Business Opportunities in the Downturn

CORPORATE RECOVERY AND INSOLVENCY GROUP

Considering the main issues when buying a business or assets from a company in financial difficulties

This article is a summary of a seminar delivered by Thilo Schneider, Helen Clifford and Nelu Abeygunasekera at Pritchard Englefield's offices on 23 June 2009.

INTRODUCTION
Companies House figures show that currently every 1 in 130 active companies go into liquidation and the number of administrations has increased by about 50% over the last 12 months.

However, the economic downturn also presents opportunities for companies that are able to take advantage of businesses in financial distress that are selling off their assets or business units at a discount, often as part of a formal insolvency procedure.

ADMINISTRATIONS
The Enterprise Act 2002 introduced a new out-of-court procedure for the appointment of administrators which has made the appointment of an administrator quicker and more cost-effective than was previously possible. The Enterprise Act 2002 also paved the way for the so-called "pre-pack administrations" where the sale of the insolvent company's business or assets is pre-arranged and completed almost simultaneously with the appointment of the administrator. Often, the business or assets will be sold to the directors or managers of the insolvent company.

As a result of the increase in popularity of the out-of-court procedure, administrations have become the principal means by which a fixed and floating charge holder would enforce his security and a buyer dealing with a company in financial difficulties is most likely to be dealing with an administrator.

One of the effects of an administration is that there will be a moratorium on insolvency proceedings and other legal processes against the company so that, for example, no creditor may enforce security over the company's property and no steps may be taken to re-possess goods in the company's possession under a hire-purchase agreement.

The most likely outcome of an administration is the sale of the business or assets of the insolvent company. Such a sale should achieve one of the statutory objectives of administrations – namely a better result for the company's creditors as a whole than an immediate liquidation – because the administration can give the administrator the opportunity to continue trading and to retain some of the goodwill of the company. On a sale, the administrator is thereby likely to obtain a higher price for the business or assets than would be the case on a forced liquidation.

STRUCTURING THE DEAL
The sale of the assets of an insolvent company may take a number of forms, depending on the types of assets involved and the interest they generate in the market. Sometimes a tender or an auction process may be appropriate.

The sale of the business – as opposed to individual assets – of the insolvent company will most commonly be carried out under a business sale agreement individually negotiated between the buyer and the administrator (acting as agent of the company).

In this context, it may be advantageous from a buyer's perspective that the relevant business is hived down into a clean subsidiary of the insolvent company and for the hive-down company to be sold to the buyer by way of a share deal.

The reason for this is that section 343 of the Income and Corporation and Taxes Act 1988 provides that in certain circumstances the hive-down may allow the buyer to carry forward the trading losses of the relevant business and to utilise those trading losses in the future.

BUYER'S CONCERNS
The purchaser of a business or assets from an administrator will have concerns which would not arise in "normal" transactions.

The first issue for the buyer to consider is whether the administrator has the necessary powers to enter into the transaction and this is the case even though the Insolvency Act 1986 states that a person dealing with the administrator in good faith and for value need not inquire whether the administrator is acting within his powers and also that an administrator's acts are valid despite any defect in his appointment or qualification.

However, the administrator's powers are not unlimited and, for example, an administrator can only sell assets free from the rights of a fixed charge holder or a hire purchase company with the prior consent of the court.

The second issue a buyer will be particularly concerned about when it comes to purchasing assets from the administrator is that the administrator will almost certainly give no warranties and representations as to the quality of and title to the assets he is selling on behalf of the company.

As a result, the buyer of the business or the assets from a company in administration will want to conduct as much due diligence as he can into the affairs of the insolvent company.

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DUE DILIGENCE

On the basis that the insolvency practitioners will not usually provide any warranties regarding title to the assets, it is essential that purchasers investigate what they are buying. Time is often of the essence in transactions as it will be important to try to retain goodwill and key staff. Moreover, the insolvency practitioner will be typically pushing for agreement and signature on the sale agreement as quickly as possible.

1. **Who owns the rights/assets?**
   One of the most common problems relates to retention of title. If a supplier of goods has supplied those goods under a valid retention of title clause then they will still own those goods and may be entitled to come onto the company's premises to collect and take them away.

   Any buyer must ask to see copies of contracts and other documents to establish who owns what and – if there appear to be issues – renegotiate the purchase price and possibly try to purchase any essential goods direct from the original supplier and perhaps negotiate a reduction in the price payable for those goods.

   Title to property must also be considered carefully. An analysis of real property is beyond the scope of this note but we would like to address intellectual property law issues that often crop up in business sales and which are particularly pertinent for sales from insolvency practitioners.

2. **The special position of intellectual property**
   The general principle with intellectual property is that the first creator is usually its owner. This means that if the target company has sub-contracted out some of its work to a third party then unless that third party has specifically assigned their rights they will still own them and the target company will only have an implied licence (on uncertain terms) to use the rights. It will also not be clear what right, if any, they have to assign such a licence to the buyer.

   Intellectual property rights may be owned jointly by the target company and third parties with whom they have co-operated on specific projects and it will be important to establish what these rights might be and how ownership or a right to use can be obtained.

