ARTICLE

Pre-Packaged Business Sales Following the Introduction of the Enterprise Act 2002

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Summary

This article summarizes the key issues to consider on a pre-packaged business sale, in light of the reforms introduced by the Enterprise Act 2002 ('EA2002'). It concludes that the formal hurdles to pre-packaged sales by administrators have been reduced by the EA2002 reforms, but notes that there may be scope for abuse by unscrupulous insolvency practitioners.

Key features of a pre-packaged insolvency sale

A pre-packaged insolvency sale ('Pre-pack') is a sale the terms of which are agreed prior to the commencement of the insolvency process of the insolvent seller company. The most common form of insolvency process linked with Pre-packs has been administrative receivership with administration as the second most likely process to be used.

The sale occurs immediately following the appointment of the receivers or the administrators.

It is not unusual for a Pre-pack to involve a sale of the business to a party connected to the insolvent seller.

There is a risk of a Pre-pack being challenged by a liquidator, mortgagee, or a creditor of the seller company after the event, as there will not have been time for a full marketing process by the receivers or administrators and the lack of opportunity for such marketing may, in the view of the liquidator or disgruntled creditor, have prevented the seller company from achieving the best price for the business or assets sold.

Pre-EA2002 – receivership v. administration?

Administrative receivership will remain available as an enforcement option for lenders whose security includes a floating charge and was created prior to 15 September 2003.[1]

Therefore, where the insolvent seller has granted security containing a floating charge prior to 15 September 2003, and where the circumstances are such that the secured lender has become entitled to appoint receivers pursuant to that security, there is ongoing scope for a Pre-pack sale by administrative receivers. There are several advantages of using administrative receivership as the insolvency process with a Pre-pack. Certain of the advantages pre-date the EA2002, and certain have arisen as a result of the provisions of the EA2002. Each is considered below.

Advantages of using administrative receivership with a Pre-pack

Little formality is required to effect the appointment of administrative receivers. The provisions of the security document will need to be checked as receivers may only be appointed once the security has become enforceable on its terms. Usually, it is sufficient either for the lender to have demanded repayment and for that demand to have gone unsatisfied, or for the seller company to have invited the lender to appoint administrative receivers. Where the lender proposes to issue a demand, because this is required to make the security enforceable, it is not uncommon, where the appointment of the receivers is not opposed by the company, for the lender to ask the company to also provide a written invitation to the lender to appoint receivers, as a means of evidencing that the appointment was not hostile and was made with the co-operation of the company and its directors.

Once the security has become enforceable, the security usually provides that the lender may appoint one or more receivers by a written instrument signed by an officer of the lender. There is no statutory form prescribed for the appointment of receivers.

Once the appointment document has been received by or on behalf of the receivers, in order for the appointment to be effective from the time that the appointment document was received, it must be

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1 Insolvency Act 1986 ('IA1986'), s.72A and Insolvency Act 1986, Section 72A (Appointed Day) Order 2003 (SI2003/1832).

accepted by the receivers in writing before the end of the business day next following the date of receipt of the appointment document.[2]

Where the proceeds of the business sale are likely to be insufficient to even repay the secured creditor's debt in full, receivership has the advantage that few duties will be owed by the receivers to the unsecured creditors of the company. This may reduce the administrative cost of the process, as compared to an administration.

Inter-creditor arrangements generally require a lender to consult with co-lenders about any proposed enforcement save where it is arguable that the appointment is required as a matter of urgency to avoid loss to the lender.

Advantages of using administration with a Pre-pack post-EA2002

The simplification of the entry routes into administration by virtue of the Enterprise Act 2002 reforms to the Insolvency Act 1986 has reduced the complexity, formality and cost of a company entering into administration. Instead of issuing an administration petition, accompanied by a witness statement and report from a licensed insolvency practitioner, and then waiting for an appointment for the court to hear the petition and to make an administration order at that hearing (assuming the court sees fit so to do), a company may now commence administration by taking the following steps (assuming that there is no statutory bar prohibiting it from using the fast-track procedure[3]):

