

PRE-PACKAGED ADMINISTRATIONS: PROGRESS REPORT TO THE ASSOCIATION OF BUSINESS RECOVERY PROFESSIONALS

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1. Introduction

This report is essentially a progress report, following on from the preliminary report on pre-packaged administrations published in September 2007.¹ It describes the findings of the most recent quantitative analysis of pre-packs, which covers the four month period from the beginning of September 2004 to the end of December 2004, and examines once again the relative performance of pre-packs and 'business sales'² according to a number of criteria. The report also describes and considers certain legal developments relating directly and indirectly to the pre-pack strategy.

a. The original and the new databases

i. Eliminating bias

The preliminary report was largely based upon an analysis of two databases, the pre-pack database and the business sale database, covering the period from September 2001 to September 2004. They contained information on 227 and 412 cases respectively. These databases were incomplete, in the sense that a number of the cases on them were ongoing: either the original procedure (administration or administrative receivership) was still operative or the case had moved into a company voluntary liquidation which itself had yet to be completed. The data gathering exercise in relation to these two databases is still ongoing as incomplete cases close.

The analysis of the original databases necessarily involved sub-samples, most notably in the area of returns to various classes of creditor: cases which had moved into a voluntary liquidation which was still ongoing had to be excluded when it came to examining returns to unsecured (and sometimes preferential and secured) creditors, simply because that information was unavailable. As a corollary, cases for which this information was available tended to be those where the original procedure (administration or administrative receivership) moved into dissolution rather than liquidation. This, as noted in the preliminary report, led to a possibility of bias: cases moving into dissolution are inevitably those where there will be no return to unsecured creditors, and these cases featured most prominently in the analysis.

The question was whether, in the roll-out of the databases, it might be possible to avoid this same possibility and one solution suggested itself. The original databases were constructed from a randomly sampled set of 2,063 cases of administrations and receiverships. It was decided that cases to be included in the roll-out should instead be selectively sampled. This meant conducting a 'sweep' of *all*

¹ See 'A Preliminary Analysis of Pre-Packaged Administrations' (hereinafter 'The Preliminary Report'), available on the R3 website at:
<http://www.r3.org.uk/uploads/documents/preliminary%20analysis%20of%20pre-packed%20administrations.pdf>.

² The generic term chosen in relation to all going concern sales of a company's business, or a part of it, which did not involve pre-procedure negotiation.

administrations and receiverships in a given period, and to categorise them as closing through dissolution or through voluntary liquidation, or as still ongoing. The new databases would contain roughly proportionate numbers of cases which had closed through dissolution or voluntary liquidation, and this in turn would allow full information on creditor returns to be entered whilst at the same time eliminating, as far as possible, the kind of bias recognised as possibly present in the analysis of the original databases.

The first roll-out covers the period between September 2004 and the end of December 2004. The London Gazette archives contain all notices of administration and receivership appointments, and these were used to perform the sweep and to compile a list of those companies named in the notices. The Companies House Direct service³ was then consulted, and the status of each of the companies on the list was checked and categorised. Overall, insolvency records for 401 companies in administration⁴ and 118 in administrative receivership were found on Companies House Direct. Of the 401 administrations, 206 had moved from administration directly into dissolution and 54 had been dissolved following a creditors' voluntary liquidation. 137 cases were still ongoing, 120 having moved into liquidation and the remaining 17 still in administration. Perhaps remarkably, 4 cases from this period emerged from the administration procedure intact and are still trading.⁵ Of the 118 receiverships, 50 involved companies dissolved without any follow-on liquidation, 11 were dissolved following liquidation and 57 were ongoing, 44 in the original receivership and 13 in liquidation.

One might question at this stage why receiverships were included in the sampling exercise at all, given that many of the objections to the pre-packaging strategy are only of real relevance in the context of administration. Administrative receivership was abolished, with prospective effect, by the Enterprise Act 2002⁶ precisely in order to promote the use of administration, which was perceived as a more transparent and a more inclusive procedure, and one which was likely to result in a higher incidence of corporate rescue and a better prospect of a dividend to unsecured creditors. Pre-packaged administrations have been criticised as opaque and exclusive and, possibly, as detrimental to the financial interests of unsecured creditors in that they are less likely to result in optimal realisations due to the business not being exposed to the competitive forces of the market.⁷ In other words, pre-packaged administrations could be said to feature the same negative characteristics as receiverships and thus to be contrary to the objectives of the Enterprise Act.

This contention, however, pre-supposes that *receiverships* were indeed guilty as charged: that the procedure was less transparent and equal-handed than administration.⁸ The inclusion of a sample of receivership cases in the current

³ In the author's opinion, one of the most exciting websites in the western hemisphere. Others would probably disagree.

⁴ It was decided to exclude the 43 Paycheck Services-related companies on logistical grounds.

⁵ As an aside, this is the highest level of 'corporate rescue' encountered in the author's researches so far.

⁶ See s.72A Insolvency Act 1986.

⁷ The perceived deficiencies of pre-packs are discussed in more detail at pages 8-9 of the preliminary report.

⁸ This issue has been examined in some detail in a number of projects sponsored by the Insolvency Service, including the author's own work and that carried out by Armour, Hsu and Walters. The reports on these surveys are available on the Insolvency Service website: see Frisby, *Report to the Insolvency Service on Insolvency Outcomes* (July 2006) at <http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/research/corpdocs/InsolvencyOutcomes.pdf>. See also, for an update on the initial Report, *Interim Report to the Insolvency Service on Returns to Creditors From Pre- and Post-Enterprise Act Insolvency Procedures* (July 2007) available at: <http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/research/returntocreditors.pdf>. For Armour, Hsu and Walters excellent comparison of costs and realisations in receivership and

survey would, therefore, add a certain further comparative dimension to the overall investigation. Further, the objectives of the project, whilst primarily directed towards an evaluation of the pre-packaged administration, include a mapping exercise of pre-packs as a whole, so as to chart their incidence and to determine whether they are used in relation to any particular types of business, or primarily in smaller or larger cases and so forth. Including receivership pre-packs (and business sales) in the survey therefore increases the number of cases available for analysis.

To return to the question of the current roll-out, having established that in both receiverships and administrations roughly half of all cases proceeded straight to dissolution it was possible to select for download proportionate numbers of *completed* cases. Of course, it was impossible to predict from the outset how many of these completed cases would involve a going concern sale of the business of the insolvent entity. As noted above, the 'sweep' exercise had identified 401 administrations and 118 receiverships for which records were available in the given period, so a total of 191 of these were sampled, comprising 154 administrations and 37 receiverships, so that around one third of all available records were downloaded. These cases were then examined in detail, and this examination revealed that of the 191 cases downloaded 92, or 48.2%, resulted in a sale of the business as a going concern (73 administrations and 19 receiverships). Of these 92 cases, 47 (51.1%) were classified as business sales and 45 (48.9%) as pre-packs. Interestingly, the pre-pack sample contained a higher proportion of administrations (82.2%) than did the business sale sample (76.6%).

Overall, therefore, the new databases contain as full an array of information as possible⁹ on the cases used to construct them. The selective sampling exercise will hopefully have eliminated at least some of the possibility of bias noted in the preliminary report. What emerges is a 'snapshot' of the period in question, which will in turn be merged into the original databases and, moreover, extended at least until September 2005 and, possibly, beyond that point.¹⁰

ii. Additional information on the new databases

Since the publication of the preliminary report the author has had ample opportunity to present its findings at several events, including regional R3 meetings, legal practitioners' forums and academic conferences and seminars. These events invariably close with a 'question and answer' session, and during these sessions a number of matters were raised which have informed the roll-out to a considerable extent. Thus, as well as extending the databases vertically along a timeline, they have also been extended horizontally to capture more information on cases. This is entirely thanks to suggestions made by those attending the events in question, and the author can take no credit in this regard.

The new databases therefore include information on the 'age' of each company (taken from the date of incorporation) in order to examine whether there is any difference in trends in this respect between business sales and pre-packs (and, indeed, between going concern sales and asset sales), and also on appointment

administration, see *The Impact of the Enterprise Act 2002 on Realisations and Costs in Corporate Rescue Proceedings*:

<http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/research/corpdocs/ImpactofEARpt.pdf>.

⁹ There remain gaps in the information, but not in relation to creditor returns. This is amplified upon later in this report.

¹⁰ In this regard, much depends upon how practicable it is to obtain a sufficient number of closed cases. On current experience, procedures which move into a subsequent liquidation may take at least three years from beginning to date of final return to close.

trends. In administration, the method of appointment is recorded: i.e., whether the appointment is made by the court, the company (acting through its directors), or by a qualifying floating charge holder (and, if this is the case, the identity of the charge holder). For receivership cases, the identity of the charge holder is recorded. A further addition comes about as a result of suggestions from practitioners and members of the Insolvency Practices Council¹¹ and relates to the nature of the business transferred. There is at least an implication that some types of commercial activity are more susceptible to the effects of entering into an insolvency procedure than are others: one of the justifications for the pre-packing strategy is that it preserves goodwill which would otherwise be eroded, and this may be a more prominent consideration in relation to certain types of business activity.¹² It was therefore decided to investigate whether pre-packs were used more frequently in relation to certain types of business.

b. Analyses conducted

As in the preliminary report, a comparison between business sales and pre-packs was carried out with reference to frequency, returns to creditors, levels of sales to connected and unconnected parties, employment preservation rates, recidivism rates, inclusivity,¹³ transparency and quality of reporting.¹⁴ In addition analyses of appointment trends and business sector trends were also conducted. It should be noted that this sample is a relatively small one in the overall scheme of the research and relates to a relatively short period. It will, however, be extended, as noted above, and fed into the original databases by the end of the research period. It may, therefore, also be possible to track trends and developments in accordance with particular timelines, which in turn may be useful in gauging the impact of legal developments on practice.

2. The Pre-Pack Landscape: A Snapshot

a. Incidence of pre-packs

It is worth recalling that the original databases identified the level of pre-packing over a three-year period as 35.5% of all the going concern sales in the sample.¹⁵ The preliminary report noted that in administration cases, the number of pre-packs taking place rose most sharply after December 2003, whereas receivership cases saw a similar rise in number from around a year earlier. For the purposes of this report, it was decided to chart the relative incidence of business sales and pre-packs, to compare the frequency of each type of sale along a timeline beginning in September 2001 and running until the end of December 2004. The results of this exercise can be seen in Table 1 below.

¹¹ Geoffrey Fitchew has been kind enough to comment on the quality of the footnotes in the author's previous reports. It would therefore be churlish not to mention him in one.

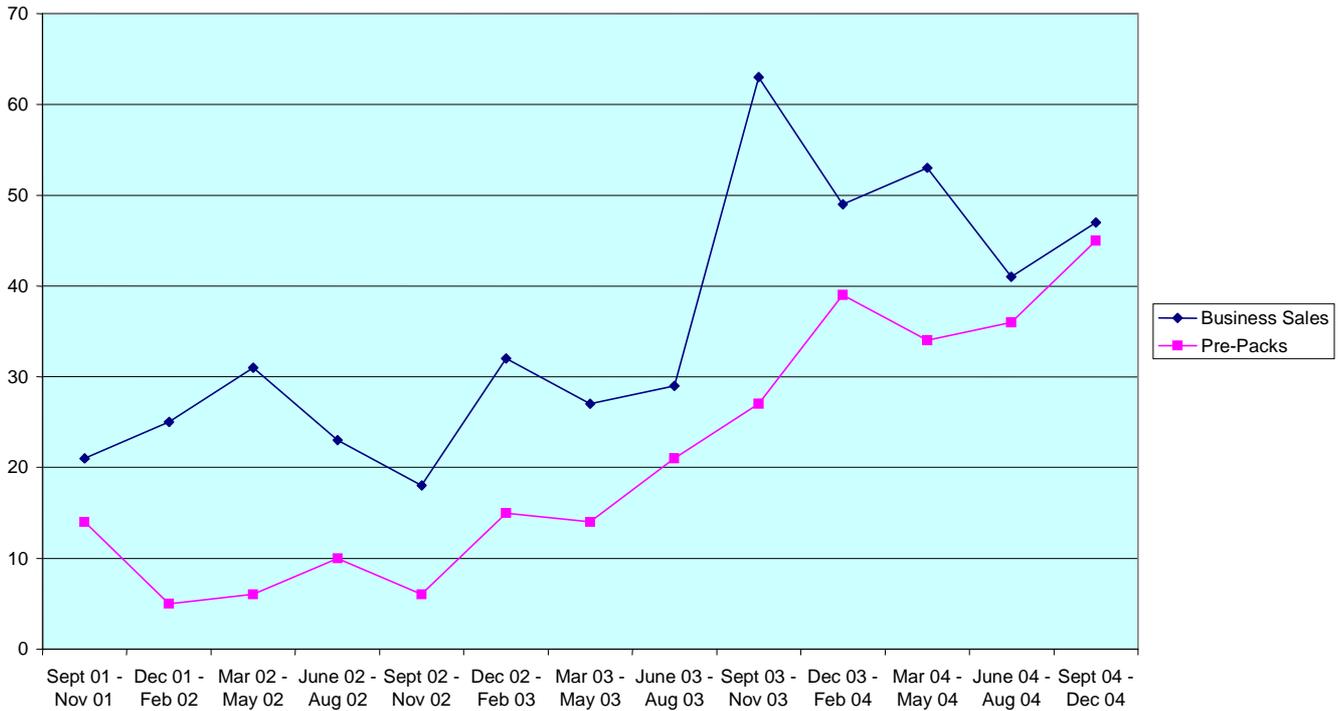
¹² 'People' businesses spring to mind, where the future of the business in question depends very much upon the particular skills of its personnel, rather than on its tangible assets. Uncertainty about whether or not the business will be sold may lead to the departure of key employees and thus destroy any chance of a going concern sale, which in turn will depress the realisable value of the estate.

¹³ More specifically, whether or not creditors had any opportunity to direct the course of the procedure through voting on proposals.

¹⁴ These do not admit of quantification with any exactitude. However, the author, through reading practitioner proposals and reports has been able to comment on the amount of information provided to creditors and whether it is likely to assure that they are sufficiently well-informed to decide whether their interests have been properly taken into account.

¹⁵ See pages 15-19 of the preliminary report.

Table 1: Incidence: Business Sales and Pre-Packs



Observations

This table is interesting in a number of respects. It appears that whilst pre-pack numbers have risen more or less steadily, there is no concomitant and contemporaneous fall in the number of business sales. There appears, therefore, to be no indication that pre-packs are routinely being used *as a substitute* for business sales although the most recent period suggests that the strategy was being used almost *as commonly* as more orthodox post-commencement marketing techniques. It should be noted that the entire sample was deliberately skewed towards post-Enterprise Act cases,¹⁶ but nevertheless there is at least an indication that the number of going concern sales (as opposed to asset sales) in the latest period is rising, which may in turn suggest that 'better' outcomes in both administration and receivership were being achieved.

b. Profiles of sampled companies

i. Age of companies entering administration and administrative receivership

Companies House Direct records the date of incorporation of every company registered at Companies House, and this information was included on the new databases. The following three tables illustrate the breakdown of companies according to age across the entire sample of going concern sales, and across the business sale sample and the pre-pack sample respectively.

