[2019] 2 IBJ (Art.) 1

Section 29A of the Insolvency and Bankruptcy Code, 2016 – Is there an opportunity for a rethink?

The debate around section 29A of the Insolvency and Bankruptcy Code 2016 shows no signs of abating. More and more cases continue to appear before the courts seeking a determination on who, in each specific case, is able to put forward a resolution plan in respect of a distressed business. Of particular interest for the purposes of this article is the question of promoters and related parties and the manner in which such parties are dealt with under the English insolvency regime.

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Related Parties

As readers will be aware, the amendments introduced by Section 29A restrict the scope of those who are able to submit a resolution plan under the Code. The amendments provide that parties who are a "*related party*" to another defaulting party, amongst others, are prohibited from putting forward a resolution plan and thereby gaining control of the distressed company and its assets. Readers will also be aware of the carve out for MSMEs but it is clear that, even with such carve out, the mere existence of the provision means that promoters and certain other parties are not being given the opportunity to salvage a distressed business, even in circumstances where the financial precariousness of the business is not of their doing but rather may be a result of the economy more generally or of other market forces. There is of course an opportunity for related parties to participate in the resolution process by clearing all outstanding debts but the question remains whether this should be the only basis on which they are allowed to do so.

The issue of sales to related parties is linked to that of phoenix companies and justifiably raises concerns amongst creditors and stakeholders around the ethical and moral nature of such sales. In some cases, the related parties may in fact be the ones responsible for the company's demise. There is an argument that, in those circumstances, it would be unjust for those same parties to then be able to benefit from the company's demise, by buying back assets at a distressed rate whilst leaving behind the company's debts.

Despite this argument, it may be that further consideration should be given to the issue and the wording of Section 29A. There are, and will no doubt be, in certain circumstances genuine and sound commercial reasons for concluding a sale of a business to a party that currently falls within the remit of Section 29A. Given that the aim of the Code is to achieve a resolution of the company's affairs rather than place it into a formal liquidation process, narrowing the scope of those who are able to help provide such a resolution appears to hinder this aim. It is also likely that Section 29A will place an additional burden on Resolution Professionals ("**RPs**") who will have to carry out enhanced due diligence when approached by bidding parties to establish their connection, or lack thereof, to the company in question. It is also likely, as already appears to be the case, that RPs will look to the Courts to determine whether or not a given party is precluded from putting forward a resolution plan in light of Section 29A. Given the volume of cases going through the courts at the moment dealing with all aspects of the Code, if this additional burden could be alleviated in some way by way, that would no doubt be welcomed by all.

It is with the above in mind that I explore below some mechanisms that exist within the English insolvency regime, which enable sales to connected parties although they require certain hurdles to be overcome and satisfied. Although legislation and regulation already provides for some of these safeguard mechanisms under the Code, there are further opportunities that could be exploited which would allow for more transparency and accountability thereby alleviating certain creditor concerns. There are clearly benefits in enabling sales to connected parties in certain circumstances, such as allowing jobs and businesses to be saved whilst also possibly staving off the additional domino effect of insolvency that would otherwise impact on trade creditors and suppliers of the distressed company further down the supply chain.

The way in which sales to connected parties, in the vast majority of cases, takes place under the English insolvency regime is by way of a pre-packaged administration sale or "pre-pack". Although a useful tool in insolvency here in England, the pre-pack sales have not been without criticism.

What is a Pre-pack Sale?

A pre-pack administration will occur when an administrator sells the distressed company's business immediately following, or very soon after, his or her appointment. Such sale will often be to the existing owners/directors of the business and all the work for the sale will have been carried out in advance of the formal appointment of the administrators. Usually, the negotiations will have taken place before the creditors will either have been told about the failure of the business or before they find out. Having said that, in reality, creditors will often be aware that the company in question is in some form of financial difficulty in circumstances where it is likely that their invoices will have gone unpaid for some time. The pre-pack will also often be negotiated under the protection of an interim moratorium triggered by the filing of a notice of intention to appoint administrators.

Despite criticism of pre-pack sales, they are still seen as one of the most effective ways of rescuing a business and achieving a return to creditors in the most cost effective way possible. Often, where news of an insolvency would cause irreparable damage to the insolvent seller's goodwill and business (and therefore impact on ultimate value obtainable), a pre-pack will be the best, or indeed the only, way to ensure that the business of the insolvent seller can continue trading without interruption or destruction of value. Although there will often be a deferred element of consideration, it may be possible for the administrators to take security over the purchaser's company to secure the deferred element of the consideration or, assuming the purchaser is a special purpose vehicle set up to make the acquisition ("**NewCo**"), a guarantee from the purchaser's parent. There will, nonetheless and in the majority of cases, be an initial upfront element of the consideration thereby immediately bringing cash into the insolvent estate early on (which in turn could allow for investigations to uncover claims and further assets to take place).

