PRE-PACKS: RECENT LAW AND PRACTICE

"Here's one we made earlier"

Introduction

1. The "pre-pack" might be described as the insolvency profession's "Blue Peter" product. It connotes a business disposal prepared and packaged, ready for completion upon the appointment of the administrator. Like the "Blue Peter" product it is the target of some criticism, and the suspicion that something important has been missed. In particular, the cynical view is that it is the mechanism of default for deviant directors to buy back the same business at a knock-down price leaving behind a trail of unpaid creditors. There has however been a massive increase in pre-packaged administrations[1]. This is because a sale arranged before administration will often provide the best realisation for the benefit of the interested parties. The reality is that the process of insolvency usually destroys value (people leave, chattels are devalued and goodwill and intellectual property assets are eroded). So the pre-pack is a practice (as distinct from a procedure) which is here to stay because it works.

2. The purpose of these notes is to review the issues which arise in relation to pre-packs having regard to the latest developments in law and practice. There has been a lot more by way of comment upon the practice than there has been on the law. We will consider these matters under the following headings:

    - Part 1: The legislative framework and agenda
    - Part 2: Protection: Twilight trusts and other devices
    - Part 3: Meeting and making the challenges

Part 1: The legislative framework and agenda

The current legislative framework

Introduction

3. Or lack of it, might be a better way of describing it. The practice of disposing of a company's undertaking before the approval by creditors of the administrator's proposals is not expressly contemplated by the rules set out in Schedule B1 to the Insolvency Act 1986 ("IA 86") and nor was it contemplated by the relevant pre-Enterprise Act provisions in the IA 86. Three questions have arisen as a result:

    - Can such a disposal be lawfully effected without the sanction of the Court?
    - Does the administrator unlawfully fetter his discretion by arranging a pre-pack?
    - Does the pre-pack approach inevitably lead to conflicts of interest and duty?

4. There is both pre-Enterprise Act (*T & D Industries Plc* [2000] 1 WLR 646) (Neuberger J) and post-Enterprise Act (*Transbus International Limited* [2004] EWHC 932 (Ch) (Lawrence Collins J) authority supporting the proposition that there may be a sale of the business before the meeting of creditors. In both cases the administrator sought directions from the Court,

[1] See the *Report on Insolvency Outcomes* presented to the Insolvency Service by Dr Sandra Frisby, 26 June 2006 @ p69. Anecdotal evidence in the industry suggests that as much as 70-80% of administrations are now pre-packed. Sq. evidence from Barclays Bank presented to the R3 conference in 2006 showed less than 50% of cases they were involved in the prior year were pre-packed.

without notice to any third party, as to whether or not a sale could be made before the creditors meeting and without sanction from the Court. In both cases the Court said yes. Two limitations have been noted in relation to these decisions; firstly, the Judges did not have the benefit of adversarial argument before reaching their conclusions; secondly, the decisions are not authority per-se that pre-packs are okay, but rather that in certain circumstances a sale of the business may be affected pre-meeting.

5. Whilst there is a natural and healthy Anglo-Saxon reluctance to place too much reliance on decisions reached without adversarial argument, the decisions themselves do contain substantial and persuasive reasons. There have been no reported challenges to their correctness. It is considered therefore that notwithstanding the lack of adversarial argument the practitioner can reasonably rely on those authorities to justify the lawfulness of pre-meeting disposals.

6. In order to consider the second limitation, namely whether or not these decisions can be said to provide authority, or comfort, to pre-pack disposals which are completed almost immediately after the administrator has been appointed, the decisions need to be considered in a little more detail.

Pre-Enterprise Act - T & D Industries

7. The decision in *T & D Industries* was pre-Enterprise Act. It remains of relevance to post-Enterprise Act administrations because (1) the *Transbus* case heavily relies on it as part of its reasoning and (2) of the way Neuberger J analyses the administrator's functions and duties. The issue which the judge was asked to answer was whether, without a specific direction of the court, an administrator can dispose of the assets of the company prior to the approval of the company's creditors in meeting pursuant to section 24 of the IA 86. That required the Court to interpret section 17 of the IA 86. Section 17(2) states that:

"*The administrator shall manage the affairs, business and property of the company-(a) at any time before proposals have been approved (with or without modifications) under section 24 below, in accordance with any directions given by the court, and (b) at any time after the proposals have been so approved, in accordance with those proposals as from time to time revised* …"

8. The Court concluded that the words "in accordance with any directions given by the court" in section 17(2) meant "in accordance with such directions, if any, as are given by the court"; and not "only to the extent specifically permitted by any directions given by the court". Accordingly the section was interpreted so as to allow the administrator to exercise his powers (conferred on him by section 14 and Schedule 1 to the IA 86) save to the extent that a direction from the court required him to do so otherwise. The purpose of the administration provisions, to create a more flexible and relatively cheaper alternative to liquidation, provided the court with a strong basis to conclude that the less court applications the better. This is a trend which has been reinforced in all recent legislative changes; out of court appointments being a good example.

9. In addition the judgment of Neuberger J recognised the need in certain circumstances for quick commercial decisions to be made. He also emphasised the importance, wherever possible, of consultation with creditors, especially if the administrator intended to adopt a course which would result in the creditors' meeting being substantially ineffective.

10. It is apparent therefore that *T & D Industries* is not authority for the proposition that the administrator may, pre-appointment, arrange for the company's assets to be disposed of, such disposal to be a fait accompli even before the administration order is made. However, the decision provides comfort to the practitioner since it serves to emphasise that the

question of whether or not a pre-meeting disposal can properly be carried out is a fact, and case, specific question. That question is to be answered by reference to consideration of, firstly, whose interests are substantially affected, and secondly, whether or not the facts justify acting before formal approval or informal consultation. Furthermore, in *T & D* the period of trading was relatively short (only 2 weeks). So whilst not a pre-pack it could well have fallen into the category of one which was "partially prepared earlier". There seems to be no principled reason why the administrator cannot consider and answer questions relating to the proper course to pursue on appointment before appointment if he can be reasonably satisfied that this course is in the best interests of the particular class of creditor(s) who will or may be affected. This debate will be revisited below however when considering the issues of "fettering discretion" and "conflicts".

Post-Enterprise Act - Transbus

11. The post-Enterprise Act provisions, set out in Schedule B1, are slightly different to those in the un-amended IA 86. It is worth considering them in a little more detail here.

12. Paragraph 59(1) of the Schedule provides: "the administrator of a company may do anything necessary or expedient for the management of the affairs, business and property of the company". Paragraph 60 of the Schedule gives an administrator the powers specified in Schedule 1 to the Act. Paragraph 68 of the Schedule provides:

    "(1) Subject to sub-paragraph (2), the administrator of a company shall manage its affairs, business and property in accordance with-(a) any proposals approved under paragraph 53, (b) any revision of those proposals which is made by him and which he does not consider to be substantial, and (c) any revision of those proposals approved under paragraph 54.

    (2) If the court gives directions to the administrator of a company in connection with any aspect of his management of the company's affairs, business or property, the administrator shall comply with the directions."

