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Sales of businesses in distress

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When a company enters a period of financial distress, directors must consider the interests of the company's creditors and, depending on the extent of the financial distress, may need to prioritise such interests over those of its members. In such distressed situations, the key current heads of liability directors may face (for which they may potentially incur personal liabilities) include wrongful trading, fraudulent trading, misfeasance and breach of duty.

The government has proposed to introduce new measures enabling directors' disqualification action to be taken against parent company directors selling a group subsidiary if within twelve months of such sale, the subsidiary enters liquidation or administration. Crucially, such directors may also face personal liability under a compensation order.

The current proposal provides that no liability will arise where:

- at the time of the sale the directors reasonably believed that the sale would deliver no worse an outcome for the subsidiary's stakeholders than a formal insolvency proceeding; or
- the subsidiary is a small- or medium-size company.[1]

As further discussed below, our view is that the current proposals may:

- Lead to more administrations and pre-pack sales as parent company directors seek to avoid potential ongoing exposure to personal liability by executing a sale of a subsidiary. Where the parent company enters administration and a sale is executed by the administrator, there would be no risk to the parent directors in respect of such sale.

- Where the sale is in fact executed by the directors, lead to potentially increased timescales as directors seek to produce analysis akin to the "*estimated outcome statement*" currently seen in the context of schemes of arrangement. Such analysis would set out the estimated returns to creditors upon an insolvent liquidation or administration (to demonstrate that the directors "reasonably" believed that the sale would deliver no worse an outcome for the subsidiary's stakeholders than would a formal insolvency proceeding).

Background

The proposal is part of an effort to support distressed companies which arises in the context of the government's proposed measures to revive and update the UK's insolvency and corporate governance framework.

Due to certain responses during the consultation process, the government has significantly watered down the proposal. For instance, it was originally envisaged that the relevant period following sale would be two years instead of the now proposed twelve months. However, some uncertainties still need to be ironed out: among other things (explained below), it remains unclear how this proposed legislation will operate in the context of a holdco or subsidiary that is not incorporated in the UK.

Timing

The government claims the legislation will be introduced "*as soon as parliamentary time permits*". However, given the government's somewhat unsatisfactory (and often vague) treatment of certain key issues in response to the consultation

[1] For the purposes of the Companies Act 2006, i.e. company must satisfy at least two of the following three criteria for a financial year: turnover not more that £36 million; balance sheet not more than £18 million; not more than 250 employees.

(and its current focus on Brexit), our view is that the proposed changes are unlikely to be introduced in short order.

Concerns for holdco directors

The scenario below highlights problems that the legislation, as proposed, may give rise to in a private equity context, and accordingly will need to be addressed in the draft legislation.

A private equity sponsor purchases a large care home provider ("Care OpCo"), appointing two directors to the boards of each group company. Following the acquisition, it becomes clear that each of the group entities beneath Care OpCo (which last financial year had 300 employees and a turnover of £40 million) in the corporate structure are financially underperforming, so Care OpCo's parent, Care HoldCo, sells Care OpCo on a distressed basis. Eleven months following such sale, Care OpCo enters administration.

Care OpCo does not qualify as a small- or medium-size company. Unless Care HoldCo's directors can prove that they reasonably believed at the time of sale that the sale would deliver no worse an outcome for the stakeholders of Care OpCo than a formal insolvency, they may potentially be disqualified from acting as directors and face personal liability under a compensation order. In their current form, these proposals raise a number of questions and concerns for the industry.

1. Directors will face a potential conflict when considering the interests of the shareholders of Care HoldCo and the stakeholders of Care Opco. The government has yet to address satisfactorily which of these duties will take precedence (para 2.9, Government response: Insolvency and Corporate Governance).
2. Potential personal liability may mean that directors will prefer to seek to place the distressed company in an insolvency proceeding rather than sell the company, which may be value destructive for stakeholders.
3. Accordingly, there is a risk that these proposals will reduce the market for rescue finance and distressed M&A more generally, deterring legitimate business sales and leading to more insolvencies that otherwise may have been avoided. As indicated above, distressed sales may be more likely to be executed as pre-packaged administration sales.

"Reasonably believed"

The government considers the courts best placed to contemplate reasonableness of conduct issues. The government has confirmed that it will publish a non-exhaustive list of considerations for the courts when deciding whether a director acted reasonably in relation to a sale. Such matters *may* include:

1. Was professional advice on the sale sought? This should usually be the case, particularly where a large subsidiary is being sold.
2. To what extent did the holdco board consult major stakeholders of the subsidiary prior to the sale? Holdcos may do this in any event, although the question of what constitutes "major" remains unanswered, including as to whether this would extend to both trade creditors and financial creditors.
3. What steps did the board of the holdco take in ascertaining that a sale would result in no worse a position for the subsidiary company and its stakeholders than a formal insolvency? As noted, we believe this may result in a trend for "*estimated outcome statements*" being used. This will likely result in longer timescales and in more expense being incurred for the holdco: for example the financial advisors in the sale process may need to conduct further valuations based on different assumptions.

However, there has been no formal guidance on how high the standard of reasonableness will be. For instance, in order to meet the above (non-exhaustive) criteria, do holdco directors need to conduct a comparative calculation of going concern versus liquidation/break up value? To instruct lawyers and other professionals each time there is a risk that a subsidiary

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being sold on a distressed business may enter insolvency proceedings in 12 months would be burdensome and expensive. The government has stated that in order to minimise these costs, it will work "*with industry to develop guidance on the steps that a director should take when considering the sale of an insolvent subsidiary*" (para 2.16, Government response: Insolvency and Corporate Governance), but nothing more specific has been said.

Conclusion

Whilst the government has provided *some* guidance on what the courts may consider when contemplating reasonableness, more detail is required, particularly in terms of the standard of reasonableness required, and no satisfactory guidance has been provided vis-à-vis: (i) conflict of duties; (ii) what the proposed potential personal liability of directors in this context may extend to; (iii) how the proposal will work in the context of non-UK holdcos or subsidiaries; and (iv) the possible damage the proposal may make to the rescue finance and distressed M&A market in the UK.

Accordingly, the extent of this liability on directors will remain unclear until the government publishes further guidance. Depending upon this and future judicial treatment, there is a risk that the obligations on directors to prove that they acted reasonably in the relevant circumstances may be onerous. In any event, the management of risk and conflicts in distressed scenarios will need particularly special consideration going forward.

The devil is in the detail: the consequences of these proposed changes will become clearer as the government provides further guidance, and as the legislation's finer drafting points develop.

For further information on any of the issues outlined above, please contact Dan Andrews.

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