LEWIS SILKIN

Buying a business in the UK

Contents

This guide is intended to assist potential buyers, who are from overseas, and have not been through the process of buying a business in the UK before and want to know a little more about what to expect. English company law does not impose any restrictions on foreigners acquiring an interest in domestic companies. These notes assume that the target business is owned by a private limited company incorporated in England, with several individual shareholders.

1. Two ways to acquire a business: "Share Purchase" or "Business/Asset Purchase"

There are two ways in which a buyer can acquire a business and the two are fundamentally different concepts. In a "share purchase" a buyer will acquire the shares in the company which owns the business from the company's shareholders; whereas in a "business purchase" (also referred to as an "asset purchase" or a "business/asset purchase") the buyer will acquire only those assets and liabilities which it specifically identifies from the company.

Why share purchase

In a share purchase all that changes hands are the shares in the company (the "**Target**") which owns the business and this is effected by the exchange of one or more executed stock transfer forms for the purchase price. The buyer, to whom the shares are transferred, then owns the Target "warts and all", including assets and liabilities which it does not know about. Examples of things which a buyer might not wish to inherit include: onerous contracts; bad debts; creditors; stock-in-trade; and onerous property (perhaps a long lease or contaminated land).

Sellers generally prefer a share purchase as this takes the entirety of the business off their hands and a share sale is often more advantageous to them from a tax perspective.

Why business/asset purchase

In a business/asset purchase only specifically identified assets/liabilities are acquired by the buyer from the company. This enables the buyer to "cherry-pick" those assets of the business which it values and leave behind with the company any assets or liabilities which it does not wish to take on. An exception to this is employees who will normally be transferred automatically under the Transfer of Undertakings (Protection of Employment) Regulations 2006.

Buyers often prefer business/asset purchases as in theory they can be selective about which elements of the business they acquire and certain capital allowances may be claimed by the buyer on the assets acquired.

The disadvantage of this route for a buyer is that assignment/novation of key contracts will often require third party consents to be sought.

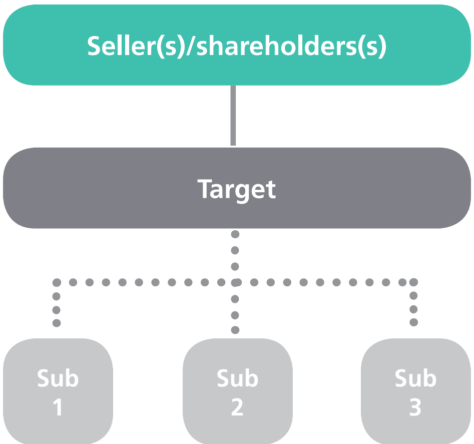
Key differences

	Share Purchase	Asset Purchase
Seller(s)	Shareholders of the Target	The company which owns the business
What is purchased	Shares in the Target	Assets, contracts, goodwill of the company

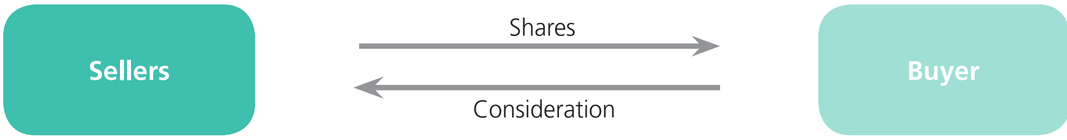
As in practice share purchases are much more common than business purchases, we focus on a share purchase in the rest of this document.

2. Share sale structure

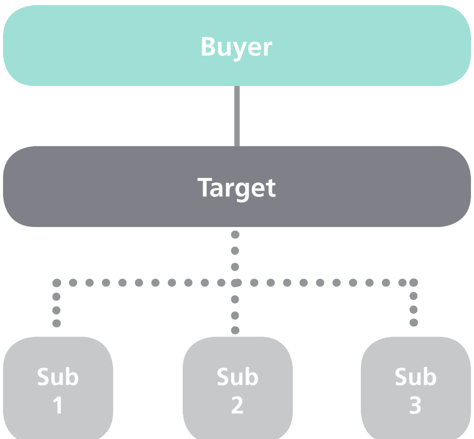
A typical pre-sale structure might look like this:



Consideration (which can be cash or non-cash - for example shares in the buyer if it is a company) will then be paid by the buyer (who may be a company or an individual) to the shareholders of the Target (the "sellers") in return for the sellers transferring their shares in the Target to the buyer.



