Selling a Company

Introduction

No two companies are the same. No two sets of shareholders and directors are the same. No two purchasers are the same. No two deals are the same. In any share sale transaction, the one thing you can confidently expect is the unexpected.

So this booklet is not about your deal – your deal will be different from any deal we have ever dealt with. Rather, on the basis of several decades of combined experience, it is about what "typically" or "usually" or "normally" happens in the course of such a transaction. It is not intended as a precise road map of the path you are heading down, but a rough sketch to give you some idea of your surroundings and the general direction we are trying to take.

The Process

In theory, it should be fairly simple to explain the process behind a share sale in a straightforward flow chart. That is the theory – in practice it never works that way as time pressures, changes in the deal and the documentation and backtracking in negotiations combine so that the distinct elements of the process become mixed. In the last few days before completion, you will typically be dealing with all the stages mentioned below in one rather confused jumble. But so that you understand the theory…

Preliminary Documents

The process starts with the heads of terms, which are explained in more detail below. As soon as they are agreed the confidentiality agreement and any lock-out terms will also be negotiated and documented.

Due Diligence Documents

By the stage when he signs heads of terms, the purchaser thinks he knows what he is buying, but before committing himself, he will want to be as sure as he can be that he has uncovered all the potential risks and pitfalls inherent in taking over someone else's business. The investigations to check what he is getting are called the due diligence exercise.

The due diligence exercise has at least two parts, known as financial and legal due diligence.

The financial due diligence exercise will consist of the purchaser or his accountants visiting your premises to go through your accounting records, to check that the accounting systems and records are up-to-date and accurate, to review the basis on which management accounts are prepared and to examine the company's tax position, looking for potential tax liabilities or seeking to understand provisions for tax in the audited accounts. They will then prepare a full written report for the purchaser, which you may or may not be allowed to see.

The legal due diligence exercise is the responsibility of the purchaser's solicitors. It takes the form of a lengthy questionnaire (frequently running to a dozen or more pages) covering every aspect of the company's affairs, with requests for copies of documents, wherever possible, to back up the information provided. Answering it will involve a seemingly endless paper chase, retrieving documentary records of contracts, internal arrangements, licences, permits etc. It can be a time-consuming and frustrating task. If you are planning to sell your company, the sooner you can start collecting together all the paperwork relating to the business, the better: it will make the task of responding to the due diligence questionnaire so much easier.

It is, however, important to make sure that the responses to the due diligence questionnaire are as complete and accurate as possible. For one thing, it is technically a criminal offence to provide false or misleading information in relation to the purchase of shares: more realistically, the process of giving warranties and disclosing against them, which we will look at in more retrieving documentary records of contracts, internal arrangements licences, permits etc.

Typically, the initial answers to the due diligence questionnaire will raise other questions in the purchaser's mind, and you can expect to get supplementary questions at intervals throughout the sale purchase.

Depending on your company's business and assets, the purchaser may want other elements of due diligence carried out. These could involve structural or environmental surveys of your company premises, or instructing patent agents to investigate the enforceability of important intellectual property rights.

The Agreements

Once at least some of the due diligence questions have been answered, the purchaser's solicitors will produce first drafts of the share purchase agreement ("SPA") and the tax deed, together with any other supplementary documents required for the particular deal, such as service agreements for directors who are staying with the company and loan note instruments.

We will review these documents and then discuss them with you at length before going back to the purchaser with a "mark-up" setting out our proposed amendments. Some of these will probably be accepted as reasonable responses: others will be accepted after a little explanation of the reasoning behind the proposals. Others will be rejected and left open for negotiation. Some negotiation will follow by phone and email, but it is usual to finalise outstanding issues by arranging a round table "drafting meeting" to negotiate the final points of principle, and agree the legal wording to give effect to them.

Having reviewed the SPA and negotiated the terms of the warranties, we will be drafting a disclosure letter for you and sending it to the purchaser's solicitors for comment. This too may contain negotiable elements, and the purchaser may ask for more details of specific issues which have been disclosed. Again, this is likely to finalised at the drafting meeting.

Ancillary Documents

As well as the main documents outlined above, completing the transaction will require many other formalities to be observed. Directors and other officers will be resigning from the company to be replaced by the purchaser's representatives. The transfers of the shares will have to be approved by the company's board. Many of the events will need to be registered at Companies House, and the relevant returns will need to be prepared in time for completion. The task of preparing all the ancillary documents falls on the purchaser's solicitors. The documents are not contentious in nature, but we will be checking them to make sure that all the necessary formalities have been thought through, and that the documentation is accurate.

Completion

Completion is the big day when everything comes together and all the documents are signed. Although this can sometimes be arranged at long distance, most transactions will end with a formal completion meeting with all parties round the table to sign. The meeting usually takes place at the purchaser's solicitor's offices for the practical reason that they will have been responsible for preparing most of the documents and, if there need to be last minute tweaks and adjustments, it is simpler and easier to do this on their premises, with their IT facilities available.