¹⁶ The original databases were constructed from a pre-existing database constructed for use on a project to determine the impact of the Enterprise Act on insolvency outcomes, sponsored by the Insolvency Service, and therefore this bias was necessary.

Table 2 - Incorporation: All Going Concern Sales

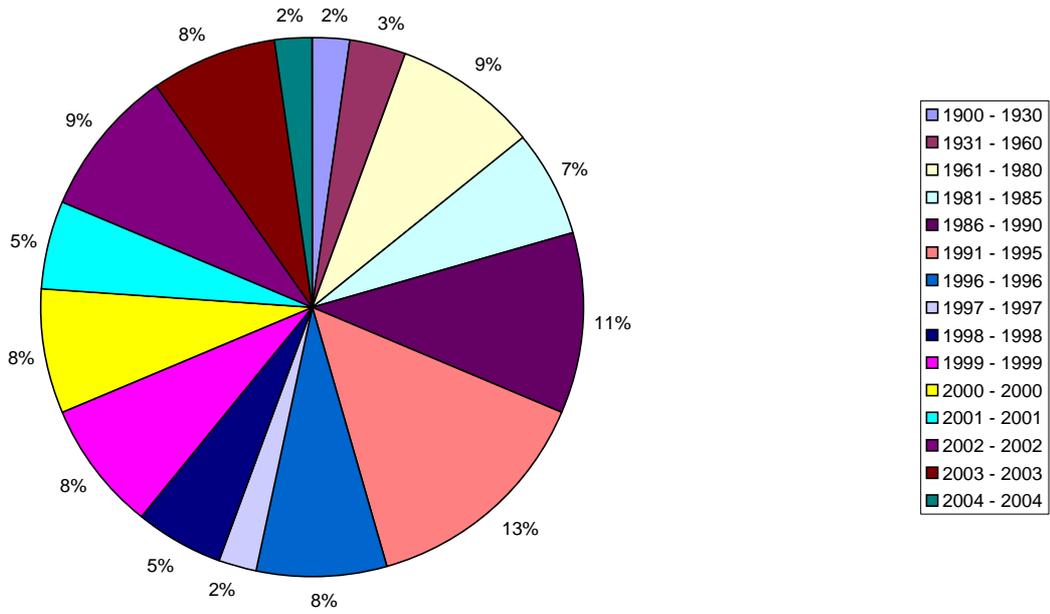


Table 3 - Incorporation: Business Sales

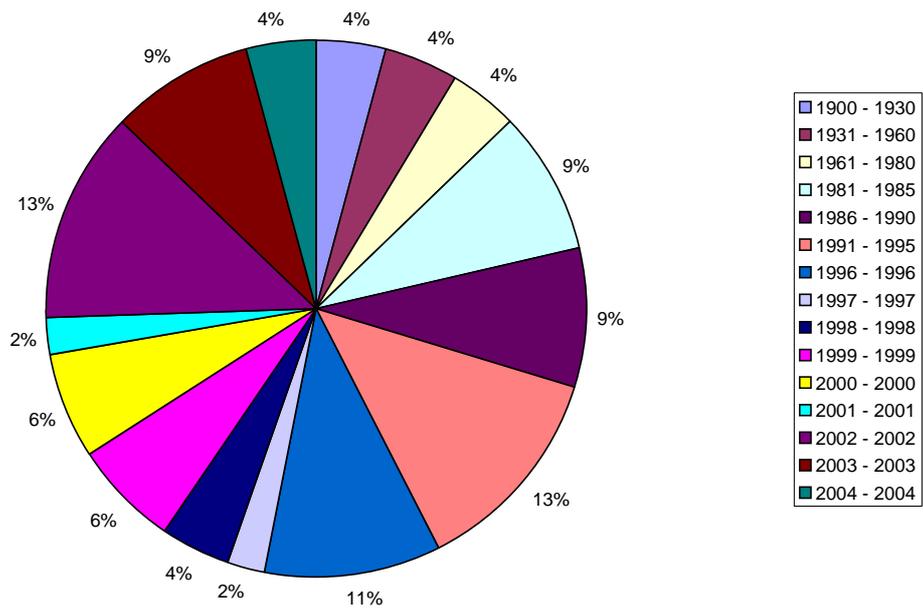
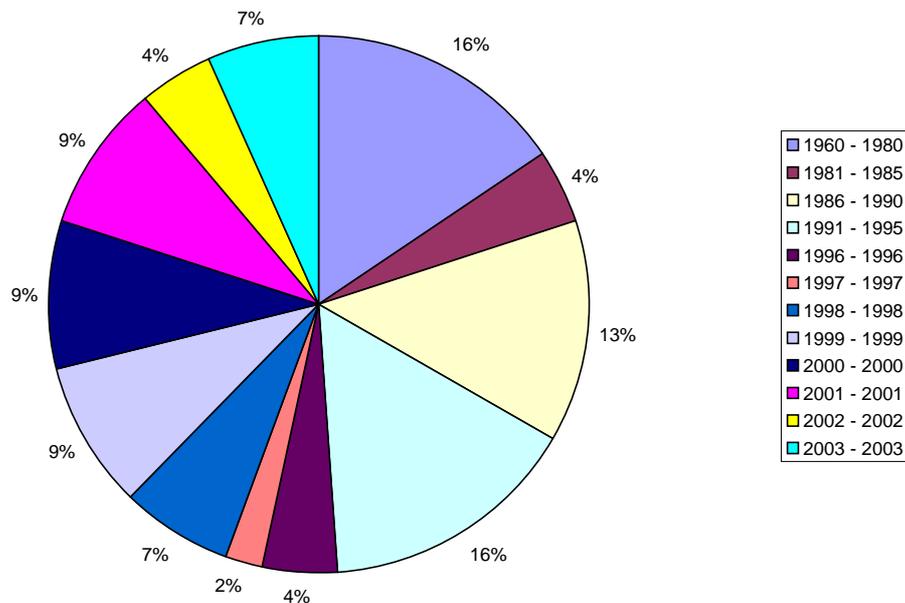


Table 4 - Incorporation: Pre-Packs



Observations

What is perhaps most notable about the above tables is the relatively high proportion of companies that enter formal insolvency within four years of incorporation. Almost one third of the entire sample falls into this category, and this is the case in relation to just over one third of all business sales in the sample and 29% of cases in the pre-pack sample. Of course, it would be naïve to assume that that date of incorporation is equivalent to the commencement of the enterprise, and in seven of the cases in the sample practitioner reports make explicit reference to the fact that the company in question was incorporated to acquire the existing business of another company which itself had entered receivership or administration. There would, however, appear to be a significantly higher level of corporate recycling of 'younger' companies, and the likelihood of failure seems to decrease the longer a company has been in existence.

ii. Appointment trends

Since the coming into force of the Enterprise Act 2002 administration appointments can be made out of court by a qualifying floating charge holder¹⁷ or by the company or its directors.¹⁸ Administration applications can still be made to the court.¹⁹ It was noted in the preliminary report that the sharp rise in the number of administration pre-packs occurred in the post-Enterprise Act period, and one possible explanation for this might be that the greater flexibility as to methods of appointment provided by the Act allowed for pre-packs to be effected without court scrutiny. This was, at the time, considered open to doubt as the *only* explanation, not least because pre-Enterprise Act pre-packs had occurred and, by definition, those administrations must have been commenced by court order.

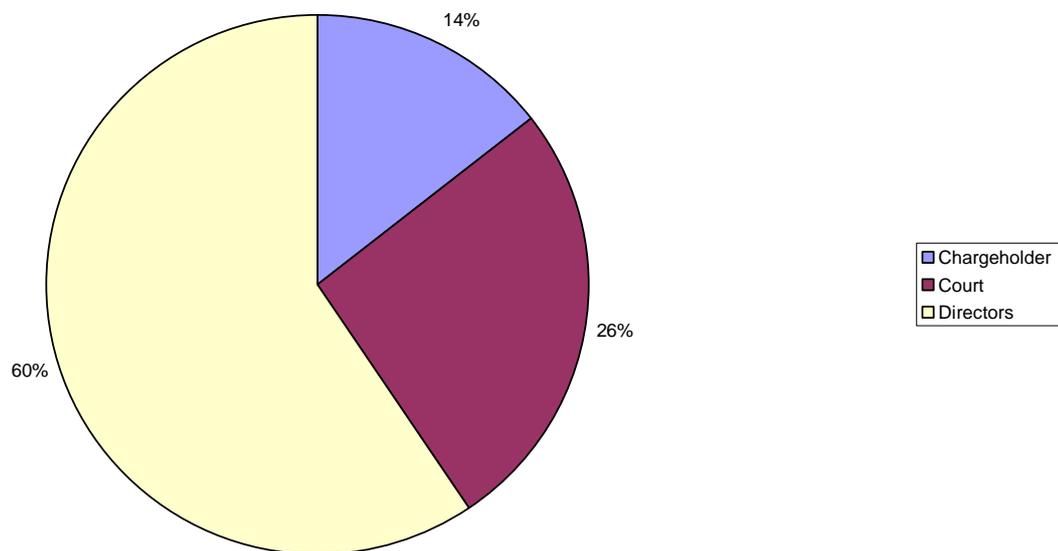
¹⁷ Under para.14 of Schedule B1 Insolvency Act 1986

¹⁸ *Ibid.*, para.22.

¹⁹ *Ibid.*, para. 12.

The new databases contained information, where available, on the method of appointment in administrations, and this information could be extracted from statements of proposals in 69 out of the 73 administration cases sampled. Where the appointment was made under paragraph 14 of Schedule B1 to the Insolvency Act 1986, the identity of the appointing charge holder was also recorded. In receivership cases, the appointment is necessarily made by a floating charge holder, and this information was similarly recorded. For the entire administration sample, appointment trends were as follows.

Table 5 - Appointors: All Administration Going Concern Sales



Observations

Clearly, the ostensible trend revealed here is towards director led appointments, with charge holders appearing to take a back seat when it comes to appointing administrators under the Enterprise Act. However, this finding should be treated with some caution to the extent that it suggests that charge holders have less influence over the appointment process than in pre-Enterprise Act days. The author's earlier research for the Insolvency Service²⁰ suggested that many paragraph 22 appointments would be the result of a process of consultation between practitioner, directors and charge holder. To quote from the Insolvency Outcomes report:

"...many interviewees (including bankers) suggested that even where directors make the appointment, in many cases this will be with the active acquiescence, and often encouragement, of the charge holder. In a manner similar to that seen in the appointment of administrative receivers, where reports often refer to the directors "requesting the charge holder to appoint receivers", it appears that many ostensibly director led appointments will be the culmination of a process of consultation and negotiation. Both directors and charge holder will have reached an agreement that an appointment should be made, and, indeed, on the identity

²⁰ See at note 8, above.

of the appointee. However, it is further agreed that the directors or the company should actually make that appointment.”

The Insolvency Outcomes report considers in some detail the circumstances in which a charge holder might resort to making an administration appointment. In very general terms, interview data suggested that charge holders, and particularly the clearing banks, would prefer not to do so and were tending more and more to be amenable to ‘walk-in’ appointments, those where the directors, or their nominee practitioner, approach the bank with a proposal for an administration appointment and the bank agrees, perhaps after some negotiation, to that appointment being made. Directors wishing to make a para.22 appointment must, of course, serve a notice of intention to appoint on any qualifying floating charge holder²¹ and this will inevitably allow such a charge holder to consider his options: the consensus was that unless the charge holder has specific reasons to object either to the nominated practitioner or, indeed, to an administration appointment *per se*, the directors will be allowed to proceed with their choice of procedure and practitioner. Therefore, it is likely that in many of the para.22 appointments there will have been some charge holder involvement.

As far as appointments by the court are concerned, there are certain explanations as to why this seemingly more cumbersome method should be adopted. One is that where a petition for the winding up of the company has been presented but not yet disposed of, the directors of the company may not appoint an administrator under para.22.²² In other words, recourse to court is *necessary* if a director-led appointment is to be made and an outstanding petition is in existence.²³ In such circumstances, the petitioner must be notified of the application²⁴ and is entitled to appear or to be represented at the hearing of the application.²⁵ It should be noted that no similar restriction exists in relation to charge holder appointments under para.14, although such an appointment may not be made if a provisional liquidator *has already* been appointed under s.135 Insolvency Act 1986.²⁶

It was not possible to determine whether this was *in fact* the explanation for perhaps unexpectedly high proportion of court appointments across the sample, as practitioner reports do not routinely divulge whether or not a petition for winding up had been presented in relation to the company.²⁷ Of the 18 court appointments across the entire sample, exactly one third involved cases where there was no qualifying floating charge holder able to make an appointment. This is somewhat higher than the proportion of cases (26%) in the entire sample where there was no charge holder. However, a further explanation for recourse to court is that a court appointment carries a certain authority perhaps lacking in private appointments, and, indeed, where the proposed course of action to be taken during the administration is seen as potentially controversial²⁸ the court order might properly be seen as a validation of this strategy. In one sense, therefore, the court appointment route might almost be viewed as a quasi-cramdown device, and might be highly functional in terms of keeping awkward stakeholders in line. As it turns out, however, the significant dichotomy between pre-packs and business sales in terms of appointment trends does not relate to court appointments at all, as the following two tables illustrate.

²¹ See para.26 of Schedule B1.

²² *Ibid.*, para.25.

²³ Malcolm Niekirk of Coffin Mew LLP pointed this out to the author, and his observations on this matter have been highly illuminating.

²⁴ See Insolvency Rules 1986, r.2.6(3)(b).

²⁵ *Ibid.*, r.2.23(1)(e).

²⁶ See para.17(a) of Schedule B1.

²⁷ Although some reports do mention this fact.

²⁸ An example of which might be a pre-pack sale of the business to its existing management.

