Ensuring a smooth sale

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Anthony Turner and Adam Carvalho give the lowdown on the sale of corporate assets by trustees

It is not unusual for trustees to hold shares in private companies whose activities may range from a single purpose vehicle owning real property to a multi-national trading business. It follows that there will be times when trustees will consider a sale; there are any number of reasons for this but commonplace reasons are to realise value from an investment, to allow the trust to make substantial distributions or to diversify or otherwise de-risk trust assets.

On the one hand, trustee sellers sit in exactly the same category as any other seller. They want to sell the asset at the best available price with the minimum of cost and at the same time reduce or remove any residual liability for themselves after the sale. On the other, trustees have very different (and onerous) duties when compared to individuals or commercial sellers. Trustees that enter into a contract with a third party generally do so as principal and therefore assume a personal liability under the contract. Even though trustees have a right to be indemnified out of the assets of the trust in the proper performance of their duties as trustees, this does not, of itself, mean that their liability to third parties is limited to the trust assets.

Corporate sales follow a reasonably settled format and inherent in this is that a seller stands behind contractual warranties and will be liable to a buyer if the company is not what the seller says it is.

For good reason, a trustee is not in the same position as a non-trustee seller. However, notwithstanding the validity of a trustee's prudence and unwillingness to assume liability, a great deal of care has to be taken to ensure that this does not affect the value on sale or the ability of a trustee to sell the asset at all. Faced with a blunt statement that the seller cannot accept liability in relation to the asset being sold, a buyer will naturally consider reducing the price (and possibly by quite a margin) to reflect the uncertainty, or decide that it cannot proceed with the acquisition. Therefore a trustee needs to ensure that it is in a position to offer some contractual comfort to a buyer in order to ensure that it can sell an asset at the best price. The trustees will also wish to protect trust assets which have nothing to do with the share sale from being caught up in restrictions imposed by the buyer.

> **It is important for trustees to make an early decision about what is on offer as part of the sale and to raise this with the buyer so that any discussions in relation to price (and choice of buyer) can be dealt with at the beginning and not affect the fundamental terms on which the sale takes place.'**

One initial point should be made: a sale can be structured as a share sale (where the trustees sell the shares in the company) or a sale of assets (where the buyer will buy a discrete collection of assets and goodwill from the company). The level of risk is usually somewhat reduced on an asset sale but in the majority of instances it would be expected that trustees would sell shares. For this reason

and because a share sale places trustees directly in a direct contractual relationship with a buyer, in this article we focus on share sales.

Readers may be familiar with the trust law issues that may arise on a sale of shares, but corporate law considerations may be less familiar. The purpose of this article is to examine the process for the sale of shares by trustees from both perspectives, and to consider how, in practical terms, trustees might structure the transaction in order to reduce the risk and protect their personal position, whilst at the same time maximising value. The same principles will apply to both individual and corporate trustee sellers, and each should seek to protect themselves in the same way.

Should trustees sell?

Trustees have to keep an eye on the balance of their investments and consider on a regular basis whether assets should be retained or sold. They might resolve to investigate a sale of shares, for example, to diversify a fund. Inevitably, trustees who own valuable shareholdings in private companies will also be approached from time to time by interested potential buyers. The questions faced by trustees in such a situation are: (a) should we sell; and (b) what steps do we need to take to ensure the decision cannot subsequently be challenged?

In some instances the trustees may feel able to make a judgment on the basis of professional advice, and/or the beneficial class may be relatively restricted such that it is possible to obtain informed consent, releases and indemnification from beneficiaries. In many cases, however, this will not be the case.

Court blessing

As part of the supervisory jurisdiction exercised by courts in respect of trusts, it is always open to a trustee who is in doubt regarding a particular course of action to seek judicial directions. Once the court has approved a course of action, the trustees will be protected from subsequent claims from beneficiaries as to the propriety of those actions.