   Although the law also provides that an employer owns the rights that an employee creates this principle is also subject to an important exception. This is that only work which is created during the normal course of employment is so owned. There has been a significant amount of dispute and case law on this subject. The starting point is always to look at the employee's contract of employment to see what his or her duties are stated to be and from there try to establish whether any invention or other right he or she developed would have been developed in the ordinary course of their duties.

   It is also common practice for the founder directors of a company to retain intellectual property developed prior to incorporation of that company in their own names and to merely license it to the company.

   If there is any question mark over ownership of any key rights to be used in the business being sold, one should seek assignments from the creators. In a normal business sale one would often ask the seller to obtain these documents but an insolvency practitioner may be reluctant to become involved so the buyer must consider how important the rights are and if necessary go about trying to obtain the rights themselves.

   An employee who develops an invention which is of outstanding benefit to his or her employers has the right to compensation. This right cannot be excluded by the contract of employment or other documents.

   Buyers will also need to consider if there are any third party claims arising from the rights such as, for example, a claim that the rights infringe that third party's rights. In that situation a buyer may need to discuss risks relating to the intellectual property with employees and others related to the business and perhaps carry out its own freedom to use searches on key rights.

3. **Recommendations**
   Buyers will need to be conscious that this is very much a situation of "buyer beware". Administrators and other insolvency practitioners will not give warranties or indemnities save in very exceptional circumstances and for very limited matters.

   Buyers should ask for access to such papers as they may need, to be able to speak with key employees and be prepared to sign non-disclosure agreements as they will be looking at highly sensitive business information. In addition, they should be ready to renegotiate on price and terms once they have more information about the business concerned.

EMPLOYMENT CONSIDERATIONS

An insolvency situation gives rise to significant employment concerns for all parties involved. This is particularly true for the employees of the business, who may find their positions at risk of redundancy and face a situation where they may not be able to recover all sums due to them from their employer.

Insolvency practioners will be concerned about potential liabilities they may incur on the adoption of contracts of employment and directors of an insolvent company may have concerns as to whether they will be at risk of being found guilty of wrongful trading and possible disqualification.

In addition, there is a potential liability which may be inherited by a buyer under the Transfer of Undertaking (Protection of Employment) Regulations 2006 ("TUPE").

When buying an insolvent business, the buyer needs to consider the nature of the insolvency and how this might affect the TUPE position.

In practice, the parties should seek the view of an insolvency practitioner at an early stage to determine which of the TUPE insolvency provisions apply so they can assess the scope of their potential employment liabilities.

The reason is because TUPE treats insolvent businesses that are subject to "relevant insolvency proceedings" (regulation 8(6) of TUPE) differently from those insolvent businesses that are subject to "bankruptcy or any analogous insolvency proceedings" (regulation 8(7) of TUPE).

Regulation 8(6)

Regulation 8(6) defines the term "relevant insolvency proceedings" as those proceedings which have been opened "not with a view to the liquidation of the assets of the seller and which are under the supervision of an insolvency practitioner", namely "non-terminal" insolvency proceedings such as:-

- administrations;
- administrative receiverships; and
- voluntary arrangements.

Where the transfer is caught by regulation 8(6), generally employees of the insolvent business have the same TUPE protections as employees of solvent businesses, for example automatic transfer of their employment contracts and protection from dismissal.

However, the two following important exceptions apply to regulation 8(6) transfers. Firstly, the seller and the buyer have greater flexibility in relation to the variation of contractual terms, but these are only permitted where they are designed to safeguard employment opportunities by ensuring the survival of the business; and the buyer will not inherit liability for certain of the seller's debts which are met by the National Insurance Fund ("NIF") up to statutory limits. The buyer is therefore only liable for those debts which are not covered by the NIF or exceed the statutory limits.

Regulation 8(7)

Regulation 8(7) applies to "bankruptcy proceedings" or any "analogous insolvency proceedings which are instituted with a view to the liquidation of the assets of the seller and are under the supervision of an insolvency practitioner", i.e terminal situations, such as:-

- bankruptcy;
- compulsory liquidation; and
- Creditors' voluntary liquidation.

Where the insolvent business transfer is caught by regulation 8(7) some of the most fundamental TUPE protections for employees are removed in order to facilitate the purchase by the buyer. These include:-

- that the automatic transfer principle does not apply, which means the seller’s employees will not automatically transfer to the buyer. As a result, the buyer may "cherry pick" which (if any) employees it would like to employ following the purchase of the business;
- any existing employment-related debts or liabilities will also not transfer to the buyer; and
- the buyer is permitted to vary the terms of employment of any of the seller’s employees that it subsequently employs.

These relaxations of the basic TUPE employment protections clearly make the regulation 8(7) regime more attractive to buyers.

However, it is not always that straightforward, because recent case law has established that these are not hard and fast rules. For example, administrations need not always fall within regulation 8(6) but could fall within regulation 8(7). It is thought that the type of administration which would fall within regulation 8 (7) are pre-pack administrations. Therefore the precise scope of regulations 8(6) and 8(7) in the context of administrations is the subject to ongoing litigation.

CONCLUSION

What is clear is that where there is a transfer of an insolvent business, modifications (some of them far reaching) have been made to the key principles of TUPE. This has helped support the rescue culture and aids the sale of insolvent businesses as going concerns.

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