Table 6 - Appointors: Administration Business Sales

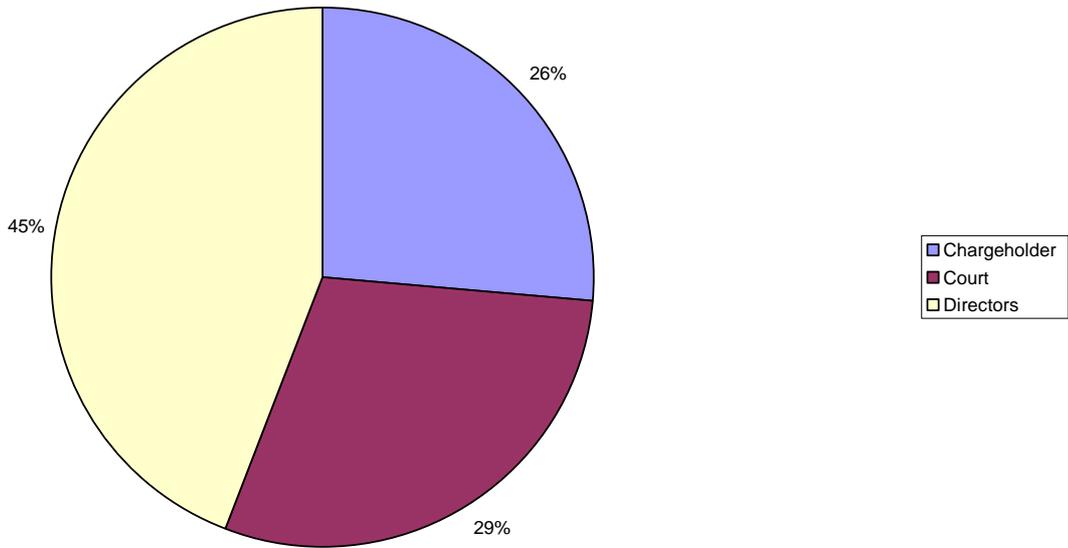
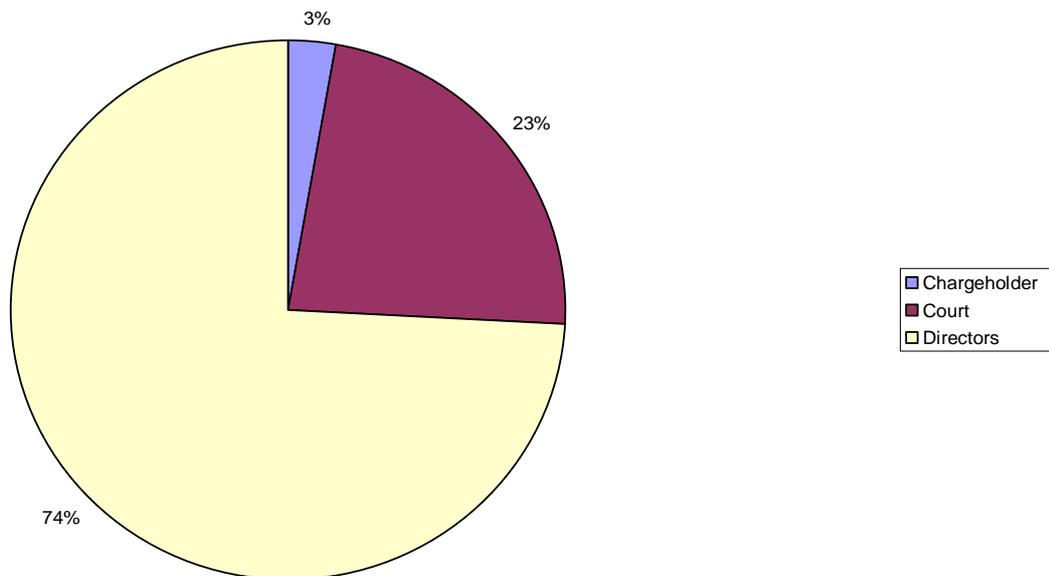


Table 7 - Appointors: Administration Pre-Packs



Observations

The much higher levels of director led appointments in the pre-pack sample, and, as a corollary, the very low level of recourse to para.14 by charge holders (only one charge holder appointment was present in the pre-pack sample) is intriguing. The reasonably similar levels of court appointments in both types of sale would tend to dispel any argument that court scrutiny is either actively avoided or positively sought in relation to pre-packs. It is perhaps too early to draw any

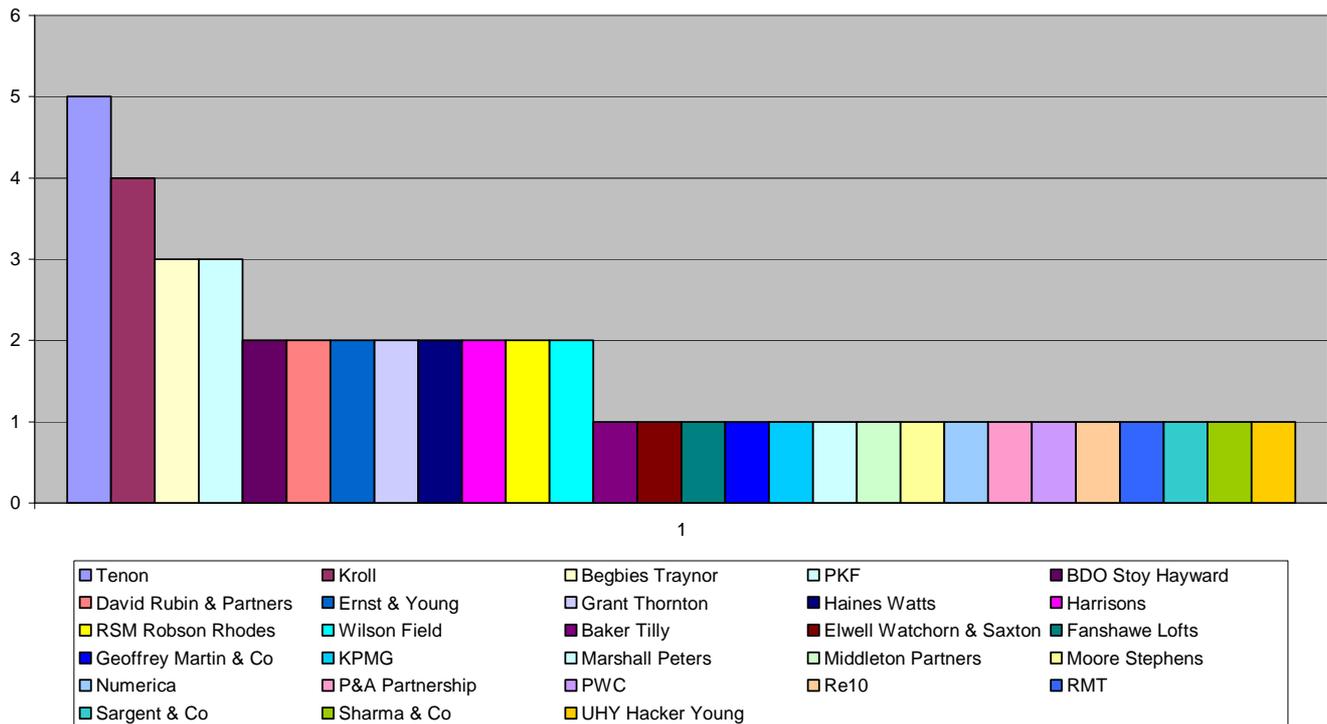
conclusions from a sample of this size that covers a limited period, and further extension of the databases will obviously throw further light on whether charge holder appointments are routinely much less common in relation to pre-pack sales. However, it may be the case that where a pre-pack is contemplated charge holders may be more anxious than usual to avoid making the appointment.

As noted above, where the company has granted a qualifying floating charge over its assets the appointment process is likely to be consensual, and many ostensibly director-led appointments will have been either directed by or consented to by the charge holder in question. It may therefore be the case that reputational considerations for charge holders drive this phenomenon rather more forcefully in pre-pack cases than in other administrations, and this may be even more emphatically the case where the prospective purchaser of the business is a connected party. It is well known that at least one clearing bank has a policy of vetoing such sales, and that others have developed, or are in the process of developing, protocols designed to test the probity and robustness of pre-packs.²⁹ There may, therefore, be a more pronounced preference towards para.22 appointments in pre-pack cases precisely so as to avoid any possible 'taint' associated with the pre-pack itself, and interview data will be used to test this theory in the future.³⁰

iii. Firms Appointed

Tables 8 and 9 below illustrate the number of appointments for each practitioner firm recorded in the business sale and pre-pack databases.

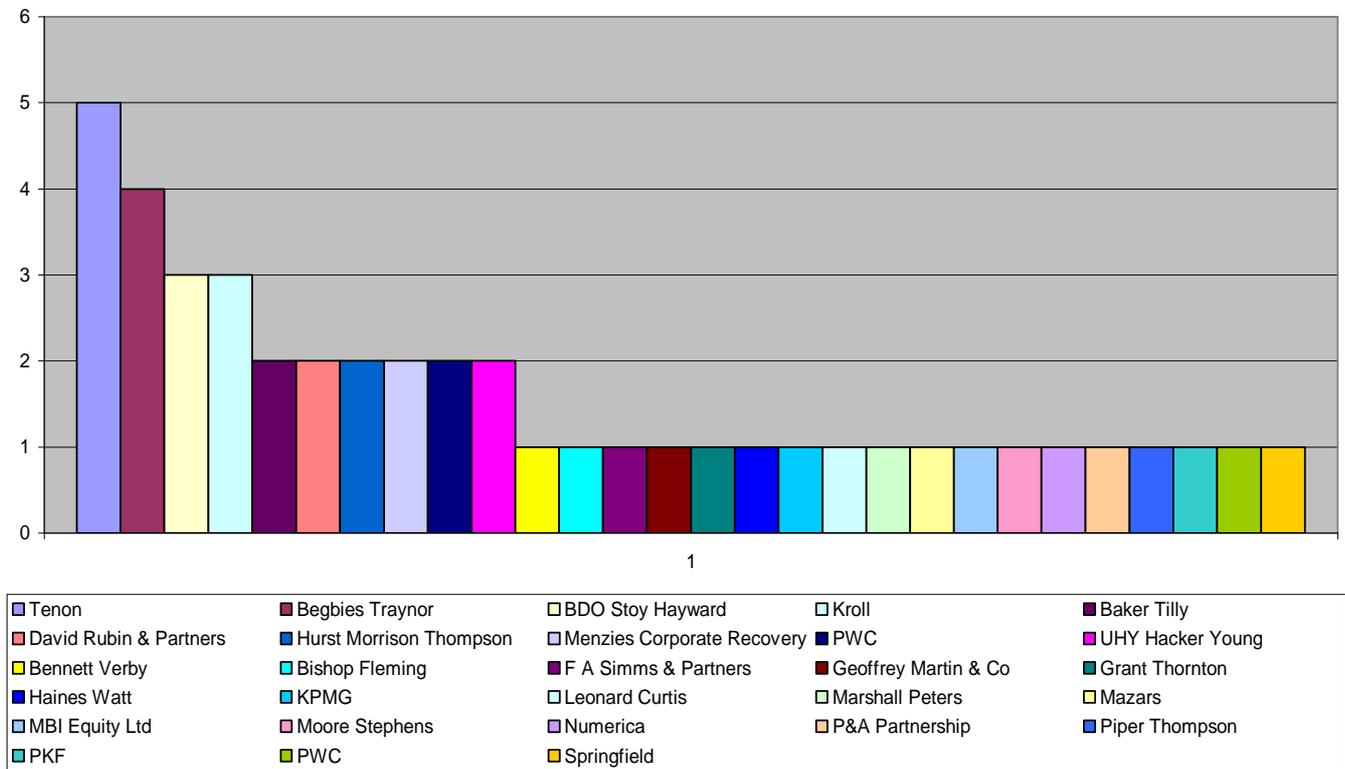
Table 8 - Firms: All Business Sales



²⁹ Interview data on these procedures will be fed into later reports and will no doubt throw further light on appointment processes.

³⁰ Interestingly, the single pre-pack charge holder appointment was made by an independent receivables financier rather than by a clearing bank.

Table 9 - Firms: Pre-Packs



Observations

The main purpose of this exercise is not so much to determine whether any particular firm is dominant in terms of appointments, numbers of pre-packs or numbers of business sales, as the sample period is too short to demonstrate trends.³¹ Rather it illustrates the continuing involvement in the pre-pack arena of a wide variety, in terms of size, of firms. This much was noted in the preliminary report and clearly continues to be the case in the first roll-out period.

It is worth mentioning here that the contribution of smaller practices to the pre-pack phenomenon is by no means insignificant, and that this may well be a very positive development. The author presented at the SPG Forum in October 2007 and was able to 'cut' the original databases so as to analyse the performance of smaller firms when it came to pre-packaged administrations. Overall, the findings were that smaller firms performed at least as well, if not better, than their larger counterparts when it came to keeping creditors informed and maximising realisations, so their continued activities in this regard is to be welcomed.

iv. Company profiles: business activity

As noted above,³² a number of interested parties have suggested that it might be worthwhile attempting to gauge whether pre-packs are being used more commonly in relation to particular types of business. The new databases record this information by using SIC 03 Codes, which classify business activities and which can be filed at Companies House on the registration of the company or at some later date.³³ One possible outcome of this exercise might be to determine whether, by comparing pre-packs and business sales, the author was in fact, in the time-honoured parlance of the judiciary, comparing apples and pears (or peas and

³¹ Although it would be remiss not to congratulate Tenon on a good few months.

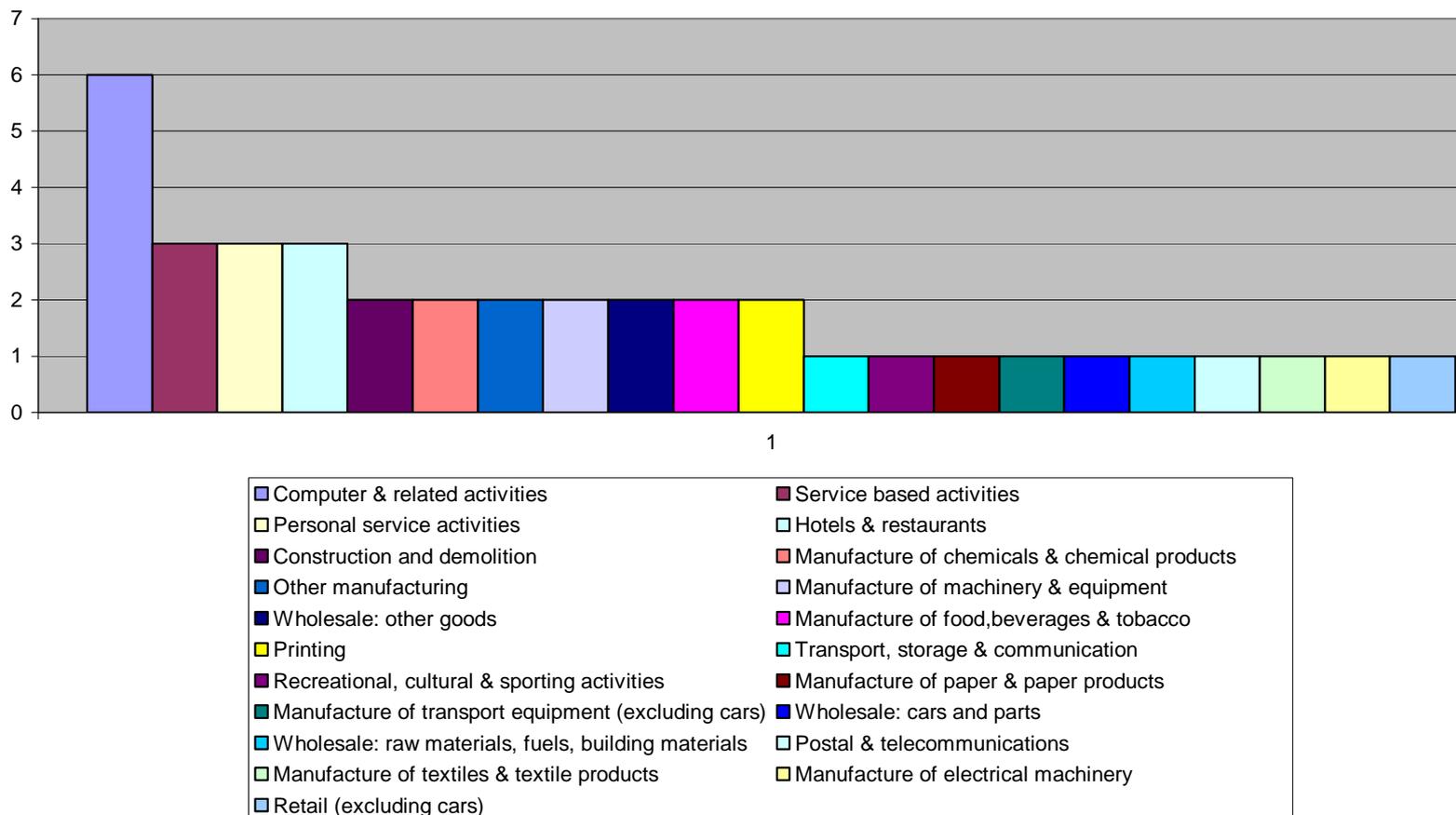
³² At page 4.