Readers may be aware that trustees may ask the court to approve a particular decision which they have made in principle (*Public Trustee v Cooper* [2001]). In many instances a trustee who is minded to sell a shareholding will want this decision to be 'blessed' by the court. Lord Oliver summarised (in *Marley v Mutual Security Merchant Bank* [1991] the approach taken by the court:

> *The question whether the trustee has demonstrated that the contract submitted for approval is in the best interests of the beneficiaries reduces, in such a case as this, to whether the trustee can satisfy the court that it has taken all the necessary steps to obtain the best price that would be taken by a reasonably diligent professional trustee. The question may equally well be expressed as whether the trustee has shown that it has fully discharged its duty.*

The facts of *Public Trustee* provide a useful, and colourful, illustration of this type of application. The claimants were trustees of a settlement held for the benefit of the brewery's employees known as the Provident Fund and owned shares in Mansfield Brewery plc, a regional brewery founded in the mid-19th century.

Roughly half the issued shares of the company were held by the Provident Fund and a second trust established by the same settlor, the Charitable Fund (held for charitable purposes), though in unequal shares

In the late 1990s, the trustees were becoming increasingly concerned about the long-term future of the company. Following the introduction of the 'Beer Orders', the market changed dramatically, with detrimental effects on regional breweries. The Charity Commission had also become concerned about the Charitable Fund's lack of diversification. Independent advice taken on the commercial position of the company concluded that there were 'severe threats' to its future. At the same time, a bid had been received to acquire the shares held by both funds.

In coming to the decision to accept the sale, the Provident Fund trustees took a number of factors into account. The terms of the bid were obviously highly relevant, together with gloomy advice on the future of the company to be 'blessed'. The court summarised that the decision to accept the offer was one that the Provident Fund trustees were entitled to take as a reasonable body of trustees. The court did not think that the trustees' duties extended to deploying the trust fund through thick and thin to support the current business unit in its current form. The Provident Fund was not (for example) a maintenance fund for a heritage asset.

The trustees had been fully conscious of the momentous nature of the decision they had to make; they had been properly advised as to the nature of the fiduciary discretion vested in them; they had taken every relevant factor into account and had not been swayed by any improper or irrelevant considerations.

The trustees' decision as to how to exercise their discretions had accordingly been 'blessed' and they could be reassured that that their decision to sell would not be subsequently challenged. The next step, of course, was to effect the sale, and we now consider the mechanics of this process.

Acquisition process

A buyer will have any number of reasons for acquiring a business and could be any of a wide range of persons, from a trade or equity buyer to an individual buying in their own capacity. However, their principal concern will be to purchase the business at the lowest price and to reduce as far as possible all risks relating to the acquisition. Inherent in an acquisition of shares in a company is that the buyer takes on the economic risk of the company's history. If the company has an unknown historic liability which comes to light after the sale, it will affect the value of the company and therefore the value of the shares. Absent contractual protections negotiated as part of the sale, a buyer will bear the risk of any liabilities of the company.

Both the seller and buyer have an interest in ensuring that a proper sale process is followed. The principal ways in which this is done in a corporate sale are as follows:

Due diligence

The buyer will carry out a due diligence process involving accountants, lawyers and business advisers, during which they will review as much information as

possible in relation to the company in order to verify both the decision to acquire the company (and the related price) and also to discover whether there are any hidden or other liabilities which might concern them. Due diligence allows a buyer to make an informed decision as to whether the target company and its business is what they expect and, if it is not, what to do about it.

Where the buyer discovers a particular issue with which it is concerned, its options are:

- to factor this in to the price, such that the price is reduced to reflect that potential liability coupled with the risk of it materialising;
- by way of a specific indemnity, which is an obligation on the seller to compensate the buyer on a pound for pound basis for any loss arising from a particular matter; or
- not to proceed with the purchase.