13. There is therefore a slight difference in the wording as between the IA 1986 and the Schedule.

14. In *Transbus* Lawrence Collins J concluded that this difference did not mean that administrators could not act if no proposals had been approved or if no court directions had been obtained. He concluded that "administrators are permitted to sell the assets of the company in advance of their proposals being approved by creditors…". He noted that paragraph 68(2) of the Schedule requires the administrators to act in accordance with directions of the court "*if* the court gives [them]" and considered that this appeared to be a deliberate choice on the part of the legislators to adopt the wording of Neuberger J in *T & D Industries*.

15. He also made some interesting observations on the circumstances in which administrators might be justified in not laying any proposals before a meeting, namely "…where they conclude that the unsecured creditors are either likely to be paid in full, or to receive no payment, or where neither of the first two objectives for the administration can be achieved: see paragraph 52 of the Schedule". He noted that if, in such administrations, administrators were prevented from acting without the direction of the court it would mean that they would have to seek the directions of the court before carrying out any function throughout the whole of the administration. Given the policy of the Enterprise Act being to reduce court involvement he concluded this could not be right.

16. So, post-Enterprise Act, it has been confirmed that sales pre-meeting can occur as much as they could occur before Schedule B1 was brought into effect. Furthermore, as contemplated by para 52 of the Schedule, in suitable cases ((a) payment in full, (b) no distribution to unsecureds save under the prescribed part (c) "receivership" type cases) the creditors meeting can also be disposed of.

17. The circumstances in which a pre-packaged sale is appropriate post-Enterprise Act is therefore not dissimilar to those pre-Enterprise Act. Furthermore the same factors will require consideration by practitioners. However, post-Enterprise Act, the administrator must always have at the forefront of his mind the objectives which must guide the functions he performs, as enshrined in paragraph 3 of Schedule B1. Paragraph 3 states as follows:

"(1) The administrator of a company must perform his functions with the objective of-

(a) rescuing the company as a going concern, or
(b) achieving a better result for the company's creditors as a whole than would be likely if the company were wound up (without first being in administration), or
(c) *realising property in order to make a distribution to one or more secured or preferential creditors*."

18. Unless the practitioner considers that objectives (a) or (b) are not reasonably practicable he must have regard to the interests of the creditors as a whole when performing his functions (sub-section (2)). Furthermore, as is well known, objective (b) can only be aimed for if objective (a) is considered to be not reasonably practicable (sub-section (3)) and, likewise, (c) cannot be aimed for if (b) is not considered to be reasonably practicable (sub-section (4)).

Fettering of discretion

19. The interesting point which arises from this is that paragraph 3 only applies after appointment. If a pre-pack is pursued such that the deal is ready to complete upon the appointment being made, might it be said that the administrator has wrongly fettered his discretion to consider objectives (a) and/or (b)? There is some argument in support of this conclusion[2] on the basis that since administrators are fiduciaries they must not enter into an engagement by which they bind themselves to disregard duties or to act inconsistently with them. However, if the administrator, pre-appointment, considers the statutory objectives as laid out in paragraph 3 and considers that objectives (a) and/or (b) are not reasonably practicable and would not be reasonably practical at the future date on which he is likely to obtain the appointment, then it is not apparent that he has wrongly fettered his discretion. In that scenario, objectives (a) and (b) would not be viable objectives upon his appointment in any event, nor does his statement that the purpose of administration is likely to be achieved require which of the layers thereof to be specified. The fact that a pre-pack was pursued would not make any difference in this respect.

20. Accordingly it is the writers' view that the common law does provide an answer to this particular conundrum. Whilst the insolvency practitioner does not have a statutory duty to consider paragraph 3 pre-appointment, common law principles (applicable by reason of the fact he will inevitably anticipate becoming subject to fiduciary duties) will require him or her to consider and act as if paragraph 3 were applicable pre-appointment. This is so notwithstanding that in *Wade v Poppleton & Appleby* [2004] 1 BCLC 674, 716 it was held that IP's giving pre-appointment advice were not fiduciaries subject to the rules applicable to trustees. It is considered this approach is entirely consistent with the flexible and pragmatic

[2] See the discussion in Walton, *Pre-Packaged Administrations – Trick or Treat?* and the response by Bloom and Harris, both in *Insolvency Intelligence,* Vol 19, No 8 (August/September 2006)

approach taken by the Courts to those cases which have come before it, as well as reflecting the need to have a rigorous framework within which the practitioner operates.

Conflicts

21. That leaves the question of conflicts. It is well established that fiduciaries may not act where they owe conflicting duties. This issue is one which each insolvency practitioner now has to expressly consider whenever an administration appointment is being taken. A proposed administrator is required to sign a declaration in Form 2.2B to the effect that (s)he has not had any prior professional relationship with the company which is to enter administration, alternatively if there has been a prior professional relationship to attach a statement setting out a short summary of any prior professional relationship(s) with the company. In that process the proposed administrator is required to address the legal duties attendant upon accepting an appointment (namely that of objectivity, independence and impartiality) and the ethical guidelines set out by its regulatory body.

22. The significance of this procedure is two-fold. First, a failure to apply the relevant ethical guidelines exposes the individual insolvency practitioner(s) to disciplinary action by the Institute of Chartered Accountants for England and Wales ("the ICAEW") or other relevant regulatory body. Secondly, a failure to apply the relevant ethical guidelines and/or to consider the wider legal duties may encourage a successful removal application and/or a potential misfeasance claim. Paragraph 88(1) of Schedule B1 provides the court with power to remove on an application under IR 2.122[3].

23. In the context of administrations, there is a useful statement of the relevant general principles by the court in *Commonwealth of Australia v Irving*, [1996] 19 ACSR 457, Branson J, where it was stated (at 464-5) that:

> "*It is not, in my view, the law that a person appointed as an administrator of a company under Part 5.3A of the Corporations Law may not have had any prior contact with the company or its directors or officers. It is now commonplace for a company to seek professional advice respecting actual or apprehended insolvency and for the advice received to be to appoint an administrator pursuant to Part 5.3A of the Corporations Law. Not infrequently, and in my view, not improperly, the proponent of the advice to appoint an administrator then accepts appointment as that administrator. There would, I consider, be an air of commercial unreality about any suggestion that this course of events is necessarily improper. … However, the authorities make it plain that substantial involvement with a company prior to its administration will disqualify a person from appointment as that company's*

[3] There is no UK case law guidance on this issue (except perhaps *SISU Capital v Tucker* - see 27 below), but it is anticipated that the court would adopt a similar approach to removal applications of other office-holders (e.g. liquidators; see section 108(2) of the Insolvency Act 1986 and the case law on whether or not 'cause' is shown). There have been decisions on the initial choice of administrator (see *World Class Homes Ltd*, HH Judge Weeks QC, 24.11.05 and *Berkeley Berry Birch plc* [2006] All ER (D) 303). In Australia, the test for removal of administrators (under its legislation) is in substance akin to the test for removal of liquidators. In *Network Exchange Pty Ltd v MIG International* (1994) 13 ASCR 544, Hague J observed that, … "it must be accepted that an order for removal should only be made if it is demonstrated that such an order would be for the better conduct of the administration". As to the perception of the lack of independence arising from prior involvement, Santow J said in *Advance Housing Pty Ltd* (1994) 14 ACSR 230 that a prior involvement with the company … would not merit removal, "provided that the involvement is not likely to impede or inhibit the liquidator from acting impartially in the interests of all creditors … or give rise to a reasonable apprehension that the liquidator might be so impeded or inhibited "… and … "creditors are frequently well served by an appointment of a liquidator who has **some** familiarity with the affairs of the company …". See also *Bovis Lend Lease* referred to in paragraph 27 below.

administrator. Such an involvement will be seen to detract from the ability of the person to act fairly and impartially during the course of administration. In Molit (No 55) Pty Ltd v Lamb Soon Australia Pty Ltd (1996) 19 ACSR 160 in speaking of the role of an administrator I said:

> *'In such a role he or she is, in my view, obliged to consider not only means to maximise the chances of the company, or as much as possible of its business, continuing in existence (s 435A), but also issues of fairness between the company and its creditors, and between the company's creditors inter se.'*

It is necessary that a person appointed as an administrator can be seen to be independent of the company and of each of its creditors so that his or her ability to perform the above role is not open to question."

