



**PENNINGTONS  
MANCHES  
COOPER**

# **BUYING A BUSINESS**



**WHAT TO EXPECT – A BUYER'S GUIDE TO THE PROCESS**

[www.penningtonslaw.com](http://www.penningtonslaw.com)

## CONTENTS

|  |    |
|--|----|
| A GUIDE TO BUYING A BUSINESS                     | 2  |
| AT THE OUTSET                                    | 4  |
| INDICATIVE TIMELINE                              | 5  |
| PRIVATE COMPANY SHARE PURCHASE PROCESS           | 9  |
| FIRST STEPS                                      | 10 |
| 'BUYER BEWARE' -<br>DUE DILIGENCE AND WARRANTIES | 12 |
| LITIGATION RISK                                  | 16 |
| AUCTIONS – WHAT TO EXPECT                        | 17 |
| MBOS   | 19 |
| STAMP DUTY                                       | 21 |

# A GUIDE TO BUYING A BUSINESS

**A company may decide to acquire another business for a variety of reasons, including the elimination of a competitor from the market, a strategic desire to obtain control over an element of its supply chain, to achieve economies of scale, to expand a group's existing operations into a new field or to enable it to take advantage of available tax losses in the target company.**

For an incumbent management team, the opportunity to buy-out the business in which they work can arise because the existing owners want to retire or realise all or part of their investment, thereby providing an opportunity for the management team to become business owners.

This guide relates to acquisitions of private companies or their businesses and assets and it is intended for:

- companies that are considering making an acquisition for the first time, either at the point where they have identified an acquisition as a strategic objective or when a particular target is in prospect; and
- management teams considering a management buy-out (**MBO**) of the company in which they are involved.

The guide outlines various considerations that might be relevant (other than tax considerations – which, except for what is said about stamp duty, are outside of its scope) and what can be expected at each stage of the process.

This guide doesn't deal with acquisitions of public companies – which, in the case of companies that are not publicly traded, may be carried out in much the same way as a private company acquisition (but there would be additional steps at the outset to dis-apply some of the legal provisions that otherwise govern public company acquisitions).

Insofar as this guide relates to management buy-outs, its focus is on smaller equity- or debt-funded buy-outs by incumbent management teams rather than larger, institutionally-led buy-outs (or buy-ins), where the acquisition process is typically led by the private equity investor rather than the management team.

**TYPICALLY, AN ACQUISITION OF A PRIVATE COMPANY OR BUSINESS WILL TAKE BETWEEN THREE AND SIX MONTHS TO COMPLETE.**



## AT THE OUTSET

Once a would-be buyer has decided that it wants to make an acquisition, thought will need to be given to the type and size of business that might be acquired, what the buyer is prepared to pay and how the acquisition might be financed (for example, from the proceeds of a fresh issue of shares by the buyer, existing cash reserves or bank funding (see MBOs below)) and the timescale within which it wants to make the acquisition. Having a clear strategy from the outset can help a would-be buyer (or corporate finance advisers engaged on its behalf – see below) to identify a suitable acquisition target.

In some cases, potential buyers will be contacted by the seller(s) (or their advisers) but in other cases, the would-be buyer may decide to approach the owners of a strategically-important business not previously put up for sale. In a management buy-out context, the management team may have been approached by the existing owners or be aware that the owners are considering an exit and decide to try to buy the company themselves.

### TIMING



Typically, an acquisition of a private company or business will take between three and six months to complete. An indicative timetable for an acquisition is included overleaf.

### THE DEAL TEAM



Assembling a team of experienced experts to manage the process is a key element in a successful acquisition – it is not something to be undertaken without that support. Advisers will manage the deal on behalf of the would-be buyer to ensure that deadlines are met and everybody involved in the process on the buy-side is kept aware of developments and knows what they have to do at any given point in time. The composition of the team (eg lawyers, accountants and tax advisers, corporate finance advisers and in some cases, technical or commercial advisers with particular sector expertise) will depend on what is needed for the size and type of deal, but on any deal it is important that the advisers are capable of working together effectively as a team.

The buyer's advisers will need to have the necessary expertise, resources and experience for the transaction. Lawyers or accountants who have been used by the buyer for everyday matters (eg preparation of a lease or auditing of accounts) may not be appropriate for the proposed transaction. In an MBO context, the company's incumbent lawyers may be representing the seller(s) so it will probably be necessary for the management team to instruct a different firm.

Appointing and involving suitably experienced professional advisers with transactional experience and capability across a wide range of practice areas (see 'Buyer beware' – due diligence and warranties below) at any early stage may save costs in the long run. Experienced legal advisers will discuss with their client, and ensure that they understand, the buyer's commercial rationale for making the acquisition, as this understanding is key to structuring and negotiating the deal appropriately. In a cross-border acquisition, experienced legal advisers can also anticipate the key issues that are likely to arise in particular jurisdictions and to help their client engage more effectively with local counsel.



