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Analysis

Caveat Emptor – Take Care Buying Assets Through a Pre-Pack

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Biography

Nick Hood is the Senior Business Adviser at the Opus Business Advisory Group (https://www.opusllp.com), the largest independent advisory, restructuring and insolvency firm in the UK.

Nick was a licensed Insolvency Practitioner, working in the business rescue market for 25 years. He is a committed internationalist, having created the largest global network of independent business rescue firms and having also worked overseas in Canada, Milan and Bahrain.

In his earlier career and after qualifying as a Chartered Accountant in 1970, Nick held senior executive positions in major companies in the construction, engineering and media sectors, as well as working for a boutique investment bank.

Nick's thought leadership and opinion blogs for Opus can be found at https://opusllp.com/resources/.

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Abstract

Buying a business and its assets through a Pre-Pack Administration process may seem like the short route to a good deal at a beneficial price, but there are some very real risks associated with such transactions. These are not ordinary Mergers & Acquisitions (M&A). In this article the author looks at the how's, why's and pitfalls of Pre-Packs for the purchaser.

The background

New regulations on Pre-Pack asset sales which came into force in 2021 have driven the volume of Pre-Pack Administrations to much higher levels. The intention of these new rules is to increase the transparency of the transactions they facilitate.

Since the introduction of the Administration (Restrictions on Disposal etc. to Connected Persons) Regulations 2021, the number of pre-packs has jumped from 201 in 2021 to 545 in 2023, according to the Insolvency Service. That's an increase of 171%. The figures, which have been extracted from SIP16 statements published by Administrators, also shows the number of sales to connected parties has more than tripled over the same period, from 106 in 2021 to 329 in 2023.

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What is a Pre-Pack?

A Pre-Pack transaction will have been negotiated and the final terms and relevant legal and other documentation agreed ahead of the appointment of Administrators to the distressed vendor company. The sale will then be completed immediately after their appointment or very soon afterwards. The purchaser will usually acquire all, or substantially all, of the business and assets of the insolvent company from the Administrators.

This type of business rescue is designed to deal with situations where the appointment of Administrators is likely to cause such fundamental damage to the business that it will become unsaleable, either immediately or shortly thereafter.

The technique was developed originally to deal with businesses that depend heavily on their employees or their reputations, such as advertising or design agencies or those in the fashion industry but is now used far more widely.

Do the new regulations work to increase scrutiny and transparency?

There are ongoing worries concerning the effectiveness of the new connected-party Pre-Pack arrangements, as highlighted by R3, the UK insolvency profession's trade association[1].

The reality is that the use of a Pre-Pack is a technique that will always raise suspicions. It is hard to see how the lack of consultation with or notification to creditors before the sale transaction has been completed, can ever be fully squared with creditors' doubts about whether something untoward has gone on.