A buyer may also want to carry out due diligence into the selling trustees. In particular the buyer may want an understanding of the structure of the trust in relation to, for example: what rights and duties the trustees have under the trust deeds (in particular to give warranties and indemnities); who can appoint and remove trustees; and whether there is a protector and, if so, what powers they have. This will be confidential information and full disclosure may well be resisted by the trustees.

Contractual protections

A negotiated sale and purchase agreement will include a number of mechanical provisions relating to the timing and manner in which the sale takes place. The bulk of the agreement however is given to the allocation of liability between the seller and buyer, in particular in the form of warranties. Warranties are contractual promises about the company and its business. If a warranty is incorrect, the seller may be liable to the buyer for breach of contract as a result. For example, if a warranty states that the company is not subject to any litigation, but the company is being sued for £1m for breach of contract, the seller will be in breach of that warranty and potentially liable to compensate the buyer for the loss suffered as a result of that litigation.

These warranties will be negotiated but will generally be broad and all-encompassing and will cover every aspect of the target company and its business, from ownership of the shares to trading contracts and employees. Warranties generally speak as at completion and are backward looking; they should not be a guarantee of any future return or reward going forward; these are risks for the buyer.

In addition, it is usual for a buyer to require an indemnity for tax. If there is a successful claim by HMRC (or a relevant tax authority) against the target company relating to the period before completion of the sale, the seller will be obliged to pay to the buyer an amount equal to that tax on a pound for pound basis, without any discount. The rationale for this is that the seller should have paid that tax before the sale and it should therefore be the seller’s liability. We consider the ways in which trustees can seek to limit their liability in such instances in the sections below.

Disclosures

If a buyer is aware of any matter relating to the target company, it can generally not make a warranty claim to the extent of that knowledge. It is therefore in the seller's interest to disclose as much information as possible to the buyer as part of the sale process. This will usually be achieved through a combination of disclosing documents to the buyer during the due diligence process and setting out detailed disclosures of material matters in a formal disclosure letter. Clearly, the seller will need a good working knowledge of the business in order to ensure that this disclosure process is robust. Where trustees do not have detailed knowledge of the target company and its business, they will need to rely on the knowledge of key employees and advisers in order to ensure that the disclosure process is properly carried out.

Limitations

A seller will naturally look for specific limitations of liability under the sale agreement. Value is probably the most important, and the standard position is that the seller will be liable for breach of the sale agreement up to a maximum of the consideration which it has received: if there is a catastrophic claim for breach of warranty, the seller may need to return the consideration which it has been paid in order to compensate for the loss. It is unusual (and unattractive) for a seller to agree to a liability in excess of it. There are also various de minimis figures, such that a claim cannot be made unless the liability reaches a certain threshold. The intention here is to ensure that frivolous or smaller claims are not made so that the seller is not visited with endless small warranty claims.

Time-based limitations are also important: the period following completion for which a seller will be liable to the buyer can be very long. The market standard for liability under the commercial warranties (excluding tax) will be negotiated but will in general last for anything between one and three years following completion. Tax warranties and indemnities will last for the much longer period of seven years from the end of the accounting year in which the acquisition takes place, to mirror the time in which HMRC can claim against the target company for unpaid tax. The exposure for a seller following a sale can therefore last for a significant period of time and, although in practice the risk of a claim should diminish over time, a prudent trustee will need to ensure that it is in a position to satisfy any claim if it arises.

Sale agreements commonly include a variety of other limitations of liability. For example, trustees should consider whether they want to have conduct of any claim which causes a liability for them under the sale agreements, as this is a way to control or limit potential exposure.

Deal structures

It is not unusual for a transaction to be structured so that part of the consideration is retained. This deferral might simply be a holdback, where part of the consideration is retained by the buyer or held by a third party in escrow so that it is readily available to satisfy a valid claim by a buyer. The time period for the retention is a matter for negotiation and, although unusual, may be as long as the entire limitation period. Trustees should resist a material part of the price being retained for more than a couple of years.