### BUYING THE COMPANY OR ITS BUSINESS AND ASSETS

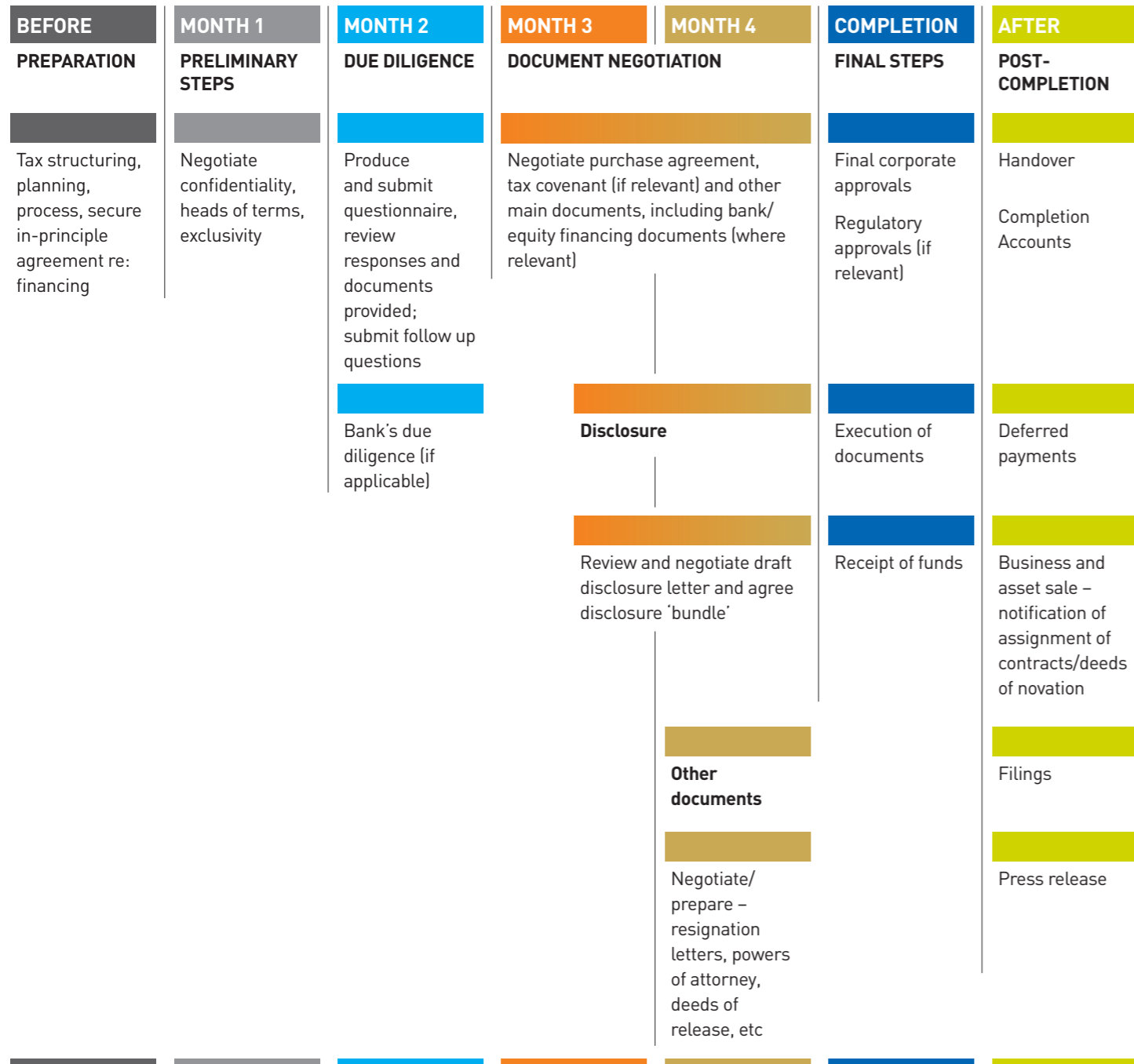
Business acquisitions can take the form of either:

- a share purchase – where the share capital of the target company is bought by the buyer; or
- a business and asset purchase – where the buyer acquires a bundle of rights and assets and may assume certain liabilities of the seller entity that are associated with the part of the seller's business that is being acquired.

Both structures have advantages: from a buyer's point of view, acquiring the business and assets of a company will often be preferable to acquiring the company itself because in general, only those liabilities that the buyer agrees to assume will pass with the business, whereas on a share sale, the target company is acquired 'warts and all'. In many jurisdictions, employment is one area of exception to this – on a business and asset sale, the employment of individuals assigned to the business unit being acquired will automatically transfer to the buyer, together with certain associated liabilities and any relevant collective agreements. Obligations to inform and consult trade unions or employees on the impending business and asset sale may also apply. As an example, in the UK, where the acquisition is structured as a business and asset sale, both the buyer and the seller are legally obliged to inform and consult with any recognised trade unions or elected employee representatives of the affected employees. The concept of 'affected employees' is broader than just those employees being transferred and can also include employees of the buyer who will be affected by the transfer or any measures being taken in connection with it.

In some jurisdictions, including the UK, anyone whose employment is terminated in connection with the transaction will be deemed automatically to have been unfairly dismissed.


# INDICATIVE TIMELINE FOR THE ACQUISITION OF A PRIVATE COMPANY OR BUSINESS



**Note:** The timings and order of events are indicative only. There are inevitably many variations in transaction features and different phases may be accelerated or overlap with each other depending on the particular circumstances.

**Note:** Where the transaction is structured as a business and asset sale and, to a certain extent, also on a share sale where relevant contracts contain change of control provisions, there will need to be some interaction with third parties, such as customers, suppliers and landlords. Their consent may be needed for the continuation of the relationships or, at the very least, they may need to be informed that there has been a change of control of the business. This process may begin (in respect of key relationships) when negotiations are at an advanced stage and will continue after completion.

**ASSEMBLING A TEAM OF EXPERIENCED EXPERTS TO MANAGE THE PROCESS IS A KEY ELEMENT IN A SUCCESSFUL ACQUISITION.**



**DIFFERENT VALUATION METRICS MAY BE APPROPRIATE FOR DIFFERENT TYPES OF BUSINESSES AND WOULD-BE BUYERS MAY WANT TO USE A COMBINATION OF APPROACHES.**

An advantage of a share purchase for a buyer is that it won't have to identify and transfer each asset needed for the continuation of the business or deal with the transfer of employees process (either through a mandatory transfer process (like TUPE in the UK and similar legislation in other jurisdictions) or through agreement with employees where this does not exist) but can acquire everything in a neat package. The buyer may also be able to take advantage of available tax losses in the target company.

In practice, the transaction structure will often be dictated by external considerations (for example, a share sale may be out of the question where there is a minority of shareholders who are unwilling to sell) or will be tax-driven – with the most favourable tax treatment for the party with the greater bargaining strength being the deciding factor. In an MBO context, or where the sellers are individuals rather than corporates, where owners are looking to exit and want to have a clean break (whether immediate or phased), share sales tend to be the norm.