This will result in the following post-sale structure:



3. Stages of the transaction

We set out below the typical stages of a share purchase transaction and the activities and documents at each stage from the point of view of the buyer's legal advisers. It assumes that we, Lewis Silkin ("**LS**"), are acting for the buyer. In the next section we have described each document in more detail.

Stage 1 Structure planning. Preliminary discussions between LS and potential buyer on key deal terms; initial tax and corporate planning on deal structure.	Day 1 - 5
Stage 2 Finalising deal structure. Working with the sellers' advisers to finalise tax and corporate planning on deal structure. ➤ Heads of terms/letter of intent ➤ Confidentiality and exclusivity agreement	Day 5 - 10
Stage 3 Legal due diligence. Preparing Legal due diligence enquiries; reviewing responses; undertaking legal due diligence and preparing full (or red flag material issues) Legal due diligence report; background preparation for disclosure process on back of due diligence materials. Ongoing liaison between LS and buyer client (and other buyer advisers, eg accountants) and communications with sellers' lawyers (while buyer liaises with sellers). ➤ Legal due diligence enquiries ➤ Legal due diligence report	Day 10 - 50
Stage 4 Preparation and negotiation of key documents. ➤ Sale and purchase agreement ➤ Tax deed ➤ Disclosure letter ➤ Employment contracts for key management sellers Drafting, negotiating and amending documents; meetings/conference calls (LS and buyer client); negotiation meetings/conference calls (all parties).	Day 30 - 60
Stage 5 Pre-completion. Intensive phase of settling all key documents and final negotiations; completing due diligence and review of disclosures from sellers; drafting and finalising all ancillary documents (Companies House forms, stock transfer forms, shareholder resolutions, board minutes etc).	Day 60 - 79
Stage 6 Completion. Final negotiation meeting and signing meeting; dealing with money flow (assuming simultaneous signing and completion).	Day 80
Stage 7 Post-completion. Arranging stamping of stock transfer forms; writing up of Target company books; share certificates; all filings at Companies House; preparing bible of documents and other immediate post-completion administration.	Day 81 - 90

4. Key documents

Heads of terms / letter of intent

The key terms of a share purchase are often outlined in a short-form document, commonly in letter form, known as the "heads of terms" or "letter of intent". The heads of terms will be drawn up at the very beginning of a transaction, before the buyer commences its due diligence and before any drafting of the key documents. They sometimes include a timetable/route map for the transaction.

Whilst not generally expressed to be legally binding, once agreed, the heads of terms have a strong moral force and deviation from these general terms by either party without the other's agreement will be met with resistance and is likely to have a knock-on negative effect on negotiations elsewhere. At the least they are a useful reminder to the parties of the key points of agreement and can be referred to once negotiations of the finer details get under way.

The heads of terms may be combined with the confidentiality and/or exclusivity agreements (covered below). Those terms will be stated to be legally binding and so the heads of terms will be signed as a contract by all parties.

Confidentiality / exclusivity agreements

These are often contained in one hybrid agreement (and they are sometimes incorporated in the heads of terms). Confidentiality and exclusivity are two distinct elements which the parties would wish to address at the earliest possible opportunity during negotiations. We consider them separately below:

- **Confidentiality agreement** (also known as "**non-disclosure agreement**" or "**NDA**"). This is usually signed during the early stages of the acquisition process and seeks to ensure that confidential information disclosed (by either party but normally only by the sellers) during the negotiations remains confidential and is not used other than for the purpose disclosed.

  Key information which the sellers will generally wish to keep confidential includes, but is not limited to, the following:

  - the fact that they wish, or are willing, to sell;
  - the terms which are being negotiated, especially in relation to price; and
  - key business information; for example, its clients, competitors, business secrets, marketing, suppliers and intellectual property.

- **Exclusivity agreement** also known as "**lock-out agreement**". This is intended to protect a prospective buyer from losing out to a rival bidder after having spent significant time and money on negotiations and due diligence in the acquisition process.

  The sellers agree not to negotiate with, or solicit offers from, other buyers for a fixed period, thereby providing the prospective buyer with a period of exclusivity in which to negotiate and hopefully complete the proposed transaction.

