LEWIS SILKIN

Selling your business

Contents

1. What are the main exit options available? 1
2. When to sell 1
3. Preparing for exit 2
4. Understanding the position of all shareholders 3
5. What is your business worth? 4
6. Appointing your advisers 5
7. The information memorandum 6
8. The different ways to sell your business 6
9. Managing the process 7
10. The due diligence process 8
11. The detailed documentation stage 9
12. Deferred consideration and earn-outs 10
13. Completing the deal 11

Many business-owners look to sell at some point. The reasons for selling may vary but often it is the opportunity for an owner to capitalise on the years of hard work that have gone into building up his or her business.

For many, selling is a once-in-a-lifetime event. This means it is usually an unfamiliar process. This guide is aimed at entrepreneurs and owner-managers who have not been through the sale process before, and want to know a little more about what to expect. It also includes a few tips on how best to prepare for sale and how to ensure that, when the time is right, the process goes as smoothly and predictably as possible.

1 What are the main exit options available?

There are a number of exit options available, the most common routes being the following:

a. Trade sale - where a business is sold, usually by way of a company share sale, but possibly also by way of a business and asset sale. Buyers might be either "strategic buyers" or "financial buyers". A strategic buyer is another business which is buying as part of an expansion strategy. A financial buyer would typically be a private equity house buying as a portfolio investment.

b. Management buyout (MBO) - strictly speaking an MBO is just another form of trade sale, but where the buyer is the incumbent management team, usually backed by a bank or private equity house. Occasionally, an outside management team will buy the business (known as a management buy-in or MBI) or it may be sold to a mixture of existing and new management. In both these cases, an outside financier will invariably be involved.

c. AIM flotation - floating on AIM (a market of The London Stock Exchange) has become an increasingly popular exit route for owner-managers of small and medium enterprises (SMEs), as the costs of an AIM listing are lower than one on the Main Market and the regulatory regime is lighter.

d. Partial sale or cash-out - not strictly an exit, as this route typically involves the owners selling a substantial minority stake. This could be a partial sale to an institutional investor or financial buyer, with a view to a period of planned expansion and eventual sale or flotation three to five years later; or, it could be a partial sale to a strategic buyer with the sale of the remaining shares planned to happen later or not at all. This route enables the owners to realise a part of their investment while still preserving a stake in the future growth and income stream of the business.

Which option is right for you will depend entirely on your objectives, the position of the business and the prevailing market conditions. For example, if you are relatively young, wish to raise some cash but feel you still have a significant contribution to make to the business, a partial sale might be the best option. If you are, or will soon be, ready to retire, then a 100 per cent trade sale may be the best option. If your objective is more about liquidity and growth in your shares and you are primarily concerned with raising capital to finance that growth, an AIM flotation may be the answer.

2 When to sell

Timing is of course critical, both in terms of the economic cycle and your own business's growth trajectory, and it is always worth considering carefully what constitutes the optimum time to sell.

Mergers and acquisitions are all about confidence, and it will come as no surprise to hear that in times of recession and

economic uncertainty, deal volumes fall significantly, as do deal values. Selling a business is essentially the sale of an anticipated profit stream, and the less confident a buyer feels about those future profits, the less it will be willing to pay for them. A reduced pool of buyers with access to the necessary cash to fund M&A activity would also have a negative effect on deal prices.

In an ideal world a business should be sold after it has a number of years of proven profitability under its belt, but before it could be perceived by buyers as having reached a plateau. Buyers look for both size and critical mass and potential for further profit growth.

Generally speaking larger, more established, businesses tend to attract a larger number of buyers, and also generate higher multiples for their owners on exit. This is because a larger business is generally perceived as more stable, and stable earnings mean less perceived risk to buyers. Less risk justifies a lower rate of return on the capital spent acquiring those earnings, which translates into a higher multiple.

Sellers therefore need to balance the imperative not to sell too early – and fail to realise the business' true worth – with the need to sell while growth remains on an upward trajectory.

Various tax reliefs may be available, depending on whether or not the seller is an individual, a corporate or a partner in a partnership or a limited liability partnership.

