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UPDATE

Administrators, Pre-Packs and Conflict Risks

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English High Court case, *VE Vegas Investors IV LLC & ors v Shinners & ors* [2018] EWHC 186 (Ch) gives guidance regarding the risks inherent in pre-pack insolvencies and the importance of managing conflicts.

Pre-packs

In the insolvency context, a pre-packaged sale or pre-pack refers to the sale of some or all of the insolvent entity's undertaking, negotiated prior to the appointment of an administrator or liquidator, with the sale being concluded by the administrator or liquidator promptly after their appointment.

Pre-packs are an established option in Guernsey. They can have the advantages of being fast, cheap and effective means of realising the assets of a distressed business. Typically much of the negotiations will be conducted by those already in the business who know it well, allowing management a greater degree of control.

Such sales can fall for criticism, particularly when the purchaser is connected to the company's existing management. Transparency and the ability to demonstrate that market value has been obtained are therefore important aspects to the integrity of a pre-pack.

Case Facts

The VE Vegas case concerned a company (Company) which faced financial difficulties. Insolvency practitioners (IPs) met with the directors of the Company to discuss options. A pre-pack sale to the directors was the favoured option.

The pre-pack was not straight forward. There was a lack of clarity over the Company's assets and a failure to provide information to the IPs when requested. The information provided was less than was sought and insufficient to properly inform an arm's length purchase.

The IPs were appointed to act as administrators of the Company on 25 April 2017 (Administrators). In making the application for the appointment of administrators, it was not disclosed to the Court that there were potential issues with a pre-pack. The pre-pack sale to an entity incorporated by the Company's directors was concluded by the Administrators the day after their appointment.

Certain of the Company's creditors sought the Administrators' removal due to their apparent conflict.

The High Court found that serious issues needed to be investigated by the Administrators, specifically:

- whether the directors of the Company breached their duties by manipulating the pre-pack sale to their personal advantage; and
- if the Administrators had breached their duties of care and skill to the Company.

The Court found that the Administrators had an 'obvious' conflict in carrying out those investigations.

The Administrators ultimately indicated that they were willing to resign, but the Court nevertheless found that the most appropriate course was that the Administrators be removed.

Lessons

The judgment does not seek to prevent insolvency practitioners from providing pre-appointment advice. It does however remind practitioners for the need to be clear who their client is and to avoid conflicts of interest going forward. The judgment expressly left the door open to conflicts being addressed by alternative solutions. However what is clear is that such conflicts need to be considered and managed.

Administrators need not find themselves in this situation. In the UK Statements of Insolvency Practice (SIPs) have been adopted. For pre-packs, the relevant one is SIP 16. Had the SIP 16 guidance been demonstrably considered, the conflicted situation may have been avoided. Failure to demonstrate regard to that guidance left the Administrators without the benefit of important safeguards.

While SIP 16 is not binding in Guernsey, its principles were adopted by the Royal Court in the 2014 case of Esquire Realty Holdings. SIPs are supplemented by further non-binding local guidance from Guernsey Insolvency Practice Statements (GIPs). GIP 5, based upon SIP 16 and effective from 3 May 2017, addresses pre-packaged sales. Adhering to the standards in GIP 5 would again appear to have avoided many of the problems in this case.

In this instance, in addition to having insufficient regard to safeguards in industry-wide standards, the Administrators appeared to make their situation worse in how they responded to the application for their removal. The manner of their resistance resulted in a contested public hearing of several days, a detailed judgment which may be reputationally embarrassing and adverse costs consequences. Had the application been met in a different manner and a collaborative solution pursued, a less damaging outcome may have been achieved.

Though the Administrators were unfortunate enough to be the ones in the firing line in this instance, the case is equally applicable to other advisors involved in pre-packs, such as lawyers or valuers, to identify and manage their conflicts. Directors too should take the steer that Courts expect office holders to scrutinise their conduct if a pre-pack sale appears subject to manipulation.

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