  Sellers are often reluctant to accept a period of exclusivity but ultimately this will depend on the strength of the parties' negotiating positions. Generally, however, exclusivity agreements are becoming more and more common in acquisitions, where intricate due diligence and protracted negotiations are often the norm.

Sale and purchase agreement

The sale and purchase agreement ("**SPA**") is the key document for the sale and purchase of the shares in the Target. Its commercial terms may already have been agreed to some extent in the heads of terms but the negotiation of the terms of the SPA is often one of the most time consuming elements of a share purchase.

Traditionally the first draft of the SPA is prepared by the buyer's solicitors.

The parts of the SPA that attract the most attention and negotiation are:

- warranties;
- indemnities;
- limitations on the sellers' liability;
- sellers' restrictive covenants; and
- pricing mechanisms (for example, earn out; completion accounts, cash free / debt free; or locked box).

The following considers those key negotiating areas in more detail.

Warranties

A warranty is a contractual statement given by the sellers in the form of an assurance or promise as to the state of affairs of the Target or its business.

English law does not provide the buyer with any statutory or common law protection as to the nature or extent of the assets and liabilities it is acquiring. Hence the need for these extensive contractual statements.

The warranties will attempt to cover every aspect of the Target and its business. To give an idea of the breadth of the warranties, the Lewis Silkin standard SPA contains warranties under these headings: Information supplied; Accountants report; Capacity of the sellers; Solvency; Effect of the SPA; Share capital; Accounts and records; Changes since the Accounts Date; Assets; Debtors, creditors and borrowings; Insurance; Contracts and trading matters; Compliance; Litigation; Employees and directors; Health and safety; Pensions; Information technology; Intellectual property; Premises; Environment; Transactions with connected persons; and Tax.

Examples of typical warranties are:

- *All books, accounts and records required by law to be maintained in connection with the Company have at all times been fully, properly and accurately maintained and are properly written up to date (Accounts and records section).*
- *The Company has not offered, promised or agreed for the future any variation in any contract of employment or engagement or contract for services in respect of the Employees, Directors or persons engaged under a contract for services (Employees and directors section).*

Normally contained in a schedule to the SPA, warranties will often account for about a third of the total volume of the SPA.

The standard warranties may be added to, removed or amended in the light of matters unearthed as part of the due diligence process and accordingly due diligence and warranties go hand in hand. For example, if the buyer's due diligence process brings to light expectations of certain employees that they will receive an imminent salary increase, the buyer would want to extend the standard Employees and directors warranty above so as to address salary increases and the expectations of employees. For example, acting for the buyer, we would add the wording underlined below:

- *The Company has not offered, promised or agreed for the future any variation in <u>salary or any other terms of</u> any contract of employment or engagement or contract for services in respect of the Employees, Directors or persons engaged under a contract for services <u>and no Employee, Director or such other person has reason to expect any such variation</u> (Employees and directors section).*

The purpose of having warranties in an SPA is twofold:

- Protection of the buyer: If a warranty given by the sellers proves to be untrue and the effect of that is to reduce the value of the Target's shares, the buyer can claim damages for breach of warranty (a form of retrospective price adjustment).
- Disclosure of known problems: The SPA will state that the sellers' liability for breaches of warranty is limited to the extent that the sellers have disclosed against the warranties. In other words, if the sellers disclose to the buyer

information that would show a breach of warranty, they are not liable to the buyer for that breach. The giving of warranties encourages disclosure by the sellers of known problems in the Target/its business prior to entering into the SPA, thereby allowing the buyer to consider whether it wishes to require a price adjustment (or other protection, such as an indemnity) in advance of entering into the SPA.

Warranty limitations

Claims under the warranties are normally restricted to claims above certain "de minimis" thresholds. For example: that no individual claim may be brought unless for a sum of more than, say, £5,000; and further that the sellers shall only be responsible for warranty claims which together total, say, £100,000 or more. This is in order to prevent the buyer bringing time-consuming claims against the sellers for very small sums and also in recognition that there may be minor breaches of the warranties of which the sellers might not be expected to have been aware.

The existence and size of any de minimis thresholds will depend on the balance of negotiating power between the parties and the size of the overall consideration being paid by the buyer.

Other limitations include caps on liability, time limits for bringing claims, conduct of claims and recovery from third parties.