Many business owners will qualify for entrepreneurs' relief – the main qualifying conditions being a minimum of 5 per cent shareholding, with corresponding voting and economic rights, and a 24 month holding period, giving an effective tax rate on the capital gain arising from the sale of 10 per cent (usual rate: 20 per cent) – this relief is subject to a lifetime cap of £10 million worth of gains. This relief has been reformed and tightened recently, so it's worth checking that you do in fact qualify.

In the real world, timing is often influenced by many other factors as well, such as the owner's decision to retire or an attractive offer being received for the business.

Whenever you decide the timing is right to sell, the key thing is that you undertake the exercise at a time of your choosing, and when you are confident the sale will succeed.

3 Preparing for exit

Buyers are ultimately looking to make a return on their investment and so will look for profitability and sustainability. This usually equates to a combination of external factors (market position, reputation, the competitive landscape, sector prospects and so on) and internal factors such as the quality of customer relationships, the quality of the management team and the culture and strategy of the business.

While some of the external factors are harder to control, the internal factors are within the management's control, and there are often things business-owners can do to improve on these factors such as:

a. **Developing the second tier management** – many business-owners are looking to retire, or at least scale down their commitment to the business, after selling. Buyers are always concerned to know that when the founder(s) retire, there is a competent second tier of management with a proven ability to run the business. This requires planning.

b. **Align the owners' interests with managements'** – share options and other share-based incentive plans are a good way to ensure your key people are pulling in the same direction as you. If well-designed and tailored to your business they can be a very powerful tool. There is no one-size-fits-all solution, and setting up the right scheme for you will take time to properly plan and implement.

c. **Critically review your finance function** – buyers are concerned to see efficient systems with the ability to produce timely and accurate monthly management reports which track the key performance indicators relevant to

the business. Fast-growing businesses can quickly outgrow their internal reporting systems, and this can ultimately result in a barrier to properly managed growth. Buyers will also want to see profit projections for at least the next 12 months, and these will be that much more credible if you can show a past history of preparing (and hopefully beating) annual forecasts.

d. **Review your tax compliance** – tax is a risk area that buyers will invariably look into. It is important that you keep your PAYE, corporation tax and VAT affairs up to date, as this will invariably be an area which the buyer and its accountants will look at closely. If there are skeletons in the cupboard, they are likely to emerge as part of the buyer's due diligence. At best, buyers will look to pass the cost of any unpaid taxes (and any accrued interest and fines) on to the seller. At worst, they will be put off making the purchase.

e. **Critically review your sales and marketing function** – it is quite common in owner-managed businesses for there to be one or two star rainmakers (often the founders) who bring in much of the business. For a buyer this poses a risk. What buyers most like to see is a well-developed sales and marketing function at the heart of the business which is not overly-reliant on one or two individuals.

f. **Raise your business profile** – people are generally willing to pay more for a brand name they recognise. Appoint PR advisers if you do not already have them and, ideally, develop a strategy to increase your press coverage.

g. **Review your client/customer base** – the larger a business is, the more exposed it becomes to the macro-economic climate. To the extent possible, a management policy to diversify and de-risk the customer base should be adopted.

h. **Review your assets** – if the business includes assets which are unlikely to be properly valued by a buyer, for example the freehold of its premises, it may be worth removing these before the sale, rather than allowing them to be transferred to the buyer for less than their true worth. If the business includes assets which are really for personal use, for example cars, flats, or Twickenham debentures, these should also be removed before sale as the buyer will not wish to pay for these. You should always take legal advice before removing surplus assets as legal issues can arise when assets are taken out of companies for less than their true market value.

i. **General hygiene** – buyers take great comfort when their due diligence reveals a well-ordered, compliant business. It gives the impression of a well-disciplined and carefully managed business. Housekeeping tasks that are commonly left undone in owner-managed businesses include ensuring all client contracts are recorded in writing, signed and on sensible terms, ensuring business-critical trade marks and domain names are properly protected, and all data protection registrations complete. If there are non-working relatives on the payroll, these arrangements should ideally all be terminated in advance of the sale to minimise the number of adjustments the buyer needs to make to arrive at the "true" value of the business. Another housekeeping task is to make sure that you do not use the business's email accounts and servers for your private emails and documents (such as the emails and documents in your capacity as owner of the business) since potentially the buyer could gain access to them after the sale.

