Break up and asset sales

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General overview of asset sales

Whether a buyer is purchasing assets from a solvent seller, or a seller which is distressed or in a formal insolvency proceeding, will give rise to a variety of different legal and practical considerations for the parties involved.

The Insolvency Act 1986 (IA 1986) regulates various formal insolvency processes for both corporate entities and individuals. The principal corporate insolvency procedures in England and Wales are administration and liquidation:

- if the company is in liquidation (whether compulsory or voluntary) and the appointed liquidator is not able to sell the business as a going concern, the liquidator will sell the assets of the insolvent company (as a job lot if possible, piecemeal if necessary) to maximise the funds available for distribution to creditors
- when a company enters administration, the administrator takes over the control of the company's assets from the company's directors, in order to achieve one of the statutory purposes of administration (See Overview: Administration—overview). In some cases, the administrator will achieve the best value for the assets of a company by means of a pre-pack sale. A pre-pack sale is a transaction negotiated before the company's administration, that completes on or shortly after the administrator's appointment. A sale of this kind is appropriate where, for example, a going concern sale represents the best value for creditors but there are insufficient assets to trade the company's business in administration while a buyer is identified. A pre-pack can deliver significant advantages through minimising operational disruption

For more information on buying a business or assets from an insolvency practitioner and the key points which differentiate an insolvent sale from a solvent sale, see Practice Note: Buying a business from an insolvency practitioner.

Outside of formal insolvency, a company which is financially distressed may seek to sell assets in order to resolve cash flow problems, thereby avoiding a formal insolvency process altogether. Cash flow can come under pressure from the loss of a significant client or a general market downturn (for example, exposure to changes in the prices of raw materials or in exchange rates may cause difficulties) and there may be pressure from finance providers to repay debt.

A sale of assets in this context is sometimes referred to as accelerated or distressed M&A (mergers and acquisitions) and it is sales in this context which are the focus of this Practice Note. Some of the key differences (and similarities) between this process, a solvent and an insolvent sale include:

- **Allocation of risk**

  In a purchase from a solvent company, the buyer will base the purchase price on a number of assumptions which are, in turn, supported by heavily negotiated representations and warranties in the acquisition agreement. If any of the assumptions turn out to be incorrect, the buyer's remedy will be a claim for breach of warranty/representation. For areas of particular concern, buyers will expect to be indemnified so that the risk of having to meet the cost of a potentially expensive liability is eliminated.

In contrast, in an insolvent sale, the office holder will (i) as far as possible, resist giving any representations, warranties or indemnities whatsoever in order to avoid any continuing liability (for himself or the company) post completion; and (ii) include express exclusions of personal liability in the acquisition agreement.

This position is justified in large part by the fact that the insolvency practitioner will, in most cases, have very little knowledge about the assets being sold (or at least no more than the buyer could uncover from its own due diligence), or because the buyer is a competitor of the seller operating in the same industry. However, given that timing is unlikely to permit the same degree of due diligence that a buyer would conduct on a solvent sale, the absence of any comfort from the insolvency practitioner or the insolvent company means that the increased commercial risks borne by the buyer are generally reflected in the purchase price for the assets.

In the context of a distressed sale, the directors who have knowledge and information regarding the assets being sold will have conduct of the sale and will lead the sale negotiations. There is, therefore, likely to be greater scope than in an insolvent sale for the buyer to negotiate representations and warranties in the acquisition agreement. However, given the seller's financial position and its desire to conclude the transaction as soon as possible to resolve any cash flow difficulties and avoid a formal insolvency proceeding, the representations and warranties are likely to be significantly more limited than in the case of a solvent sale. In addition, such representations and warranties will most likely be of limited value if the distressed sale is not enough to avoid an insolvency process.

- Timing

An asset sale by a solvent company typically takes several months to prepare and execute, with an extensive due diligence process built into the timeline.

By contrast, time is of the essence when the assets of an insolvent company are being sold. The insolvency practitioner will be aiming to maximise the funds available for distribution to creditors and the longer the company remains in an insolvency process prior to sale, the greater the risk that the value of the assets will deteriorate.

Where a company is experiencing liquidity issues (but is not in a formal insolvency proceeding) the transaction will also often need to be accelerated. Accelerated M&A transactions are therefore usually completed within a few weeks, or even just days, often with the commercial driver being the avoidance of insolvency and its accompanying destruction of enterprise value.