Indemnities

Non-tax

An indemnity is a promise by the sellers that they will reimburse the buyer in respect of a particular type of liability, should it arise. This usually relates to a specific potential liability which has been identified by the buyer and which the buyer is particularly concerned about. For example, if the buyer's due diligence has unearthed a breach by the Target of third party intellectual property rights, then the buyer might seek an indemnity from the sellers to cover any liability that may be incurred by the buyer or the Target as a result of this breach.

This allows the buyer to recover on a pound for pound basis and, because they have been specifically identified as areas of risk to the buyer, the indemnities are not usually subject to the same limitations as the warranties.

The right of a buyer to receive payment under an indemnity is an absolute right and simply requires the buyer to prove the liability incurred. Accordingly, indemnities are usually a cause of great concern to sellers and are heavily negotiated.

Tax

It is common for the sellers on a share purchase to covenant to pay the buyer an amount equal to the tax liability that has arisen in the Target in respect of the period prior to completion, subject to certain exceptions. This is what the tax covenant, or tax deed, does.

Restrictive covenants

Restrictive covenants contained in an SPA will often mirror, or at least be very similar to, those in new service agreements negotiated simultaneously in respect of sellers who are also key members of the management of the Target. In particular, they would cover these areas:

- non-compete;
- non-solicitation (clients, employees, suppliers);
- confidentiality; and
- non-dealing.

As with restrictive covenants in service agreements, the enforceability of restrictive covenants in an SPA will depend on them being reasonable in terms of their length, scope and geography. It is often possible to achieve longer "reasonable periods" under an SPA than under a service agreement, because the English courts recognise that a buyer should be able to protect the investment it has made by buying the Target.

Completion Accounts v Locked Box

The buyer will often have assessed how much it considers the Target's business to be worth, and hence how much it wants to pay for the Target company (the "enterprise value"). It may assess that that is how much it wants to pay on the basis that the Target has no cash and no debt ("cash-free / debt-free basis"). To the extent that the Target has cash on completion, the buyer would pay extra for that cash and to the extent that the Target has debt on completion, the amount of the payment is reduced by the amount of the debt. The company would produce "completion accounts" (essentially a balance sheet as at the completion date) to enable the parties to assess and make adjustments for the amount of cash and debt in the Target at completion, so that the parties can calculate the price payable on or as soon as possible after completion. Completion accounts and similar adjustments can also be used where the parties have agreed that the Target will have, at completion, an agreed level of "working capital" (often net current assets).

Another pricing mechanism, which does not use completion accounts, is called "locked box". The target produces a balance sheet as at a date prior to, but usually fairly close to, completion. The buyer calculates the price based on that balance sheet. To the extent that there is any "leakage" in the value of the Target between the date of the balance sheet and completion, the sellers agree to reimburse the buyer.

Earn outs

An earn out is a general expression covering any mechanism where, on the sale and purchase of a company's shares, the purchase price is wholly or (more usually) partially determined by reference to the future performance of the Target.

Earn outs tend to be most frequently used in relation to acquisitions of companies in the service sector and are also particularly popular in share sales of owner-managed companies. In these circumstances, the assets being acquired may be worth only a small fraction of the overall purchase price and future performance can often be the key to justifying the price. They are also extremely common where the Target company has a short track record and/or significant growth potential.

A common earn out scenario would involve an initial payment to the sellers on completion, followed by successive "earn out payments" to be made following calculation of the profit figures of the Target for the next, say, three financial years.

An earn out has advantages for both the sellers and the buyer as follows:

Sellers

- The sellers can reap the full benefit of selling a profitable business. Without an earn out, the price the buyer is prepared to pay may be discounted as a result of doubt about the actual profitability and prospects of the Target; and
- the sellers may have an opportunity to benefit from the synergistic advantages of being part of the buyer's larger group. This may unlock value that would not have been realised otherwise.

Buyers

- An earn out ensures that part of the purchase price is directly linked to the actual performance of the Target after completion. This can remove a significant element of uncertainty from the transaction;
- deferring part of the purchase price for a period after completion will be beneficial from a cash flow perspective; and
- in a scenario where all or some of the sellers are key to the Target business, the existence of an earn out can incentivise those sellers and help to retain their loyalty and continued involvement with the business.