³³ A full list of SIC 03 Codes is available on the Companies House website at: <http://www.companieshouse.gov.uk/about/gbhtml/gba2.shtml#sic>

beans).³⁴ Although this information was not recorded on the original databases it ought to be possible to make the addition in time for the final report, but for present purposes it was thought worthwhile to investigate this question. On the business sale database, a SIC 03 code was available in 39 of the 47 cases, and for pre-packs the code was available in 41 of the 45 cases.

For ease of exposition, codes were 'bunched' into a generic category: the SIC 03 classification is extraordinarily detailed and contains well over one hundred different codes, and it would be difficult, if not impossible, to graphically illustrate the frequency of each individual code. Thus, a whole range of activities from the provision of legal services to photography were included in the category 'service based activities'³⁵, and hairdressing, washing and dry-cleaning and the provision of physical well-being and funeral services were categorised as 'personal service activities'.³⁶ The following two tables break down the activity carried out by the company in question for business sales and pre-packs.

Table 10 - Business: Business Sales

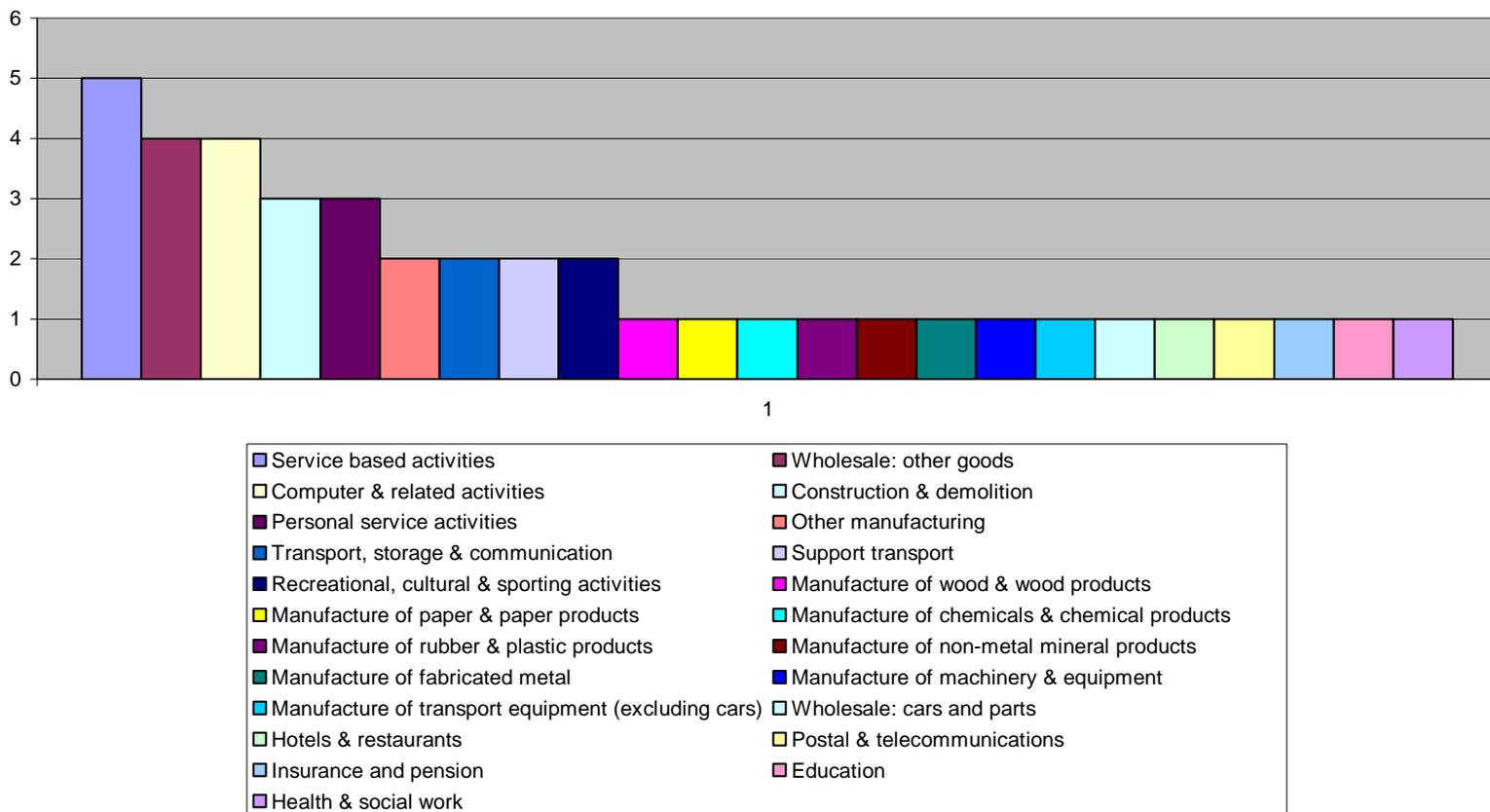


³⁴ Judges tend to use this aphorism to denote dissimilarity, which has always puzzled the author who would tend to think of apples, pears, peas and beans as pretty much alike in a number of respects. 'Chocolate and beansprouts' might get the point across more effectively.

³⁵ SIC 03 bunches these as 'other business activities'.

³⁶ On reflection, a perhaps unfortunate choice of denomination.

Table 11 - Business: Pre-Packs



Observations

With samples of this size it would be overly ambitious to draw any firm conclusions, but a few tentative remarks may be offered. Firstly, there is no *clear* variance between business sales and pre-packs when it comes to the business activity of the companies in question. What would, in the author’s secondary school days, have been denominated ‘tertiary’ activities (i.e., neither agriculture, mining, fishing, nor manufacturing), and can now be generically termed as ‘services’, are dominant in both types of sale, and this may simply be symptomatic of the higher levels of insolvency in general in relation to this type of business. Computer and related activities feature prominently in both samples. Secondly, both types of sale have occurred in an almost equally wide range of categories of business activity: businesses manufacturing a variety of types of products have been sold through pre-packs and business sales, as have construction and wholesale businesses. This admittedly small sample would therefore tend to suggest that the pre-pack strategy is not reserved for any particular type of business any more than is a post-appointment marketed sale. Whether the business classification exercise will demonstrate more concrete distinctions between the two when applied to the original databases (and to further roll-outs) remains to be seen.

v. Purchaser profiles and survival rates

It is worth recalling that the preliminary report noted that sales to connected parties³⁷ were slightly more common in pre-packs sales than in business sales, and this prevalence became more pronounced in the post-Enterprise Act period. Tables 12 and 13 below demonstrate the position as recorded in the new databases.

³⁷ Almost always existing owner/managers.

Table 12 - Purchaser: Business Sales

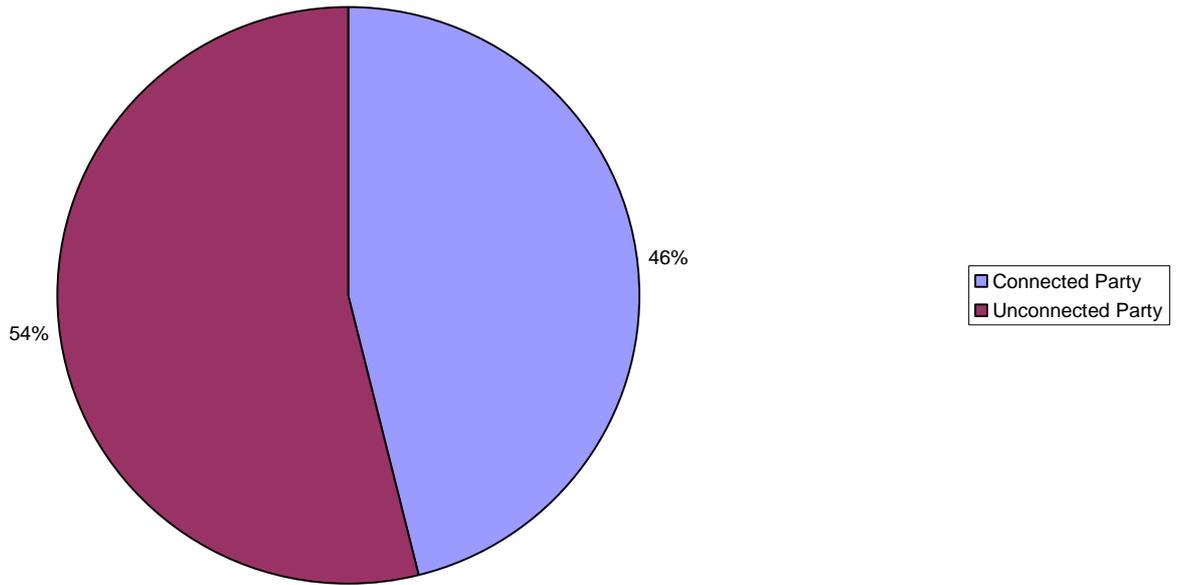
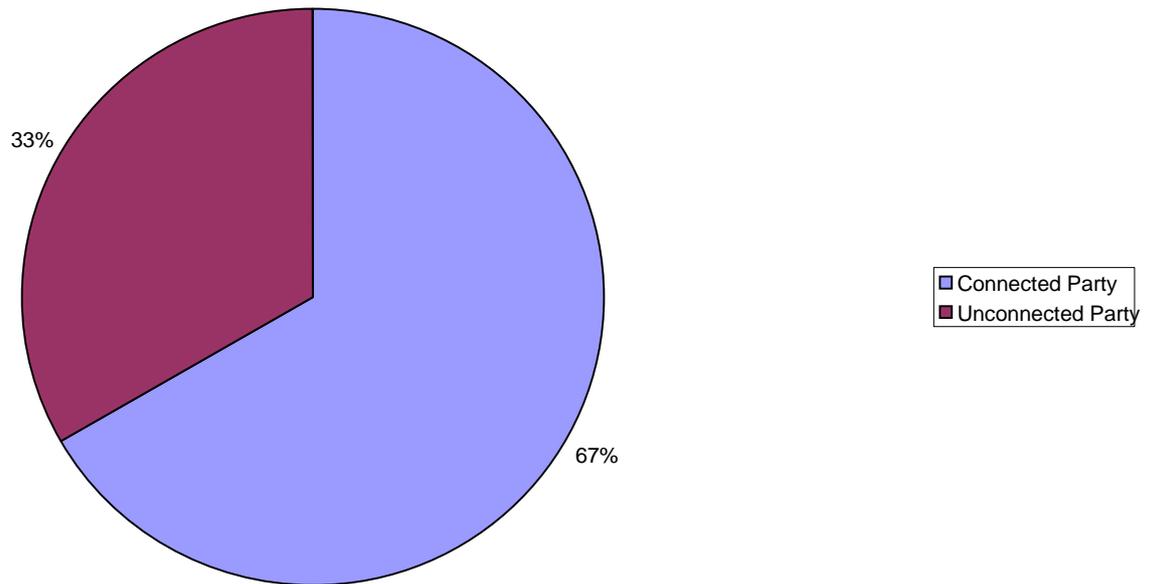


Table 13 - Purchaser: Pre-Packs



Observations

There is a significantly higher proportion of sales to connected parties in the pre-pack sample. The identity of the purchaser was available in relation to 39 of the 47 business sales, and in all 45 pre-packs cases, and the figure of 67% of sales to connected parties for the pre-pack sample is 5% higher than that for post-Enterprise Act cases on the original pre-pack database. Again, one should be somewhat cautious as to the representative potential of this smaller sample, but it *might* indicate an overall acceleration in the trend towards 'pre-packing back to management'. In contrast, the percentage of post-Enterprise Act business sales to connected parties decreases from 51% on the original database to 46% on the new database.

It is worth repeating that this phenomenon is not *in itself* objectionable, and certainly not unlawful, but there are clearly some aspects of it that may give cause for concern. One salient point, as noted in the preliminary report,³⁸ is that it may be perceived as a re-emergence of the 'phoenix syndrome'. It is understandable that creditors, and particularly unsecured creditors who are left unpaid following the sale, are likely to question the propriety of a sale to existing management: whilst the 'second chance' ideology of the Enterprise Act is perhaps laudable, it is nevertheless difficult for unpaid creditors to accept the fact that the party to whom the second chance has been offered is able to continue blithely at the helm of a debt-free business, having somehow managed to jettison a sometimes substantial raft of unsecured liabilities. This may be condemned as a simplistic perspective, but there can be little doubt that it is not uncommonly held,³⁹ and to the extent that it is particularly associated with pre-packs there is a danger that the strategy will be increasingly viewed as inherently suspicious.

A second possible cause for concern arises out of the finding in the preliminary report that the likelihood of a subsequent failure of the purchasing entity appeared to rise when that entity was connected (usually by common directors) to the insolvent vendor company. It is therefore convenient to next examine, in the first instance, overall survival rates for business sales and pre-packs and then the relevant survival rates of business sales and pre-packs to connected and unconnected parties. To recall the findings of the preliminary report, 65% of business sales were 'successful' in the sense that the purchaser had not fallen subject to a subsequent insolvency procedure (so that the rate of recidivism for business sales was 35%). For pre-packs, 61% of cases survived, with a subsequent failure rate of 39%. However, further analysis revealed that where the sale in question was to an unconnected party a survival rate of 72% was recorded for both business sales and pre-packs (and, therefore, a failure rate of 28% in both cases): as a corollary, survival rates for business sales to connected parties fell to 58% and for pre-packs to connected parties to 51%. The following Tables are based upon the new databases, and illustrate some very interesting developments in this regard.

³⁸ At page 40.

³⁹ The author is currently canvassing views of trade creditors on this matter.

