Thinking of selling your business? Part 3

A Guide To Completion

BESWICKS LEGAL

Thinking of Selling Your Business?
Part 3

A Guide To Completion

Introduction

Welcome to Part 3, the concluding part of our guide to selling your business. This follows:

- Part 1, which covered getting sale-ready, and
- Part 2 on reaching Heads with a prospective buyer.

In Part 3 we discuss the execution phase of a business sale, which culminates in Completion for successful transactions. This involves due diligence and the negotiation of the sale documentation; the principal document being the sale and purchase agreement (SPA). It is also the phase in which the transaction may fail (called an abort or aborted transaction).

Please note: This is a general guide. Specific advice, particularly in relation to tax, should always be taken.

Execution Phase

In Part 2 we discussed granting the buyer exclusivity on entering Heads. A period which the buyer is given to conduct due diligence and negotiate the sale documentation. During exclusivity you can expect:

1. **Due diligence**. A detailed examination of the business by the buyer.
2. **Sale documentation**. The negotiation of the sale documentation including the SPA.

As we said in Part 2, reaching Heads is not the end of the transaction. It is a milestone ahead of this final phase.

As due diligence informs the sale documentation, both processes normally run together aligning at Completion or in an aborted transaction.

Remember that the deal agreed in the Heads was subject to due diligence and negotiating sale documents. This means a buyer can use matters revealed during due diligence to re-negotiate the price. This may be justified, or it may be opportunistic. Your advisors, who will be experienced in this type of transaction, will be able to assist you in identifying which category a re-negotiation falls into.
If a seller is sale ready (as described in Part 1 of our guide) in advance of due diligence, the likelihood of new matters being revealed is reduced or those matters may have been resolved through the housekeeping involved in getting sale ready.

Due diligence

Due diligence is the process of investigation by the buyer into the business. It is designed to provide information about the business and reveal issues in it. It is intrusive and burdensome. Be prepared! It can take several weeks as the information will need to be gathered by the seller, filtered by the legal and finance teams and assessed by the buyer and their legal and finance teams.
The team you have assembled (based on the advice in Part 2 of our guide), both internally and externally, will be relied on to support you through due diligence. This is also why getting sale-ready pays dividends as much of the information will be readily available and potential issues addressed in advance.
Remember that you may also be relying on employees to assist in due diligence and a good process may require their goodwill and cooperation. It is not unusual for a seller to recognise this through a sale incentive paid for as part of the deal (there may already be an employee share scheme of course). An incentive may also limit the chances of the potential sale leaking to other employees, customers or suppliers.
On a typical transaction due diligence will cover:

- Legal.
- Finance (accountancy and tax).

Depending on the nature of the business it may also involve a deeper investigation on specialist areas such as real estate; HR; pensions; environmental; IT; IP.
Most due diligence starts with a detailed questionnaire on each area which is then followed by further questions based on the responses given. Each response will need to be full and supported by documents. The process is normally managed by your legal or corporate finance advisor through a virtual data room.

Things that you have taken for granted may not be taken for granted by a buyer if you cannot supply adequate answers or documentation. Typically, we may see a seller who has proceeded quite happily with few written contracts; unwritten employment terms; no statutory registers; slow moving stock; long debtor days; an expired lease etc. These may not be acceptable to a buyer who may require further assurance on them or in some cases a price reduction or revised deal structure to reflect them.

It can be tempting for a seller to not want to reveal information which shows an issue or concern. This is natural but may lead to a claim after completion (see below) or if revealed late or reluctantly, damage the relationship with the buyer. Remember that your advisors will have seen it all before, so be open with them and they will guide you on how best to present adverse information.

Remember that during this process a seller will also be negotiating the sale documentation as well as continuing to run the business as normal!

Abort/aborted transactions

Due diligence is the most common reason why a transaction fails. Before we move on to the happier scenario of a successful completion let's consider typical reasons for a deal failing.

Once Heads are signed most deals do not fail lightly; both sides have spent considerable time and resource in getting the broad transaction agreed and assembling teams. Of course, people may have a genuine change of heart, find another opportunity to pursue in priority or the buyer may not be able to secure funding.

Aside from that, normally something fundamental occurs or is revealed, commonly through the due diligence process. For example, unorthodox tax arrangements; unusual accounting policies; a significant tax issue; a material piece of litigation or potential litigation; a valuable piece of IP is not as robust as it was thought to be; a significant customer or supplier may not be as secure as envisaged; an environmental issue may be revealed; a pensions deficit may exist; a key employee may leave etc.

To reduce the likelihood of this, as we have said on many other occasions in this guide, getting sale-ready may have revealed this earlier and most importantly may have dealt with issues in advance.

Other matters that can lead to an abortive transaction include:

- disagreement between sellers (in the case of a share sale);
- an inability to secure key employees for the ongoing business;
- a landlord or key customer/supplier holding the deal hostage;
- the death or divorce of a seller;
- general economic conditions changing suddenly or for a particular sector.

