Buying a business from an Administrator

Mayer Brown International LLP has represented all categories of interested parties – administrators, liquidators, receivers, purchasers and secured creditors – in the sale and purchase of assets of companies in distress, including where the transaction is to be implemented as part of a "pre-packaged" sale process. Mayer Brown can deliver the inter-disciplinary approach that is essential to achieving meaningful results in a distressed acquisition process.

Introduction

In most formal insolvency processes there will be an attempt by the officeholder (i.e. the receiver, liquidator or administrator) to sell the assets of the distressed debtor company either as a going concern or on a piecemeal basis. If done properly, and absent extraordinary circumstances (such as the purchaser's participation on a collusive sale or in some other fraud upon the creditors), such a sale permits the purchaser to obtain the assets from the officeholder free and clear of all security, claims, and encumbrances. However, any prospective purchaser should be well aware of how the process works, as well as the benefits and the pitfalls.

The parties generally approach the sale in much the same manner as a seller and purchaser would do in a non-insolvency context (for example there may be an auction process, bidders may enter into confidentiality agreements, limited due diligence may be carried out etc.). However, the purchaser will have to recognise that the officeholder will have limited knowledge of the assets which are being sold and that the sale will often need to be conducted in a short timeframe, meaning that there will be limited time to conduct any form of due diligence exercise. The gaps in the purchaser's knowledge of the assets being acquired will be reflected in the purchase price, which will be materially reduced as compared to an arms length solvent sale. These issues are considered in more detail below.

Appointment of an administrator

Although the considerations set out below will on the whole apply equally to liquidators and receivers or administrative receivers, it is most likely that a prospective purchaser of distressed assets will be dealing with an administrator, which is currently the most widely used corporate insolvency procedure. The primary objective of an administrator is to rescue the company as a going concern. However, if this is not possible, the administrator's objective is to achieve a better result for the company's creditors than would be the case if the company were to be

wound up. In realising the company's assets the administrator will seek to achieve the best price possible for the business so as to maximise the distributions available to the creditors as a whole, taking into account other relevant factors such as the speed with which the deal can be done and the availability of ready cash. Maintaining a viable trading business for sale as a going concern will usually maximise the value of the assets of the company.

The administrator can be appointed by the company itself, by its directors or by any secured creditors who fit the criteria of a "qualifying floating chargeholder" (i.e. the holder of a floating charge over all or substantially all of the company's assets). If the company or its directors seek to appoint an administrator they must first give notice to any qualifying chargeholder of their intentions, allowing the qualifying floating chargeholder five business days to nominate and appoint their own administrator. The traditional route of appointment of an administrator by the courts is still available, but typically the administrator will be appointed without the need for a formal court hearing, although certain documents will need to be filed with the court.

Pre-Packs

"Pre-packs" are much in the news at the moment. Pre-packs are pre-arranged sales where the directors and secured lenders agree in advance with a proposed administrator to sell the business of the distressed company as a going concern to another company, often a newco set up by existing management, immediately on appointment of the administrator.

In the majority of cases there are sound commercial reasons for a pre-pack, particularly for service companies where the value is in the employees of the company and their customer lists, and in those cases delay will inevitably lead to a diminution of value for the company's creditors and loss of jobs. However, the process is open to abuse.

As a third party purchaser, your opportunity to get involved in a pre-pack will be limited, as the deal is normally done before you get to hear that the company in question is in administration. As a creditor, your knowledge of the deal will again be after the event, but the administrator must disclose to the company's creditors a large amount of information relating to the sale, and the Insolvency Act 1986 allows creditors to challenge an administrator's conduct of a company where they feel the administrator has acted in a way which has unfairly harmed the interests of the creditors. The Insolvency Service has also recently set up a hotline for members of the public to raise complaints where they feel there has been misconduct in a pre-pack or they have been unduly disadvantaged.

Warranties and indemnities

The Insolvency Practitioner (a licensed insolvency specialist, normally an accountant by training, and often referred to as the "IP") who is appointed as administrator will have only very limited knowledge of the distressed company and its business and assets and will not wish to use creditors' money expending time and resources to increase his knowledge. As a result, the administrator will not be prepared to give any title guarantees in respect of the assets to be sold and will instead only sell

whatever "right, title and interest as the seller may have (if any)" in the relevant asset. Similarly the administrator will not be prepared to give warranties or indemnities in relation to the assets.

