The voice of long-term investment

1st Floor North, Brettenham House
Lancaster Place, London WC2E 7EN
T: +44 (0)20 7420 1800
F: +44 (0)20 7420 1801
E: bvca@bvca.co.uk
www.bvca.co.uk

The Insolvency Service
IP Policy Section
Zone B, 3rd Floor
21 Bloomsbury Street
London
WC1B 3QW
By email: ippolicy.section@insolvency.gsi.gov.uk

7th July 2011

Re: Publication of Working Copy of Draft Statutory Instrument on Pre-packaged Sales ('the Proposed Rules')

Dear Sirs

A About the BVCA

The British Venture Capital Association (the BVCA) is the industry body and public policy advocate for the UK private equity and venture capital industry. With a membership of over 450 firms, the BVCA represents the vast majority of all UK-based private equity and venture capital firms and their advisors.

The BVCA has 25 years of experience representing the UK private equity industry to government, the European Commission and Parliament, the media, regulatory and other statutory bodies at home, across Europe and around the world. It promotes the industry to entrepreneurs and investors, as well as providing services and best practice to its members.

This response has been prepared by the BVCA's Legal & Technical Committee which represents the interests of BVCA members in legal, accounting and technical matters relevant to the private equity and venture capital industry. The views set out in this response do not necessarily reflect the views of all members of the BVCA.

B Summary Response

In the limited time-frame available for commenting on this aspect of the Insolvency Service consultation our approach in responding is to comment broadly on those aspects of the Proposed Rules which we consider likely to impact significantly on private equity investment. We have a number of general observations and then make further observations in relation to each of the provisions included at parts 2, 3 and 4 of the Proposed Rules.

The BVCA supports the government's policy in seeking to improve transparency and confidence in pre-packaged sales in administration. Accordingly, the BVCA is in principle supportive of the proposed measures at Parts 2 and 4 of the Proposed Rules requiring the administrator to opine on the efficacy of the pre-pack administration and requiring the administrator subsequently to report details of the pre-pack. However, we are concerned that the approach proposed in Part 3 of the Proposed Rules (which envisages advanced notification being made to creditors of a prospective sale to a widely-defined category of connected or associated party) will be damaging to the economy as it is likely to deter existing private equity house investors (and presumably, existing bank lenders) from funding the rescue of businesses in financial difficulty. If the Proposed Rules are implemented we are of the view that fewer businesses will be rescued, fewer jobs will be saved as more company assets will fall to be disposed of on a break-up value basis, or on the basis of a depleted going concern value. Accordingly, we would urge a re-think on the introduction of the proposals at Part 3 of the Proposed Rules. Alternatively, the scope of Part 3 of the Proposed Rules should be significantly reduced so as to minimise the adverse impact of this aspect of the Proposed Rules.

We would also add that it is important that issues concerning the regulation of pre-packs are viewed in context. The reality is that where pre-packaged sales to existing lenders or private equity houses (as other potential sources of on-going funding) are contemplated it will invariably be the case that the value of the business breaks at the secured creditor level, with the consequence that (subject to limited statutory priority) unsecured creditors will lose out by reason of the secured creditor's prior claim on the assets. Unsecured creditors may nevertheless benefit from the sale of the business as a going concern because the higher values achieved will increase any prescribed part falling to be paid under the Insolvency Act. Creditors may also have the opportunity to continue to trade with the business going forward and employment opportunities may continue.

C: Specific Comments:

Part 2 of the Proposed Rules – The Administrator's opinion concerning a pre-pack strategy.

In principle (and presumably subject to appropriate amendments to reduce the currently rather open-ended statement envisaged of the administrator to one consistent with the administrator's existing standard of care in relation to sales) the provision of such a statement is consistent with the government's strategy of increasing transparency and so may be helpful to creditors. As the administrator is a court officer and owes duties to creditors as a whole, (and further could be pursued in an action for breach of duty pursuant to paragraph 74 Schedule B1) we envisage that that a proposed administrator intending to pursue a pre-pack strategy would be able and willing to provide such an opinion. The office holder would presumably want to satisfy itself as to the efficacy of the pre-pack in any event from a compliance and risk-management perspective.