Looking back at figures available for 2017, they show that only 2% of the corporate insolvencies that took place involved a pre-pack.[1] As such, although pre-pack sales are concluded in a very small proportion of overall corporate insolvencies, they continue to attract a disproportionate amount of column inches in the national newspapers as well as time in Parliamentary debate. Why is this and are the criticisms justified?

Criticisms of pre-pack sales

Criticisms of pre-pack sales, which generally come

1. *Pre-Pack Pool Annual Review 2017 (published May 2018)*

from creditors and other stakeholders, tend to arise in circumstances where a sale has been negotiated and completed to a connected party. The following issues tend to be raised: (i) lack of transparency; (ii) marketing; (iii) valuation; and (iv) directors and shareholders being perceived to benefit from obtaining the assets and business but leaving behind a trail of debt and unsatisfied creditors. There is also often criticism levelled at NewCo itself if it fails within a short period, thereby effectively simply stalling the failure of the ultimate business.

Lack of transparency comes from the fact that marketing of a distressed business and its ultimate sale by way of a pre-pack will often take place quickly and, in some cases, quietly. Part of the reason for this is to preserve value as, if news of a company's financial difficulties were to become widely known, that is likely to have an impact on value, which the administrator is seeking to maintain for the ultimate benefit of creditors.

Criticism of the amount of marketing done (in terms of number of parties approached and time allowed for conclusion of a sale) stems from the same issue, being the speed with which pre-pack sales tend to be concluded and lack of publication of the marketing process. Sales will often be concluded within a matter of weeks and there is an argument that the market has not been properly tested to allow an informed view on what would be market value for the business.

Finally, there are criticisms levelled at valuations received by the administrators and from whom. So, for example, is there a secured creditor involved who has influenced the decision around which valuation agent to use? The recent case of *Davey v Money[2018] EWHC 766 Ch* considered this point and noted that there is no issue in an administrator using an agent recommended by the secured creditor as long as the agent in question has the relevant expertise.

It is with these criticisms in mind, and others, that in July 2013 the UK Government commissioned a review of the pre-pack sale process.

Government Intervention

Teresa Graham CBE was tasked to carry out an independent review which resulted in a report called the Graham Review being published in June 2014. In very broad summary, the Report concluded that pre-packs attracted a disproportionate level of attention and criticism given the numbers of pre-packs actually being concluded at the time. The review made six key recommendations including:

(*i*) the setting up of the pre-pack pool ("**the Pool**");

(*ii*) that SIP 16 reports be monitored by the Regulated Professional Bodies ("**RPBs**") rather than the Insolvency Service as was the case at the time; and

(*iii*) that marketing of businesses and assets of a distressed company comply with six principles of good marketing with any deviation from these to be brought to the creditors' attention.

This year, the Government is due to review the impact of the Pool as well as the other reforms which were brought in to tackle issues around the use of pre-packs. With Brexit looming, however, it is difficult to say how much time the Government will have to dedicate to such review. Interestingly, part of the aim of the review is to consider whether sales to connected parties need to be further regulated or indeed banned altogether. If the Government were to ban such sales, many of us working within the insolvency industry here in England would consider that to be ill-advised in circumstances where there is clear benefit to be had, if carried out in the right manner and with the correct safeguards in place. As such, it is a tool that should remain but one that should be closely monitored.

Statement of Insolvency Practice 16 ("SIP16")

Insolvency Practitioners ("**IPs**") follow a set of guidelines set out in what are known as Statement of Insolvency Practices ("**SIPs**") which are numbered and agreed by the RPBs. The SIPs deal with wide ranging issues such as conflicts and time recording and although not binding, carry sufficient force that any IP would be unwise not to follow them in circumstances where compliance is monitored by their respective RPBs.

