PRE-PACKS: AN EMPIRICAL VIEW FROM THE UNITED KINGDOM

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Introduction

This paper outlines the results thus far of the author's research into pre-packaged administrations. The research was commissioned by the Association of Business Recovery Professionals (R3) in response to concerns raised about the pre-pack strategy, mainly by groups outside of the insolvency profession but also from within it. For the uninitiated, a pre-pack is simply a method of selling the *business* of (and not the shares in) an insolvent company: it is not unusual for practitioners to sell businesses as going concerns, and it is usually the case that such sales will raise more than a sale of the corporate assets on a break-up basis and so will result in optimal outcomes for the company's creditors.

The defining feature of a pre-pack sale is that negotiations for the going concern sale take place at some point prior to the commencement of the insolvency procedure: the purchaser is identified, as are the assets to be transferred and the consideration to be paid for those assets, in what might be termed the run-up to the formal insolvency. Once the insolvency procedure (most commonly administration nowadays) commences, the contract for sale is very quickly executed, and often on the opening day of the insolvency appointment. This can be compared with the position where the procedure commences and the practitioner, believing the business to be saleable, takes steps to market it and, if all goes well, eventually concludes an agreement for the going concern sale. This type of sale, for the purposes of the research, is (somewhat unimaginatively it has to be said) termed a 'business sale'.

Opponents of the pre-pack strategy make a number of objections to it. These are, in outline, that pre-packs do not adequately expose the business to the market and so may fail to maximise value, that they disenfranchise unsecured creditors by frustrating opportunities to participate in the decision-making process, that they are insufficiently transparent, and that they are biased towards secured creditors, who will almost certainly have been fully informed of, and consulted upon, the sale. Further, pre-pack sales to 'insiders', usually owner/managers, are seen as particularly worrisome, in that they smack of the discredited 'phoenix' syndrome and appear especially suspicious to those creditors who will be left unpaid from the proceeds of the sale. It is worth noting that this catalogue reflects to a marked degree the disenchantment with administrative receivership which led to its prospective abolition in s.72A Insolvency Act 1986.

Pre-pack supporters, on the other hand, argue that this strategy is often the best, and sometimes the *only* realistic means of achieving a going concern sale of the business. Pre-packs deliver, at the very least, certainty of outcome, and attempting to sell an insolvent business, once that insolvency is public knowledge, can be fraught with difficulty and uncertainty. Any premium that goodwill might attract is often lost, key employees may leave, again driving value downwards, and the costs of keeping the business trading during a marketing campaign may outstrip any added value that that campaign achieves. Indeed, in some cases there is simply no funding for trading, so that a pre-pack is crucial if the business is to be sold.

This research attempts to evaluate the pre-pack strategy and to determine whether the charges levelled against pre-packs, and, indeed, the justifications proposed for them, are made out or not. A preliminary report has been delivered to R3 and is available on its website, and the final report on the project will be delivered towards the end of this year.

Research Methods

The project involves examining actual cases of both pre-packs and business sales and comparing a range of outcomes for each type of sale. This was achieved by the construction and analysis of databases of pre-packs and business sales. At present, details of 459 business sale cases and 272 pre-packs have been recorded, and the process is still ongoing. The cases in question commenced between September 2001 and December 2004, and are predominantly cases of administration, the main 'non-terminal' UK insolvency procedure. A further comparison of outcomes in going concern sales and break-up asset sales is also being conducted.

