The City of London Law Society

4 College Hill
London EC4R 2RB
Tel: 020 7329 2173
Fax: 020 7329 2190
www.citysolicitors.org.uk

The City of London Law Society insolvency committee response to the Insolvency Service consultation/call for evidence on improving the transparency of, and confidence in, pre-packaged sales in administrations

The City of London Law Society ("CLLS") represents approximately 13,000 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 consultation has been prepared by the CLLS Insolvency Law Committee.

Question 1

Do you believe that the current framework governing the operation of pre-pack sales in administration provides a sufficient level of confidence that pre-packs are only being used in appropriate circumstances and with an appropriate degree of transparency?

The problem is largely one of perception which has been fuelled by press and political comment and is more often than not based upon hearsay rather than any rigorous investigation of the process. Insolvency practitioners and their regulators appear broadly satisfied with the current framework but media focus suggests that there are continuing complaints from unsecured and junior secured creditors affected by pre-packs. The true mischief is selling at an undervalue. We suspect that sales at undervalue rarely, if ever, occur at the top end of the market, but there is a strong perception of unfairness. We accept that there may be limited instances of abuse at the bottom end of the market but, even then, probably only where purchasers are connected parties.

Question 2

If not, what are your main concerns with the way pre-packs are currently executed?

At the top end of the market, transparency appears to be the key area of contention, particularly in the period running up to the appointment of administrators and sale.

As the original guidelines set out in SIP 16 recognised, there may be little time to consult with all the stakeholders before effecting a sale. In particular, the information requirements under SIP 16 only require the administrator to engage with creditors after the business and assets have been sold. If this is the case, then pursuant to the guidelines in SIP 16, administrators must be able to justify to creditors, why the particular circumstances did not permit prior consultation with creditors. In many of the large restructurings, however, there is an open dialogue with creditors who retain an economic interest in the business, before a pre-pack takes place.

In addition, there is a tendency to treat SIP 16 as an exhaustive checklist and not to volunteer additional information which would assist creditors' understanding. We accept that SIP 16 would be improved by the inclusion of an overriding principle to be observed by insolvency practitioners making reports.

The report on the operation of SIP 16 for July to December 2009 indicates a relatively high level of non-compliance but a distinction should be made between the form and substance of these results. In particular, only a limited number of non-compliant responses were actually evidence of improper action and very few resulted in any disciplinary action being taken. In addition to this, we consider that the introduction of a new reporting system was bound to involve a "bedding down" period during which insolvency practitioners and regulators found common standards of compliance. We would expect to see progressive improvements in compliance levels flowing from greater familiarity with the requirements.

Question 3

Do you believe that pre-packs are presently subject to abuse? If so, how? Please indicate whether you believe it is the actions of directors, insolvency practitioners, secured lenders or any other parties that are contributing to any perceived or actual abuse and to what extent you believe this is a problem.

See our answer to question 1 above. We doubt the scale of genuine abuse but recognise a need for greater transparency. We would not single out any particular constituency for blame as regards abuse. Insolvency practitioners must necessarily bear the principal responsibility for ensuring transparency.

Question 4

Some of the following options would require a distinction to be drawn between pre-packs and "conventional" administrations. What do you think should be included in a statutory definition as to what constitutes a pre-pack transaction?

We consider the current definition in SIP 16 is sufficient. A more precise definition would be inflexible.

Question 5

Do you believe that the new pre-appointment cost recovery mechanism will have a significant effect on transparency and confidence?

No. It will have some effect but we doubt if the effect will be significant.
Question 6

Do you believe that by giving statutory force to the SIP 16 disclosure requirements creditors would be given better information about the reasons and justification for the pre-pack?

No. SIP 16 engages in a level of detail which would be inappropriate for legislation. Further, giving SIP 16 statutory form would make it much more difficult to respond to changes in market practice. A compromise solution might be to include a statement of the underlying principle in legislation (with a duty to observe it) leaving SIP 16 to articulate the more detailed requirements.

Question 7

Do you believe that such a requirement will increase costs and reduce the returns available to (a) secured creditors, and (b) unsecured creditors? If possible, please provide an estimate of the impact on each.

No. We do not consider that the form of the requirements would materially affect the cost of compliance.

Question 8

Do you believe that it would be appropriate for details of the pre-pack to be filed at Companies House? If not, why not?

No. Any such filing would be after the event and would serve only to inform those who would not otherwise receive notice. Since those receiving notice already include all known creditors, we do not see the need for wider public dissemination of the information.

Question 9

Do you believe that it would be appropriate for a statutory offence to be created in circumstances where the pre-pack disclosure requirements are not adequately met?

If legislation includes a duty to observe the underlying principle of disclosure (see our answer to question 6 above), then it would follow that there should be some sanction for breach of the duty. However, since compliance will inevitably involve some judgments being made by the insolvency practitioner, we think it important that practitioners should only be exposed to sanction in cases of flagrant or inexcusable breach.