Simple as it sounds, the completion meeting involves a complex set of logistics. It needs careful planning and organisation to make sure that not only the key documents are signed, but that all the ancillary matters mentioned above are also dealt with. If the purchaser is borrowing money for the purpose of the transaction, or taking in investment from a venture capitalist, all the documentation and formalities for those transactions will also have to be completed. It would not be unusual for a simple completion process to need signatures on 50 or more pieces of paper. The best organised completion meeting is therefore likely to last an hour or more, but be warned, every corporate lawyer will have a war story of the completion meeting that went wrong and lasted through the night, or even over several days.

Post Completion

After completion, the solicitors will sort out the mountain of paper on the table, making sure that each party keeps the original documents it requires. The purchaser's solicitors will be responsible for ensuring that all the necessary returns are made to Companies House, and will usually then prepare a "bible" – a file (or a CD) containing copies of all the documents for future reference.

The Key Documents

Once heads of terms have been signed, the majority of the negotiations in relation to the sale will revolve around four or five key documents

- A Confidentiality Agreement
- The Share Purchase Agreement
- The Schedule of Warranties in the SPA
- The Tax Deed
- The Disclosure Letter

Confidentiality Agreement

Before committing himself to buying the company, the purchaser will want to have a lot of information about your company and its business. Much of that information will certainly be confidential information that you would want to keep from competitors and other third parties. Some of it may even be genuinely secret formulae, product development plans, future marketing ideas etc.

You will therefore want to get the purchaser to sign a confidentiality agreement agreeing to keep all information provided confidential. The agreement will limit disclosure of the information within the purchaser's organisation on a "need to know" basis, and may even restrict disclosure to specific individuals within the purchaser's employees and advisers. The purchaser will also have to undertake to return or destroy any information (and any reports or analyses prepared from it) if the deal does not go ahead.

It is important to get these undertakings from the purchaser, but you should be aware that there are inevitable risks in disclosing confidential information under any circumstance. If, for example, the purchaser is a competitor, it is difficult to stop the purchaser using the information for its own benefit. Most purchasers do, as a matter of honour, keep confidentiality information secret, but if they do not, you will have a hard job proving in court that any leaks were the purchaser's fault.

Share purchase Agreement

This is "the" document which sets out the terms of the deal. Like most contracts, there is a good deal of legal wording and boiler plating.

Definitions

There will be several pages of definitions, usually at the start of the agreement. Whilst some of them (such as "the Company", "the Accounts", "the Directors") seem obvious and even unnecessary, subtle interpretations of some of the other definitions will make a substantial difference to the meaning and impact of the agreement itself.

It is usually difficult to decide whether a definition is right or not until you have seen how it works in a particular context, but it is important to go back and re-check definitions once you have found the contractual provisions which they affect. (By convention, defined terms are usually given capital letters throughout the main text of the agreement.)

The Deal

Definitions taken care of, the SPA then sets out the key elements of the deal: what shares the purchaser is buying, what he is paying for them, and how and when payment will be made. In the simplest transactions, this is merely a matter of reciting that the purchaser will pay cash for the shares at completion. In many cases, however, it will involve spelling out the terms of payment of any deferred consideration, the calculation and payment of earn outs, the key elements of any loan stock to be issued, the timing of payments and so on. As such, it contains the key elements of the transaction which have already been agreed in principle in the heads of terms, but sets out the specific, mechanical details which may give rise to considerable further negotiation.

Completion

The SPA will set out a basic agenda of the things which will need to be done at completion. For more details of what completion involves, see the section on it under "The Process".

Warranties

The main body of the SPA will set out the legal terms on which you are giving warranties to the purchaser. From the legal point of view, warranties are contractual terms: breach of a warranty will entitle the purchaser to sue you for damages. In conceptual terms, what the purchaser is saying is: "I'm paying you this much money for the company on the assumption that these statements are true. If I knew now that some of the warranties were not true, then I might not pay you so much, so if I find out later that a warranty wasn't true, I want some of my money back."

A separate schedule, frequently running to 30 pages or more, will set out the detailed terms of the warranties themselves, and these are likely to give rise to much of the most detailed negotiation in the course of the transaction. They consist of a series of statements about the company which the purchaser expects you to confirm are true. The warranties will typically cover every aspect of the company's affairs, from its constitution to its employees, from its contractual relationship to its properties, from its accounts and tax affairs to its intellectual property.

It will be critically important for us to go through the warranties with you in detail and check that they are completely accurate. If a warranty is not true, there are several things you can do about it. Sometimes, the warranty can be deleted or amended so that it is true; more commonly, however, the purchaser will insist on you making disclosures explaining why the warranty is not true. The principle behind disclosure is that if you have told the purchaser that a warranty is not true, he cannot subsequently bring a claim under that warranty in respect of the things you have disclosed.

