



Research
Programme
2006-2009

Prepack Administrations and Company Voluntary Arrangements



IPF Research Programme
Short Paper Series
Paper 9

February 2011

This research was commissioned by the
IPF Research Programme 2006-2009



Investment
Property Forum

This research was funded and commissioned through the IPF Research Programme 2006–2009.

This programme supports the IPF's wider goals of enhancing the knowledge, understanding and efficiency of property as an investment class. The initiative provides the UK property investment market with the ability to deliver substantial, objective and high quality analysis on a structured basis. It will enable the whole industry to engage with other financial markets, the wider business community and government on a range of complementary issues.

The programme is funded by a cross-section of 24 businesses, representing key market participants. The IPF gratefully acknowledges the continuing support of the contributing organisations.

ADDLESHAW GODDARD



Deloitte.



PRUPIM



IPF Research Programme Short Papers Series

Prepack Administrations and Company Voluntary Arrangements: *The regulatory environment, current practice and the implications for investors*

IPF Research Programme 2006–2009

The IPF Research Programme Short Papers Series has been established to address current issues facing the property investment market in a timely but robust manner.

The aims of the series are:

- **to provide robust information in a short format on specific issues;**
- **to generate and inform debate amongst the IPF membership, the wider property industry and related sectors;**
- **to publish on topical issues in a shorter time-scale than we would normally expect for a more detailed research project, but with equally stringent standards for quality and robustness;**
- **to support the IPF objectives of improving awareness, understanding and efficiency of property as an investment asset class.**

The IPF Short Papers are published in full and downloadable free of charge from the IPF website. For more information on these and other IPF Research Programme outputs contact Sue Forster, IPF Executive Director (sforster@ipf.org.uk) or log on to the IPF web site at www.ipf.org.uk.

PREPACK ADMINISTRATIONS AND COMPANY VOLUNTARY ARRANGEMENTS

IPF Research Programme Short Papers Series

Prepack Administrations and Company Voluntary Arrangements: *The regulatory environment, current practice and the implications for investors*

IPF Research Programme 2006–2009

February 2011

Research Team

Patricia Godfrey, *Nabarro*

Nick Lloyd, *Nabarro*

Malcolm Frodsham, *IPD*

Lee Manning, *Deloitte*

Disclaimer

This document is for information purposes only. The information herein is believed to be correct, but cannot be guaranteed, and the opinions expressed in it constitute our judgement as of this date but are subject to change. Reliance should not be placed on the information and opinions set out herein for the purposes of any particular transaction or advice. The IPF cannot accept any liability arising from any use of this document.

Introduction

With the difficult economic climate, both business failure and tenant administration have become common occurrences. Company directors and insolvency practitioners (IPs) wishing to rescue the viable part of a business may enter into a pre-packaged administration agreement (a prepack) for the sale of the business and assets or propose a company voluntary arrangement (CVA), rather than merely seeking to sell the assets and business within the scope of the administration alone.

When IPs recommend a pre-packaged sale or CVA, it is usually because they believe it will maximise realisations for the creditors and return the business to a viable position, thereby saving jobs. However, the generally held perception of many landlord creditors is that pre-packs and CVAs do not have sufficient regard to their interests as creditors and are difficult to challenge if a landlord believes it has suffered undue prejudice in the terms that are imposed as a result of the process, even if the requisite majority of creditors have voted in their favour.

This paper seeks to set out in a balanced way, the current regulatory position regarding prepacks and CVAs and to explore the implications of these arrangements for commercial property investor landlords. Recent key cases are examined and the position in some continental European markets is also set out to establish the context within which these arrangements are currently being discussed. This paper is one of a set of three IPF Research Programme Short Papers being published that focus on leasing issues of current significance to the market¹.

¹ See also IPF Short Paper 10: Break Clauses - Who holds the Risk in your Rental Income? and IPF Short Paper 11: Rent Reviews - Revolution of Evolution?

PREPACK ADMINISTRATIONS AND COMPANY VOLUNTARY ARRANGEMENTS

1. Introduction to pre-packed sales

Brief description of legal background and role

A pre-pack is a pre-negotiated agreement for the sale of an insolvent company's assets and/or business which is devised in advance of the company entering into a formal insolvency process, and executed by the IP shortly after their appointment. The IP is typically actively involved in the sale negotiations in the run up to their appointment but will often work in conjunction with the company's directors.

