Guide to Purchasing a Company

(An Overview of the Legal Issues)

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1. Preliminary Stages

This will largely concern negotiations over price. Before getting involved in detailed discussions, you may be asked to sign a confidentiality agreement as the vendor will be disclosing sensitive information to you. You should insist on the vendor signing a "lock out" agreement which will prevent the vendor from negotiating with other potential purchasers.

You should also structure the purchase so that it achieves the best outcome for both you and the vendor. One of the most important considerations is the tax effect on the vendor. This should be done with your financial and legal advisers.

2. Due Diligence and Warranties

Due diligence is the information-gathering process carried out by you to find out as much as possible about the Company early on in the negotiations. Through this process, you aim to gain a complete picture of the Company - 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 identify the level and areas of protection needed and any risks which you should avoid completely. The information obtained through due diligence will help you decide whether to proceed with the acquisition and, if so, at what price and on what terms. It is therefore a crucial element of your bargaining tools.

Due diligence can also help you plan the integration of the new business and identify any consents (for example, because of change of control provisions) and ancillary documents that are necessary.

The due diligence exercise generally comprises an assessment of the financial, legal and commercial status of the Company. It is typically carried out by your financial and legal advisers in conjunction with your own personnel. Depending on the nature of the Company, the purchaser may also need to involve experts such as environmental consultants and surveyors.

3. Employment

Assuming that the shares of the Company are purchased (as opposed to business assets) no serious immediate employment problems should arise, as existing service contracts need not be disturbed. However, new service contracts should be negotiated if any of the existing directors of the Company are to remain.

4. Tax

The acquisition will involve a wide variety of tax issues and will require your lawyers and accountants to work closely with you. You should be satisfied as to the present tax liabilities of the Company and be aware of likely future liabilities, taking particular account of your business plan.

It is customary to require that a Tax Deed be entered into which normally takes the form of a covenant from the vendor to pay to you a sum to cover all pre-completion tax liabilities, other than those about which you know.

5. The Sale and Purchase Agreement

The sale and purchase agreement is traditionally drafted by the purchaser and is the key agreement which documents the agreement between the parties to sell and purchase the entire issued share capital of the Company at the specified price.

The main provisions of the agreement deal with:

(i) the sale of shares;

(ii) the calculation of the purchase price and its payment, including deferred consideration and security for any deferred consideration;

(iii) completion accounts;

(iv) the composition of the board after completion;

(v) the entering into of any service agreements with any directors and senior managers who are to continue being employed after completion;

(vi) the entering into of the tax indemnity;

(vii) the warranties and any limitations on them;

(viii) the delivery of the disclosure letter;

(ix) non-competition covenants by the vendor; and

(x) any agreed pension arrangements.

6. The Disclosure Process, the Questionnaire, the Warranties and the Disclosure Letter

6.1 The last thing you want is to have a claim against the vendor after completion. Nearly always, you will have negotiated the price before being able to carry out an extensive investigation of the Company. Before you become obliged to buy the Company, you need as much information as possible to verify the assumptions on which the price was agreed and to ensure that there are no horrors in the cupboard. Information goes to price, and most of it has to come from the vendor.

6.2 The disclosure process often starts with your solicitors sending out a questionnaire raising basic questions about the corporate structure of the Company, its assets and liabilities, its properties, its contracts, its insurance arrangements, its employees, its intellectual property and its tax position. Answering the questionnaire involves a lot of work for the vendor, his accountants and solicitors.

6.3 There are no standard warranties, and no warranties are implied by law in the sale of shares. It is the duty of your solicitors to ensure that full and adequate warranties are obtained and tailored to the particular deal.

6.4 Most clients gasp at the length of modern warranties. They find the length daunting and frustrating because of the time required to read, let alone to negotiate, the warranties. This attitude is understandable because clients naturally have confidence in the deal they have struck and want to clinch it. Solicitors, on the other hand, are professional pessimists and assume that what can go wrong, will go wrong. Their duty is to protect the client against his own over-optimism.

6.5 Warranties briefly cover five areas relating to the Company:

(i) the commercial aspects of its business, including its contracts;

(ii) its properties;

(iii) its financial and tax position;

(iv) its intellectual property;

(v) its pension scheme.

The commercial warranties provide a check list designed to produce information relating, for example, to the Company's last audited accounts, its assets and liabilities, its employees and any litigation in which it may be involved. There is always a certain overlap between the information disclosed in answer to the questionnaire and the disclosures made in respect of the warranties.

6.6 Warranties have three main purposes for you:

(i) to obtain disclosure;

(ii) to provide protection if some undisclosed liability arises; and

(iii) to shift the risk on to the vendor for unknown liabilities.

6.7 Let us illustrate this by considering a usual warranty - "the Company is not a party to any litigation or arbitration proceedings, there are no claims or actions pending or threatened or anticipated against the Company, and there are no facts likely to give rise to any such proceedings, actions or claims". Suppose that the Company manufactures sophisticated machinery which is protected by a patent. You will obviously want to know if the Company is in dispute with one of its main suppliers of components used in manufacturing the machinery. If the vendor discloses that the Company is in dispute with one of its suppliers of steel, you are unlikely to be too concerned, because many companies supply steel. On the other hand, you are much more likely to be concerned if the vendor discloses that he knows of another manufacturer whose machinery may infringe the Company's patent.

6.8 The issue will also arise whether the Company's machinery infringes the patents of any other manufacturer. The vendor may say that, as far as he is aware, it does not. The question is whether it is you or the vendor who is to bear the risk of an enraged manufacturer slapping a writ for patent infringements on the Company the day after completion. As we are in the realms of the unknown, the answer is one of risk allocation or apportionment, not disclosure.

