

COVER STORY | BY MUAZZIN MEHRBAN

## Pre-packaged bankruptcies back in fashion



Some experts believe that pre-packaged bankruptcies are an effective means of preserving a company as well as a cheaper option than traditional insolvency processes. A pre-packaged solution, or pre-pack as it also known, allows companies to devise a reorganisation plan with its creditors prior to entering insolvency. To avoid liquidation, the company then enters bankruptcy proceedings so that the plan can gain court approval. Their use has become more frequent in recent months, as businesses attempt to salvage operations that have been devastated by the financial crisis. Their purpose is to offer a shorter, simpler bankruptcy process, ultimately saving money on legal and accounting fees. However, others question whether this is the case, claiming that sometimes more time and money is consumed outside of formal insolvency while arranging the pre-pack. In addition, the process has been criticised for lacking transparency, and failing to protect the interest of all creditors.

### UK expansion

In the UK, pre-packed bankruptcies are on the rise, and the continued uncertainty in the

financial markets means the trend is likely to continue. Chris Mallon, a partner at Skadden, Arps, Slate, Meagher & Flom (UK) LLP, explains some of the reasons behind the effect. "Pre-packs provide a simple but effective 'fast track' process to restructure a company's assets and business, particularly when compared to the alternatives such as schemes or company voluntary arrangements. Also, from a debtor's perspective, pre-packs are a far more attractive restructuring tool than a trading administration, as it allows the debtor to retain control over the sale process – meaning the management remains in control. There is also minimal disruption to business operations," he observes. Furthermore, the shortage in liquidity means that accessing the money needed for a trading administration remains difficult, and pre-packs can reduce those costs.

Backers of the pre-packaged process in the UK maintain that it can effectively achieve a successful turnaround while minimising disruption and reducing the risk to reputation, staff, assets, customers and suppliers. A traditional bankruptcy not only takes longer but also affects the enterprise value of a business.

Furthermore, there are extra risks and costs involved when trading a business through conventional insolvency. "Pre-packaged sales significantly reduce the time a debtor will spend in administration, which means there is little or no chance for further review by either the courts or creditors," affirms Mr Mallon. "In general, financially distressed companies are able to recover quicker and more cheaply in circumstances where a reorganisation or sale is agreed before entry into a formal process," he adds. Efficient pre-packing prevents legal and other professional costs from escalating while contingencies can be made to ensure funding is available if and when required.

Most importantly, the pre-pack process allows debtors to continue operations while chasing a sale, a route that is not possible in normal UK bankruptcies. In this scenario, where operations are maintained and a set course has already been plotted, suppliers, employees and customers will be far more cooperative, knowing that to some degree it is business as usual.

But the use of pre-packs has been criticised by some experts who believe that the sale of a company under this process can often lead to it being undersold, as it is not expected to true market conditions. "Also, there are serious concerns about the objectivity and transparency of the process, as it often involves the sale of assets to existing management and shareholders," notes Mr Mallon. However, recent legislative changes include SIP 16 (Statement of Insolvency Practice) which sets out the requirements that insolvency practitioners are expected to meet. In addition, a code of conduct has been outlined aimed at preventing the misuse of pre-packs. The new regulations could be extended further, should issues regarding transparency persist.

### Changes in the US

As in the UK, statistics show that pre-packaged bankruptcies are on the rise in the US. Experts believe this is partly due to companies seeking ►►

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the help of financial advisers much earlier in the process, giving them more time to act on the advice. They are increasingly realising that if professional help is sought too late, there is very little that can be done to save a company. Also, “the financial and legal advisers being brought in are very aware of the changes to the Bankruptcy Code that occurred in 2005,” adds Thomas J. Salerno, co-chair of the International Insolvency Reorganization Group at Squire, Sanders and Dempsey LLP. “Specifically, there is now an absolute drop-dead date for a debtor’s exclusivity period to file a plan of 18 months from the filing date, which is significant.” In addition, Mr Salerno highlights the effects of the subprime mortgage crisis, which has made it difficult to raise exit financing in the US. Plans to reorganise will often hinge on the company’s ability to obtain viable exit finance.