Table 14 - Survival Rate: Business Sales

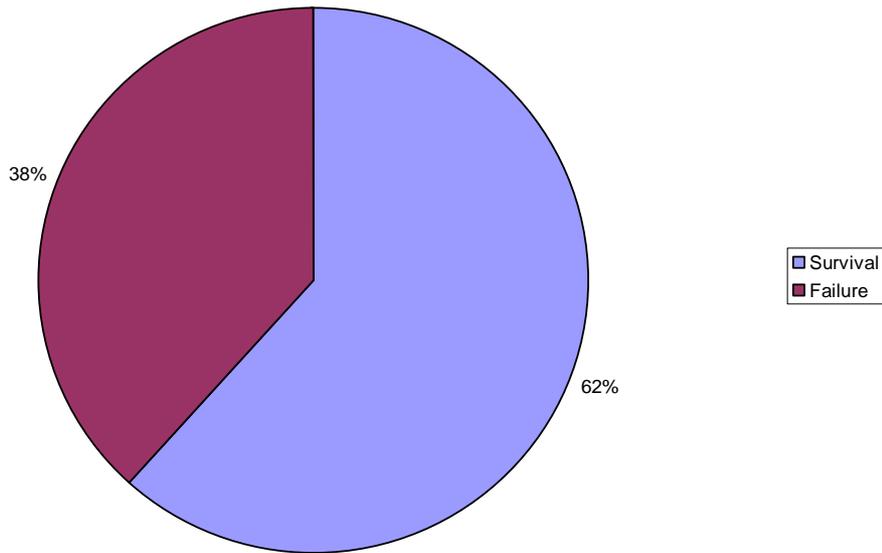
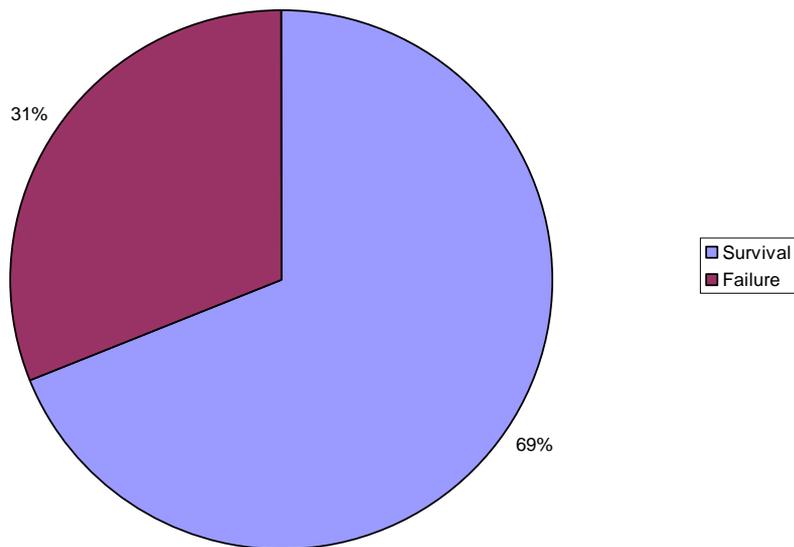


Table 15 - Survival Rates: Pre-Packs



Observations

The survival rate for pre-packs in the sample is 7% higher than that for business sales, something of a turnaround from the previous position. As far as sales to connected and unconnected parties are concerned, the picture is as follows.

Table 16 - Survival Rate: Unconnected Purchaser: Business Sales

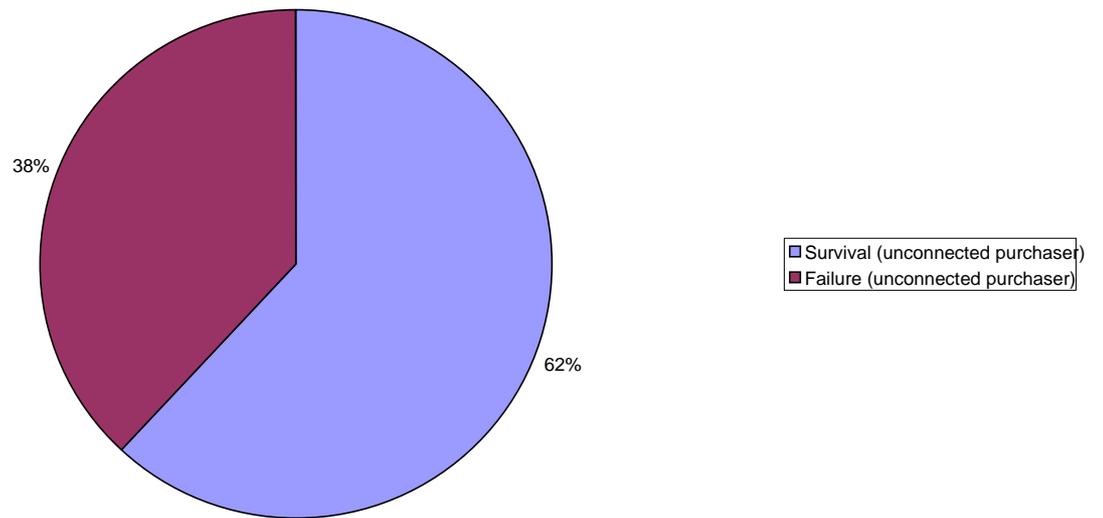


Table 17 - Survival Rate: Connected Purchaser: Business Sales

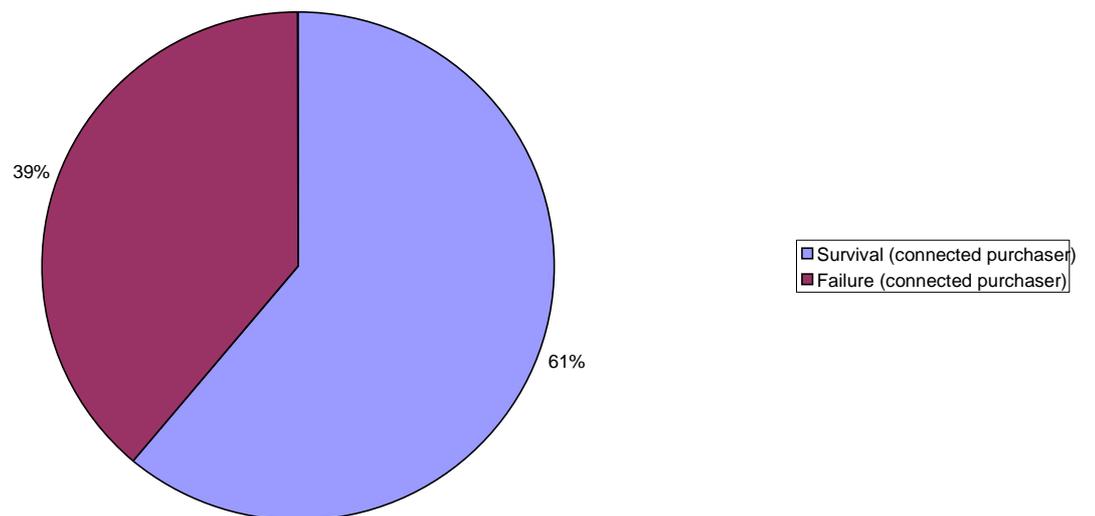


Table 18 - Survival Rates: Unconnected Purchaser: Pre-Packs

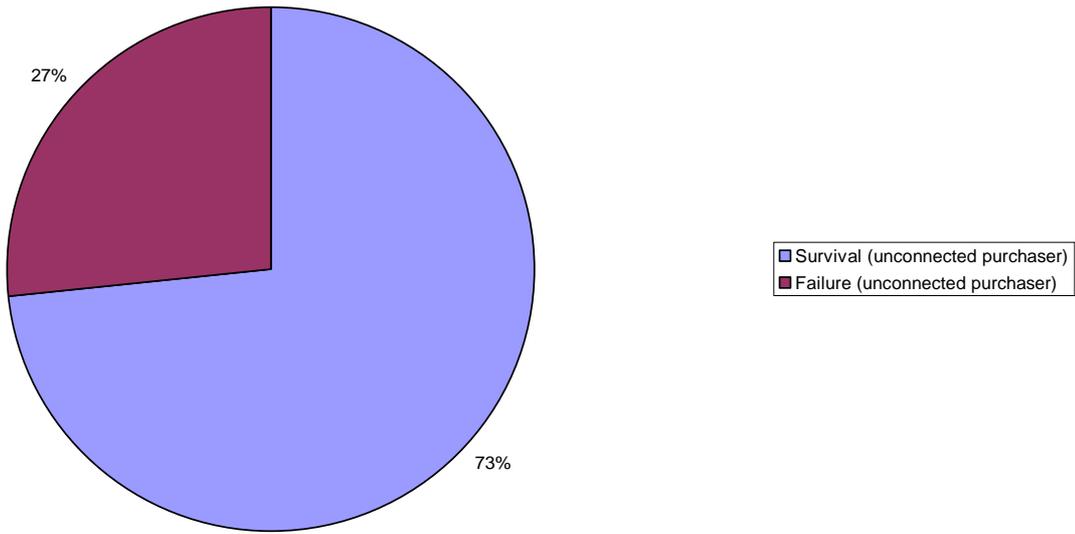
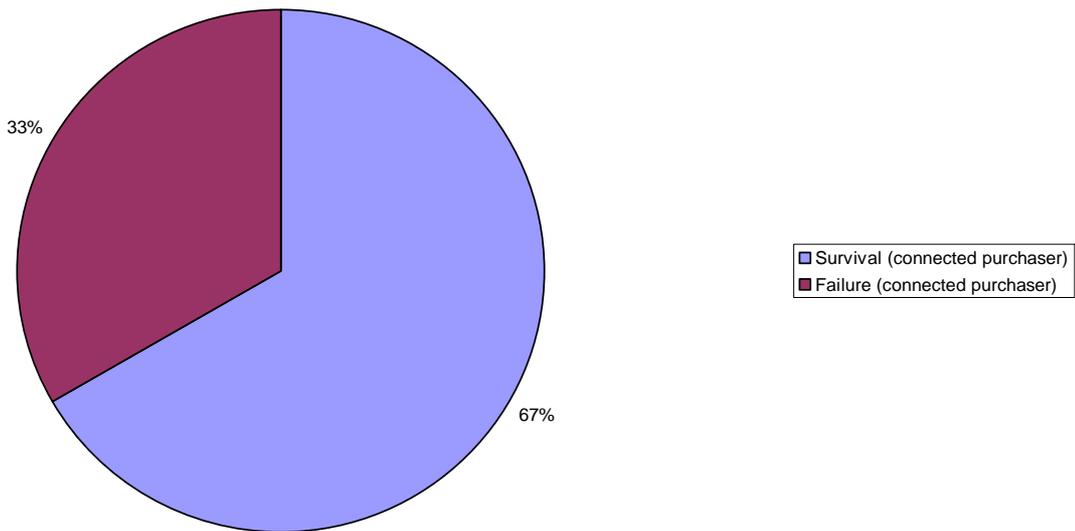


Table 19 - Survival Rate: Connected Purchaser: Pre-Packs



Observations

The results here, and again it bears repeating that a smaller sample has been used, whilst tentatively supporting the proposition that sales to connected parties are more likely to result in a subsequent insolvency, are far more positive as far as pre-packs are concerned. As the overall survival rate for pre-packs was higher than for business sales, so too are the survival rates for pre-pack sales to both connected and unconnected parties. There is also a much higher survival rate for pre-pack sales to connected parties than noted in the preliminary report.

How, then, to explain this? Obviously, as the data-gathering exercise continues more cases may determine whether the current findings are simply a 'blip' or represent a genuinely positive development and interview data will be used to further investigate this matter. However, the optimist might mull over the possibility that pre-pack purchasers, and particularly connected purchasers, are seeking, obtaining and taking expert professional advice on their prospects of turning around a failed business if afforded the opportunity to start with a 'clean slate', as it were.⁴⁰ As noted in the preliminary report, Michael Green⁴¹ very astutely pointed out that many sales to connected parties may simply see the new entity commence business with considerably less unsecured debt, but nothing new in the way of either equity or loan capital. It may be that during the period under examination access to loan capital was becoming easier, cheaper and more flexible: certainly there is clear evidence of the rise of receivables finance in recent years, either through independent financiers or the invoice discounting arms of the clearing banks, and this source of additional capital may be providing the necessary financial boost to purchasing entities. So too, the clearing banks may, through their 'relationship banking' activities, be playing a part in supporting purchasers going forward, and, of course, this upturn in survival rates may in part be symptomatic of the fact that at least some directors learn from their previous mistakes.

In the final analysis, there are at least provisional grounds to suggest that pre-packs have at least as strong a chance of survival as do business sales, and, further, that sales to connected parties have a much better than evens chance of survival into the longer term. The second chance culture espoused by the Enterprise Act might be dismissed by the cynical as blue skies thinking, but to the extent that pre-pack and business sales to connected parties preserve viable businesses, which, it should not be overlooked, may well go on to purchase from their previous creditors and sell to their previous customers, then this second chance must surely be seen as a commercially and economically sound objective.

3. Stakeholders in Pre-Packs and Business Sales: General Considerations

a. Transparency: a step in the right direction?

i. To pre-pack or not to pre-pack? Explanations to creditors

The preliminary report noted that, in terms of providing creditors with adequate information, practitioner reports and communications varied enormously, and that the variations were almost 'random', in that they could not be associated exclusively with either pre-packs or business sales, with one particular procedure, with particular firms or even with particular practitioners. Whilst this issue is not quantifiable with exactitude, it was felt that there was room for discussion as to

⁴⁰ The views of members of the Society of Turnaround Professionals would obviously be extremely valuable in this regard, and will be sought as a matter of some urgency!

⁴¹ Research Fellow of the University of Wales, Bangor.

how creditors could best be served in terms of the provision of information and what should be included as a matter of good practice, and hence routine, in communications to creditors.

In this regard, it has to be said that in general the statements of proposals and reports on which the new databases are based appear to be somewhat fuller and more informative than those consulted in the preparation of the preliminary report. In the first instance, it was far easier to distinguish between pre-pack and business sales by reference to practitioner communications: indeed, the term pre-pack was reasonably commonly used in reports from the roll-out period, and practitioners appear more comfortable with using it openly. Explanations as to why the pre-pack strategy was considered the most appropriate were more frequently offered, although the level of detailed exposition varied in this regard. Ten reports were extremely clear and meticulous, starting with a detailed history of the company in question up until the point at which the practitioners were first consulted and followed by an account of the practitioners pre-appointment actions in relation to the business and their reasons for deciding to effect a pre-packaged sale.⁴²

Across the sample, and once again, the most frequently cited rationale for the pre-pack was the absence of available assets with which to fund a post-appointment trading period during which the business could be marketed. Explicit mention was made of the fact that the company's main lender had been approached in an attempt to obtain funding and had not been willing to provide it in eight reports, and in a further six the directors' failed endeavours to refinance the company in the run-up to consultation of the practitioners were referred to. In one relatively large case, the end of the month was approaching and insufficient funds were available to meet the salaries of the nearly 400 strong workforce, so that the pre-pack was seen as the only means of preserving the business and the forward contracts it had entered into.