#### IS THE PRICE RIGHT?

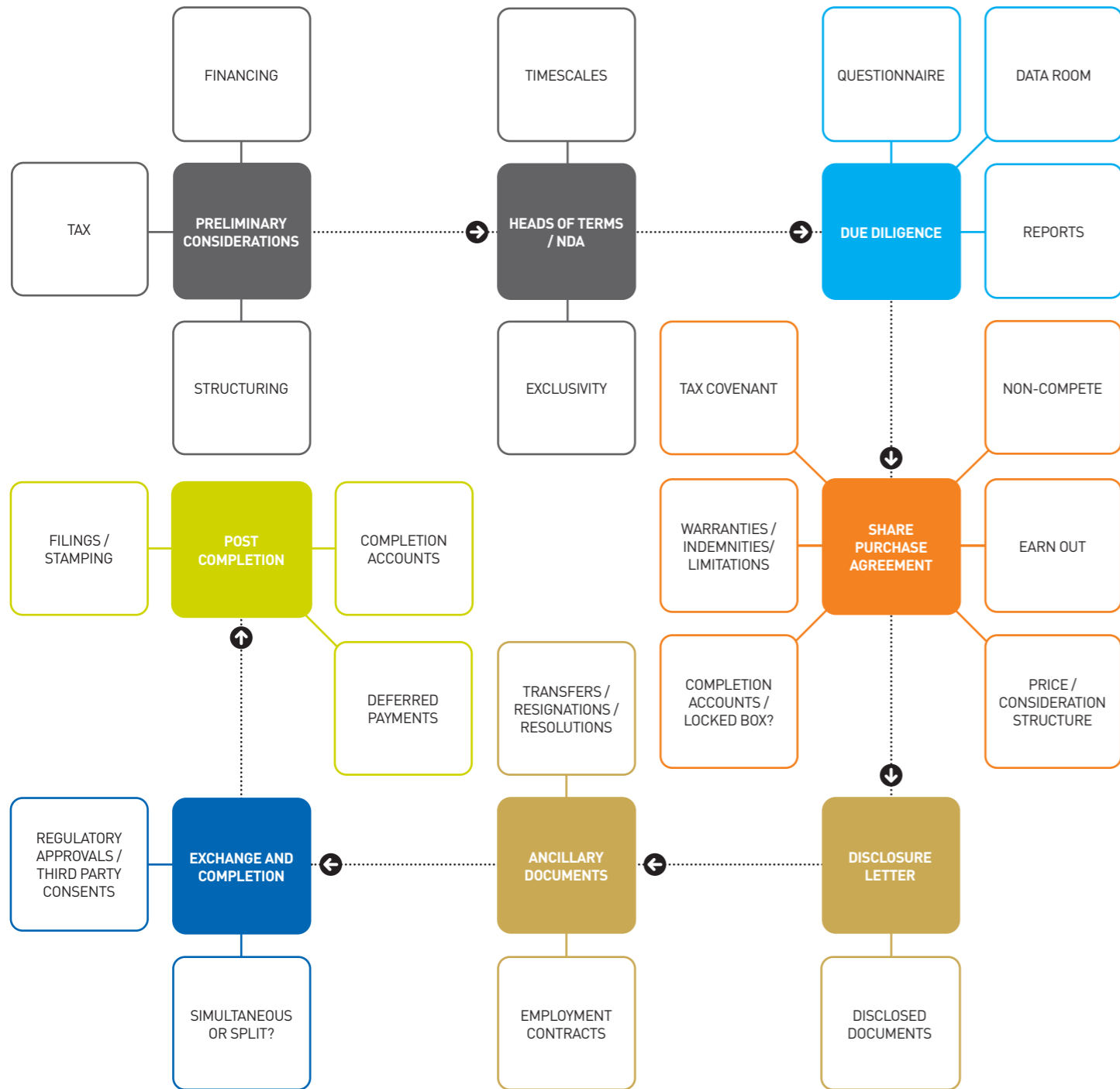


Valuing a business is an art and not a science. How much a buyer pays for a business is a matter for negotiation between buyer and seller(s) and will be influenced by many factors including

the buyer's reasons for making the acquisition and future plans for the business, whether it is being sold by way of competitive tender or auction process, the seller's motivation for selling and future plans. Sometimes owner-managers wishing to exit will be prepared to accept a lower price in return for a quicker process and a clean break.

Different valuation metrics may be appropriate for different types of businesses and would-be buyers may want to use a combination of approaches. Corporate finance advisers (who may be part of an accountancy practice or a niche corporate finance specialist) can help in valuing a business and provide guidance on what might be an appropriate price. There are corporate finance advisers who specialise in advising on both the buy-side and the sell-side and have expertise in particular industry sectors and their advice can be invaluable. Sometimes they will also be able to help a would-be buyer in sourcing finance for an acquisition via their network of contacts.

# PRIVATE COMPANY SHARE PURCHASE PROCESS



## FIRST STEPS

### CONFIDENTIALITY



Before a would-be buyer is provided with any information about the target, it will be required to sign a confidentiality agreement (also referred to as a 'non-disclosure agreement' or 'NDA'). This may well be the case even where the buyer is the incumbent management team because the seller(s) will be keen to avoid news of the proposed sale becoming too widely known either within the business (which could unsettle or demoralise employees) or within the wider market (which could affect relationships with customers and suppliers).

The confidentiality agreement will place the buyer under a legal obligation to use the information it receives about the target only for the purpose of assessing the target (and not for its own gain) and to keep it, and the existence of the transaction, confidential. The confidentiality provisions may be incorporated within the term sheet (see *Heads of terms* below) rather than being in a standalone confidentiality agreement.

### HEADS OF TERMS



The next step is usually for buyer and seller(s) to enter into **heads of terms** (sometimes also referred to as a 'term sheet', 'heads of agreement', 'letter of intent' or 'memorandum of understanding'). This document, which could take the form of a simple letter from the would-be buyer to the seller(s) or could be something more detailed drafted by their legal or corporate finance advisers, records the main terms of the deal upfront. The purpose of heads of terms is to flush-out any areas of disagreement that might otherwise stymie the deal later on, once more significant time and costs have been incurred.

With the exception of the provisions relating to confidentiality and exclusivity, which usually are legally binding, the other provisions of the heads of terms usually are not because they lack the level of detail necessary for a workable contract.