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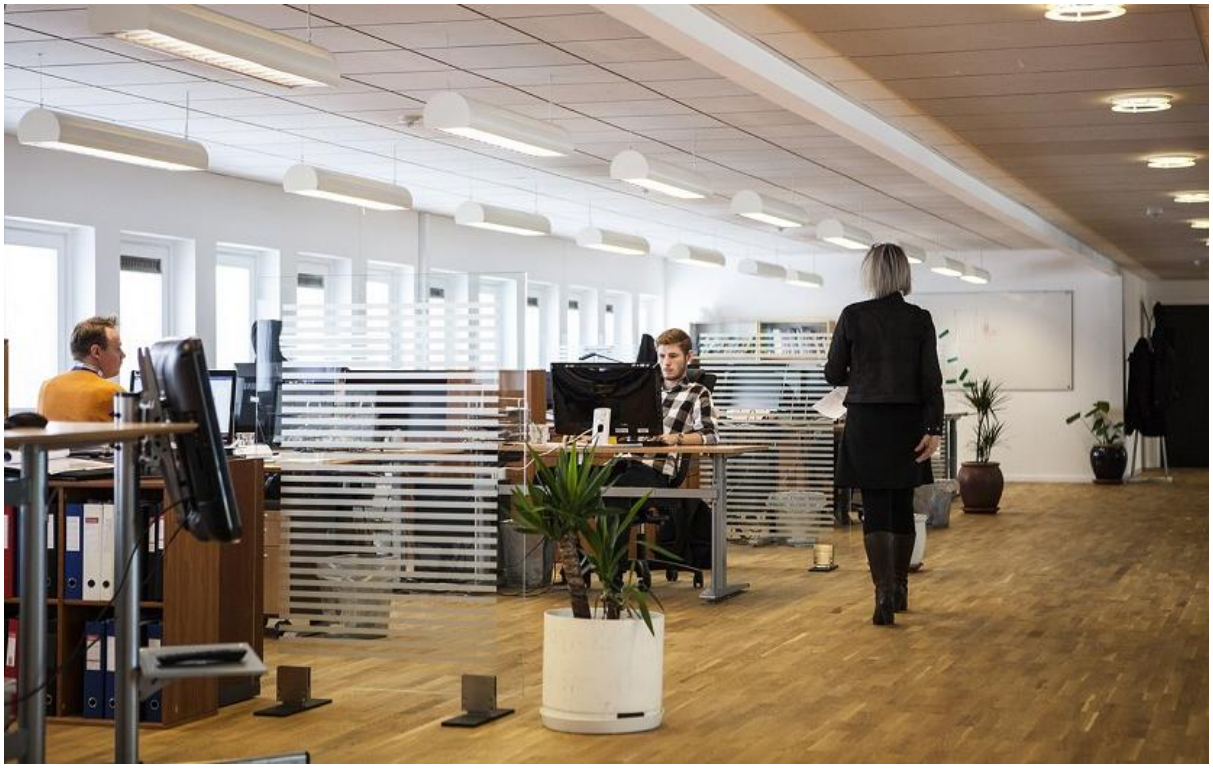
Although in theory, this issue does not involve the purchaser, it is always possible that such doubts could motivate key trading partners to avoid entering into a commercial relationship with the new owners, either at all or on acceptable terms.



Why do Pre-Pack sales happen?

The acquisition of a distressed business is obviously an attractive proposition from the point of view of value, given that the buyer is getting a going concern clear of all or most liabilities, apart from any ransom payments they may have to make or any operational leases they might need to adopt.

Nevertheless, these deals come with an unusual set of risks and abnormalities, quite different to a normal Mergers & Acquisitions (M&A) transaction. Purchasers should never expect the reassurances of a solvent acquisition, such as the opportunity for thorough due diligence, nor a comprehensive set of representations and warranties from the Administrators.

Key considerations for Pre-Pack purchasers

1. **Confirming what the sale covers and documenting it in the agreement** – Fundamental to a Pre-Pack sale is the transfer of the key assets of the distressed company to new owners, thereby facilitating the continuation the business to as a going concern, but leaving the debts, liabilities and obligations behind in the original insolvent entity. It is vital to ensure that the assets to be included in the sale are correctly identified. Equally important is specifying what is excluded from the transaction.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2. **There will be no warranties or indemnities to protect purchasers** – During the negotiations, the prospective Administrators will themselves usually only have very limited information about the business and assets to be included in the deal. They will also not be prepared to provide any comfort through representations or warranties as to the assets offered, which are sold by them after their appointment on an "as is" and "where is" basis. This is not a bargaining stance, it is non-negotiable.

3. **Comprehensive due diligence will usually not be possible** – In practice, the ability of the purchaser to carry out any due diligence at all is likely to depend on the cooperation and responsiveness of the insolvent company's management, but it is bound to be seriously limited because of the short time available in which to negotiate, agree and complete the sale.

4. **Preserving vital customer or supplier contracts may be problematical** – Pre-existing contracts do not transfer automatically to the purchaser in a Pre-Pack sale, so the assignment or novation of each one individually will have to be negotiated. It's important for the purchaser to realize that contractual counterparties are not obliged and may not be willing to trade with the new owner. Even when they are, they may seek to capitalize on the situation to renegotiate prices and trade terms. They may also try to use any operational leverage they have to recoup losses caused by the original company's insolvency by demanding ransom payments against their unpaid bills.

5. **Staying in the premises** – Purchasers usually take over premises under a licence to occupy, instead of a lease assignment. Getting landlord consent to and completing a formal assignment is rarely possible within the accelerated timetable of a Pre-Pack sale. A licence to occupy the property for a specified time gives the purchaser time to negotiate with the landlord, although there is no certainty their consent to an assignment will be given.

