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CORPORATE BULLETIN

Buying a business

Buying a business can be expensive, complicated and time-consuming, so you need to plan carefully and get the right advice at an early stage.

Why buy?

There are many reasons for buying a business. For example, you may want to expand your existing business faster than by organic growth; to remove a competitor from the market; or to acquire a supplier or distributor to bring your sourcing or distribution systems in-house. Alternatively, you may want a presence in a new customer market or geographical area, or to diversify into new product lines.

Research has shown that many acquisitions fail to achieve their objectives and that the following elements are essential for success:

- a thorough investigation of the target business, to help ascertain its true value and identify any potential liabilities;
- effective management of the acquisition process, particularly if the buyer is running its own business at the same time;
- careful planning to decide how to run the business, and integrate it into any existing business of the buyer, after the acquisition.

As the buyer, you may have to pay a high price for the business (particularly if it is well-established and has valuable goodwill) and incur substantial expenses and professional fees. You may also have to spend a huge amount of management time on the process - which can distract you from running your existing business, if you have one - so you must do all you can to make the acquisition a success.

Shares or assets?

Assuming the target business is operated through a company, there are two ways for you to acquire it: by buying the shares in the company from its shareholders, or by buying the assets of the business from the company.

There are several differences between the two:

Assets and liabilities: in a share sale, the buyer buys the target company along with all its assets and liabilities but in an asset sale, you can "cherry pick" the assets you want (if the seller will agree) and leave all liabilities other than employees with the seller. For this reason, buyers normally prefer to buy assets, rather than shares.

Form of transfer: shares are transferred by a simple stock transfer form, whereas different assets require different forms of transfer. For example, property requires a conveyance or assignment, and customer contracts must be assigned or novated.

Consents and approvals: on an asset sale the assets have to be actually transferred to the buyer and this may require the consent of third parties. For example, customer contracts may not be transferable without the consent of the customer, and the transfer of a leasehold property will require the consent of the landlord. If you cannot obtain consent for the transfer of a key asset, a share sale may be the only option - on a share sale, the problem of obtaining consent will only arise if a document entered into by the target company (e.g. a bank loan agreement) contains a "change of control" clause which gives the other party the right to terminate the agreement on a sale of the shares.

Tax: in a share sale, you will inherit the target company's tax liability and will therefore need specific protection from the seller against this, whereas on an asset sale, the tax liabilities of the business normally remain with the seller. An additional advantage of an asset sale is that you can write off goodwill acquired from the seller against profits you earn in the business over time. Against this, in a share sale, if the target company has significant tax losses, you may be able to make some use of these to set off against profits in your existing business, if you have one.

Stamp duty: on a share sale, you must pay stamp duty at 0.5% of the sale price. On an asset sale, you will have to pay stamp duty land tax of up to 4% of the price of any land being transferred. Generally, stamp duty is no longer payable on the transfer of other assets, such as goodwill, intellectual property or customer contracts.

Sale proceeds: on a share sale, the price is paid directly to the individual shareholders, whereas on a sale of assets by a company, the price is paid to the company and then, if the shareholders want to receive the money personally, the sale proceeds have to be transferred from the company to the shareholders. This may trigger a double tax charge, first for the selling company and secondly for its shareholders, which may make an asset sale very unattractive to the seller.

Generally speaking, for the reasons given above, buyers tend to prefer to buy assets, whereas sellers prefer to sell shares. The choice will depend on the parties' respective bargaining strengths and the nature of the business - for example, if the main asset of the business is a property, you may prefer to buy shares, rather than pay stamp duty of up to 4% of the price.

Getting started

The first step is to find a business to acquire. Often, the business will be one which the buyer has already dealt with - for example, a competitor, supplier or distributor. It can help if you already know the business. Alternatively, businesses can be found through personal contacts, brokers, advertisements in the trade press, or websites offering businesses for sale.

Once you have chosen a business to purchase, you will need to carry out some initial investigation, with a view to valuing the business and agreeing a price. The valuation will cover such things as premises, equipment, stock, debtors, creditors, goodwill and other assets, and will normally be done with the help of an accountant, valuer or broker.

The next step is obtaining the necessary finance. Unless you can fund the acquisition from your own resources, you will need funding from a bank or other lender. The lender will want to see a business plan and cash-flow forecast for the business and will require security for the loan, in the form of a charge over the assets of the business, or even personal guarantees from the directors or shareholders of the buyer and charges over their own property.