Whilst heads of terms are often a fairly short document, that may run to no more than a few pages, they will cover all of the main areas that will be dealt with in the acquisition documents and will inform the content of the draft acquisition agreement (known as the 'share purchase agreement' or 'SPA') and provide the basis for the more detailed negotiations that follow. The first draft of the SPA is customarily prepared by the buyer's legal advisers – except in an auction context (see *Auctions – what to expect* below).

Generally speaking, heads of terms will cover the following points:

- the headline price (and how it has been reached – often it will be based on some multiple of profits, though assets-based valuations may be more appropriate for some businesses);
- it is common for deals to be struck on the basis that the target will be **debt free** (ie no historic borrowings for the buyer to pay off), **cash free** (ie no excess cash in the business that the seller(s) would want to extract) and with a **normalised level of working capital** (ie enough cash, debtors, stock, etc for the business to continue to operate as a going concern without the buyer having to make a big cash injection, typically for a period of 12 months). This may be measured by **completion accounts** – drawn up to a date following the acquisition to verify the financial position on the completion date, with the price being adjusted depending on whether the figure is positive or negative compared to the expected position. Alternatively, a **locked box** structure may be used, where the price is calculated on the basis of a set of pre-completion accounts that the buyer will verify and the seller(s) are restricted in the value that they can extract from the business (known as 'leakage') between the date to which those accounts are made up and completion of the acquisition. Where a locked box structure is used, often the seller(s) will seek to negotiate an additional payment calculated on a daily basis from the locked box accounts date up to completion to compensate them for profits generated in the business during that period;
- how the price will be structured – eg whether it will all be paid in cash on completion (which is relatively rare), whether there will be deferred payments (whether or not subject to what is known as an '**earn-out**' where further payments and their amount are subject to conditions including achievement of sales or profits targets, individual sellers remaining employed in the business, or the renewal of certain key contracts), and whether there will be any non-cash consideration – eg whether part of the purchase price will be satisfied by the buyer issuing shares to the seller(s);
- where there is a deferred element to the consideration, whether any security will be sought in respect of the buyer's payment obligations;
- which sellers will give warranties, in what proportions they will be liable in respect of them and any limitations on their liability;

**AN UNDERSTANDING OF THE BUYER'S FUTURE PLANS FOR THE TARGET BUSINESS IS CRUCIAL TO ENABLING ITS LEGAL ADVISERS TO SCOPE AND TARGET THE DUE DILIGENCE APPROPRIATELY.**

- whether there will be any indemnities – depending on the outcome of the buyer's due diligence (see *Due diligence* and *Warranties and indemnities* below);
- whether any sellers will remain employed in the business following completion of the acquisition and for how long afterwards they will be prevented from setting up or working in a competing business; and
- exclusivity and costs (see below).

#### EXCLUSIVITY



Whilst agreeing heads of terms can reduce the likelihood of a transaction aborting later on because the parties are unable to agree on the key terms, there remains a risk from a prospective buyer's point of view, that it will spend time and money on the acquisition process only to find that the seller(s) later accept a better offer. To mitigate this risk, normally when heads of terms are agreed, the seller(s) will agree to give the buyer a period of exclusivity in which to negotiate the deal during which the seller(s) won't discuss alternative deals with third parties. The exclusivity period is legally binding and the seller(s) will be liable for the buyer's wasted costs if the exclusivity is breached.

## 'BUYER BEWARE' - DUE DILIGENCE AND WARRANTIES

### DUE DILIGENCE



As a general principle in most common law jurisdictions and many civil law jurisdictions, the onus is on the buyer to investigate the company or assets that it wishes to buy rather than the onus being on the seller(s) to disclose any problems. This means, the starting point is that the buyer assumes the risk of there being unexpected liabilities of the target company or defects in the assets (or the seller's title to them).

One of the ways in which a buyer can mitigate the risk it is assuming is by thoroughly investigating the target and all aspects of its assets and operations before the acquisition takes place to understand whether anything is likely to emerge that could derail the target business or make the deal economically unattractive. This investigation is known as '**due diligence**'. The due diligence process usually kicks off once agreement in principle for the acquisition has been reached and heads of terms have been signed, but before negotiation of detailed legal documents begins (though it is likely to be ongoing while legal documents are being negotiated (see *Warranties and indemnities* below).

Due diligence typically includes financial, tax, commercial and legal due diligence and may include more specialist technical due diligence depending on the nature of the business. Prospective buyers will need to identify a team of individuals within their own business who have the necessary experience of the various areas of operations to review and assess the due diligence findings.

Legal due diligence will be undertaken by the buyer's legal advisers (though sometimes a legal due diligence report will be prepared on behalf of the seller(s) and addressed to the ultimate buyer – see *Auctions* below) who may also be able to undertake tax due diligence as well – Penningtons Manches Cooper LLP has this capability. However, this guide focusses mainly on the legal due diligence process.

Usually the legal due diligence process is begun by the buyer's legal advisers submitting a detailed questionnaire to the seller(s), via their legal advisers, requesting information and various confirmations in relation to all aspects of the target business. Whilst most legal advisers will have a standard template legal due diligence questionnaire, it is important, from a buyer's point of view, to feed in any known industry risks or concerns so that the questionnaire is as tailored as possible to the particular target.

The seller(s) will provide responses to the due diligence questionnaire and copies of the documents requested. Usually these are uploaded to an online data room to which the buyer and its advisers are given access.