4 Understanding the position of all shareholders

It is important to understand at all times what the attitude of your fellow shareholders will be to an exit, both in terms of timing and valuation expectations. It is also useful to know which shareholders have a legal right to veto a sale, and which shareholders can be "dragged along" under provisions in your articles of association (articles) or shareholders agreement if necessary.

For example, if you have a private equity investor with a substantial minority stake, they are likely to have the ability under the investment documents to veto a sale if they consider it undervalues the business. This means that they must be consulted at an early stage in the sale process, as without their approval the sale cannot go ahead.

Alternatively you may have shares distributed amongst a number of employees, but have "drag and tag" provisions in your articles, which will give you the certainty of being able to deliver 100 per cent of the shares to the buyer even if one or more of these smaller shareholders refuses to sell for any reason.

As most buyers will expect to buy 100 per cent of the shares in a company in order to obtain complete control (other than where the exit is a partial sale), it is always worth knowing whose affirmative approval is needed, and what their attitude is to selling at any given time.

If your business comprises a group of companies, the same applies to any minority interests in your subsidiaries.

If there are several shareholders with potentially conflicting agendas it may make sense to get all shareholders to enter into a formal memorandum in advance of the sale outlining key issues such as pricing expectations, who will give the warranties, who will participate in any earn-out and what forms of non-cash consideration are acceptable to whom. The advantage of doing this is that it focuses everybody's mind on such matters and can help flush out any potential areas of dispute. It is far better that these issues are discussed and resolved before the sale process starts in earnest than after it has begun, potentially derailing the entire process.

Finally, buyers prefer simplicity in an ownership structure. If there are minority shareholders who are no longer involved in the business, you could consider buying them out now in order to simplify the structure (and of course this may also enhance the amount realised by the remaining shareholders on eventual sale).

5 What is your business worth?

There is only one true answer to this question: your business is worth what someone is prepared to pay for it. If you are in the fortunate position of having recently received indicative offers for your business, you will have some idea of this. Otherwise, you will probably have a view of what your business may be worth, typically on one of the following bases:

a. **Multiple of earnings basis** – the most common valuation method used by strategic buyers, especially for people businesses which have little in the way of tangible net worth. The most appropriate multiple to apply will depend on a whole host of factors, all of which ultimately boil down to sustainability of earnings and growth prospects. In private company sales in the UK, research shows that the majority of deals are done at multiples of between 5 and 10 times EBIT (earnings before income and tax), with a typical multiple being between 6 and 8 times EBIT. However, the details of most transactions are never made public and so it is very difficult to obtain reliable data. Even where details of deals are made public, the multiples paid for private companies can often look higher than they really are as a typical private company's audited accounts are likely to understate the true underlying profits as a result of measures taken to reduce tax.

   In any case, our experience shows that there are frequent and large variations around multiples, and a fast-growing company with a good name in a hot sector can easily attract a double-digit multiple.

   It should always be borne in mind that buyers will only take account of what they consider to be maintainable earnings, so if you are estimating the value of your business using this technique you may need to adjust for abnormal or non-recurring items such as below market rate remuneration for the owner-managers, or earnings from one-off projects that are unlikely to be repeated.

b. **Discounted cashflow basis** – the DCF method of valuation converts the anticipated future operating cashflows of the business into a present day value using an appropriate discount rate to reflect the risks inherent in the business. This is a complex valuation technique and one which relies on a number of assumptions and estimates. However it is also commonly viewed as the most sound way to value financial assets, as it focuses on what is most important to investors, namely cash generation. It is a less commonly used technique for valuing SMEs, although it is perhaps more scientific.

c. **Net assets basis** – this method of valuation is unlikely to be appropriate on its own for most private companies (except perhaps for property or investment holding companies) as most of the value will be in the goodwill of the business. However net asset values may still feature in the overall valuation, particularly where the net current assets are in excess of the business's working capital requirements.