The legal process

Heads of agreement: once the parties have agreed a deal in principle, they will often draw up heads of agreement (also known as heads of terms, an offer letter or a letter of intent). The heads are designed to identify the main issues (e.g. deal structure, price and timetable) and act as a "route map" for the rest of the transaction. They will be assumed to be legally binding unless stated otherwise so, if you do not want to be committed to the deal until you have signed a formal sale agreement, you must make sure the heads state that they are not legally binding. Some provisions will normally be legally binding - for example, you may want a period of exclusivity during which the seller cannot sell the business to anyone else and must pay your costs if it does so. In turn, the seller will often require you to keep confidential any information provided to you during the negotiations or even to pay a deposit which the seller will keep if you pull out of the deal. It is important to avoid spending too long on the heads - especially if they are not legally binding - as you can waste time and costs negotiating them.

After the heads have been finalised, you will carry out your investigation of the target business and your solicitors will prepare the sale agreement *(see below)*. It is generally better for your solicitors to draft the agreement, because this can help your negotiating position.

Exchange and completion: when the documents have been finalised, each party will sign the sale agreement and give its signed copy to the other party ("exchange of contracts"). The parties will be committed to the deal at this stage, although there may be a delay before completion. On completion, you will pay the price and the seller will transfer the shares or assets. You may need a period between exchange and completion - for example, to obtain any necessary consents from third parties, such as customers (the seller will be reluctant to tell customers about the sale until a formal sale has been agreed) or, in the case of an asset sale, to consult with employees. In addition, in a large transaction, the acquisition could require regulatory approval under competition law. You should try to identify these issues at the outset, and perhaps make the acquisition conditional on resolving them before completion.

The length of the process can vary enormously between transactions, but you should normally anticipate at least six weeks from the signing of the heads of agreement until completion.

Due diligence

Once the parties have agreed the principal terms, you will begin investigating the target business. This process – called “due diligence” - falls into three main categories:

- **Financial:** reviewing the accounts and the financial and tax situation of the business. This is normally done by the buyer’s accountants.
- **Legal:** examining the corporate structure, the contractual and other legal obligations of the business and any regulatory issues. This is usually done by the buyer’s solicitors.
- **Business:** reviewing the products, market position and trading relationships of the business, which is normally done by the buyer.

Other advisers, such as surveyors, environmental experts or IT specialists, may be needed to investigate specific aspects of the business.

Due diligence can help you to identify problems which need to be covered in the sale agreement, and any consents required for the transaction (e.g. from customers). Issues arising from due diligence may make you want to renegotiate the price or even pull out of the deal altogether.

What should you look for? For example, you will be interested in the trading position of the business (e.g. key contracts, debtors, creditors and capital commitments), onerous obligations (e.g. long-term contracts involving high payments), ownership and condition of assets (e.g. title to land, the terms of any leases, or the condition of stock), employees (e.g. employment terms, salary payments, pensions and other benefits), litigation (e.g. disputes with customers or claims by employees), taxation (e.g. tax arrears or disputes with the Revenue) and IT/intellectual property issues (e.g. computer contracts and rights to software or trade marks). If the business owns a property, you will need to carry out searches and enquiries (eg at the local authority) and you may want to do a survey of the property.

Due diligence is advisable for any buyer, but it can also be expensive and time-consuming. You and your advisers should identify and focus on the areas of particular interest and the specific risks in the relevant industry sector, and you must keep the exercise in proportion to the value of the acquisition. You should also avoid spending too long on it, particularly if there is a risk of losing the sale to another buyer.

Share/business purchase agreement

This is the most important document in the transaction, and most of your solicitors’ time will be spent in preparing and negotiating it. It will set out the key commercial terms which have been agreed between the parties, including:

Conditions: if the sale is subject to certain conditions - for example, obtaining the consent of a key customer to the transfer of its contract - these will be covered in the agreement and must be satisfied before the sale can complete.

Price and payment: the buyer normally pays the price in full on completion, but you may want to hold back part of the price until a later date (a “deferred payment”), make the price dependent upon the business achieving certain targets in the period after completion (an “earn-out”) and/or hold back part of the price in a joint account to use in settling any problems which arise after completion (a “retention”). In contrast, the seller may require a deposit on signing of the heads or the sale agreement.

