The City of London Law Society

4 College Hill
London EC4R 2RB
Tel +44 (0)20 7329 2173
Fax +44 (0)20 7329 2190
DX 98936 - Cheapside 2
mail@citysolicitors.org.uk
www.citysolicitors.org.uk

David McIntosh QC (Hon)
Chairman

Insolvency Practitioner Policy Section
3rd Floor, Zone B
21 Bloomsbury Street
London
WC1B 3QW

For the attention of Chris Phillips, Senior Policy Advisor

27 June 2011

Dear Sir

<u>Insolvency Law Committee response to Insolvency Service consultation on the Insolvency (Amendment) (No. 2) Rules 2011 (dealing with pre-packaged administration sales)</u>

The City of London Law Society ("CLLS") represents approximately 14,000 City lawyers through individual and corporate membership including some of the largest international law firms in the world. These law firms advise a variety of clients from multinational companies and financial institutions to Government departments, often in relation to complex, multi jurisdictional legal issues.

The CLLS responds to a variety of consultations on issues of importance to its members through its 17 specialist committees. This response in respect of the Insolvency Service's draft of the Insolvency (Amendment) (No. 2) Rules 2011 (the "Rules") (dealing with pre-packaged administration sales) has been prepared by the CLLS Insolvency Law Committee.

Our comments on the Rules assume that a policy decision has already been taken to introduce measures to regulate the practice of pre-packing to connected persons. However, we note that any such measures will inevitably reduce the scope for such pre-packing and the logic of doing so is not obvious in circumstances where neither pre-packing (which is recognised to be necessary to prevent the destruction of value in some cases) nor sales to connected persons (who are often those who are willing to pay the best, or only, price) are not considered to be of themselves objectionable.

By according a higher priority to transparency than to the preservation of value for creditors, the policy will cause some damage to the UK economy. In our experience, the absence of protection from contractual termination during administration and the difficulties with the law on administration expenses have been significant contributors to the growth in the practice of pre-packing. These difficulties will continue to militate against trading in administration after the introduction of the Rules and we doubt whether stakeholders will be any more willing to support continued trading during the notice period than before.

One particular consequence of regulating pre-packing may therefore be to increase the number of cases where the employees of a company are dismissed at the time of appointment which may in turn lead to an increased level of employee claims against the National Insurance Fund.

Furthermore, unless financial restructurings at the holding company level are excluded from Part 3 of the Rules (as suggested below), the Rules are likely to have a seriously detrimental effect on UK restructurings at the higher end of the market.

For all of these reasons, we urge you to do an impact assessment before making the Rules.

The Rules set out to deal with both administration and liquidation. We do not think that the procedures are analogous as regards pre-packs because liquidation does not afford the same opportunity to conduct an asset sale before third parties are aware of the insolvency. We therefore concentrate our comments on the provisions of the Rules dealing with administration (but those comments, on matters of pure drafting, are equally applicable to the equivalent provisions in the Rules which deal with liquidation).

Subject to those general observations, our comments on the drafting of the Rules are:

1 Sub-paragraph (b) of proposed IR 13.20 reads "*the assets needed for continuance of the business of the company or a substantial part of the business of the company,*" (emphasis added). This wording is also used elsewhere in the proposed rules. The use of the definite article (as underlined) implies that that only one such group of assets would be objectively identifiable in respect of any given business or substantial part of a business. We think that there will often be cases where there will be more than one such group of assets and that the use of the definite article might be relied upon to avoid the application of the proposed rules.

2 Proposed IR 2.3(6) (and the proposed rules to like effect in connection with other forms of appointment) would require the prospective administrator to opine that "*the consideration to be received for the pre-pack sale will achieve a better result for the company's creditors as a whole than anything else*" (emphasis added). As to that:

   (a) the Rules do not address the potential tension between this opinion and the purpose of administration in a case where Sched B1 para 3(3) and (4) apply; and

   (b) it is unrealistic to expect an insolvency practitioner to opine using the underlined wording.

