Ashurst

Pre-pack appointments and sales

1. Pre-pack concept

Pre-pack sales are planned, negotiated and agreed to by the key stakeholders prior to, but in contemplation of, a formal insolvency administration. Most often this is done with the intention of the sale being completed shortly after the commencement of the administration.

The key stakeholders will vary from company to company but, typically, will include:

- shareholders;
- directors;
- major creditors, including secured creditors (such as banks and other financiers);
- key customers; and
- key suppliers.

A pre-pack may be the outcome of an informal workout arrangement with creditors who have agreed to a standstill whilst a restructuring plan for the company or its business is developed.

The key objective of a pre-pack is to maximise the chances of a successful turnaround of the company or its business without the loss of goodwill usually associated with an insolvency appointment for which there has been no or only limited planning as to how the company and its business will be managed or its assets realised.

2. Advantages of pre-packs

A pre-pack can:

- expedite the transfer of the assets or business of a distressed company;
- encourage early engagement with creditors (especially major financiers) and reduce the risk of those creditors enforcing their rights before a sale is finalised;
- assist with retaining employees, especially good management, who may be essential for maintaining the ongoing operations of the company and enabling it to continue to trade;

- avoid or minimise the general costs associated with the process of realising all major assets through a protracted insolvency, including funding to continue trading during administration; and
- facilitate the continuation of key business contracts.

3. Concerns about pre-packs

The use of pre-packs in Australia is somewhat controversial. Despite the Productivity Commission's recommendation in its Report on the Inquiry into Barriers to Business Entries and Exits that pre-pack sales be permitted, the Commonwealth Government expressly declined to adopt that recommendation. A particular concern was that pre-packs "may facilitate fraudulent phoenix activity".

Reflecting that concern, the Government passed the *Treasury Laws Amendment (Combating Illegal Phoenixing) Act 2020* (Cth) to amend the *Corporations Act 2001* (Cth) (**CA**). These amendments effectively mean that the anti-phoenixing provisions only apply to pre-packs if the company goes into liquidation following the completion of a pre-pack sale. Given that the implementation of a pre-pack sale will usually involve the appointment of either a receiver or a voluntary administrator, the risks of the legislation applying to the transaction can be mitigated as set out in following table.

	Receivership pre-packs	Voluntary Administration pre-packs
Requirement	Receivers have a statutory duty to sell assets of a company for market value pursuant to s 420A of the *Corporations Act 2001* (Cth) (see Receivership)	While pre-packs can be implemented with or without a Deed of Company Arrangement (**DoCA**), a DoCA will be executed following a pre-pack to restructure the company.
Mitigation	Receivers will need to be satisfied that they have fully complied with their obligations. If so, the relevant provisions will not apply, as it is only enlivened where the assets are sold for less than market price.	The effect of a DoCA is to take the company out of insolvency. Therefore, the pre-condition to the operation of the legislation will not be satisfied.

Beyond the possibility of phoenix transactions, unsecured creditors may have particular concerns that their interests could be harmed by a pre-pack, including:

- the sale price was not the best price achievable;
- credit was incurred inappropriately prior to the external administrator's appointment;
- they have been deprived of the opportunity to influence the transaction;
- they have insufficient information to investigate and challenge the transaction and any related decisions.

On the other hand, these concerns may be allayed by the various duties and obligations of directors and external administrators to give creditors the opportunity to review and challenge transactions entered into by a company, particularly the reporting obligations of voluntary administrators (see Voluntary Administration).

Where pre-packs are undertaken at the instigation or with the informed consent of major creditors and care is taken to ensure that independent advice is provided to all stakeholders, they can be an acceptable and effective form of restructuring. Pre-pack restructures are most commonly used in short-term contracts or service-based businesses that would suffer from prolonged periods of informal insolvency proceedings.

4. Impediments to the use of pre-packs

A major impediment to the use of pre-packs in Australia has been the insolvent trading law. This law imposes a duty on the directors of a company to prevent it from incurring debts while the company is insolvent. Directors in breach of this duty can be personally liable for all the company's debts incurred as a consequence of the breach. The insolvent trading law gives rise to the following two considerations:

(1) As discussed in (Informal Workouts or Administration), the principle way for directors to avoid this liability is to appoint an administrator. However, the concept of pre-pack transaction conflicts with the administration process, as the terms are agreed and documented before the formal appointment of an insolvency practitioner, with only the completion of the transaction to take place after that time.

(2) Despite the above, the introduction of the safe harbour defence enables the risk of insolvent trading liability to be mitigated, as it allows directors to take steps that will obtain a better outcome for the company than immediate insolvency (See Informal Workouts). By implementing a sensible pre-pack, directors may be able to take advantage of the safe harbour defence.