The warranties inevitably ask for assurances in respect of matters which you cannot say for certain are true – for example, that there are no circumstances which could give rise to a claim being made against the company. These warranties are often watered down by expressions such as "so far as the Vendors are aware" or "to the best of the Vendors' knowledge, information and belief." The effect is that the purchaser must show that you were actually aware of the breach, but you must be able to show that you have made whatever checks you reasonably can to make sure that warranty is true.

Indemnities

It is becoming increasingly common for the purchaser to ask for specific indemnities in relation to some aspects of the company's affairs. This usually arises when the purchaser finds out in the course of his due diligence exercise, or as a result of your disclosures that the company may have a liability of some sort in the future. Typically, this will be a liability which may or may not arise (a dissatisfied customer is threatening to sue, but may or may not actually do so) or a liability which has already arisen, but can't be quantified (e.g. the customer has sued, but there is an argument over what damages he is entitled to).

An indemnity provides that you will pay the purchaser pound for pound for any loss he suffers as a result of the thing in question. This is a very onerous liability and the exact terms of any indemnities need to be carefully negotiated.

Restrictive Covenants

Having taken on substantial financial commitment to buy the company, the purchaser will inevitably want to make sure that you are not in a position to "steal" the business back, and will want to impose restrictive covenants, like those typically seen in the employment contracts. Usually these will stipulate

- That you must not be involved in any way at all in a competitive business
- That you must not poach customers from the company
- That you must not poach staff from the company
- That you will not interfere with supplies to the company

In the employment contracts, these restrictions have to be very limited in order to be enforceable. In a share sale agreement, the courts will enforce much wider restrictions, and covenants lasting two or three years are routine. Although you are not likely to be able to avoid the restrictions altogether, it is important to discuss your future plans and projects with us so that we can try to ensure that detailed wording of the covenants leaves you free to do what you want to do after completion, whilst offering the purchaser the protection.

Vendor Protection

The purchaser has a lot of rights under the warranties you have given. In particular, he can sue at any time up to 6 or 12 years after the date of the contract, and can claim any amount of damages. We will add a schedule to the agreement limiting these rights. This is likely to be another area of intense negotiation, but it is usually accepted that the so-called vendor protection schedule will limit the purchaser's rights in the following ways:

- The purchaser must bring his claim within a limited period of time (typically between 18-24 months)
- The purchaser must notify you immediately he becomes aware of a potential claim
- The purchaser cannot claim for the trivial amounts (what is "trivial" is something that is likely to involve a good deal of haggling)
- The purchaser accepts that he takes an element of risk, and that he cannot claim at all unless the aggregate of all his claims exceeds a certain value.

We would also want to provide that, if the claim arises from a claim against the company, you have the right to negotiate and settle that claim or take control of legal proceedings about it, and that, if the loss is something the company is insured against, the purchaser must claim on the insurance, not rely on his rights against you.

Tax Deed

It is standard practice in a share purchase deal for the seller to give the purchaser an indemnity against any unforeseen tax liabilities: i.e. any liability which has not been taken into account in preparing the company's last audited accounts or which has not arisen "in the ordinary course of trade" since those accounts were prepared.

The document is a highly technical legal document – and even more incomprehensible than most legal agreements. The key point in negotiating it is to liaise with your in-house accounts department and your auditors to ensure that you are aware in advance of any potential tax liabilities which could arise and give the purchaser a claim under the deed.

Disclosure Letter

We have explained above that, provided you explain to the purchaser that a warranty is not true, the purchaser will not have a claim against you under that warranty. The explanations are contained in a letter written by the sellers to the purchaser, known as the disclosure letter.

The disclosure letter starts with a series of "general" disclosures. The purpose of general disclosures is to stop the purchaser from suing you for a breach of warranty if the breach relates to something which the purchaser knew about, or should have found out about in the course of investigating the company's affairs. Some general disclosures (e.g. matters registered at Companies House) are generally accepted. The vaguer the disclosure becomes, the more likely it is that the purchaser will argue with it, but we will try to put in general disclosures relating to, for example, anything which should have been apparent from an inspection of the company's buildings and anything that should have been apparent from reading the accounts.

The second part of the disclosure letter lists the "specific disclosures".

Some warranties will require you to make specific disclosures: for example, there will usually be a warranty that "there is annexed to the disclosure letter a list giving full, complete and accurate details of all the employees of the business." These are self-explanatory, but in addition, you will need to check the rest of the warranties very carefully and spell out everything that is not true in the disclosure letter.

For a disclosure to be effective, you must tell the purchaser precisely:

- The facts or circumstances which would constitute a breach of warranty
- Which warranty (or warranties) it is a breach of
- What the consequences are likely to be for the company.