24. The market tendency towards pre-packs makes it likely that the courts will need to recognise the practical need for administrators to have a suitable lead-in period. Where his advice and assessment concludes that value can only be maximised by a disposal, and that proper value requires avoiding the value eroding taint of insolvency, then the market will (indeed already does) demonstrate the need for that lead-in period to embrace steps preparatory to a disposal.[4] In these circumstances the practitioner needs to be even more aware of the threats to his or her objectivity.

25. In this respect, the relevant Insolvency Statement was revised with effect from 1 January 2004. It guides insolvency practitioners who are members of the ICAEW in relation to matters not covered by the insolvency legislation. The first part sets out the specific ethical principles of objectivity as it applies to insolvency appointments to which every practitioner must adhere. The second part comprises an annexed list of "particular circumstances" – common situations in which practitioners may face ethical dilemmas, analysed by reference to a Framework. The Annex is, in turn, divided into three sections.

26. The Insolvency Statement itself recognises that it is the spirit of the guidance which is paramount. In this way, the Insolvency Statement does not create some form of strict liability under which a breach of its terms would result necessarily in a finding of misconduct. The Framework to the Insolvency Statement explains the dual requirement of identifying a threat and dealing with it. "Safeguards" appear to play an important role, although the Statement provides no further information about the nature or extent of safeguards which are contemplated. Detailed consideration of this Statement (and the associated Principal Guide issued by the ICAEW) is beyond the ambit of these notes. Suffice it to say here that there are two important categories which must be considered. Firstly, those circumstances where there have been material professional relationships (in the previous three years) before appointment such that there is a self-review threat. Secondly, there are self-interest threats, which are those which can affect the reasoning the practitioner applies because it is, or might be, affected by considerations that either favour, or are prejudicial or disadvantageous to the practitioner.

27. In the case of *SISU Capital Fund Limited v Tucker* [2005] EWHC 2170 Ch (Warren J) at paragraphs 121 - 132 (a case in which applications for the revocation of CVAs on the ground of unfair prejudice and for removal of administrators were made), issues of conflict of interests were addressed (and dismissed on the facts of the case). There it was held that, although conflicts of interest were not irrelevant, they and any breaches of professional guidance to which office holders were subject, came into the picture only so far as they were relevant to establish unfair prejudice. A conflict, even a serious one, and a breach of professional rules were not enough, by themselves, to establish unfair prejudice. The issue

[4] See also paragraph 89 below on market self regulation.

of conflicts should be treated with some circumspection when alleged as a ground for removal/unfair prejudice. (It is instructive to consider this approach with that in *Bovis Lend Lease Pty Ltd v Wily & Another* (2003) 45 ACSR 612, in which Austin J concluded that an administrator should be removed because a reasonable observer would consider him to lack independence and impartiality).

28. A principal risk which arises in relation to pre-packs is where the IP might have been involved in advising the directors. For example if the directors have been given advice as to whether or not they can safely continue to trade prior to an administration order being made, the practitioner may not be able to objectively scrutinise that conduct subsequently when considering his duties to the company or under the CDDA. At a practical level putative administrators are assiduous to ensure that directors obtain separate advice upon their duties which, if provided by suitably experienced lawyers with a full appreciation of the situation, can frequently set the boundaries of and alleviate the anxieties which both they and the directors may experience in continuing to trade in a cash constrained environment (as to which see paragraphs 42 to 49 below).

29. It might also be perceived that there is a potential risk where the appointment is made by the floating charge holder. Prior to appointment that charge holder will be the client and will be principally responsible for payment of the IP's fees. In these circumstances it may be argued that the pre-pack was organised in the interests of the charge holder and not the interests of the creditors as a whole. However, as stated above, if the IP adopts the approach that they have to be guided by the spirit of paragraph 3 of Schedule B1 even before appointment then there does not seem to be any reason in principle why the necessary objectivity cannot be safeguarded (and among the major accounting firms, there is a real recognition of the need to maintain the integrity required by that paragraph and, also, to avoid the taint of a material prior relationship which, in part, can be addressed by carefully crafted terms of engagement).

The legislative agenda

Introduction

30. Generally speaking the legislative agenda has encouraged the use of administrations. Further, and in particular, as explained further below, there are a number of legislative changes soon to be implemented and/or proposals which, if implemented, will also give some boost to the pre-pack practice (even if it is not the intended consequence).

The Companies Act 2006

31. The first category of legislative changes which are particularly relevant to pre-packs are those to be introduced by the Companies Act 2006 ("CA 06"). No doubt this Act will have been carefully read from start to finish by all the attendees of this seminar[5]. Some parts of this Act have already been brought into effect. The particular provisions referred to below have not yet been brought into force, but are expected to be brought in any time up to October 2008.

32. The first change we wish to consider here are the new sections relating to substantial property transactions. Keeping directors honest in their dealings with the company they serve has been an abiding theme in English company law. Part of this has been the limitation placed on substantial property transactions involving directors. The current

[5] The Act is the longest act in English legal history with 1300 sections, 16 schedules and runs to 700 pages. The Secretary of State may wish to forget the day in March 1998 when she announced that the Act would be "concise".

provisions are contained in sections 320 to 322 of the Companies Act 1985 ("CA 85"); they require the approval of members to transactions between the company and a director or person connected with the director concerning the acquisition of a non-cash asset above certain prescribed values. Whereas there is an exception for transactions made by companies in insolvent liquidation, no such exception exists in relation to administrations (or receiverships).

33. This is understandable where the interests of shareholders are affected, but it is well established that once a company is in the zone of insolvency, the focus of the directors' responsibilities to the company shifts from the impact on shareholders to the impact on creditors. Shareholders can be, and most often are, out of the money in receivership and administration. What business, therefore, is it of shareholders to be sanctioning MBO transactions out of administration? Any doubts on this score were settled by the decision in *Demite v Protech Health Limited* (1998), in which it was held that section 320 continued to apply even in receivership, and that a proposed sale to a purchaser with which the vendor's directors were involved required a shareholders' resolution to be clear of the risk of avoidance. As a consequence, MBO deals out of receivership or administration have either to be structured so as to avoid director involvement or have required shareholder consent. The effect of *Demite* has been to enfranchise those with no economic interest and, in some cases, to provide out of the money equity with leverage to exploit as the price of consent, sometimes to the detriment of creditors - surely an unintended consequence.