Part 3 of the Proposed Rules – The administrator not to sell the whole or part of the assets or the business of the company to connected or associated persons unless they were previously available for sale in the open market or three clear business days notice is given to creditors.

The Proposed Rules rightly contemplate that offering the company assets for sale in the 'open market' may not always be feasible, and go on to provide for a notification procedure in that eventuality. We believe that there will be circumstances where there has been substantial exploration of the market, but not open market offer because that has been concluded to be value destructive. We do not understand why notice should be required for a connected sale in those circumstances. A requirement to give notice (where no prior open market valuation has been conducted) will cut across and undermine the very basis upon which ordinarily pre-packs operate to drive the best realisation value for a business. This dampening effect on value (and accordingly level of creditor recoveries) is likely to arise for the following reasons:

(1) Once a public announcement of an intended pre-pack is made to creditors a company's value is likely immediately to reduce because of the risk that counterparties to its contracts, customers, suppliers and licensors and the like, may choose opportunistically to terminate those contracts and walk away. Any potential purchaser of the business through a pre-pack will inevitably factor in this risk of significant erosion of the goodwill value of the business to its pricing when making its purchase offer.

Therefore, whilst the transparency of the process may have been increased, this is likely to correlate directly with a reduction in the value of the business. The fall off in value of the goodwill of the business might, of course be reduced if changes were also to be introduced to limit the extent to which contractual termination clauses are enforceable, although this provision is not proposed in the Proposed Rules (and presumably may in any event need to be made by means of primary legislation.)

(2) Part 3 of the Proposed Rules appears to introduce potentially:

- rather open-ended periods of uncertainty from the point of view of a prospective purchaser, and also;

- potentially rather open-ended periods of time and costs for the administrators (and related fees of the administrators' advisors) in dealing with any representations received from creditors who are notified on the proposed pre-packs.

The periods of uncertainty arise because it is not clear if a creditor makes representations how the company or its proposed administrators are, should or might deal with this. If all that is intended is to create an opportunity for a creditor to intervene with the court to restrain a sale to which it objects, a challenge which it seems likely would require evidence of bad faith, we suggest that be made clear. Otherwise, in order to ensure that the administrator is not at risk to misfeasance proceedings arising in connection with a creditor representation under the Proposed Rules, the administrator or those advising the administrator, may consider it prudent to apply to court for directions. This will increase costs and reduce distributions. It will also increase the burden on the courts. Further, the contemplated purchaser may choose to walk away from the potential purchaser in the face of the associated delay and uncertainty.

The issue of delay is also relevant in the requirement to give individual notice to creditors. This could present a substantial logistical challenge. There are presumably also issues of when the notice would be regarded as having been given. It seems to us that advertisement would be a better method of announcing the intended sale. We consider that individual notices would do little to preserve confidentiality.

It may be that a policy decision has been taken that the aim of creating more transparency takes priority over realizing best value for creditors. If that is so, it would seem legitimate to consider whether there may be other interests to weigh against the desire for transparency. These need not necessarily be creditor interests. They might include the likelihood of serious harm, economic or otherwise, to third parties (such as customers relying heavily on continuity of supply including of customised products and customers of businesses providing care or other essential services) arising from the delay in consummating the sale. Accordingly, if a notice regime is to be introduced, we strongly suggest that the court be given the discretion to waive the requirement if it considers that compliance with it would be disproportionately detrimental to creditors or others.

