Feature

KEY POINTS

- If secured lenders (as connected persons) engage the evaluator as part of the pre-pack planning process prior to the commencement of the administration then the secured lenders will arguably walk away with a more robust and defensible sale without any resulting delay.
- Secured lenders could execute a successful pre-pack sale without becoming connected persons; they may wish to do so to avoid the complexities of obtaining creditor consent or an evaluator's report.
- It is unclear what the extent of liability attaching to an evaluator could be and what recourse a creditor or the administrator could have to the evaluator; this uncertainty could result in difficulties for a secured lender (as a connected person) when negotiating an appropriate fee arrangement with a potential evaluator.

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The new pre-pack regulations and the impact on secured lenders

The new regulations on pre-pack sales to connected persons impose additional hurdles on the pre-pack process which, in our view, could be managed by an efficient pre-pack planning process.

If secured lenders (who fall within the definition of connected persons) and their advisers engage the evaluator prior to the commencement of administration and ensure open communication lines among themselves, the evaluator and the would-be administrator then the goal of increasing transparency in the pre-pack process would likely be advanced in a manner consistent with the efficient execution of a pre-pack sale.

INTRODUCTION

It is estimated that around $9trn of debt that could be characterised as "highly leveraged" sat on the balance sheets of companies around the world in 2020. This was driven in large part by low interest rates in the developed world which encouraged corporate borrowing. In addition, the credit quality of leveraged debt has deteriorated significantly over the years. As traditional maintenance covenants have been stripped away and replaced with so-called "covenant-lite" instruments, lenders have lost an essential early-warning system of looming debtor distress.

At the start of the coronavirus pandemic in 2020, most debtors bridged their liquidity gap by drawing on their existing lines of credit. Although, as we write this, the vaccination campaign appears relatively successful in the developed world, a full economic recovery is forecast to take much longer than initially expected. Therefore, if debtors cannot service or refinance their debt in the long term, and if such debt is of the high quantity/low quality nature described above, debtors could face default scenarios and be forced to act swiftly to significantly deleverage their balance sheets or to file for a terminal insolvency procedure.

A debt-for-equity swap is widely recognised as an effective deleveraging method. Stakeholders would ideally implement a debt-for-equity swap on a consensual basis with the support of lenders and shareholders. Nevertheless, despite the intention to carry out such a transaction consensually, it is widely recognised that it is important to have a "Plan B". Pre-pack administration sales have been instrumental in providing a workable Plan B (as well as in focusing shareholders' minds on the desirability of supporting a consensual deal).

Pre-pack sales are a useful restructuring tool which facilitate the rescue of distressed businesses while minimising the destruction of value that would result from an open-market sale, stakeholder instability and the stigma of looming insolvency. According to the Government's pre-pack sales in administration report published 8 October 2020 (October Report), pre-pack sales occur in approximately 29% of all administrations. However, they have been subject to increased scrutiny, not least of which from the "remaining" creditors who are left in the dark until after a lender-led pre-pack sale has completed and left questioning the transparency and fairness of the sale.

In response to the enduring criticism of pre-pack sales (and the failure of the voluntary pre-pack pool to gain traction), the government has introduced the Administration (Restrictions on Disposal etc to Connected Persons) Regulations 2021 (the Regulations) which impose new requirements on pre-pack sales to connected persons and apply to all companies entering administration on or after 30 April 2021.

Critically, in relation to a pre-pack sale which constitutes a substantial disposal to connected persons within the first eight weeks of administration, the Regulations require either creditor approval or an independent report in relation to the sale to justify the price and terms of the sale.

This article focuses on how these Regulations might impact secured lenders seeking to implement a pre-pack sale.