1. convene a board meeting, or a members' meeting and pass a resolution that, in view of the insolvency of the company, it is appropriate that the directors, or the members, as the case may be, seek to put the company into administration;
2. assuming that the company has granted security containing a floating charge over all of its assets, the directors/the company should then complete a 'Notice of intention to appoint an administrator by company or director(s)' (Form 2.8B) and file this at court,[4] together with a copy of the board or members' resolution recording the decision of the directors or the company to proceed with an administration;
3. give five business days' notice to any floating charge holders (and to any other required parties) by sending them a copy of the Form 2.8B;[5]
4. assuming that the floating charge holders have no objection to the appointment, proceed to complete and file with the court a 'Notice of appointment of an administrator by company or director(s)' (Form 2.9B), accompanied by a 'Statement of proposed administrator' (Form 2.2B) completed by each proposed joint administrator and a brief statement confirming the relative roles of the joint administrators for the purposes of IA1986, schedule B1, paragraph 100(2).[6] The Form 2.9B must be filed within ten business days of the date on which the Form 2.8B was filed with the court.[7]

The timetable can be shortened where all floating charge holders are in agreement with the administration and provide their written consent by return following receipt of the notice. This could assist in the timely implementation of a Pre-pack. The wording on the current Form 2.9B does not provide for the appointor to say anything other than that the floating charge holders have been given five business days' notice. It would be preferable for the form to give the appointor an option to say instead that the charge holders having been given notice in accordance with IA1986, schedule B1, paragraph 26 have all consented in writing to the appointment of the administrators. The rules do allow for an appointment to be made on the earlier of (a) the expiry of the five business day notice period or (b) receipt of written consent from all floating charge holders.[8]

This process may be curtailed where there is no lender holding a floating charge. In such a case, the directors/company may skip the notice stage and go straight to filing with the court a completed 'Notice of appointment of an administrator by company or director(s)' (Form 2.10B), accompanied by the Form 2.2B for each administrator, the statement pursuant to paragraph 100(2) and the copy of the board or members' resolution recording the decision to appoint administrators.[9]

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2 IA1986, s.33(1) and Insolvency Rules 1986 ('IR1986'), r.3.1.

3 IA1986, sched B1, para 24.

4 IR1986, r.2.20.

5 IA1986, sched B1, para 26.

6 IR1986, r.2.23.

7 IA1986, sched B1, para 28(2).

8 IA1986, sched B1, para 28(1).

9 IR1986, r.2.23.

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Where there are difficulties in convening a board or members' meeting, or where there is disagreement between the directors or members such that no appointment by the directors or the company is possible, a secured lender might consider appointing the administrators itself, to get round the difficulties. Such an appointment should be filed with the court using a 'Notice of appointment of an administrator by holder of qualifying floating charge' (Form 2.6B), together with the administrators' statements on Forms 2.2B and the paragraph 100(2) statement.[10]

Where there are floating charge holders with priority to the lender appointing, that lender must give notice to those charge holders and must, prior to appointing and filing a Form 2.6B, must file a 'Notice of intention to appoint an administrator by holder of qualifying floating charge' (Form 2.5B).[11] The process, unfortunately, assumes that any regulation of priority as between secured lenders will be straightforward. In practice, how would one approach a situation where a different lender each has priority over a different class of assets, as is not uncommon where a company has granted security both to its clearing bank lender for its overdraft and term loan facilities and also to its factor or invoice discounter for any liabilities arising out of its debt factoring? Maybe we will see an increase in the sophistication of inter-creditor deeds specifically to address such issues?

Much like the ability of a lender to appoint administrative receivers out of business hours, EA2002 introduced a procedure for floating charge holders to appoint administrators out of business hours, by filing a copy a 'Notice of appointment of an administrator by holder of qualifying floating charge' (Form 2.7B) with the court using an out of hours fax number (020 7947 6607). Unlike an appointment during court office opening hours, there is no need for separate statements by the administrators to be filed, the statements instead appearing on the Form 2.7B itself, which is signed by both the administrators and the appointor. Any statement required by paragraph 100(2) does, however, need to be filed with the Form 2.7B. The appointor can use the out of hours appointment method where there are prior ranking charge holders, provided that they have previously been given notice on a Form 2.5B and have not objected within the time allowed (two business days). Where an out of hours appointment has taken place, the appointor must on the next day that the court is open for business, file copies of the papers, the fax transmission report confirming the time of filing, together with a statement giving the reasons as to why an out of hours appointment was considered necessary, including an explanation of why it would have been damaging to the company and its creditors not to have so acted.[12]

Duties and powers of administrators post-EA2002

If the seller company proposes administration as the process by which to effect the Pre-pack, what considerations are there for the insolvency practitioner appointed as administrator, in light of the EA2002 reforms?