If the buyer is in a strong bargaining position it may be possible to secure certain concessions (such as a warranty that the administrator has not encumbered assets), although such concessions are rare in practice. The lack of a title guarantee, warranties and indemnities reinforces the need for the purchaser to carry out as thorough a due diligence exercise as is possible in the circumstances. In reality this is likely to be limited given the timeframe to which all parties will be working to and the limited information which the administrator will hold. It may amount to little more than a day or two spent in a hastily arranged data room, or a visit to the site itself. Therefore the purchaser will have to get comfortable with the risks inherent in this type of deal.

Additionally it is common for the administrators to exclude personal liability for themselves, their employees and agents in dealing with the company's assets. This will typically form a clause in the sale agreement as well as the administrator specifically executing the documents without personal liability.

Payment for the business and/or assets

In most cases, the purchase price for the business and assets will need to be paid on completion. It is possible that the purchaser may be able to negotiate alternative methods of payment, for example, payment in instalments or a retention against specific liabilities such as redundancy claims, but in competitive bidding situations an administrator will often elect to deal with whoever is in a position to give them the best cash deal up front, even if it is not the highest aggregate bid, particularly where subsequent payments are not guaranteed (e.g. if performance related). It is not unusual for the administrator to require, at an early stage in negotiations, evidence that the purchaser has the purchase price readily available.

Asset considerations

The contract for sale to be entered into between the company, administrator and purchaser will need to deal with specific asset types. The following are common concerns and issues raised in relation to the principal classes of asset:

Stock/work in progress – often it will not be possible to determine the precise value of stock in time for completion, but it is also relatively uncommon for the sale agreement to provide for an adjustment of the price based on a subsequent stock take. Note that stock may also be subject to retention of title clauses in favour of the suppliers, discussed in more detail below.

Plant and machinery – concerns will focus on the obsolescence (and therefore value) of items of plant and machinery, the degree of annexation to any rented property (which could impair title) and the cost of removal of items if the premises are not taken on. There may also be issues of access where there is a dispute with landlords. Items of plant and machinery may also be subject to hire purchase agreements (which are again discussed below).

Land/buildings – most issues arise out of a purchaser's desire to use and occupy leased premises following the sale. Ideally, the purchaser would take an assignment of the lease, but this can be time consuming, normally requiring landlord consent (and the agreement on the part of the purchaser to meet the landlord's legal costs) and agreement as to the treatment of outstanding rent. The purchaser will also need to demonstrate its financial robustness to the landlord. In the current market the rent paid by the seller may be higher than the purchaser's estimation of market value, and the purchaser may want to renegotiate the rent as part of its discussions with the landlord. Historically it has been common for administrators to grant the purchaser a short term licence to occupy the premises whilst the purchaser negotiates with the landlord. However, purchasers should note that licences to occupy are typically terminable by the administrator without notice in order to protect their position and may be in breach of the lease.

Intellectual property rights – if the insolvent company owns registered IPR which the purchaser requires for the ongoing business, post-completion assistance is likely to be required to formalise the legal transfer/registration process. The company may also have the right to use other licences (e.g. computer software) but such licences may be terminable on insolvency or may not be assignable. Often such software is "shrinkwrap", such as Microsoft Office, and it may be easier for the purchaser to acquire its own copies rather than seek to assign the seller's licences.

Trade name – the purchaser will normally be able to purchase the trade name and the associated goodwill to allow the purchaser to continue the business using its existing brand name.

Book debts/receivables – the seller's right to receive payment for goods supplied to customers prior to completion is often excluded from the sale, particularly where the book debts have been assigned to an invoice discounter or factoring company. The sale agreement may provide for the purchaser to assist the administrator in collecting pre-appointment book debts and there is often scope for commission or some other form of compensation to be paid for doing so. A further benefit to the purchaser is that this can allow the purchaser to manage relations with its new customers better than if it allows the administrator to pursue customers for debts whilst the purchaser is trying to establish commercial relations with them.

Excluded asset considerations

As well as outlining assets to be acquired by the purchaser, the contract for sale will need to address those assets to which the company does not have title or which are otherwise to be specifically excluded from the sale.

Reservation of title (**"ROT"**) – where stock supplied to the company is subject to valid ROT clauses in the supply contracts, the company cannot give good title to the stock, and the administrator would be potentially liable to the supplier if he purported to sell that stock to the purchaser. Commonly the contract will exclude stock known to be owned by a third party and will allow the purchaser to take possession of remaining stock, but on the basis that if any of that stock is found to be subject to valid ROT provisions, the purchaser will either deliver up to, or purchase the stock from, the owner, and will hold the administrator harmless against any

claims bought or threatened by the supplier. Where possible, ROT stock should be identified and detailed as an excluded asset in a schedule to the contract for sale.