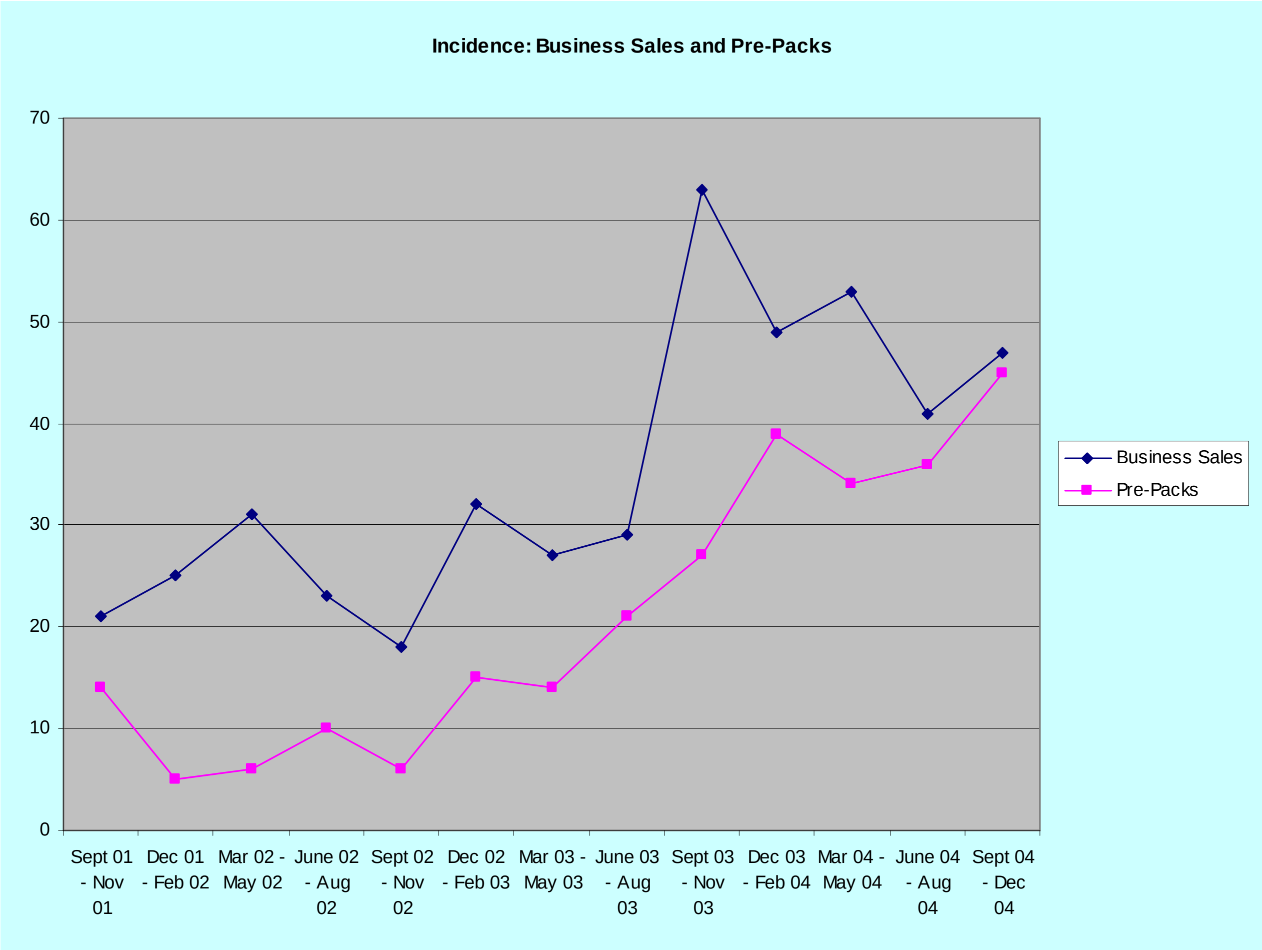
Cases for analysis were identified by searching *The London Gazette* for administration appointment notices, and just under a third of all administration cases were subsequently sampled. The information recorded on the databases is drawn from practitioner reports and communications required to be filed at Companies House (the UK repository for corporate information). These include appointment notices, statements of proposals to creditors, progress reports and abstracts of receipts and payments. Information was gathered on a range of variables, including practitioners appointed and methods of appointment (i.e., whether the appointment was made by the court, by the company's directors or by its secured creditor), business sectors of the companies in question, dates of going concern sales and identity of purchasers, levels of debt owed to secured, preferential and unsecured creditors and levels of returns to each class, employment preservation rates, and whether the purchasing entity has survived or has since entered into an insolvency procedure. It should be acknowledged that not every piece of information is available in every case, and, indeed, a significant proportion of cases are still ongoing. However, it has been possible to conduct interim analyses and once all cases are fully completed (in the sense that any follow-on liquidation has closed) a comprehensive analysis will be conducted.