First, the practitioner will need to bear in mind the statement that he is required to make on the Form 2.2B: 'I am of the opinion that the purpose of the administration is reasonably likely to be achieved'. The EA2002 has introduced a three-stage purpose.[13]

The primary objective of administration is 'rescuing the company as a going concern'. The inclusion of the word 'company' in the context is key – where the practitioner knows that immediately following his appointment, he will complete a Pre-pack sale of the business and assets of the company, how can there be any prospect of the company, as a corporate entity, surviving? The company will be left as an insolvent shell with no assets. Therefore, when the practitioner signs the statement on the Form 2.2B, what he must have in mind is that it is not the primary purpose of administration that is reasonably likely to be achieved but rather the secondary objective of 'achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration)', or the objective of last resort, being 'realising property in order to make a distribution to one or more secured or preferential creditors'.

Thus, where a practitioner proposes to accept an appointment as administrator with a Pre-pack agenda, he would be well advised to prepare a report at the time of his appointment demonstrating why he believed that a Pre-pack sale of the business and assets would be reasonably likely to achieve a better result for creditors that an immediate liquidation, or would be able to realize property for the benefit of the secured and preferential creditors. In the event of later enquiry as to the basis for his decision, the practitioner will then be well prepared to demonstrate the rationale behind it. Such a report could also form the basis of a

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10 IR1986, r.2.16.

11 IR1986, r.2.15.

12 IR1986, r.2.19.

13 IA1986, sched B1, para 3.

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defence to any action brought by a creditor seeking the court's interference with the earlier sale.

Where the objective that the practitioner believes is capable of achievement is the 'better realization' objective, he must perform his functions 'in the interests of the company's creditors as a whole'.[14] This means that in considering the appropriateness of giving the statement on the Form 2.2B, the practitioner must be satisfied that the Pre-pack is in the creditors' interests. What if there is a class of creditors who would be unfairly prejudiced by the Pre-pack? Does this mean that the secondary objective is also incapable of fulfilment? Absent any guidance on the intended meaning of 'interests of the company's creditors as a whole', it might be prudent for the practitioner, where there is a risk of prejudice to a particular class, to seek to justify the Pre-pack on the basis that it is reasonably likely to satisfy the objective of last resort, i.e. realize property to distribute to secured and preferential creditors. Cases where the only creditors to be paid a return on their debt are the secured and preferential creditors are, unfortunately for the majority of creditors, not uncommon. It is likely that many Pre-packs will only need to satisfy this third objective, the objective of last resort.

The administrator's powers have been widely restated in the EA2002 reforms. The administrator has a general power to 'do anything necessary or expedient for the management of the affairs, business and property of the company'.[15] Without prejudice to this general statement, the administrator retains the powers set out in schedule 1 to the IA1986.[16] The power of sale is at paragraph 2 to schedule 1, and extends to a power to sell or otherwise dispose of the company's property by private contract (this is the same power that is granted to an administrative receiver in addition to any other powers under the security pursuant to which he was appointed[17]). The administrator thus has sufficient authority to effect the Pre-pack sale.

Considerations for the insolvency practitioner

Certain considerations for the practitioner who is to effect the sale will remain key, whether as receiver or administrator. These include:

1. obtaining independent valuations of the assets prior to the sale. Given that there will be no opportunity post-appointment to market the business and assets for sale, the practitioner will need to be satisfied that the price to be paid by the Pre-pack purchaser is an appropriate price for the assets. If the price is too low, there is a risk of subsequent challenge to the sale by a liquidator, creditor, the company or a mortgagee;
2. satisfying himself that the price achievable for the business and assets will be greater on a Pre-pack than on a delayed insolvency sale. Reasons why this may be the case may include:
   a. lack of funding to trade the company in administration. If there is a secured lender and that lender is unwilling to fund any trading losses out of floating charge assets or the realizations thereof, the practitioner may be under pressure to effect a prompt sale. Even where the lender is willing to bear some trading costs from the floating charge assets and realizations, the practitioner may be under commercial and competitive pressure to demonstrate his ability to realize the value of the security whilst incurring only a minimum of cost;
   b. risk of key staff leaving. If the company is to trade in a period of insolvency, key staff may be deterred by the prospect of a cessation of trading or liquidation, or may fear imminent redundancy and may choose to seek alternative employment. Pre-packs, for this reason, have provided a useful restructuring tool where the directors and staff are a key feature of the business, such as in service industry businesses;
   c. prospect of maximizing debtor collections. Where the book debts are a key asset of the insolvent company, continued trading by an immediate successor following a Pre-pack should enable the level of collections of the book debts to be maximized. Commonly on a Pre-pack, the buyer will be appointed to collect the book debts as agent for the seller, on the basis that there will be less damage to the goodwill of the business. Furthermore, there would be a greater prospect of collection in full where the collection is by a solvent company continuing the trade of the seller than by a receiver or administrator who is unable to complete work in progress or correct snagging or other deficiencies in the work previously undertaken by the seller. The value of the book debt collections is an increasing important consideration given the rise in the number of companies factoring their

