Pre-packaged Sales ("Pre-packs")

About R3

R3, the trade body for Insolvency Professionals, represents over 97% of Insolvency Practitioners. R3 members are trained and regulated accountants and lawyers who have extensive experience of helping businesses and individuals in financial distress.

Overview

Pre-packs are a frequently misunderstood insolvency tool, the benefits of which are lost in the debate over their perceived impact on creditors.

Independent research shows clear evidence that **pre-packs fare considerably better than alternatives in terms of the retention of jobs and returns to secured creditors**.

Many types of businesses across the UK have been pre-packaged - from the service industry to the construction industry. The number of pre-packs has risen in recent times, in line with general company insolvencies (which have increased dramatically over the last few years).

Criticism of pre-packs is often directed at Insolvency Practitioners; but a pre-pack is entirely consistent with the current insolvency legislation. When Insolvency Practitioners do a pre-pack, they are operating within the established statutory framework and they pursue the procedure in order to deliver greater returns to creditors and to save businesses from closure. Insolvency Practitioners do not have a special interest in pre-packs, and there is no benefit to them personally in carrying out a pre-pack rather than another insolvency procedure. **If the Government were to alter the rules on pre-packs or abolish them altogether, it is businesses and the economy (as opposed to Insolvency Practitioners) that could suffer as a result.**

What is a pre-pack?

A pre-pack is an agreement for the sale of an insolvent company's business and assets which is put in place before the company goes into a formal insolvency process, usually administration. The terms for the sale of the business will have been agreed before an Insolvency Practitioner (IP) is formally appointed, and is then rapidly executed once the appointment is made.

Pre-packs are not new. They have often been used to sell insolvent businesses where commercial pressures require urgent action. Before the Enterprise Act 2002 (EA), administrations were less common and most pre-packs were receiverships. This changed as the EA made administration less cumbersome to use and phased out most types of receivership.

Benefits of pre-packs

More jobs are preserved

Research has found that the performance of pre-packs in relation to employment preservation is noticeably better than in business sales (i.e. a going concern sale of the business negotiated and arranged after the commencement of the insolvency procedure). In 92% of pre-pack cases, all of the employees were transferred to the new company compared with 65% in a business sale.

It is worth bearing in mind the beneficial impacts that the retention of jobs has on the economy and the staff as a whole. It should also be borne in mind that a "traditional" insolvency by no means guarantees a favourable result.

Returns to creditors

Understandably, the starting position of creditors is that they should be paid their debts in full. However, when dealing with a company in financial trouble, IPs are operating in a salvage situation rather than a 'normal' business environment. The reality is that unsecured creditors of a company in financial trouble very rarely receive all (if any) of the money owed to them. It is more accurate to consider what creditors might reasonably expect to receive rather than the total amount owed.

Recent research conducted by Dr Sandra Frisby in 2010 has found that the **average returns to secured creditors in pre-packs was 35%, which compares to 33% in straight-forward business sales. Unsecured creditors, who have been the focus of a great deal of concern about the operation of pre-packs, were also found to have fared better. They receive an average return of 5% in a pre-pack, which compares to 4% in a straight-forward business sale.[2]**.

[1] Frisby, Dr S, *A Preliminary Analysis of Pre-Packaged Administrations*, 2007. Available at https://www.r3.org.uk/publications/default.asp?dir=press&pag=prepackanalysis&i=420

[2] Frisby, Dr S, A The pre-pack promise: signs of fulfilment?, RECOVERY magazine, Spring 2010. www.r3.org.uk/recovery

How does a pre-pack work?

A company in financial trouble, or one of its creditors, calls in legal advisors or an IP. Having examined the company, its assets and liabilities, the legal advisors or the IP will offer their professional advice on the options available to help save the company.

Various solutions may be recommended: winding the company up, trading the company on while an attempt is made to sell the business or pre-pack administration.

Clearly, winding-up is the most drastic solution and would be a last resort. Trading on is only possible where key staff and suppliers continue to support the business, and where there are funds to cover the cost of the wage bills and other associated costs of running a business. Where those funds are not available and there is no possibility of trading the company on while it is in administration, the IP could recommend a pre-pack.