An understanding of the buyer's rationale for making the acquisition and its future plans for the target business is crucial to enabling its legal advisers to scope and target the due diligence appropriately, to maximise value for the buyer and ensure that time and costs are not wasted in making in-depth investigations into areas that aren't significant. The exact scope and focus of the legal due diligence review will therefore be a matter to be agreed between the buyer and its legal advisers and will, to a certain extent, depend on the type of business being acquired. However, legal due diligence usually covers the following areas, to a greater or lesser extent:

- incorporation and ownership of the target company – including reviewing its filing history, examining any capital transactions (eg share buybacks or reductions of capital – which may be void if defectively carried out, meaning that there could be additional shareholders whose interests would need to be dealt with before the acquisition takes place) and identifying anything in its current articles of association that may have a bearing on the proposed acquisition;
- books and records – checking that these exist and they have been properly maintained in accordance with applicable requirements;
- banking and finance – looking at current arrangements and how they will be affected by the transaction and any steps that will need to be taken as a result;
- customer and supplier contracts – reviewing key contracts to understand whether they may be affected by a change of control of the target and, in a business and asset sale context, whether they permit assignment by the seller or whether the counterparty may be entitled to renegotiate their terms. Key contracts should also be checked to see whether they contain any unusual or onerous provisions (for example, that may prevent them being terminated in the future otherwise than on penal terms) and to verify that contractual rights are vested in the target (rather than, for example, a member of the seller's group);
- intellectual property – depending on the nature of the business, verifying that the target has the legal right to exploit (either by its own use or licensing to third parties) any intellectual property rights required for the continuation of the business or which are purportedly owned by it and whether any such rights, in particular created by (non-employee) founders or contractors, have been properly assigned to the target. The due diligence should identify any rights that will need to be licensed to the target by the seller's retained business or group to enable the target business to continue to operate without

interruption, and investigate any existing or potential liabilities arising out of either past or proposed continued use by the target of intellectual property rights;

- IT systems – investigating what IT systems are used by the target, how they are used and the associated contractual commitments. Also whether the systems are secure and whether the functionality is sufficient to meet current and future plans. The due diligence should identify whether the target has the necessary legal rights to use the IT systems employed in the business, if those systems are shared with anyone and verifying the ownership of rights in any bespoke software developed or used by or on behalf of the business, including source code, particularly where third party contractors have been involved. It should also establish whether any element of the IT system incorporates any open-source software and the terms applicable;
- data protection – given that infringement of data protection legislation can result in substantial fines, assessing a target’s maturity as regards compliance is an increasing area of focus in due diligence. The due diligence should assess the target’s compliance with data protection law, its approach to accountability (including its internal policies and procedures) as well as the extent to which work will be required post completion to bring the target into compliance. For example, cyber security flaws can have a material financial impact, either through additional investment required to remediate risks, fines or reputational damage. Understanding the nature of the personal data being processed by the target will be essential to tailoring the due diligence.
- human resources & immigration – investigating compliance with relevant legal requirements relating to employment and employees having a legal right to work in the jurisdiction where they are working, understanding the target’s labour relations history (including, often significantly nowadays, seeking to identify the existence of non-disclosure agreements that may relate to harassment and misconduct issues and any procedures that the target has in place for dealing with such matters), any trade union recognition or collective bargaining and any outstanding disputes or claims;
- employee incentives/share options – evaluating any schemes to understand the effect of the proposed transaction on existing options. Usually existing options will become exercisable but additional steps may be required to enable a ‘cashless’ exercise to take place before the acquisition takes place or to ‘roll-over’ existing options into a new option scheme. Our share incentives team find many of the purportedly tax-favoured employee share incentive schemes that they review in due diligence

fail to meet all of the qualifying criteria for having tax-favoured status. Because of the significant differential in tax treatment, this is something that will need to be carefully managed from an employee-relations point of view;

- pensions – it is crucial to identify the type of pension scheme to which current and any former target employees belong as early as possible in the transaction as it may be necessary to involve the Pensions Regulator and this can have a significant impact on the timing (and cost) of the transaction. UK employers are required to automatically enrol all eligible ‘jobholders’ into a pension scheme and to make a certain minimum level of pension contributions and due diligence will look into whether the target (or the seller, in the case of a business and asset sale) is compliant with the relevant legislation both in terms of existing employees and having adequate systems in place to manage the auto-enrolment process in respect of new joiners and any employees whose status changes;
- environmental & sustainability issues – liabilities to carry out environmental remediation work can take a long time to crystallise. The extent of any due diligence required will depend on the nature of the target’s operations and any premises it occupies. Adoption of sustainable working practices and environmental, social and governance reporting is becoming an area of increasing focus in due diligence;
- real estate – carrying out and reviewing searches on the premises, investigating the target’s ownership or right to use any premises it owns or occupies, considering termination or change of control provisions in any leases, planning matters (including change of use) and considering whether there are likely to be any significant issues arising out of its use or occupation of those premises, including any liabilities that a target company may have in relation to any previously-occupied property;
- litigation and disputes – understanding whether there are any pending or threatened disputes involving the target, amounts claimed and the stage the proceedings are at – if they are at an early stage then there is the potential for significant legal costs to be incurred before the matter reaches a conclusion.

In an MBO context, where the MBO team has been intimately involved in the day-to-day operations of the business, the due diligence process may be less extensive. However, any providers of finance for the acquisition will require to see some level of due diligence (see *MBOs* below).

**IT IS CRUCIAL TO IDENTIFY THE TYPE OF PENSION SCHEME TO WHICH CURRENT AND ANY FORMER TARGET EMPLOYEES BELONG AS EARLY AS POSSIBLE IN THE TRANSACTION.**



#### **DUE DILIGENCE ACROSS BORDERS**

Where the target business has subsidiaries overseas, the buyer should conduct due diligence on these subsidiaries particularly in jurisdictions where the target business has significant assets or material sales.

The scope of due diligence set out above is generally applicable across jurisdictions, but some of the key jurisdiction-specific legal issues will include foreign shareholding restrictions, anti-trust compliance, labour and employment issues and environmental issues. Buyers have also been increasingly anxious about data protection rules. A growing number of countries have introduced data protection laws that limit the manner in which personal

data can be shared with third parties and across different jurisdictions. It is crucial that local counsel in each relevant jurisdiction be consulted early in the process.

Where local regulatory approvals are required (for instance, the target business may hold a material licence and the acquisition will trigger a change-of-control provision in such licence), the buyer should consider the time needed for such approvals to be obtained. The approval process in some jurisdictions can be significantly more complex and uncertain than others. A buyer should seek certainty from the seller around timings such as imposing a long-stop date or require payment of a reverse-break fee in the event approval has not been obtained by a certain date.