The opinion currently envisaged sets a higher standard than the administrator's duty of care in the exercise of his power of sale (see *Silven Properties Limited v Royal Bank of Scotland plc* [2004] 1 WLR 997). We suggest that consideration be given to requiring an opinion "*...that such a sale is likely to achieve the best price reasonably obtainable in all the circumstances.*"

3 We appreciate that Part 3 of the Rules is free-standing in that it is not, in terms, confined to pre-packs. However, we believe that, provided the question of open marketing is addressed (see below), these provisions would have little practical application outside the context of pre-packs.

4 The definition of a connected or associated person in proposed IR 13.13(21) is our single most serious concern. It appears to us that this extraordinarily wide definition will include:

(a) persons who are not readily identifiable as such by the responsible insolvency practitioner; and

(b) others who, whilst being identifiable, are not commonly thought to be within the mischief which the Rules seek to address.

As an example of our second point, we note that the test would be satisfied if a secured creditor holds more than one third of the voting rights in the purchaser of the assets and that, for these purposes, it is arguable that s435 aggregates all secured creditors in a syndicate. This will impact severely on the utility of pre-packing in large insolvencies (including those brought into the London market precisely because these mechanisms are available), for example a debt for equity arrangement where the only affected creditors may be the participating finance creditors. The definition therefore raises a serious policy issue. Since it is not pre-packing *per se* which is being regulated but only pre-packing to connected persons, we had thought that the Rules were prompted by public disquiet at the owner managers of smaller companies being perceived to carry on regardless of the failure of their companies and trade creditors being left unpaid. In the light of that, we suggest that there should be carve-out for pre-packs under which it is proposed that all creditors other than finance creditors be paid in full. This could be done by excluding pre-packs of financial indebtedness at the holding company level.

5 We have three further concerns about proposed IR 13.13(21):

(a) the definition will have capricious results (for example, an independent 5% shareholder is not within the definition but his wife's uncle would be);

(b) the apparent ease with which its application could be avoided by a director's resignation immediately before the sale; and

(c) its application is not expressed to be confined to the other provisions of the Rules. It should be made clear that, for example, it has no application to the rules on connected persons' voting, to the provisions of the Act dealing with claw-back or to pensions rules.

6 Proposed IR 2.33B prohibits the administrator from selling (other than perishable goods) unless the prescribed conditions are not satisfied. The Rules do not state what the consequences of breach will be for either the administrator or the purchaser. As a result of the stakeholder meeting on 20 June, we understand the Insolvency Service to consider that:

(a) a breach of the provisions brought into force by Part 2 of the Rules (and, presumably, Part 4) would be a matter of conduct involving the administrator alone; but

(b) a sale in breach of the provisions brought into force by Part 3 of the Rules will be a nullity because the administrator will have had no power of sale and the purchaser will have known of the breach.

As to that:

(a) although the purchaser will likely be better placed than the administrator to know whether it is connected or associated, we do not think that it will invariably know and we consider that there remains a possibility of inadvertent breaches;

(b) there is also the possibility that innocent mistakes could be made as to whether, for example, the assets had previously been offered in the "*open market*";

(c) we do not think it is obvious that the Service's opinion that a purported sale in breach would be a nullity is correct; but

(d) if that opinion is correct, it is entirely possible that the nullity will only be discovered some time after the event with (i) the potential for serious adverse consequences for innocent third parties (including employees) who have had dealings with the "purchaser" in the meantime and (ii) severe practical difficulties in identifying and returning assets.

We consider that the consequences of all breaches should be made clear and that they should not include nullifying the sale. Overall we think that transactional certainty should be the paramount consideration in this context, but a compromise solution would be to model the consequences of breach on s241 (including the protection of good faith purchasers for value).

