MANAGEMENT OF DISTRESSED ASSETS – PRESERVING NETWORTH, EMPLOYMENT, BRAND VALUE & GOODWILL

AN OVERVIEW OF PRE-PACKS - A SPECIFIC INNOVATIVE MEASURE IN THE UK LOAN MARKET

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Abstract

The human world is changing at an unprecedented rate, the result of globalization, the spread of free markets, and changes wrought by information and communications technology. Amidst this, resides the universe of Finance and in it resides the Loans & Agency (Syndication) function, with a mission to educate students, from undergraduates to MBA’s to doctoral candidates, to understand the challenges and navigate successfully in this fluid environment. In this paper we seek ---- beyond that ---- to equip the theorists – navigators who will chart the waters of distressed loan management ahead. The goal of this article can be simply stated: To throw light on the subjects that converge to form the distressed asset management discipline and understand the innovation quotient from a present day scenario. The paper, further research, discoveries, and insights, expressed through writing, speaking, and sharing, can shape the business world in the next century and also intends to promote financial competence.
Introduction

With default rates rising, lenders in the syndicated loan market are likely to come across the use of insolvency “PRE-PACKS” as a method of achieving roughly the same end result as a consensual restructuring. It assists to deal with ‘hold out’ lenders who essentially end-up frustrating a consensual restructuring. It may also demand an interface with subordinated lenders who have no economic interest in the business or assets because the value is less than what is owed to the senior lenders.

Risks & Roadblocks to Distressed Settlement – Specific to the EMEA region (Syndicated loans segment)

- Extended settlement durations that increase counterparty risk
- Thin edge between performing and distressed assets / trades in the turbulent market
- Processing distressed trades are still very manual and paper intensive, slow to settle
- Comprehensive consensual restructurings lead to longer settlement times
- Complex and non standard deal structures create settlement bottlenecks in the market (Lyondell, Tribune report 2009)

In the EMEA region, ‘pre-pack’ sales are construed as an English invention; but the recently announced re-engineering of Chrysler serves to remind market participants that it is a process that can be used in other jurisdictions as well. Pre-pack techniques may not be common in other EU States as of now; but the need to preserve the value of an underlying business and to deal with restructuring a company when not all lenders can agree to the covenants in proposals, means this kind of procedure is useful.
There may be certain key attributes to the domestic UK market which discourage the implementation of this type of solution. The local insolvency legislation may be time consuming, too formalistic and have limitations in scope. For example, in Denmark, there has been recent case law which would suggest that a Danish insolvency court would be very unlikely to support an agreement that is (or may be) detrimental to a specific group of creditors. In Norway, though, the preliminary administration period is sometimes used as a time to negotiate a deal with a new investor, with the transaction only being concluded with the formal insolvency administrator once appointed, in order to protect the intended deal against any voidance right the formal insolvency administrator might otherwise have.

However, cross-border insolvency technology is rapidly disseminating and we are witnessing some interesting proposals which we get to learn from experience in other jurisdictions; so it may be that this tool becomes more widespread. An example of this is the recent (Jan 2010) safeguard law in France. This has been used in a deal known as auto-distribution, where a pre-packaged deal which was agreed to by a majority group of creditors was submitted to the court using that law in order to bind all of the creditors. The key aspects are as below.

- Re-engineered closing process due to increased volumes on distressed assets
- Focus on straight throughput for distressed trades – more “Par-like”
- Resolution to bottlenecks in the market using Loan Settlement Technical Advisories
- Automate distressed operational components via electronic settlement systems
- Automate inventory management (Collateral valuation)
- Automate Agency processes to improve workflow and transparency

What is a pre-pack?

The term ‘pre-pack’ is used to illustrate the pre-consented sale of the business of an insolvent firm which is carried out immediately after the company enters into formal insolvency proceedings. Depending on the jurisdiction, either the court, or the insolvency arbitrator once appointed, will be involved in ascertaining the value of the business and consenting to the terms of a sale so that, shortly after the start of the insolvency proceedings, a sale to the participator can be completed. A pre-pack is a mechanism used to achieve a rapid sale,
It is also a good way to cherry pick assets, such as real estate & bond holdings, taking only those that are viable. As creditors in the queue do not like to see other creditors getting treated better than they are, there may be close scrutiny of the pre-pack terms. The key issue in a pre-pack is value. The court or insolvency arbitrator will need to be comfortable that, in proceeding with a pre-pack, the best price has been obtained for all creditor groups with an economic interest and in any sale as a going concern, some creditors get prioritized. For example, trade creditors, although unsecured, may end-up better than lenders who are secured. But that is the price to be paid (by the secured creditors) for the needed result of getting the value available from a going concern sale. For syndicated risk participants/lenders, primary questions will be who owns the purchaser (and therefore who takes any equity upside in the sale) and what percentage of debt gets transferred as part of the sale and what debt is left behind. This will depend entirely on where the sale-value breaks. If it breaks in the senior debt, and the security trustee has the power to release security, guarantees or even indebtedness on the guidelines of the senior lenders, the junior creditors may receive little benefit from the pre-pack.

Pre-pack techniques may not be common in other EU States as of now; but the need to preserve the value of an underlying business and to deal with restructuring a company when not all lenders consent to the proposals, results in this kind of procedure being useful. Examples of pre-packs in the UK in recent years include MFI, Mark One, Polestar, USC and Torex Retail. And the biggest and most recent example is the pre-pack of Chrysler, announced on 30 April 2009, which will use section 363 of the US Bankruptcy Code to force through a sale of Chrysler assets to “new Chrysler” when not all creditors would agree to make the necessary sacrifice. You could call this a State sponsored pre-pack, given that it has the express backing of the Barrack Obama administration.