SIP 16 deals with pre-pack sales and sets out various issues that the IP needs to answer and which, ultimately, will be put before creditors in the form of a report that must be delivered within 7 calendar days of the sale. It is in this way that transparency is achieved as the IP's whole decision making process is laid bare for all to scrutinise. In the event that a creditor or stakeholder takes issue with any aspect of the sale, it is within their gift to make an application to Court to have the matter considered. Further, if considered appropriate, a complaint can also be made to the IP's RPB for failure to comply with SIP16, for example. As well as being sent to creditors, the SIP16 report will also be sent to the IP's RBP, of which there are five in England and Wales. The RPBs produce a combined annual report which indicates the number of SIP 16 reports they have received, the number that have been reviewed, and also lists the percentage deemed to be non-compliant. In recent years, the RPBs have not been reviewing all SIP16s received but have rather focused on those submitted from IPs who have previously been found to be non-compliant, those who have not submitted for a long period of time or, conversely, from those IPs who appear to be submitting a disproportionately high number.

SIP 16, as revised following the Graham Review, requires IPs to explain any deviances from the marketing principles which are: (*i*) broadcast the business as widely as possible; (*ii*) justify the marketing strategy; (*iii*) exercise independence; (*iv*) allow a sufficient time period for marketing; (*v*) use different methods of publicising; and (*vi*) explain how the marketing strategy has achieved the best value possible.

The Pool

The Pool, one of the recommendations that came from the Graham Review, was set up in 2015 and is made up of 20 members, all of whom come from the world of commerce. The aim of the Pool is primarily to ensure that the viability of any proposed "phoenix" entities is considered by an independent business expert. To a degree it also provides comfort and reassurance regarding the terms of the proposed transaction, but the Pool's remit is limited to opining on the viability of NewCo, not on the commercial terms of the transaction. The Pool is independent of the Government. In short, a connected party purchaser may approach the Pool for an opinion on the viability of its proposal to trade the business of the insolvent seller from a new entity.

The responsibility for making a referral to the Pool lies with the connected party purchaser, not with the relevant IP. This is notable as it could explain why it is that the number of referrals has dropped since the Pool came into existence. Currently, there are no consequences for purchasers in the event that they do not refer a purchase, which should in fact have been referred, and no pressure is being applied on the purchasers (by banks or trade creditors for example) to act as an incentive to ensure they do in fact make a referral. The only obligation on the IP is to inform the purchaser of the option to use the Pool.

The Pool has no binding authority and no judicial force. The cost of making an application is £950 plus VAT and the Pool aims to respond with an opinion within two working days from the application being made and the fee being received. All applications are received on a rotational basis and purchasers are not able to choose a specific member of the Pool to review the application.

When a referral is made, one member from the Pool will review it and deliver one of three opinions on the proposed sale: (*i*) the case for the pre-pack is not unreasonable; (*ii*) the case for a pre-pack is not unreasonable but there are minor limitations in the evidence provided; or (*iii*) the case for the pre-pack is not made.

A review carried out by the Pool in May 2018 of the period 1 January 2017 to 31 December 2017 highlighted the following:

- A total of 23 proposed connected party pre-pack sales were submitted to the Pool for review. Of those, 11 received a "not unreasonable" opinion, 8 received a not unreasonable but limitations in the evidence and 4 received a case not made out opinion.[2]
- According to the RPB's, in that same period, there were 356 SIP16 reports filed, of which 203 involved a purchase by a connected party (57%).

Interestingly, the number of referrals to the Pool has dropped in its second year of operation. The first year, 2016, saw one in four eligible cases being referred to the Pool. In 2017, this figure dropped to one in ten. There could be a number of reasons for this drop such as IPs becoming more confident in the manner in which they are conducting themselves in relation to such sales or the number of pre-packs actually taking place. The opinion as delivered by the Pool will be made available in the SIP 16 report as well.

Comment

Through the use of both SIP16 and the Pool, the insolvency regime in England has made it easier for sales to connected parties to be concluded in an open and transparent manner and makes IPs accountable for their conduct. Having these mechanisms in place has gone some way to tackling the criticisms that were previously levelled at pre-pack sales and has enabled several businesses and jobs to be saved as a result. In particular, the guidelines around marketing have sought to ensure that IPs have parameters within which to work and must explain any deviances to creditors. Ultimately, the aim is to achieve the highest return to creditors which, in some circumstances, will involve a sale of that business to related parties.

Often there will only be a very small market of individuals or other competitor companies interested in the business or assets up for sale. This may be because of a niche industry or due to what is being asked of the proposed purchasers (timeframe, logistics, funding, due diligence requirements). As such, it may be legitimate to conduct a small marketing exercise and sell to a connected party.