Pre-packs are most commonly used in conjunction with administration, although they can be used with other insolvency processes, such as creditors' voluntary liquidations and administrative receiverships.

Despite their common use, there are currently no specific provisions in English insolvency legislation which either deal with or contemplate the use of pre-packs. However, IPs who enter into pre-packs on behalf of an insolvent company are regulated by statute and the codes of practice of their professional bodies.

The Statement of Insolvency Practice 16 (**SIP 16**), which took effect on 1 January 2009, seeks to redress the lack of statutory guidance on pre-packs. SIP 16 sets out guidelines for IPs involved in pre-packaged sales. The intention is to provide greater transparency for creditors by obliging an IP to provide them with detailed information about the terms of the sale, the buyer of the business and with more visibility into the formal insolvency process generally. In addition to SIP 16, IPs are required to follow the Code of Ethics for Insolvency Practitioners (the "**Code**"). The Code also came into force on 1 January 2009 and sets out five fundamental principles which IPs should follow, which include acting with integrity, acting objectively, acting with professional competence and due care (which includes adhering to confidentiality and acting in a professional manner). Although failure to observe the Code will not itself necessarily lead to any professional misconduct on the part of the IP, it would be taken into account when assessing the IP's conduct.

Therefore, if a court or professional body found that an IP has acted improperly by entering into a pre-pack without adhering to SIP 16 guidelines, the IP may be liable for a number of sanctions including misfeasance and disciplinary proceedings. In section 3 below, we set out some of the challenges available to aggrieved creditors of insolvent companies that have been subject to pre-packs.

How prepacks are used in practice

Pre-packs are not a new phenomenon and have been used over many years to sell businesses where commercial pressure dictates that urgent action is required to salvage part of a company. They have become a 'hot-topic' in recent times, with a series of high profile businesses, including Leeds United Football Club, Whittard of Chelsea Limited, Cobra Beer and recently, Wind Hellas, all becoming the subject of a pre-pack.

In certain circumstances, a pre-pack may be the best method of:

- Maximising realisations for a financially distressed company to the advantage of all the stake-holders;
- Selling the business without the same level of negative publicity, as trading a company's business whilst in administration may seriously damage goodwill and hence the value of the business;
- Saving jobs. Pre-packs are often a useful tool in 'people' businesses where the 'leakage' of key personnel to competitors can rapidly erode the attraction of a business to prospective purchasers.

Despite the above advantages of pre-packs, critics still argue that the lack of transparency and lack of the need to obtain court sanction (as is the case in other jurisdictions, such as the United States of America) leaves prepacks open to abuse. For example, a management buy out (**MBO**) of a company's business and assets (through an administration) to a newly formed company consisting of the former management of the insolvent company can, in certain circumstances, lead to accusations of process abuse and so-called "*phoenixism*". This is because the management are able to carry on the business of the insolvent company and take the value (such as the business and assets) whilst leaving behind in the insolvent company all of the unwanted debts, with little prospect of any of those debts being settled.

Although the marketing of an insolvent company's business and assets should take place in advance of any sale, either by the directors or appointed professional advisers, it is not necessarily that visible. Creditors therefore feel they are presented by the administrator with a "done-deal" many weeks after the event (at a creditors meeting which can be held up to 10 weeks after the start of the administration) without having had the opportunity to influence the process in any way.

Notwithstanding their use over the years, pre-packs have not attracted significant judicial commentary primarily because the active involvement of the court to consider the transaction is rarely necessary in order to place a company into administration. The case of **Kayley Vending Limited [2009] B.C.C. 578** gave the court an opportunity to comment on a pre-pack prior to the company entering into administration and prior to the pre-pack deal being effected. In this case, the court said that for an application to court seeking an administration order, there should be full disclosure, as required by SIP 16, of any intention to effect a pre-pack.