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14 IA1986, sched B1, para 3.

15 IA1986, sched B1, para 59(1).

16 IA1986, sched B1, para 60.

17 IA1986, s.42.

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debts as a means of financing ongoing trade or capital expenditure;

d. no ready market for the business. In many cases, the only likely interested party will be a connected party, commonly a company controlled by one or more of the seller's directors. The connected party with existing and often intimate knowledge of the seller's business will be in a position to rely commercially on that knowledge of the business in the absence of representations and warranties from the seller (on issues such as the ownership of assets by the seller and the suitability of the assets for the running of the business). Neither should a connected party require time between the appointment of the receivers or administrators and the completion of the business sale to conduct due diligence enquiries;

e. the business is highly specialized. Where this is the case, such as with a business that manufactures a highly technical piece of machinery or component part, it is unlikely that anyone without specialist sector knowledge and a pre-existing relationship with the seller's customer will be interested in buying the business and continuing it. Such situations lend themselves well to Pre-packs, as they ensure the least disruption to trade and the supply of the goods to the customers;

f. there would be little prospect of any enhancement to the value of the business by any continued trading. This may be the case where trading continues at a loss and there are few assets (other than goodwill) to leverage a sale to a third party given a reasonable period post-appointment, or where most of the seller's projects were completed prior to the appointment, or could only be completed at a loss. Also, where trading for a period following the appointment of administrators or receivers would be likely to result in the seller's customers terminating their arrangements with the seller and sourcing their supplies from an alternative source (because they have several supplier options open to them), it may add value to sell via a Pre-pack to avoid the loss of business likely to arise during any such administration or receivership trading period;

g. there are few complex issues involving, for example, landlords or retention of title claimants. Where a purchaser is likely to need consents from key landlords to assignment to it of leasehold interests, a Pre-pack will be unlikely to be satisfactory to the purchaser, who may want to first investigate the likelihood of such consents being forthcoming and may then want the sale, or payment of parts of the consideration, to be conditional on obtaining those consents. Similarly, where a successor will have difficulties continuing the trade of the seller because there are numerous and significant retention of title claims from suppliers, a Pre-pack strategy may not offer sufficient time to source alternative supplies or reach agreement with the aggrieved suppliers.

3. ensuring that any shareholder approval required by section 320 Companies Act 1985 is obtained to the sale. Such approval will be required where a director of the seller or its holding company is taking an equity stake in the purchase vehicle. The exemption for sales by a company which is being wound-up[18] does not extend to sellers in administrative receivership[19] or administration;

4. ensuring that the proceeds of sale flow through the administration or receivership account. Where the purchaser is a connected party, such as a sister company, and the appointor is the lender to both the insolvent seller and the buyer, this is particularly desirable, to avoid challenge;

5. ensuring that the terms on which the sale is concluded are similar to those in any usual receivership or administration sale. Again, this is even more important where the purchaser is connected, as the practitioner will want to avoid any suggestion of giving the connected purchaser special treatment and accepting lighter indemnities in favour of the seller and the receivers or administrators. Where the sale is by administrators rather than receivers, the practitioner may have a better bargaining position in achieving the inclusion of protections for the seller company, by relying on his status as an officer of the court[20] bearing a differing level of duty to all creditors of the company, as compared with the duties that a receiver has to his appointor;

6. satisfying himself that no creditor approval is required. A receiver will need consent from his

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18 Companies Act 1985, s.321(2)(b).

19 *Demite Limited v Protec Health Limited* [1998] BCC 638.

