

## Pre-Pack Administrations: Holding Administrators to Account

### Introduction

1. The “pre-pack administration” is a creature born and developed through practice, without the involvement of the legislature or (direct) assistance from the courts. Perhaps the most telling sign of this is that the term does not appear in the insolvency legislation, and there is no one commonly-accepted definition.
2. The closest we have to an official definition of the pre-pack is that given in Statement of Insolvency Practice 16 (“SIP 16”) produced by the Association of Business Recovery Professionals in January 2009. SIP 16 describes a pre-pack as:

*“an arrangement under which the sale of all or part of a company’s business or assets is negotiated with a purchaser prior to the appointment of an administrator, and the administrator effects the sale immediately on, or shortly after, his appointment”.*

3. A similar definition was given by HHJ David Cooke in his helpful decision in Re Kayley Vending Ltd [2009] EWHC 904 (Ch):

*“Pre-packs are increasingly common and highly controversial. The term refers to a sale of all or part of the business and assets of a company negotiated ‘in principle’ while it is not subject to any form of insolvency procedure, but on the footing that the sale will be concluded immediately after the company has entered into such a procedure, and on the authority of the insolvency practitioner appointed”.*

4. Pre-packs can take many forms, but will generally exhibit some or all of the following features:

(1) very often the insolvency procedure chosen will be administration, with the company’s directors appointing an administrator out of court under paragraph 22 of Schedule B1 to the Insolvency Act 1986. Although this talk deals only with administrations it is worth noting that pre-pack features appear in other

insolvency processes: indeed before the passing of the Enterprise Act 2002 pre-packs were more common in receiverships than administrations;

- (2) the assets will be sold to a newly-created company whose directors and shareholders are those of the company in administration;
- (3) those assets tend to be sold as a 'job lot' including the goodwill of the old company, rather than being sold off piecemeal. The employees of the old company will often be transferred to the new along with the business;
- (4) there will be little or no marketing of the assets sold, and frequently the new company is the only entity with which sale negotiations take place;
- (5) the sale will take place within an extremely short period of the appointment of the administrator, and almost invariably before a creditors' meeting can be held.

#### **How Do Pre-Packs Fit With the Existing Legislation?**

5. As noted above, the pre-pack process does not arise from anything contained in the insolvency legislation, and, in consequence, the use of a pre-pack means that there will be points where the administrator diverges from the general scheme of the administration procedure as envisaged by the statute and rules. There are three main points of divergence:

- (1) the administrator's choice of the "purpose of the administration" will necessarily be narrowed where a pre-pack procedure is used;
- (2) there will usually be little point in holding a creditors' meeting where the company's assets have already been sold; and
- (3) much of the administrator's work will have been carried out *before* rather than *after* his formal appointment, i.e. before the administration process has commenced.

(1) The “Purpose of the Administration”

6. Since the Enterprise Act 2002 the law governing the administration is primarily contained in Schedule B1 inserted into the Insolvency Act 1986 by the 2002 Act (“Schedule B1”).
7. At the core of Schedule B1 is the administrator’s duty to select the “purpose of the administration” from the three possible purposes set out in paragraph 3(1). Those purposes are:
  - (a) rescuing the company as a going concern;
  - (b) achieving a better result for the company’s creditors as a whole than would be likely if the company were wound up (without first being in administration); and
  - (c) realising property in order to make a distribution to one or more secured or preferential creditors.
8. Unless the administrator feels that he can successfully pursue one of those three purposes then administration is not an appropriate insolvency procedure for the company, and indeed the court will not make an administration order unless it is satisfied that one of those purposes can be achieved.
9. The administrator does not have an unfettered choice between the three possible purposes: rather, they are listed in descending order of priority. The administrator must pursue the first purpose unless he believes that it is not reasonably practicable to do so, or he thinks that the second objective would achieve a better result for the company’s creditors as a whole (and not merely for secured, or any other class of creditors). He may only pursue the third objective if he thinks neither the first nor the second is reasonably practicable and he does not unnecessarily harm the interests of the creditors of the company as a whole by so doing.
10. When the administrator chooses to put into place a pre-pack arrangement and sell the company’s assets to a ‘newco’ he is therefore bypassing purpose (a), rescuing the company as a going concern, and selecting either option (b) or (c) as the purpose of the administration. He must be of the view that rescuing the company as a going concern is not reasonably practicable, even with the benefit of the statutory