The principle laid down in *Kayley Vending Limited*, was adopted and expanded upon in the recent case of **Hellas Telecommunications (Luxembourg) II SCA [2010] B.C.C. 295**, commonly referred to as "*Wind Hellas*". *Wind Hellas* is a very important case concerning the court's current position on the use of pre-packs, as it was the first case where the court expressly gave positive support to a specific pre-pack strategy. In this case, it was held that the guidance for proceeding with a pre-pack in SIP 16 had been fully complied with and that therefore, express permission was given to the administrators to enter into the proposed pre-pack sale with the purchaser. The court also held that when it is faced with a pre-pack, it has a number of options, which are (broadly speaking):

- If, on the evidence before it, the pre-pack sale appears to be an abuse of the administrators' powers, the court can either direct that the pre-pack sale does not proceed or, alternatively, not make the administration order;
- If, on the face of the evidence, it is obvious to the court that the pre-pack is the only way forward, it can direct that the administrators proceed with the sale, thereby 'blessing' the pre-pack;
- If the position is not clear, the court can make no direction at all on the pre-pack and leaves the matter in the hands of the appointed administrators.

In both *Kayley Vending Limited* and *Wind Hellas*, the court held that the merits of the proposed transaction were a matter for the officeholders to consider once they were appointed and that they should comply with their obligations under SIP 16. Should any creditor feel aggrieved by the pre-pack agreement, then they would have the right to challenge the administrators' conduct. However, this is not a straightforward procedure and can be both time consuming and costly for creditors.

PREPACK ADMINISTRATIONS AND COMPANY VOLUNTARY ARRANGEMENTS

Some practicalities of pre-packs

Are landlords truly disadvantaged by a pre-packaged sale of a business, as compared with a sale by an administrator after a number of weeks?

In many circumstances an administrator is appointed at a time when there remains an unexpired portion of a prepaid quarter's rent and, if the rent hasn't been paid up to date, then the administrator is liable for the ongoing rent while he remains in occupation, unless he agrees a compromise with the landlord (in accordance with the recent decision in **Goldacre (Offices) Ltd v Nortel Networks UK Ltd (In Administration) [2009] EWHC 3389 (Ch)**).

Administrators may often enter into a sub-licence with a purchaser of a business (in contravention of the lease) but that purchaser or, more importantly the administrator, remains liable for the accruing rent if the premises are occupied. It is then up to the landlord to negotiate a surrender of the existing lease and to agree new terms with the purchaser or grant a licence to assign.

The circumstances where a pre-pack is immediately followed by the company vacating the premises is typically where the premises are undesirable for the business and, arguably, where the purchaser has determined that he is not interested in negotiating new occupancy terms with the landlord. In other words, the premises would have been abandoned whether or not a pre-pack agreement had been put in place.

Would landlords be in the same position if the company had gone straight into administration, as against a company that had tried to continue to trade?

For the reasons outlined above, there may be a good argument to say that unlucky landlords are in the same position they would have been in had the company gone straight into administration and lucky landlords are arguably better off. The only loss a landlord would suffer is that of the right of distress over any historic (i.e. pre-appointment) rent arrears, which would become forfeit and, therefore, unsecured. A landlord can pursue an administrator for rent that accrues post his appointment, as the administrator is liable for any occupational rent on a daily basis and, potentially, after Goldacre, for an entire quarter if the administrator is in office on the day the quarter commences.

The decision to continue trading outside of a formal insolvency process, such as administration, is a commercial decision driven by cash-flow pressures and not whether a pre-pack administration is around the corner. Where a sale is contemplated, each site will be judged on its relative merits both by a vendor and purchaser of a business in administration. Purchasers, especially those involving former management, are often prepared to take on more operating units than, arguably, they ought to, as they usually have time to test the market of each unit before signing up to any formal lease. The company's directors must also have regard to their duties to creditors as a whole where a company is insolvent, as failure to do so may lead to claims against them personally, including, for example, a wrongful trading claim.

Research into pre-packs and their possible future reform

Research by Dr Sandra Frisby of the University of Nottingham

Dr Sandra Frisby of Nottingham University was commissioned by the insolvency trade body, R3, to conduct an independent review into the efficacy of pre-packs, in particular the suggestion frequently made in the press that pre-packs prejudice creditors. The research involved an analysis of pre-packs and business sales (where the business of an insolvent company is sold as a going concern without that element of a pre-commencement negotiation associated with pre-pack going concern sales). In summary, the outcome of the research suggested that pre-packs maximise value to both secured and unsecured creditors whilst, at the same time, increasing the likelihood of jobs being saved.

Whereas Dr Frisby acknowledged that concerns about propriety, transparency and disenfranchisement are absolutely understandable and may well persist, the reality was that the financial interests of creditors, far from being prejudiced, are marginally enhanced where a pre-pack strategy is employed.

