Guide to company sales and purchases

Buying or selling shares in a company is a significant step to take, but our specialist corporate solicitors can help you navigate the legal complexities. This guide will explain the key legal aspects involved in buying and selling a company and hopefully make the procedure itself more manageable and easier to understand.

Introduction

The sale and purchase of a business can proceed in two ways:

1. A share purchase: This involves the sale of the shares of the company, and therefore the acquisition includes all assets and liabilities of that company; or

2. An asset (or business) purchase, where only specific assets transfer from the seller to the buyer.

This guide will focus only on share sales and purchases. If you require further advice on asset purchases or the factors to consider in determining how to structure your sale or purchase, please contact one of our specialist solicitors.

In addition, please note that this guide relates to the sale and purchase of non-listed companies only. If any party to the transaction (buyer, seller, or target company) is a listed company, additional rules and regulations will apply.

Preliminary stages

Heads of Terms

The Heads of Terms are agreed between a seller and a buyer, and they set out the key terms of the deal, e.g. price, what is being acquired, timetable etc. They are also sometimes referred to as Heads of Agreement, Memorandum of Understanding, Letter of Intent or a Term Sheet.

Heads of Terms are usually not legally binding, although there are two areas within the terms that parties often ensure are binding, namely exclusivity and confidentiality. Exclusivity is where a buyer may want the seller to agree that for a fixed period of time, the seller will not talk to any other buyers or market the target company for sale. Confidentiality is, as you would expect, where the seller tries to ensure that any information given to the buyer about the target company is kept confidential.

Whether or not Heads of Terms should be used will depend on the nature of the deal. For larger transactions, i.e., where the consideration is high, or the arrangement is complex, Heads of Terms can serve a useful purpose as they help ensure that all the parties are on the same page from the outset.

However, for smaller or more straightforward transactions, it is unnecessary to incur the time (and expense) that Heads of Terms can create. Instead, resources are better spent by proceeding with the negotiation of the share purchase agreement.

Involving a solicitor if a transaction calls for Heads of Terms is essential. The test in law as to what constitutes a binding contract is relatively easy to satisfy, and great care needs to be taken to ensure that the parties avoid inadvertently creating a binding contract when negotiating and entering into Heads of Terms.

Regardless of whether the parties enter into Heads of Terms, a seller should always ensure a binding Confidentiality Agreement (also known as a Non Disclosure Agreement) is entered into before any commercially sensitive information is disclosed. This will place an obligation on the buyer to keep confidential all information that is disclosed to it about the target company.

Due Diligence

Due diligence is the information-gathering process by a prospective buyer to find out as much information as possible about the target company early in the transaction negotiations. The purpose of due diligence is for the buyer to investigate the assets, liabilities, trading performance and finances of the target company. Through this process, the buyer should aim to gain a complete picture of the target company and its critical success factors, strengths and weaknesses. There are commonly three types of due diligence:

1. Commercial - the buyer carries this out to decide whether or not to acquire the target company;

2. Financial - the buyer's accountants should then carry out a financial investigation into the target company to make sure that the proposed price is accurate and reflects its true value;

3. Legal - after the buyer is satisfied with the first two points, then the buyer's solicitors will raise various questions of the seller's solicitors.

Legal due diligence will often involve a lengthy questionnaire from the buyer's solicitor requesting information from the seller. The focus of legal due diligence will depend on the nature of the company being acquired.

For example, if the target company is a property company, the main priority will be to fully investigate the title on its key properties. A software company's focus will often be on intellectual property rights. The buyer's solicitor will usually then prepare a legal due diligence report for the buyer, highlighting any potential legal issues.

Due diligence is an essential preliminary to ensure contractual protection. It can help identify the level and areas of protection needed and any risks the buyer should avoid completely. At any point during the due diligence process, something could be uncovered, the nature of which means that the buyer decides not to proceed with the purchase, seeks a reduction in the price, or at the very least, that some specific protection is sought in the share purchase agreement.

The purpose of due diligence is to either provide the buyer with the comfort that the target company is clean and issue-free or, to the extent that there are issues, that the buyer knows about these and the relevant protections can be built into the share purchase agreement, or a price reduction sought. Effectively, the due diligence process helps the buyer decide whether to proceed with the acquisition and, if so, at what price and on what terms.

The Share Purchase Agreement

The Share Purchase Agreement (SPA) is the principal contractual document in a share acquisition. It contains several important provisions governing the terms of the transaction, including details of the company being acquired and the respective parties' obligations in connection with the transaction.