20 IA1986, sched B1, para 5.

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appointor to the price and the terms of the sale, subject to his power to apply to court for an order for the sale of charged property.[21] An administrator does not need approval of the creditors of the company generally[22] but will need consent from lenders having fixed charge security over the assets to be sold, unless he proposes to seek an order authorising the sale of such assets.[23] In the context of a Pre-pack however, it is likely that any secured lender will have been kept fully in the picture during the planning of the sale, so that consent to an immediate post-appointment sale can be assured.

Tax considerations

When considering whether a receivership or administration offers the best prospective return to creditors, the practitioner should bear in mind the implications of the change to the rules on accounting periods. A company's accounting period automatically ends the day before a company enters into administration where the administration starts on or after 15 September 2003.[24] This means that any chargeable gains that arise out of the disposal of assets (such as property) by the administrators cannot be minimized by offsetting such gains against pre-administration trading losses, as trading losses cannot be carried forward to set against capital gains of later accounting periods.

Practitioners will be particularly keen to avoid liabilities to corporation tax on chargeable gains arising during an administration, since the tax liability is payable as an expense of the administration.[25]

This change in the accounting treatment has no bearing on receiverships and in some cases the effect of these changes will be such that a receivership will offer a significantly better prospective return to creditors than an administration.

Particular considerations for secured lenders

Unless the seller company granted floating charge security on or after 15 September 2003, the floating charge realizations following the sale of the business and assets by receivers or administrators will not be subject to 'top-slicing', i.e. the receivers or administrators will not be under any obligation to ring-fence a prescribed part of the floating charge realizations for distribution to unsecured creditors. The provisions of IA1986, s.176A only apply to floating charges created on or after 15 September 2003.[26]

Where either a receivership or administration commences on or after 15 September 2003 and the security granted by the seller company to its lender pre-dates 15 September 2003, the lender stands to get a double-benefit as the floating charge realizations arising from the disposal of the business and assets by the receivers will not be subject to either payment of Crown preferential debts or 'top-slicing'.

It may, however, be worth noting that if the ultimate decision in the higher courts in the case of *National Westminster Bank Plc v Spectrum Plus Limited and others*[27] is such that realizations of book debts and their proceeds are deemed floating charge realizations, as opposed to fixed charge realizations, the 'double-benefit' of the non-application of Crown preference and top-slicing to the realizations of floating charges pre-dating 15 September 2003 may have a more marked effect.

Where a lender knows in advance of any sale that it would want to fund the practitioner, following the Pre-pack, to make certain investigations or take certain claims on behalf of the seller, an administrator would have a greater range of powers open to him as compared to a receiver, such as the ability to issue proceedings for the reversal of transactions at an undervalue[28] or preferences.[29]

Scope for abuse

Administration is now easier than ever before to implement. As a consequence, there is a prospect that companies who do not have a viable business will nevertheless seek to use administration as an alternative exit route to a liquidation, as a means of minimising the opportunities for their creditors to consider the reasons for the insolvency and question those involved with the companies.

Notes

21 IA1986, s.43.

22 *Re T&D Industries Plc* [2000] 1 All ER 333.

23 IA1986, sched B1, para 71.

24 Finance Act 2003, schedule 41.

25 IR1986, r.2.67(1)(j).

26 IA1986, s.176A(9) and Insolvency Act 1986 (Prescribed Part) Order 2003 (SI2003/2097).

27 [2004] EWHC 9(Ch).

28 IA1986, s.238.

29 IA1986, s.239.

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There is scope for a practitioner agreeing to accept an appointment as administrator on the basis that he believes that either the secondary objective or the objective of last resort is reasonably capable of achievement. He may then cease all trading and secure an immediate sale of a valuable asset to a connected party, such as a director or a company connected with him. Where the proceeds are insufficient for there to be a likelihood of any distribution to unsecured creditors, the practitioner could apply for a dispensation from the holding of the creditors' meeting within ten weeks of his appointment[30] and thereafter he could seek to put the company straight from administration into dissolution,[31] thus trying to avoid any investigation by the official receiver into the conduct of the administrator for misfeasance or investigation (beyond any done by the administrator) into the conduct of the directors of the company.

In such cases, there are rights for creditors to require meetings and to object to an immediate dissolution, but whether such cases are contested will very much depend on whether creditors are active in exercising their rights.

The authors thank Geoff Carton-Kelly of Baker Tilly for his assistance.

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30 IA1986, sched B1, para 52.

31 IA1986, sched B1, para 84.

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