



## Private Company Share Sales: The Legal Process



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## Buying a company is easy – or is it?

Acquiring the shares in a private limited company can seem deceptively simple. The ownership of the shares can be transferred by a single page stock transfer form, but the buyer needs to appreciate that along with those shares he will acquire all the assets and liabilities of the company, whether he knows about them or not. For example, there may be unpaid tax, liabilities under a property lease or disputes relating to trading contracts. All of these will immediately become the buyer's problem, whilst the seller sits back and counts his money.

Because of the potential liabilities that come with a share acquisition, private companies are rarely bought and sold on the basis of a stock transfer form alone. A key issue for any buyer thinking about acquiring a company is *due diligence*. This is the buyer's investigation into the affairs of the company to better understand what he might be buying.

## First steps – the indicative offer and confidentiality undertakings

Before a seller discloses any confidential information he will want to feel comfortable with the likely sale price and the buyer's ability to pay it. The buyer will need information so that he can formulate an offer. Without a certain amount of non-publicly available information the buyer may not be able to secure even a preliminary offer of finance (assuming the purchase will need external finance). So the starting point may be an *indicative offer* after a limited disclosure of information, subject to renegotiation if necessary when further information becomes available.

At an early stage the seller should ask the buyer to sign a *confidentiality undertaking*. This may be a mutual undertaking particularly where the buyer is a listed company.

Even when a confidentiality undertaking has been signed the well-advised seller will be wary of providing sensitive commercial information until he is very confident that the transaction will proceed to completion at an agreed price.

## Firm offer and term sheet / heads of agreement

Once the buyer feels he has enough information, he should be in a position to agree a firm price for the company with the seller even if it is still subject to due diligence. At this point the parties should draw up a document recording the main points of the deal. On small or low value transactions, a simple *term sheet* setting out the price, the assumptions behind the price and the basic terms of the eventual purchase agreement should suffice. On larger deals a fuller *heads of agreement* may be prepared.

There is no requirement to have a term sheet or heads of agreement and, since such documents are rarely legally binding, some may question the point of doing so. However, they are an essential part of a well-managed sales process and will be the reference point when the legal agreements are being drawn up and negotiated.

The biggest risk in many transactions is the damage to the company from a badly managed sales process. For the seller struggling to run his business as well as deal with the due diligence and the sales process this can be highly disruptive. The performance of the business may suffer and professional costs run out of control. It is quite common for the sellers to be asked the same or overlapping questions by the buyer, its investigating accountants and its solicitors.

To avoid this, it is good practice to set out in the term sheet/heads of agreement the scope of the due diligence to be undertaken by the buyer and the timetable for doing it. Doing so can help to ensure that the buyer and its advisers operate the due diligence process efficiently.

## Lock-out?

Buyers on large transactions will often ask for a binding commitment (known as a *lock-out* or *exclusivity* arrangement) from the seller in the heads of agreement to negotiate only with the buyer for a set period. Such commitments are often backed up by an agreement from the seller to pay the buyer's costs if the seller breaches the

exclusivity arrangement and sells to someone else. This tends to be less of an issue on smaller transactions, partly because owner managers will not have the time to negotiate with more than one potential buyer whilst also trying to keep their business running.

## Due diligence

When the price and other terms of the deal have been agreed, the due diligence process can start in earnest. The process can be as long or short as the parties wish to make it and, to a large extent, will depend on the size of the company in question and the activities it undertakes. A company operating a consultancy business from small rented premises will obviously need less investigation than a multi-site manufacturing company with a large workforce.

The due diligence process typically involves the buyer sending the seller a list of questions about the company and its affairs, together with requests for various documents. On larger acquisitions these requests may be split between legal, accounting, commercial and tax matters and the buyer may even send its own advisers in to the company to conduct investigations. On smaller deals, however, the buyer may choose to review the due diligence information himself, with support from his advisers.

## Legal documentation

Following the signing of a term sheet or heads of agreement the process will continue on two parallel tracks. The buyer will continue to deal with any issues which have been raised by the due diligence, which may involve requesting further information from the seller or seeking expert advice, whilst the parties start negotiating the *share purchase agreement* ("SPA"). The SPA is the document which ultimately governs the terms on which the company is sold to the buyer. It is normally prepared by the buyer's solicitors and negotiated at length between the parties and their advisers. A comprehensive SPA on a reasonable sized transaction can often extend to over 100 pages.

The SPA has two main purposes. Firstly it sets out the mechanics of the sale of

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the company, such as how the purchase price will be paid, which directors will resign at completion and who will replace them. Secondly, it protects the buyer from some of the possible problems within the company, either unknown or discovered in the course of due diligence. It does this through the use of *warranties* – statements of fact about the company given by the seller. If any of those warranties prove to be untrue, and the buyer suffers loss as a result, the buyer may be able to claim compensation from the seller.

The negotiation of the warranties is often the biggest issue in agreeing the SPA. This will also involve agreeing a set of limits on the seller's liability to pay for breaches of warranty, such as a maximum amount (usually the purchase price) and a time limit for the buyer to bring any claims. The seller will also want to protect himself by the process of "disclosure". This involves the seller setting out any exceptions to the factual statements in the warranties in a document known as a disclosure letter. This is yet another document to be negotiated between the parties.

All of this inevitably takes time and resources. On very small company sales, a buyer must weigh up the

potential benefits of an SPA with full warranties and disclosure against the costs of negotiating the documents. If the buyer feels that the likelihood and scale of any potential liabilities is small, then he may decide to proceed with a much more streamlined SPA in the interests of getting the deal done quickly.

## Completion

Once the SPA (in whatever form) has been agreed, and the final loose ends tied up in the due diligence process, the parties can complete the deal. There is usually a suite of documents to be signed at completion. As well as the SPA and disclosure letter, there will be board minutes of the relevant companies, resignations of directors, company secretaries and auditors, and forms to change the company's registered office and accounts date. Finally, there will be the stock transfer form which, despite all of the above, still performs the task of ultimately transferring the shares to the buyer.

## Post completion

After the legal process has been completed, the buyer must ensure a proper and efficient handover of the business. This may involve the seller acting as a consultant for a period of time. Any such consultancy will have

been an important part of the sales negotiations.

On a transaction structured with an *earn-out* (part of the price being left outstanding contingent on the performance of the company after completion) tensions between the interests of the buyer and seller may quickly emerge. These tensions should have been anticipated in the negotiation of the heads of agreement and the SPA.

## Final thoughts

This Fact Sheet has considered the legal process alone. The sale of an owner-managed company can be very challenging with sensitive personal and business issues to be considered and agreed.

The assistance of an intermediary such as a merger broker or a corporate finance accountant can be invaluable. On smaller transactions the budget may not extend to such an intermediary and in that case the seller will be more reliant on his legal advisers. In these situations it is all the more important that the seller chooses a legal adviser who is sensitive to the personal and business issues as well as the legal issues.

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