An alternative structure, perhaps less a protection mechanism than a commercial way of structuring the transaction, is an earn-out where a proportion of the consideration will be paid depending on the performance of the business over a defined period following completion. This is one area where the buyer and the seller will share the risk, so that if the business does not perform to agreed financial metrics the consideration paid to the seller will be reduced. The advantage to the buyer is that the earn-out will be paid from ongoing revenue (so is self-funding) and the buyer will not have overpaid for the shares.

Trustee specific issues

Trustee points

Most modern trust instruments should contain a power for trustees to enter into warranties and indemnity s, and other administrative powers or (arguably) the general law may provide assistance. In the worst case, a trustee could apply under s57 of the Trustee Act 1925 for power to enter into relevant warranties and indemnities, though timing issues may well arise if this is necessary. Careful scrutiny of the trust deed is therefore advisable at the outset.

A trustee has the right to indemnification from the trust fund for trust expenses properly incurred. In England and Wales this has been put on a statutory footing by s31 of the Trustee Act 2000. This is supported by the equitable lien, which is a 'bundle' of rights giving trustees an equitable interest in the trust assets similar to an equitable charge. The right to indemnification and (arguably) the equitable lien will continue to operate once the trustees have parted with trust assets.

Where a trustee is a seller of shares, the contractual obligations under the sale agreement are a personal obligation of the trustees who are personally liable on the contract. Notwithstanding the rights to indemnification and the equitable lien, this is clearly an unattractive position for trustees, whether they are professional trustees or otherwise. In addition to the more standard approach to liability limitations, there are a number of ways in which a trustee might seek to limit their liability under the sale agreement.

Limited recourse wording

The most simple, and usual, protection for trustees is to include limited recourse wording. In broad terms, this wording will state that the trustees are entering into the sale agreement as trustees of a trust and that, accordingly, the liability of the trustees under the sale agreement will be limited to the assets of the trust from time to time. This is a contractual limitation and not a creature of trust law.

Although possibly an obvious protection for the trustee seller, a buyer is likely to have concerns accepting this restriction as the buyer has no certainty as to what assets will remain in the trust from time to time. One can easily imagine the scenario in which a full consideration is paid in cash on completion and there is then an immediate distribution of a large part of that sum by the trustees to the beneficiaries. In this case, the trust will have no assets and therefore in practice the ability of the buyer to enforce the claim against the trustees will be limited. In this case the buyer may attempt to negotiate a requirement as to the retention of trust assets, as described below.

There is also a potential risk that beneficiaries make a claim against the trustees that they acted without due authority and therefore should not have the right to be indemnified out of trust assets.

Retention of trust assets

A buyer may accept limited recourse against a trustee but include as an additional requirement a prohibition on the trustee distributing capital assets, so that the buyer is assured that the trust fund will remain of a sufficient value to satisfy any claims. The buyer may go further than this and require the funds to be immediately accessible in cash, or near cash, assets and may (although this may well be seen by trustees as an unwelcome intrusion) limit the ability of the trustees to invest the funds other than in ways the buyer considers will not unduly dissipate the trust assets. There is a commercial risk for the buyer that even then the value of the assets may reduce.

Trustees should, in addition, consider how they will pay for the legal and other costs associated with a future claim, as these may be substantial.

Of course, this is not a short-term solution and the trustees may need to retain these funds for a prolonged period (up to seven years in respect of tax) which will be an unattractive decision. In practical terms, one can expect that most liabilities under a sale agreement would become evident to a buyer within the first two or three years following completion, once at least two accounting periods had passed under the control of the buyer. There will be an argument to say that the limitation on the distribution of assets should be reduced over time (perhaps annually) to reflect the reduced likelihood of a claim being made.

Indemnity from beneficiaries

Trustees may take the view that if they receive a full indemnity from beneficiaries, they will then be able to agree to give additional obligations to the buyer on the basis that if a claim was made they would be able to recover against the beneficiaries. Clearly, there is a greater degree of risk for the trustees, as they sit in the middle of any claim and enforceability against the beneficiaries (and ability to pay) is the risk of the trustee, rather than the buyer. Trustees will want to ensure that the beneficiary is of sufficient financial strength to make good the indemnity if it is called.

