

Pre-Packs

The View From The Coalface

Definition

A pre-pack is a deal for the sale of an insolvent company's assets which is put in place before the company goes into a formal insolvency process (hence it is "pre-packaged").

The deal will be agreed before the Insolvency Practitioner is appointed but will be executed shortly thereafter.

A pre-pack is generally associated with Administrations and in short is a seamless transaction ensuring the smooth handover of a business' ownership with minimal disruption to its ability to maintain ongoing operations.

Other definitions are, however, less favourable, including this one courtesy of Alchemy Partners John Moulton:

"A company is heading into trouble. Its directors and shareholders are introduced to an appealing fellow who drives a very nice BMW, who explains that if they work with him they will get rid of most of their costs and buy the business back pretty well immediately at a very modest cost"

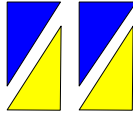
History lesson

To understand why pre-packs have become so widely used it may be useful to explain how an insolvent company's business and assets used to be sold.

Basically, the clearing bank debenture holder would appoint Administrative Receivers who would make immediate economies (redundancies), place an advertisement in the Financial Times and trade on while negotiating with (hopefully) competing interested parties, attempting to minimise any trading losses in the meantime.

The aim of the process was to keep any trading losses at a level lower than the enhanced value of the company's assets compared to a shutdown situation. By way of an example, if the assets were valued at £0.5m on a shutdown and £1.0m as a going concern, the Administrative Receiver would be able to afford significant trading losses in order to achieve the higher valuation. If trading losses exceeded £0.5m (the enhanced value), the decision to trade could, however, be questioned. Often it was a borderline decision with no guarantee of success.

Very often the appointment of Administrative Receivers would find outstanding distrains over the company's assets, a negligible stock of raw materials, production lines down, key machines in need of repair, the company on stop with key suppliers, angry customers demanding long overdue orders, transport companies claiming liens and, inevitably, a very anxious workforce. In a worst case scenario, the Administrative Receiver would find all of the above and more and such appointments were therefore often fraught with uncertainty and the process was highly reactive.



Enter the prepack

On 15 September 2003 the Enterprise Act became law with the loss of preferential status for HM Revenue & Customs and the replacement of Administrative Receiverships with Administrations for floating charge holders.

One of the key changes introduced by this legislation was the ability of directors to be able to appoint an Administrator out of court with the consent of the chargeholder.

Administrators were therefore able to be appointed and execute sales of businesses quickly and without any ratification by creditors, other than chargeholders.

Couple with this the sea change in the type of business undertaken in the UK with the pre-eminence of service based industry as opposed to the more traditional manufacturing, whose very nature dictated that in order to preserve the value of the, generally intangible, asset base the sale of the business as a going concern, and quickly, must be achieved and it becomes easier to understand why prepacks became de rigueur in the mid-noughties.

Trading on in Administration can be, as has been demonstrated above, fraught with uncertainty and its success often wholly dependant on competing parties driving the price up to an acceptable level. Take away this element of competition, however, and add high trading costs and the deterioration of the service industry asset base as customers quickly look for certainty and you have the recipe for disaster in the shape of a low sale price and a high trading loss.

So, at some point, the prospective Administrator came across a situation where a buyer was already in place, his agent confirmed that the price being offered was unlikely to be beaten on the open market, it included a demonstrable premium for goodwill, the business did not break up with employees and customers moving to greener pastures as the sale was presented as a fait accompli and the Administrator had no trading loss, no stress and the creditors benefited accordingly.

Brilliant!

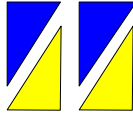
Within a very short space of time, prospective Administrators were looking at every situation as a potential prepack as it was seen, with some justification in the right circumstances, as a safer, cost effective route with the benefit of certainty for all stakeholders.

Prepack evolution

Although it did not seem that way for a while, it is now clear that the prepack is not the universal answer to all problems. It is appropriate to consider it, however, in certain circumstances including:

- Situations involving customer sensitivity (such as a deposit taking business);
- A business where the likely diminution of market share will inevitably result from any trading on in Administration (such as contract hire)
- If it is likely that the trading loss will exceed the enhanced value of assets
- Where there is over reliance on a major customer
- Where the asset base is all encumbered leaving no free assets with which to trade
- If the company has received an offer which is too good to turn down

Good practices are also recognised or enshrined in Statement of Insolvency Practice 16 and include:



- The importance of the demonstrable premium (effectively the price paid by the purchaser over and above the market value in return for exclusivity)
- Agents input
- Consultation with key creditors and other stakeholders
- Open market advertising (albeit often on a no names basis)
- Prompt notification to creditors including justification for the sale by way of a prepack
- Evidence of why trading was not possible

Negative perceptions

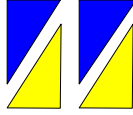
Any negativity surrounding the public perception of prepacks tends to focus on the sale of the business to a connected party – generally the existing directors. This aspect of phoenixism is viewed with suspicion; is this just the directors “dumping debt” and carrying on regardless (and see John Moulton’s comment above)?

It is a fact of all Administrators’ lives that in many situations the directors are special, or even the only, purchasers. The aim of an Administrator is to maximise the return to creditors and that generally means maximising the value of the business and assets. If the highest offer comes from existing management, all other things being equal the Administrator will have no qualms in selling the business to them – and quite rightly so as creditors may be equally unhappy if a significantly lower offer from an unconnected third party was accepted which resulted in a lower dividend.

Like anything else, this is an area which has been abused by a tiny minority of Insolvency Practitioners but should be viewed as a fact of commercial life if the Administrator has properly implemented best practice..

Final word

The prepack is here to stay. In the right circumstances it is the right process but it is not the right process for all circumstances. It allows a quick seamless transition of an insolvent company’s business and assets in circumstances where the business may otherwise implode and therefore allows for the optimum return to creditors, which is the prime focus for any insolvency practitioner.



Who are we?

The firm was formed in 1983 by Geoffrey Martin, who was until then a partner with Arthur Andersen. It now operates from offices in Leeds and London which collectively employ 5 partners and 30 staff.

We are business recovery professionals (the new term for what used to be called insolvency practitioners). We have no audit or corporate finance arms or associations and are solely dedicated to assisting companies, partnerships or individuals with financial or cash flow difficulties.

We would welcome the opportunity of working alongside you to provide bespoke solutions to the needs of your clients. These would not necessarily be formal insolvency procedures.

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