### WARRANTIES AND INDEMNITIES

Another way in which the buyer can mitigate the risk of there being problems and liabilities associated with the target that may emerge later on is through the

inclusion of contractual protections in the share purchase agreement in the form of **'warranties'**. Warranties are statements - effectively contractual promises - made by the seller(s) to the buyer about particular states of affairs in relation to all aspects of the target and its assets and operations.

Warranty statements speak at a particular point in time - usually the point at which the SPA is entered into, though they may also be repeated at the point when the acquisition completes, (if later). The warranties must be read in conjunction with another document, known as the **'disclosure letter'**, in which the seller(s) will set out details of any matters of which they are aware that would constitute breaches of, or exceptions to, the warranties as at the date on which they are given. Disclosures made in the disclosure letter operate to qualify the warranties. If a warranty statement turns out to have been untrue when made, the buyer may have a legal remedy against the seller(s) except to the extent that the relevant matter has been disclosed.

The warranties are usually set out in a lengthy schedule to the acquisition agreement and their precise scope will be a matter for (sometimes intense) negotiation between buyer and seller(s) and their respective legal advisers. Drafts of the disclosure letter will be provided to the buyer before the acquisition agreement is entered into and frequently matters referred to in the various drafts will prompt additional enquiries from the buyer's due diligence team. In this way, the warranties and the disclosure letter will be negotiated in tandem and will overlap with the due diligence exercise, all of which are likely to be ongoing right up to the point when the share purchase agreement is entered into.

Often the acquisition agreement will also contain **'indemnities'**, which are a different type of contractual promise made by the seller(s) to the buyer. Indemnities are contractual promises by the seller(s) to reimburse the buyer (or sometimes, the target company - though the tax consequences of this should be considered carefully) in respect of a specific, identified liability if and when it crystallises. A buyer should seek to include indemnity protection in the SPA in respect of any liabilities it discovers in due diligence that have not yet crystallised or are not yet quantifiable. It is customary on a share acquisition for the SPA to make provision for certain tax liabilities to be for the account of the buyer and others for the seller and for indemnities to be included in support of this (referred to as a **'tax covenant'**).



### DON'T CUT CORNERS ON DUE DILIGENCE

The due diligence exercise can account for a very significant proportion of the professional fees on an acquisition.

However, its importance cannot be underestimated. It can be tempting for prospective buyers to save costs in terms of due diligence and instead rely on the warranties in the acquisition agreement. However, this is a very risky and inadvisable strategy for the buyer for a number of reasons:

- bringing a warranty claim can be a costly process, both in terms of legal fees (as well as its own legal costs, a buyer may be ordered to contribute towards a seller's legal fees in the event that the claim is unsuccessful) and management time, and where there is an ongoing relationship between buyer and seller(s), litigation will not be an attractive option;
- in order to bring a successful claim the buyer will need to be able to demonstrate not only that the warranty concerned was untrue and the seller did not make an adequate disclosure against it in the disclosure letter, but also that as a consequence of the breach of warranty, the buyer has suffered a loss - in terms of the company or business being worth less than it would have been had the warranty been true. In practice this can be difficult to demonstrate and may entail a costly valuation exercise. A cost or inconvenience suffered by the target will not necessarily translate into an equivalent recoverable loss in the hands of the buyer; and
- in addition to identifying any issues that might affect the buyer's decision to go ahead with the acquisition, the price it is willing to pay, and areas where enhanced warranty or indemnity protection may be required, the due diligence exercise will also identify any third party consents that will be required as part of the acquisition process (for example, from a regulatory body) and the understanding of the target business that it provides can be invaluable for the buyer in planning how it will integrate the target into its existing operations.

In a business and asset sale context, the due diligence process should identify which contracts permit assignment (where the counterparty will need to be notified that the assignment has taken place) and those where the third party will need to be approached in advance and either a new contract negotiated or the existing one novated. The timing of these discussions will need to be considered carefully. Sometimes, where a contract is of particular importance to the business but the existence of the transaction is commercially sensitive, it may be appropriate for the third party to be approached only after the share purchase agreement has been entered into but for completion of the acquisition to be made conditional on satisfactory contractual arrangements being agreed between the buyer and the third party. Where notification of assignment of contracts is all that is required, this process may be ongoing after completion of the acquisition.

## LITIGATION RISK



### MECHANISM FOR RESOLVING DISPUTES

As with any corporate transaction, an acquisition can result in disputes. The provisions most likely to give rise to disputes are the provisions on warranties, indemnities, limitations on liability and jurisdiction clauses. In a cross-border acquisition, arbitration tend to be the preferred mechanism for resolving disputes. There are a few reasons for this such as the greater ease of enforcement of arbitral awards in other jurisdictions and the perception that an arbitral tribunal is more neutral than a national court.



### WARRANTY AND INDEMNITY (W&I) INSURANCE

W&I insurance is common where the sellers are financial sponsors such as private equity funds. W&I insurance obviously benefits the seller as recourse is sought by the buyer from the insurers instead of the seller in event of a breach of warranty, but it can also benefit the buyer. For instance, the seller may be more willing to expand its package of warranties, thereby expanding the buyer's basis for recovery under the W&I insurance policy. It may also be quicker for the buyer to get the deal through. Additionally, W&I insurance can be helpful in preserving post-closing relationships with the seller by allowing the buyer to pursue a claim against the insurer instead of the seller.

**IT CAN BE TEMPTING FOR PROSPECTIVE BUYERS TO SAVE COSTS IN TERMS OF DUE DILIGENCE AND INSTEAD RELY ON THE WARRANTIES IN THE ACQUISITION AGREEMENT. HOWEVER, THIS IS A VERY RISKY AND INADVISABLE STRATEGY.**

## AUCTIONS – WHAT TO EXPECT



Where the sellers of a business have decided that they want to exit and they expect that there may be significant interest from a number of would-be buyers, then in order to achieve the most favourable terms as to price and/or otherwise, they may decide to run an auction process. Where this happens, prospective buyers will be identified by the seller(s) and/or their corporate finance advisers and contacted to canvass possible interest. Those who have indicated an interest will then be asked to sign a confidentiality agreement and will be provided with further information about the target, often in the form of a document known as an **'information memorandum'**, as well as information about the procedure for submitting bids and the rules of the auction. The interested parties who have reached this stage will then be asked to submit indicative offers for the target – these aren't legally binding but will be used by the seller(s) and their advisers to assess which bidders to take through to the next stage of the process.