“As such,” continues Mr Salerno, “pre-packaged bankruptcies are being used to lock in exit financing whenever and wherever possible to avoid the vagaries of the volatile credit and capital markets. Hence, companies want a pre-packaged or pre-negotiated process to help speed it through the process,” he explains, adding that there are also some pitfalls that businesses should be aware of when planning for

a pre-packaged bankruptcy. For example, Mr Salerno considers pre-packaged bankruptcies to be inappropriate when there are a number of widely dispersed claims. In those situations, a company will need the normal bankruptcy system to bind claimant groups. Within a pre-packaged bankruptcy, it could be difficult to determine all creditors, “You need Chapter 11 to do that,” he asserts. “The pre-packaged and pre-negotiation bankruptcies work best when you are aiming them at finite and sophisticated constituencies, such as bond holders.” Furthermore, the pre-packaged process can leave troubled companies open to disgruntled creditors. If approached regarding a pre-packaged bankruptcy, they could react by filing for an involuntary bankruptcy, choosing the option which is most likely to see them recoup their lending. This is one of the reasons why discussions regarding pre-packs can take a long time. Aggressive debtors can be very disruptive in this period, so communication is an important element of planned Chapter 11s.

In addition, the process does not always save money or time – rather, they are just consumed in different ways. Businesses may spend less time in the actual formal bankruptcy process, but this does not necessarily change the amount of time and money spent negotiating with creditors as part of the restructuring plan. “Statistically speaking, many pre-packaged bankruptcies do not result in a resolution of the financial problems for a distressed company,” says Mr Salerno. “Experts conferred that pre-packaged bankruptcies were statistically more likely to result in a second bankruptcy filing, unlike bankruptcies that were negotiated through the usual, in-court process.” Many analysts suggest that while pre-packaged bankruptcies may be a ‘quick fix’, they are not always the ‘best fix’.

**Return of the German pre-pack**

In Germany, pre-packaged bankruptcies have not played a major part in restructurings. Indeed, insolvency as a whole is still considered to be a threat to the reputation of a company, despite some success in previous cases. However, Jochen Wentzler, a partner at Deloitte, believes the attitude towards insolvency in Germany is slowly changing, meaning that the use of pre-packs is becoming increasingly acceptable. “Against the background of the current situation, the use of pre-packs seems to be a feasible alternative as a final negotiation between the

stakeholders to avoid an insolvency becoming more difficult,” he says. “However, it is still a challenge to introduce the option of a pre-packaged bankruptcy in a restructuring process. Only companies which have engaged very experienced restructuring advisers will choose a pre-packed insolvency.” Nonetheless, this is a positive development. When compared to an out-of-court restructuring process, the cooperation of creditors can be attained more quickly and easily in insolvency. It also provides a way for companies to dispose of highly leveraged liabilities and disadvantageous contracts.

Because of Germany’s trepidation regarding the insolvency process, the only noticeable pre-packed case was that of Sinleffers, a German department store. In order to successfully emerge, the retailer was forced to close nearly half of its stores and eliminate over a third of the workforce. However, the pre-pack was deemed to be successful, and the company may well become profitable during the next year.

Whether such successes will dissolve the negative stigma that comes with insolvency remains to be seen. Ultimately, it is vital that attitudes change to ensure that viable companies do not end up losing both customers and suppliers. “This is why it is necessary to convince the relevant parties that the pre-pack plan is a perfect alternative,” explains Mr Wentzler. Furthermore, pre-packs have several advantages over the traditional insolvency process. “In Germany, the administrator is chosen by the court - the company and the creditors have very little influence on the decision,” warns Mr Wentzler. “There is a risk that the insolvency administrator takes the easy way out and sells business operations in an asset deal.” For this reason, it is recommended that a company develops a pre-packed plan once it becomes clear that bankruptcy is inevitable.

It is important that restructuring measures and the bankruptcy plan are outlined before insolvency proceedings begin. If a plan is tabled afterwards, the damaged reputation of the company could result in negative actions on behalf of creditors, customers and suppliers. “As opposed to a regular insolvency, where the business of the company will be sold in an asset deal, a bankruptcy plan implies the restructuring of the company. It will therefore usually lead to better quotes for creditors. As the legal entity is maintained, shareholders will regain shareholder value as well,” explains Mr Wentzler.



