

# Pre-packs: a legitimate means to phoenix an insolvent company

**Using pre-packs to resurrect insolvent businesses is far from being illegal and may offer significant advantages.**

A pre-pack sale is co-ordinated by the insolvent company's existing management. Typically, the assets or business are sold for market value to a related company, which we will call New Co. New Co re-employs the existing staff and produces the same goods and services from the same premises. While you may think 'that is a phoenix and is illegal', we would like to challenge that view.

## The USA

The United States of America has used the pre-pack model of selling assets since 1978. In 2009, approximately 12,000 companies used the framework in an attempt to restructure and save their businesses.

In late 2009 General Motors Inc (GM), the largest automobile manufacturer in the US, was sold as a pre-pack for \$50 billion. The sale was finalised only 40 days after initiating the protection of Chapter 11 of the United States Bankruptcy Code. Some 225,000 staff were re-employed by New GM Inc after it purchased the \$85 billion-worth of assets from Old GM. The purchase was funded and approved by the United States Government. GM was the fourth largest corporate failure in history and is the biggest pre-pack to date.<sup>1</sup>

Another of the largest corporate failures in the US to date is Lehman Brothers. The day after it entered Chapter 11 protection, Barclays Bank announced its agreement to purchase its investment-banking assets. A week later that agreement was approved by the courts. This sale was not a pre-pack but it was a sale of \$600 billion in assets made within 24 hours of the regulator's rubber stamp.<sup>2</sup> It certainly demonstrates a quick sale can be a good sale.

The entire structure of Chapter 11 is designed to provide existing management with time to sell an insolvent business into a new entity. However, in our view the US system is cumbersome and expensive because the process is controlled by the courts.

## The United Kingdom

The UK Insolvency Act 1986 was revamped by the Enterprise Act 2002, which permitted a company to appoint an administrator without judicial scrutiny. The UK Act was modelled on Australia's Voluntary Administration laws but it has some twists.<sup>3</sup>



The most significant difference between the Australian voluntary administration procedure and the UK version is that the UK administrator gets involved early and assists management in undertaking the pre-pack sale of assets prior to their formal appointment. After the terms of the sale have been agreed, the UK administrator is formally appointed. The administrator will then immediately sign the contract for sale.<sup>4</sup>

- Whittard of Chelsea (the tea and coffee retailer) sold to private equity by Ernst & Young immediately after their appointment as administrator. This business had 130 retail stores and more than 1000 staff.

The Insolvency Service (the UK's equivalent of ITSA and ASIC) has stated: *'a pre-pack may offer the best chance for a business to be rescued, preserve goodwill and employment, maximise realisations and*

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This point must be emphasised: the UK administrator will typically sign off on the pre-pack sale on the day of their appointment. In the UK, there are around 100 pre-pack sales per month.<sup>5</sup>

Some examples of recent pre-pack sales include:

- Officers Club, the men's retail clothing chain sold to the existing management by PwC immediately after their appointment as administrator. This business had 120 retail stores and more than 1000 staff.

*generally speed up the insolvency process*.<sup>6</sup>

The UK's insolvency regulatory bodies have in fact sanctioned pre-pack sales and issued a guidance note to accountants and lawyers to assist them to undertake pre-packs. The 'Statement of Insolvency Practice 16' (SIP 16) sets out the basic principles and essential procedures that are to be followed.

It has been adopted by each of the United Kingdom's regulatory bodies, including the Insolvency Practitioners Association (UK), the Institutes of

Particulars	Pre-pack sale (%)	Insolvency sale (%)
All employees transferred to new company	92	65
Secured creditor return	42	28
Average return (unsecured creditors)	1	3
Sale of assets to related party	59	52

Chartered Accountants in England and Wales, Ireland and Scotland, and the relevant Law Societies.<sup>7</sup>

SIP 16 is not a definitive statement of law, but insolvency practitioners are liable for disciplinary action by their respective regulatory trade body if they fail to comply with its guidelines.

The website of the UK Attorney General states:

*'It is perfectly legal to form a new company from the remains of a failed company. Any director of a failed company can become a director of a new company'.<sup>8</sup>*

During the eight years pre-packs have been used in the UK, some research into the process has been undertaken which is summarised in the table opposite.<sup>9</sup>

The key statistic from this table is 52 per cent of all insolvency sales by a liquidator in the UK involve a sale of some assets to a related party.

### Reform of pre-packs

It is our view that the UK model for pre-packs is a commendable first attempt to get the process right; however, it could be refined and improved if the following modifications were adopted.