Hire purchaser/leased assets – large items of plant and machinery or vehicles may be subject to hire purchase or leased asset agreements with finance companies. Such agreements are typically terminable on insolvency and such items should be returned to the finance providers (it should be noted that title to such items is likely to have always remained with the finance providers). It is therefore important to ensure that such items are excluded from the sale and (where possible) identified in a schedule to the contract for sale. Where such items are crucial to the ongoing trading of the business, the purchaser may need to negotiate terms with the finance providers to ensure that the items remain in place going forward.

Tax and VAT considerations

There are several tax issues for a purchaser to consider when acquiring from an administrator.

VAT – generally, where the sale of the business operates as a transfer of the business as a going concern (otherwise known as a "TOGC") it will not constitute a taxable supply and no VAT will be chargeable on the price. A transfer of a business can still be a transfer of a going concern even though it is under the control of an administrator. What constitutes a TOGC will depend on the particular circumstances and advice on this should be sought in every situation, but is typically where the whole or substantially the whole of a readily identifiable business is to be sold to the purchaser. Even if the sale is a TOGC, VAT may be chargeable on the transfer of certain interests in land or buildings where the company has previously opted to tax the land or buildings (although the purchaser can itself, in most instances, opt to tax the land or buildings to avoid paying VAT on the acquisition).

It is a condition of being a TOGC that the assets transferred are used by the purchaser in carrying on the same kind of business as that carried on by the seller. Administrators will therefore usually require that the purchaser agrees to operate the business (for a certain period of time) in a manner consistent with the way in which the business was run in the seller's period of ownership and to indemnify the company and the administrator if HM Revenue & Customs subsequently deem that VAT is payable.

Stamp duty and stamp duty land tax – stamp duty may be payable by the purchaser on transfers relating to shares in subsidiaries. Stamp duty land tax may be payable where land and buildings are transferred by the administrator to the purchaser.

Corporation tax – on the purchase of assets from an administrator, a purchaser may be able to benefit from certain reliefs from corporation tax. Relief may be available in respect of intangible property such as goodwill and intellectual property and a purchaser should obtain a tax deduction for the amount paid for any stock. Further specific advice on this area should be sought.

Capital Allowances – allowances may be available on a reducing balance basis for qualifying expenditure on, amongst other things, industrial buildings (although these allowances are being phased out) and plant and machinery, reducing the purchaser's potential liability to corporation tax. Again, specific advice should be sought on this.

Customer/Supplier contracts

Whether the company's rights under certain customer and supplier agreements can be included in the sale will depend on whether any such agreements remain in force after the seller's insolvency and whether they are capable of assignment or novation. Long term and potentially valuable agreements may well be terminable on the insolvency of the company. Such agreements may therefore be excluded from the sale and it is incumbent on the purchaser to make its own arrangements with key customers and suppliers. Indeed the purchaser should take steps to sustain and rebuild all customer and supplier relationships as soon as possible as they are likely to be crucial to the ongoing trading of the business. If such agreements remain intact post insolvency, they will need to be novated and/or assigned to the purchaser, normally with the consent of the customer/supplier. Provision will need to be made for this within the contract for sale and it is often the case that a further assurance clause is included which will provide that the administrator of the company will take reasonable steps to assist the purchaser in this process.

Employees

One of the key issues for the purchaser will be the potential impact of employment legislation and, in particular, the Transfer of Undertakings (Protection of Employment) Regulations 2006 (otherwise known as "TUPE"). Under TUPE, where there is a "relevant transfer" of a business undertaking, the employees engaged by the transferor in that undertaking, together with all rights and liabilities in connection with their employment, will automatically transfer to the transferee. Dismissal of staff by the administrators or the company prior to the sale will not necessarily circumvent TUPE, and worse, any dismissal made in connection with the transfer will automatically be unfair, giving rise to a claim or claims for unfair dismissal which may transfer to the purchaser. TUPE applies by operation of law and will apply to a sale even if the contract for sale only describes the sale of assets or specifically states that employee liabilities do not transfer.