SECURED LENDERS AND PRE-PACKS

Typically secured lenders implement a pre-pack sale as follows:

- following an event of default, secured lenders enforce their security and either:
  - appoint an administrator in their capacity as holder of a qualifying floating charge; or
  - invite the directors of the company to appoint an administrator on the basis that the company is no longer able to pay its debts as they fall due;
- the administrator then sells all or substantially all of the business of the

company to a lender-owned vehicle (SPV) swiftly, if not immediately, following his or her formal appointment; such sale having been diligenced, negotiated (including as to price) and agreed in advance of the appointment; and
- the secured lenders release debt in an amount equal to the value of the business being acquired by the SPV. Any excess debt that is not released remains owing by the debtor and secured by the existing security.

SECURED LENDERS MAY NOW BE "CONNECTED PERSONS"

The October Report states that approximately half of all pre-pack sales are to a connected person.

While the Statement of Insolvency Practice 16 (England and Wales) (SIP 16) in relation to pre-packaged sales in administration previously excluded secured lenders from the ambit of connected persons, the Regulations now intentionally capture some of them (and SIP 16 has been updated accordingly).

"Connected person" has the meaning given to it in para 60A(3) of Sch B1 to the Insolvency Act 1986 (IA), which in turn refers to s 435 of the IA with respect to what "associate" means. The definitions are broad, but relevantly a company is considered to be an associate of another company where the same person has control of both. "Control" for these purposes is defined as an entitlement to exercise or control the exercise of one third or more of the voting power at a general meeting of the company. Where lenders have taken share security over one third or more of the shares in the company and have the ability to exercise voting rights in respect of those shares and, at the same time, hold the voting rights in over one-third of the shares in the purchasing SPV, they would fall within the definition of connected persons and the Regulations would therefore apply to the pre-pack sale.

CREDITOR CONSENT v INDEPENDENT REPORT

As stated above, unless the connected person purchaser obtains an independent report from an evaluator, the substantial disposal cannot be effected without creditor approval. Creditor approval is obtained via a decision-making process – likely a deemed consent process whereby the transaction would be deemed to be approved by creditors unless 10% of creditors object. Creditors can only vote the value of their unsecured debt – therefore secured lenders might be able to vote if it can be demonstrated that the value break leaves a portion of their debt in effect unsecured. If 10% of creditors do object to the proposals under a deemed consent procedure, then a further decision from the creditors would need to be sought under which a majority in value would need to approve the proposed transaction. This process is likely to be lengthy (creditors need to be given 14 days' notice of the decision-making process) and potentially value destructive as a result of its publicity.

Therefore in practice it is highly likely that the relevant parties will opt for the evaluator's independent report route. This of course may disappoint stakeholders and creditors who were, following the introduction of the Regulations, expecting to be consulted or more closely involved in the process prior to the execution of the transaction. However, such extensive consultation and involvement could undermine the rescue objective of a pre-pack by destabilising the debtor's business as a result of negative publicity.

THE EVALUATOR

The evaluator is required to issue a reasoned independent report which includes one of the following statements:

- **"Case made":** the evaluator is satisfied that the consideration to be provided for the property, and the grounds for its disposal, are reasonable in the circumstances; or
- **"Case not made"**: the evaluator is not satisfied that the consideration to be provided for the property, and the grounds for its disposal, are reasonable in the circumstances.

In the event that a connected person received a "case not made" opinion from an evaluator, there is nothing in the Regulations that would prevent that connected person from "shopping around" for another opinion with the aim of obtaining a "case made" opinion. When choosing an evaluator (including when shopping around) the connected person should bear in mind that the choice of evaluator and the content of the opinion will be closely scrutinised by the administrator. In practice, we expect that a secured lender (as a connected person) would benefit from discussing the choice of evaluator and their engagement terms with the administrator prior to instructing a particular evaluator.

In terms of timing, a connected person (here the secured lender) could instruct the evaluator while the primary deal and the Plan B pre-pack deal are being negotiated, with the report to be released on or shortly after the administration commences. Therefore, although adding an extra cost or administrative burden, unlike the creditor consent route described above, this route could viably be undertaken as part of a more quickly implemented pre-pack.