moratorium imposed by the administration, and believe that the pre-pack will achieve a better result for the company's creditors as a whole than an immediate liquidation. The primary purpose, as selected by the legislature, will simply never be an option in a pre-pack.

11. The difficulty that a creditor may have in disputing the administrator's selection of option (b) or (c) is illustrated by the case of Re DKLL Solicitors [2007] EWHC 2067 (Ch), a decision of Andrew Simmonds QC which is widely regarded as a judicial endorsement of the pre-pack process.
12. In that case the majority creditor of a "hopelessly insolvent" firm of solicitors was HMRC, which had issued a winding up petition against the partnership and bankruptcy petitions against the partners themselves. The partners applied for an administration order in order to allow the proposed administrators to effect an immediate sale of the firm's business to a new firm for £400,000.
13. HMRC believed that the assets of the partnership could achieve more than that, and (having issued a winding-up petition themselves) were of the view that a better result for creditors would be achieved by an immediate liquidation. However they had no evidence to support their view (see paragraph 10 of the judgment, and as might be expected given that the administrator had far better access to the books and records of the partnership than HMRC) and the Judge made an administration order, allowing the sale to go ahead despite HMRC's objections.

## (2) The Creditors' Meeting

14. Just as central to the scheme of Schedule B1 is the measure of control given to creditors by means of the administrator's statement of proposals and the creditors' meeting. The timetable envisaged by the Schedule (which is somewhat shortened from the timetable of the pre-Enterprise Act 2002 regime) is as follows:

- (1) as soon as is reasonably practicable after the company enters administration, and in any event within eight weeks of that date, the administrator must send to all creditors a statement setting out his proposals for achieving the purpose of the administration (para 51). That statement must include, inter alia:

- (a) how it is envisaged that the purpose of the administration will be achieved, and how it is proposed that the administration will end (rule 2.33(2)(m) of the Insolvency Rules (“IR”) 1986);
- (b) the manner in which the affairs and business of the company have been managed and financed since the date of the administrator’s appointment, including, where assets have been disposed of, the reason for the disposals and the terms upon which they were made (IR 1986 rule 2.33(2)(o));
- (c) the basis upon which it is proposed that the administrator’s remuneration should be fixed under rule 2.106 (IR 1986 rule 2.33(2)(k)).

(2) Each copy of the administrator’s proposals sent to a creditor under paragraph 51 must be accompanied by an invitation to a creditors’ meeting, which must be set for a date as soon as reasonably practicable after the company enters administration and in any event not more than 10 weeks after that date.

(3) At the creditors’ meeting the creditors may approve, modify or reject the administrators proposals entirely.

15. Because a pre-pack means that the entirety of the company’s assets will have been sold well in advance of any creditors’ meeting (and often before a statement of proposals could even be prepared) any such meeting will generally be rendered pointless, and the administrator will usually take advantage of the exceptions in Schedule B1 and the Rules which allow him not to call a meeting (see paragraphs 52 and 80 (2) of Schedule B1.

16. The administrator’s power to sell the company’s property before holding a creditors’ meeting was confirmed well before the introduction of the Enterprise Act 2002 and the current vogue for pre-packs by Neuberger J (as he then was) in Re T&D Industries Ltd [2000] 1 All ER 333. Asked to consider whether, without a specific direction of the court, an administrator could dispose of the company’s assets prior to a creditors’ meeting the judge held that he could, even where the sale involved the entirety of the company’s undertaking.