Note that there is often a tension when balancing timing considerations. On the one hand, sellers may be keen to agree a quick sale in order to alleviate the pressure from finance-providers, creditors and other stakeholders. However, if a sale is conducted too quickly, it may send the wrong message to the market that the sellers are desperate for a sale and buyers can be expected to take advantage of this.

- Negotiating strength

As with an insolvent sale, often, the most likely buyer of assets from a distressed company will be one of its competitors. In this case, the distressed seller may be able to take a tougher negotiating stance on the basis that the buyer has the benefit of industry knowledge and is thus better placed to assess the risk in purchasing assets on an accelerated basis. Conversely, where there are very few participants in a small or specialised market in which the only possible buyer is a competitor, the buyer may have the stronger position.

- **Structuring the price**

  For reasons of liquidity, a distressed seller will usually insist on the purchase price for assets being paid in cash and in full on completion, and is unlikely to accept deferred consideration or payment in shares or kind. This is similarly the case in an insolvent sale where the insolvency practitioner is under a duty to conduct insolvency proceedings without undue delay and to realise the company's assets as soon as possible. In the case of a solvent sale where there is no 'burning platform' driven by the company's cash requirements, there is likely to be greater scope for the parties to agree to structure the consideration in a mutually beneficial way, which may involve the payment of non-cash consideration.

What type of cases benefit from the break up and sale of assets?

An accelerated M&A is the best option when it provides a better return for creditors and shareholders compared to the alternatives, be that insolvency, a refinancing or a solvent wind down. Accelerated sales processes are often used in group scenarios where there is a distressed or non-core division or subsidiary. Accelerating the sales process can help reduce the cash costs of ongoing trading and the level of management time required to manage an underperforming business. This allows groups to realise value from underperforming subsidiaries to invest in future growth opportunities.

Where there is no funding to continue trading (including the payment of staff costs), employees will often need to be made redundant. The accelerated M&A process aims to better realise value for creditors by running a traditional corporate finance style process within an abbreviated timescale, often leading to greater recoveries together with increased certainty of outcome and minimising job losses.

What drives a break up/asset sale?

The aim of an accelerated sales process is to deliver the maximum value in what are inevitably complex, time-pressured, and unpredictable circumstances often caused by any one or more of the following fac-tors:

- liquidity shortfalls
- stakeholder unwillingness/inability to provide additional financing
- declining trading performance
- complex stakeholder groups
- disaffected management

In these circumstances, investors may look to exit or refinance the business to address the problem. However, marketing distressed assets openly for sale can frequently impair enterprise value.

As concerns over the company's viability increase, concern grows among customers and employees, while lenders and suppliers can withdraw credit lines. In circumstances of business fragility, an accelerated M&A process can be a vital tool to realise value for shareholders and/or creditors without damaging an underlying business. Typically, it is banks and private equity, as investors in the business, who desire a solution that avoids an administration or other (more terminal) insolvency process.

Key considerations

Every distressed M&A process is different, however the key considerations any buyer/seller should take into account are:

