how it is structured? Will there also be more scrutiny on credit bids (where lenders use their existing secured claims as consideration to effectively "bid" for the assets of the company), particularly where there is limited daylight between the credit bid and the nearest cash bidder?

- **“Substantial disposal”:** The definition of “substantial disposal” will also need to be considered. The draft regulations do not deal with what an administrator is required to do where he or she undertakes a series of smaller sales to connected parties. The definition of “substantial disposal” expressly provides that the disposal can be effected in a series of transactions, but what is the point at which the disposal has been of “a substantial part” of the company’s business or assets? And what does the administrator need to do when he or she effects the smaller sale which (when taken with the previous sales) constitutes a substantial part of the company’s assets? Is there a requirement at that stage to obtain the independent opinion or creditor approval, and does that have any impact on the smaller sales that have already been effected?

A requirement for mandatory independent reporting or creditor approval certainly provides an extra layer of scrutiny and protection for creditors, so should address some of the concerns around connected party pre-packs. The independent report (or creditor approval, as the case may be) will also be welcomed by administrators as adding transparency to connected party deals, which may see complaints about the process reduce. Whether the measures go far enough to satisfy some of the harshest opponents of pre-packs remains to be seen and we will need to wait for further guidance and for market practice around the independent reporting process to develop, before a proper assessment can be made.

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