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Insolvency Doctor Knock: not Prozac but Related Party Pre-Packs (RPPP's)

A post by Rolef De Weijs, Luca Ratti & Johan Zwemmer

The EU wants to introduce pre-packs as a new type of insolvency procedure as a cure for financial failure. The French novel 'Dr Knock' provides a clear warning about doctors and medicines. Too much medicine weakens a healthy society. The following contains two spoilers. The first as to the plot of Dr. Knock. The second as to what will happen if the current EU Pre-Pack Proposal is adopted where it forces Member States to allow for Related Party Pre-Packs at the expense of creditors and employees.

The story of Dr Knock

The French novel [Dr Knock](#) (1924) by Romain Rolland tells the story of a doctor in a rural French town who wants to retire. The ambitious doctor Knock takes over the practice. The main problem is that the population is too healthy. Dr Knock, however, is of the opinion that healthy people are simply people that don't realize they are sick. Dr Knock then offers each citizen a free consult, where he discusses new ailments and the risks of microbes. Soon half the population is under doctor supervision and the local hotel is turned into an emergency hospital.

The influence of the insolvency industry on legislation

Insolvency law is no longer limited to cutting up a business into pieces. It increasingly is positioned to also rescue financially distressed companies or to at least save the viable parts. Insolvency proceedings have therefore partially transformed from the morgue to the emergency room. With this expansion in scope, there is also more of an insolvency industry.

In the US, the influence of the insolvency industry on legislation is well recognized. [Skeel](#) writes: *'Bankruptcy lawyers exert significant influence over the shape of the bankruptcy process, and they have a strong incentive to maximize the use of bankruptcy.'*

A step further is to change legislation to serve not the general interest, but the interests of the insolvency industry. The clearest example is the UK when it introduced its Superscheme as a new insolvency procedure in 2020. The government's [explanatory notes](#) provided: *'The introduction of such provisions will help the UK maintain its position as a leading global restructuring hub.'* (par. 5.148).

Good pre-packs, bad pre-packs and past experiences

The EU is about to adopt a new insolvency tool by its [EU Pre-Pack proposal](#). A pre-pack is a prepared insolvency procedure. Rather than selling assets out of a public insolvency procedure as a kind of fire sale, the sale is prepared prior to the insolvency procedure. After a silent phase in which the highest bidder is sought, the company is declared bankrupt. Upon appointment, the trustee will transfer the business to the pre-selected buyer. The trustee will receive money and distribute this among the creditors. The creditors can no longer go after the assets, because the creditors have a claim against the old bankrupt owner. The new legal entity can also determine to which employees an employment contract will be offered.

As long as the business is sold to outside parties, there is little room for abuse in relation to both creditors and employees. In stark contrast stand related party pre-packs, in which the business is continued by the same owner through a new company. Related party pre-packs present a high risk of abuse and opportunistic behaviour.

There are different ways in which shareholders can ensure that they will be the ones that acquire the business. First of all, there is the problem inherent to pre-packs, namely the closed bidding environment. By the nature of pre-packs, it is impossible to reach all potential bidders. The shareholder can also take steps to ensure that the business cannot realistically be sold to any other party than the shareholder. This can be done by cutting up a functioning business into many pieces and putting these pieces in separate legal entities.

Related party pre-packs undermine the working of insolvency law as a tool for the interests of creditors. Also competition is distorted if the failing business gets a release of liability. Currently, the Transfer of Undertaking and Protection of Employees Directive ([TUPE-Directive](#)) at least provides employees protection in case of related party pre-packs. Following case law in [CJEU Estro](#) and [CJEU Heiploeg](#), employees do transfer along with the business if the [old shareholder](#) acquires the business.

If pre-packs with related parties are allowed, these become a very attractive procedure for business owners. Rather than ensuring creditors are always paid, an owner can inquire with an insolvency advisor what the alternative steps of a pre-pack procedure are. Countries that have already gained experience with pre-packs quickly see a large proportion (Netherlands), or even the large majority ([UK](#)), of cases involving pre-packs with related parties. Insolvency experts [Mokal and Nochilla](#) have argued that also after revision, the UK pre-pack regime 'has no effective mechanism, legal or market, for the protection of creditors as a whole.'

The EU Pre-pack Directive: the problem and easy but necessary fixes

Despite the bad experiences in the UK, the EU Pre-pack Proposal embraces the pre-pack to the fullest extent. The proposal dictates that pre-packs with related parties shall be facilitated (art. 32 Proposal). Secondly, the Proposal takes away existing TUPE-protection of employees (art. 20/2 Proposal). This exclusion of workers' protection will supercharge related party pre-packs. Quite striking and a tell sign of catering to the desires of the insolvency industry is that there are no underlying studies discussing the benefits and risks of the Pre-pack Proposal.

The EU should not itself open the door to related party pre-packs and should leave the issue to the Member States. Moreover, the EU should uphold workers' protection and continue to provide that in case of related party pre-packs, employees transfer automatically with the business.

Insolvency as an emergency room for all companies

The proposed EU Pre-pack will undermine creditor protection, workers' protection and competition. If the EU Pre-Pack Proposal will be adopted and related party pre-packs are forced on Member States, this will be most beneficial

for shareholders and the insolvency industry as their advisors. It will lure companies into the emergency room that would otherwise never make use of insolvency law. The radical pre-pack cure will turn out to be very attractive, also for companies suffering from minor ailments, which would otherwise be dealt with by less drastic means.

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