As well as the collection and analysis of data, the research involves seeking and reporting the views of as wide a range of stakeholders as possible. Insolvency practitioners are being consulted not only to offer their perspectives on the pre-pack debate but also to throw further light on some of the database findings. Other consultees will include debt financiers, trade creditors, Her Majesty's Revenue and Customs (by far the largest unsecured creditor since the abolition of the Crown preference in the Enterprise Act 2002), valuers, legal practitioners and regulators. The Insolvency Practices Council, a United Kingdom body concerned with the ethical implications of insolvency practice, is also taking an active part in informing the research.

The Main Findings So Far

1. The pre-pack landscape

The database demonstrates a rise in the number of pre-packs from September 2001 to the end of 2004, with a sharp acceleration in numbers of administration pre-packs in the post-Enterprise Act period. By the end of 2004, pre-packs accounted for very nearly half of the entire going concern sale sample, as the following table demonstrates:


Incidence: Business Sales and Pre-Packs
70
60
50
40
30
20
10
0
Sept 01 - Nov 01
Dec 01 - Feb 02
Mar 02 - May 02
June 02 - Aug 02
Sept 02 - Nov 02
Dec 02 - Feb 03
Mar 03 - May 03
June 03 - Aug 03
Sept 03 - Nov 03
Dec 03 - Feb 04
Mar 04 - May 04
June 04 - Aug 04
Sept 04 - Dec 04
Business Sales
Pre-Packs

The pre-pack strategy is used by a wide variety of practitioner firms, ranging from the 'big four' (the four largest UK firms, these being Deloittes, Ernst & Young, KPMG and PriceWaterhouseCoopers) through the mid-tier to the sole practitioner. Equally, the use of pre-packs is not confined to any particular 'size' of company: the majority of the cases on both pre-pack and business sale databases involve small enterprises, but this reflects overall trends in corporate insolvency. There was, however, no significant difference between pre-packs and business sales in relation to the size of the company involved. Interestingly, the present figures do not suggest that pre-packs are used predominantly in relation to any particular *type* of business. Whilst they are employed most commonly in relation to 'service' activities (and information technology related supplies and services in particular), this is also true of the business sale sample of cases.

The post-Enterprise Act era has seen a dramatic rise in the number of administrations, and this can in part be attributed to fact that entry routes into administration have been broadened to allow for non-court appointments, usually made by the company directors or its major secured creditor (the 'charge holder'). It might be expected that, where a pre-pack is contemplated, director or charge holder appointments would be prevalent, so as to avoid court scrutiny. This, however, turns out not to be the case. The proportion of court appointments was reasonably similar for both types of sale, accounting for 29% of the cases on the business sale database and 23% of the pre-pack cases. This would tend to suggest that practitioners do not attempt to avoid court scrutiny of pre-packs (nor, indeed, to actively seek it), and, further, that courts are routinely making administration orders in the knowledge that there will follow an immediate sale of the business in a pre-pack scenario.

<u>Purchaser profiles and survival rates</u>

Pre-pack sales to 'connected parties', almost invariably to existing owner/managers of the insolvent company, are more common than business sales to connected parties. Overall, around 62% of all pre-pack cases involved a sale to a connected party, as compared with a figure of around 50% in the business sale sample. Clearly, this is in part a function of the absence of a public marketing campaign in relation to pre-packs, although it is also possible that in certain circumstances in which pre-packs are used the *only* potential purchaser is the company's existing management. Further research will investigate this phenomenon and the reasons for it in greater depth, but for the present it would appear that the 'phoenix syndrome' can be more readily associated with pre-packs than with other types of going concern sale.

This, of itself, may not be objectionable, particularly given the emphasis of the Enterprise Act on the promotion of a 'second chance' culture (although whether the second chance should be offered to the management of a company, as opposed to the company itself, is debatable). However, there are grounds to believe that creditors, and especially trade creditors, are more likely to be suspicious of a 'phoenix' sale, and this of itself may discredit the pre-pack strategy in the eyes of creditors. This tendency might best be addressed by full and open disclosure in practitioner reports to creditors, explaining why the pre-pack was considered the best, if not the only option for the business and, further, that a sale to a connected party was considered justified in all the circumstances.