### Pre-packs in the offshore context

Pre-packs as understood in the countries discussed above do not really work in most of the key offshore jurisdictions. Take, for example, the Cayman Islands. This is considered to be a creditor-friendly jurisdiction and its financial laws do not subscribe to the current rescue culture seen in other developed markets, particularly the US. The insolvency process in the Cayman Islands is essentially liquidation, and is not comparable to US chapter 11 or UK administration. "Accordingly, pre-packs are virtually an alien concept in the Cayman environment," says Andrew Bolton, a partner at Appleby. "However, the courts in the Cayman Islands have a long tradition of practical flexibility when it comes to insolvency procedures and if presented with a sufficiently compelling case, there is a possibility that something akin to a pre-pack could be accomplished in the Cayman Islands," he suggests. On the other hand, Mr Bolton admits that the Cayman Islands are not as experienced in such processes and it is likely that any such mechanism would be much slower than a true pre-pack.

Frequently, a scheme of arrangement is used to aid troubled companies in the Cayman Islands. Successful implementation of such a

scheme may enable the company to continue running as a business. A scheme can only be approved if a majority in number and 75 per cent by value of creditors in every asset class votes in favour of the arrangement. Schemes take some time to implement, time that could be minimised by obtaining the necessary support in advance, through a pre-pack. But courts can still dismiss the arrangement if it feels the minority creditors are being treated unfairly.

Alternatively, a pre-negotiated sale of a company's business and assets might be possible, though it would involve court proceedings. "If the sale did not generate sufficient money to pay all creditors, it would be a brave board of directors that would conclude the insolvency process outside the environment of an insolvency proceeding," remarks Mr Bolton. New legislation introduced to the Cayman Islands at the beginning of March stipulates that voluntary liquidation is only available when a company is solvent, so in insolvent situations there is no out of court option. "In addition, because of a need to notify creditors, there is always a time lag between the presentation of a winding up petition and the making of an order appointing official liquidators," explains Mr Bolton. "Provisional liquidators can

be appointed in the interim, but they are not normally empowered to commence the actual liquidation, as it is their responsibility to preserve assets that are at risk." Mr Bolton suggests that in limited circumstances the court might let a provisional liquidator conclude a pre-negotiated deal where the debtor has demonstrated to a court that that deal was the best option available to creditors and, that it would not be available by the time official liquidators were appointed.

### Conclusion

Differences in location aside, it is important for companies considering a pre-packaged bankruptcy to have agreements with as many constituencies as possible before making an official filing. Immediate action is essential to any bankruptcy plan as forces outside a company and creditor control may force it into bankruptcy. Without prior arrangements, a distressed business could enter a freefall bankruptcy, an unpredictable scenario, wherein liquidation could occur regardless of its effect on the stability and longevity of a company. Although not always avoidable, it is a circumstance that debtors should at least try to steer clear of. ■



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Andrew Bolton is a Partner, and the Global Head of Appleby's Litigation and Insolvency Practice group. His experience is in the area of commercial litigation, including fraud, asset recovery and professional negligence. He currently divides his time between the Jersey office of Appleby, from where he manages the practice group and provides litigation and insolvency advice on Cayman and BVI matters to clients in European time zones, and the Cayman office, which is his home jurisdiction.

Clients and legal practitioners interviewed by Chambers Global in 2006 and 2007 describe Andrew as follows: "Measured, sensible and reliable' presence on insolvencies and large-scale commercial disputes, as well as trust

litigation'. 'Onshore litigators say his experience at Freshfields in London provides him with an edge over competitors'. 'On a different page altogether from anyone else'. 'Technically strong and responsive, he is a hit with international clients because of this assured, down-to-earth, solid advice that you can trust and rely on".

Andrew has been ranked by Chambers Global for Dispute Resolution and Litigation: General Commercial from 2004 – 2007, and for Dispute Resolution and Dispute Resolution: Trusts in 2008. He was ranked by IFLR1000 for Insolvency & Restructuring in 2007, as well as by Practical Law Company (PLC) Which Lawyer? in 2006, 2007 and 2008 for Dispute Resolution, and Restructuring and Insolvency for 2007/ 2008.

Andrew has written articles on a variety of topics and has spoken at conferences both in the Cayman Islands and in the United States.

Andrew qualified as a Solicitor, England and Wales in 1989 (now non-practising). He Worked for Freshfields (now Freshfields Bruckhaus Deringer) in London and Brussels from 1987-1997, including a year on secondment to the Bank of England. Andrew joined Appleby in 1997 and was admitted as an Attorney-at-Law in the Cayman Islands. He became a Partner in 1999. In 2006, he was admitted as a Solicitor of the Eastern Caribbean Supreme Court (British Virgin Islands Circuit).