The report must be obtained by the secured lender (as a connected person) and provided to the administrator. The administrator is required to send a copy of the report to the company's creditors and to Companies House at the same time it sends a copy of its statement of proposals (ie by no later than eight weeks after the company enters administration). The administrator is not bound by the report and, following receipt of a "case not made" report, could still proceed with the sale. However, the administrator would then be required to set out their reasons for taking a different view.

The Regulations therefore expect the administrator to take the evaluator's report into account. However, the Regulations do not specify whether the evaluator owes a duty of care to the administrator or the connected person that commissioned the report or the wider creditor body, all of whom are entitled to see the report. It is therefore unclear

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what the extent of liability attaching to an evaluator could be and what recourse a creditor or the administrator could have to the evaluator.

The above uncertainty could result in difficulties for a secured lender (as a connected person) when negotiating an appropriate fee arrangement with a potential evaluator. The requirement under the Regulations that the report is widely disclosed would likely result in a potential evaluator quoting high on account of the high risk of challenge; and it is expected that any quotes will be significantly higher than the £950 previously required to be paid if the parties elected to obtain an opinion relating to the sale from the Pre-Pack Pool.

POTENTIAL WORK-AROUND?

The financing deal could be structured to prevent secured lenders becoming connected persons at the time of a pre-pack sale by providing that secured lenders would not automatically assume voting rights in respect of the pledged shares in an enforcement scenario. An English law share pledge usually provides that prior to the occurrence of an event of default or (for certain sponsors/ borrowers) the delivery of an acceleration notice, the pledgor remains entitled to exercise its voting rights in respect of the shares. The secured lender is only entitled to exercise or control the exercise of such voting rights upon and following the occurrence of one of those events; therefore, it is only at that later time that it becomes a "connected person". The share pledge could be drafted to provide that the entitlement to exercise or control the exercise of voting rights would only arise following the delivery to the pledgor of an election by the secured lender to do so. Therefore, if such an election is not made then the secured lender would not be a connected person and the pre-pack sale would not fall within the scope of the Regulations.

If a share pledge is drafted to prevent secured lenders acquiring voting rights and thus becoming connected persons at the time of the pre-pack sale, as suggested above, the prejudicial effect on secured lenders appears limited. The voting rights attaching to the pledged shares would not be exercised to affect the actual pre-pack sale. And in the moments prior to the pre-pack sale, secured lenders could rely on the usual protections under the finance documents which prevent any perverse exercise of voting rights by the pledgor – for instance, the prohibition against altering the rights attaching to the shares or issuing new shares, dividend restrictions and the general requirement that the pledgor does not exercise any voting rights or powers in a manner which would prejudice the interests of the secured lenders.

Secured lenders could therefore execute a successful pre-pack sale without becoming connected persons, and they may wish to do so to avoid the complexities of obtaining creditor consent or an evaluator's report. However, if the evaluator report route is managed efficiently as suggested above, secured lenders may prefer it over the work-around described in this section because the end-result would likely be a more transparent and thus more defensible pre-pack sale.

CONCLUSION

There is no doubt pre-pack sales will remain relevant and useful provided, of course, they are implemented appropriately and for good reason – they enable the sale of a business while minimising any impact on value, help preserve stability with employees, customers and suppliers, and enable viable parts of a distressed business to survive, and can save jobs.

The attraction of the pre-pack process is that it can be implemented swiftly and without greatly destabilising the debtor's business. Although the Regulations present an additional hurdle to the pre-pack process as we know it, in our view if secured lenders (as connected persons) engage the evaluator as part of the pre-pack planning process prior to the commencement of the administration then the secured lenders will arguably walk away with a more robust and defensible sale without any resulting delay. Time will tell what the impact of the Regulations will be but, in spite of the additional costs, the Regulations appear to be a positive step towards a transparent pre-pack process which the public could have confidence in. ■

Further Reading:

- The revised SIP 16: a practical perspective (2016) 3 JIBFL 168.
- A preponderance of pre-packs? (2008) 1 JIBFL 23.
- LexisPSL: Restructuring & Insolvency: Overviews: pre-pack administrations – overview.