An alternative to this approach is to require a beneficiary that receives a distribution from the trust fund to give a direct indemnity to the buyer limited to the value of the distribution to that beneficiary. There would therefore be a direct contractual link between the beneficiary and the buyer, and the trustees' liability would reduce by the same amount. The trustee is then free to distribute from the trust provided that a beneficiary agrees that it will have a liability to the buyer. If this process is pre-ordained in the sale agreement, it can take place without the consent of the buyer. There will need to be careful thought given to this, in particular to ensure that the apportionment of liability between the trustees and the beneficiaries is clear in the event of a claim.

Warranty and indemnity insurance

Although this insurance has been available for some time, it has gained greater

prominence over the previous years as the process is now quick and pricing not prohibitive. If taken out, the effect of the insurance is that the insurance policy will apply in the event of a claim so that any loss is covered by the policy and not the seller. This is clearly an attractive option for trustee sellers as it takes away at least some of the liability as a result of a sale. Clearly the insurance premium is a cost but this can either be factored into the purchase price or otherwise seen as an additional cost of the sale.

As with all insurance, there may be a risk that the policy will not adequately cover the position. The actual structuring of the warranty and indemnity insurance – and which party takes this policy out – is important and will need to be considered in detail in each particular case to ensure that the structure reflects the risk profile of the seller.

Minority stakes

It may be more arguable that a trustee should not give warranties where they hold a minority stake in a company and where they have no direct knowledge or involvement in that company. In these circumstances, it would be sensible to introduce into the corporate documentation put in place at the time of the initial investment an acknowledgement from the other shareholders that the trustees will not give any warranties in relation to commercial matters.

Several liability

Where there are other sellers, the trustees will want to make sure that their liability is several and that they cannot be held liable for another seller. If this is impossible to negotiate, the trustees will need to ensure that they put in place a robust contribution agreement with the other sellers so that no seller bears a disproportionate amount of any claim by the buyer.

Fettering discretion

As readers will be aware, fiduciaries cannot bind themselves as to the manner in which they will exercise their discretions in the future (ie fetter their discretion). The trust deed may allow trustees to restrict their powers, provided if this is in the best interests of the beneficiaries. There may be arguments that certain arrangements, if they are commercially justifiable and reasonable, do not constitute an unlawful fetter (see, for example, *Jones v Firkin Flood* [2008]). Nonetheless, trustees will wish to take careful advice on this issue. Buyers will need to exercise caution as the courts may refuse to compel trustees to perform an action on the basis that they have fettered their discretion (in which case the buyer will just be left with a claim against the trustees for breach of contract).

Practical tips

The aim of this article has been to bring together corporate and trust law considerations in relation to the sale of corporate assets by trustees. There are, of course, a number of other relevant areas (such as tax), and in cases where trustees are not UK-resident or assets are held via non-UK underlying companies the laws of those jurisdictions will also be relevant.

It is important for trustees to make an early decision about what is on offer as part

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of the sale and to raise this with the buyer so that any discussions in relation to price (and choice of buyer) can be dealt with at the beginning and not affect the fundamental terms on which the sale takes place. In more complicated/high value sales, an auction process might be one way of achieving this where the overall package offered by potential buyers in terms of price and contractual protections is put to the seller in order for it to determine which bid to choose. This is not to say that a buyer will agree to waive all contractual protections but it might mean that the trustees could receive a slightly lower price in order to receive the benefit of more restrictive warranties.

Once trustees embark upon the process of considering a potential sale, it is important that advice on the various different areas of law is sought quickly to ensure that commercial negotiations can unfold smoothly while the necessary legal issues are resolved.

This publication is a general summary of the law. It should not replace legal advice tailored to your specific circumstances.
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