The IP will often try to identify (discreetly) if there are any parties who may be interested in buying the company. Often the directors will know the likely buyers and may well have already been through a marketing process. Discretion is crucial because of the adverse affect that the suggestion of formal insolvency has on the confidence of the company's staff, suppliers and customers and hence on its value.

If a sale can be agreed on terms that are in the interests of creditors, the IP is appointed administrator and immediately sells the company to the buyer. The business (usually including the workforce) is transferred to a new company and the proceeds from the sale are used to pay back creditors in the normal order of priority: secured creditors are paid first, followed by preferential creditors and, finally, unsecured creditors.

Retention of value in the company

It is a reality of insolvency that once word of a company's financial difficulty gets out (for example, if it is placed in administration), it becomes much harder for the business to retain the staff, suppliers and customers necessary to keep the company viable. This problem is particularly acute in the service industry because much of the value of the company is in the staff and the customer base rather than tangible assets, such as buildings or products.

Although in an ideal world, a vigorous marketing effort over several weeks would culminate in a sale, in many cases stakeholders are not prepared to risk the value diminution that would entail. Because they are completed very quickly, pre-packs are an excellent method of dealing with a failing company while preventing the whittling away of value. In retaining value in this way, the IP should be able to negotiate the best available price for the business and therefore secure greater returns for creditors.

Criticisms of pre-packs

Failure to put the business on the open market

Once a company's financial difficulties become known, IPs face considerable problems in maintaining supplies, preserving staff and keeping hold of customers. As outlined above, this is a particular problem in the service industry because, increasingly, there are few tangible assets (such as buildings or products) and the value of the company is in its staff (their knowledge and expertise) and its customers. A pre-pack has the benefit of being an almost seamless transition for both since they are usually transferred to the new company.

Because pre-packs happen very quickly, there is less opportunity for news of financial difficulty to affect the confidence of staff and customers. In seeking to preserve value in this way, IPs are in a position to try and get the best price for the business and thus a higher return for the creditors.

Following the production of Statement of Insolvency Practice 16 (SIP 16)[3], IPs are required to disclose to creditors any attempts they have made to market the company, and while it will not be offered on the open market, they may do this by approaching competitors or parties who have expressed an interest in the past. In addition, the IP will examine the value of the business with regard to external benchmarks, and will usually have had discussions with the parties financially affected by the pre-pack; often this will only be the secured creditor. In these ways, the IPs can be satisfied that they have achieved the best available result for the creditors as a whole.

Insufficient transparency in the procedure

Creditors, particularly unsecured creditors, are usually not informed of the pre-pack until after it has been completed although secured creditors may be consulted in advance as they have proprietry rights over assets included in the deal.

It is perhaps understandable that creditors who are informed of the deal after the fact would be suspicious of the procedure. It should be noted, however, that in 75% of business sales the deal has also taken place before proposals are sent to creditors, and this is largely due to the commercial urgency involved in selling businesses from within an insolvency procedure.

There have been moves to improve the transparency of pre-packs. SIP 16 was introduced to require IPs to disclose to creditors why the decision to pre-pack was taken and large amounts of associated information concerning that decision and the connections between stakeholders. Failure on the part of the IP to adhere to the disclosure requirements set out in SIP 16 could result in the IP being subject to disciplinary or regulatory action. Creditors who feel that the IP has not properly acted in their interests have the power to take a complaint to the regulators or the courts.

Sale of the business back to connected parties

Faced with the decision between selling the business to a connected party or winding the company up, the best decision for the creditors is to sell the business on rather than sell the assets on a break up basis as the returns would be considerably less. Selling the business on is also preferable to allowing the company to fail in terms of the numbers of jobs and customers that are retained (as outlined above).

In some cases there may be very strong commercial reasons for selling the business back to connected parties. For example, connected parties might be the only people who are interested in buying it or the only people with the necessary skills to run it.

The sale of a business back to connected parties is not exclusively a feature of pre-packs. Dr Frisby found that in 52% of all standard business sales the business was sold back to connected parties, this figure was 59% in pre-pack administrations.

[3] A Statement of Insolvency Practice (SIP) is a guidance note issued to licensed Insolvency Practitioners with a view to maintaining standards by setting out required practice and harmonising Practitioners' approach to particular aspects of insolvency.