5. Forms of pre-pack

There are three primary forms of pre-pack in Australia:

(1) a pre-pack receivership sale of assets of a distressed company either under the receiver's statutory power or the power conferred by the relevant security document (**Receivership pre-pack**);

(2) a pre-pack sale by a voluntary administrator (**VA pre-pack**) under the administrator's power; and

(3) a pre-pack restructuring and trade-on through a DoCA (**DoCA pre-pack**).

Receivership and VA pre-packs usually result in an immediate sale upon their appointment. A sale under a DoCA is governed by the timing requirements for approval of a DoCA under the CA. However, for all three types of pre-pack sales, the desired outcome is agreed by key stakeholders before the appointment of the insolvency practitioner who is to give effect to the transaction.

A VA or DoCA pre-pack may be useful if there is a need to rely on the moratorium on creditors' claims that comes into effect with those forms of administration. As set out in detail in Administration, this will enable the continued operation of the company's business, despite the right certain individual creditors may otherwise have to enforce against the company or to recover property in its possession such as leased premises).

Example: pre-packs and leases	
VA/DoCA pre-pack	Lessor is unable to terminate the lease due to the company entering into administration. However, lessor could terminate lease if other breaches, including non-payment of rent.
Receivership pre-pack	Lessor is entitled to terminate the lease to the company, and the receiver is not in a position to restrain such an action otherwise than by agreement.

Additionally, a DoCA pre-pack can be used to facilitate an equity restructuring as well as a debt restructuring. A common form of DoCA pre-pack is a recapitalisation through a balance sheet restructuring which may involve:

- the DoCA's administrator transferring the existing shares in the company;
- issuing further equity to creditors who agree to write off part or all of the debt owed to them by the company; or
- issuing further equity to third parties who are providing fresh finance to the company.

The transfer or issue of shares in the company will typically be a pre-condition to the operation of the DoCA including the release or compromise of creditors' claims as approved by the creditors. A restructuring through a DoCA can be a far more efficient way of preserving value than a sale of assets. Transfers and issues of equity as part of a recapitalisation is discussed in Administration.

6. Receivership pre-packs

6.1 Engaging the Secured Creditor

If the company wishes to promote a pre-pack, then early engagement with the major secured creditor is an essential first step. That support, both for the implementation of the proposal (including the appointment of receivers to complete the pre-pack sale) and the continued operation of the company, will be a significant contribution to the success of any proposed pre-pack sale. Beyond that, it will be desirable if the prospective receivers are also involved early in the process, at least for the purpose of agreeing the process by which the sale is to be undertaken.

6.2 Receivers' Duty of Care

The most frequently encountered impediment to a receivership pre-pack is s 420A of the CA. As discussed in Receivership, this imposes a duty on receivers to take all reasonable care to obtain the market value of the company's assets or business or, if there is no market value at the time of sale, the best price that is reasonably obtainable, having regard to the circumstances existing when the asset is sold.

6.3 Compliance with the Duty of Care

When considering the requirement to sell the property for market value, the courts have focused on process rather than outcome. Compliance with the duty of care is further considered in Receivership. Pre-pack sales, therefore, are normally effected only after a structured and public marketing campaign has been undertaken in respect of the company's business or assets (in a way which would satisfy the duty to take all reasonable care to obtain market value) and the details of the pre-pack sale negotiated and settled by the receivers or the company.

However, this approach may not always produce the best result. For instance, an open and protracted marketing campaign designed to satisfy the requirements of the duty may, in some circumstances, result in a lower sale price than might be obtained from an immediate sale or transfer of the company's assets or business to a particular entity. This will be the case particularly where contractors with or suppliers to the company take the opportunity to review the terms of their relationship with it.

As already noted, the involvement of the receivers in the sales process up to the time of their appointment can facilitate both the transaction and the satisfaction of their statutory duty. Different considerations could apply if the receivers were not involved in the sales process prior to their appointment. For example, the receivers can take into account the work done by the company to market its assets or business. However, the assessment of the extent and adequacy of pre-appointment work by the receivers will impact upon the timeliness of the completion of the sale.

6.4 Steps for a Receiver pre-pack

A possible plan for the lead up to the receiver's formal appointment (whether those steps are taken by the company in consultation with the secured creditor and the proposed receivers, or by the proposed receivers) is as follows:

- review relevant security documentation;
- advertise the assets for sale and request expressions of interest;
- conduct due diligence on possible purchasers;
- organise tender bids (discussed below);
- identify the purchaser and begin to negotiate a Sale and Purchase Agreement (**SPA**); and
- finalise purchaser due diligence and the form of the SPA.

Once the receivers have determined the scope of the sale process and timing, the receivers can then proceed as follows:

- run an expedited sales process;
- enter into sale documentation;
- resign.