17. That decision, which was subsequently confirmed in relation to the post-Enterprise Act 2002 regime in Re Transbus International Ltd [2004] EWHC 932 (Ch), represented a significant increase in the administrator's freedom of operation and was a marked contrast to earlier decisions such as Re Consumer and Industrial Press Ltd (No 2) (1988) 4 BCC 72 in which Peter Gibson J held that:

*"I am very unhappy indeed at the suggestion that the court should make an order such as will mean that there can be no useful meeting of creditors. It seems to me that the power that the court undoubtedly has ... should only be exercised in circumstances in which it can readily be seen that the disposals are really the only sensible course to be adopted and when unsecured creditors have had a chance to say what they think about the proposals in the administration. It seems to me that quite exceptional circumstances would be needed for the court to frustrate that part of the Act which requires a meeting of creditors to consider proposals by the administrators".*

18. Although the law on this point, and the administrator's power to dispose of the company's entire undertaking immediately upon taking office if he considers it appropriate to do so, is now settled the negation of the purpose of the creditors' meeting in a pre-pack administration, and so the removal of creditors' control envisaged by Schedule B1 remains controversial.

19. The Re DKLL Solicitors case refers to above represents another, more recent, attempt by creditors to reassert some control and the status of the creditors' meeting. The argument put forward by HMRC in that case was that, as it was the majority creditor of the partnership by value, if a meeting of creditors were held to consider the proposed sale of the partnership assets HMRC would be in a position to defeat that proposal. As the administrator's proposed course of action meant that there would in fact be no creditors' meeting HMRC would be "disenfranchised".

20. This argument was rejected by the Judge on the grounds that (at para 18) *"even a majority creditor does not have a veto on the implementation of the administrator's proposals. The court could, exercising its powers under para 55.2 of Sch B1, authorize the implementation of those proposals, notwithstanding the opposition of the majority creditor. Accordingly, if the present case were not concerned with a pre-*

*pack sale, and a creditors' meeting prior to the implementation of proposals were envisaged, I would not accept that the Revenue's opposition meant that it was not 'reasonably likely' that the statutory objective would be achieved".*

21. The Re DKLL Solicitors decision thus confirms that even (particularly) in the case of a pre-pack there is nothing sacrosanct about the creditors' meeting, and even a majority creditor does not have the right to have his views followed.

### (3) The Timing of the Administrator's Work

22. A third feature inherent in the pre-pack is that, as indicated by the definitions quoted in the introduction to this talk, much of the administrator's work, including the negotiation of the sale of the company's assets, will be carried out in the period before the company enters administration, and so before potential creditors of the company are aware that it represents a trading risk.
23. As pointed out by HHJ David Cook in the Kayley Vending case *"if the negotiation takes place before [the administrator's] appointment and the business is continuing to trade in that period, there is an obvious risk that credit incurred in that period will not be paid, so that the negotiation takes place at the risk of creditors"* (para 8).
24. There seems to be no data available on the length of time which commonly elapses between a company's directors first approaching an insolvency practitioner and his appointment of an administrator, and so the risk to which potential creditors are being put, and there seems little that can be done to mitigate that risk, although in an extreme case a disappointed creditor could consider bringing a wrongful trading application under s 214 of the Insolvency Act 1986 upon the company's eventual liquidation.
25. A corollary of this point, and one which may afford a measure of satisfaction for creditors who feel that their position has been abused by a pre-pack is that a substantial body of the administrator's costs will have been incurred before the administration and so cannot, without a court order or the approval of the creditors, be treated as an administration expense. This point is dealt with in more detail below.

## **Criticism of the Pre-Pack Process and SIP 16**

26. Criticisms of the pre-pack process is legion and widely documented, and beyond a brief mention it is perhaps not necessary to repeat it here. This talk is not intended as an addition to the many examples of attacks on the pre-pack: in the absence of legislative intervention it seems that the procedure is here to stay, and academic and practitioners' debate could consequently be more usefully focused on 'best practice' within the existing rules.