34. For almost every MBO pre-pack the provisions of sections 320 to 322 have to be complied with. Sections 190-196 of the CA 06 affect some changes to the prescribed values. More importantly however, by section 193, transactions made by companies in administration will also be exempt from the requirements relating to substantial property transactions. This facilitates the process of disposing of the assets of the company in administration to the directors of Oldco, and will act as a legislative fillip to administrations with MBO realisation strategies.

35. The second change to be implemented by the CA 06 concerns the abolition of the provisions of the CA 85 (sections 151 et seq.) relating to financial assistance for the acquisition of a private company's own shares thereby removing the need for the "whitewash procedure". The need for the "whitewash procedure" can arise, for example, when a target company grants security to a purchaser's bank upon an acquisition. The principal impact in relation to pre-packs however is that a failure to comply with the provisions relating to the prohibition on financial assistance could lead to a challenge to the disposal. The spectre of that particular challenge will now be removed, and will provide comfort to lenders financing sales of shares (e.g. of the trading subsidiaries by an insolvent holding company - a not uncommon situation for some private equity backed investments which have gone sour). The real security value lies downstream in the subsidiaries' assets, not in the shares in those companies acquired under the deal. The risk of avoidance of security for financing the purchase can limit the availability of finance, and the need for compliance with the whitewash procedures can block deals proceeding as share sales, serving to drive down values.

36. Thirdly, and finally, in relation to the CA 06 changes, there is a new codification of directors' duties to members (under sections 171 et seq.) and a new derivative claims procedure. However (subject to what we have to say in paragraph 39 below) it is not anticipated this will lead to a substantial change in relation to the duties of directors acting in the "twilight zone" shortly before the commencement of a formal insolvency procedure. Section 172(3) preserves the common law position that where a company is insolvent or of doubtful solvency, the directors must have regard to the interests of creditors.

37. The current legislative formulation in section 172 of the 2006 Act was described in the second White Paper on Company Law Reform (2005) as preserving the position of creditors

interests. However, it differs from the formulation offered by the Final Report of the Company Law Reform Steering Group (2001), which had said (in paragraph 3.15) that, where a company comes under financial pressure " … the normal synergy between the interests of members, who seek the preservation and enhancement of the assets, and of creditors, whose interests are protected by that [insolvency], progressively disappears. As the margin of assets reduces, so the incentive on directors to avoid risky strategies which endanger the assets of members also reduces; the worse the situation gets, the less members have to lose and the more one-sided the case becomes for supporting risky, perhaps desperate, strategies".

38. So, what we have is a codification of what is expected of directors when their proper emphasis is upon the interests of shareholders, but the 2006 Act has left the same directors without any equivalent statutory clarification of how they should act when they enter the zone of insolvency, leaving the common law to step forward to fill that gap.

39. We speculate that the clarity of the positive duty to act in the interests of members under the new legislation may come to challenge the Government's belief that it preserves creditor interests. Merely subjecting that positive obligation to a duty to have regard to creditor interests is the stuff which gave rise to the US theory of "deepening insolvency" (i.e. causing or worsening insolvency - now discredited following *Re CITX Corp.* (448 F 3d 672; 2006) and *Trenwick America v Ernst & Young LLP* (Del. Ch.2006)). The court in *Trenwick* was required to determine if additional duties, beyond those owed to a shareholder, were owed to creditors of an insolvent company (or one that was in the "zone of insolvency"). Some of the US States courts had ruled that fiduciary duties to creditors arose prior to actual insolvency. Of particular importance in this debate was the case of *Credit Lyonnais Bank v Pathe Communications Corp* (1991, Del. Ch). In reviewing that case in *Trenwick*, the Delaware court indicated that the phrases "insolvency", or the "zone of insolvency" should not declare open season on corporate fiduciaries. "Directors are expected to seek profit for stockholders [shareholders], even at the risk of failure. …. so long as directors are respectful of the corporation's obligations to honour the legal rights of creditors, they should be free to pursue in good faith profit for the corporation's equity holders. Even when the firm is insolvent, the board may pursue, in good faith, strategies to maximise the value of the firm, while recognising that the firm's creditors have become its residual claimants and the advancement of their best interests has become the firm's principal objective". The court also stated that if the board of an insolvent corporation, acting with due diligence and good faith, pursues a business strategy that it believes will increase the corporation's value, but that also involves incurring additional debt, it does not become a guarantor of that strategy's success. Such statements may not be the law as we know it in England, but they may find themselves being analysed in years to come, given that the positive duties set out in section 172(1) bear resemblance to the Delaware court's observations in *Trenwick*.

40. Separately from the CA 06, there are a number of proposals and/or other potential changes in the pipeline which might impact on pre-packs:

Pre-administration expenses

41. Firstly there is the question of recovery of pre-administration expenses, and in particular fees incurred during that period. Any outstanding fees and expenses at the date of the administration are prima facie to be treated as an unsecured claim (see Dear IP letter in September 2005). This problem in relation to pre-administration costs is particularly acute in relation to pre-packs where almost all the work is carried out pre-administration. Nicholas Briggs & Catherine Burton in their notes entitled "A Year in Administration" address this issue in more detail. Suffice it to say here that it is understood the new insolvency rules (to be laid and made in or about October 2007 and coming into force in April 2008) will bring in a new regime in relation to pre-administration costs. It is proposed to give creditors (or the "paying

party") an opportunity to approve the recovery of pre-appointment expenses after the administration order has been made.

Use of prohibited names

42. Secondly, some disquiet has been caused by the decision of the Court of Appeal in *Churchill & Churchill v First Independent Factors & Finance Ltd* [2006] EWCA Civ 1623. This concerned sections 216 and 217 of the IA 86. Section 216 of the IA makes it an offence for directors of a company which goes into liquidation to reuse the name, or trading name, of the business of Oldco. Section 217 provides that in certain circumstances the directors can be made personally liable for the debts of Newco. There are three statutory exceptions to section 216: firstly, where the notice provisions under IR 4.228 are used (which require notice to be given in the prescribed form within 28 days of the sale to all creditors of the Oldco that Newco intends to use the name); secondly, where the director applies for leave of the court within the prescribed time limits (under IR 4.229); thirdly, where the name has been in active use by the Newco for at least twelve months before Oldco went into liquidation IR 4.230).

43. The *Churchill* case concerned the proper interpretation of IR 4.228 and in particular whether or not the notice had to be served before the directors could commence acting as directors of Newco. It was confirmed in the Court of Appeal that notice had to be given before the directors could commence acting. On that basis the directors in that case were fixed with civil liability for certain debts of the Newco. This causes a problem because in an MBO scenario continuity of trading and management is normally essential. Whilst it might be possible to avoid this problem, in the context of disposals by administrators, by exiting the administration straight into dissolution (thereby avoiding putting Oldco into liquidation) or by not using the old name for a period of time (which could cause problems in itself), the safest stop gap solution for present is for the directors to make an application to court immediately after the Oldco goes into liquidation (using the procedure under IR 4.229). There is a proposal from the Insolvency Service, however, that the rules may be changed in 2007 so as to reverse the effect of this change (though such change will not be retrospective).