Question 10

Do you believe that confidence in pre-packs would be improved by requiring companies whose business and assets had been sold through a pre-pack to exit administration via compulsory liquidation? What would be the possible costs and benefits?

No. We believe that this would be a retrograde step which would reintroduce an inflexibility which was removed by the Enterprise Act reforms.

Question 11

Do you believe that an insolvency practitioner providing advice to a company on the potential for a pre-pack has an inherent conflict of interest when accepting a formal appointment as administrator with a view to subsequently executing a pre-pack sale?

No, the administrator has an overriding duty to act in the best interests of the creditors, and provided in exercising that duty he satisfies himself that the transaction produces the best available result for creditors, then no conflict arises. The administrator must form an independent view as to the suitability of administration as the chosen procedure and as to the desirability of his then negotiating a pre-pack before he completes the transaction.

Question 12

If so, do you believe that such a conflict extends to circumstances where the insolvency practitioner has had an ongoing prior relationship with the company in the context of undertaking review work for a secured lender?

Not necessarily. It all depends on the circumstances.

Question 13

Do you believe that a requirement for a different insolvency practitioner to accept appointment as administrator would improve confidence that pre-packs are only used in appropriate circumstances?

Theoretically yes, this must almost necessarily be the case. However, in practice, both practitioners would be likely to be appointed at the same time by the same party (and the practitioner intended to take the appointment will not get the job unless he has pre-committed to complete the transaction). In addition, there will be adverse costs considerations and the involvement of a different practitioner should be reserved for cases where the prior practitioner's role has been such as to create a genuine conflict of interest.

Question 14

Do you believe the requirement to use two separate insolvency practitioners would increase costs and delay therefore reducing the returns available to (a) secured creditors, and (b) unsecured creditors? If so, please provide an estimate of the impact on each.

Yes. We are not best placed to estimate actual costs and suspect that the impact would vary enormously according to the circumstances of different cases.

Question 15

Do you believe the requirement to use two separate insolvency practitioners would reduce the number of business sales effected through a pre-pack sale? If so, please provide an estimation of the impact.

Yes. While there might be some cases where the second practitioner did not consider that the proposed pre-pack was in the best interests of creditors, the plans will generally have been carefully constructed and reasonably conservative. In any

event, it is likely that, even if a second practitioner disagreed, a third would agree. At the bottom end of the market, there might be a proportion of cases where pre-pack proposals were abandoned because of the additional costs of engaging a second practitioner.

Question 16

Is it desirable that unsecured creditors, who may not stand to receive any dividend from the proceedings, be given an opportunity to influence the proposed pre-pack sale where the business is being purchased by a connected party? If so, why?

No. In most cases that we have encountered at the top end of the market, all stakeholders were already well aware that a restructuring of some sort was needed and to the extent that they have an economic interest in the business are able to participate in discussing the proposals, or where appropriate participate in the sale process as prospective purchasers. Pre-packs rely on the speed with which the sale can be achieved so that value of the business is preserved, even though a sale process may have been ongoing for some time beforehand as part of the restructuring. They are often used as a last resort to rescue a business and safeguard employment and need to be achieved with as little disruption as possible to the underlying business. A failure to consult with out of the money junior creditors and unsecured creditors may be viewed in a less than favourable manner by those creditors who may ultimately lose out, but there are often practical reasons which mean that full disclosure before the pre-pack takes place is simply, not possible. For example customers may defect and suppliers withdraw lines if too much information is disclosed before the sale occurs. Any advance approvals would reduce the efficacy of the procedure which is often essential to its success in preserving value..

Question 17

Should approval for such a sale initially be sought from unsecured creditors with a recourse to the court, or from the court in the first instance? If you believe unsecured creditors should be given the opportunity to approve in the first instance, what percentage in value of their claims should be required for approval to be obtained?

No. In our view the costs of either creditor or court approval would be likely to outweigh the benefits. We would consider it more beneficial to encourage (as SIP 16 does,) practitioners to engage where appropriate, in discussions with unsecured creditors (and junior secured creditors) at an early stage The question for the court would almost certainly not be a question of vires (which can be addressed on an application to directions if necessary) but rather a commercial decision as to whether the pre-pack proposal is the best solution for creditors. We do not consider that this is a judgment which the courts are well equipped to make. An application on notice would be counter-productive and an application without notice would be unlikely to serve any useful purpose since the court would necessarily have to attribute great weight to the applicant practitioner's views.

Question 18

Would the prior approval of the court or creditors for the proposed sale improve confidence that pre-packs are only used in appropriate circumstances?

We consider that it would undermine the utility of the practice. We doubt it would improve confidence in the procedure but would instead risk bogging down an efficient and useful restructuring process in unfruitful creditor negotiations.

Question 19

Do you believe the requirement to obtain court or creditor approval would increase costs and delay therefore reducing the returns available to (a) secured creditors, and (b) unsecured creditors? If so, please provide an estimate of the impact on each.

Yes. See also our answer to question 14.

Question 20

Do you believe the requirement to obtain court or creditor approval would reduce the number of business sales effected through a pre-pack sale? If so, please provide an estimation of the impact.