Those who are successful at this stage will be invited to carry out their due diligence – either by being given access to an electronic data room or, in some cases, by being provided with copies of due diligence reports prepared on behalf of the seller(s) in advance (known as **'vendor due diligence'**). The bidders may also be provided with a draft acquisition agreement which will usually be very seller-friendly in its terms and they will be asked to return it with their final bid, with any marked-up amendments required for it to be in a form that they would be prepared to sign without further changes.

The seller(s) and their advisers will review the final bids received, together with the marked-up drafts of the share purchase agreement and will select (usually) a single (though sometimes more than one) preferred bidder to enter into more detailed negotiations and, ultimately, agree the final terms.

From a prospective buyer's point of view, as well as thinking about what would be a competitive offer in terms of price, in marking-up the draft SPA, there is a balance to be struck between maximising protection for itself in those areas where it matters most, and taking a reasonable position that could be attractive to the seller(s). This requires a would-be buyer, working with its advisers, to identify at an early stage what is really fundamental in terms of warranty and indemnity cover and other terms, and to be prepared to drop other points which might have been 'nice to have' – but can mean that if successful, the acquisition will proceed swiftly from that point.

**THOSE WHO ARE SUCCESSFUL AT THIS STAGE WILL BE INVITED TO CARRY OUT THEIR DUE DILIGENCE – EITHER BY BEING GIVEN ACCESS TO AN ELECTRONIC DATA ROOM OR, IN SOME CASES, BY BEING PROVIDED WITH COPIES OF DUE DILIGENCE REPORTS PREPARED ON BEHALF OF THE SELLER.**



# MBOS

## STRUCTURE



Where the buyer is a management team, a new company (a **newco**) will be set up that will be owned by the members of the management team (and any private equity investor) and it will be that company (or wholly-owned subsidiary of that company), rather than the individual managers themselves, that will buy the target company or business. The new company will need to have articles of association and probably also a shareholders' agreement that reflect the ownership structure of the newco and regulate the rights and obligations of the managers and the newco.

## FINANCING THE MBO



Most often, the management team will not be in a position to fund the acquisition out of their own financial resources. Usually therefore, a significant portion of the purchase price will be financed either through equity investment from a private equity investor or using bank debt, possibly combined with any cash balances in the target (which may be loaned to the buyer to enable it to pay the seller(s)). A bank will lend money to the newco, and in return will take security, in the form of a debenture, over the whole of its business and assets, including the shares in the target, backed up with cross-guarantees. In addition, the bank will usually expect the individual members of the MBO team to make some kind of financial contribution out of their own resources by way of subscription for shares in the newco. Where the management team are already shareholders in the target, then they may be required to reinvest any sale proceeds they would otherwise receive into the newco by way of subscription for shares in that company. Sometimes both debt and equity investment will be combined. Where bank debt is involved, the amount required will form part of the discussions with the bank, taking into account the financial position of the individuals concerned and the overall financial position of the target. Managers should therefore expect to have to make full and frank disclosure of their assets and liabilities to the bank.

It will not always be possible for the management team to be able to raise the full amount needed to fund the acquisition from third party finance providers. Sometimes, where the seller(s) are keen to sell to the management team, they will be prepared to agree to a phased acquisition of the target, which may involve the seller(s) taking a percentage of the shares in the newco, to be bought out by the management team later on out of profits paid to them by way of dividend. Alternatively, the seller(s) may be agreeable to helping to fund the acquisition by means of what is known as a **'vendor loan note'**, whereby part of the purchase

price is left outstanding on completion of the acquisition as a loan note (effectively, a form of IOU), the terms of which will be commercially agreed between the buyer and seller(s), including as to interest and security for payment. Commonly, restrictions will be imposed to prevent any monies being paid out to shareholders by way of dividend (or otherwise) until the bank debt and vendor loan note have been repaid and, usually, where there is both bank and vendor debt, the latter will be subordinated to the former.

The timing of the payments may be scheduled in advance over a period of a few years, or may be linked to (or contingent on) achievement of particular milestones in the business or the renewal of particular contracts. Some individual sellers may remain involved in the target business for a period following completion as employees or consultants. The exact structure is very much transaction-specific, depending on the objectives and financial positions of the various parties.

Where equity investment is involved, the provider of equity finance may hold a different class of shares in the newco to the management team and may be entitled to preferential dividends or receipts on a sale of winding-up of the newco.



## WARRANTIES ON AN MBO

Because the MBO team will have been involved in running the target business, the scope of the warranties given by the seller(s) will typically be much more limited than it would be on a sale to an unconnected buyer. Often the warranties will be limited to the seller(s) confirming that they own the shares in the target company and have the right and capacity to sell them and perform their obligations under the SPA. However, to the extent that there are areas of the business in which the members of the MBO team have not been involved, then it will be reasonable to ask the seller(s) to give more comprehensive warranties in relation to those aspects. The cap on seller liability under the warranties will usually be lower on an MBO than on a fully arm's length transaction.

However, where the buy-out is funded by a private equity investor, a reduced level of warranty cover is unlikely to be attractive to the investor (who may favour a business and asset purchase or consider taking out warranty & indemnity insurance). The members of the management team may be asked to give 'back-to-back' warranties (in the same terms as those given by the seller in the share purchase agreement) in the investment agreement entered into with the investor, in addition to warranting the reasonableness of the assumptions on which the managers' business plan has been prepared and any forecasts contained within it.

Generally speaking, a private equity investor will want any warranties given by a management team to be given by them on a 'joint and several' basis – meaning that the investor can choose to pursue any one of them for the full

amount of any claim. This can be difficult to resist, but managers may be able to agree individual liability caps based on their own financial circumstances and earnings, or enter into contractual contribution arrangements between themselves to reapportion liability for any claims.

