PRIMER ON PRE-PACKS

Background on pre-packs

In this note a pre-pack means where the directors of a distressed company prior to an insolvency filing team up with an investor(s) "the incumbent bidder" who conducts due diligence and formulates an investment plan with a view to using the insolvency procedure to implement the plan. The plan can involve a straight sale of assets or an equity injection coupled with debt reduction or other variations depending on what the particular insolvency regime and circumstances will support.

Pre-packs are only possible in jurisdictions where the directors retain effective management control post filing, can predict the outcome of the insolvency with a sufficient level of certainty to entertain a filing in the first place and believe their position will benefit as a result.

The "seller" of the asset is a combination of the Directors who are approached prior to filing and must invite the investor in, the trustee in bankruptcy and /or the court who authorize the plan and /or the sale, and the creditors to the extent they get a vote.

The creditors do not always get a vote, for example the article 190 and 191 pre-pack provisions under Spain's insolvency procedure. Where some of the creditors are also the investor, their interest may not align with an arm's length seller.

An important route to identifying and sourcing these opportunities is through the purchase of illiquid distressed credits i.e. non-performing loans "NPL's". They can also be identified and sourced via industry contacts, advisors to distressed companies, and the purchase of liquid distressed credits. [i.e. distressed credits which trade, have a quoted bid/offer and can be purchased from broker dealers without having to source directly from original holding banks.]

Sourcing these opportunities is therefore not wholly reliant on banks selling their NPL's and is therefore an additional and separate way to take advantage of the distressed European market.

Why a financial advantage can be obtained when investing through pre-packs.

The strategy in the right circumstances puts the investor in the position where the seller's primary motivation is not to achieve the best price and where there will either be no competing bids or where competing bidders have access to lower quality information and less time to conduct due diligence on the information they do have.

Why achieving the best price is not the seller's primary motivation.

In all jurisdictions the trustee in bankruptcy and /or the court when authorizing the sale of assets of a bankrupt estate will have a duty to achieve a good price to help maximise returns for the creditors. For a going concern business or a complex asset whose value is

not already well understood by the market this requires marketing, the dissemination of information, and time. Where the assets of the bankrupt estate include a business that has the potential in whole or in part to be maintained as a going concern the trustee will also have a duty to safeguard the survival of the business and in particular employment. It is always the case that, to a greater or lesser extent depending on the type of business, once a company files for insolvency the value and viability of the business deteriorates as new business is lost, key employees leave, working capital runs out etc. This creates a real or perceived tension between the trustee taking time to achieve the best price vs. not damaging the business with the consequent negative impact on employment and creditors' returns. In nearly all jurisdictions to a greater or lesser extent the duty to save the business and jobs takes precedence over the duty to creditor returns.

Where a pre-prepared bid that maintains the viable portion of the business and employment is put on the table at the time of filing, the bankruptcy trustees and or the court tend to exercise their discretion in favour of the incumbent bidder. If the business is sold and employment maintained that is a success for the trustee /court and in most countries there is little incentive for them to exercise their discretion to help post filing competing bidders for the sake of achieving a better return to the creditors that may or may not materialize and risk damaging the business [bids can be formulated to take advantage of this pressure by placing short time limits on associated DIP financing necessary for the continuation of the business].

"A bird in the hand is worth two in the bush" In this sense the seller's primary motivation is not to achieve the best price.

Why the incumbent bidder has better information and limited competition.

Directors and senior management control access to the information necessary to perform due diligence. Once the directors have developed a relationship with their new finance provider, they will view them as their boss, and they will not risk alienating them by using their control over the flow of information to drum up competition beyond their legal responsibilities. This provides the incumbent bidder a period of exclusivity prior to filing and any competing bidder has to run to catch up post filing.

Providing robust data for due diligence and following up with effective management Q&A sessions requires considerable time and effort. Where time is short, as it tends to be in sales out of insolvency, and management are not motivated to help, the quality of information provided to competing bidders will likely be of a lower standard than that obtained by the incumbent bidder. The difference can easily be material in the context of providing a competitive bid. For this reason, other bidders may shy away from bidding at all.

Where information material to pricing the asset is either publicly available or available to competing bidders in the same industry then the advantage is nullified. In these circumstances you might see a fund with expertise in distressed co-invest with an industry specific bidder.

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