The erosion of the value of goodwill was also a factor said to justify the use of a pre-pack, and here practitioners were rather more forthcoming about precisely what they meant in this respect. The ability of the company to service ongoing contractual obligations whilst trading in administration, or, more accurately, the less than sanguine perceptions of its contracting partners in this regard, tended towards a pre-pack solution in five cases examined. These cases involved contracts incorporating *ipso facto* clauses, which give the counterparty a right to terminate on the commencement of an insolvency procedure. Whilst this right need not necessarily be exercised,⁴³ the practitioners involved were at pains to explain that the various counterparties had expressed concern over the impact that entry into an insolvency procedure might have on the company's ability to perform its obligations. In particular, the prospect of its suppliers, and in two cases its employees, deserting it during the trading period was considered to be not unlikely. The pre-pack therefore delivered an element of certainty which would have been lacking during a marketing campaign, and, according to the practitioners, was therefore necessary to persuade its contracting partners not to exercise termination rights. Two further cases, both to connected parties, involved preserving specific expertise: essentially, the value of the business, and its future viability, resided in the technical (if not the business) acumen of its purchasers.

Whilst, on the whole, the roll-out sample comprised a higher proportion of better quality reports, this was not the case for the entire sample: it is encouraging to note that it was possible to identify the purchaser of the business in all the 45 cases, although this did involve the author in a certain amount of detective work in

⁴² Interestingly, two of these reports were administrative receivers' reports.

⁴³ And, indeed, was not exercised in the cases in question.

relation to three cases.⁴⁴ On the other hand, it is suggested that around one quarter of the reports in the sample could have been slightly more detailed, particularly in relation to the rationale for the pre-pack itself. Of course, these less detailed reports suffered in comparison to the very high quality ones, and the author would hesitate to condemn them as opaque or inadequate. However, to the extent that the justification for the pre-pack is couched in rather vague terms, there must be a danger that creditors reading it are unconvinced or, indeed, actively suspicious. Finally, there remains a hardcore, albeit a very small minority, of demonstrably deficient reports, which do no more than report the pre-pack sale with no attempt at rationalisation.

The formulation of a pre-pack Statement of Insolvency Practice may well be all that is needed to guide practitioners in this regard. Equally, when the proposed amendments to rules 2.33 and 2.67 of the Insolvency Rules 1986 are enacted practitioners will be required to provide very detailed and specific information to creditors in order to obtain their sanction to the drawing of pre-administration fees and expenses.⁴⁵ One further positive force in this context may be the development and adoption of protocols for pre-packs by the major clearing banks: anecdotal evidence is to the effect that practitioners seeking the support of a charge holder for a pre-pack strategy will be required to justify that course, and this may in turn feed into reports to creditors. In any event, it is to be hoped that the seeming trend towards the provision of more information and explanations in the roll-out sample continues in future roll-outs.

ii. Business sales and pre-packs compared: more on transparency

The preliminary report found that more or less serious deficiencies in transparency were by no means confined to pre-packs, and that practitioner communications in relation to business sales were equally variable. In the roll-out sample of business sales there was once again discernible overall improvement in the quality and quantity of information provided to creditors in statements of proposals, administrative receivers' reports and progress reports. More reports contained more comprehensive accounts of the company's descent into insolvency, and there was widespread (but not complete) compliance with the requirements of r.2.33 of the Insolvency Rules. Interestingly, in the business sale reports there were rather more 'gaps' than in the pre-pack reports, and in seven cases it was impossible to discover the identity of the purchaser of the business. The level of unsecured debt was also more frequently undisclosed in business sale reports: this information was omitted from only one pre-pack case, as compared to four business sale cases.

In relation to both types of sale, one very important piece of information that creditors would surely wish to know was the consideration received for the business itself. Encouragingly, most communications disclosed this, and more than half contained a breakdown of how the consideration was apportioned between the various asset groups transferred. There were, however, instances of less than full disclosure in this regard, and statements along the lines that 'an offer, considered acceptable by my valuers, was accepted' were not altogether uncommon. Again, a small minority of reports in both business sale and pre-pack cases simply reported the sale of the business, with no mention of whether a valuation had taken place

⁴⁴ These were cases where the purchaser was named as an individual. Recourse to the directors enquiry facility on the Companies House Direct website revealed that the individual in question was a director of the insolvent company, and, further, had incorporated a new company, of which he was appointed a director, very shortly before the commencement of the procedure and, of course, the pre-pack.

⁴⁵ See <http://www.insolvency.gov.uk/insolvencyprofessionandlegislation/policychange/DraftLA.doc>. At the time of writing, however, the author's enquiries suggest that it appears unlikely that this amendment will be in force before October 2009.

and no intimation of how much had been, or was to be paid for the business. There would appear to be no real justification for this omission, as questions of commercial confidentiality may be relevant at a stage when the negotiations for the sale of the business are taking place, but surely less so after the event.⁴⁶

Where the payment of the consideration was deferred, again this was more or less routinely disclosed, and creditors were kept reasonably well informed in progress reports as to whether and when staged payments had been made. The question of deferred consideration is perhaps a troublesome one in some respects, and in three of the cases examined (all of them pre-packs) the purchaser entered insolvency subsequently (one administration and two creditors' voluntary liquidations) without having paid for the business either in full or at all. What is a little worrisome about these cases is that in all three the purchaser was a connected party, and that in two of the cases the uncollected portion of the consideration would have accrued to the benefit of the unsecured creditors of the company. This is not, of course, a transparency issue at all, but it is convenient to deal with it here, and these three cases demonstrate the advantages of practitioners requiring security (preferably in favour of the vendor company) over the purchaser's newly acquired assets.

By and large, it would appear from the roll-out samples that practitioners are becoming more and more accustomed to providing reasonably comprehensive accounts to creditors in both business sales and pre-packs. The pre-pack communications in particular evidenced a greater willingness not only to justify the pre-pack but also to give very detailed information on the purchaser, the consideration and the levels of debt involved. In the case of business sales, the majority of reports were reasonably clear on the objective of the administration (usually that laid out in para.3(b) of Schedule B1, but occasionally the para.3(c) objective), and only a few omitted to mention matters that the author would consider to be of real interest to creditors. In both types of sale, charge-out rates, the apportionment of fees and expenses, and hours spent on various activities were exhaustively detailed.⁴⁷ It is not suggested that problems with transparency do not arise, or are overstated, but nevertheless it appears that they are increasingly being acknowledged and addressed in the majority of cases.

b. Including creditors in the process: some developments

i. Commercial exigency in business sales

The preliminary report found that the issue of disenfranchisement present in all pre-pack cases was nevertheless not exclusive to that type of sale. To amplify, the general scheme of administration in the Enterprise Act is 'inclusive'. Statements of proposals are to be sent to creditors within eight weeks of the commencement of the administration,⁴⁸ and those proposals must be accompanied by an invitation to an initial creditors' meeting, to be called within ten weeks of the commencement of the administration.⁴⁹ Where there is no prospect that unsecured creditors will receive a dividend in the administration,⁵⁰ or that all creditors will be paid in full,⁵¹ the requirement to call an initial meeting may be dispensed with unless such a meeting is required by creditors owed at least 10% of the entire indebtedness of

⁴⁶ Although the author stands to be corrected on this point.

⁴⁷ And, if practitioners' instincts are correct, never consulted by creditors, who file them in a purpose-built, cylindrical, open-topped receptacle.

⁴⁸ Schedule B1, para.49.

⁴⁹ *Ibid.*, para.51.

⁵⁰ As will be seen, a not unlikely circumstance.

⁵¹ About as likely as Kevin Keegan picking up Manager of the Season award: although read on....

the company.⁵² The purpose of the initial creditors' meeting is to consider the administrators' proposals and to approve them (with or without modification).⁵³

The very obvious democratic deficit in relation to pre-packs is that the administrator is, in essence, acting without the envisaged creditor sanction: creditors, or more accurately those with a financial stake in the outcome of the administration, are deprived of their opportunity to vote on the very action which might affect the value of that stake. However, the preliminary report found that this disenfranchisement is also present in the majority of business sale cases, with 76% of the business sales on the original database taking place *before* statements of proposals are sent to creditors. The position has changed very little on the roll-out database, with 74% of business sales similarly preceding the statement of proposals.

As noted in the preliminary report, this phenomenon is borne purely out of the unique pressures of selling the business of an insolvent company during the course of an insolvency procedure: in short, speed is of the essence, and there are very good commercial reasons why practitioners focus their efforts on achieving a going concern sale as soon as reasonably possible, many of which are equally relevant to a decision to pre-pack a business. Moreover, the cases of *In re T & D Industries plc*⁵⁴ and *In re Transbus International Ltd*⁵⁵ both explicitly recognise that sometimes substantial action must perforce be taken in administration without first obtaining creditor approval. Both cases also acknowledge that the commercial judgment of the practitioner is, firstly, not a matter for the court and, secondly, *may be* a matter for creditors *ex post*. Neither case involved a pre-pack, but a recent development suggests that similar reasoning process will be adopted by the courts.

ii. Pre-packs validated? Re DKLL Solicitors LLP⁵⁶

The *DKLL* case appears to be the first judicial opportunity to consider the merits (or, indeed, the legal implications) of a pre-pack.⁵⁷ It is certainly an unusual case on its facts, involving an insolvent limited liability partnership (a firm of solicitors) rather than a company. The firm was insolvent to the tune of around £2.4 million, £1.7m of which was owed to Her Majesty's Revenue and Customs. HMRC petitioned for the winding up of the firm, and two of the equity partners of DKLL made an administration application to court. The order was sought with a view to the administrators effecting a pre-pack sale of the business of the firm to Drummonds Kirkwood LLP (a connected purchaser) for a consideration of £400,000. HMRC appeared at the hearing to oppose the application, its main contention being that, as majority creditor, it would be able to defeat the sale proposal if it were put to a meeting of creditors. Therefore, the court "ought not to make an administration order in circumstance where it was known that the majority creditor opposed the proposed sale, and would, in effect, be disenfranchised ... by a pre-pack sale without a creditors' meeting taking place."⁵⁸ The reason for the Revenue's opposition to the pre-pack was that it considered the value of the firm to be much higher than was contemplated in the agreement.

⁵² Schedule B1, para.52.

⁵³ *Ibid.*, para.53.

⁵⁴ [2000] 1 WLR 626 – a pre-Enterprise Act administration case.

⁵⁵ [2004] 1 WLR 2564 – a post-Enterprise Act case.

⁵⁶ [2007] EWHC 2067.

⁵⁷ Other than in the context of an administration application in which a pre-pack is contemplated: it will be recalled that 23% of the cases in the new pre-pack sample involved court ordered administrations (see page 10, above).

⁵⁸ Para.18 of the judgment.

Andrew Simmons Q.C. (sitting as a Judge of the High Court), referred to the judgment of Neuberger J in *Re Structures & Computers Ltd*⁵⁹ to the effect that an administrator could apply to court for the implementation of proposals even where the majority creditor opposed them. The *Structures & Computers* case concerned a pre-Enterprise Act administration, but the learned judge considered that the outcome would not necessarily be different under the post-Enterprise Act provisions:

“The court could, exercising its powers under paragraph 55.2 of Schedule B(1), authorise the implementation of those proposals, notwithstanding the opposition of the majority creditor.”

In such circumstances, and on the evidence before him, he considered that on an application under para. 55(2) there was a real prospect that the court would authorise the proposed sale had that proposal been rejected by the Revenue and notwithstanding the Revenue’s opposition.⁶⁰ The fact that the case involved a pre-pack made no difference to this reasoning. The learned judge went on to make the administration order.

The learned judge’s ruling appears, at least inferentially, to represent a judicial sanction of the pre-pack strategy *in appropriate circumstances*. It should be noted that the legality *per se* of a pre-pack was not a point explicitly argued before the court, but nevertheless one would have thought that the learned judge, had he considered pre-packs illegitimate, would have said so. However, it should not be taken as a *carte blanche* for the deployment of the strategy in every given situation: certain facts of *DKLL* were quite uniquely compelling of a pre-pack, specifically the prospect of Law Society intervention which would have reduced the value of the business to virtually nothing and which could only be avoided by the use of a pre-pack. It is probably unlikely that such an overwhelmingly potent justification for a pre-pack will present itself in the majority of cases, which will not involve the very special considerations attaching to the insolvency of a firm of solicitors. If nothing else, however, *DKLL* is an object lesson on the merits of being able to present a reasoned and commercially sound rationale for a pre-pack, in this case *ex ante*, but also as a general rule *ex post* in the form of ‘proposals’ under para 49 of Schedule B1.

4. Outcomes for Stakeholders in Pre-Packs and Business Sales

a. Returns to creditors: general observations

As noted above,⁶¹ the new databases have taken a rather more selective approach in relation to the cases they comprise so as to attempt to reduce the possibility of bias in respect of returns to creditors. All the cases on the new databases are ‘complete’⁶² and both databases comprise a proportionate number of cases⁶³ which proceed to dissolution and cases which involve a follow-on CVL. As a starting point, the average return to creditors across the entire sample of pre-packs and business sales was calculated. This exercise was also carried out in relation to the original databases, where it was found that the average percentage return to creditors in business sales was 21.8% and in pre-packs 22%.

⁵⁹ [1998] 1 BCLC 292

⁶⁰ This is an extremely interesting legal question of general application. Certainly, academic commentators have taken a rather different view of the court’s discretionary powers in this respect: see Sealy and Milman, *Annotated Guide to the Insolvency Legislation 2007/2008*, (Sweet & Maxwell, 2007), page 547.

⁶¹ See pages 1-3.

⁶² In the sense that no further payments to creditors of any class will be made.

⁶³ Proportionate to all the procedures for which records are available at Companies House in the period under investigation.

The average percentage return to creditors from business sales on the new database was 35.9% and for pre-packs the figure was 33.6%. This would tend to confirm the suspicion that the original sample analysis was skewed by the higher proportion of cases involving a move to dissolution it contained. It should be noted that this database is undergoing an update, so that returns from cases involving a CVL will be recorded on it as they become available. It should also be noted that, eventually, old and new databases will be merged to allow for a complete analysis.

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, and as in the preliminary report, the question of the *recipients* of whatever value is realised is an important one. It is also worth mentioning here that, as with the original samples, records were kept of whether or not the business had been marketed prior to sale, and whether it had been valued prior to sale.

As far as marketing is concerned, the preliminary report noted that positive mention of marketing was made in 7.9% of pre-pack cases, with the corresponding figure for business sale cases being 55.6%. Analysis of the new database produces some quite startling results in this respect. In 31.1% of the cases in the pre-pack sample there was evidence that the business had been marketed prior to the procedure. The *method* of marketing was certainly less aggressive than might normally be the case, but accounts of the directors canvassing offers from potentially interested parties (in eight cases, competitors) were present in 14 reports. These approaches tended to be made in the four to six months preceding the commencement of the procedure, and in some cases began as an attempt to dispose of the equity in the company. Interestingly, in five out of the fourteen cases the eventual pre-pack was to a connected party, but in five of the remaining nine cases the eventual purchaser had already been approached by the company's directors and was subsequently re-contacted by the practitioners prior to their appointment. The other four cases involved the practitioners using their own contacts and resources (discretely, it must be said) to identify potential purchasers.