7 Proposed IR 2.33B(1) refers to "*assets*". In so far as a company's assets may include assets to which the Financial Collateral Arrangements (No. 2) Regulations 2003 apply, we consider that such assets should be excluded from the notice procedure. The purpose of this suggestion is to preserve the integrity of the carve-outs from the ordinary insolvency rules which the Regulations achieve.

8 The use of the undefined term "*open market*" in proposed IR 2.33B(2)(b)(i) implies some form of public offering. However, an administrator (or any other seller) will in many cases (depending on the nature of the assets or the market) be advised that a public offering would not be the most efficient method of selling or the method calculated to maximise price. In the most extreme example of this issue, there are

assets which cannot be the subject of a public offering without infringing the Financial Services and Markets Act 2000. Another example of a situation where an administrator would be advised to sell by private solicitation would be where the only feasible purchasers are a small group of major competitors. There is therefore a tension between this provision and the administrator's more general duties as to price (referred to above). It would be a perverse result if these measures led to administrators disregarding professional sales advice merely in order to satisfy the "*open market*" test. We suggest that it should be sufficient to satisfy proposed IR 2.33(2)(b) that the assets being sold have been offered to independent purchasers.

9 We agree with the comments of others at the stakeholder meeting that the Rules do not accommodate the possibility of a "stalking horse" sale to an insider on terms which require the buyer to better any price offered in after the event marketing (or to return the assets). Such sales appear to be outside the mischief being addressed by the Rules and could properly be the subject of a carve-out.

10 Proposed IR 2.33B(2)(b)(ii) requires notice to be given to every creditor of whose address the administrator is aware. A number of points arise in this connection:

(a) the status of a "creditor" may be in doubt but notice will have to be given out of caution, which may lead to vexatious interventions;

(b) there is no provision for a creditor to waive the requirement for notice; and

(c) in small cases there may be a perverse incentive to pay off dissenting creditors who will thereby gain an undeserved leverage.

11 The use of the word "*specify*" in proposed IR 2.33B(3) will lead to uncertainty. On authority, the meaning of the word varies according to context, see, for example, *EM TV & Merchandising AG v Bayerische Landesbank & Ors* [2003] JLR 80 and the authorities reviewed therein. However, it will be assumed that the word means the same for the purposes of both sub-paragraphs (i) and (ii). As to that:

(a) such a construction would appear to preclude the administrator from satisfying sub-paragraph (ii) by some generic reference to all the other assets of the company; and

(b) the administrator may not be in a position to "*specify*" with confidence the assets of the company which are not the subject of the pre-pack.

For the second of these reasons, administrators' sales contracts are customarily drafted to sell only itemised assets or classes or assets and thereby to avoid inadvertently including assets which have not yet been identified as being part of the company's property.

12 We consider that administrators will require greater clarity about the degree of detail which will have to be given in order to comply with proposed IR 2.33B(3)(e).

13 It appears to us that in many cases the only practical way for an administrator to give notice under proposed IR 2.33B(4) will be by first class post and that CPR 6

will apply under IR 12A.3. The consequence of the deemed service provisions of CPR 6 will materially extend the nominal 3 business days notice period. As to that:

(a) the attendant delays will inevitably mean that some pre-packs are not viable; but

(b) we also question the utility of such a short period for dissenting creditors and would be rival purchasers.

More generally, we question why this aspect of the proposed rules needs to be addressed by individual notices to creditors at all and we suggest that notice by advertising should be sufficient.

14 We do not understand why the carve-out in proposed IR 2.33B(5) needs to be restricted to perishable goods when s166 expressly permits the disposal of other goods whose value is likely to diminish if not the subject of an immediate disposal. Further;

(a) the term "*assets*" would be more appropriate to modern trading conditions than "*goods*" since a business may now have significant assets of a rapidly wasting nature that are not tangible movables; and

(b) the term "*perishable*" is also unduly restrictive because value can be lost by, for example, failing to take a seasonal opportunity to sell, even where the asset in question is not of a wasting nature.