Consultation paper prepared by the Insolvency Service dated March 2010

During the first six months of 2009, the Insolvency Service monitored the use of pre-pack sales and the effectiveness of SIP 16.

The review found that in only 65% of cases were the disclosure requirements of SIP 16 complied with. In 3% of cases the conduct of the IP was regarded as sufficiently serious to consider disciplinary action against them.

The Insolvency Service concluded in its review that there was no evidence of any more collusion or abuse under a pre-pack in comparison with any other insolvency process. The view of the Insolvency Service at the time was also that their enforcement regimes were sufficient to deal with any misconduct by the IP, which suggests that the Insolvency Service did not think any change was needed to the regime at that time. In turn, this suggested that a disgruntled creditor should, therefore, rely on the existing avenues of challenge, being, primarily, an allegation of misfeasance, a challenge on the basis the pre-pack unfairly harms the interest of the creditor or, alternatively, an action against the directors, for example, on the grounds of wrongful trading.

Partly because of the findings of the Insolvency Service (that in around a third of cases information was not being provided in accordance with SIP 16), but probably more because of the strong and prevailing perception that creditors' confidence in pre-packs remains low, the Insolvency Service is consulting on a number of options to improve transparency and confidence in pre-packs.

The first option is to do nothing and leave SIP 16 without any statutory force.

The second option is to give statutory force to the disclosure requirements in SIP 16 and, most importantly, provide sanctions for non-compliance. This would mean SIP 16 moving from being a statement of best practice to being a statutory requirement. Furthermore, the information becomes more transparent by virtue of the requirement to put it into the public domain by filing at Companies House.

The third option is to restrict exit from a pre-pack administration to compulsory liquidation, which will automatically mean that the sale transaction is scrutinised by the official receiver as part of that process and, if the official receiver considers the deal is not in the best interests of the creditors, file an appropriate report on the directors' conduct.

The fourth option attempts to improve transparency by suggesting that an IP who advises a company as to the pre-pack sale cannot then act as the company's administrator. In other words, a new IP would need to be appointed at that stage who would scrutinise whether the deal was appropriate and in the best interests of creditors.

The fifth and final option would allow creditors to have a say in whether a sale is permitted to occur in circumstances where it is to a connected party (which usually promotes the greatest concern in relation to undervalue disposals); sales to unconnected parties remaining unaffected. Creditor intervention under these circumstances would inevitably slow the process down.

What steps if any will be taken in light of responses to the consultation remains to be seen.

PREPACK ADMINISTRATIONS AND COMPANY VOLUNTARY ARRANGEMENTS

2. Company voluntary arrangements

The legal background and their role

A CVA is a rescue procedure for a company in financial difficulties. A CVA is defined as "a compromise or other arrangement" with creditors under Part I of the Insolvency Act 1986 (the **1986 Act**).

A CVA is carried out under the supervision of an IP, known as the nominee before the proposal is implemented and as the supervisor afterwards. The arrangement will be binding upon creditors (if the relevant majorities vote in favour of the proposal at meetings of creditors and shareholders of the company). A CVA does not affect the rights of secured or preferential creditors unless they agree to the proposal.

The limited amount of court involvement (restricted to filing various documents) means that a CVA is potentially a simpler and lower cost form of restructuring. Theoretically, this should mean that CVAs would be a popular, low-cost option.

On 1 January 2003 the Insolvency Act 2000 (the **2000 Act**) introduced an optional 28-day moratorium for small companies to allow them to put a CVA proposal to their creditors. However, the criteria for what constitutes a small company, based on maximum turnover, asset values and number of employees, arguably excludes most businesses of any significant size from obtaining a moratorium. As set out in section 5 below, there is currently a government proposal to extend the CVA moratorium period to all qualifying companies for an initial period of three months.

Prior to the 1986 Act, a company wishing to enter into an arrangement with its creditors would only have had recourse to the scheme of arrangement procedure, now contained in Part 26 of the Companies Act 2006. The aim of introducing the CVA procedure was to allow companies to avoid liquidation by entering into a binding agreement or compromise with the company's creditors with the minimum of court involvement. CVAs may be used to avoid or supplement other types of formal insolvency procedures, such as administration or liquidation.

The CVA procedure may be used by both solvent and insolvent companies in financial difficulty.

How they are used in practice

The essence of a CVA is that the directors of a company (unless it is in administration or in the process of being wound up) make a proposal under Part I of the 1986 Act to the company and its creditors for a "*composition in satisfaction of its debts*" or a "*scheme of arrangement of its affairs*".