Needless to say, every business is unique and there is no "one-size-fits-all approach" to valuation. You are likely to get the most realistic valuation range if you take professional advice from a valuation specialist who understands your business and the market sector in which you operate. A good corporate finance adviser or accountant should be equally able to perform a valuation exercise for you. However, this will remain a matter of pure conjecture until the theory is put to the test and discussions commence in earnest with potential buyers.

And PS: many sellers of businesses share their experiences with their peers, and often multiples get mentioned. In our experience, this information is best ignored unless you have full information about the deal terms (which is rare!). The same overall price could be expressed as a very different multiple depending on what you take a multiple of, for example, is it profit before tax, profit after tax, EBIT or EBITDA and over which year or years? What adjustments were applied to those earnings and how much was upfront and how much on an earn-out? Was it all paid in cash or was some of the price paid in other, more riskier forms, such as shares? Unless you know the answer to these and other questions, the multiple you hear quoted will mean very little.

6 Appointing your advisers

Appointing your financial advisers

In most cases it makes sense to appoint a firm of corporate finance advisers to assist with identifying potential buyers and advise on the most appropriate sale process. They will also help with marketing the business and advise on the sale negotiations once a buyer has been found. As they will play such a significant role in this process, it is crucial to select advisers who are competent, have the necessary geographical reach for your pool of potential buyers, and whom you like and trust. Ideally they will also have good personal connections in the market you operate in, a track record of previous successful transactions and a strong research capability. If you are careful in selecting the right advisers for you, the rest of the process will become much easier.

Speak to your usual Lewis Silkin contact if you would like us to recommend some appropriate corporate finance advisers.

Appointing your legal advisers

Typically your lawyers will need to be involved in the transaction from the outset; although their role at the early stages will generally be limited to preparing a confidentiality agreement (also known as a non-disclosure agreement or NDA), reviewing the terms of engagement of your other advisers and (if you are proceeding by way of an auction) reviewing the information memorandum (IM) to ensure it contains the right disclaimer wording.

If the negotiations with a buyer lead to a letter of intent (LOI) or heads of terms being prepared, your lawyers should also at the very least cast an eye over that for legal issues. A lawyer with a lot of M&A experience should be able to add value at the LOI stage, as they should be able to anticipate the key areas of contention and have ideas on how to resolve commercial issues that arise. In addition, tax lawyers will be able to suggest ways to structure the transaction to maximise its tax efficiency.

It is important to select lawyers whom you like and trust. They will have an important role to play in the transaction and it is important that you have full confidence both in their abilities and their approach. Your chosen firm should have a good track record of similar types of transaction, and the necessary expertise in all the complementary areas of practice that may be needed such as tax, intellectual property, real estate and employment law.

If in any doubt, ask for client references.

Appointing your accounting advisers

To complete the team, you will need to appoint a firm of accountants to advise on the accounting treatment of the sale and to help with accounting warranties and completion accounts (if any).

Maintain secrecy

Any discussions around the subject of a sale are likely to be commercially very sensitive and so these should be restricted to the smallest possible number of people on a need-to-know basis. Rumours of an impending sale can be destabilising for staff, who may become anxious about their jobs and future prospects. There are also the sensitivities of client relationships to keep in mind: it is generally best for clients to learn of a sale as part of a managed communications exercise rather than via the rumour mill. And last but not least, it is not unthinkable that your competitors may seek to take advantage of rumours that you are planning to sell, if there is a way to portray this in a negative light.

But prepare for leaks

Despite everybody's best efforts, confidential information has a habit of leaking. If the rumour mill reaches a level where you feel compelled to answer direct questions from clients or staff, be prepared with a suitable response. A cheerful but non-committal "Well, we are always receiving approaches from people" type response is much more effective than a blanket denial or refusal to answer questions, which can look defensive and arouse suspicions even further.

It is also prudent to prepare an agreed form of press release at an early stage, so that you are not caught on the back foot if rumours reach the press. If you have appointed PR advisers, they should be able to assist with this.

