Briefing Note

Buying or selling a business

The process of buying or selling business can be particularly time consuming. The process is demanding and usually, for a seller, the biggest challenge will be running the business at the same time as participating in the sales process while not allowing news of the impending sale to leak out to staff and customers of the business. This article will focus on the legal process of selling a business.

The key steps and some of the critical legal issues in selling a business will be:

A KEY STEPS

Seek Professional Advice Early

It is critical to discuss the sales process early with your key advisers which at this stage would include your lawyer and a tax adviser. Because of the different tax rates which apply, agreeing a sale of a business (an Asset Sale) rather than selling the shares in the company (a Share Sale) which owns the business can result in tax payable in excess of 50% of the proceeds rather than 10%.

The downside to a Share Sale is that the transaction costs are usually higher for a seller. The reason for this is that the purchaser will be acquiring all of the liabilities of the company (e.g. tax, employment issues, contractual issues, liability issues) and so he will want to carry out extensive due diligence on these potential liabilities in order to understand what he is exposing himself to. The tax position is also more complex in a share sale. However, from a positive point of view, there are usually significant stamp duty savings for a purchaser in a Share Sale as compared with an asset sale. By way of example, if the target business had a property worth £2.5m and the price for the business was £5m (including the property), the stamp duty on an Asset Sale would be £100,000 whereas the stamp duty on a Share Sale would be a maximum of £25,000 and possibly lower. It may be possible to negotiate some of these savings into the price for the business.

At the early stages, your advisers should also be raising with you the types of issues that a purchaser will wish to conduct due diligence on. Your lawyer should be able to assist in assembling the documentation with you in a manner that will be helpful to the purchaser and his solicitors. Due Diligence is considered in more detail below.

Appointing an agent

Leaving aside all of the commercial issues around the choice of agent to go with (if indeed an agent is required), the key issues will be around the Agent's terms of engagement. They will often seek exclusivity and a fee regardless of whether they introduce a purchaser. The terms of appointment should be considered carefully and key issues negotiated at this point.

Head of terms

The heads of terms can be as brief as a couple of pages and are not usually legally binding. The structure of the transaction will need to be dealt with at the heads of terms stage and that is why it is helpful to have investigated this early on so that you are prepared and are not in a difficult negotiating position with the purchaser further down the line. While the heads of terms might be seen as non binding and a road map for the transaction, it is usually difficult to depart in any material way from the main points in the heads (certainly without opening up negotiations on other points).

One of the key areas is obviously the price payable. This area can be enormously complex and requires a great deal of experience and understanding in order to identify and record what has been agreed. It will be considered in further detail below.

Due diligence

Due diligence is the process a buyer will go through in making an assessment of the business and will usually cover commercial, accounting, tax and legal issues. It is often done in stages, so that initial due diligence may be confined to the last 2 or 3 years' accounts for the business plus perhaps an initial look at any key contracts. More detailed due diligence will be conducted in the middle phase and is likely to cover meetings with key personnel which can be difficult to handle. The process may highlight issues of concern for a purchaser which may feed into indemnities in the relevant Share Purchase Agreement (SPA) or influence the price offered for the business.

B KEY DOCUMENTATION

A purchaser will usually prepare the first draft SPA and Tax Deed of Indemnity (Tax Deed) (assuming the transaction is a share sale).

i. Share purchase agreement

The key areas of the share purchase agreement are:

1. Price

There are a number of different ways of arriving at a value for the business and this may determine the price and any detail which has then to be agreed.

Two of the more popular valuation bases are:

EBITDA basis

EBITDA is earnings before interest, tax depreciation and amortisation. The EBITDA basis takes the EBITDA from the profit and loss accounts (usually an average over the last 2 or 3 years if the business is a stable state business) and after certain business specific adjustments, a multiplier is applied to the adjusted EBITDA figure to arrive at a price. The multiplier to be used will depend on a range of factors, including the industry in which the business operates (some industries will be more sought after than others at any given point in the economic cycle), the quality of the business itself (e.g. management, customers and strength of contracts), quality of property owned (especially if a hotel or care home for example). The multiplier will be a range of anything from 1 to about 15. A multiplier of 4 or 5 is not uncommon, particularly in the current economic climate.

By way of example, if the average adjusted EBITDA is £m and the multiplier is 5, the price is then £5m.

Of course, when buying a company, the balance sheet in effect moves every day because of changes in the cash position, debtor book, creditors, tax, salaries and so forth. In an EBITDA based transaction, the detail around these changes would largely be disregarded and normally what you would see is a target Net Asset Value (Target NAV) being dropped into the SPA based on the last set(s) of accounts, a balance sheet being drawn up to the completion date (usually within 6-8 weeks or so after completion) and provided the actual NAV at completion is within a tolerance range of the Target NAV, there is no adjustment to the purchase price.