The standard wording of a contract for sale from an administrator will confirm that, to the extent that TUPE applies, the purchaser will be responsible for all transferring rights and claims and will indemnify the administrator in respect of them. The purchaser will therefore seek to obtain as much information as possible regarding the existing and recently dismissed employees of the company to ascertain whether employees or liabilities in relation to former employees (such as claims for unfair dismissal) will automatically transfer. Once identified, the purchaser may seek to ensure that such liabilities or transfers are reflected in the purchase price for the business. It is, however, highly unlikely that the administrator will be prepared to provide an indemnity in the event that it subsequently transpires that certain employees and/or claims transfer post completion.

It should be noted that a recent decision of the employment appeals tribunal has found that employees did not automatically transfer to a purchaser in a pre-pack scenario where the company from which the business was sold had entered into administration and the administrators had concluded a rescue of the company was not possible. This leaves a degree of uncertainty as to what view a tribunal might

take of administrations in which it is unclear at the outset whether the rescue of the company is a viable option. As a result, both the purchaser and the company should seek advice as to whether the employees in question will transfer under TUPE.

Regulatory considerations

Consideration should also be given to issues which are specific to the company itself and the sector in which it operates. For example, the business and certain personnel may hold licences or permissions from local or central government and regulatory bodies which the purchaser may need for the continued operation of the business. Examples of such licences or permissions include HGV operators licences and liquor licences. Consideration will need to be given as to whether the purchaser can take the benefit of such licences and if so how they can be transferred, particularly if such licences are personal and the employees in question will not be taken on by the purchaser. In certain situations the licences will be so crucial to the business in question that a failure to ensure that they transfer could result in the failure of the transaction altogether.

The purchaser will also need to consider whether or not there are any outstanding environmental issues which arise from the sale of the business. Under the environmental laws of England and Wales, the responsibility for meeting the required standards in correcting past failures on environmental issues can pass from the seller to the purchaser on a business sale. Regulated areas principally consider the use, disposal and clean up of hazardous substances and breaches can carry severe civil and criminal penalties. The risk may be so great that in the absence of any form of warranty or indemnity from the company or administrators (which are unlikely to be forthcoming) the purchaser may not wish to proceed with the acquisition. To guard against the risk, the purchaser will look to undertake as thorough environmental audit as possible in the circumstances. Insurance may also be available, but where there has been limited due diligence carried out it is likely to be expensive.

Books and records

The company's statutory books and records will not be included in the sale as they will need to be retained by the administrator. However, it is usual that the purchaser will have access to all other records in order to ensure the smooth running of the business being acquired. Normally the administrator (and subsequent liquidator) will also require access to such records in order to discharge their own duties effectively. Typically, the administrators will grant the purchaser possession and use of the records for an agreed period of time post-completion with a right on the part of the administrators to access them in the meantime.

The position is slightly different in relation to VAT records. Where a business, or part of a business, has been transferred as a TOGC, the seller will need to retain the VAT business records for a period of up to 6 years. This obviously creates a problem for administrators where they will seek to dissolve the company once they have concluded its winding up but will not therefore be able to do so until the 6 year period required under the VAT legislation has expired. In practice the likely solution is for

the seller to "loan" the records to the purchaser but on terms whereby the records are returnable on demand to the seller, or for the seller to allow the purchaser free access to take copies of the VAT records.

An alternative is for the purchaser to take over the VAT registration of the business acquired as a going concern, but this will result in the purchaser taking on all VAT responsibility of the business, such as unpaid output tax, unclaimed bad debt relief and record-keeping requirements, and therefore this is unlikely to happen in practice.

Completion requirements

Whilst the drafting and negotiation of the contract for sale will take up the bulk of the time of the advisers to the administrators and the purchasers, it is important that certain practical completion requirements are also considered.

The administrators will need to ensure that not only is the purchaser able to pay the completion monies but preferably that those completion monies have been paid into the administrators solicitor's account to be held to the purchaser's order prior to the formal completion of the sale of the business. All parties will need to ensure that the necessary signatories are in place at the time in which it is envisaged that the sale of the business will be completed, and that those signatories are authorised to sign on behalf of the parties they are purporting to sign for.

The purchaser will also look to ensure that the administrators have obtained the releases of security over any of the assets which are being sold along with the business. The administrators will therefore need to ensure that all secured chargeholders have both approved of the sale of the business and have provided deeds of release in advance of completion. Where the administrators are either selling property or allowing the purchaser access to property, the purchaser will need to ensure that keys to such property are provided on completion.

We would be happy to discuss this and other issues in more detail. Please contact David Morrison (Tel: 020 3130 3876; email: dmorrison@mayerbrown.com) or your regular contact at Mayer Brown International LLP for further information.

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