In share acquisitions, it is usual for the SPA to be prepared by the buyer's solicitors. This is because the buyer will want certain protections from the selling shareholders. These include:

- Warranties (discussed below) - these are contractual statements given by the seller about various aspects of the target company and its business. If these statements are untrue or misleading, the buyer may be able to sue the seller for damages (unless the seller has disclosed why the statements are untrue or misleading).

- Indemnities - these provisions require the seller to compensate the buyer (on a pound-for-pound basis) for specific losses or liabilities (if they arise).

- Restrictive Covenants - these can prevent a selling shareholder from competing with the company's business or poaching key customers or employees for a specified period.

The seller's solicitor will then want to make amendments to the draft SPA to protect the position of the seller and limit the claims that can be made under the warranties and indemnities, for example, by limiting the time within which the claim can be brought and the amount that can be claimed.

A liability period of between one and two years is common for non-tax warranties and seven years for tax warranties (although this depends on the parties' bargaining power and the nature of the business). A seller will also usually seek to limit the aggregate liability under the warranties to the purchase price received from the buyer.

The complexity of a SPA will vary depending on the nature and circumstances of the transaction, but it will typically be a lengthy document, half of which (or sometimes more) can be taken up by a schedule of warranties. Common provisions in a share purchase agreement include:

- Parties. In the simplest share purchase transactions, there may only be two parties to the agreement - the seller and the buyer. However, an additional party may be required in certain circumstances, such as a parent company guarantor or a third-party warrantor.

- Agreement to sell and purchase shares. This provision is probably the most important operative provision in the SPA, yet it tends to be one of the shortest and simplest clauses in the agreement. The buyer's main concern will be to ensure proper title to the shares is transferred.

- Conditions precedent. Where there is a split exchange and completion, i.e. they take place on different days, a significant amount of additional drafting is required to cover matters that might arise in the intervening period. A split exchange and completion are likely to be required where regulatory or third-party consent is required for the sale of the shares.

- Consideration. The amount of consideration may be fixed at completion, or it may be adjusted following completion based on an agreed mechanism. In these cases, the SPA may need to provide for the preparation of completion accounts and a mechanism for adjusting the provisional consideration paid at completion. Commonly, the price agreed at the outset in principle may be adjusted to reflect the true net asset value on completion, or the company is acquired on a 'cash free, debt free' basis. A buyer may also require that part of the purchase price be withheld as a retention pending the finalisation of the completion accounts.

- Warranties and indemnities. The warranties will usually cover all aspects of the target company and its business. Any indemnities sought by the buyer will usually relate to specific identified (but possibly unquantifiable) problems that the seller agrees to underwrite.

- Retention. The parties may, in certain circumstances, agree that part of the purchase price will be paid into a retention account (also known as an escrow account) at completion to secure certain post-completion obligations of the seller, for example, the seller's potential liabilities under the warranties and indemnities in the SPA. Such provisions can be contentious as, whilst the buyer will want the added protection of retention, the seller will often resist this.

- Restrictive covenants. The buyer will usually want to prevent the seller after the sale from establishing a competitive business that could diminish the goodwill of the newly acquired target company or from soliciting existing customers, suppliers or employees.

- Completion. The SPA normally contains an extensive completion schedule which lists all the documents the parties are required to deliver and all actions they must take at the completion of the transaction.

The tax covenant

It is normal for a seller to give an indemnity in respect of taxation suffered or incurred by the target company for the period before completion. Effectively, this provides that the tax risk before a specific date (usually either the last accounts date or completion) is the liability of the selling shareholders, and the tax risk after this cut-off point is for the buyer. This indemnity is provided for in the Tax Covenant (also known as a Tax Deed). The Tax Covenant may be a separate document or form part of the SPA itself (i.e. as a schedule). The basic principle which will be enshrined in any Tax Covenant is the seller's obligation to compensate the buyer for the following:

- Any tax liability of the company which exceeds the provision in the company's accounts for the period up to the last accounts date;

- Any tax liability arising after the date of the last accounts but pre-completion to the extent that it is outside the ordinary course of the company's business. Unless completion accounts are involved, tax arising from the ordinary course of business since the accounts date will not usually be caught by the covenant. If the buyer is to benefit from trading since that date, it should also bear the tax.

Where completion accounts are being prepared to take a 'snap shot' of the target company at completion, the tax liability will be ascertained. Therefore the covenant will not exclude tax in the ordinary course of business since the date of the last accounts, as the liability will be known once the completion accounts have been agreed upon. A price adjustment will occur at that point.

Accordingly, the principal function of the Tax Covenant is to provide the means of adjusting the price where the target company's tax liabilities prove to be more than the buyer expected. The Tax Covenant operates so that the buyer will receive an amount equal to the amount of any additional unprovided for tax liability suffered by the target company.