In the business sale sample, explicit mention of a marketing campaign was made in relation to 63.8% of the cases. Methods of marketing were similar to those used in the previous sample of business sales: advertising in the Financial Times and/or in local newspapers was not uncommon, and marketing agents were also frequently used, as were firms' own internal records. Overall, therefore, the level of marketing in pre-packs seems to have risen quite steeply, and in business sales there is also a rise, although less pronounced. This may also help to explain the seemingly increased levels of returns to creditors demonstrated in the new samples. Valuation continues to be used in the vast majority of both business sales and pre-packs. Positive mention of valuation was made in 86.6% of pre-pack cases and 87.2% of business sale cases.

b. Returns to secured creditors

The average percentage return to secured creditors from business sales was 68.8%, compared to 66.7% from pre-packs. This is a very significant improvement from the original databases, and again is probably best explained by the fact that reasonably high proportion of the cases on those databases were still ongoing at the time of analysis. The following two tables illustrate the frequencies of returns to secured creditors in business sales and pre-packs.

Table 20 - Frequencies of Returns To Secured Creditors: Business Sales

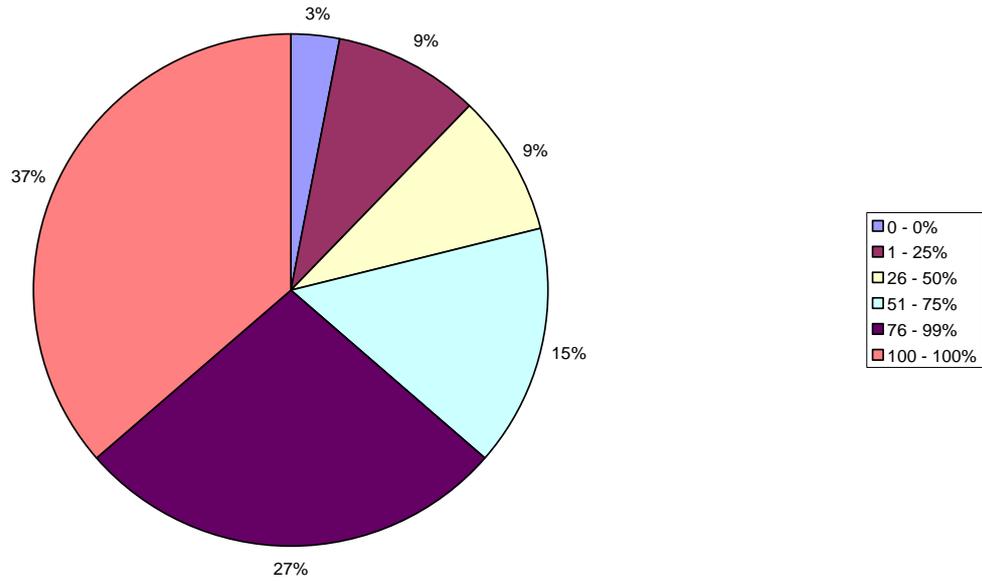
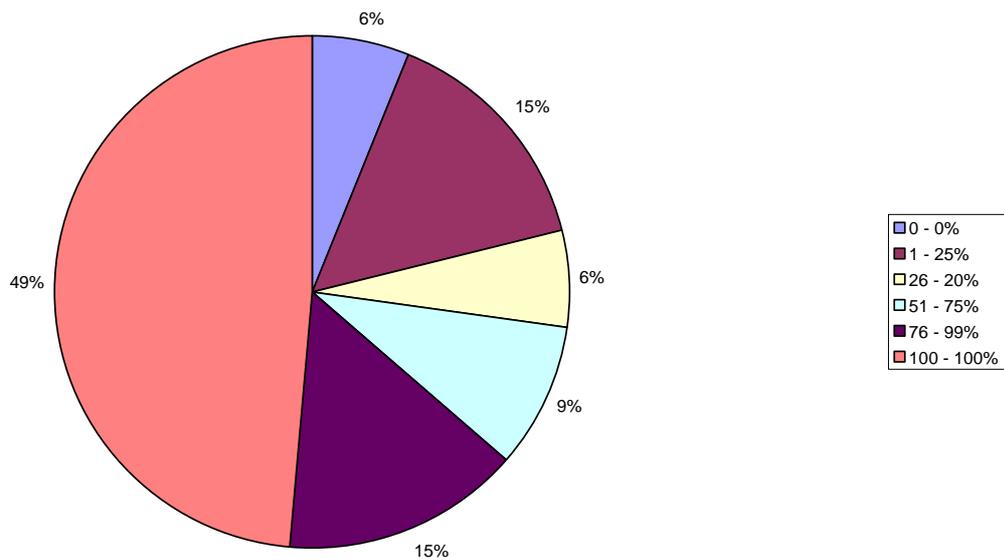


Table 21 - Frequency of Returns to Secured Creditors: Pre-Packs



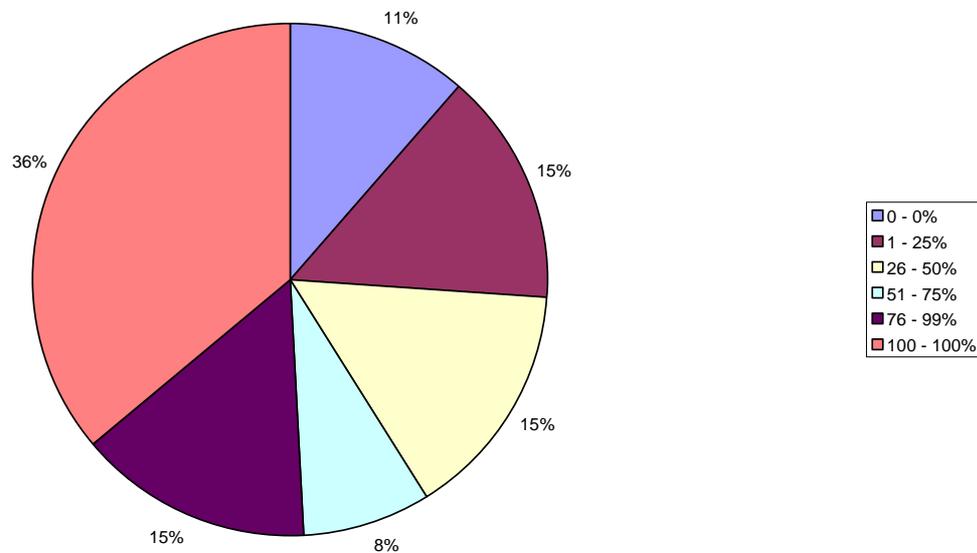
Observations

The most notable distinction between business sales and pre-packs in this regard is the greater level of 100% returns to secured creditors in pre-packs, with nearly half recovering all they were owed. In 64% of both samples secured creditors

receive at least 75% of their indebtedness, but a higher proportion of pre-packs sales return less than 25% to secured lenders (21% as compared to 12% of business sales). It is unwise to attempt to draw conclusions from a sample of this size and limited duration, and the next roll-out period will continue to chart trends in this area.

One further, and new exercise was also carried out for this progress report. As well as sampling pre-packs and business sales, the author has also constructed a database of administrations which resulted not in a going concern sale of the business at all, but in a break-up sale of its assets. This database is here used to test the widely held assumption that a going concern sale will tend to maximise value, and also to illustrate how creditors fare when synergy is lost.⁶⁴ The overall average return to creditors from business sales is 23.3%, pointing to a loss of 'value' of at least 10% when assets are sold on a break-up basis. The average return to secured creditors was 38.9%, which is just over half the average return for a going concern sale. Frequencies of returns to secured creditors in asset sales are as follows:

Table 22 - Frequency of returns to Secured Creditors: Asset Sales



The superior perform of going concern sales, whether pre-pack or business sale, can be seen by comparing this table with Tables 20 and 21 above. A 75% and above return is present in just over half the asset sale sample (as compared to 64% of both pre-packs and business sale samples) and returns of less than 50% appear almost twice as likely. This matter is touched upon further later in this progress report.

⁶⁴ A further very interesting finding from this database is reported later.

c. A few words on preferential creditors

Since the abolition of the Crown preference⁶⁵ in September 2003, preferential debts are almost exclusively employee-related. As will be discussed later, where a going concern sale of the business is effected during the course of an insolvency procedure this will very often be accompanied by a transfer to the purchaser of at least a proportion of the workforce and, along with them, the accrued liabilities of the vendor company to the workforce. Many such accrued liabilities might otherwise be payable as preferential debts. This phenomenon, when coupled with the abolition of the Crown preference, has seen the level of preferential debts plummet dramatically in insolvencies, indeed, many cases of going concern sales will involve no preferential debt at all, as the employees to whom it would have been owed have transferred to the purchaser. Preferential debts are payable out of floating charge realisations in priority to the claims of the floating charge holder, but are vulnerable to the expenses of the insolvency procedure.⁶⁶

Analysis of the new databases demonstrated an average return to preferential creditors of 57.2% from business sales and 83.6% from pre-packs. Nothing very much should be made of this dichotomy in terms of the relevant merits of each form of sale: the sample sizes varied (from 24 cases of preferential debt in the business sample to only 12 in the pre-pack sample) and in both samples there was an overwhelming tendency for preferential creditors to be paid either 100% of their debt or nothing at all (71% of cases in the business sale sample returned 100% to preferential creditors, with 21% returning zero: the figures for the pre-pack sample are 73% and 18% respectively.)

What is more instructive in this regard is to consider the position where the business is not sold as a going concern: the break-up asset sale referred to above. A sample of 63 cases produced an average return of 55.7%, but in 44% of the cases in the sample preferential creditors received no payment, and a return of 100% was made in 48% of cases. It would seem, therefore, that the orthodox wisdom that going concern sales maximise returns to creditors holds as true for preferential creditors as it does for secured creditors.

d. Returns to unsecured creditors

The preliminary report recorded not unexpectedly poor levels of return to unsecured creditors in both pre-packs and business sales, but also that business sales tended to outperform pre-packs when it came to unsecured dividends. The new sample shows something of a general upturn in this respect, although this may be accounted for by the case selection process (which was designed to minimise bias). The average percentage return to unsecured creditors does, however, remain higher from business sales than from pre-packs, working out at 6.5% and 2.4% respectively. The frequency of levels of return to unsecured creditors in business sales and pre-packs is illustrated in tables 23 and 24 below.

⁶⁵ See s.251 Enterprise Act 2002.

⁶⁶ S.175(2), para.65(2) Schedule B1 Insolvency Act 1986.

Table 23 - Frequency of Return to Unsecured Creditors: Business Sales

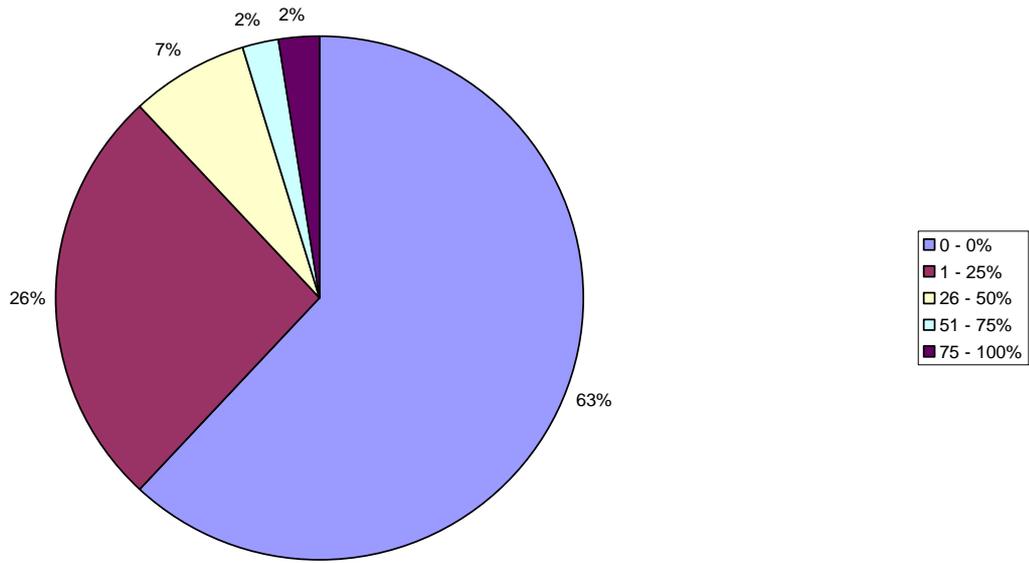
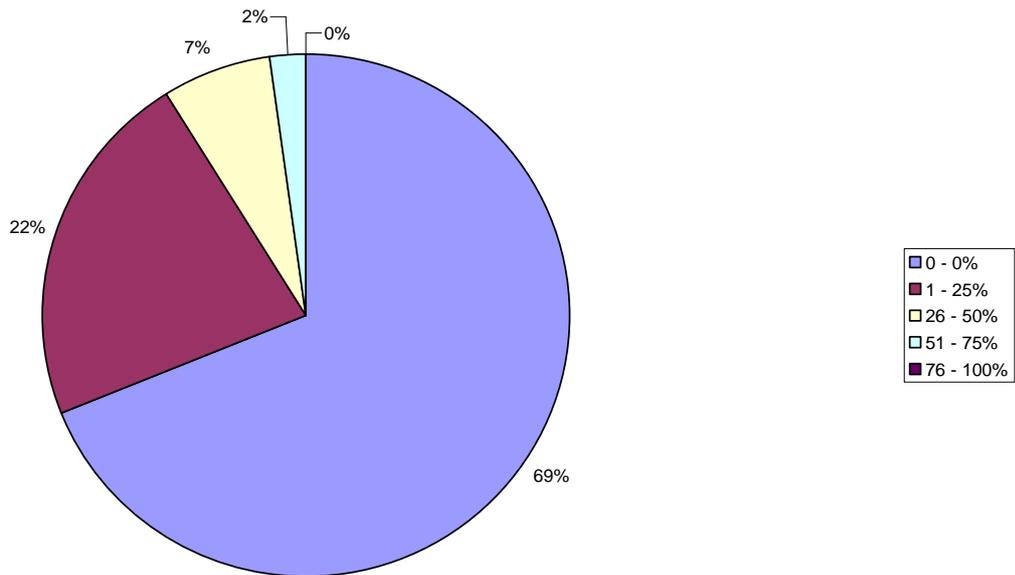


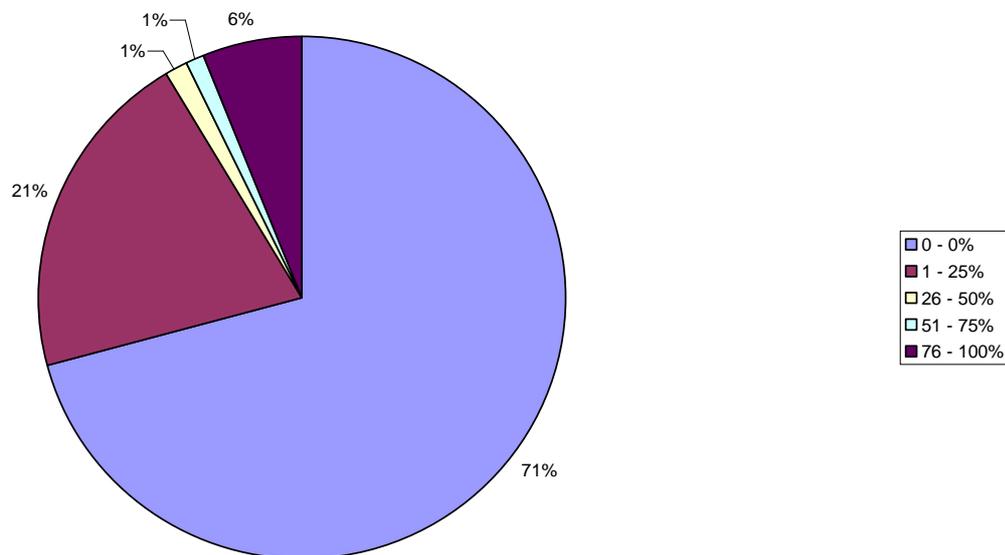
Table 24 - Frequency of Returns to Unsecured Creditors: Pre-Packs



Observations

Pre-packs produced a zero return to unsecured creditors in 6% more cases than business sales, although returns of between 26% and 50% were equally common in both forms of sale. The sample size is, of course, small and the overall picture may be distorted by a few cases of unusually high returns in the business sale sample.⁶⁷ However, the overall picture is not dissimilar to that seen in relation to the original databases, with unsecured creditors seemingly likely to receive higher returns from business sales. An analysis of the sample of asset sales produces the intriguing finding that the average percentage return to unsecured creditors is 4.29%, falling somewhere between the business sale and the pre-pack figure. The breakdown of frequency of returns in asset sale cases is as follows.