The essential lesson for a seller in minimising the risk of deal failure is to control the controllables. It would have been hard for anybody to predict the pandemic and its effect on a transaction but as a seller you can control the readiness of your business for sale. Getting sale-ready, with the housekeeping it involves, is often a seller's best friend in a successful transaction.

Sale and Purchase Agreement/SPA

In this section we will focus on share sales. An asset sale works on the same principle albeit individual assets and liabilities pass from seller to buyer and the liability provisions (see below) are less extensive as the corporate history of the business does not automatically pass to the buyer.

The SPA is the linchpin document bringing the transaction together. Under it will sit ancillary documents but they are only entered into under the SPA and triggered by it. Like the Heads, the SPA is normally produced by the buyer. Like the Heads, it is essentially an offer to buy based on the terms of the SPA. The seller then negotiates those terms by amending the SPA to which the buyer responds and so on until the transaction is agreed or aborts.

The SPA can be read as a linear document starting at page one going through to the last page. That's probably the easiest way initially to get a feel for its structure and key points. Thereafter it may be more helpful to look at it as a set of components that link together.

Component parts

- **The parties**. Who the buyer is, who the seller is and if any person is providing a guarantee of any of their obligations.
- **The price**. What the price is, how it is calculated, how it is paid. In Part 2 we discussed this element in detail.
- **Protection of goodwill/restrictive covenants**. Restrictions prohibiting the seller from harming the goodwill of the business after completion.
- **Liability provisions**. The warranties and indemnities the seller (or some of them) will give the buyer to underwrite the price. It is unusual for institutional shareholders or minor shareholders to be subject to liability provisions other than confirming they own the shares they sell.
- **Transfer formalities**. The logistical formalities of the change of ownership. For example, changing directors, changing the registered office, changing the bank mandate, changing the accounting reference date, entering new employment arrangements with the seller or key staff, registering the transfer of shares etc. These will be dealt with in documents ancillary to the SPA known as ancillaries.
- **Boilerplate**. Standard legal clauses that provide contractual certainty. For example, specifying how notices are given after completion, how variations to the SPA can take place, what the governing law is etc.

Looked at as a set of component parts, the SPA becomes less intimidating and more manageable.
We looked at the parties and price in Part 2. The transfer formalities and boilerplate are largely mechanical and uncontroversial. The remaining areas to focus on for both buyer and seller are the protection of goodwill and liability provisions.

Protection of goodwill/restrictive covenants

By buying the business the buyer will want to ensure its goodwill remains protected from the seller. The seller after all knows the business and now has the funds (through the price) to compete with it or otherwise damage its goodwill.
Like restrictive covenants in an employment contract, they are only enforceable if they serve a legitimate interest. That interest is generally broader than allowed under an employment contract and normally prohibits the following:

- being involved (in its widest sense) in any business competing with the business. What is deemed to be competing is entirely dependent on the business being sold. For example, a city centre clothing outlet may only have competition from other outlets predominantly selling clothing within that city centre, whereas an internet retailer may have competition across the internet regardless of location;
- poaching or even engaging staff;
- using confidential information;
- interfering with customer or supplier relationships.

To be legitimate these provisions are subject to a time limit (other than for confidential information). Typically, 12-36 months.
There are normally exceptions for small interests in competing businesses (particularly if listed with the seller holding only a small proportion) or for specific business interests the seller may already have identified and with which the buyer is comfortable.
Protection of goodwill clauses are rarely contentious. It is generally a question of the seller understanding what they can and cannot do and seeking consent for anything they know or think they want to do. They tend to come into play when a seller, after Completion, wants to re-enter the sector within the restricted period. If a seller is in that position, they should contact their legal advisor to assess how they can do it without falling foul of the prohibition or falling foul of it but mitigating the consequences.

Liability provisions

The liability provisions under an SPA are matters which retrospectively adjust price, usually through a claim made by the buyer. They normally relate to issues in the business that have not been revealed through due diligence or are known to exist and subsequently materialise.
The liability provisions are the most extensive part of an SPA and, alongside price, the most keenly negotiated. The buyer wants to be able to revisit the price if the business is not as presented or if known matters materialise and the seller wants to receive the price and have a clean break.

Warranties and indemnities

In an SPA context there are usually fewer indemnities than warranties. This is because an indemnity should only generally apply to a known item that will or may have a future impact on the business. Had it happened before Completion it would have resulted in an upfront pound-for-pound price adjustment. For example, an unpaid tax liability; a piece of litigation that may be lost; property dilapidations claim yet to be settled etc. As they would have resulted in a pound-for-pound reduction in price before Completion so an indemnity will normally require the seller to make a pound-for-pound repayment after Completion.

An SPA will normally include a tax indemnity even if a tax issue has not been identified. Broadly this covers unpaid tax and tax arising outside the ordinary course of business.

