Client guidance note

Group Structure Simplification

Introduction

New corporate entities are commonly added to the group structure chart as business organisations expand, whether through organic growth into new sectors and geographies or through inorganic growth by way of mergers and acquisitions. Adding new companies is often the simplest short-term solution to facilitate such growth.

However, over time business and regulatory environments change and an organisation's strategy evolves, resulting in the original rationale for some group entities becoming obsolete. This can leave an organisation's legal entity structure overly complex, inefficient and unnecessarily expensive to maintain. A complex group structure can also present additional operational risks.

Organisations can improve their business performance by reducing the number of legal entities in their group structure and combining their operations in other group companies. This is sometimes known as 'legal entity rationalisation'.

The business case for legal entity rationalisation

All legal entities cost money and management time to hold and maintain. In terms of cost-reduction, potential savings may include the following:

Accounting	Preparation of accounts; audit fees; shared services cost allocation; inter-company accounting; monthly/quarterly/annual reporting
Treasury	Bank account service fees; transaction charges; compliance with debt covenants; cash flow forecasting
Legal	Filing fees (eg. Companies House); maintenance of statutory books and records; licensing and regulatory registrations; tax compliance
Risk and compliance	Directors governance matters; legal compliance; D&O insurance
Operational and Human resources	Duplicated administrative services; cost allocation for internal staff secondments; misalignment of management reporting lines; duplicated insurance arrangements
IT Systems	Costs relating to general ledger input; system capacity

Different approaches to legal entity rationalisation

There are several different ways to approach any legal entity rationalisation programme, three common approaches being:

- **Low-hanging fruit**
  This approach focuses on eliminating those entities whose operations are simple and easy to transfer to other group companies (typically, dormant companies). Although cost-savings are easily obtained, those savings are likely to be only relatively modest and the programme will not have addressed any potential improvements to the coherence and efficiency of the group structure.

- **Trial and error**
  Under this approach an organisation has the overall objective of reducing the number of entities in its group structure, but does not necessarily have a specific set of criteria for determining how this will be achieved. The organisation considers each legal entity in turn to gauge whether it is suitable to be eliminated. The advantage of this approach is that it does address the principal aim of reducing cost and complexity. However, it can be a fairly slow process. Also, whilst it will result in a smaller group structure, that structure might nevertheless remain incoherent and inefficient.

- **Blank page**
  Under this approach the organisation designs the group structure it would ideally like to have were it to be built from scratch, without regard to the 'baggage' of the existing structure. Although practical considerations may prevent the desired structure being fully achieved, this approach does have the clear advantage of aiming to create a coherent structure and thereby achieve the greatest cost-savings and eliminate unnecessary

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complexity. The aim is to align the legal entity structure with the business model as it actually exists. Whilst the 'blank page' approach is likely to involve the greatest amount of time and effort, buy-in within the organisation should be at its highest – not only are the cost-savings likely to be maximised but the resulting corporate structure should be easily understandable and relevant going forward.

> *"Everything should be made as simple as possible, but not simpler."*
>
> Albert Einstein

What does a group simplification programme involve?

A group structure simplification programme will involve a number of stages in its planning and implementation:

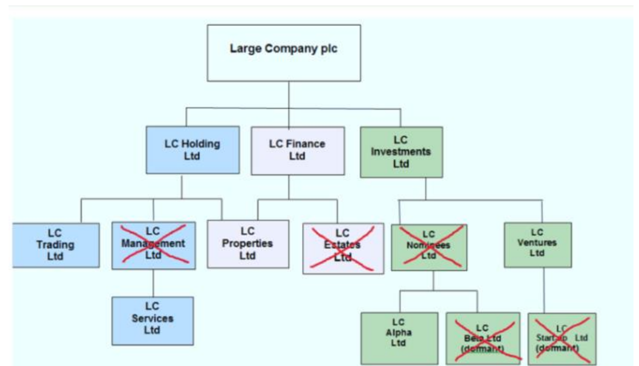
- **Setting the objectives**
  The initial planning will need to set the objectives for the project and the timescale by which they need to be achieved. This will inevitably involve discussions regarding the approach to be taken (see 'Different approaches to legal entity rationalisation' above).