In the UK, the business is not openly advertised for sale. Instead, it is commonplace for the business to be sold in secret. We feel this approach is a mistake. A justification for this approach is that almost all companies have exhausted their lines of credit and cash reserves before they approach a liquidator seeking advice. An

and suppliers;

- retains staff;
- avoids the personal exposure of a voluntary administrator, including occupational health and safety obligations, which can cause liquidators significant concern;
- avoids funding a trade-on administration, which is always difficult and therefore avoids significant liquidator/voluntary administrator fees; and
- eliminates the costs of an auction/formal liquidation sale, which are significant.

The UK legislation has considered these pros and cons and seemingly formed the view that a secret sale is better than no sale at all. Creditors have criticised this aspect of the process, suggesting that asset realisations may be improved through wider marketing.

Second, we contend that a further material defect of the UK pre-pack system is that the administrator works with management to organise the sale. Thereby, the administrator in waiting will help management with:

- valuations of the business;
- discussions with prospective buyers;
- obtaining the support of secured creditors and suppliers;
- setting the sale price and terms of the contract for sale.

When all the details are agreed and a sale agreement is ready to be executed, the formal appointment of the administrator is then attended to. The problem here is the administrator who put together the deal

specifically prosecute the directors and advisers who fail to realise market value from a sale.

### Other jurisdictions

In Spain, the Insolvency Act was amended by Royal Decree 3/2009, which created a pre-insolvency negotiation period to enable a pre-pack plan to be developed.<sup>10</sup>

In New Zealand, which has largely adopted Australia's voluntary administration regime, the Companies Act 1993 was recently amended to accommodate phoenix arrangements. The explanatory material suggests that many phoenix situations are legitimate and operate to promote the interests of creditors of the insolvent entity through lower transactions costs and higher sale price as the business is sold as a going concern.<sup>11</sup>

### The advantages of pre-packs

We need to re-think the idea that a sale of an insolvent company's assets to the existing management is always unconscionable. We should invite legislative reform to embrace pre-packs. Pre-packs offer a means to increase the survival rate of insolvent companies.

For small business, pre-packs offer by far the best chance for existing management to save their business. Pre-packs are a common, everyday occurrence for our trading partners but in Australia, they remain a developing process that should only be attempted by a professional to ensure creditors' interests are preserved. □

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<sup>1</sup> Coburn, Niall, 'The Phoenix Re-examined' (1998) 8 *Aust Jnl of Corp Law* 321.

<sup>2</sup> Carter T and Kendall D, 'So what is a pre-pack Pat?' *Accountancy Age* London, 11, June 2009, p 19

<sup>3</sup> Already cited at note 2 above

<sup>4</sup> Already cited at note 2 above

<sup>5</sup> Black, Anthony, *In the Black*, 'A crystal clear result', February 2010 pp 42–45

<sup>6</sup> Already cited at note 2 above

<sup>7</sup> Statement of Insolvency Practice 16 (E&W), 'Pre-Packaged sales in administrations', Effective Date 1 January 2009, Published by Solicitors Regulation Authority

<sup>8</sup> <http://www.attorneygeneral.gov.uk/nfa/actionfraud/FAB/Pages/PhoenixCompanies.aspx>

<sup>9</sup> Frisby SA *Preliminary analysis of pre-packed administrations* 2007 <https://www.r3.org.uk> (follow the Publications link)

<sup>10</sup> *InsolWorld*, first quarter 2010, 'The pre-packaged plan and its legal uncertainties (Spain)'

<sup>11</sup> *National Accountant*, 'The flight of the Phoenix' by Geoffrey McDonald, February 2008, pp 73–74

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administrator will only trade an insolvent company if the cash flow during the trade-on period is positive, there is certainty as to the value of the assets that are to be sold, or there is an indemnity for trading losses.

Any liquidator will say that when an administration commences:

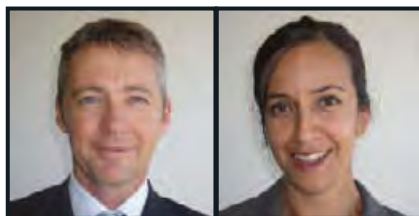
- customers stop paying their debts and suppliers withdraw credit and supply; and
- employees undoubtedly want to and do leave, which can be a particularly bad scenario when a company has a high dependency upon a small group of skilled employees.

We suspect it is for these reasons that the UK approach has sought to avoid the sale of assets by a publicly advertised process. The UK approach ensures that the business will continue to trade up until the date of its sale. It is clear that a sale, by way of limited marketing exposure, offers the following benefits, in that it:

- preserves the goodwill of customers

also has the responsibility for checking to see if the sale has realised market value on behalf of creditors.

This means that there is an inherent conflict of interest in the two roles. There can be no doubt that management will enjoy the expertise of an administrator or pre-pack expert. Selling an insolvent company is a specialist role and only a few have knowledge and experience to do the job well. However, fundamentally, a liquidator should only sit on one side of the fence, and ideally, the administrator should be appointed by creditors to preserve and protect their position and



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