6. **Transferring operational licences** – The purchaser must ensure that any licences or regulatory consents required are in place to enable the business to keep trading. Licences such as for the sale or alcohol or provision of regulated entertainment will have automatically lapsed on the appointment of the Administrators. Co-ordinating the transfer or reinstatement of any such licences with the sale is essential but may be far from straightforward under the particular circumstances of a Pre-Pack.

7. **Employee liabilities follow the business and assets** – In almost all cases, if the Pre-Pack sale is of all or substantially the whole of the business, then all the employees and the liabilities attached to them will transfer automatically to the purchaser as a result of the Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE). This includes even those staff the purchaser does not intend to retain. The sale and purchase agreement cannot provide otherwise.

   This means that the purchaser takes over all the insolvent company's rights, obligations and liabilities flowing from the transferring employment contracts.


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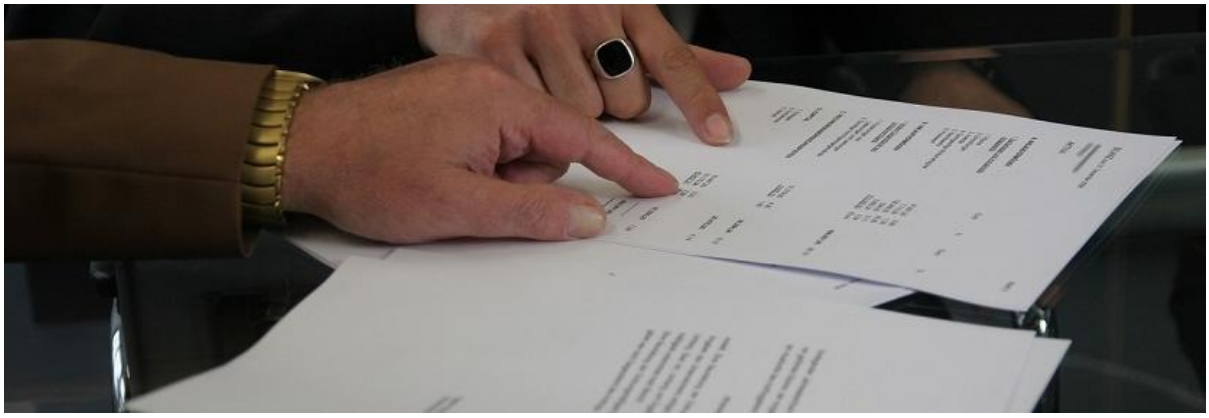
The potential liability relating to transferring employees will be a key concern for the purchaser and is often reflected in a lower purchase price.



The purchaser will have to give indemnities to the Administrators

The Administrators will not take on any risk, which means that they will require the purchaser to indemnify them against any liabilities arising in relation to the sale transaction or to the assets themselves. Among other things, indemnities covering any employment liabilities relating to the transfer of business will be non-negotiable.

An appointment as an Administrator is personal to the individual insolvency practitioner concerned, not to the firm for which they work or where they are a Partner. As a result, any liabilities which fall on the Administrators as office holders are personal too, hence the extreme risk aversion.

The Evaluator's report

Where the proposed transaction is with a connected party such as the existing management or owners, an 'Evaluator's report' will be required[2] under the terms of the Administration (Restrictions on Disposal etc to Connected Person) Regulations 2021. These mean that the purchaser is obliged to obtain at its own expense a report of an independent Evaluator on whether the terms of the sale are reasonable. This increases the cost of a Pre-Pack purchase.

Instructing the right advisers

It is essential for the purchaser to have legal and other professional advisers who understand the Pre-Pack sale and purchase process and its risks, and who are experienced in conducting negotiations under the tight deadlines and within the limited risk mitigation options fundamental to such sales.

Reference

1 Jukes, M. (August 2024) 'Pre-pack numbers soar but concerns remain over new connected-party process'. *Recovery*. Available at: https://www.r3.org.uk/technical-library/recovery/recovery-news/more/32174/page/1/pre-pack-numbers-soar-but-concerns-remain-over-new-connected-party-process/?

2 Haywood, M. and Wilkins, S. (July 2021), 'Pre-Packs: The New Regulations'. *Digest*. Available at: https://southsquare.com/articles/pre-packs-the-new-regulations/