The receivers can take steps to mitigate the risks of them failing to comply with their statutory duty which may include:

- obtaining an independent valuation of the assets or business;
- seeking specific court directions to the effect that it was proper for the receivers to complete the sale, although the court may take the view that the decision to sell is primarily a commercial issue which does not raise any legal issues requiring court intervention;
- obtaining expert advice on the sale, especially where the assets or business have particular characteristics requiring specialised knowledge about the market in which they might be sold. For example, the location of the business or the assets have a particular characteristic (such as major works of art) which would give them added value in the context of a specialised market.

6.5 The bidding stage

If the secured creditor is involved in the development of the plan to sell the company's business or assets, it may adopt a "stalking horse" model, whereby it chooses an interested person to make the initial bid so as to avoid low bids on the assets. This model may include providing the chosen purchaser with an option to purchase accompanied by a break fee.

A lender may also end up with control of a company through the process of "credit bidding" where the company's business and assets are sold by an auction process.

7. VA/DOCA pre-packs

7.1 VA pre-pack

Voluntary administrators can conclude a pre-pack sale at any time after their appointment under the power to terminate or dispose of all or part of the company's business, and dispose of any of its property.

When completing a sale, the administrators must comply with their legal duties, which will often require them to be satisfied that the sale is in the interests of the company and its creditors.

That will involve a number of considerations including:

- whether the continued trading of the company's business will involve ongoing losses with a consequential adverse effect on the interest of creditors; and

- if the sale is not completed, whether there will be a loss of goodwill resulting from the company's continuing administration, which may adversely affect the ultimate sale price of its business or assets.

A pre-pack sale completed soon after an administrator's appointment may raise questions about whether the administrator has properly considered alternative options for the company or otherwise complied with their duties.

One critical question raised in these circumstances is whether potential administrators engaged in the development stage of a pre-pack are sufficiently independent. Under the Australian Restructuring Insolvency & Turnaround Association's Code of Professional Practice (**Code**), insolvency practitioners cannot accept appointment as administrators if they have had a professional relationship with the company in the previous two years. There is an exception if the relationship involved giving advice or information that is restricted to:

– the financial situation of the company;

– the solvency of the company;

– consequences of insolvency; and

– alternative courses of action in the case of insolvency.

The limitations imposed by the Code are reinforced by CA s 448C, which disqualifies people who have certain connections with the company from acting as its administrators.

Despite these restrictions, there is some scope for an insolvency practitioner to advise on a pre-pack but only as one of a number of alternative courses of action.

Given the duties administrators are subject to, administrators with no, or limited, prior involvement may be reluctant to complete the sale immediately after being appointed without investigating the affairs of the company, examining the proposed transaction and being satisfied that it provides a proper sale price. This issue is similar to that faced by receivers who have not been involved in the development of the sale. That said, the exact circumstances of the company in administration may mean that its continued operation may be difficult (if not impossible) and result in a significant loss of goodwill. This factor may favour a quick sale without undertaking a complete sales process. In these circumstances, the voluntary administrator may also make an application to the court for directions if they have any doubt about the appropriateness of a sale without a proper campaign.

7.2 DOCA Pre-pack

A DoCA pre-pack is suitable where it is possible to settle the terms of sale of the company's assets or business before the administrator's appointment, and where the key stakeholders have consented to the terms of the proposed sale and committed to support the company until the sale is completed.

The particular stakeholders who may be involved in a DoCA pre-pack are:

- the directors;
- the shareholders;
- major creditors (including suppliers); and
- the proposed purchaser.

Similar to Creditors' Schemes of Arrangements, the relevant stakeholders may wish to enter into an agreement with the voluntary administrator to support both the continued operation of the business and the subsequent implementation of the DoCA. This agreement may help mitigate some of the potential drawbacks of a DoCA pre-pack:

- **Licence to operate business and indemnity**

  Once appointed, the administrator may licence the potential purchaser to operate the business until the approval of the DoCA. This poses some risk to the administrator, who can be personally liable for debts incurred during the trade-on period prior to the execution of the DoCA. The administrator, therefore, may require the purchaser to provide an indemnity for any debts or liabilities incurred during its period of control (and ensure that the indemnifying party has both the financial capacity to support its obligations under the indemnity and the ability to provide security for the indemnity).

- **Statutory timeframe**

  The statutory timeframe for the holding of creditor meetings to consider a DoCA can be a potential drawback, as the earliest a DoCA pre-pack could be adopted is approximately 20 business days after the appointment of the administrator. Sufficient time is also required for the administrators to prepare their report and for the creditors to consider the proposed arrangement. These delays could harm the company's business and reduce its value, and are inconsistent with one of the usual objectives of a pre-pack; namely, the expeditious transfer of the business to the purchaser following the administrators' appointment. An implementation agreement with major stakeholders can help mitigate this and, if time is of critical importance, the administrators may be able to complete the sale prior to seeking creditor approval of the DoCA.