7 The information memorandum

One of the first and most important tasks for the corporate finance adviser is the preparation of the IM. This is essentially a selling document designed to attract buyer interest. It will contain a detailed description of the business and its history, the reasons for selling, CVs of the management team and key financial information and forecasts. It can contain as much or as little detail as the circumstances warrant, and in some cases can run into many pages. A good IM will also contain an executive summary setting out the key attractions of the business, to ensure that it catches the attention of prospective buyers with little time to spare.

While the IM is a selling document and therefore needs to put the business in its best light, it also has to be fully accurate. Any exaggerations or inflated claims about the business will inevitably be picked up as part of the buyer's due diligence, and will at best damage the seller's credibility and, at worst, undermine the buyer's confidence in the business and make it withdraw from the process.

Generally speaking, the IM would be preceded by a one or two page teaser document (which would not identify the company by name) to attract initial indications of interest from would-be buyers. Those who find the teaser of interest would be asked to sign an NDA before being supplied with a copy of the IM.

Careful thought needs to be given both to the content of the IM and to whom it is sent. In many cases, the short-listed buyers will include competitors of the business who might be in a position to take advantage of the information contained in the IM, and indeed of the very fact that the owners are looking to sell. Requiring these people to sign NDAs may provide a degree of protection, but residual concerns may remain. This is an area where there are no easy answers, and where ultimately you will need to judge the relative merits of finding a potential buyer versus the risks of allowing commercially sensitive information to fall into the wrong hands.

8 The different ways to sell your business

How you go about selling the business is an important decision, and a good corporate finance adviser should be able to advise you on the pros and cons of each route.

The unsolicited approach

Despite this arguably not being the best way to maximise value on a sale, many businesses are sold as a result of someone making an unsolicited offer. Sometimes it's obvious that the person who has made the offer is the most logical buyer for the business, and perhaps they are offering a strategic premium as well. If the timing seems right, then often a rational decision is made to go with just that buyer. This approach often results in a successful transaction being concluded.

A little extra caution is needed in the absence of competing bidders to strengthen the sellers' negotiating position, but the absence of competition is not such a problem if the sellers know they can walk away from the deal if the terms aren't right.

When an unsolicited offer is received, the question of whether there might be a better offer out there invariably arises. Generally speaking, there is not much to lose in testing the market on receipt of an offer, and the question then is how you do that.

The informal auction

Businesses which have received an unsolicited approach and want to test the market might undertake an informal auction, to discreetly see (within a pre-determined timeframe) who else may be interested before they commit to a single buyer. Informal auctions can also be used by businesses which have not received an approach, but which for one reason or another do not wish to undertake a full-blown auction process in order to sell the business.

Generally informal auctions are more suited to smaller businesses, where it is not anticipated that they will generate sufficient levels of interest to dictate a strict timetable to would-be buyers.

As the term implies, an informal auction is more flexible than a full-blown auction, and generally involves the corporate finance advisers having a dialogue with a small number of potential buyers, with a view to getting each to submit offers for the business within a given timeframe. There are no hard and fast rules about how this is done, but generally the would-be buyers are made aware that they are in a competitive situation.

The formal auction

In a formal auction the process will be run in accordance with a strict timetable. Potential bidders will be sent a process letter, which will invite them to submit indicative bids on the basis of the information memorandum. The bidder or bidders seen as making the best offers are shortlisted and given "preferred bidder" status. The task of selecting the preferred bidder is one of the most important decisions in the process and there will be many factors influencing this decision, including:

a. Who is offering the best price and deal terms generally?

b. Do some buyers appear better able than others to finance and execute the transaction in the allotted time?

c. Whom do you most trust not to chip away at the purchase price at the last minute?

d. Who will provide the best home for you and, no less importantly, your staff?

Once a preferred bidder or bidders are chosen, they will typically be given an opportunity to perform due diligence, usually by means of access to an online data room, meet management and perform site visits. If they remain interested in the business they will be invited to submit final offers by a set deadline along with a mark-up of a sale and purchase agreement (which will have been sent to them by the sellers) showing the terms on which they are prepared to transact. The bidder who makes the best offer at this final stage will usually go on to complete the purchase.