44. In one pre-pack deal which was in gestation as the *Churchill* decision came out, the putative administrators were content to undertake to give the directors 4 weeks prior notice of any intention to move the company from administration to liquidation, to enable the directors to make their application for leave to act in good time.

Part 2: Protection: Twilight trusts and other devices

The need for protection

45. A key concern for directors who are trading in anticipation of an administration process is whether or not by continuing to trade they are exposing themselves to personal liability for wrongful trading under section 214 of the IA 86 in the event that the company subsequently enters insolvent liquidation. In particular, where the directors have concluded (or ought to have concluded) that there was no reasonable prospect that the company would avoid insolvent liquidation then unless the directors can show that they "took every step with a view to minimising the potential loss to the company's creditors as…he ought to have taken" they are susceptible to a finding of personal liability (sub-section (3)). If, for example, there is a good business case for continuing to trade outside an administration but nevertheless it is doubtful whether that continued trading will benefit unsecured creditors then well advised (or cautious) directors will need protection from this potential liability.

46. In addition, directors will also have in mind the need to have some protection from an allegation of unfit conduct leading to disqualification proceedings being brought against them.

47. For directors in such situations there is a very real dilemma. Their lawyers may remind them of the colourful descriptions from the *Continental Assurance*[6] case that directors of companies in liquidation are assumed to be "rogues or idiots", and that seeking the safe harbour of a formal process too soon is the "cowards way out". For directors wanting to do the right thing, the need to sustain the going concern edifice in the search for maximum value imposes a real strain on their decisions about credit and creditors. They will need to maintain "business as usual" and be cautioned against giving preferences for existing credit from suppliers from whom they seek continued supply.

48. Where the value breaks below the point where the secured creditors will be repaid in full, any guarantee exposure may ease that dilemma for the directors. However, if they are not guarantors, they are entitled to ask that the party who stands to gain from the directors "playing the game" should stand behind them and provide an indemnity against any new credit being left unsatisfied in a subsequent administration. In our experience, such requests get kicked into the long grass but, if pressed, some additional working capital is made available rather than indemnities being given.

49. In the US, recent amendments to the Bankruptcy Code have provided a partial legislative response to the issue of the "tail end Charlie" supplier. By section 503(9) of the Code, those who supply goods in the ordinary course of business within the period of 20 days prior to the opening of a case under the Code, now enjoy administrative priority (i.e. are an expense of the case) for payment. Whilst such a provision is not on any horizon in England & Wales, the equivalent protection is a legitimate concern for directors to raise.

Trusts

50. One important and increasingly used tool to protect directors who cause companies to continue to trade in the "twilight" period immediately before an administration order is made is the trust. There are two beneficiary categories directors frequently wish to give protection to: customers who make deposits or advance payments for goods, and suppliers on whom the company depends to be able to continue trading. There are two recent cases which illustrate the issues and difficulties which can arise in relation to these two categories, namely *Re Farepak Food & Gifts Ltd* [2006] EWHC 3272 (Mann J, 18 December 2006)(customer advances) and *Re Sendo International Ltd* [2006] EWHC 2935 (Blackburne J, 24 November 2006) (suppliers credit). We propose to consider each of these categories in turn.

Customer deposits/advances

Re Kayford

51. The starting point in relation to twilight trusts and in particular trusts relating to customer advances is the decision of Megarry J in *Re Kayford* [1975] 1 WLR 279. That case concerned a trust set up for customer deposits. Notwithstanding the fact that no formal trust deed had been executed it was concluded that the three requirements of an express trust (namely certainty of words, subject matter and objects) were established on the facts of that case. Subject to satisfaction of the "three certainties" it was generally thought, following this case, that there should not be any difficulty in setting up a trust for the protection of customers making deposits or advances during the "twilight period". It has been followed and applied in

[6] [2001] BPIR 733

subsequent cases where such trusts have been upheld[7] (but has not escaped academic criticism as to its preferential effect - see e.g. Adrian Walters in *Vulnerable Transactions in Corporate Insolvency* (Armour & Bennett, eds, Hart Publishing, 2003) at paragraph 4.36). It is with this background in mind that the decision in *Farepak Food & Gifts Limited* [2006] EWHC 3272 falls for consideration.

Re Farepak

52. In *Farepak* the administrators sought directions as to whether and how they should distribute certain funds held by them, and in particular whether the moneys were held by them on trust in favour of customers of a Christmas hamper company. The application was issued and heard for one day in December 2006, primarily with a view to permitting distributions to the intended beneficiaries immediately after Christmas. Such rapidity meant that some of the material was less than might otherwise have been the case and, given that insufficiency; the judge treated the application as equivalent to one for summary judgment. The judge declined to make the directions sought.

53. The salient facts are as follows: Essential to an understanding of the judgment is the difference between the Farepak customer, who "saves" for Christmas by making payments throughout the year to buy the hamper or voucher, and the Farepak agent, who receives the payments from the customer (who may also be a customer and who is usually a friend, neighbour or relative of the other customers). The judge concluded that the Farepak agent was the agent of Farepak for the purposes of receiving deposits from the customer. On 11 October 2006 the directors concluded that the company would have to cease trading and be placed into administration. On the same day they took steps to obtain confirmation from the Bank that monies received from that morning would be excluded from the bank's charge and they received that confirmation late in the day. A declaration of trust was executed on the 12 October 2006 which stated that Farepak would hold the moneys paid into the account on or after the 11 October 2006 on trust as trustee for the benefit of the relevant payors. The declaration of trust executed by the company contained a mistaken, although ultimately rectifiable, reference to an empty bank account rather than the one holding the alleged trust funds. The administrators were appointed on the 13 October 2006. They were holding funds gathered in the three days prior to the administration, which the directors sought to ring fence for the benefit of the customers who had paid them.

54. The administrators (and a representative customer/agent) advanced four avenues for the trust status: a Quist close type trust; a constructive trust based upon the unconscionability of retaining customer money following a decision to cease trading; or an express trust (alternatively an implied trust based on the same facts); and the rule in *Ex parte James*. The judge concluded that none of these arguments justified him making directions for a distribution.

55. First, the Quist close trust argument was advanced on the basis that, irrespective of the declaration of trust, the customer paid monies to Farepak for a particular purpose and since that purpose had failed the monies were held on resulting trust. The judge concluded that the facts did not support a conclusion that there was a Quist close/purpose trust. It was apparent that the customers were making advance payment towards the price of goods or vouchers to be supplied by the company. That was a contractual relationship, not a trustee/beneficiary relationship. In addition, amongst other things, the fact that the monies were mixed by the agent and also by Farepak itself militated against such a conclusion. So did the fact that this argument, if successful, would apply to all customers of Farepak in the 2006 Farepak year.