A further possible cause for concern about sales to connected parties is that the earlier cases on both databases appear to demonstrate a correlation between such a going concern sale and the subsequent insolvency of the purchaser. For cases commencing before September 2004, 65% of all business sales survived, compared to 61% of all pre-packs, but where the sale in question was to an *unconnected* purchaser a survival rate of 72% was recorded for both types of sale. The survival rate for business sales to connected parties was 58% and for pre-packs to connected parties 51%. Therefore, it would appear that where a business is sold as a going concern to its existing owner/managers it is more likely to fail than a business sold as a going concern to an independent purchaser.

However, more recent cases, specifically those commencing between September 2004 and the end of December 2004 demonstrate a rather different trend. As far as survival rates in general are concerned, the rate for pre-packs in the sample is 69%, 7% higher than that for business sales, and something of a turnaround from the previous position. Even more interesting is the finding that, whilst sales to connected parties fail more often than those to independent purchasers, this may be a decreasing trend. Survival rates of both business sales and pre-packs to connected parties rose significantly in the new sample, coming in at 61% and 67% respectively, and again pre-packs perform better than business sales in this regard.

Whether this upturn continues into even more recent cases remains to be seen, but to the extent that it emerges that sales to connected parties remain more vulnerable to a subsequent failure it will be important to understand why this is the case. One obvious explanation is that those owner/managers who led the original company into insolvency in the first place remain ill-equipped to manage the business after its sale to them. Equally, independent purchasers may be better placed to inject new capital into the purchased business than its owner/managers, who may have exhausted their funds in acquiring it in the first place. Further, creditors who traded with the old company and who lost money in the initial insolvency may be less inclined to trade with the new company, or at least to extend it further credit, where the purchaser is a connected party. These, and any other reasons that suggest themselves, will be examined in the remaining phases of the research.

<u>Transparency and fairness between creditors</u>

Transparency, or the lack of it, is sometimes seen as a major issue affecting pre-pack sales in particular. There are two limbs to this contention: firstly, creditors are excluded from the decision-making process in a pre-pack scenario because all decisions are made prior to the commencement of the procedure, and are simply a matter of report afterwards; secondly, it is contended by some that practitioner reports to creditors are less forthcoming than they might be on the subject of the pre-pack. The fact that *secured creditors* will almost inevitably be consulted on (and kept immaculately informed about) the pre-pack tends also to lead to allegations that the strategy is biased towards secured creditors. Such creditors are generally repeat players in the market, with the experience, the resources and the commercial muscle to protect their own interests and it might therefore seem iniquitous that the odds are stacked even further in their favour purely by reason of the method of sale.

However, the research suggests that issues of transparency, whilst they certainly exist, are by no means exclusive to pre-pack sales. In the first instance, three quarters of all *business sales* take place without consultation of (unsecured) creditors, which is probably inevitable given the urgency attaching to any attempt to sell a business subject to an insolvency procedure. In any event, the case of *Re DKLL Solicitors* [2007] EWHC 2067 confirms, inferentially at least, that the pre-pack strategy is, of itself, lawful, notwithstanding that it inevitably excludes certain creditors from participation in the decision-making process. Secondly, there was no significant different between the quality of practitioner reports according to the method of sale, and, in fact, reports on pre-packs sales were in general more informative than those on business sales.

Just over one third of the reports surveyed presented a reasonably full account of the practitioners' motives for preferring a pre-pack. By far the most common was that there was no funding available to meet the costs of trading during the procedure itself, even for a very short time, and that therefore the only means of preserving the business was through a pre-pack sale. It was also frequently noted that there were grounds to believe that any goodwill associated with the business in question would be immediately obliterated on the commencement of insolvency. This was most often cited in relation to businesses with a large customer base, and where those customers could reasonably easily find an alternative source of supply. The uncertainty associated with insolvency was seen as potentially fatal to the possibility of selling the business *after* the procedure had commenced, as continuity of supply would become speculative as far as customers were concerned. Further, many practitioners referred to the possibility of key employees 'jumping ship' if a pre-pack was not effected.