Warranties and the disclosure letter

Warranties

In agreeing to acquire the shares of a company, a buyer will usually have relied upon various statements and assumptions originating from the seller. To compensate for the lack of statutory protection available to a buyer and to ensure the buyer can recover its loss if the basis of its decision to proceed with the purchase subsequently proves to have been incorrect, the main statements and assumptions being relied on are usually included in the SPA and are known as warranties.

The number of warranties and the matters covered will vary considerably depending on the nature of the business carried on by the company, the extent of the company's assets and the identity of the person providing the warranties. The most common areas covered by warranties are:

- Capacity/authority to sell
- Ownership of shares

- Group structure
- Accounts
- Contracts
- Licences/consents
- Litigation
- Title to assets
- Intellectual property rights
- Employment matters
- Taxation matters

Warranties given in these areas relate to matters in the past or present but will not normally relate to the company's future performance.

If a warranty is incorrect, the buyer can bring a claim against the seller or warrantor for contractual damages. The buyer will need to show both a breach of the warranty (i.e. that it is untrue) and that it has suffered a loss due to the breach to bring a successful claim. The buyer's claim will be for such damages as are sufficient to put it in the position it would have been if the relevant warranty had been true. The buyer has a duty to mitigate its loss.

Where a specific liability is identified, the buyer will likely seek to include an indemnity in the SPA rather than a warranty. Indemnities provide a guaranteed remedy to the buyer in circumstances where a breach of warranty may not necessarily give rise to a claim for damages.

The disclosure letter

As mentioned above, if a warranted fact turns out to be untrue or misleading, the buyer is likely to make a claim to recover its losses. However, such a claim will fail if the facts which gave rise to the breach were disclosed. A full and proper disclosure exercise is in both parties' interests. For the seller, it may protect against a breach of warranty claim or at least may provide a successful defence to such a claim. For the buyer, it supplements the due diligence exercise in giving the buyer the fullest picture of the target company.

The disclosure letter is, therefore, a key document in any company sale or purchase as it is the seller's opportunity to make 'disclosures' against the warranties. The disclosure letter usually takes the form of a letter from the seller to the buyer and is prepared by the seller's solicitors. It is typically divided into two parts (general and specific disclosures) and will have attached copies of the documents disclosed to the buyer (the disclosure bundle).

General disclosures cover certain matters that appear in public records and/or of which the buyer ought to be aware on the basis of pre-contract enquiries or searches actually made or that a buyer would normally make. The general disclosures are often the subject of substantial negotiation between the buyer and the seller's solicitors. Whilst it is in the seller's interest for these general disclosures to be as comprehensive as possible, the buyer's solicitors will seek to limit them.

Specific disclosures are the seller's opportunity to specifically disclose actual matters which, if not disclosed, would constitute a breach of warranty. The specific disclosures are made by reference to the warranties themselves.

For example, if there is a warranty within the SPA that the target company is not a party to any litigation, the seller must disclose full details of any current litigation affecting the company. Also, certain warranties may require specific information to be listed in the disclosure letter or included in the disclosure bundle (such as material contracts, pension schemes etc.).

The disclosure bundle can often be voluminous and should contain all documents referred to in the warranties and/or the specific disclosures. Two copies of the bundle must be prepared: one for the buyer and one for the seller.

The seller's approach

The seller should ensure that everything relevant is disclosed in as much detail as possible, even if the buyer is already aware of a particular matter. If the seller has any doubts as to whether something should be included, the prudent approach is to include it.

Depending on the definition of 'disclosed' negotiated between the parties and included in the SPA, to be valid, any specific disclosures must usually be 'full and fair' and provide sufficient detail for the buyer to understand the nature and scope of the matter purportedly disclosed. If a disclosure is not specific and precise, the seller risks that a court may find that disclosure insufficient to preclude a claim for breach of warranty.

The seller should ensure that enquiries are made of all relevant personnel to ensure the disclosures provided are as accurate and full as possible. Revisions and updates to the disclosure letter often take place right up to completion.

When approaching disclosures, the seller must review each warranty and consider whether it is true and accurate. If not, then full details should be noted in full (and supporting documents located and copied) as the basis of a specific disclosure against that warranty. Key personnel and professional advisors (such as accountants) are essential to this exercise.

Every warranty must be addressed this way to ensure the disclosures are as comprehensive as possible. The seller should explain the breach fully, quantify the consequences and identify all warranties affected. It is insufficient to provide the buyer with the bald facts of the disclosure; it must be 'spelt out' in terms of detail, effect, and cross-referenced warranties.