[7] This decision was followed and applied in relation to customer deposit/advances trusts in *Re Lewis's of Leicester Ltd* [1995] 1 BCLC 428 (Robert Walker J) and in *OT Computers Ltd v First National Tricity Finance Ltd* [2003] EWHC] 1010 (Ch) (Pumfrey J)

56. Secondly, the judge accepted that a constructive trust might arise is and insofar as it could be established that moneys were paid to Farepak by customers at a time when Farepak had decided that it had ceased trading, and indeed at a time when it had indicated that payments should not be received. The difficulty which arose however was the fact that on the facts the judge could not determine that all the moneys in relation to which he was asked to make a decision fell within that argument. That was because the date of receipt should be taken as the date the agent received the money, not the date the monies were received by Farepak in its bank account.

57. Thirdly, the judge was willing in principle to give effect to a (rectified) express trust. However the judge concluded that an additional problem presented itself in relation to this argument; namely that insofar as the money had already been paid to the company (via the agent) the relevant customers were already creditors. Accordingly by declaring the trust the company was apparently giving a preference. The judge considered that there was no obvious answer to this problem, though he noted the point was not argued before him. We return to this point further below.

58. The fourth and final avenue explored by the administrators was whether or not the rule in *Ex parte James* (as officers of the court) might require them to return the monies to the customer. Mann J concluded that the principle could not to be used to override the company's interest in the monies, or to dispense with the preference issue, even if to do so might produce a "fair" result for the contributing customers. That may produce "palm tree justice", but was not sufficient to bring it within the principle in *Ex parte James*.

59. In his concluding observations, Mann J was assiduous to leave open the opportunity for the parties to return to court on more substantial material to justify the proposed distribution, and expressed regret that he could not endorse the distributions which the administrators wished to make. However, even if some of the obstacles might be seen as technical points, they were nevertheless real, and had to be disposed of properly and on the basis of law, not purely on the basis of "sympathy and Christmas". The writers are not aware that the administrators have sought to re-open the matter on the basis of a fresh application.

Comment

60. The first point to note in relation to the *Farepak* case is that it was not a pre-pack. In fact the directors were seeking to institute trusts to protect payments which the company was thought to be receiving from its customers in its bank account/s after cessation of trading. In fact, as it turned out, in all probability those funds were received by the company, through its agents, before the decision to cease trading was made. So the facts in *Farepak* were quite unusual and do not provide much helpful guidance to the pre-pack scenario.

61. Secondly, the decision in *Farepak* is not considered to be a valid authority for the proposition that a company cannot effectively retrospectively constitute itself a trustee of customer deposits (in respect of customers who had become creditors). The first point to note is that *Farepak* was to be treated as summary judgment application. Secondly, the preference point was not argued before the judge. Thirdly, whilst the judge's conclusion could be justified on the facts in *Farepak*, in most pre-pack cases the directors motivation will be to be able to continue trading (whilst reducing, as far as possible, the risk of an allegation of wrongful trading or unfit conduct). In these circumstances it is suggested the directors may well have a good basis for contending that the requisite desire to prefer under section 239 of the IA 86 is absent; see *Re Lewis's of Leicester Ltd* [1995] 1 BCLC 428 (Robert Walker J). See also the comments below in the context of trusts in relation to suppliers

Trusts for suppliers

OT Computers

62. It was expressly noted by Megarry J in *Re Kayford* above that different considerations might apply in relation to a trust set up in relation to suppliers/creditors. That turned out to be the case in *OT Computers Ltd v First National Tricity Finance Ltd* [2003] EWHC 1010 (Ch) (Pumfrey J). *OT Computers* concerned both a customer deposit/advance type trust and a supplier/creditor trust. The judge upheld the former but concluded the latter was ineffective by reason of the fact that there was insufficient certainty of beneficiaries (objects). In particular the trust referred to the beneficiaries being "urgent suppliers" and the judge, correctly in our view, concluded this was an inherently uncertain concept. The draftswoman who prepared the trust deeds in *Re Sendo* may well have had this decision in mind when drafting the trust deeds for that company.

Re Sendo

63. *Re Sendo International Ltd* [2006] EWHC 2935 (Blackburne J, 24 November 2006) was (to all intents and purposes) a pre-pack case. The company operated as a manufacturer and distributor of mobile telephones, and depended for its financial support upon its major supplier, Celestica, which was also a secured creditor owed in the region of $220m. The indebtedness was considerably greater than the security available, but it was agreed that money should be carved out from the security to establish a trust fund to correspond (at least in theory) to the liabilities being incurred as the sales process was explored. Two separate trust deeds were established to provide for liabilities incurred by an insolvent company during the process of seeking a sale of its businesses.

64. The validity of the trusts were not in issue; the definition of trust creditors was clearly set out in the trust deeds and there was no question of there being a lack of certainty as regards the objects of the deed. The court found that the clear purpose of the trust deeds was to permit SIL (and the group companies) to continue trading notwithstanding their insolvency, by ensuring that sufficient monies were carved out of Celestica's security and placed into trust to cover the trading liabilities. The funds ceased to be available to SIL's creditors generally, but became subject to the trust deeds instead.

65. Rather, the issue was the extent of the trust creditor's interests in the fund. That was an issue of construction of the trust deed/s.

66. The administrators sought to distribute balances in the trust accounts, in each case by way of pro rata distribution (net of expenses and remuneration) to the creditors identified in the schedules which had been created in accordance with the trust deeds. There were discrepancies between the identities and amounts of the creditor claims in the schedules and those which the creditors claimed for themselves. The administrators said that it was clear that the funds were held on trust and were no longer part of the company's property, and urged the court to avoid detailed investigations as to the entitlement of those interested in the funds in the interests of economy and expedience.

67. Few creditors attended the application. One claimed a greater sum than was listed, but wanted an early distribution in any event. The other, a trade creditor, also said its claim was substantially understated, and sought to participate in the trust fund distribution on a more accurate reflection of its claim.

68. The administrators argued that the trust deeds identified the trust property and the beneficiaries as listed in the trust account schedules (being those which the company reasonably believed were unsatisfied liabilities in the relevant period), and that such

identities and amounts represented the funding in the trusts for the liabilities incurred during the trust period. It was not necessary to look beyond the schedules themselves to establish to whom the trust funds should be distributed. They contended that the trust deeds and the schedules created pursuant to those deeds were definitive of the beneficial interests of the trust creditors.

69. Against that proposition, it was argued that the deeds contemplated an objective standard for ascertaining the extent of the creditors' claims. It was contended that the intention of the settlor was an accurate identification of the creditor claims. Reliance upon the schedules carried the risk of intrinsic error, and distributions which could be arbitrary or capricious. The schedules should not be viewed as being determinative but merely operative machinery. Properly understood the trust deeds were intended to provide that the trust funds were to be ring fenced to meet actual liabilities incurred in the relevant period. The creditors' claims should be assessed no differently than if no trust fund had been established for their benefit.

70. In the event, Blackburne J favoured the administrators' approach on the construction of the deeds. Even though an oversight in a creditor's claim may give cause for a grievance, it did not provide any enhancement in the trust fund declared in that creditor's favour. He ordered that the funds be distributed in accordance with the administrators' protocol (i.e. pari passu in favour of those listed in the schedules to the trust deeds). The only consolation for the disgruntled creditor was that the judge ordered that its costs of representation be paid as an expense of the administration of the trust funds as he considered their participation had been of assistance.