The explanations in the letter should also be backed up by any documentary evidence that is available which forms the "disclosure bundle".

Checking the disclosure letter is complete and accurate and fulfils the requirements set out above, and that all relevant documentation has been copied and put in the disclosure bundle is a major exercise which will require considerable input from you and your team.

Other Documents

What documents will be needed for a particular transaction of course depends entirely on the specific details of the deal. The following are just some of the additional documents which may need to be prepared, negotiated and finalised in the course of a share sale.

Head of terms

Once negotiations with the purchaser have reached the stage where you have informally shaken hands on a deal, it is worth setting out the outline of the deal in writing. The purpose of this is to make sure the parties do not start spending a lot of time, effort and money going through the sales process only to find that some deal-breaking issue had not been properly agreed before they started. It is also important, however, to remember that the purpose of the heads of terms is only to outline the deal: there will inevitably be many details which need to be ironed out and negotiated as it progresses and you need to avoid getting too deeply involved in the nitty-gritty and holding up the transaction over matters which can be resolved at a later date.

The heads of terms will be expressed to be non-binding. They are not the final contract between the parties, but merely a starting point for the preparation of full documentation. The purchaser will, however, want to include at least one legally binding term, known as the "lock out".

The purchaser is going to incur considerable costs and spend a lot of time investigating the company and negotiating the sale terms. He will want to avoid the risk of being "gazumped" by another purchaser, and will get you to sign a binding undertaking not to enter into talks or negotiations with any other prospective purchaser for a guaranteed period to allow him to complete his investigations and the legal process.

Service Agreements

If some of the company's directors and key employees are staying with the company after completion the purchaser will almost certainly want them to sign new service agreements, guaranteeing as far as possible that they stay with the company and setting out the usual terms of employment. We can help with general comments about standard terms and conditions for such agreements, and with the sort of matter which can be regarded as "typical", but each of the relevant directors and employees will need to consider the precise terms of their individual contract, and should consider getting independent legal advice on their personal position. (As our solicitors act for all the shareholders, we cannot advise individual shareholders in case their best interests are in conflict with the interest of the group as a whole.)

Loan Stock

For tax reasons you may be advised to take loan stock as part of the price rather than cash. In theory, loan stock is like shares: the purchaser's company promises to pay you a sum of money in the future, and you can sell the right to receive some or all of that money to a third party. (In practice, this happens very rarely, if ever.) The loan stock instrument sets out the terms of the "loan" due from the company. These include the rate of interest, how and when the loan will be repaid and what happens if the company fails to make any payment when due. It also contains detailed provisions for transferring the loan stock and arrangements for meetings of stockholders, if any are required.

Glossary

The world of company sales and purchases is awash with a bewildering mixture of legal and accounting terminology and buzz words and phrases which would justify a mini-dictionary. This glossary is not intended to be comprehensive, but gives a very brief explanation of some key concepts with cross references to further explanations in this document.

Completion - The meeting at which all the documents to give effect to the deal are finally signed (see "Completion" under "The Process" above).

Consideration – The legal term for "the price", including everything the purchaser is giving in return for the shares.

Deferred Consideration – Any part of the consideration which is not actually being paid at completion. Payment is usually dependent on achieving future targets for turnover or profitability.

Disclosure – An explanation to the purchaser of ways in which a warranty is not true.

Disclosure Bundle – The files of documents delivered to the purchaser to support the information given in the disclosure letter.

Disclosure Letter – A letter from the sellers to the purchaser delivered immediately before completion setting out the disclosures.

Due Diligence – The process by which the purchaser investigates the company to make sure he is getting what he expected from the deal.

Due Diligence Questionnaire – The questionnaire from the purchaser's solicitors listing their due diligence questions.

Earn Out – A part of the consideration that varies depending on future results.

Heads of Terms – An initial, non-binding agreement between the sellers and the purchasers setting out the basic terms of the deal.

Loan Stock – A debt owed by the company which the creditor can transfer to a third party.

Loan Stock Instrument – The document setting out the terms on which loan stock is repaid.

Lock Out – An agreement that the sellers will not enter into any discussions or negotiations about selling the company with anybody other than the purchaser for a given period of time.

Restrictive Covenant – Contractual terms designed to prevent the sellers from competing with or poaching customers or staff from the company after completion.

Share Purchase Agreement ("SPA") – The main agreement setting out the legally binding terms of the transaction and incorporating the warranties.

Schedule – Particulars placed at the end of an agreement setting out details which it might otherwise clutter the main agreement.

Tax Deed – A deed under which the sellers indemnify the purchaser against any unexpected tax liabilities.

Venture Capitalist (“VC”) – A third party investing for shares in the purchaser’s company.

Warranties – Contractual terms comprising statements about the company which entitle the purchaser to sue for damages if they are not true.