6.9 You cannot claim for breach of warranty where the vendor has made a proper disclosure. The disclosure letter, which contains the disclosures, is, therefore, a crucial document.

6.10 Where the vendor makes an unwelcome disclosure, you will have various choices. You can accept it. You can insist on reducing the price. You can, in an extreme case, withdraw from the deal. You can, where appropriate, ask for an indemnity, which will shift the risk back to the vendor.

7. Tax Indemnity and Indemnities

7.1 There are two main differences between warranties and indemnities:

(i) You can claim under an indemnity where you knew at the time it was given that there might be a claim. You cannot sue for breach of warranty in such a case.

(ii) Damages under an indemnity are easier to establish because an indemnity allows a specific sum to be claimed. Damages for breach of warranty are calculated by reference to the reduction in the market value of the shares in the Company as a result of the liability, and, furthermore, you have a duty to mitigate loss. There is no duty to mitigate with a claim under an indemnity.

7.2 An example will illustrate this. Suppose that the Company has an undisclosed liability of £100,000 and you make a claim for breach of warranty. The vendor will argue that, with corporation tax at 30%, the Company's loss is only £70,000, and that the market value of the shares in the Company has not fallen by £100,000 but only, say, by £70,000. Under an indemnity you would claim £100,000.

7.3 Indemnities in connection with the sale of shares in private companies cover taxation and protect you in respect of certain negotiated items which the vendor has disclosed. The indemnities for taxation appear in a separate Tax Indemnity or Tax Deed, to which the Company may be a party; they provide an indemnity in respect of all the Company's taxation up to completion, except for the tax provided for in the last audited accounts and except for corporation tax, PAYE and VAT arising in the normal course of business since those accounts were prepared. Making the Company a party enables it to claim under the indemnity and ensures that the money is put back in the right pocket but, as a result of the decision in *Zim Properties*, it is not tax effective to give the Company any chose in action such as the right to claim under a tax indemnity as the Company will be taxed on a disposal of that right which it received for no consideration.

8. Limitations to Warranties and Indemnities

8.1 There are no standard limitations. The limitations have to be negotiated afresh for each deal.

8.2 There are nonetheless some usual limitations. The principal ones are:

(i) a cap equal to the purchase price on the vendor's liability, although, if you have had to advance money to the Company to discharge its indebtedness to the vendor, you would want the cap also to include the sum advanced;

(ii) a threshold below which you cannot claim. This is usually approximately 1% of the purchase price;

(iii) that claims must be made within a certain period after completion. This is nearly always longer for claims relating to tax, because the Revenue has (at least and in certain cases more than) six years in which to make an assessment in the absence of fraud, wilful neglect or default.

9. Summary

After a deal the clients may find that warranties, indemnities and their limitations echo in the mind like a bad dream and think that too much time in the negotiations had been taken up discussing them. That is a mistake, because warranties and indemnities are intended to protect you against "nasties" that you would normally not have thought of and limitations and the disclosure process to protect the vendor. The happiest outcome is for the Company's business, after completion, to thrive and for the documents, over which there was so much struggle, to gather dust in the safe.

Appendix

List of documents normally required in the sale of shares

Key:

Pur	:	Purchaser
Ven	:	Vendor
PSol	:	Solicitors to Purchaser
VSol	:	Solicitors to Vendor
PAcc	:	[Purchaser's Accountants]
VAcc	:	[Vendor's Accountants]

1. Preliminary

1.1	Heads of agreement	Pur/Ven
1.2	Lock out agreement	PSol
1.3	Confidentiality undertaking	VSol
1.4	Legal due diligence questionnaire	PSol
1.5	Financial due diligence	PAcc

- review long form report (if available)
- audited accounts
- management accounts

2. Sale and Purchase Agreement

2.1	Agreement between Vendor and Purchaser	PSol/VSol
2.2	Tax Deed	PSol/VSol
2.3	Share certificates (or deed of indemnity for lost certificates)	VSol
2.4	Stock transfer forms	VSol
2.5	Cheques / bank drafts	Ven
2.6	New bank mandates	Ven
2.7	Waiver of pre-emption rights	VSol
2.8	Certificate of incorporation, seals, financial records, statutory books, title deeds, other documents arising from due diligence exercise	Ven
2.9	Resignation letters (where appropriate) of existing directors and secretary	VSol
2.10	Resignation letters of existing auditors	PSol

3. Disclosure letter VSol

4. Tax considerations

Review requirement for tax clearance letters PAcc

5. Pensions

Review pension implications PSol

6. Loans

6.1 Venture Capitalist loans

- Debenture release

6.2 Bank loans

- Debenture release

6.3 Other finance considerations:

- Intra-group debt dealt with?
- Debts/guarantees released?
- Other charges removed?

7. Service contracts

7.1	Service contracts for continuing executive directors	PSol
7.2	Resignation letters	PSol

8. Internal business

8.1	Completion Board minutes of purchaser to approve the transaction and documents	PSol
8.2	Completion Board minutes of vendor to approve the transaction and documents	VSol
8.3	Shareholder approvals (if required)	PSol/VSol

9. Property/Land

9.1	Detailed requirements depend on whether title is registered or unregistered	PSol/VSol
9.2	(If appropriate) a certificate of title (in the agreed form)	VSol

10. Miscellaneous

10.1	Completion Accounts?	PAcc
10.2	Announcements	Pur
10.3	Filing at Companies House (watch time limits)	PSol

Contacts

If you have any queries please do not hesitate to contact a member of our dedicated team:

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