Table 25 - Frequency of Returns to Unsecured Creditors: Asset Sales



This table demonstrates that whilst asset sales result in a zero return slightly more frequently than do either business sales or pre-packs, returns of over 75% are more common. Indeed, proponents of pre-packs might be somewhat concerned that asset sales appear to produce better returns for unsecured creditors than do pre-packs. Granted, the finding must be treated with extreme caution given the small sample size and limited period under examination, but it will nevertheless bear further investigation as the existing databases are completed and the roll-outs merged with them. What is clearly of interest is the finding described in the preceding sections that both secured and preferential creditors appear to receive much better levels of return from pre-packs (and from business sales) than from asset sales. It will therefore be necessary to thoroughly explore the possible explanations for what seems to be an anomaly.

⁶⁷ The one case of a 100% return to unsecured creditors is the first the author has ever encountered in her travails thus far. The circumstances of this case, however, were probably equally unprecedented.

One possible explanation, posited in the preliminary report, is to the effect 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. The overt marketing of the business or its assets, on the other hand, will be better placed to capture a premium, which in turn will be available to unsecured creditors. This would tend to hold water in the comparison between business sales and pre-packs, where reasonably high levels of return to both secured and preferential creditors were noted, but the poorer performance of asset sales in relation to secured and preferential creditors raises some questions as to its absolute validity.

A second point is that the asset sale database comprises 83 cases for which information on returns to unsecured creditors was available, and in 17 of those cases (just over 20%), no secured debt was owed at the beginning of the procedure. Obviously in such cases unsecured creditors will stand a much better chance of receiving a dividend. However, both pre-pack and business sale samples also contained cases where no secured debt was owed, and, indeed, both samples recorded a higher proportion of such cases (26% and 25% respectively). Further analysis will be carried out to see whether secured debt is proportionately higher in pre-pack cases,⁶⁸ but for the present the relative absence of secured debt does not appear to explain the lower returns to unsecured creditors in pre-pack cases.

A further avenue for exploration is the possibility that the procedural costs of pre-packs is significantly higher than in either business sales or asset sales. This would at first appear to be a counter-intuitive proposition: the fact that the business is sold quickly would appear to leave less for the practitioner to do during the course of the procedure itself. On the other hand, pre-appointment fees and expenses⁶⁹ 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': it is very common to find much of the post-sale period for all three types of sale to be occupied by the collection of book debts and agreement of claims. Further analysis of the database and interview data will no doubt shed some light on this query. Finally, the question of the relative employment preservation rates also arises, and is dealt with in more detail in the next section of this report.

One closing point that perhaps ought to be made is that, as between going concerns sales (both pre-packs and otherwise) and asset sales, there may be certain indirect benefits to trade creditors in particular arising from the former which may not arise in the latter. Whether or not such benefits compensate for the financial loss in the insolvency is an interesting question, but it should be acknowledged that a sale of the business as a going concern may at least leave a disappointed trade creditor with a future customer: there are certainly indications in practitioner reports that trade creditors have been willing to deal with the successor of the business, and the reasonably high survival rates noted above may bear this out.⁷⁰

e. Employment preservation in pre-packs and business sales

Employment preservation rates in business sales and pre-packs in the sample period are illustrated in Tables 26 and 27 below.

⁶⁸ This is best left until a larger sample is available.

⁶⁹ An area itself fraught with legal difficulty and uncertainty.

⁷⁰ It is hoped that trade creditors will be able contribute to the research in this regard.

Table 26 - Employment Preservation: Business Sales

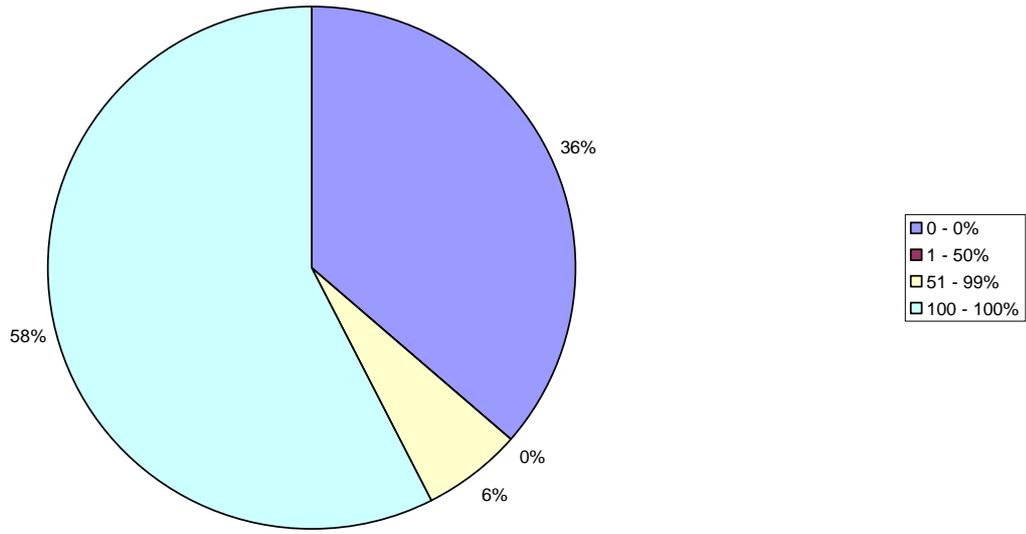
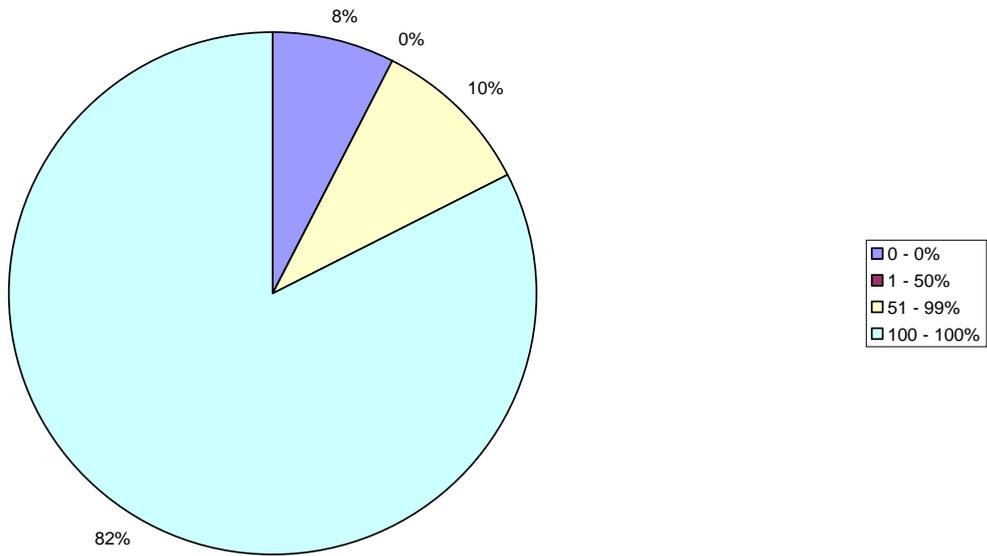


Table 27 - Employment Preservation: Pre-Packs



Observations

The significantly superior performance of pre-packs when it comes to employment preservation was noted in the preliminary report and continues in the roll-out sample. The findings from the original and the new databases are that pre-packs preserve 100% of the workforce's jobs in well over one quarter more cases than business sales and business sales are four times as likely to result in the entire workforce being made redundant than are pre-packs. The inherent job-saving characteristics of pre-packs can probably be largely attributed to the Transfer of Undertakings (Protection of Employment) Regulations 1982,⁷¹ and the increased survival rates from both pre-packs and business sales noted earlier in this report⁷² would tend to reinforce the positive attributes of going concern sales in terms of employment preservation.

In the roll-out sample, employment preservation rates of 100% have declined somewhat (by 10% in pre-pack cases and by 7% in business sale cases), but this is very likely explained by the much smaller sample size. It should, of course, be noted that where a going concern sale of the business does not take place wholesale redundancy is an inevitable result. In the preliminary report,⁷³ the author speculated that there might be a link between the seemingly poorer returns to unsecured creditors and the higher rates of employment preservation from pre-packs, and it is worth considering here whether that hypothesis might also apply to explain why break-up asset sales in the current sample⁷⁴ appear to produce better returns to unsecured creditors than do pre-packs.

The original thesis was that purchasers of businesses from pre-packs might well be inclined to take into account both actual and contingent TUPE liabilities in determining the level of their offer for the business, and that this might result in a lower valuation than would have been the case if the business could be transferred with fewer, or no employees. It has since been cogently pointed out to the author⁷⁵ that this proposition is actually somewhat counter-intuitive: higher levels of debts owed to employees will often be preferential and, further, to the extent that they are not, will swell the ranks of unsecured creditors, whereas a high level of employment transfer reduces both preferential and unsecured debts, which should, in turn, increase overall returns to unsecured creditors. A question then arises as to what extent employee claims are met out of the National Insurance Fund⁷⁶ rather than by the company, although where this is the case the Secretary of State is subrogated to the claims of the employees.⁷⁷ Whether or not this right of subrogation is actually exercised in every case may be important to the current enquiry. Finally, the position where employees can claim in relation to deficits in a pension fund should not be overlooked: this is a highly complex area and the author will perforce rely on expert interviewees to try and unravel the implications.⁷⁸ The author's speculative suggestion that there may be some kind of correlation between higher rates of employment preservation and lower returns to unsecured creditors therefore needs much more thought and investigation.⁷⁹

⁷¹ See SI 2006/246, and see, for amplification, page 72 of the preliminary report.

⁷² See pages 14-20, above.

⁷³ See pages 72-73.

⁷⁴ Where the redundancy rate will almost invariably be 100%.

⁷⁵ Thanks are due to the Insolvency Law Discussion Group at Nottingham Trent University.

⁷⁶ See Employment Rights Act 1996, s.166. There is an overlap between debts that can be claimed out of this fund and preferential debts: see s.184.

⁷⁷ *Ibid.*, s.167(3).

⁷⁸ This is a call to Grant Jones of Squires Sanders!

⁷⁹ Although no apologies are made for flying the kite in the first place...

4. Conclusions and Next Steps

Overall there appear to be some positive findings to report in the first roll-out phase of the database. Most specifically, the improved level of transparency in practitioner communications with creditors to that seen in relation to the original database is encouraging and the author is in the process of studying the exemplary examples in order to construct a composite 'template' which might be of assistance in determining the contents of a 'pre-pack' Statement of Insolvency Practice. Whilst it is premature to draw conclusions from a sample of this small size and period, it is to be hoped that the overall increased level of returns to unsecured creditors and survival rates of purchasing entities continues into further roll-outs.

One possible cause for concern is the finding that pre-packs continue to perform less effectively than business sales and, it would appear, break-up asset sales when it comes to unsecured creditor dividends. The precise reasons for this are unclear at present: the fact that both business sales and pre-packs are significantly better in terms of their overall percentage return to all creditors than break-up sales suggest that it is not so much a question of pre-packs failing to maximise value *per se*, but rather as to the destination of what value is realised. Further analysis of this question is left to the next roll-out phase: not least because with a small sample there may simply something anomalous about the pre-pack cases⁸⁰ (or, indeed, the business sale and asset sale cases⁸¹) which will skew results. Interview data will also be invaluable in exploring this question further.

A further fertile area of newer research is assisted by the inclusion of (selective) analyses of break-up asset sales. One particularly interesting research avenue in this regard is to consider the effects for creditors of failed attempts to sell a business within administration.⁸² The current sample of asset sales contains seven cases⁸³ where the initial strategy was to market the business for sale as a going concern, this objective eventually being abandoned. In each of the cases it became clear from progress reports that a good deal of time and effort had been expended in terms of marketing and negotiations, but that eventually acceptable offers were simply not forthcoming. What is pertinent to the present enquiry is that a post-commencement business sale tactic may on occasion cost more than it actually achieves. This is certainly not in any way intended as critical of practitioners' judgment,⁸⁴ rather it introduces one perhaps veiled advantage of a pre-pack strategy, that advantage being the certainty it offers in terms of outcome. In conclusion, the ongoing research continues to raise questions for which responses will be sought through further quantitative and qualitative analysis.

⁸⁰ One or two cases of disproportionately high levels of secured debt, for instance.

⁸¹ As an example, both business sale and asset sale samples contained one case of a 100% return to unsecured creditors, something the author had not encountered in the preceding sample of 2063 cases.

⁸² The author would very much like to take the credit for this excellent idea, but it was suggested by Philip Revill, of the P&A Partnership. Not so much a case of 'I wish I'd said that' as 'I wish I'd thought of that'.

⁸³ This is probably a conservative number. The cases in question were ones in which the statements of proposals were most explicit and informative on the chosen strategy.

⁸⁴ Which would be rich, coming from an academic lawyer.