Another major concern regarding Part 3 of the Proposed Rules is the proposed scope of its application. It would appear that the rules would encompass many if not all sales of business assets to newco vehicles established by existing private equity funders to the business. Also, we consider that the use of the definition of “associate” in section 435 of the Insolvency Act would be inappropriately restrictive of private equity acquirers of businesses in pre-packaged administration sales, where there are existing private equity owners. We say this because private equity funds are invariably established as limited partnerships. The test for shareholder "association” with companies is based on actual control or 30% voting rights. Limited partners have no involvement in the management of the partnership or its assets, whether or not the limited partnership satisfies the actual control or 30% test in relation to a company in which it has invested. However each limited partner will be an associate of each other partner and therefore of any company associated with the partnership. For this reason bids from individual limited partners attract the notice requirement. The same would also apply to other private equity bidders if they had among their limited partners persons who were limited partners in the current limited partnership shareholder, or indeed were the spouses or civil partners of such partners. Investors in private equity funds are often overseas parties and frequently have holdings across a number of funds. This would make the analysis of “association” extremely difficult for an administrator.

In response to the current world economic climate many funds have been established to target distressed assets. This is a welcome source of additional risk capital at times when bank finances are constrained. We doubt it is the intention of the draft rules to disadvantage bids from such funds (or other private equity bidders) purely of the basis of one or more common limited partners. We suggest that at very least the reference in the draft rules be modified so that there is no association triggering the notice requirement by reason only of membership as a limited partner of a limited partnership.

For the reasons we refer to above, such potential private equity purchasers may choose instead to walk away (and to pull the plug on rescue funding) in the light of the uncertainties and risks created by the Proposed Rules. This would indeed be unfortunate particularly given that there are existing remedies available to creditors (in particular paragraph 74 of Schedule B1) should they consider that the administrator’s conduct falls short of the standard required of him in agreeing the sale.

If the proposed provisions dealing with creditor notice are implemented we would urge that they are limited in their application to SMEs given the broadly consensus view that abuse of pre-packs is more likely to be prevalent in the smaller value cases (see, for example paragraph 2.8 of the Government’s response to consultation.)

We also consider that Part 3 of the Proposed Rules is in any event too prescriptive of how the administrator may market the sale of corporate assets without triggering the proposed notification requirement. The rules contemplate that the assets will be made available for sale in the open market, a term which is not defined, but which seems to imply some form of general publication. In our view it is doubtful that a blanket requirement to advertise publicly is likely in all (or even in many) cases to be the best way to achieve value, and we say this for substantially the same reasons as our comments above relating to termination rights and uncertainties. We consider that administrators should determine in every case the best way to achieve value and should be afforded maximum flexibility to do so according to sometimes rapidly changing marketplace practices. The Proposed Rules may in practice act as a fetter on administrator's discretion to take the most appropriate marketing steps. Purchasers of distressed assets in other jurisdictions, for example the US, are in certain circumstances entitled to claim fees for acting as a 'stalking horse', where there is uncertainty as to whether the purchase with them will complete, and at the top end of the market a similar practice might become more widespread in the UK. In other cases, an administrator may seek to negotiate what is sometimes termed an 'anti-embarrassment fee' providing for the purchaser to make an additional payment to the company in administration in the event of an on-sale within a fixed short-term time-frame, for profit. Part 3 of the Proposed Rules might promote greater transparency, but in several respects would be likely to do so at the expense of value and recovery. Notwithstanding the above, if there are to be rules requiring notice of proposed connected sales (hopefully on a narrower definition) we think that advertisement of that notice is preferable to giving notice to individual creditors.

Part 4 – Details of the sale to be reported if it takes place before the administrators' proposals

In our view the information published needs to take account of commercial confidentiality. If there is a requirement to publish information which a prospective purchaser would view as sensitive in the future operation of the business, this is likely to affect the price offered or the willingness to bid. There should at least be a power for the court to order that certain information not be disclosed on the basis of its commercial sensitivity.

It is not clear to us why there is a need to publish details beyond those provided for in SIP 16. If this is thought necessary it is difficult to see why administrators should also have to publish the narrower SIP 16 information.

Please do not hesitate to contact me should you wish to discuss the BVCA response in further detail.

Yours faithfully

Simon Witney
Chairman, Legal and Technical Committee, BVCA