9 Managing the process

There are many ways of managing a sale process, and below we talk about the most common scenario for SMEs, namely a sale following an unsolicited offer or informal auction.

The initial offer

The initial offer will typically be made in a (subject to contract) letter or email, which will set out the basic terms that the buyer would be prepared to agree to. The offer will not be detailed at this stage as the buyer will not want to commit too much resource to the offer before it knows whether it is likely to be accepted in principle. From there a deal will be hammered out in outline, usually by a combination of face-to-face meetings and correspondence, and with the assistance of financial advisers.

The letter of intent

The next step is usually for the buyer or its advisers to draft a LOI (also known as "heads of terms" or a "term sheet") setting out the key terms of the deal that have been agreed in principle. This letter, which is usually non-legally binding, should ideally set out:

a. The financial terms, including the formula for arriving at any earn-out or deferred payment.

b. The form that the purchase price will take if any of it is to be in non-cash forms, such as loan notes or shares in the buyer.

c. The deal timetable and target completion date.

d. Whether the buyer is to be granted a period of exclusivity, and if so for how long.

   Exclusivity does not mean there is any commitment on either side to complete the deal, but just means the sellers agree not to talk to other competing bidders during the exclusivity period. Most buyers will want this level of comfort before committing to the significant time and expense involved in negotiating the detailed sale and purchase agreement and conducting due diligence. You as seller will want to ensure that the exclusivity ends if the buyer stops proceeding or tries to renegotiate any of the agreed terms.

e. Any conditions to which the buyer's offer is subject, typically legal, commercial and financial due diligence, board approval, satisfactory tax structuring and agreement of definitive transaction documents.

Even though it is expressed as non-legally binding, the LOI is one of the most important documents in a transaction, and will be referred back to at numerous times as the detailed negotiations proceed. A good LOI should cover the commercial points in enough detail to ensure that all the potential "show-stoppers" have been dealt with, but should not go into comprehensive detail, as this is the job of the definitive documents. Its principal purpose is to enable the parties to invest in the next stage of the transaction with a reasonable degree of confidence that they have a common understanding as to the main terms of the deal.

The LOI will generally contain some legally binding elements, such as provisions relating to confidentiality, exclusivity and responsibility for fees. These could be important if the negotiations break down for any reason and so should be reviewed by your lawyers.

10 The due diligence process

Once an LOI has been signed and exclusivity granted the buyer will embark on its due diligence process. Most sellers report that this process is far more of a drain in terms of time and resources than they ever imagined. The basic legal principle underlying a company purchase is caveat emptor (buyer beware). In other words, once the buyer has bought the business, it can't complain afterwards. The vast majority of buyers are therefore keen to find out everything they possibly can about their target business before parting with their expensive capital. Due diligence typically breaks down into four principal categories.

a. **Commercial due diligence** – focussed on the strength and quality of customer relationships, contractual terms of business, internal business processes and anything else the buyer considers important commercially

b. **Financial due diligence** – usually carried out by a firm of accountants, this is one of the most important elements of a buyer's due diligence and will include a detailed examination of past trading performance, future forecasts, accuracy of reporting systems, assets and working capital. Sellers should expect to be faced with seemingly endless requests for financial and accounting information

c. **Legal due diligence** – invariably carried out by the buyer's lawyers, this aspect will focus on matters such as legal structure and ownership, contractual terms, loans and bank security, property matters, employees, pensions, intellectual property and environmental compliance. Whereas typically the buyer's accountants might spend a few days on site at the commencement of the financial due diligence, the legal due diligence tends to be carried out remotely. The buyer's lawyers will submit a due diligence questionnaire requesting information and copy documents on all of the above topics and it is usually left to the seller's personnel to perform the laborious task of copying and collating all the information needed to respond fully to the buyer's requests. This is then sent on to the buyer's lawyers (sometimes via the sellers' lawyers) who will then prepare a due diligence report to the buyer.

d. **Tax** – sometimes included as part of the financial due diligence, the buyer will be concerned to understand how tax compliant the sellers' business is and will carry out exhaustive tax due diligence in order to find out.