27. The most common objections to the pre-pack were set out by HHJ David Cooke at paragraphs 7 and 8 of his judgment in Re Kayley Vending and can be summarised thus:

- (1) because the sale of the company's assets is not undertaken in the open market it has not been exposed to the 'competitive forces' which might lead to a higher price being obtained for the assets;
- (2) the rights of 'stakeholders' to participate in the decision-making process by means of the creditors' meeting are frustrated;
- (3) the process is insufficiently transparent leading to a want of accountability and calls of bias towards secured creditors or floating charge holders along with ensuring that practitioners' fees and expenses are paid (a charge which SIP 16, discussed below, was intended to address);
- (4) where the sale of the business is to the previous directors and shareholders the process resembles the practice of "phoenixing";
- (5) there is a risk to potential creditors as the company continues to trade throughout the negotiation process and before the company enters administration.

### SIP 16

28. An attempt to address the lack of transparency inherent in the pre-pack process was made in the publication of the guidance note SIP 16 in January 2009. SIP 16 drew practitioners' attention to their duties as administrators pointing out that "[the line

of cases in which the courts have held that administrators have the power to sell assets without the prior approval of the creditors] *does not protect administrators from potential challenges to their conduct under paragraph 74, or claims for misfeasance under paragraph 75, of Schedule B1 to the Insolvency Act 1986. In order to avoid the risk of such exposure, care should be taken to ensure that such power is only exercised in genuine furtherance of the purpose of administration*".

29. Under the heading "Disclosure" SIP 16 states that *"it is in the nature of a pre-packaged sale in an administration that unsecured creditors are not given the opportunity to consider the sale of the business or assets before it takes place. It is important, therefore, that they are provided with a detailed explanation and justification of why a pre-packaged sale was undertaken, so that they can be satisfied that the administrator has acted with due regard for their interests"*.
30. The guidance goes on to list the information which *"should be disclosed to creditors in all cases where there is a pre-packaged sale"*. Much of this is similar to that which IR 1986 rule 2.33 provides should be contained in a statement of affairs, and among the facts which should be included are:
  - (1) the source of the administrator's initial introduction;
  - (2) any valuations obtained of the business or the underlying assets;
  - (3) whether efforts were made to consult with major creditors; and
  - (4) the name of and any connection between the purchaser and the directors, shareholders or secured creditors of the company.
31. Unfortunately, it appears from the Insolvency Service's latest "Report on the Operation of Statement of Insolvency Practice 16" from July to December 2009 that compliance with SIP 16 has not been all that might have been hoped.
32. During that period the Insolvency Service reports that it received SIP 16 information in respect of 497 companies where there had been a pre-pack. Of those some 38% of cases were found not to be fully compliant with the SIP, and of those cases 36 were sufficiently non-compliant that the practitioners involved were referred to their professional bodies for regulatory and disciplinary perspective (although it

appears from section 2.5 of the report that, in general, the action taken against the practitioners has not been severe).

