Evaluation of Industry Measures to Improve Transparency of Connected Party Pre-pack Administration Sales

Submission from insolvency and restructuring trade body R3
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Overview

Making up a small share of all annual corporate insolvency procedures[1], 'pre-pack' administrations attract a disproportionate amount of public attention. They are consequently one of the most visible and most discussed parts of the UK's insolvency and restructuring framework. Perceptions of pre-packs can and do affect the perception of the wider insolvency and restructuring framework.

R3's view is that pre-packs are a valuable business and job rescue tool. Crucially, they represent an effective way of maximising returns to creditors in the event of a corporate insolvency. Without pre-packs, including those involving a sale to connected parties, creditors would be likely to see less money back from insolvency procedures.

That said, the criticism aimed by stakeholders at pre-packs, and connected party pre-packs in particular, is understandable. The speed of actions that need to be taken to preserve the value of an insolvent company's business, and with it, the value of creditor returns, can simultaneously lead creditors and others to feel like they have been left out of the loop.

Helping achieve the balancing act between transparency and creditor returns is the insolvency and restructuring profession. The insolvency practitioner's role in a pre-pack is to provide assurance that the pre-pack will maximise returns to the insolvent company's creditors. As a profession, insolvency practitioners take this safeguarding role very seriously, and a well-established regulatory structure exists to ensure that insolvency practitioners are executing this role properly.

Despite the existing protections for creditors, R3 is conscious of the need to use every opportunity to continue to build stakeholders' trust and transparency in pre-packs – and by extension, the wider insolvency and restructuring framework. The Graham reforms have been an important part of this process, and R3 has been supportive of the reforms since their inception. R3 will continue to support efforts to improve confidence in the pre-pack process.

However, R3 believes it would be an error either to ban or over-regulate connected party sales from administrations. The loss of the ability to make such sale in any administration would seriously affect the ability of the UK's insolvency and restructuring framework to achieve business and job rescue, and consequential creditor returns. This would have consequences not only for the insolvency framework in particular, but also the wider UK economy in general.

Instead, the Government should support and develop the reforms already introduced by the insolvency profession and creditor groups in 2015. The Government should also consider making separate reforms which would provide alternatives to the pre-pack process and could offer both transparency and optimal creditor returns. Pre-packs are not used for their own sake: they are used because there are few practical alternative solutions in the difficult situations that confront both businesses in financial difficulty and their creditors. If more practical and effective alternatives were available, demand for pre-packs would fall.

[1] Approximately 2% in 2017

Key Points

- Pre-packs – including those involving a sale to a connected party – are a valuable tool for rescuing businesses and jobs, and maximising creditor returns.
- The Government should not ban or over-regulate connected party sales from administrations.
- Pre-packs and connected party sales are already regulated. There is a well-established regulatory framework overseeing the work of insolvency practitioners who provide the assurance that connected party sales lead to the best return for creditors.
- The Government should support and help develop the reforms made in 2015 and should look at the impact of the reforms as a whole, not just the Pre-pack Pool.
- The Government should look at the pre-pack reforms in a wider context: introducing the 2016 Corporate Insolvency Framework Review proposals would provide tools which would reduce the need for pre-packs.

The Value of Pre-packs – and Connected Party Sales

The original 2014 Graham Review of Pre-pack Administrations offered a detailed breakdown of the economic value of pre-packs. While the review flagged some concerns with pre-packs and identified areas for reform, the report concluded that "there is a place for pre-packs in the UK's insolvency landscape."[2] Since the review's publication, there have been no fundamental changes to the way pre-packs work which would undermine this conclusion. Indeed, in response to Graham's recommendations, reforms have been made to address criticism and improve the pre-pack process.

R3 recognises that the 'value of pre-packs' is a separate issue from the Government's power to ban or regulate sales to connected parties, although the two are linked. Over half of all pre-packs involve a connected party sale[3].

Creditor and stakeholder queries about connected party sales, particularly in a pre-pack, are understandable. Creditors will always ask questions about the circumstances of an insolvency or the sale of a business. This is particularly so where they only find out about a sale after the event. Concerns can be further exacerbated where a previously insolvent business continues with the same or connected management with apparently little or no consequence to the insolvency save that debts will not be paid in full.