Another way of dealing with this is a more relaxed approach of simply warranting that the Target NAV at completion is not materially worse than the NAV as at the date to which the last accounts were prepared. Usually here, no completion accounts are prepared. The protection for the purchaser is much weaker and there is scope for a fair degree of argument after the event.

One of the downsides to a seller is that there will be an expectation of a normalised working capital position being left in the company at the point of sale and the seller will not receive the benefit of this. Close scrutiny of the working capital position could be maintained in the lead in to the sale and any excess could potentially be cleared out by way of pre sale dividend. A purchaser may not like this however and it may lead to a price reduction – it would more than likely have to be disclosed against the warranties in the SPA and it could also be tax inefficient.

Another peculiarity with pricing a deal this way is in connection with the property if it is owned by the Company. Because the price is struck with reference to the profits of the company, the price may not necessarily reflect the true value of any property owned by the company. Looking at it one way, the Company could generate the same level of profits by leasing property rather than owning it as the costs could be similar. Consideration should be given to this and whether it may be possible as a seller effectively to increase the price for the business by carving the property out of the sale – perhaps a lease to the Company from the point of sale onwards. Needless to say, this throws up a number of issues to consider, including tax, price discussions with the purchaser and potentially it could impact on a purchaser's ability to fund the acquisition as it may have been contemplating using the company's property to secure borrowings for the acquisition.

Debt Free, Cash Free basis

These types of transactions are popular where a transaction is structured as a share sale for tax reasons but would otherwise have been an asset sale. They are most prevalent in relation to businesses where the property is owned and is a key or the sole reason for the acquisition – for example an area of development ground owned through a company, an office block owned through a company, a hotel business or a care home.

The key issue to bear in mind is that the balance sheet of the company on the completion date is being bought and sold, albeit the intention may be simply to acquire the company's property.

The static part of the balance sheet will be the fixed assets – predominantly the property. There may also be long term debt – a mortgage over the property and usually the parties will know the precise figure for this at completion – the price payable on the completion date is often then the agreed value of the property less any term debt associated with it and this would be the Initial Consideration.

The current assets (e.g. stock, debtors, bank and cash) and current liabilities (e.g. accrued but unpaid salaries, accrued VAT, corporation tax, trade creditors) are the difficult bit in the middle of the balance sheet sandwich which move on a daily basis and it is usually not possible to know what this figure is on the completion date until some time afterwards. As a result, the normal process is to agree that completion accounts will be drawn up as soon as possible after completion, looking back to the completion date. This Net Current position (whether positive or negative) will adjust the final purchase price up or down. There may be retentions from the purchase price if there is a concern that there will be a shortfall on the price. Equally, there may be a disregard band, for example £10,000 either way where no further price adjustment would take place.

The process is very detailed and technical and there are many traps for the unwary and ill advised. A carefully crafted set of accounting instructions will be required to be agreed in the SPA, including issues such as corporation tax rates (which can change depending on ownership issues), revaluations of assets, debtor provisions and so forth.

There are also very complex tax issues concerning the base cost of assets which can have a material impact on the tax position and therefore the price payable.

Earn Outs

As a general concept, a purchaser paying a fixed sum for a business is taking the risk that the past financial performance of the target business will continue after he has acquired it. As a result, the sale of a business will often have an element of purchase price which is contingent on future performance, such as meeting certain turnover hurdles or profit hurdles. In conceptual terms, this moves some of the risk of the business' future performance from the purchaser back on to the seller. The art in this process is getting the correct balance of cash up front for the business coupled with the earn out element.

There are taxation, legal and commercial issues for a seller to consider when faced with an earn out scenario:

Tax

From a tax perspective, it is often the case that the earn out element of the price (where it is quantifiable), will be taxed as if the full amount of the earn out proceeds were received on the date of sale of the business, regardless of the fact that some or all of the proceeds are never received. From a seller's perspective, care is required to ensure that the fixed element of the sales proceeds are at least equal to the tax payable.

Legal

With all of the shares being transferred to the purchaser on the completion date and some of the price left outstanding, consideration should be given to taking a guarantee of the price from a third party (e.g. a director). Equally, thought should be given to what form of security is appropriate – for example would the shares in the company transfer back or would security be given over another asset such as a property.

Commercial

It would be normal to consider the inclusion of accelerators of the earn out – for example if the business was sold to someone else in the earn out period, a fixed sum for the earn out might be agreed in advance and fall due for payment on a sale.

Anti- Embarrassment

In certain circumstances, particularly where the agreed sale price is discounted for any reason, it would be appropriate to consider a mechanism to return additional consideration to the seller if the business is sold on relatively soon for a profit.

2. Restrictive Covenants

A purchaser will wish to ensure that a seller cannot reinvest the proceeds of sale in a new business which competes with the target business after the sale. Typically, the range of covenants will be:

- Non – compete: not being involved with a competing business in an agreed geographical area for an agreed period of time.
- Non solicitation of senior staff
- Non solicitation of customers/clients.
- Non solicitation of suppliers (where they are unique suppliers).