Whether or not one actually accepts these justifications, it is fair to expect some account to be made to creditors, even where they have no financial stake in the insolvency at all. At the very least, it may help to allay the perhaps understandable suspicions of such creditors, and this is more compellingly the case where the business is sold to an insider, who creditors may believe to be directly responsible for the company's parlous position. As a corollary, where little or no justification for the pre-pack is offered, and where little information as to the sale itself is provided, it is not unlikely that such suspicions will be aroused.

<u>Financial outcomes for stakeholders</u>

Given that a relatively large number of cases on the databases are still ongoing, the following should perhaps be treated with some caution. It appears that, in terms of *overall returns to all creditors*, there is no significant difference between pre-packs and business sales. The reasonably similar level of overall return in pre-packs and business sales might tend to suggest that in terms of value maximisation there is little to choose between the two methods of sale. However, in the breakdown of returns to *classes* of creditor some interesting findings emerge. Firstly, returns to secured creditors do not differ substantially according to the method of sale, although business sales do appear to result in a larger proportion of 100% returns to secured creditors. Unsecured creditors, on the other hand, appear to fare significantly better from business sales than they do from pre-packs (by at least 3%).

As noted above, these findings are somewhat tentative as they represent an incomplete analysis (in the sense that they do not encompass all the cases on the databases, and, further, that they may involve a disproportionate number of 'administration to dissolution' cases, which will by definition result in zero returns to unsecured creditors). However, if further and fuller analysis continues to demonstrate a propensity in relation to pre-packs to deliver lower dividends to unsecured creditors explanations are clearly in order. It may be that pre-pack sales are inherently more likely to be for a consideration that will be sufficient to discharge secured and preferential debts along with the expenses of the procedure. A further avenue for exploration is the possibility that the procedural costs of pre-packs are significantly higher than in either business sales or asset sales: pre-appointment fees and expenses may be relatively steep in this regard, particularly where the pre-appointment period is fairly lengthy. It should also be noted that the earlier sale date in pre-packs does not necessarily mean that the insolvency period will be any shorter than in either business sale or asset sale cases, nor does it mean that there is necessarily less for the practitioners to 'do' after the event.

However, a further possibility relates to the finding that pre-packs are far more effective when it comes to employment preservation than are business sales. In 92% of the pre-pack cases examined and for which this information was available, all employees of the insolvent company were transferred to the purchaser: the corresponding figure for business sales was 65%, and, further, business sales are four times as likely to result in the entire workforce being made redundant than are pre-packs. Whether there is a link between the tendencies for pre-packs to preserve employment whilst delivering less to unsecured creditors is an intriguing question. One possibility is that purchasers, on calculating what they are prepared to pay for the business, take into account not only actual but also *contingent* liabilities imposed upon them by the Transfer of Undertakings (Protection of Employment) Regulations: these will inevitably be much higher where a greater proportion of the workforce are transferred, and so may drive down the price paid for the business to a significant extent. Thus, it may be that unsecured creditors are subsidising employment preservation, but this is highly speculative and requires further investigation.

The Next Stages

The databases are currently being rolled out, and, when complete, ought to give a fuller picture in relation to the issues outlined above. Interviews with stakeholders will shed further light on the pre-pack landscape, and most specifically on the question of why, if the current trend proves ongoing, pre-packs seem to deliver less value to unsecured creditors than do other forms of sale. The issue of survival rates is also important: it is imperative that *all* stakeholders have confidence in insolvency procedures in general, and in pre-packs in particular, and to the extent that pre-packs are seen as synonymous with lower returns and higher rates of subsequent failure that confidence will almost certainly begin to ebb, which would be highly regrettable. The solution lies at least partly in the practitioners' hands: complete transparency as to their reasons for opting for a pre-pack strategy would go some way towards allaying the suspicions and the mistrust which currently accompany it. The final report on this research will incorporate the views of interviewee stakeholders, and any input into this phase would be most welcome and inordinately valuable.