However, there are a number of unavoidable facts when dealing with connected party pre-packs:

- A sale to a connected party may be the best way of maximising returns to creditors, as the connected party may be the only potential purchaser who possesses the necessary knowledge to make an insolvent company's business work (and therefore have value); they may also be the only people to value that company's business. In some cases, particularly when dealing with small companies, the connected party purchaser themselves is the company's only asset: without that individual's involvement, there would be no business to sell.

- Speed and discretion are necessary to protect the value of a company's business and assets in many circumstances, while there are frequently funding obstacles to more 'transparent' alternative rescue procedures, such as a trading administration. Without the right protection, the publicity of a company's financial problems can undermine its brand value,

[2] Graham Review into Pre-pack Administration, page 5
[3] Pre-pack Pool Annual Report 2016 and 2017

while there is a risk that the company could lose key staff, customers or suppliers as a result of uncertainty. A declining business value means declining returns to creditors. There is also the risk that, should a company be open about its financial problems ahead of an insolvency procedure, it exposes itself to the risk of a hostile creditor action, such as a winding-up petition, where creditors seek to exert pressure to secure payment priority.

- A sale to a connected party from a pre-pack or any administration should only occur when it maximises returns to creditors. Any cases where this does not happen should be reported to the insolvency practitioner's regulator. The alternative to a pre-pack or a connected party sale would be lower returns to creditors.

Until there is an alternative means of fully marketing a struggling business for sale or engaging with creditors about a company's problems without the worries of the impact this might have on the company's business value, the risk of a winding-up petition, or the ability to fund a trading administration, there will be a need for pre-packs – and connected party sales.

As a result, the popularity of pre-packs as a method of choice for preserving both value and jobs continues. News reports of business and job rescues frequently refer to pre-packs and connected party sales.

Preventing an insolvency practitioner from making a sale to a connected party from any administration, or making such a sale financially unviable, would potentially significantly undermine the value of post-insolvency returns to creditors in UK insolvencies, and would seriously undermine the UK insolvency and restructuring framework's effectiveness for job and business rescue.

Protection for Creditors

As noted above, it is the insolvency practitioner's obligation to protect the interests of creditors in a pre-pack or any other administration. If the insolvency practitioner fails to ensure that a connected party sale would be the best outcome for creditors, they should be referred to their regulator.

Judging the by the most recently available statistics on insolvency regulation, complaints regarding insolvency practitioner non-compliance with pre-pack regulations are rare.

In 2017, no complaints were made about pre-packs via the Complaints Gateway[4]. In 2016, less than 1% of complaints to the Insolvency Service about insolvency practitioners related to a pre-pack (a total of three complaints)[5]. Further, the Insolvency Service's 2016 annual review of regulation noted that two-in-three pre-packs were wholly compliant with SIP16, and that the "vast majority of the non-compliant statements, the breach was not deemed to be serious and was merely of a technical nature."

On this basis, it would appear the insolvency and restructuring profession is effectively fulfilling its duty of protecting creditor interests in pre-pack administrations – including those which involve a connected party sale.

The impact of the Graham Reforms

R3 recognises the importance of continually building creditor and stakeholder confidence in pre-packs and, by extension, the wider insolvency and restructuring framework. As such, R3 has

[4] Insolvency Service Annual Review of Regulation 2017
[5] Insolvency Service Annual Review of Regulation 2016

supported the implementation of the Graham review recommendations and is supportive of efforts to further develop these reforms.

Reaction to the Graham reforms has been mixed, with some changes being seen as more effective than others. Clearly, use of the Pre-pack Pool by connected party purchasers has been disappointing and to-date R3 members tend to view the Pool as an ineffective reform. On the other hand, the marketing and valuation changes to SIP16 *have* been seen as effective by R3 members (see below for the full results of R3's pre-pack survey).

It is crucial that the Government assesses the impact of the Graham reforms as a whole, and does not let the low referral rate to the Pool overshadow the impact of other changes.