Where a company is in administration, a proposal for a CVA may be made by the administrator and where the company is in liquidation, by the liquidator.

CVAs are becoming an increasingly popular vehicle for companies to use to restructure their business. They are increasingly popular in the retail sector, with a number of fairly recent high profile cases including Blacks Leisure and JJB Sports.

However, the steps required to implement a CVA are fairly complex and are set out below.

Who may act as nominee?

A proposal for a CVA should identify a person who will act as the nominee in relation to the CVA, either as trustee or otherwise, for the purpose of supervising its implementation. Where an administrator or a liquidator makes a proposal for a CVA, the administrator or liquidator will normally act as the nominee.

Setting up a CVA—the process:

Nominee considers proposal and reports to court

Where the nominee is not a liquidator or an administrator, he must, within 28 days of being given notice of the proposal for a voluntary arrangement (this can be extended by court order), submit a report to the court stating whether, in his opinion, meetings of the company and of its creditors should be called to consider the proposal. This effectively gives the nominee a period of time to consider the proposal and its viability. If the administrator or liquidator is the nominee, he may simply summon a meeting of shareholders and creditors without a need to first report to the court.

Statement of the company's affairs

To enable the nominee to prepare his report, the persons making the proposal, usually the directors, must give him a document setting out the terms of the proposed voluntary arrangement and a statement of the company's affairs, containing details of the company's creditors, debts, liabilities and assets.

The meetings

Where the nominee recommends to the court that meetings should be held, he must call the meetings at the time and place recommended in his report to the court, unless the court orders otherwise.

Notice to the creditors

The person who calls the creditors' meeting must summon every creditor of the company of whose claim and address he is aware. Creditors must be given 14 days notice of the meeting.

Authorising the CVA

The creditors and members decide at their relevant meetings whether or not to approve the proposed CVA, with or without changes. Where the decision of the creditors' meeting differs from that of the members' meeting, the decision of the creditors takes precedence.

Any proposal must allow for the payment of any preferential debts in priority to other unsecured creditors. Otherwise, the proposal must be approved by a simple majority in value of the members and by more than 75 per cent in value of the company's creditors present and voting.

However, the creditors' meeting cannot approve any proposal or modification that affects the rights of a secured creditor to enforce its security without its consent.

Binding on all creditors

Before the 2000 Act came into force a CVA only bound those creditors who had notice of the proposal and were entitled to vote at the relevant meeting. This caused problems with creditors who could not be traced. From 1 January 2003, an approved CVA binds not only creditors who having notice of and entitlement to vote at the meeting, but also creditors who would be entitled if they had received notice of the meeting.

Other issues on implementing a CVA

Other problems in practice include determining the voting rights of creditors in relation to disputed, unliquidated or unascertained debts. This can be a very difficult task for the IP but cases have shown that the court is unlikely to allow challenges to the IP's estimates of the value of the creditors' debts, if made in good faith.

The operation of a CVA

The approved CVA takes effect as if made by the company at the creditors' meeting. The nominee becomes the supervisor of the CVA and is given the power to implement the proposal.

PREPACK ADMINISTRATIONS AND COMPANY VOLUNTARY ARRANGEMENTS

Implementation may involve the directors (or liquidator/administrator, if he is not the supervisor) handing over the assets of the company to the supervisor. The supervisor can petition for the winding-up or administration of the company. The power of the supervisor derives from the terms of the CVA, but in carrying out this role the supervisor is entitled to apply to the court for directions. If the supervisor considers that the CVA should cease he may apply to the court for an administration or winding-up order.

If the CVA is successful, the supervisor must send a report on the implementation of the proposal to all members and creditors who are bound by the CVA within 28 days of its final completion. A successful CVA typically results in the company being relieved of its entire pre-CVA debts and being able to trade uninterrupted throughout the CVA process.

3. Possibility of challenge

Brief commentary on the ability of a creditor landlord to challenge a pre-pack sale, a CVA proposal or a CVA once made

The starting position is that a landlord, absent any sufficient security (such as a properly charged rent deposit deed), will be an unsecured creditor of the insolvent company and that the insolvent company, acting by its insolvency officer-holder, will (in most cases) have a proprietary right to remain in the property. Therefore, the landlord will not be able to seek immediate recovery of the leasehold property and may be left in a position where little or no rent is being paid.