### **Protection for Creditors (and IPs): What is “Best Practice” in relation to the Pre-Pack?**

#### What Redress is Available to Creditors?

33. A creditor who feels that his rights have been unfairly infringed is likely to face considerable difficulties in obtaining redress. Much of this will be caused, as was demonstrated by the Re DKLL Solicitors case, by the fact that the creditor will frequently be in possession of far less information than the administrators in relation to the value of the assets sold, and will in any event find it extremely difficult to demonstrate that the sale of assets, particularly goodwill, was at an undervalue.
34. If the creditor has sufficient time one option is an application under para 88 of Schedule B1 for an order removing the administrator in order that another insolvency practitioner can consider the proposed sale. Such an order was made in the recent case of Clydesdale Financial Services Ltd v Smailes [2009] EWHC 1745 (Ch) where David Richards J, while not impugning the integrity of the administrators, made an order removing them, having accepted that the circumstances surrounding a sale suggested a need for further investigation.
35. Similarly a creditor who feels that it would be beneficial for the course of the administration to take a different course in the future can challenge the conduct of the administrators under paragraph 74 of Schedule B1 on the grounds that they are acting, or have acting, so as to unfairly harm his interests. The court may remove an administrator under that paragraph as well as paragraph 88.
36. Finally, if a pre-emptive challenge is not possible, and where he feels that he has sufficient evidence to do so (which may be rare), a creditor can apply under paragraph 75 for an order that the administrator make a contribution to the company's assets on the grounds of misfeasance or breach of a fiduciary duty in relation to the company. However, even if the applicant can overcome the problems he will face in demonstrating that the administrator has not acted properly, this is unlikely to be a sensible approach for a 'junior' creditor to take,

since any return will quite possibly be swallowed up in the general liabilities of the company, leaving the applicant with the costs risks of pursuing the application for very little reward.

37. A more 'creative' way for a disappointed creditor to obtain at least a measure of redress is suggested by the recent decision of HHJ Purle QC in Re Johnson Machine and Tool Co Ltd [2010] EWHC 582 (Ch), relating to an administrator's pre-appointment costs.

38. In that case (and the related case heard at the same time, Re Empire Surfacing Ltd), the Judge had previously considered it appropriate to make an administration order where a pre-pack was proposed. However he declined, upon so doing, to allow the administrators' pre-appointment costs to be treated as an expense of the administration.

39. In giving reasons for this decision the Judge referred to an earlier decision of Norris J, Re SE Services Ltd (9<sup>th</sup> August 2006) which drew a distinction between an administration that was plainly for the benefit of creditors and one where the balance of advantage appeared to lie heavily with the management. In both cases before HHJ Purle QC he accepted that there was evidence demonstrating compliance with SIP 16 and was persuaded that the proposed administration and pre-pack was *"reasonably likely to result in a somewhat better result for creditors as a whole than would be the case in a winding-up, although the outlook was still bleak for unsecured creditors"*.

40. However, despite this, he held that *"in applying the test advanced by Judge Norris ... what the court is called upon to compare is whether the advantage to the purchasing directors in retaining a business shorn of debt is clearly outweighed by the advantage derived by creditors from the pre-pack. Where the directors (or a company which they control or have a substantial connection with) are purchasers, it is rarely possible to establish clearly that the balance of advantage is in the creditors' favour"*. Accordingly the judge refused to allow the administrators their costs as an expense of the litigation, the effect of which, it seems, was that they were payable by the directors themselves.

### “Best Practice”: What Should Administrators Be Doing to Protect Themselves?

41. Within the context of the possible forms of redress available to creditors it is possible to identify a number of ‘best practice’ principles which administrators should be applying in pre-pack cases in order to protect themselves from potential claims, and which, conversely, disappointed creditors should look for if they think a claim under one of the heads outlined above is a possibility.

### Compliance with SIP 16

42. The first, and most obvious, way in which the administrator can avoid a potential claim is through scrupulous compliance with the requirements of SIP 16. Although, as the Insolvency Services Report for July to December 2009 acknowledges (at section 2.3) *“there is presently no statutory or regulatory requirement for insolvency practitioners to send SIP 16 information to the Secretary of State”*, and although there is no statutory remedy for non-compliance, the requirements of SIP 16 are increasingly being taken into account by judges considering administration cases (see, for example, not only Re Kayley Vending, but the Re Johnson Machine & Tool Co and Clydesdale Financial Services cases.
43. Non-compliance with SIP 16 will certainly be of assistance to any creditor seeking the removal of an administrator under paras 74 or 88 of Schedule B1 and it seems probable that, in demonstrating a general lack of compliance, it would be of assistance to a court considering a misfeasance application under paragraph 75.