Warranties on the other hand deal with the unknown. In the warranty section of an SPA the buyer will ask the seller to make potentially hundreds of statements about the business. The buyer will want them to be as wide as possible and the seller will want them to be narrow and specific. This is normally settled between legal advisors. It is the seller's job to go through the warranties and provide detailed information with supporting documents to the extent that there are matters inconsistent with the warranties.

This process is called disclosure and results in a disclosure letter which provides agreed exceptions to the warranties. If something is revealed in disclosure that is material and was not revealed in due diligence, then the buyer may just live with it; require that matter to be dealt with as an indemnity; seek an upfront price adjustment; or require rectification prior to completion. If something is later revealed which was not in the disclosure letter and was inconsistent with a warranty, then the buyer has a potential claim against the seller.

Like due diligence, disclosure is a laborious exercise but like due diligence, is made much easier by being sale-ready.

For the seller it is essential that disclosure is conducted with care to protect the price.

For the buyer it is comforting to know that the seller has contractually confirmed due diligence and revealed other issues that may exist in the business.

Limitations on warranties and indemnities

Buying and selling a business is big deal. A lot of work has gone into it and the last thing a buyer and seller want to do is to have to re-open it after completion with a dispute. Moreover, the seller will want a clean break without having to worry about the liability provisions still applying.

As part of agreeing the liability provisions, the parties will negotiate limits in terms of monetary amounts and time. These can be different for warranties and indemnities. Remember that no limitation will apply if a seller is fraudulent or wilfully conceals matters from the buyer. Also, no limitation will apply to fundamental matters such as the seller owning the shares it sells.

Although not covered in this guide, a seller may insure its exposure under the liability provisions through Warranty and Indemnity Insurance (W&I Insurance). Your legal advisor will be able to discuss this with you if appropriate.

Limitations on warranties

As warranties deal with the unknown, liability under them can be different to an indemnity. Instead of an automatic pound-for-pound claim, the buyer is normally under an onus to show that the business is worth less because of the issue. The buyer essentially has more to prove under a warranty than an indemnity.

The most important limitations on warranties are time and money. Like the warranties themselves, the limitations are keenly negotiated. They are often the last negotiated point.

1. **Time**. There is general agreement that claims for a breach of warranty must be brought before a cut-off to enable a clean break. Naturally a buyer will want a long period and a seller a short period. In most cases a typical cut-off is between 12 and 36 months from Completion. Most warranty claims will be known soon after Completion when the buyer is able to get under the bonnet of the business. A seller should expect 18-24 months with anything less or more reflecting bargaining power rather than actual risk.
2. **Money**. In most transactions the monetary threshold for warranty claims is threefold:

a) **De minimis**. A single claim must exceed a threshold to count. The threshold is normally determined by the value of the transaction so is relative to price. This is to avoid trivial claims being used to reclaim price. In some transactions the parties may agree to forego the de minimis threshold and instead rely solely on the basket (below).
b) **Basket**. All claims that exceed the de minimis threshold must exceed a cumulative threshold (of course a single claim may exceed both the de minimis and basket). Again, this is relative to price.
c) **Cap**. The overall cap on liability that the seller has under the warranties. The starting point for a buyer is the full price paid i.e., it can get its money back. The starting point for a seller is that having gone through a transaction it should have some reward even if the business has a fundamental flaw. Ultimately this is a negotiation and both buyer and seller should look at the likelihood of risk rather than taking a fixed position on principle.

Limitations on indemnities

Generally, because indemnities relate to known matters, they have far fewer limitations than warranties. If they would have reduced price pound-for-pound before Completion, then they should reduce the price pound-for-pound after Completion.
This is a reasonable position for a buyer to take although it is equally reasonable for a seller to ask for liability to be ring-fenced in some measure to enable a clean break.
As indemnity matters are known about at Completion then normally the timescale in which they will materialise and the liability they can incur can be more accurately predicted. If that is the case, they can be subject to similar but separate limitations as the warranties i.e., in terms of time and/or money.
Tax is an anomaly. The time limit on the tax indemnity is normally dictated by HMRC's ability to act on tax matters (5-7 years) and it is normally included within the cap under the warranties.

Final thoughts

The final phase of the transaction is often long and intensive. It can come as a surprise to a seller who believed that the deal was done at Heads. It requires time and attention from the seller to protect the price and also to continue to run the business. This execution phase is a second job and should be treated as such.

With the right preparation and the right team, a seller is put in an excellent position to manage the transaction and not be carried along by the buyer on the buyer's terms. It also mitigates the chances of the transaction ending in an abort or renegotiation. Getting sale-ready is by far the most valuable thing a seller can do to achieve a successful Completion.

We hope that you have found each part of this guide helpful. We have sought to provide an insight into what the sale of a business involves and how best to navigate the process from first thought to Completion.

Got more questions?

If you've got more questions about how to prepare your business for sale, contact the Beswicks Legal Corporate Team to discuss your plans. Email enquiry@beswicks.com or phone 01782 205000, 0121 516 3025 or 0161 929 8494.