Due diligence report

Due diligence is the information-gathering process carried out by the buyer to find out as much as possible about the Target and its business early on in the negotiations. Through this process, the buyer aims to gain a complete picture of the Target: its critical success factors, strengths and weaknesses. Due diligence is an essential preliminary to contractual protection (in the form of warranties and indemnities), and can help to identify the level and areas of protection needed and any risks which the buyer should avoid completely. The information obtained through due diligence will help the buyer to decide whether it wants to proceed with the purchase and, if so, at what price and on what terms. It is therefore a crucial part of the buyer's bargaining tools.

Due diligence is generally divided into three main areas: (1) legal due diligence (undertaken by the buyer's solicitors); (2) financial and tax due diligence (undertaken by the buyer's accountants); and (3) commercial due diligence (undertaken by a third party provider or the buyer itself).

The legal due diligence process will generally begin with the buyer's solicitors sending Legal due diligence enquiries to the sellers' solicitors. These are a list of questions and requests for information/documentation. The sellers' responses to these enquiries and the supporting documentation provided will inevitably lead to the buyer's solicitors raising further enquiries with the sellers and eventually reaching a point where the buyer's solicitors are happy that they have received all of the information required to advise the buyer fully in relation to the legal aspects of the acquisition.

The buyer's solicitors will then produce the Legal due diligence report which will be addressed to the buyer (and sometimes the funding bank). A full report will contain not only a commentary/report on the legal position of the Target with an executive summary of highlighted issues, but also recommendations which a prudent buyer should seek to address post-completion. Often, however, a buyer will request just a "red flag/headline only/high level/material issues" report. Here the report will not contain commentary on every aspect of the Target; instead it will address solely the key issues which have arisen out of the due diligence exercise.

Impact of due diligence

The legal due diligence process will highlight any areas of concern to the buyer and typically, depending upon the impact of the issues which have been uncovered, may lead to one or more of the following actions being taken by the buyer:

- a post-completion review of the issue and follow up of recommendations made in the report;
- an increase in warranty protection;
- an indemnity being requested and negotiated;
- retention by the buyer (possibly using an escrow account) of part of the purchase price as security for a breach of warranty or indemnity;
- a reduction in the purchase price;
- the buyer pulling out of the deal.

Disclosure letter

The purpose of the disclosure letter is to limit the scope of the warranties by the sellers disclosing to the buyer facts and circumstances which would otherwise give rise to a breach of warranty. To the extent that a matter is fairly disclosed by the sellers in the disclosure letter, the sellers cannot be sued for breach of warranty in respect of that matter. However, a material issue brought to light at this late stage (rather than during the due diligence process) may be met with a request from the buyer for an indemnity or a reduction in price.

The disclosure letter usually takes the form of a letter from the sellers to the buyer. It is divided into two parts: "general disclosures" and "specific disclosures", and is accompanied by copies of the documents being disclosed (known as the "disclosure bundle"). The general disclosures will usually be much shorter than the specific disclosures, but can consume more negotiating time.

General disclosures

These disclosures cover certain matters which appear in public records and/or of which the buyer (arguably) ought to be aware on the basis of due diligence enquiries or searches actually made, or which a buyer would normally make. The general section will normally be based on the sellers' solicitors' standard form and will set out to be as comprehensive as possible.

As the buyer will be treated as having knowledge of the general disclosures made, it should not accept any such disclosure unless all relevant members of its team have had full opportunity to review, understand and investigate that disclosure. For example, if a series of property searches are listed as a general disclosure, the buyer must be sure that they have been carried out, or negotiate to have that general disclosure amended to include only searches actually carried out.

Specific disclosures

These 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, against a "no litigation" warranty, the sellers would need to disclose details of any current litigation affecting the Target. The warranties are therefore a prompt for the disclosures and, because the sellers will be concerned to avoid liability for breach of warranty, they serve to flush out information. Also, certain warranties may specifically require information to be listed in the disclosure letter (for example, all pension schemes with which the Target is involved).

5. 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 purchases of real estate in the UK, the buyer is not expected to pay a deposit on exchange of contracts if exchange and completion are not taking place simultaneously.

There is no duty of good faith to negotiate under English law. Accordingly, if the buyer decides to break off negotiations and pull out of the deal, the sellers have no recourse against the buyer, even for their costs. However, to minimise any adverse effects on its reputation, the buyer should give a plausible explanation for pulling out, for example, that it wasn't happy about a particular due diligence finding.

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:

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