### Choosing the Purpose of the Administration

44. As set out earlier in this talk, choosing the purpose of the administration is central to the administrator’s duties and the decision to not to pursue the primary purpose of rescuing the company as a going concern can only be taken if it is not reasonably practicable to do so or pursuing a ‘lower’ objective would be in the interests of creditors **as a whole**. The duty to select the purpose of the administration is a fiduciary duty of which breach would found an action under paragraph 75, and the decision must be exercised rationally.

45. Consequently if it can be shown that the administrator considered the wrong questions in reaching his decision, or purportedly considered the right decision while not really applying his mind to it or shutting his eyes to the facts, he has not in fact reached a proper decision and the court may intervene.

#### Acting in the Interests of Stakeholders

46. One interesting point which has been raised in recent cases is the extent to which, although the administrators' duty as expressed in Schedule B1 is to act in the interests of the company's creditors as a whole, he may in fact consider the interests of other stakeholders, and in particular the employees of the company.

47. This point was raised in Re DKLL Solicitors, where the judge, in making an administration order, stated that "*I am particularly influenced [in making an administration order] by the fact that the proposed sale appears to be the only way of saving the jobs of the 50-odd employees of the partnership. The proposed sale is also likely to result in the affairs of the partnership being dealt with, with the minimum of disruption*".

48. An administrator who finds a pre-pack sale impugned may well find this paragraph of assistance as an additional factor justifying his reasoning, regardless of any express acknowledgement of the interests of non-creditors in the legislation.

#### Costs

49. As the Johnson Machine and Tool Co Ltd decision makes clear, the fact that an administrator has acted properly in putting a pre-pack into place does not necessarily mean that he is entitled to his costs as an expense of the administration.

50. Although that case concerned the situation where the administrators were appointed by the court, the Judge noted, at paragraph 8, that where an out-of-court appointment of administrators is made their pre-appointment costs are frequently approved as part of the administrator's proposals under paragraph 49(1) of Schedule B1.

51. In the light of the Judge's comments that such an approach "seems misconceived" (at paragraph 8), and given the court's apparent reluctance to award administrators their pre-appointment costs, it would be sensible for creditors to be on the watch for such a proposal, and consider disputing it in an appropriate case.

#### Consultation

52. Finally, and most importantly, administrators should remember that, although their power to make a sale before a creditors' meeting has taken place is now established, that does not release them from the requirement, if at all possible, to enter into any consultation with creditors. This is implicitly recognised in SIP 16, which requires administrators to disclose what consultation process has taken place, and administrators would do well to remember the words of Neuberger J in Re T&D Industries.

53. Although the Judge was clear that neither the court's nor creditors' approval at a meeting was necessary for a sale to take place, he was equally clear that the administrators should, wherever possible, consult, holding, in his concluding points that:

*"administrators should not be able to take unfair advantage of the fact that the creditors rights are [limited in relation to consultation]. There will be many cases where an administrator will be called upon to make urgent and important decisions and where the urgency means that there is no possibility of a s 24 meeting being called to consider the decision prior to it having to be made. However, the importance of the decision and the time involved may well be such that the administrator should have what consultation he can with the creditors. An obvious case might be where there were three days to make a decision and there were only four creditors of the company, or there were four creditors who make up 80% in value of the total creditors of the company. In those circumstances it seems to me that the administrator should at least consider consulting with those four creditors".*

54. Although Neuberger J was not explicitly considering the modern 'pre-pack' situation, such considerations are now even more important. An administrator who consults

as widely as possible before entering into any pre-pack sale will not only be putting himself in the best possible position to demonstrate compliance with SIP 16 and his fiduciary duties, but will be able to 'flush out' any potential disagreement as early as possible, possibly limiting the risk to himself of future claims.

55. Furthermore, early informal consultation and the widest possible disclosure would go a long way towards reintroducing the measure of creditor control envisaged by Schedule B1 and dispelling the oft-held impression that a pre-pack is a secretive and somewhat murky affair, which might in itself be the best possible protection against a claim that an administrator could achieve.

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