Challenges to CVAs

As set out above, a CVA binds all of an insolvent company's unsecured creditors. Once in place, a creditor cannot take any step against the insolvent company to recover any debts due to it.

However, under the Insolvency Act 1986 (the **1986 Act**), a CVA can be challenged in court on the grounds of unfair prejudice or material irregularity within 28 days of the approval being reported to court. The effect of any successful challenge is that the CVA is revoked.

The most common grounds used by landlords to challenge a CVA are in circumstances where steps are taken to compromise the claims the landlord has against the tenant's guarantor.

Challenges to pre-packs

Pre-packs can potentially be challenged in a number of ways. Possible lines of attack against the IP include:

- A misfeasance application;
- An application alleging conduct by the IP which is unfairly harmful to the interests of the applicant;
- An indirect route by challenging the remuneration of the IP;
- An application to remove the IP;
- A challenge brought by a third party who asserts that the IP has in some way infringed his contractual or proprietary rights.

Whether one or more of the above grounds has any merit would need to be assessed on a case by case basis by reference to the relevant facts.

Other possible avenues to explore include the ability to challenge the directors who were complicit in the pre-pack deal. This could, potentially, involve a wrongful trading action by a subsequently appointed liquidator and/or misfeasance claims, alleging breach of fiduciary duties or breach of the codified Companies Act 2006 duties.

Successful challenges to pre-packs, whether before or after the event, are notoriously difficult. Recent case law, culminating in *Wind Hellas*, arguably makes a successful challenge even harder. A number of commentators would nonetheless argue that it is only a matter of time before a successful challenge is mounted. In the meantime, it is essential that each situation is carefully assessed on the facts and information available.

Issues and difficulties encountered by landlords and examples of challenges

As set out above, the most topical issue for a landlord in any restructuring will be to ensure it is best placed to recover past and future rental liabilities.

PREPACK ADMINISTRATIONS AND COMPANY VOLUNTARY ARRANGEMENTS

In many cases a landlord may have the benefit of a parent guarantee which means that, if the tenant defaults on the rent and/or is placed into a formal insolvency process, the landlord will have the benefit of a claim not only against the insolvent tenant's estate but also against the (hopefully) solvent parent.

One difficulty which has arisen for landlords in the context of CVAs, is 'guarantee-stripping'. This is the process by which a CVA can have the effect, in principle, of depriving a creditor landlord of a third party guarantee of the tenant debtor's liabilities. **Guarantee-stripping** has been the subject of two reported cases: **Prudential Assurance Company Ltd & Others v PRG Powerhouse Ltd and Others [2007] EWHC 1002 (Ch)**; and more recently, **Mourant & Co Trustees Limited and another v Sixty UK Limited (in administration) and others [2010] EWHC 1890 (Ch)**.

Both of the above cases held that, as a matter of principle, guarantee-stripping is possible but only if it is not unfairly prejudicial to the relevant creditor (in both cases the landlord). In considering whether or not the CVA is unfairly prejudicial, the court will look at the "*vertical comparison*", which compares the position of the landlord creditor under the CVA to its position if the company were in liquidation, and the "*horizontal comparison*", which compares the position of the landlord creditor and other creditors or classes of creditor.

In both cases the CVA attempted to not only compromise the claim the landlord had against the insolvent tenant, but also the claim the landlord had against the insolvent tenant's perfectly solvent parent guarantor. Therefore, by applying the vertical comparison, the court held in both cases that had the insolvent tenant gone into liquidation, the landlord would have had claims against the insolvent tenant's liquidation estate and a claim against its solvent parent guarantor, with no suggestion that the solvent parent would not be able to meet its obligations under the guarantee. Applying the horizontal comparison, the landlords, in the main, were left in a position where the claims against the insolvent tenants were compromised and the claims against the solvent parents were extinguished. It was demonstrated, therefore, that the landlords had clearly been prejudiced against and, in both cases, the court revoked the CVAs.

4. Proposals for change

The current consultation on CVAs is looking into extending the moratorium against action to all companies who propose a CVA. Broadly speaking, the extension under consultation would introduce the following provisions:

- An initial court sanctions a three month moratorium, with the intention of giving a company the breathing space it would have received had it been in administration. Any further extensions would require a further court order;
- Conditions will attach to applying for the three month moratorium, to include the company having a viable business, the company's creditors supporting the restructuring plan and the company being likely to be able to continue trading during the moratorium. This is likely to deter any vexatious applications;
- During the period of the moratorium the company will remain under the control of the directors, although the concept of a 'monitor' is also being considered;
- Any debts incurred during the period of the moratorium will have "super-priority" status in any subsequent insolvency process.

