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Review

Corporate Strategy & Finance

Pre-appointment costs- to be paid or not to be paid? That is the question!

NEW RULES ON PRE-ADMINISTRATION COSTS

Insolvency Practitioners have been eagerly awaiting the implementation on 6 April 2010 of the Insolvency (Amendment) Rules 2010 ("New Rules"). In addition to the many modernising changes made by the New Rules is the long awaited inclusion of what was believed to be a statutory entitlement to recover pre-appointment costs such as in negotiating a pre-pack. as an expense of the administration (New Rule 2.67(1)(h)).

New Rule 2.33(2A) provides that "pre-administration costs are: (i) fees charged, and (ii) expenses incurred, by the administrator, or another person qualified to act as an insolvency practitioner, before the company entered into administration but with a view to its doing so".

1 April will mark a significant change to the renewables sector in the UK.

CERTAINTY

Prior to the implementation of the New Rules, one option for administrators seeking payment for pre-appointment costs has been to seek the court's discretion to include an order for those costs in the application for an administration order. The New Rules clearly remove that discretion from the court and will provide a complete code on administration expenses that will apply to administrations commenced by court order and using the out of court procedure.

Unfortunately there remains an unwelcome element of uncertainty to this crucial issue for insolvency practitioners and their advisors: what is included in work carried out with a view to the company entering administration?

PAYMENT FOR PRE-PACK WORK?

The question of how an insolvency practitioner can receive payment for the work he carries out on behalf of a distressed company before an appointment is made has been hotly debated for some years, in particular where that work has included the preparation for a pre-pack sale of the company. Consequently the assumption of many carrying out pre-appointment work has been that the New Rules will allow for the payment of administrators' fees and expenses in connection with pre-pack sales.

The New Rules do not define what items can be included as expenses nor what nature of work is to be classed as being undertaken with a view to the company entering administration. As with much of the administration legislation this is left to be clarified by case law.

In the matter of Johnson Machine and Tool Co. Limited and in the matter of Empire Surfacing Limited [2010] EWHC 582 (Ch) ("*Johnson Machine*")

Although the very recent decision in Johnson Machine is based on the old rules and so was a case where the court was asked to exercise its discretion to grant an order for pre-administration costs, the comments of the judge (HHJ Purle QC- of Nortel "fame") on what pre-appointment costs could be allowed as administration expenses cannot be ignored when interpreting New Rules 2.33(2A) and 2.67(1)(h).

In *Johnson Machine*, the application for an administration order included an application for the payment of the administrators' pre-appointment costs. Whilst making the administration order the judge declined to allow the pre-appointment costs to be treated as an administration expense.

NARROW INTERPRETATION

Part of the reason given in *Johnson Machine* for not allowing pre-appointment costs as an expense of the administration was because the costs involved work in connection with a pre-pack sale:

"the largest element of costs incurred by potential administrators will be referable to the negotiation of the terms of the pre-pack sale, ascertaining what assets are to be sold, arranging any valuation advice and considering whether to market the business or go for a pre-pack. **These are not really costs of preparing the Form 2.2B or witness statement; they produce the factual situation reported on by those documents. Ordinarily, therefore, they would not fall properly to be treated as an administration expense."**

This judgment is not consistent with the expectations that the New Rules relating to administration expenses are intended to include all pre-appointment work, including that in connection with pre-pack sales, which will be a very significant element of this type of work. However, in our view until there is further case law and judicial interpretation of New Rule 2.67(1)(h), it remains unclear as to what costs will come under this new rule and the restrictive interpretation of *Johnson Machine* should be assumed to prevail.

IF NOT A PRE-APPOINTMENT COST, WHAT OTHER WAYS CAN PRE-PACK COSTS BE RECOVERED?

The likelihood of a creditors' committee applying the narrow interpretation given to "pre-administration costs" and expenses when they are determining the extent of their approval of the pre-administration costs under New Rule 2.67A should be a concern for insolvency practitioners and their advisors.

Practitioners therefore now need to consider carefully how otherwise they can ensure recovery of their remuneration and expenses when dealing with the implementation of any pre-pack strategy. The following suggestions are untested and will not always be acceptable, but it may be appropriate to consider options such as:

- money on account of costs, particularly for advice leading to a the resolution of an appropriate strategy, and for agreed costs of implementing the strategy pre-administration;
- company engagements backed by appropriate assurances with any bank or other secured funder involved to discharge costs with authority to deduct from the company's facilities as a secured debt immediately prior to appointment;
- engagement direct with the secured funder;
- ensuring that where the assets being disposed of are subject to fixed charges, obtaining approval for the pre-appointment costs from the fixed charge holder as agreed costs of fixed charge disposals;
- negotiating with buyers for the costs to be paid by the buyers as part of the transaction costs.

Johnson Machine does not dispute the legitimacy of pre-packs and the right of administrators to be paid for pre-appointment work is now definitely within the administration regime, so the exclusion of pre-pack work from administration expenses seems hard to reconcile. Insolvency practitioners already fully justify pre-pack sales that are for the purpose of the administration in accordance with SIP 16: if the view has been taken that a pre-pack is the best way of achieving the purpose, then the costs of implementing that must surely be "for achieving the purpose of administration" and so should properly be payable as an expense. However, HHJ Purle QC disagrees and until we have some further guidance from the Courts, insolvency practitioners and their advisers are better being safe than sorry.

FOR MORE INFORMATION

With the imminent implementation of the New Rules and the appeal of pre-packs as the route to achieve the best return to creditors whilst protecting jobs and the value of the business, the need to ensure proper payment for insolvency practitioners and their advisors engaged in this work is essential.

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