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Pre-Pack Regulation: Two Years On

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It is now two years since the 30 April 2021 introduction of the Administration (Restrictions on Disposal etc. to Connected Persons) Regulations 2021 (the "Regulations") and a good time to look back at whether the Regulations have achieved their purpose, what issues remain and what the next two years might look like.

Summary

- The Regulations came into force on 30 April 2021 with the intention of addressing concerns around pre-pack administration sales to connected persons.
- Previously, there was a voluntary obligation to have a sale to a connected person considered by the 'pre-pack pool.'
- The Regulations compel administrators, who are intending to engage in disposals to connected persons, to first obtain either creditor approval or a qualifying report from an independent evaluator (such report being commissioned and paid for by the connected buyer).
- Some aspects of the Regulations remain open to interpretation and we have not yet seen any aspects of the Regulations clarified before the Courts.

How We Got Here – Unease and Unsuccessful Self-Regulation

Criticisms of pre-pack administrations have often arisen where: (i) the buyer is connected to the

insolvent company; (ii) there has been a limited and short marketing process; and (iii) the purchase price doesn't appear from the outside to reflect the value of the business. Where those circumstances result in low or no returns for creditors whilst the former directors continue to profitably trade the business within their new company, those criticisms are amplified.

There are often very good reasons why each of the above are factors in a successful pre-pack sale. The directors of the insolvent company may sometimes be best placed to acquire the business or there may not be any third-party interest. Any marketing process must seek to protect the value of the business and may, therefore, necessarily be limited in scope so as not to alert the market to the company's financial position. Finally, the price for a distressed business, even on a going concern basis, can often be significantly lower than what the business may have been worth just a matter of months before.

However, the Regulations sought to provide some additional comfort for creditors by mandating that administrators either seek creditor approval or obtain a qualifying report form an evaluator. For the reasons discussed when the Regulations were introduced, the likelihood of being able to obtain creditor consent in advance of a pre-pack sale is so small that, in practice, the effect of the Regulations is to require the production of the qualifying report.

The Regulations

The Regulations were brought in with the aim of regulating the practice of pre-pack disposals to connected persons and they sought to do this by explicitly preventing an Administrator from making "*a substantial disposal*" to a "*connected person*" within the first eight weeks of administration without either "*the approval of the company's creditors*" or a "*qualifying report*" from an independent evaluator.

Connected buyers have to obtain (and pay for) these reports, which detail the evaluator's credentials and PI cover, to satisfy administrators of the reasonableness of a disposal.

The Regulations intended to replace the voluntary provisions requiring a similar referral to the pre-pack pool and to supplement the regulations that administrators are already subject to under SIP16 and the protections in the Insolvency Act 1986 including restrictions on re-use of company names under s.216.

Ongoing Issues

1. *What is a substantial disposal?*

The Regulations only apply where there is a '*Substantial disposal*.' This is defined as a disposal of, "*in the administrator's opinion, all or a substantial part of the company's business or assets*." What constitutes 'all or a substantial part' is not further described in the Regulations. Leaving it to the administrator to decide whether a sale is a '*substantial disposal*' can place a proposed administrator in a difficult position where the position is not obvious.

Government guidance suggests that "*establishing whether a disposal is substantial should include but is not limited to considering*:

- *the value of either the business, assets or both involved in the disposal;*

- *how much of the business is being disposed of; and*
- *whether the trading style and goodwill of the business forms part of the disposal."*

Similar wording ("*whole or substantially the whole of the company's property*") is found in paragraph 14(3) Schedule B1 of the Insolvency Act 1986 and was considered in the Australian case *Re Australian Property Custodian Holdings Limited [2010] VSC 492*. In that decision, which is helpful but not binding in England and Wales, the Judge considered that a reference to 68 percent of the company's assets should not be considered to be substantially the whole of the company's property.

It is difficult to see how a sale could not be a substantial disposal where there is a transfer of a going concern, even if certain assets are not acquired by the buyer. However, where a buyer is just acquiring certain assets then an administrator may want to consider whether the sale falls within the Regulations. Given the lack of guidance at the moment, we would expect administrators to err on the side of caution and require a qualifying report. It follows that a buyer may pressure an administrator not to require a report on the basis that the sale is not a 'substantial disposal' and this may place an administrator in a difficult position.

2. *Negative qualifying reports*

Where creditor approval is not sought and a qualifying report is commissioned which does not provide the requisite statement of satisfaction, the administrator is still able to carry out the pre-pack (albeit with an explanation to the creditors). It is perhaps surprising that the Regulations mandate a qualifying report to be obtained but not that such report be binding on the administrators. In practice we would be surprised if an administrator proceeded with a pre-pack sale where a statement of satisfaction was not obtained.

3. *Evaluator qualifications*

The Regulations do not provide explicit parameters or express qualifications for the role of evaluator. Instead, they state that an evaluator will be qualified if they (and the administrator) are satisfied that they have "*sufficient relevant knowledge and experience to make a qualifying report*." Although the evaluator must be independent (i.e., not connected to the company/connected person), this lack of concrete criteria does not help to increase transparency for creditors who may ask whether such an evaluator is qualified and in receipt of sufficient information to allow a proper decision to be made.

4. *Opinion shopping*

Equally, the Regulations do not require a connected person to obtain the consent of the administrator in respect of its choice of evaluator or prohibit the number of reports obtained (although details of previous reports should be included in the final report). This potentially allows for a scenario in which connected persons shop around until a supporting qualifying report is provided.

What has been the Impact of the Regulations In the Last Two Years?

It is difficult to fully assess the impact of the Regulations, albeit pre-pack administrations continue to be a valuable and effective restructuring tool for businesses with many pre-pack sales preserving many jobs. Whilst the Regulations have expanded on the previous, voluntary pre-pack pool process, they do not address all creditors' concerns and neither do they have the effect of increasing the

transparency of the pre-pack process for creditors.

The hope that the Regulations will provide sufficient comfort to creditors to reduce criticism of pre-pack sales has probably not been achieved and newspaper reports continue to portray pre-pack sales to connected persons as being in some way unethical or politically unsatisfactory. For example, the Prime Minister's wife, Akshata Murty, has recently faced criticism for being an investor in a furniture business which was sold in a pre-pack administration leaving behind creditors. There is no suggestion that the pre-pack sale was improper but the concept has been reported negatively in the press, particularly as HM Revenue & Customs (HMRC) is a significant creditor. There is little remark for the fact that, as an investor, Ms. Murty would have lost the value of her own investment (made through an investment vehicle).

It is difficult to see how the Regulations in their current form will be able to challenge this ongoing perception or how any further proposals would be able to do so whilst still allowing pre-pack administrations to continue effectively. Further efforts to ensure that the process is as transparent as possible for creditors should be welcomed but not at the expense of making the successful delivery of a pre-pack administration harder.

It will be interesting to see what, if any, further measures may be considered by the Government.

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