5. Other jurisdictions

Notwithstanding SIP 16 and the consultation currently underway, pre-packs continue to be effected with relative ease in the UK as a means of rescuing businesses and maximising realisations for creditors. This contrasts markedly with other jurisdictions, where either the possibility of a pre-pack is not available or where it is only possible subject to greater checks and balances. To avoid the risks and problems of pre-insolvency asset deals or restructurings in **Germany**, the sale of the operation is often pre-arranged prior to the opening of insolvency proceedings and only becomes effective on such proceedings being formally opened. Depending upon the circumstances, a pre-packaged sale may thereby be part of a regular proceeding or an Insolvency Plan under German insolvency legislation. Interestingly, there is now a draft Bill in Germany, which is subject to consultation by various interested parties. Potential reforms include the ability to effect pre-pack sales with greater ease.

In the **Netherlands** it is also possible for a restructuring to be pre-arranged prior to the opening of insolvency proceedings and, like the German system, only becomes effective upon such proceedings being formally opened. A pre-packaged sale in this manner may increase the chances of a successful implementation and execution of a Dutch composition plan.

As a general rule of thumb, where the concept of a pre-pack exists in other European jurisdictions, it is either subject to some form of court or creditor sanction in advance and cannot be executed with the same ease or speed as is currently possible in the UK. Advocates of the pre-pack will assert that it is the speed and ease of the process that leads to a seamless continuity of the business and, very often, results in the best return for creditors while simultaneously preserving jobs.

6. How are prepacks and CVAs affecting income?

It is estimated in the IPD / Strutt & Parker Lease Events Review that the proportion of tenants experiencing liquidation or receivership has risen to 5.5% of total annual estimated rental value in both 2008 and 2009.

Table 1: Percentage of tenants experiencing liquidation

2002	2003	2004	2005	2006	2007	2008	2009
0.9	1.7	2.3	2.3	2.6	1.3	5.5	5.5

Source: Strutt and Parker/IPD Lease Events Review

These figures are not attempting to quantify the lost income to the owner from defaults. The income loss to the owner from tenant default will depend upon factors such as the level of rental arrears, recourse to the original tenant on assignments, guarantees from parent companies, rent deposits, eventual recoveries from liquidators, time taken to re-let, costs of re-letting, service charge losses, dilapidations and empty rates.

The proportion of tenants involved in a pre-packaged sale or CVA in 2009 is estimated at only 0.3%—a fraction of the 5.5%.

This suggests, that whilst tenant insolvency has been a significant issue for commercial real estate investors in both 2008 and 2009, neither ‘pre-packs’ nor CVAs have been a major factor within this.

PREPACK ADMINISTRATIONS AND COMPANY VOLUNTARY ARRANGEMENTS

7. Conclusion

Pre-pack administration sales continue to attract significant attention in the media, with a string of high profile retailers being the subject of a pre-pack in recent years. A major concern is that a business is not properly exposed to the market and, as a result, maximum value may not be obtained for creditors. Another significant criticism is the lack of transparency and accountability in the process, resulting in creditors believing they are provided with insufficient information and limited opportunities to ensure their interests are not prejudiced. Pre-packs have become all the more controversial with connected parties (often existing management or shareholders) being frequently the purchaser of the business of the solvent company, thus acquiring the assets and leaving the debts behind.

Set against the above criticisms, in many cases a pre-pack may be the only viable option available to preserve the business and maximise realisations, as often there is simply no money available to fund a trading administration. Furthermore, if the business is in a service industry where customers, employees, suppliers and goodwill can rapidly erode, a pre-pack is often the best way to maximise value and, therefore, the return to creditors. In contrast with some other jurisdictions, the UK currently does not have any special form of financial help for businesses in difficulties. In the US 'superpriority' or 'debtor in possession' ("DIP") funding is available and in Germany 'Insolvenzgeld'—a statutory mechanism to ensure that employees are paid—is in place, where the state makes money available to pay wages and thereby facilitates continuity of the business as part of an insolvency process.

