Insolvency
Case Law Update
Rosling King LLP

Background

Pre-pack administration sales involve the sale of a company's assets by the administrator at the very start of the administration process, thereby preserving value and effectively allowing a 'going-concern' sale. Whilst pre-packs have been useful to enable a quick transfer of assets where a company is facing difficulties, there is an inherent lack of transparency as the negotiation of sale terms occur between the company, the purchaser and the proposed administrator prior to the formal appointment of the administrator. As a result, pre-packs have been subject to criticism, particularly where there are connected parties and from unsecured creditors who may see the purchaser as "asset stripping".

As a result of the need to ensure all creditors have confidence in the process, the Government has now published its amended draft legislation around the independent scrutiny of pre-pack administration sales.

Under the draft regulations, it should be mandatory that the sale of assets to connected party purchasers be referred for an independent opinion. The decision not to ban sales to connected parties in pre-packs should be welcomed by insolvency and restructuring practitioners because pre-packs administration sales involving connected parties are a key rescue tool for businesses, both for preserving a business and maximising returns to creditors. The purpose of the new laws is to therefore regulate pre-pack sales to connected persons, with the aim of balancing the rights of creditors (to protect their value) and viable business rescue options.

The new regulations should come into force on 30 April 2021, following debate in the Commons and the Lords, and will apply only to administrations that commence on or after this date.

The key provisions under the new regulations are as follows:

Substantial Disposals by an Administrator

The restrictions will apply to a 'substantial disposal', which is defined as '*a disposal, hiring out or sale to one or more connected persons, during the period of 8 weeks beginning with the day on which the company enters administration, of what is, in the administrator's opinion, all or a substantial part of the company's business or assets*.'

Under the new regulations, administrators must not make a substantial disposal unless either:

- the approval of the company's creditors for the disposal is sought in the statement of administrator's proposals, which includes proposals for making the disposal, and the company's creditors subsequently approve the proposals (with or without modifications); or

- a qualifying written report in respect of the disposal has been obtained by a connected person, made by an individual who is an evaluator, and given to the administrator who must consider its contents and be satisfied that it both meets certain requirements and includes specific content, as set out in the new regulations.

The Evaluator

For the purposes of the regulations, the administrator needs to be satisfied that the individual (e.g. the evaluator) making the report has "*sufficient relevant knowledge and experience for the purposes of making a qualifying report'*. In practice, the connected person should ask the administrator for a recommendation for an evaluator to prepare the report.

The evaluator will satisfy the requirements as to independence, unless they are connected with the company or the connected person or know or have reason to believe they have an interest with respect to the disposal. The administrator must have no reason to believe that the evaluator has been made bankrupt or is subject to any disqualification orders (the regulations include a list of disqualifications). The evaluator also needs to meet the requirements as to insurance (e.g. by having professional indemnity insurance in place).

Qualifying Report

The qualifying written report must contain specific information, including identification of the relevant property and the connected person and their connection to the company; a statement that the evaluator is satisfied that the consideration to be provided for the relevant property and the grounds for the substantial disposal are reasonable in the circumstances; and the evaluator's principal reasons for proceeding with the transaction. The new regulations detail what needs to be contained in the qualifying report, including any additional requirements where previous reports have been obtained.

The administrator is also subject to notification requirements where a qualifying report is obtained. The administrator is required to send a copy of the qualifying report both to Companies House and to every creditor of the company, together with the administrator's statement of proposals. In situations where the evaluator's report is negative, the administrator also needs to provide a statement explaining the reasons for proceeding with the disposal. This statement must be sent to Companies House and to all creditors of the company, along with a copy of the report.

Commentary

In the insolvency and restructuring market, pre-packs are a useful tool for rescuing businesses in financial difficulties. They allow the sale of assets to occur quickly without being negatively impacted by the administration. They can also prevent the need for trading in administration and the costs associated with this, thereby resulting in higher returns to creditors.

The new regulations are the Government's attempt to control pre-pack administration sales by ensuring that there is an independent third-party reviewing these sales where there are connected parties, so as to protect businesses and the restructuring process and the interests of creditors. Should the regulations come into force in April, they may go some way in allaying criticism that connected parties are simply transferring assets out of a company in difficulty for their benefit, leaving only liabilities behind for the remaining creditors.

However, the new regulations are not perfect and do not deal with situations where the connected party's evaluator's report says the buyer is over-paying or under-paying. In cases of

the former, the business will benefit but the company's creditors could then sue the administrator for a sale at an undervalue (although whether this would be a cost-effective remedy for the creditors is another matter). In the latter case, the administrator is likely to sell in any event because it is the best sale that can be achieved thereby benefiting the creditors as a result of the higher return.

In addition, the Government could consider putting in place a framework, or some form of criteria to be met, to ensure that the evaluator in each instance is suitable for the role. The evaluator needs to be independent, qualified and have relevant business experience to give an opinion on the pre-pack administration sales process. It is only with an approved evaluator in place that the market will have greater confidence that pre-pack sales to connected parties are legitimate.

Nonetheless, as we start to look at life beyond lockdown, it is likely that pre-packs will be widely utilised in the coming months by businesses which have benefited from the Government's support throughout the pandemic but which may struggle to continue once these support packages come to an end. The new regulations should be welcomed, and pre-packs should continue to be seen as a useful rescue tool for businesses, even where there is a connected party involved in the sale of assets. Once they come into force, the regulations will hopefully strike a balance between preserving a business where possible and maximising returns to creditors, all while creating greater transparency in the process.

Should you wish to discuss this in more detail, please do not hesitate to contact Alexander Edwards or the Partner with whom you usually deal.