Comment

71. Although the settlor of the trust property was the insolvent company, it was not the real provider of the funding, which came from funds which would otherwise have fallen subject to Celestica's security, and could only be used to meet the trading liabilities with Celestica's agreement. There was no debate as to whether, upon such release, the company found itself declaring a trust over its own monies (i.e. which upon release became its own property, albeit for a specific purpose). Instead of a general pro rata application, the trust deeds set out a mechanism under which some of the liabilities could have been either omitted or understated. To the extent of such inaccuracies, the advantaged parties might have been preferred to the detriment of the disadvantaged, but such an argument was not addressed in the judgment, nor was any issue of conflict for the administrators acting as de facto trustees of the funds. That said, the pragmatic approach urged by the administrators appealed to the expediency of the situation.

72. In addition, and more generally, simply because it might be said that certain creditors were preferred over others, it does not follow that the declarations of trust constituted unlawful preferences under section 339. As commented above in relation to the Farepak decision, if the true motive was to enable the company to continue to trade then the requisite desire to prefer under section 239 of the IA 86 might well have been absent.

73. Finally, the *Sendo* case does raise a serious question for directors; if trust arrangements which are put in place allow for unsecured credit to increase are they at risk of liability under section 214? Whilst an objective standard for ascertaining creditors was contemplated in that case the judge concluded it was not a condition precedent. In these circumstances might it be said that the directors had not taken every step with a view to minimising the potential loss to the company's unsecured creditors as he ought to have taken?

Part 3: Meeting and making the challenges

Challenges to the insolvency practitioner

74. Readers of *Accountancy Age* last summer will have seen stridently expressed comments:

> ***27 July 2006*** *- Legislation has been mooted to manage the controversial process of pre-pack administrations … suggestions have included forcing administrators to file a statement with the courts giving detail of why a pre-pack approach was taken …*
>
> ***3 August 2006*** *- Pre-pack to face challenges. If it is so controversial, why has the profession not found itself bogged down under the weight of case law, brought by unhappy creditors? … creditors are loath to "throw good money after bad" … It's pure chance that there hasn't been anything yet, but a challenge means putting money where your mouth is".*
>
> ***17 August 2006*** *- Hedge funds will be the first creditors to force administrators into the courts and fight over the value gained from a pre-packaged administration … [they] are in the prime position to challenge administrators if they believe they have failed to gain sufficient value from an insolvent company's sale.*

75. There are at least four different ways in which the actions of the IP who administers a pre-pack might be challenged: first, by a misfeasance application; secondly, by an application alleging conduct which is unfairly harmful to the [financial] interests of the applicant; thirdly, by a claim in tort; fourthly, by the indirect route of a challenge to remuneration (there is potentially a fifth; a removal application, which is considered briefly in paragraphs 22 and 27 above in the context of conflicts). Each will now be considered in brief terms below.

76. As regards misfeasance applications, it should be noted that these may now be brought under paragraph 75 of Schedule B1 to the IA 86 whilst the administrator is in office as well as after the administrator has ceased in office (pre-Enterprise Act, under section 212 of the IA 86, a misfeasance claim could only be brought after liquidation). In the context of pre-packs the allegations could range from straight-forward negligent undervalue claims (such as those alleged in *Re Charnley Davies* [1990] BCLC 760) to allegations of mis-applications of monies (such as the failure to pay expenses in the proper order of priority). If the administrator has had his release/discharge, permission of the Court is required before an application can be made. It is considered that the administrator who has overseen a pre-pack is most likely to have to meet allegations of misfeasance under paragraph 75 in the context of an allegation of a transaction at undervalue by a disappointed interested bidder (i.e. one which is also a creditor; external bidders would have no standing to complain, but their disappointment is evidence for those who do - if they learn of it). The writers are unaware of any reported decision, however, where such a challenge has been successful.

77. The second route of challenge might be under para 74 of Schedule B1 to the IA 86, which provides that a creditor or member may apply to court claiming that the administrator's actions (or proposed acts) unfairly harm the interests of the applicant (whether alone or in common with other members or creditors). In relation to section 27 of the IA 86 (the predecessor to paragraph 74) it was held that (*Re Charnley Davies* above) without more a negligent sale at an undervalue would be insufficient to establish relief. In the context of a pre-pack it is anticipated that this provision is unlikely to have any real use because the sale will already have completed by the time any application is considered. Moreover, the evidential difficulty of challenging the sufficiency of the values achieved will undoubtedly mean that creditors will hesitate to throw good money after bad, unless (as in *Charnley*

Davies itself) there is an organised cadre of disgruntled creditors with a sufficient coincidence of interest to take up cudgels.

78. The third type of challenge could be by a third party who asserts that the administrator has in some way infringed his contractual and/or property rights. Such challenges cannot be treated as being mere nuisances; in *SCi Games Ltd v Argonaut Games Plc* [2005] EHCH 1403 it was held that it was inappropriate on a summary application to decide whether an administrator could or could not be liable for unlawful interference with contractual relations if they procured a company to commit that tort. In the context of speedy sales of assets the IP needs to be mindful of the potential for these types of challenges.

79. Last, but by no means least, the IP could find themselves subject to an indirect challenge in relation to their fees. In the context of pre-packs where the bulk of the fees have been met out of third party funds this should not be a particular concern. This may become more of a concern however if, as anticipated, the new rules might allow and require the IP to seek approval for pre-appointment expenses.

Challenges to directors

80. The means by which a challenge can be brought against directors who are party to a pre-pack deal are well known to most practitioners and therefore we will only summarise the same here. They include the following: a wrongful trading claim by a liquidator under section 214 of the IA 86 (see above when discussing the use of twilight trusts); statutory (section 212) and/or common law misfeasance claims alleging breaches of fiduciary duties (or based on the new codified duties set out in the Companies Act 06); for civil liabilities arising from breaches of the CA 85 (though see above in relation to changes concerning section 320 of the CA 85) and the prohibited names provisions of the IA 86 (see the case of *Churchill* above).

Challenges to the deal

81. It is useful to consider challenges to the deal in two categories; those challenges made before the deal is completed and those made afterwards. The former will be rare indeed. The English system invests its trust in the stewards of the process, who are empowered to act prior to creditor sanction (*T&D Industries*; *Transbus*), and who are accountable after the event rather than before. The US system is much more procedurally open and involves a high level of external approval by the supervising court prior to closure either of a reorganisation plan or of a sale "free and clear" of liabilities under section 363 of the Bankruptcy Code (which is a much closer analogy to English pre-packs).

82. An example of a challenge being made to a proposed disposal prior to closing (though there would not appear to have been any involvement of an IP in this transaction at the relevant time) was in *Customs & Excise Commissioners v Anchor Foods Ltd* [1999] 1 WLR 1139, where the Court was prepared to grant HMC&E a freezing order upon a suitable cross-undertaking in damages being offered where there was credible evidence that the disposal was at an undervalue. The Court was willing to grant such an order notwithstanding the fact that there was some independent evidence to justify the value at which the assets were intended to be disposed of. In the event, HMCE's challenge was not sustained, but the case is also illustrative of the potential for valuation evidence to be widely disparate (the range was from £9m to £100m initially). However in the classic pre-pack case it is envisaged that it will be difficult to satisfy the Court that a freezing order, preventing a sale, will be justified since in most cases there will be compelling reasons why a sale needs to proceed (and if the administrator elect has not assembled the evidence to justify the sale, then more fool him). (Compare with *Walker v WA Personnel Ltd* [2002] BPIR 621 where a court appointed receivership route was successful).