The buyer's approach

No matter how thorough the buyer is in its due diligence process, the first draft of the disclosure letter nearly always throws up previously undiscovered problems.

The buyer must raise enquiries in relation to the drafts of the disclosure letter and associated disclosure documents to ensure that the disclosures are unambiguous and that it fully understands the consequences of accepting them. The buyer should expose any problems at the negotiation stage rather than having to cope with them after completion.

The problems may be so significant that the buyer decides not to proceed with the transaction, or it may seek to renegotiate the price or indemnities. Accordingly, a buyer should require the seller to disclose all possible issues as early as possible within the process.

<u>Other transactional documents</u>

In most share acquisitions, several ancillary documents will be required in addition to the SPA, Tax Covenant and disclosure letter. These documents might include the following:

- A contribution agreement - this is used in a transaction involving multiple sellers. Its main purpose is to apportion liability between the sellers as regards their contractual liability under the SPA, which is often joint and several.

- Security documents - where there is an element of deferred consideration, a seller may want to take some form of a charge over an asset of the buyer or the target as security for such future payment. This could be a mortgage, a legal charge, a debenture or a cross-company guarantee. Further, where a bank funds all or a significant proportion of the purchase price, the bank will almost always require some form of security over the buyer and/or the target's assets.

- A deed of guarantee and indemnity - this may be used where the buyer requires a specific individual to 'stand behind' the obligations and liability of the seller under the SPA.

- A loan note instrument - loan notes can sometimes be used as an alternative to cash in a share purchase transaction. They are effectively financial instruments that evidence the existence of a debt and set out the terms that have been agreed between the parties in relation to such debt.

Exchange of contracts

In many transactions, the signing of the SPA and completion of the transaction will take place simultaneously. However, in some cases, there may need to be an interval between signing and completion to allow time for certain conditions to be fulfilled or for third-party consent to the transaction to be obtained. In such cases, significant thought will need to be given to the apportionment of responsibility for any matters which may arise in the intervening period. The parties should consider in particular:

- How the business of the target company will be carried on in the period between exchange and completion, and the extent to which the buyer can control or influence this;

- Who will bear the risk of any breach of warranty or other material adverse events that may occur in relation to the target company in the interval between exchange and completion;

- Whether the seller's warranties will be given at exchange of agreements only or if they will be repeated at (or on each day up to and including) completion.

Where the SPA includes conditions that must be satisfied before completion can occur, there must also be absolute certainty as to when the conditions have been satisfied or are no longer capable of being satisfied. The SPA should specify which party is responsible for satisfying each condition. It should provide for what will happen if any of the conditions have not been satisfied (or waived) by an agreed longstop date.

Where the buyer or seller are corporate entities, their respective boards of directors should hold board meetings to approve the terms of the acquisition and the execution of the transaction documents before the SPA is signed.

Completion and post-completions

Negotiating the SPA will take some time, and various drafts will pass between the solicitors before they are happy from their client's perspectives. By using experienced corporate solicitors, you do minimise the chances of unnecessary and protracted negotiations.

On completion of a share purchase, the shares in the target company will be transferred to the buyer's ownership, and the buyer will pay the purchase price for the shares per the terms of the SPA.

The SPA will usually set out the documents the seller must deliver to the buyer on completion. The completion documents required will largely be driven by the structure of the transaction and the agreed method of discharging the purchase price. However, the completion documents will normally include the following:

- Share certificates (or an indemnity for lost share certificates)
- Letters of resignation from the directors, secretary and auditors (if there are any) of the target company
- Settlement Agreements for any directors who were also employees
- Documents relating to any purchase price retention
- Stock transfer forms

Board meetings are usually held by the target company (and any subsidiaries) at completion to approve those matters necessary to pass control of the company to the buyer. Board minutes for such meetings will usually be prepared by the solicitors involved.

Following the completion of a share purchase, the buyer will need to attend to various post-completion matters. Although these matters will vary according to the structure of the transaction, they may include announcing the transaction, paying stamp duty on the purchase price for the shares, making any necessary filings (e.g. changing the target company's directors, secretary, registered office etc.) and dealing with various other administrative matters.

Conclusion

As is clear from the above, a lot is involved in buying and selling a company, but when using our specialist team, we not only take a lot of the stress out of the process but also ensure our clients are adequately protected.

The sale or purchase of a company is a huge decision, both professionally and personally, and therefore we aim to ensure that things run as smoothly as possible.

If you would like more information on any of the points raised in this guide or are thinking of buying or selling a company, please contact us.