It remains to be seen what changes, if any, will follow from the recent consultation. The ability to approach and effect a pre-pack confidently will continue to turn on the quality of the steps and debate that occurs during the 'live side' process. If pre-packs are to remain an option in distressed situations, they must be exercised with careful planning and an abiding sense of fair play for all stakeholders. One way of ensuring that this is achieved (over and above SIP 16) would be to implement one or more of the measures put forward in the Insolvency Service's consultation. A further means could be greater court involvement. Traditionally, the courts have become involved in sanctioning pre-packs and have recognised the role of the professional and the skill and experience required to effect a pre-pack sale. Although, historically, the courts were reluctant to entertain an application for approval prior to a sale, on the basis that it was a matter for the administrator and creditors and it was inappropriate for the court to make the administrator "bomb proof", there is some evidence of that approach changing. In particular, the Wind Hellas case, which was the first example of the court expressly supporting a specific pre-pack strategy. Whether we see more court applications as a means of "rubber stamping" pre-packs and protecting administrators from a future back lash remains to be seen. In the meantime, the pre-pack continues to be an essential tool in the insolvency kit bag and landlords are likely to see its ongoing use, particularly amongst retailers in distress.

With the debate on pre-packs rumbling on, landlords might feel that the pendulum is continuing to swing against them. However, there have been important developments to tip the balance more in their favour over the last year, which may affect the way in which administrators deal with property in the future. For example, landlords are now able to claim rent as an expense of an administration where a tenant's administrators are in occupation of all or part of a leasehold property. A further win for landlords was the court ruling that rent can be claimed as an expense of the administration when a tenant's administrators permit occupation of a leasehold property under a licence. By making it clear that rent ranks as an expense, ahead of other claims in an administration including the administrator's own remuneration, the position of landlords is considerably strengthened.

The recent Miss Sixty decision further bolstered the landlords' position when the court upheld a claim of unfair prejudice on a CVA in circumstances where the landlord's closed retail stores were to lose the benefit of third party guarantees without adequate compensation or sufficient justification. Although, following on from Powerhouse, Miss Sixty has still left the "guarantee-stripping" door open, it now appears that it would be very difficult to do this where the solvency of the guarantor is not in issue, even where the compensation offered is based on fair assumptions.

From the investor perspective

Only in a relatively select number of instances is losing a paying tenant part of an investor's strategy for an asset. Typically, this would be when seeking to engineer a vacancy for redevelopment or refurbishment purposes, improving tenant mix and/or resetting a lease to a market rent higher than the passing rent. In any event, it is something a landlord would wish to have control over and this is perhaps the crux of how investors view pre-packs.

As has been argued, pre-packs may only accelerate vacation from a unit that was already unsuitable for a tenant, but, in doing so, it does limit the possibility of constructive dialogue with a tenant whose business is struggling. In such instances the landlord may be happy to agree a rent concession or a restructuring of rental payments. Pre-packs are typically a feature of a weak occupier market and landlords will strive to retain tenants as such times. Given the burden of empty rates, even a late paying, struggling tenant helps reduce landlord's outgoings.

In the event that the landlord's asset is one the tenant is seeking to keep, the negotiations can still be relatively one-sided, with the landlord often having little option other than to accept rent concessions. In the case of CVAs, a majority rather than a unanimous vote of creditors is required to approve the proposal, so a landlord with a unit that has asset management opportunities, for instance, may be hampered in realising these, even if they vote against the arrangement.

With investors relatively unable to take a proactive stance in the pre-pack process, the focus tends to be on what to do with units when they become vacant. Among other features of the last two years, the prevalence of pre-packs has focussed investors' attention on asset (and tenant) quality and, in particular, on the issue of re-lettability. Within portfolios, and for potential purchases, assets should be assessed for either their quality relative to possible competition or their appropriateness for the location and catchment: are they 'fit for purpose' and will they continue to attract tenants in most economic climates? Assets should be considered for sale if they present material risk to the portfolio's income generation and, therefore, future performance. This also highlights the importance of securing rental deposits wherever possible or parental guarantees where a landlord has concerns over a tenant's ability to continue to pay the rent.



Printed on recycled paper

Investment Property Forum

New Broad Street House

35 New Broad Street

London EC2M 1NH

Telephone: 020 7194 7920

Fax: 020 7194 7921

Email: ipfoffice@ipf.org.uk

Web: www.ipf.org.uk