- **Conducting due diligence**
  Having decided upon the overall objectives, the organisation will need to test the feasibility of the project and highlight any significant road blocks which will need to be removed and any other issues which will need to be addressed. The due diligence stage will require input from a number of different fields, including legal, tax, accountancy and operational. Although the project is principally an intra-group affair, it is likely to affect external third parties, and therefore it is important to identify at an early stage all regulatory approvals and licences which may be required, as well as any third party consents (such as bank approval or consents from joint venture partners).

- **Producing a 'Step Plan'**
  To ensure that all practical and legal steps are taken in the correct order, a document will be prepared which (i) sets out the legal, tax and accounting implications and objectives of each component part of the project, (ii) lists the actions required in sequential order, and the documents needed to implement those actions, (iii) identifies the persons responsible for overseeing that particular step, for preparing the documents, filings and other actions, and (iv) sets the dates by which those steps should be achieved.

- **Obtaining consents and approvals**
  Where third party consents and approvals are required, these should be obtained ideally before the start of the programme.

- **Drafting documentation and implementing**
  The exercise is likely to involve legal documentation, such as business or asset transfer agreements, board minutes to approve the transactions, shareholder resolutions to authorise elements of the transactions, as well as other confirmatory documents (such as assignments of business contracts, stock transfer forms, transfers of intellectual property rights and property transfers).



Legal issues likely to arise

The implementation of any legal entity rationalisation programme will involve careful consideration of tax, accountancy and legal issues. In terms of legal issues, what should you watch out for?

- **Distributions in kind**
  Intra-group transactions are commonly undertaken for a purchase price which is not equal to the market value of the assets concerned. This raises the question as to whether such a transaction constitutes a distribution in kind and whether the transferring company therefore needs to have sufficient distributable profits to carry out the transaction.

  Where a transferring company has profits available for distribution, when it transfers a non-cash asset to a parent company or fellow subsidiary the amount of the distribution arising will be:

  - zero, if the consideration received is equal to or exceeds the book value of the assets; or
  - the amount by which the book value exceeds the consideration.

- **Availability of distributable profits**
  In view of the rules relating to distributions in kind (see above), it may be necessary to restructure the balance sheet of the transferring company, in order to 'create' sufficient distributable profits to facilitate an intra-group transfer of assets. It is possible to reduce the share capital and other non-distributable reserves of the company and transfer the amount arising on such reduction to the company's profit and loss account. This requires the directors of the company to make a formal declaration of solvency regarding the company's immediate position and over the next 12 months.

- **Third party consents**
  It is possible that third parties may need to be approached to give their approval to a transfer of assets. This could be relevant in the case of assets owned though a joint venture with a third party. Also, assets which have been given as security under a banking facility may require the consent of the bank to be transferred from one group company to another. It may be necessary to obtain approval from a regulator where the business concerned operates in a regulated market, such as financial services, or one where a licence is needed in order to operate.

- **TUPE**
  An intra-group transfer of a business might trigger a transfer under the Transfer of Undertakings (Protection of Employment) Regulations 2006 (otherwise known as 'TUPE'). If TUPE applies, the employees of the transferring company will transfer, on their existing terms, to the transferee company. The parties will be under obligations to inform, and in some circumstances consult with, the employees in advance of any such transfer.

- **Pensions**
  If the transferring company participates in a defined benefit pension scheme, the company may need to consult with the scheme's trustees to explain what impact the transfer might have on the scheme, taking into account the financial covenant strength of the new employer company.

- **Cross-border merger**
  Where the transferor and transferee companies are incorporated in different EU Member States, it may be possible to effect the business transfer by way of a merger in accordance with the EU Cross-border Mergers Directive.

Meet the team

Cripps has a wealth of experience in working with clients and other professionals, in particular tax accountants, in delivering successful simplification of corporate group structures.

If you would like any further information about rationalising your corporate group structure, please speak to your usual contact at Cripps or:

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