Guide to Selling a Business

(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 should insist that the purchaser signs a confidentiality agreement as you will be disclosing sensitive information to them. Sometimes you may be asked to sign a "lock out" agreement which will prevent you from negotiating with other potential purchasers.

Even though a potential purchaser might have signed a confidentiality agreement, you should give serious thought as to when it is appropriate to disclose sensitive information such as details of customers. It is also good practice not to inform employees about the possible sale of the Business as this could cause uncertainty and potential problems with the workforce until you are required to do so under TUPE (see below).

You need to carefully consider your tax position prior to a sale so as to establish whether it is possible to do any pre-sale tax planning. It is vital that tax planning considerations are taken into account when negotiating the structure of a sale. This should be considered with your financial and legal advisers. In addition, you should ensure that the Business is in the best possible condition for sale. This means ensuring that its books and records are up to date and locating all title deeds and other documents of title and contracts.

Sometimes "asset purchases" are seen as a cleaner way by a purchaser to buy a Business rather than buying the company that operates a Business. When a Business is acquired by means of an asset sale, the assets to be acquired and the liabilities to be assumed can be specifically identified by the purchaser and all other assets and liabilities of a vendor can be excluded from the sale.

2. Due Diligence and Warranties

The initial approach on due diligence will be for the purchaser to construct a draft shopping list for full information. The purpose of the information-gathering process is for the purchaser to build as complete a picture as possible of the Business and the issues which will be relevant to the acquisition such as the nature and condition of, and title to assets, transfer issues and details such as timing and regulatory consents. The Business may consist of a number and variety of different assets including tangible assets such as land, machinery, vehicles, fixtures and fittings, raw materials, stock, work in progress and office equipment and intangible assets such as the benefit of contracts, goodwill and intellectual property rights.

In particular, the purchaser will focus early in the due diligence process on the key asset or assets which they wish to acquire and ensure that title can be effectively passed. Different businesses may be based on one or a combination of key assets such as:

◆	Property:	for example, a hotel where the key asset is the building itself
◆	Employees:	for example, a computer consultancy business or modelling agency
◆	Intellectual property:	for example, a computer software company, record company or literary agency where the business is composed of copyright, or a pharmaceutical company whose patents are likely to be crucial
◆	Customers:	for example, a manufacturer for a large retail outlet
◆	Licence from an	for example, a television or radio company with an authority: area or channel franchise

The information-gathering process will aim to find out information on a number of "specialist" areas which may impact on the negotiation process and, in particular, on the price the purchaser is prepared to pay and the protection they wish to seek in the form of warranties and indemnities.

The due diligence exercise generally comprises an assessment of the financial, legal and commercial status of the Business. You will therefore need to work closely with your lawyers who will manage the process and with your accountants who will be providing necessary financial information.

3. Employment

Where a Business undertaking is transferred to a new employer, the employees of that undertaking are transferred to the new employer no matter what a sale and purchase agreement states by virtue of the Transfer of Undertakings (Protection of Employment) Regulations 2006 ("TUPE").

Therefore, under TUPE, the purchaser takes on responsibility for all employees working in the Business, including responsibility for all outstanding claims they may have against you.

Therefore, the purchaser will insist that you give indemnities to cover all liabilities to such employees up to the date of completion. TUPE also provides that employees being transferred and other affected employees must be consulted prior to a transfer. You will also be required to provide certain information relating to the employees to the purchaser and the purchaser is also required to provide certain information to you prior to the transfer.

4. Contracts

The purchaser will seek to identify the most important contracts of the Business.

Each contract will be reviewed carefully. Some contracts may have restrictions or even prohibitions on its assignment, for example, hire purchase contracts will usually have a prohibition on an assignment and the sale of the asset on hire purchase. In such a case, the third party's consent will be required for an assignment or the purchaser will need to novate the agreement.

If a contract does not expressly prohibit or restrict assignment, the benefit of the contract (i.e. the vendor's rights under the contract) but not the burden (i.e. the vendor's obligations under the contract) may be assigned by you to the purchaser without the consent of the third party.

Pending the entering into of a new agreement with the third party to the contract, it is normal that the purchaser agrees to indemnify the vendor for the future performance of such contracts.

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 Business and its assets at the specified price.

The main provisions of the agreement deal with:

(i) the sale of the Business and assets;

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

(iii) the apportionment of liability in respect of the Business, its contracts and general outgoings;

(iv) the VAT aspects of the acquisition; no VAT should be payable if the acquisition is a transfer as a going concern;

(v) the apportionment of risk in relation to the transfer of employees;

(vi) the warranties and any limitations on them;

(vii) the delivery of the disclosure letter;

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

(ix) any agreed pension arrangements.

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

6.1 The last thing the purchaser wants is to have a claim against the vendor after completion. Nearly always, he will have negotiated the price before being able to carry out an extensive investigation of the Business. Before the purchaser becomes obliged to buy the Business, he will 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 the purchaser's solicitors sending out a questionnaire raising basic questions about the Business, the 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 a Business. It is the duty of the purchaser's 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 The warranties provide a check list designed to produce information relating, for example, to the accounts of the Business, its assets and liabilities, its contracts, its employees, its properties 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 - "No gratuitous payment has been made or promised in connection with the actual or proposed termination or breach ….. of any employment……". Suppose that the vendor has made such an agreement with employees - under TUPE, the purchaser will be responsible for this. The purchaser will obviously want to know if the vendor has granted generous termination provisions so that he may consider his potential liability to such employees.

6.8 The purchaser 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 and involves time-consuming work and, perhaps, several visits to the Business premises for the vendor's solicitors. The time and care is well spent because neither party wants to end up with a claim after completion.

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

7. Indemnities

There are two main differences between warranties and indemnities:

(i) A purchaser can claim under an indemnity where he knew at the time it was given that there might be a claim. He 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 relevant asset as a result of the liability, and, furthermore, the purchaser has a duty to mitigate loss. There is no duty to mitigate with a claim under an indemnity.

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;

(ii) a threshold below which the purchaser cannot claim; this is usually approximately 1% of the purchase price;

(iii) that claims must be made within a certain period after completion.

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 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

- audited accounts
- management accounts

2. Sale and Purchase Agreement

2.1	Agreement between Vendor and Purchaser	PSol/VSol
2.2	Ancillary documents to transfer assets, e.g. transfer of property and intellectual property rights	PSol/VSol

3. Disclosure letter — VSol

4. Obtain any consents — PSol/VSol

Contacts

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