There appear to have been notable changes to the demographics of pre-packs in recent years, which suggest the reform package as whole may be making a difference. In 2010 and 2011 (the last two years for which pre-Pool data can be found), 72% and 79% of pre-packs involved a connected party sale; in the first two years of the Graham reforms, this percentage had dropped to 51% in 2015-16 and 57% in 2017. It may be the case that, while referral rates are low, the Pool and the other reforms may be serving to discourage demand for some connected party pre-packs.

Further Reforms

While R3 would not agree with the Government using the full extent of its reserved power (to *ban* connected party sales from administration) and would urge a very cautious approach to additional regulation, there is scope to further improve the reforms.

Parts of the reforms are seen to have been effective: the new valuations and marketing requirements in the revised SIP16, for example. Notably, these changes are compulsory and are insolvency profession-led. The insolvency profession must comply with the revised SIP16 and, as the Insolvency's Service's reviews of regulation acknowledge, insolvency practitioners do so.

The parts of the reforms which are not seen to have been effective are the parts which are voluntary. Notably, they are also the parts of the reforms that are not fulfilled by an insolvency practitioner: referral to the Pre-pack Pool and the preparation of a viability report. Both of these reforms require action by a connected party purchaser. R3 would recommend that, if further reforms are to be made, these focus on non-insolvency stakeholders: the insolvency profession is already doing its part to make the existing reforms work.

The most pressing need for further action to be taken is to deal with the use of the Pre-pack Pool.

While R3 welcomed the introduction of the Pool, its voluntary nature is holding back its effectiveness. Although insolvency practitioners are required to alert connected party purchasers to the option of using the Pool, they cannot *compel* connected party purchasers to refer a sale to the Pool. As a result, the majority of connected party purchasers opt not to do so.

The most obvious reason why purchasers are not making a referral is that they face no consequences for not doing so: a connected party sale may go ahead without an approach to the Pool. There also appears to be little public reaction from creditors and stakeholders to a connected party purchaser's failure to approach the Pool after a pre-pack. Few suppliers, government bodies or lenders appear to require a NewCo that has completed a connected party pre-pack to have approached the Pool as a pre-condition for doing business. Pressure from a NewCo's potential customers and suppliers would provide an incentive to use the Pool which does not currently exist.

However, given creditor engagement is a perennial problem in insolvencies, and that creditors of an OldCo often find themselves with little financial choice but to trade with connected party pre-pack NewCo, it is unlikely that the necessary shift in approach will happen quickly. As such, R3 would recommend making it mandatory for a connected party purchaser to make a referral to the Pool.

Crucially, the responsibility for referral to the Pool must remain with the connected party purchaser, and must not be transferred to the insolvency practitioner. It would be inappropriate for insolvency practitioners to be given the responsibility for making a referral for a number of reasons:

- The insolvency practitioner is not an Office Holder at the 'Pool stage'. Therefore they have no standing and it would be inappropriate for them to make a submission since they have no capacity in which to make it;

- The insolvency practitioner is already subject to a rigorous regulatory framework. To require them to make a referral to the Pool would be adding further unnecessary regulation to an already heavily regulated profession.

However, there is still room for further insolvency practitioner involvement to make the Pool as effective as possible.

The insolvency practitioner should, for example, be given the opportunity to share necessary or relevant information with the Pool, separately to a purchaser's application. This could include information about alternative bids or valuations. This information should be treated confidentially and not shared with the purchaser. This would allow the Pool reviewer to have a full picture of the reasoning behind a pre-pack which the purchaser may not be in a position to provide.

And while R3 is clear that the insolvency practitioner should not be required to make the Pool referral themselves and that additional burdens on insolvency practitioners should be avoided, R3 does recognise that it would be difficult, within the existing framework, to compel a purchaser to use the Pool. As there is no regulatory framework covering 'connected parties', it may make sense to use the existing insolvency framework to ensure the Pool is approached by connected party purchasers. As such, one possible option could be to alter SIP16 so that insolvency practitioners are prevented from completing a connected party pre-pack sale unless the Pool had been approached by the purchaser. This would not be a significant additional burden for the insolvency practitioner and it would lend weight to any insolvency practitioner advising a purchaser to use the Pool. Importantly, the insolvency practitioner should still be allowed to proceed with a connected party pre-pack sale, even if the Pool provides a 'negative opinion' on the deal. The Government should consult with stakeholders on the most appropriate means to make a connected party referral to the Pool mandatory.