Completion accounts: you may want the price to be dependent on the value of certain specific assets, such as stock, work in progress or debtors which are valued on completion using “completion accounts”, with the price being adjusted downwards or upwards if the value of the assets is lower or higher than the figures which the parties have agreed in advance.

Apportionments: on an asset sale, the parties will normally draw a line at completion, with the seller being responsible for all liabilities before completion, and the buyer responsible for those after completion. Pre-payments by or to the seller will also be divided pre- and post-completion. For example, if the seller has already paid rent for a period which straddles completion, the amount for the post-completion period will be added to the price you will be paying, whereas if the seller has received a deposit from a customer for work to be done after completion, the deposit will be deducted from the price.

Book debts: the agreement will govern how book debts are collected after completion. In a share sale, the book debts are automatically inherited by the buyer but in an asset sale you

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could agree that the seller will keep them and you will collect them on the seller's behalf, or that you will buy them and collect them for yourself. You will probably not want the seller contacting customers for a period after completion.

Premises: on a share sale you will automatically take on any premises owned by the target company but, on an asset sale, the agreement will need to specifically deal with the transfer of the premises, including obtaining the landlord's consent if the property is leasehold.

Employees: on a share sale, the employees remain with the target company which you are acquiring. On an asset sale, the end result is similar in practice, as the regulations known as "TUPE" provide that the employees' contracts are transferred from the seller to the buyer on completion, so the employees will become employed by the buyer. This means that you cannot unilaterally change their contracts. The seller cannot dismiss employees immediately before completion if they are surplus to requirements going forward, and nor can you dismiss them immediately after completion, without following the correct legal procedure, as either action could lead to claims against you.

If you have an existing business, you may have to select some of your own employees for redundancy, rather than making all redundancies out of the employees you inherit from the seller. It is essential for you to get the right legal advice on all employment issues – including pensions and share schemes, which are treated differently from other employee rights on the sale of a business.

Restrictive covenants: the buyer will often restrict the seller from competing with the business, and taking clients or employees, after the sale. These "restrictive covenants" must be reasonable in scope, duration or geographical area, or a court may refuse to enforce them at all.

Warranties, limitations & disclosure letters

One of the main sections of the sale agreement deals with the warranties and indemnities. These are detailed statements by the seller about various aspects of the business, such as trading, finance, assets, liabilities, employees, property, litigation and tax. You will rely on these statements and if any of them turns out to be untrue and you suffer loss as a result, then you can claim damages against the seller. The seller will want to limit its liability: first, by negotiating the warranties so they only contain statements about the business which the seller is happy to give; secondly, by preventing claims above a specified limit (e.g. the price) or after a certain date (e.g. 2 years after completion); and thirdly, by preparing a "disclosure letter" which lists any exceptions to the warranties, so you cannot claim damages for those matters.

Other major documents

- **Tax deed:** on a share sale, you will inherit all tax liabilities of the target company and you should therefore ask for a specific indemnity against these - given in the form of a tax deed or tax covenant.
- **Service contracts:** you may also want individual sellers or key employees who are remaining with the business to sign new service contracts governing their relationship with you going forward.
- **Banking documents:** if you are borrowing part of the purchase price, you will have to sign a loan agreement and security documents, creating charges over the assets of the business in favour of the lender. You and your directors or shareholders may also be asked to sign personal guarantees and mortgages over your own property to secure repayment of the loan.

After completion

The hand-over period immediately after completion is a crucial phase, when you will need to focus on retaining existing customers, motivating staff and integrating the target business into any existing business you are already operating.

Note for sellers: this bulletin is aimed at buyers. For an explanation of the issues affecting sellers, please read our bulletin entitled "Selling a business".

HOW WE CAN HELP

RadcliffesLeBrasseur advises on all aspects of company and commercial law, including mergers and acquisitions, joint ventures, partnerships, banking and finance, private equity/venture capital, employment, intellectual property, commercial contracts, litigation and insolvency.

If you need advice on any of the issues mentioned in this bulletin, please contact Peter Coats, a partner in our Corporate Department at peter.coats@rlb-law.com.

Readers should take professional advice before taking any action based on this bulletin.

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