There can also be advantages of a DoCA pre-pack:

- creditors are given an opportunity to approve the sale including its terms and conditions;
- the DoCA can provide for a release of creditors' claims as well as a moratorium on the pursuit of those claims;
- where ongoing access to leased premises under existing leases is an important element of the business case supporting the sale, landlords can be required to continue to observe their obligations under those leases;
- where the sale involves the company itself, the administrators of the DoCA can transfer its shares, if necessary, with the approval of the court; and
- if it is enacted, a DoCA will not enliven the operation of the anti-phoenixing legislation.

7.3 Equity restructuring under a DoCA pre-pack

The key features of a DoCA pre-pack that can support an equity restructuring are:

- the directors appoint an administrator and support a DoCA;
- the shareholders (who are usually also directors) agree to sell their shares to the purchaser of the company and its business on approval of the DoCA;
- the purchaser agrees to take on trading risk (pending the second meeting of creditors), usually by way of a licence from the administrator and fund the DoCA, subject to conditions precedent being satisfied; and
- major creditors agree to the key DoCA terms and undertake to vote for a DoCA in those terms.

7.4 Steps for a VA and DoCA pre-pack

A typical step plan for any VA or DoCA pre-pack is as follows:

- review any relevant security documentation;
- consider which insolvency practitioners should be appointed as administrators;
- conduct due diligence on possible purchases and the terms of the DoCA;
- identify the purchaser and begin to negotiate the DoCA, SPA and/or licencing arrangements (if the potential purchaser is to operate the business under licence);
- finalise purchaser due diligence, SPA and DoCA;
- appoint the administrators;
- (if applicable) the administrators grant the purchaser a licence to operate the business;
- the administrators call the first meeting of creditors (within 8 business days from the appointment date);
- the administrators call the second meeting of creditors and seeks their approval for the DoCA (25 business days, or 30 business days in the Christmas and Easter periods, from the day after the appointment of the administrator);
- the DoCA is approved and entered into by the company and the deed's administrators;
- the DoCA is implemented.

In some instances, the company may enter into implementation deed with key stakeholders when the terms of a DoCA are being finalised, binding them to take the necessary steps both to implement the taking transactions.

8. Comparison with overseas jurisdictions

8.1 Introduction

Australia differs from other jurisdictions in relation to both the practice and the law pertaining to pre-packs.

In the United Kingdom and the United States, there is no equivalent of the Australian Receivership Pre-Pack. The United Kingdom has largely removed the right to enforce securities created after 15 September 2003 by providing for the appointment of an Administrative Receiver, and the United States has not had a tradition of enforcing securities by the private appointment of a receiver.

8.2 United Kingdom

By contrast with the cautious approach to pre-packs in Australia, pre-packaged insolvencies are very common in the United Kingdom. There, the Statement of Insolvency Practice 16: Pre-pack Sales in Administrations (SIP16) seeks to deal with concerns about pre-pack administrations and their impact on the interests of creditors by setting out marketing guidelines for pre-pack sales and requiring disclosure of the reasons for and details of a pre-pack, so that creditors can be satisfied that administrators are acting with due regard for their interests.

Where a pre-pack involves a purchase of a company's business by a "connected party", SIP16 advises administrators to:

- tell creditors where the connected party has requested an opinion on the pre-pack from a member of an established pool of experienced business people (known as a "pre-pack pool");
- provide creditors with that opinion (if the connected party has provided it to the administrators); and
- provide creditors with the connected party's "liability statement", which details what the purchasing connected party will do to mitigate the risk of the business failing (if such a statement has been prepared and provided to the administrators).

A pre-pack sale is likely to occur before the information stipulated in SIP16 is provided to creditors. However, the information can assist creditors reviewing the administrators’ conduct and may assist administrators in defending themselves against any subsequent claims of improper conduct.

8.3 United States

In the United States, pre-packs are often used as part of a Chapter 11 reorganisation process. Prior to entering Chapter 11, the company and its keys stakeholders will agree on a restructuring plan, and only once there is sufficient support and approval will the company file in the United States Bankruptcy Court.

One of the largest Chapter 11 pre-packs to-date was the General Motors reorganisation in 2009. Under this pre-pack, a pre-negotiated sale was entered into between General Motors and key stakeholders, including the United States Government, which agreed to invest US$50 billion in exchange for 60% stake in the reorganised company. This plan was ultimately approved by the United States Bankruptcy Court (despite General Motors being insolvent during the negotiation period) and the sale was finalised 40 days after filing.