“Pre-Pack” - How and when to use

A pre-pack can be used, for example, to preserve networth; to save employment; and as an alternative to a voluntary work-out or to facilitate a financial restructuring by routing the business and assets to a new company. It may also be rolled-out as a ‘Plan B’ to drive through a consensual restructuring when there are litigant creditors. The Chrysler pre-pack is an example of the ‘Plan B’ having to be implemented. It was made necessary because some ‘hold out’ creditors refused to agree the write down that others were prepared to take.

Pre-packs’ image – Good boy’s image gets shadowed

Despite their distinct advantages in appropriate circumstances, pre-packs have suffered from a negative image. This originates partly from the fact that the sale of the organization is lined up behind closed doors, ahead of the insolvency process, and creditors are simply presented with an accepted deal. This can raise suspicions about whether the deal struck was in the best interests of all creditors and whether the best price was obtained. Where the business is sold to an entity owned by the secured creditors and/or existing management, these issues get magnified.
Although there are certain components of the UK insolvency regime which lend support to Pre-Packs, it is useful to understand the key features that arise on these transactions, as they bring-forth a number of common concerns. In the UK, many pre-packs are carried out by an arbitrator shortly after his or her appointment. It is common that the prospective administrator will have been involved in, or at least be aware of, the negotiations for the transfer. But it is important that any administrator is seen to act independently and, in particular, make sure the best price is obtained for any risk participator / creditor who has an economic interest in the company whose assets are to be sold.

Creditors left in the dark/lack of transparency

It is in the nature of a pre-pack that unsecured creditors will not be completely aware of and certainly will not be given a chance to approve the sale of the business before it takes place. First in 1-Jan-09 and then in Jan-10, in the UK, best practice Guidelines (Pre-Packaged Sales in Administrations) have been introduced with the purpose of enhancing transparency in “Pre-Packs”. These Guidelines focus particularly on the role and responsibilities of the arbitrator and the requirement for full disclosure of the circumstances surrounding the pre-pack and the nature of the transaction. The Guidelines set out the specific information that should be disclosed in all cases including:

- All marketing activities conducted;
- All valuations obtained of the business or the underlying assets;
- Various courses of action that were considered by the administrator, with an explanation of possible financial outcomes;

Sale prior to initial creditors’ meeting – purpose of administration

The main purpose of the initial creditors’ meeting is to attest the administrators’ proposals. With most pre-packs, the creditors cannot approve the sale as it would have already have taken place. In a series of cases, the courts have held that, where the circumstances of the case warrant it, an arbitrator does have the power to sell the company’s business and assets without the prior approval of the creditors or the permission of the court. The administrator must also be satisfied that the sale achieves a proper purpose given the terms of the administration order.

Absence of marketing and obtaining best price reasonably obtainable

An arbitrator may need to be able to illustrate that the best price was obtained. If so, valuation advice will be needed. A Pre-Pack is often used following a failed sale process where bidders are not prepared to take on all the assets and liabilities of the business and want to leave certain liabilities behind. Such a process may provide some evidence to the valuation of the business. Where the assets of the company are subject to security and the valuation evidence demonstrates that the business is worth significantly less than the secured debt, the administrator will usually be able to take comfort from the fact that the unsecured creditors are “out of the money” and therefore have no economic interest in the assets. The secured creditors would need to approve the deal and release their security. But, where the valuations of the business are close to the level of the secured debt, or there is no secured debt or where
there are multiple tiers of secured debt and it is not clear from the evidence where the value breaks, there is an increased risk of challenge to the sale by an aggrieved creditor and the valuation evidence will be crucial.

Other considerations - Implementation and timing

In a pre-pack, the terms of the sale of the business are agreed in advance. Accordingly, the co-operation of the company and its existing management will be needed. The potential administrator has no powers to act until formally appointed, even though they are likely to be involved in negotiations in a capacity as advisor to the company or the lenders.

Fees and indemnity

Any fees charged by a proposed administrator before the appointment is not an expense of the administration. In practice, either the company or the lenders will pay those fees on the basis that this is in the best interests of creditors generally. An administrator may require an indemnity before accepting the appointment and carrying out a pre-pack sale. In a secured lending situation, the indemnity would typically be provided by the secured lenders.

Court approval

An issue is whether court approval should be obtained if the sale takes place prior to the creditors’ meeting. In practice, this is unlikely to be a workable proposal. It would add to the cost of the process (and potentially slow things down) and, in any case, the UK courts have made it clear that commercial decisions are for the administrators. So, except in cases of particular difficulty, an application for court approval is unlikely.

Conclusion

Pre-pack sales are undoubtedly a good way to preserve value. They are usually very good for all or most of the book creditors. They are good for the senior secured creditors. But they may leave some creditors out in the cold. An arbitrator must be sure that those left out in the cold would not have been better off if the company’s assets had been sold on a piecemeal basis. If one can get the President of US to attest the Pre-Pack, so much the better. As with Chrysler, it is likely that the loan market participants would see more pre-packs being used or proposed as a ‘Plan B’ to drive through a restructuring that, for whatever reason, could not be agreed on a consensual basis. Pre-pack sales are undoubtedly a good way to preserve value. They are usually very good for all or most of the risk participants. They are good for the senior secured creditors. But they may leave some creditors out in the cold.
References

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