We suggest that it would be more in the interests of creditors if this provision read "*...transferring any assets the value of which is likely to diminish if they are not disposed of.*".

15 It is clear from the drafting of proposed IR 2.33(2ZA) that the administrator retains a complete discretion as to what course he pursues in the light of any representations he receives from creditors. The Rules therefore appear to be directed solely towards promoting transparency before the event rather than, as with the present procedures, transparency after the event (the onus will remain on individual dissenting creditors to pursue personal remedies). It appears to us that this transparency will come at a heavy price in terms of business rescue and the preservation of employment.

16 We appreciate that proposed IR 2.33(2)(ea) (and other proposed provisions in the Rules modeled upon it) are also not focused on pre-packs as such but rather on prior disposals more generally. It is not clear to us why, in those circumstances, the requirement for disclosure of any previous relationship only applies where the sale has been "*to a single person or a group of connected or otherwise associated persons*". Surely, there would be logic to requiring the disclosure to be made in all cases of prior disposal unless the view is being taken that there is something inherently suspicious about sales to single persons or such groups.

17 The disclosure requirement in proposed IR 2.33(2)(ea) (and other proposed provisions in the Rules modeled upon it) relates to any "*previous relationship*" with "*the administrator*". As to that:

(a) "*relationship*" is not defined;

(b) if the relevant relationships include those with all members of the administrator's firm there could be extraordinarily long disclosure lists, for example in cases where the appointee comes from a large firm and the secured creditors include large bank syndicates; and

(c) the interaction with the Code of Ethics is not addressed (we suggest that consideration be given to using the concept of the significant professional or personal relationship from that Code).

18 We note with concern that compliance with proposed IR 2.33(2ZA) will require the administrator to have knowledge of the buyer's own after the event dealings with the assets. In practice, administrators will have to make provision for such disclosures in their sale contracts and then make appropriate enquiries before making their statement, but it does not follow that they will necessarily be told everything that they need to know. Our concerns in this respect are compounded by the fact that a breach could be regarded as a matter of conduct.

19 Finally we note that proposed IR 2.33(2ZA) substantially replicates the requirements of SIP 16. The purpose of this, if SIP 16 is retained, is not clear. On the other hand, if SIP 16 is not retained, the result will be a significant delay in the dissemination of information to creditors (because of the relative timing of SIP 16 disclosures and the statement of the administrator's proposals). Either way, we do not see why this should be thought to be in the interests of creditors.

Yours sincerely

Hamish Anderson
Chair
CLLS Insolvency Committee

© CITY OF LONDON LAW SOCIETY 2011.
All rights reserved. This paper has been prepared as part of a consultation process. Its contents should not be taken as legal advice in relation to a particular situation or transaction.

THE CITY OF LONDON LAW SOCIETY
INSOLVENCY LAW COMMITTEE

Individuals and firms represented on this Committee are as follows:

Hamish Anderson (Norton Rose LLP) (Chairman)
K. Baird (Freshfields Bruckhaus Deringer) (Deputy Chairman)
N. Barnett (Denton Wilde Sapte LLP)
T. Bugg (Linklaters LLP)
A. Cohen (Clifford Chance LLP)
P.Corr (Sidley Austin LLP)
S. Foster (Hogan Lovells LLP)
S. Frith (Stephenson Harwood LLP)
S. Gale (Herbert Smith LLP)
I. Hodgson (Slaughter and May)
B. Larkin (Berwin Leighton Paisner LLP)
Ms R. Lowe (CMS Cameron McKenna LLP)
C. Mallon (Skadden Arps Slate Meagher & Flom (UK) LLP)
Ms J. Marshall (Allen & Overy LLP)
B. Nurse (Eversheds LLP)
J.H.D. Roome (Bingham McCutchen LLP)
M. Woollard (S.J. Berwin LLP).