Ensuring confidentiality during the process

Given the amount of unusual activity that takes place during due diligence, and the number of people that need to be involved in the process, this can be quite hard to achieve. Usually a small deal team comprising senior, trusted, personnel s assembled to work on the responses to the various due diligence requests, and the presence of various unknown people around the office is put down to a routine audit or similar pretext.

11 The detailed documentation stage

While due diligence is progressing, the buyer's lawyers will usually be working on the detailed documents of which the sale and purchase agreement (**SPA**) will be key. This will set out the definitive terms of the purchase, and include all the protections sought by the buyer to safeguard its investment. Sellers are often surprised at the length of this document, which might be anything from 40 to 100+ pages in length depending on the size and complexity of the deal. The SPA will include the following:

a. **The price and all payment terms** – where the deal includes an earn–out element (see below for explanation), the SPA will also include the formula for arriving at the earn-out payments – usually a multiple based on average profits over a three to five year period. The definition of profits for these purposes will usually be very detailed and can run into several pages, with numerous adjustments to the reported figures shown in the statutory accounts.

b. **Any price adjustment mechanisms agreed** – buyers commonly require the business to be left with sufficient working capital in order to be self-funding when it takes the business over. As the level of working capital will fluctuate on a daily basis, it is quite common for the SPA to provide for accounts to be drawn up after completion based on the position as at the completion date (known as completion accounts) and for the price to be adjusted retrospectively, depending on whether the working capital shown in the completion accounts is above or below a pre-agreed target figure.

c. **Seller restrictions** – buyers frequently seek to impose non-compete restrictions on sellers for a period after the sale, to protect the goodwill of the acquired business.

d. **Warranties and indemnities** – typically comprising the bulk of the SPA, warranties are the means by which the buyer obtains additional protection (over and above its due diligence) against unwanted surprises that affect the value of its investment. The warranties are a series of statements by the sellers about the condition of the business at the date of sale. If these turn out to be untrue, the buyer has a means of redress by way of a claim for breach of warranty. These will cover everything from the accuracy of the accounts used by the buyer to value the business to the absence of disputes with staff and relationships with customers.

Because the warranties are so extensive it is invariably the case that they will not all be true. This does not mean that the warranties cannot be given, just that the seller must make disclosures, so that the buyer is aware of the true position before completion. Before the SPA is signed the seller and its advisers produce a list of all the areas where the warranties do not accurately describe the business in a letter known as the **disclosure letter**. This is delivered to the buyer on signing of the SPA. To the extent of the disclosures, the buyer will not be able to claim breach of warranty. The more comprehensive the disclosures are, the less risk there will be of the buyer making a warranty claim after the deal has completed.

For its part, the buyer must review the disclosures before signing the SPA, and if it is unhappy about anything it will raise the issue with the seller and, if necessary, seek an adjustment to the price, or an indemnity.

An **indemnity** is an undertaking by the seller that it will meet a specific potential liability which has been identified by the buyer and which the buyer is particularly concerned about.

A buyer and sellers may wish to impose additional controls over the disclosure of "**privileged**" documents and legal advice. Privileged material can be withheld from production to third parties or the court. In order to avoid such material losing this special status, limited disclosure is often accepted for warranty purposes, with the buyer not being allowed to make copies or a written record of the material.

Other principal documents

At the same time that the SPA and disclosure letter are being negotiated, the parties and their lawyers will be negotiating the other deal documents, which are likely to include some or all of the following:

a. **Tax covenant** – this can be either a standalone document or a schedule to the SPA. It is designed to ensure that the buyer is able to recover pound for pound from the seller(s) if it transpires that the target company has not paid (or provided for) all the tax it is liable for at the date of the sale.

b. **Service agreements** – if the sellers are to remain with the business as employees following the sale, they are likely to be required to sign new service agreements, or employment contracts, usually incorporating post-termination non-compete restrictions.

c. **Loan notes** – often where there is a deferred element to the purchase price, the buyer will offer to satisfy this in the form of loan notes, and the form of the loan note instrument will need to be agreed, together with any bank guarantee if applicable. Certain types of loan note can also assist sellers with their capital gains tax planning.

d. **Shareholders' agreement** – if the sale is proceeding by way of a partial sale so that for a period of time both the sellers and the buyer will be shareholders in the company then the parties will need to agree the basis upon which they will co-own the business. The shareholders' agreement together with new articles of association will set that basis out. The shareholders' agreement may also contain "put" and "call" option arrangements which prescribe how the buyer will purchase the remaining shares from the sellers.