As above, while the Pool is a high profile part of the Graham reforms it is not the only part, and the success of the reforms should not be judged on the referral rate to the Pool alone.

The Wider Context

Connected party sales and pre-packs happen because, with the existing insolvency procedures available, they are the most effective way of maximising returns to creditors in certain circumstances.

However, in 2016, the Government proposed a number of measures which may provide alternatives to pre-packs (and connected party sales) which could protect or enhance creditor returns while boosting transparency and creditor confidence.

- **The Moratorium** could provide companies with the chance to be open with their creditors about their financial difficulties without worrying about the risk of a winding-up petition. This concern can be a significant driver in the use of a pre-pack. The increased transparency available in the proposed moratorium could also make it easier for a company to find a non-connected party purchaser for parts of the company's business if a sale is necessary.

- **The Restructuring Tool** could make it easier for companies to take action to resolve financial problems at an earlier stage, and with creditor engagement.

- **Rescue Finance** proposals could make it easier to fund a trading administration, which would increase transparency for creditors and remove the need for a pre-pack.

The most effective 'pre-pack' and connected party purchaser reforms would be to introduce viable alternatives to both.

Importantly, the Government must recognise that banning or detrimentally regulating connected party sales from *any* administration would be a step too far. If the Government did wish to use its powers, they must be applied to connected party pre-pack sales only.

As outlined above, a connected party sale may be the only option to create creditor returns in some cases. A ban would essentially undermine the use of administration to restructure a company under its existing ownership (potentially dissuading companies from proactively resolving their insolvency in the first place) and would ultimately lead to an increase in company liquidations and the loss of value for creditors and UK plc.

R3 Survey results

R3 has conducted a survey of our members to establish their views on the Graham reforms. The results obtained are as follows.

- **79%** of respondents said the Graham reforms have had **no impact on their decision** about whether to propose a pre-pack or not.

- Respondents were **evenly split** on whether the Graham reforms have been **helpful**: just over a **third** (**37%**) thought they have been, just over a **third** (**36%**) said they haven't, and another **quarter** (**27%**) said they've been neither.

- **Half** of respondents (**51%**) thought the Graham reforms should be given **more time** before the government makes a decision on whether to use its power or not.

- **86%** of respondents were **opposed** to the government using its reserved power.

- Respondents were most likely to believe the new SIP16 **valuations** and **marketing** requirements have been **effective** at improving the perception of pre-packs. By contrast, **over half** of respondents felt that the **Pool** and the **viability review** have been **ineffective**.

- **63%** of respondents believed the valuations requirements have been effective when it comes to improving the perception of pre-packs; only **12%** disagreed.
- **62%** of respondents believed the updated marketing requirements in SIP16 have been effective when it comes to improving the perception of pre-packs; only **15%** disagreed.
- **46%** of respondents believed that the RPBs taking on responsibility for monitoring SIP16 reports has been effective when it comes to improving the perception of pre-packs; **35%** did not think it had made a difference either way; **14%** disagreed.
- Only **17%** of respondents believed that the introduction of a viability review has been effective when it comes to improving the perception of pre-packs; **50%** believed it has been ineffective.
- Only **14%** of respondents believed the Pre-pack Pool has been effective when it comes to improving the perception of pre-packs; **53%** believed it has been ineffective.

- **89%** of respondents believed that the value of pre-packs as a tool for returning money to creditors and rescuing jobs and businesses **at least somewhat outweighs** negative publicity about pre-packs and concerns about transparency; **58%** believed the value of pre-packs **significantly outweighs** these concerns.

- The most common reasons given for why a case **was** referred to the Pool include: the purchaser saw the referral as just 'part of the process' of the pre-pack; the purchaser wanted further assurance for creditors, regardless of creditor pressure; NewCo's bank or other backer required the referral.

- The most common reasons given for why a case **was not** referred to the Pool by the purchaser include: they saw no benefit in referring the case to the Pool; they didn't want or need the extra assurance; the cost of applying to the Pool.