- buying assets from an insolvency practitioner has certain advantages over buying from a distressed company. A transaction entered into by a company in insolvency proceedings is not liable to be unwound as a voidable transaction. However, in the case of a distressed company which subsequently enters an insolvency proceeding, the sale transaction is likely to be heavily scrutinised by the appointed office holder who may seek to challenge it as a reviewable transaction under provisions of IA 1986. See Practice Note: Can a liquidator or an administrator challenge or unwind transactions entered into by the company before it was wound up or entered into administration?
- directors should be mindful of their statutory duties under the Companies Act 2006 (CA 2006), especially during a distressed M&A sale where the duty to promote the success of the company under CA 2006, s 172 may be qualified by the duty to consider or act in the interests of creditors (CA 2006, s 172(3)). If a company is approaching insolvency, directors must put the interests of creditors as a whole above those of shareholders. Directors should ask themselves on a regular basis during the sale process whether the company remains solvent, applying both the cash flow test (can the company pay its debts as they fall due?) and the balance sheet test (do its liabilities exceed its assets?). Any transaction completed in the run up to insolvency, particularly if assets are being sold at a knock-down price, may be challenged by a subsequently appointed administrator or liquidator. In order to protect directors, board meetings should be held regularly and minuted so that they can defend themselves against any challenge to the transaction later down the line, or any allegations against them of wrongful or fraudulent trading. See Practice Note: Director's guide to dealing with a company in financial difficulty
- on the face of it, an accelerated M&A process is simply a typical corporate finance process run over a significantly shorter period. However, the key difference is that the sale is often run against the backdrop of a 'burning platform' driven by the company's cash requirements. This is often therefore reflected in the price to be paid for those assets. Timing therefore takes on increased importance, possibly over and above other points that would otherwise have been the subject of lengthy negotiations in the context of a solvent sale. If there is a risk that value may break below the equity level, the process should be started (and specialist advice taken) early in order to preserve value. Confidentiality is also of particular importance, because the likely achievable price for the assets will depend on keeping the deal under wraps
- managing multiple stakeholders is a key aspect to any successful accelerated sales process. In many instances there are a wide range of stakeholders—directors, shareholders, one or more banks, often one or more asset-based lender, employees, potentially a private equity house, bondholders, junior debt providers or active credit insurers. The key is early engagement with all the key stakeholders and recognising that a consensual solution is required. The seller must be able to deliver the message that this may be 'the least worst' alternative and influence stakeholders to accept an outcome that is often not perfect from their individual perspectives
- setting the price at the right valuation for the business, given its distressed state, is key. If the price is set too high, this may invite buyers to conduct a more thorough due diligence on the assets and ask for contractual protection that is more appropriate for a non-distressed scenario. The risk of too low a price is that buyers may sense a desperate situation and take advantage of it
- In order to bridge the gap between a buyer's desire for contractual protection, such as warranties, representations and indemnities and a seller's reluctance to give such comfort in a distressed sale, warranty and indemnity insurance may help to give the seller the benefit of a clean break while offering the buyer the comfort it requires

Structure of the sale and assets to be sold

A solvent, an insolvent or a distressed sale may take place by way of private treaty or contract, through an auction or by inviting sealed bids or tender offers. Whichever method is most appropriate will depend on a variety of factors, such as the complexity of the transaction, the size/value of the asset and the level of competition to purchase the asset.

Generally, a distressed company will usually be prepared to consider selling the assets using the structure preferred by the buyer, unless the specific circumstances make a particular structure notably more cost efficient for the seller. This usually takes the form of a direct sale of the assets from the distressed company to the buyer. The form of agreement used in a direct sale is typically an asset sale agreement that identifies all the assets that the buyer seeks to acquire, together with any liabilities to be transferred. These are invariably listed in schedules to the agreement.

Many of the issues that an insolvency practitioner (see Practice Note: **Buying a business from an insolvency practitioner**) or a solvent seller of assets will need to consider will still apply in the context of a distressed sale. For example:

- provided that any mortgage or other charge over freehold property is released, generally there is nothing to prevent a distressed seller from selling freehold property
- generally a distressed company cannot, without the consent of the relevant landlord, assign a lease. Any mortgage or other charge over the leasehold property must also be released
- directors may be tempted to split the assets and sell a particularly profitable asset of the business (especially one that is highly cash generative) on the grounds that it is likely to provide a large amount of cash to pay down debt and keep creditors and finance-providers at bay. However, directors are under a duty to have regard to a long term view (**CA 2006, s 172(1)(a)**). Selling a high performing asset may be tempting in the short term but may have a severely detrimental effect on the business's future prospects and long term cash flow projections
- provided that the contract does not prohibit it, while a distressed company can assign the benefit of a contract, it may not assign the burden of a contract. For a contract to be transferred it must be novated. The benefit of contracts may also be subject to security which must be released before the contact is novated
- a distressed seller will likely retain all cash in hand, at bank, investments and securities. Shares in subsidiary companies may be sold along with the other assets of the distressed company, depending on the terms of the agreement with the buyer
- assets that the distressed company holds in trust will be excluded from any sale since they do not belong to the company and thus the directors have no powers to deal with them
- depending on the nature of the assets being sold, there may be a transfer of personal data (such as names and contact details) from the seller to the buyer (for example, relating to customers or suppliers). This transfer of personal data gives rise to obligations on the buyer and seller under the **Data Protection Act 1998** (and, from 25 May 2018, the EU General Data Protection **Regulation (EU) 2016/679**†)

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