12 Deferred consideration and earn-outs

There are many reasons why part of the purchase price may be deferred on a deal, and these include:

a. The buyer and seller cannot agree on a valuation at the date of sale. In this case a common solution is to make part of the price dependent on the financial performance of the business after completion of the sale. This is known as an **earn-out**. Earn-outs are a feature of many transactions as they reduce the buyer's risk of paying a multiple of profits that fail to materialise, and they give the sellers the opportunity to achieve a higher overall sale multiple if their predictions of the business's growth prospects are borne out in practice.

b. The buyer wishes to lock in some or all of the selling shareholders after the sale. This is commonly done in people businesses where the continued involvement of particular individuals is seen as critical to the success of the company in the period immediately following sale.

c. The buyer cannot afford the whole of the purchase price upfront.

Sales that include an earn-out element are invariably more complex than those that don't, as both buyer and seller need protecting in different ways during the earn-out period. For example, on a typical three year earn-out based on a combination of gross income growth and EBIT the SPA will need to define clearly how the gross income and earnings are arrived at, what items of income and expense should be excluded, what management fees the buyer's group is allowed to charge against revenues and how to deal with a whole variety of exceptional situations that might arise. The sellers for their part will want assurances related to their ability to operate the business independently and relatively free from interference during the earn-out period, and will want to be assured that the buyer will not be able artificially to increase or accelerate expenditure, reduce profits, or require fundamental changes to the business that may impact on the sellers' ability to maximise the earn-out.

There will also be debate about what the impact should be of a key seller leaving during the earn-out period, and what constitutes a "good" leaver and what constitutes a "bad" leaver in this context.

The use of deferred consideration also involves some complex tax and accounting issues, especially in relation to the sellers' capital gains tax position, and this is an area where it is vital to obtain specialist advice early in the process.

13 Completing the deal

If the buyer is happy with everything its due diligence has revealed, and the negotiations over the SPA and accompanying documentation are successful, the deal can be signed and contracts exchanged. Exchange may take place simultaneously with completion (and payment of any purchase price due) or at an earlier date. The usual reason for having exchange and completion taking place at different times is that completion remains conditional on certain conditions being fulfilled, for example the obtaining of consents from a third party such as a landlord or a bank. Unlike the way property purchases are done in the UK, it is not common for the buyer to pay a deposit on exchange of contracts if exchange and completion are not taking place simultaneously.

Whenever completion does take place, it is always a landmark event for the sellers, generally accompanied by sighs of relief, large piles of paperwork and a glass or two of champagne. For the sellers the sale usually marks the end of an era, although statistics show that many will carry on working with their new owners; at least for an agreed handover period, often for much longer.

Whatever your reasons for selling, we hope to be able to help you throughout the process, and to raise a glass with you at the completion meeting.

Contact details

If you would like any more information about these matters or any other aspect of corporate law, please contact your usual Lewis Silkin LLP contact or:

Karish Andrews

Partner

+44 (0) 20 7074 8106
karish.andrews@lewissilkin.com

LEWIS SILKIN

Lewis Silkin LLP
5 Chancery Lane – Clifford's Inn
London EC4A 1BL
DX 182 Chancery Lane
T +44 (0)20 7074 8000 | **F** +44 (0)20 7864 1234
www.lewissilkin.com

This publication provides general guidance only: expert advice should be sought in relation to particular circumstances. Please let us know by email (info@lewissilkin.com) if you would prefer not to receive this type of information or wish to alter the contact details we hold for you.

© April 2019 Lewis Silkin LLP