## TAX



It is important that members of the management team on an MBO receive tax advice – structuring any deal in the right way can have a significant impact on the tax treatment of any eventual receipts in the hands of the managers. Penningtons Manches Cooper LLP can provide this advice, if required.

## GOOD LEAVER, BAD LEAVER



Usually the provider of finance for the transaction (whether a bank, private equity investor or the seller(s)) will want to ensure the members of the MBO team are incentivised to remain involved in the business for a period following completion of the acquisition. This is because their involvement is likely to be key to the success of the business (and consequently, the newco's ability to repay the bank or vendor debt or, in the case of a private equity-backed MBO, to the achievement of the investor's desired rate of return on its investment).

This is usually achieved by including provisions in the articles of association of the newco and any shareholders' agreement requiring a manager who leaves their employment with the newco or the target company to sell their shares either back to the company (if it is legally able to buy them) or to the other shareholders. The price that the leaver will receive will depend on why and when they leave. The articles of association will usually refer to **'good leavers'** and **'bad leavers'**. 'Good' leavers are entitled to receive market value for their shares whereas 'bad' leavers would receive less.

The precise circumstances in which a leaver will be deemed to be a 'good leaver' will vary from deal to deal, and will depend on the relative bargaining strengths of the management team and finance provider. However, generally speaking a good leaver will be someone who leaves by reason of their death or because they are wrongfully or unfairly dismissed (other than where their dismissal is only procedurally unfair) and a bad leaver will be someone who leaves for any other reason. Often arrangements will be put in place under which shares will 'vest' over a period of years following completion (which may correspond to the period for which any bank debt will be outstanding), such that a leaver may initially be treated as a bad leaver in respect of all of their shares regardless of the reason for their departure, but as time elapses, an increasing proportion of their shares will no longer be subject to the good/bad leaver provisions.

**'GOOD' LEAVERS ARE ENTITLED TO RECEIVE MARKET VALUE FOR THEIR SHARES WHEREAS 'BAD' LEAVERS WOULD RECEIVE LESS.**

## CONFLICTS OF INTEREST



On an MBO, managers need to be aware of potential conflicts of interest that may arise if they are already directors of the target company and also directors of any newco acquisition vehicle; failure to manage this appropriately can result in personal liability. Being involved in an MBO can be a time-consuming and stressful process and it is important that members of the MBO team don't 'drop the ball' in terms of performing their roles as directors of the target company.

Even where managers aren't already directors of the target, they should be mindful of the fact that they risk breaching the terms of their employment (and could face summary dismissal) if they try to embark on an MBO process without their employer's consent.

## OTHER CONSIDERATIONS



Investment agreements customarily contain a number of other provisions which are not covered in detail in this guide. Usually, managers will be subject to restrictions preventing them from competing with the target company or soliciting employees for a period after they cease to be involved with it. These are likely to be similar to restrictive covenants that would typically be contained in an employment contract, but their duration may be longer and they are more likely to be enforceable against the manager. Any equity investor will usually also require certain control rights and managers will likely be restricted in what they can do in relation to the running of the business without the investor's consent.

## STAMP DUTY



Stamp duty may be payable in respect of an acquisition of shares. It is typically [calculated as a percentage](#) of the purchase price and buyers should factor this in to their funding models. Where the purchase price is not being satisfied in cash then there will need to be some correspondence with relevant tax authorities (HMRC in the UK) around valuation.

In the UK, for example, the current rate at which stamp duty is charged is 0.5% (rounded up (if necessary) to the nearest £5). Payment of the stamp duty and stamping of the stock transfer form (which is required, in addition to the share purchase agreement, to transfer legal title to the shares) are necessary in many jurisdictions (including the UK) for the buyer to be entered in the register of members of the target company. In the UK, the stock transfer form should be presented to HMRC's Stamp Office within 30 days of its execution to avoid incurring penalties and interest in addition to the duty itself. Other jurisdictions have similar penalties for failure to stamp.

Where payment of some of the purchase price is deferred, special rules may apply depending on whether or not the total amount can be ascertained at the point when the duty is payable. Again, in these circumstances, correspondence between the buyer's legal advisers and the relevant stamp duty office may be required.

In a business and asset sale context, where the assets include real property, then stamp duty land tax may be payable.

Buyers should be aware that where individual assets are acquired, VAT may be payable unless the business is being acquired as a going concern.

### ABOUT PENNINGTONS MANCHES COOPER

Penningtons Manches Cooper LLP is a leading UK and international law firm which provides high quality legal advice tailored to both businesses and individuals. We are acknowledged as a dynamic and forward-thinking practice which combines comprehensive legal services with a responsive and flexible approach.

Our corporate team is recognised for its expertise in acquisitions, disposals, venture capital investments together with IPOs and other capital markets transactions. We have a broad domestic and international practice supported by well-established links with law firms throughout the world. Penningtons Manches Cooper is a member of Multilaw and the European Law Group, networks with lawyers in over 100 countries, and many of our experts play leading roles in various international bodies.

Through our active involvement with the Department for International Trade (DIT) and its UK Advisory Network (UKAN), we are well placed to advise on all aspects of UK inward investment, from technology start-ups to large international relocations. Where problems occur, in any jurisdiction, our international litigation lawyers are able to recommend effective strategies at an early stage.

Our wider industry sectors span technology, life sciences, education, banking, finance and financial services regulation, real estate, retail and international wealth. Among our clients we count private individuals, founder-owned businesses, start-ups and multinational corporations as well as public companies, professional partnerships, venture capital and private equity investors, banks and financial institutions.

*The information contained in this guide is general in nature and is not intended to constitute legal advice. It has been prepared to reflect the law as at June 2022.*

© Penningtons Manches Cooper LLP



**PENNINGTONS  
MANCHES  
COOPER**

**Penningtons Manches Cooper**  
Incorporating **Thomas Cooper**

**[www.penningtonslaw.com](http://www.penningtonslaw.com)**

Penningtons Manches Cooper LLP is a limited liability partnership registered in England and Wales with registered number OC311575.  
It is authorised and regulated by the Solicitors Regulation Authority.