With the aim of the IBC being resolution rather than formal liquidation, it may be that enabling sales to related parties in certain circumstances would achieve this in more cases and Section 29A therefore needs a rethink.

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2. *Pre-Pack Pool Annual Review 2017*

[2019] 2 IBJ (Art.) 6

Insolvency and its Powers Over Pending Winding Up Proceedings

In this brief note, the author deliberates on the ruling of the Supreme Court in the case of Jaipur Metals *upholding the overriding effect of a Corporate Insolvency Resolution Process initiated during the pendency of winding up proceedings where no final order for liquidation was passed.*

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Overriding Effect of Corporate Insolvency Resolution Process

The Supreme Court, on 12th December, 2018, passed a landmark judgment, in the matter of *Jaipur Metals & Electricals Employees Organisation* v. *Jaipur Metals & Electricals Ltd*. [2018] 1 IBJ (JP) 697, wherein it upheld the overriding effect of a Corporate Insolvency Resolution Process ('CIRP') initiated during the pendency of winding up proceedings against the Corporate Debtor where no final order for liquidation was passed. The reasoning of the Supreme Court favoured the filing of an independent proceeding by the Financial Creditor under the provisions of the Insolvency and Bankruptcy Code, 2016 ('Code'), as it would prevail over anything inconsistent in terms of Section 238 of the Code.

Mandatory Effect of Section 434 of the Companies Act, 2013

As the winding up proceedings pending against the Corporate Debtor had originated on the basis of a reference for winding up made by the Board for Industrial & Financial Reconstruction ('BIFR') under Section 20 of the Sick Industrial Companies Act, (Special Provisions) ('SICA'), the Supreme Court also looked into the Companies (Transfer of Pending Proceedings) Rules, 2016 ('Transfer Rules')and held that while such cases of winding up initiated as per Section 20 of the SICA would remain pending with the jurisdictional High Courts, they must mandatorily be transferred by the High Court on an application made before it in terms of Section 434 of the Companies Act, 2013 (the Act) as amended by the Insolvency and Bankruptcy Code (Amendment) Act, 2017.

Genesis of Case before Supreme Court

The case before the Supreme Court arose out of the order dated 1st June, 2018 passed by the High Court of Rajasthan wherein the High Court stayed the CIRP admitted by the National Company Law Tribunal ('NCLT') against the Corporate Debtor, *inter alia*, relying on the Transfer Rules, stating that it would remain with the High Court where the petition for winding up has been served on the respondent, and that the NCLT had no jurisdiction to intervene in the winding up proceedings pending before it. Further, certain writ petitions filed by the labour unions of the Corporate Debtor, for recovery of their salaries and dues were also pending before the same High Court and the impugned judgment asserted jurisdiction and right to proceed with the same, in lieu of directions issued to the Official Liquidator to act provisionally in evaluating the assets of the company, for possible repayment of the labourers' dues.

Ruling of the Supreme Court

The Supreme Court held that on account of repeal of the SICA, winding up proceedings initiated in terms of Section 20 of the SICA would remain with the jurisdictional High Court until a party files an application in terms of Section 434 of the Act for transfer of the proceeding to be dealt with under the relevant provisions of the IBC. The Supreme Court explained that Rule 5(2) of the Transfer Rules, before they were omitted by amendment, put an embargo on the transfer of proceedings, initiated under Section 20 of the SICA, to the NCLT. The Supreme Court held that cases which fall under Section 20 of the SICA are to be dealt separately under Rule 5(2) and cannot be treated as proceedings where an order for winding up is made for "just and equitable reasons" under clause (*f*) of Section 433 of the Companies Act, 1956. The Supreme Court helped explain the legislative intent in excluding Rule 5(2), stating it was done to indicate that after repeal of the SICA, proceedings under Section 20 of the SICA were to continue to be dealt by the High Courts.

Pertinently, the Supreme Court upheld the ability to file a fresh insolvency proceeding before the NCLT, despite pendency of winding up proceedings and prior to passing of a liquidation order. The most pertinent holding made by the Supreme Court in this regard is that, by virtue of Section 238 of the Code, the CIRP would prevail and hence the winding up proceedings as well as all the writ petitions for recovery of workers' dues would be disposed in order to allow proceedings under the IBC to run their entire course. In doing so, the Supreme Court also dismissed the argument that Section 434 of the Act is amended by the Eleventh Schedule of the Code, and hence, it cannot be hit by Section 238 of the Code, on the basis that Section 434 is a part and parcel of only the Act.

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