83. Perhaps the most interesting recent development has concerned an application by H M Revenue & Customs opposing an administration order in respect of an insolvent solicitors partnership in which the clear intention was to effect a pre-packaged transfer of the business on the making of the order (which was necessary because of an extant winding up petition issued by HMRC, which was the major creditor by some margin). The partners proposing the administration order, supported by the prospective administrator, considered that a better result for the partnership's creditors would be achieved within the meaning of paragraph 3(b) of Schedule B1: the Commissioners (as majority creditor) opposed the application, and claimed that they were in a position to veto the administration if they were opposed to it. The issues were whether or not such opposition prevented the purpose of administration from being achieved. Although only briefly reported[8] ,Andrew Simmonds QC (sitting as a deputy High Court judge) granted the administration order, and indicated that even a majority creditor could not veto implementation of the administrator's proposals which the court could authorise notwithstanding objections from the majority creditor. The objections did not mean that it was not reasonably likely that the purpose of administration would be achieved; indeed there was a real prospect of it being achieved.[9]

84. Our understanding is that the judge in *DKLL* felt that if the prospective administrator said that the purpose could be achieved, it would require very clear indications to the contrary to overturn that view. As to the position of HMRC as majority creditor, the judge felt it was not just the majority creditor's view which counted, but that all stakeholders (including the employees and clients of the insolvent firm) whose views were entitled to be canvassed. A fuller report is anticipated, but for present purposes, it is interesting to note that the challenge to the administration order (and the pre-pack sale which would follow in its wake) was brought by the tax authorities (with echoes of *Anchor Foods Limited*). Perhaps more importantly, it shows the credence given to the views of the prospective administrator, and that the purpose of administration is a self standing test, rather than as a function of the wish of creditors, even if they control the voting at the creditors' meeting at which the administrator's proposals would come to be considered. Absent a more detailed report, the case would seem to be very strongly supportive of pre-packs as a legitimate technique in the service of the purpose of administration and will make it more difficult still for successful challenges to be brought prior to administration, reinforcing the view that complaints will find themselves dealt with after the event rather than before or at the time of administration.

85. A further line of attack from a disgruntled shareholder/creditor might be a hostile administration application with evidence in support from an alternative IP. As a tactic, the applicant would need to heed the lessons of the *Colt Telecom*[10] decision of Jacob J, where a muscular approach by an American hedge fund was seen as too muscular for English tastes, particularly as to the evidence relied upon as to solvency in that case.

86. Another, somewhat novel, line of challenge, would be for an interim declaration that the proposed pre-pack deal would, if implemented, be unfairly harmful to the interests of the applicant (under para 74(1)(b)); see above) and for an injunction preventing such a pre-pack being completed. Whilst such an application would be novel, there are good reasons why the Courts should be prepared to entertain such applications if, as appears likely, the creditor is unlikely to have any opportunity to influence events after the administration has commenced. That said, the creditor would need to produce credible evidence that it was financially interested, particularly if those (such as the secured creditors, whether senior or

[8] *Re: DKLL Solicitors* [2007] All ER (D) 68; 6 March 2007

[9] Cf. , under the old law, the opposition of creditors may be relevant as to whether there is a real prospect of achieving the purpose of administration, but it was not determinative; *Re: Structures & Computers Limited* [1998] BCC 348

[10] [2002] EWHC 2815 (Ch)

junior, were supportive of the deal and were at the margin of full repayment themselves). Where the value breaks below the level at which a complainant has a financial interest, then the valuation and marketing evidence available to the putative administrator and the directors will push many such claims into nuisance value territory.

87. In relation to challenges to the deal after the event, there are the following possibilities:

- A challenge to the administrators conduct under para 74(1)(a) (conduct unfairly harmful to the interests of the applicant). Such an application could be the launching pad for the argument that pre-packs are unlawful, contrary to the assumptions made following *T & D* and *Transbus*. Para 74 might also be used for a more typical transaction at undervalue allegation, though in the context of a pre-pack this route is unlikely to provide the applicant with any meaningful relief;
- An application by a subsequent liquidator alleging that the transaction was at an undervalue for the purposes of section 238 of the IA 86 and seeking restorative relief (cf. *Walker v WA Personnel Ltd* above);
- Before the relevant provisions of the CA 06 come into force, there remains the possibility of attack where there has been unlawful financial assistance contrary to section 151 of the CA 85 (and where the whitewash procedure has not been followed).

Conclusion

88. Challenges to pre-pack deals, whether before or after the event, are notoriously difficult to make. Even where there might be concerns as to the value obtained, it will usually be the case that the practitioner will be able to point to strong commercial reasons why the sale was justified in the circumstances. In an earlier instalment of the Trident saga (*Trident Fashions Limited* (No 2) [2004] EWHC 293 Ch - Lewison J), at paragraph 39 et seq., it was said (in relation to a material irregularity complaint) that "the court should only interfere if a judgment made by the administrator about the material to be placed before the creditors was a judgment to which no reasonable insolvency practitioner could come. That judgment should, I think, be made on the basis of the material available to the administrator at the time and not with the benefit of hindsight."

89. Moreover, it is now common knowledge that, in November 2005, Barclays Bank promulgated its "best practice" guidelines for the use of pre-packs in relation to cases where it was involved (usually as secured creditor). Other clearing banks adopt similar positions, and the discipline of complying with that protocol is now widespread, and an effective tool for market self-regulation. The very existence of the protocols will make any effective challenge to decisions taken (by an administrator) to pre-pack a business sale on his appointment very difficult to sustain if the IP concerned has acted in accordance with that protocol and can demonstrate that he has done so. Further, given that new style administrators are required to act quickly and efficiently (under paragraph 4 of Schedule B1), we consider that they are entitled to act upon "merely" adequate (even if not full) information upon which to reach a considered conclusion.

90. The practitioner is most likely to be at risk where the standard professional rules and practices are not followed, for example where the rules as to conflict of interest are broken, or where robust professional advice on disposals is not obtained. For those who are seeking to make a challenge they might be well advised to consider a challenge before the event (when notice of the disposal has come to the attention of the applicant) even if only with the aim of ensuring a better deal is struck with the proposed purchaser. However, they would need to exercise care that their action did not have the effect of destroying the deal and the value it represented to those with a genuine interest as residual claimants.

91. As regards the buyer, any challenge after the event would have a limited impact provided the buyer dealing with the administrator did so in good faith and for value. Under paragraph 59(3) of Schedule B1, such persons need not enquire as to whether the administrator acts within his powers. And, as regards the directors, one of the key advantages for pre-packs is that the administrator takes the seller's value decision, thereby externalising that risk to the IP and away from the management.

92. In closing, we would draw delegates' attention to the recommendations on pre-packs in the 2006 Annual Report of the Insolvency Practices Council (whose remit is ethical and professional standards). These reflect several of the issues addressed in this paper, including explanations to creditors of the decision to pre-pack and emphasising the importance of addressing conflicts of interest.

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