Yes, and most significantly in smaller cases.

Question 21

Do you believe that any provision requiring the prior approval of the court or creditors for business sales to connected parties should be extended to apply to such sales out of all formal insolvency procedures (i.e. not restricted solely to administration)? If so, why?

We refer to our answer to question 16. We regard "phoenixism" as a different issue. There would be a logic to adopting a uniform approach but we think the question should be addressed the other way around. If it is appropriate to have prior creditor or court approval for a sale to connected persons generally, then we recognise that it would have to be applied also to pre-packs (because otherwise practitioners and connected parties would be given a perverse incentive to undertake pre-packs in order to circumvent the prior approval requirements).

Question 22

Do you believe that a requirement to obtain court or creditor approval for a pre-pack business sale to a connected party should be combined with the attachment of personal liability to directors and connected parties who purchase a business without obtaining the requisite approval?

We are uncertain what is meant by attaching personal liability to directors and connected parties in this context. Personal liability for what? It could mean shared exposure to sanctions for non-compliance with legislative requirements. We can see the case for all those responsible for a breach being exposed to such sanctions. More generally, (as stated in our answer to question 1), the true mischief is sale at an undervalue. Personal liability might therefore mean personal liability to make good the deficiency in a case where a pre-pack had involved a disposal at an undervalue. However, we do not see the logic of imposing such liability only in cases of pre-packs which have not had the requisite prior approval.

Question 23

Do you believe that it would be appropriate for pre-pack business sales to connected parties executed without the requisite approval to be rendered void?

No, connected parties may be the only willing purchaser, we believe the practical consequence of automatic avoidance would be the destruction of value.

Question 24

To what extent do you believe that pre-packs provide a positive contribution to the wider economy by allowing economically viable parts of insolvent companies to continue trading? How would you quantify such a contribution? Please provide any evidence you may have to support your comments.

We believe that pre-packs have played an important part in saving businesses. The practice is not new although the recent scale of its use is very different. The practice has always played a useful role in preserving businesses which would be destroyed by exposure to the open market. Latterly, it has helped practitioners preserve businesses where funding would not have been available for continued trading during administration. We are not in a position to quantify the contribution. However, we observe that the frequently claimed benefit of job preservation needs to be treated with some scepticism. The practical effects of saving jobs in insolvent businesses may, to some extent, simply result in over-capacity elsewhere in the wider economy.

Question 25

To what extent do you believe that pre-packs create market distortions by allowing companies to "dump debts" and continue trading to the detriment of competitors? How would you quantify this? Please provide any evidence you may have to support your comments.

We recognise these risks as being inherent in rescue procedures generally. We do not regard them as being a particular feature of pre-packs. Although we recognise the potential for competition issues, we are not in a position to quantify the problem.

Question 26

To what extent do you believe that pre-packs create job losses "upstream" by allowing companies to "dump debts" and continue trading to the detriment of suppliers who then experience knock-on financial difficulties? How would you quantify this? Please provide any evidence you may have to support your comments.

See answer to question 24.

Question 27

To what extent do you believe that any economic value preserved by a pre-pack sale (e.g. employees, customers, suppliers) would otherwise transfer to alternative ventures (e.g. competitors) if a pre-pack sale was not undertaken? Please provide any evidence you may have to support your comments.

We recognise the issue but we are not in a position to comment.

Question 28

Do you believe that any of the options identified would have a significant impact on the behaviour of secured lenders? If so, what do you think this is likely to be? If possible, please provide an estimation of the impact.

Pre-packs are attractive to secured lenders because they control costs and provide certainty of outcome. Any measures which are adopted and which make pre-packs more difficult or more expensive in practice are likely to impact on the behaviour of secured lenders. The most likely consequence would be reduced forbearance.

Conclusion

Question 29

Which of the five proposed options would be your preferred solution(s), and why?

We favour option 1 subject to SIP 16 being updated in the light of Dear IP 42 and the possible statement of an underlying principle in legislation (with a duty of observe it).

Question 30

Are there any alternative measures that you believe ought to be considered?

No

Question 31

Please provide an indication (if not obvious) as to the nature of your involvement in, or exposure to, pre-pack transactions and the approximate incidence of that involvement or exposure if relevant.

We refer to the opening paragraphs of this response.

Date: 30 June 2010

THE CITY OF LONDON LAW SOCIETY
INSOLVENCY COMMITTEE

Individuals and firms represented on this Committee are as follows:

H. Anderson (Norton Rose LLP) (Chairman)
A.Cohen (Clifford Chance LLP)
P.Corr (Sidley Austin LLP)
S. Gale (Herbert Smith LLP)(Deputy Chairman)
M.B. Andrews (Denton Wilde Sapte)
K. Baird (Freshfields Bruckhaus Deringer)
T. Bugg (Linklaters LLP)
S. Frith (Stephenson Harwood LLP)
S. Foster (Lovells)
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)
J.H.D. Roome (Bingham McCutchen LLP)
M. Woollard (S.J. Berwin LLP)