Care is required particularly if the seller has other business interests. The covenants can have an interaction with earn out payments- for example they should be disapplied if there is a breach by the purchaser in making payment.

3. Warranties and Indemnities

This area is a very large part of what the legal advisors will lead on, will consume much time in negotiating and will require significant input from a seller.

A warranty is essentially a promise from a seller to a purchaser that a particular statement is true. Depending on the nature of the target business, there may be 200 or so warranties in an SPA. These will cover areas such as ownership of the sale shares, the company's ownership of its property, the accuracy of accounts, warranties about the existence of disputes or litigation, the validity and extent of insurance cover and the insurance claims history, compliance with health and safety regulations, detailed warranties about the employees – their terms of employment, promises about promotion and salary increases, employee relations issues, environmental warranties, condition and maintenance of assets, warranties about properties such as ownership, title disputes, mortgages and a suite of technical warranties such as that the seller has confessed any anxieties he has about the business which if disclosed to the purchaser might have affected the purchaser's willingness to complete the acquisition.

The purpose of the warranties is twofold; firstly to provide recompense to a purchaser if the warranty proves to be incorrect and secondly to drive out disclosures in the lead up to signing the SPA.

This disclosure process usually results in a formal disclosure letter where technical language concerning the disclosures would result in the seller being relieved from liability under the warranties in respect of the disclosure. Each warranty needs to be carefully considered and discussed with a seller and a decision made, either to delete the warranty, qualify it to the extent of a seller's awareness or to disclose against it.

The disclosure letter will be produced quite soon after the draft SPA has been received from the purchaser and will be updated throughout the negotiations. Sellers can often be anxious about the disclosure process because of its detailed nature and there is a great deal of skill required from a seller's solicitor in handling the disclosure exercise and responses from a purchaser. Those responses can range from a decision not to proceed with the transaction, a price reduction, a retention against the purchase price to deal with contingent liabilities disclosed to indemnities against the potential liability.

The indemnity issue is simply that the seller would be responsible for the costs of the matter if it actually arises. Thought needs to be given to limiting the effect of the indemnity – similar limitations as to warranties are discussed below.

Limitations on warranties

Another key part of a seller's solicitors work is to limit the warranties with a set of Vendor Protections (or warranty limitations).

The key limitations are:

A limit on the amount that can be claimed under the warranties. The worst case would be having no limit on warranty claims, receiving £1m by way of price for the shares for example but having to pay back £2m by way of warranty claims. The established practice is to limit the value of claims to the value of the purchase price.

A time limit. A time limit for making claims is appropriate and would normally be in a range of 12 to 24 months. This does not mean the warranties are repeated on every day during that period – the warranties are usually given on the completion date but the 12-24 month period is the period during which claims can be made.

De minimis (hassle factor levels) – usually, a disregard band is agreed which might be around 0.5-1% of the overall price so that if a claim does not exceed this level, there is no liability. There may also be individual claims limits of a lesser amount which contribute to this aggregate level.

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i. Tax deed (of indemnity)

The tax deed is a very complex transaction document which requires close co-operation between the lawyers and accountants representing each party.

While it interacts with protections under the warranties and the completion accounts mechanism in respect of the price, it also stands alone. It is designed to provide a purchaser with protection against any tax liabilities a target business may have, whether those are for corporation tax, VAT, PAYE, national insurance or others.

A seller will require to limit liability to the extent that provision is made in accounts and in completion accounts and there will be a number of other areas such as retrospective tax increases, degrouping shares, increases in corporation tax rates as a result of joining a new group and a host of others. Additionally, there will be a negotiation around savings and over provisions.

A seller should also endeavour to limit liability in the way that is discussed above for the limitation of liabilities in respect of warranties. Time limits are usually extended to 7 years and there may be a differing of opinion between the respective solicitors over the appropriateness of a cap on the warranties.

Summary

This briefing note, while lengthy, covers the key basic concepts and documentation in relation to a share sale. Every deal is different and will have its own dynamic to it which will drive the shape of negotiations and the documentation.

The note is written from the perspective of selling a company to a trade purchaser. A myriad of variations of the issues arise in different scenarios relating to the sale of part of the shareholding in the company to a private equity house, on an auction sale or arising in connection with a management buyout.

This must not be read as advice in any way – it is provided as a general guide to the key concepts arising in a share sale on the basis that the reader would take professional advice from an experienced corporate lawyer in entering into a sales process.

Please contact Turcan Connell's Business Law team for more information on directors and the various types of directorships.

Please note that this briefing note is intended as a short summary of buying or selling a business. No responsibility can be accepted for any action taken in reliance on this note and specialist advice should be taken in every case. Turcan Connell would be happy to provide such advice.
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