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# SELLING A BUSINESS



## WHAT TO EXPECT - A GUIDE TO THE PROCESS

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# A GUIDE TO SELLING A BUSINESS

## BEFORE YOU START

### THINKING ABOUT IT



Selling a business takes time. The process of 'thinking about' whether business owners are ready to sell will vary from deal to deal but it is not unusual for the process to start some 12-18 months before actually marketing the company.

Would-be sellers should ask themselves questions such as: when is the best time to sell? What is the business worth? How can the value be enhanced? How long will the transaction take? What will the impact of the sale process be on the business and can confidentiality be maintained? Should the whole business be sold or any part retained? Dealing with these questions at an early stage will help ensure that sellers are comfortable with the deal that is eventually struck.

### THE DEAL TEAM



Assembling a team of experienced experts to manage the sale process is a key ingredient in the success of the sale process – it is not something to be undertaken without that support. Sellers' advisers will project-manage the deal to ensure that all deadlines are met and that each person is kept aware of developments and knows what they have to do at any given time. The make-up of the team (eg lawyers, accountants, corporate finance advisers) will depend on what is needed for the size and type of deal in question but, on any deal, it is important that the advisers are capable of working together effectively as a team.

The appointed advisers will need to have the necessary expertise, resources and experience for the transaction. Lawyers or accountants who may have been used for everyday matters (eg preparation of a lease or auditing accounts) may not be appropriate for the proposed transaction. Appointing and involving professional advisers at an early stage may save costs in the long run.

In a cross-border acquisition, experienced legal advisers can also anticipate the key issues that are likely to arise in particular jurisdictions and help their client engage more effectively with local counsel.

### IS THE PRICE RIGHT?



Valuing a business is an art not a science. The value of shares in an unlisted company can be affected by a number of factors and owner-managers are not always best-placed to put a price on what a third party will pay. Ultimately, the price that a seller will achieve for the sale of a business will depend upon how much someone is willing to pay for it.

Corporate finance advisers (who are usually part of an accountancy practice or are niche corporate finance specialists) can assist in valuing the business. They can also help in finding a market for the sale of the business and they will usually have good contacts to help source finance for any acquisition, eg bank and/or venture capital funding for a management buy-out.

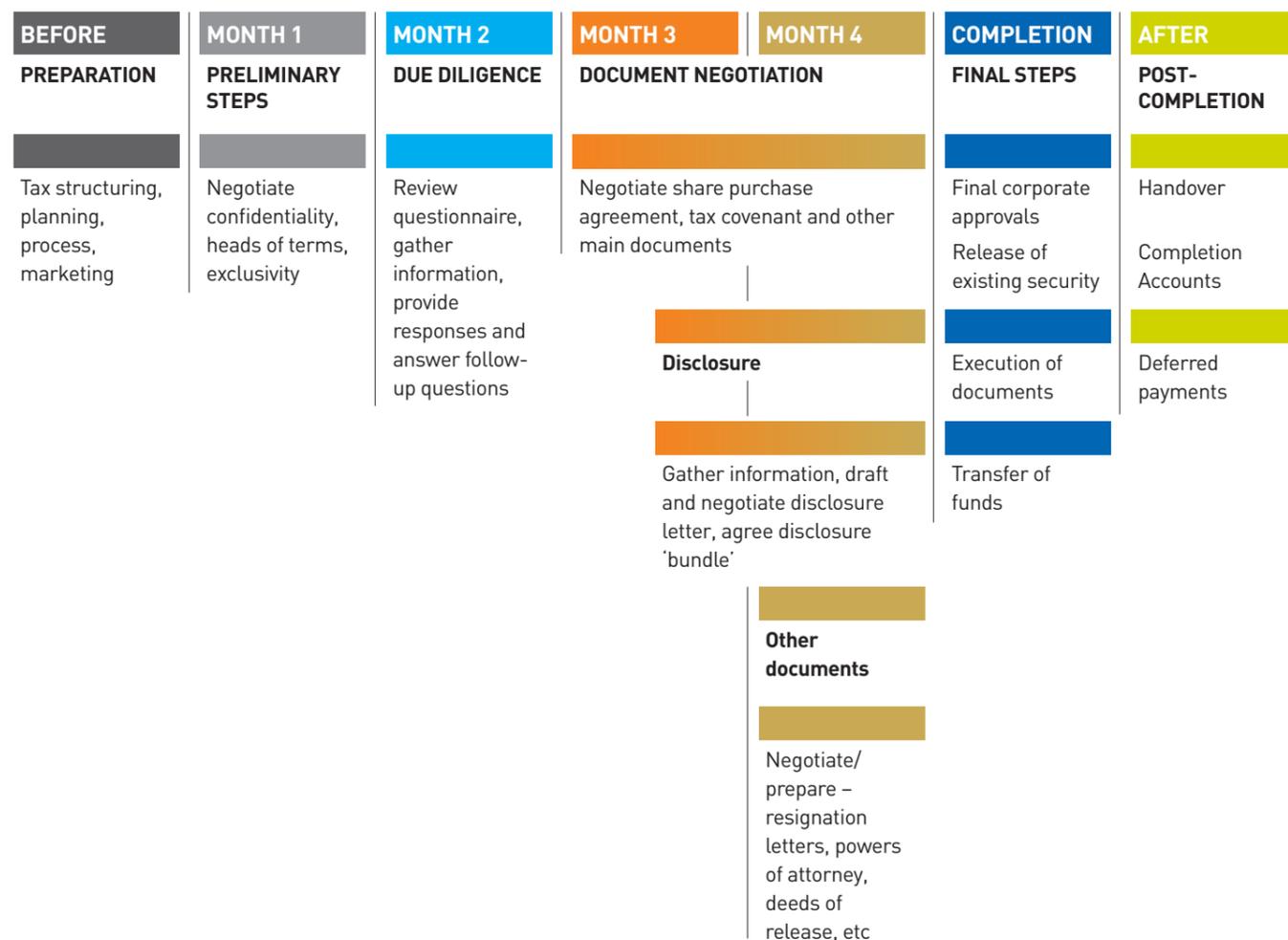
### IDENTIFYING BUYERS



The structure of the deal will vary depending on who is likely to acquire the business. It may be appropriate to carry out some kind of pre-sale re-organisation to divest certain parts of the business or assets or to structure it as a business and asset sale rather than a share sale.

Potential buyers will usually be trade competitors (who may want to complement their existing business or simply remove a competitor from the market), the existing management team (who may already be shareholders or who would like to become so), or private equity firms (who will look to invest with a view to a later trade sale, secondary buy out or flotation).

# INDICATIVE TIMELINE FOR THE SALE OF A PRIVATE COMPANY



**Note:** The timings and order of events is 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 is likely to begin when negotiations are at an advanced stage and will continue after completion.

## FIRST STEPS

### CONFIDENTIALITY



Before any information is given to a potential buyer, it is essential that it signs a confidentiality agreement. This will place the buyer under an obligation to use the information only for the purpose of assessing the business (and not to use it for its own gain) and to keep it confidential. Where the potential buyer is a competitor, it may be advisable for commercial reasons not to pass across particularly sensitive information too early in the process, even where a confidentiality agreement is in place.

If negotiating with a management team, confidentiality provisions will help to prevent news of the proposed sale becoming too widely known within the business and the wider market, which could have an unsettling effect on staff.

### HEADS OF TERMS



Once the initial negotiations have settled the principal commercial terms of a transaction, buyer and seller(s) will often sign heads of terms setting out the deal. Their purpose is to flush out any potential deal-breaking issues and to serve as the basis for the more detailed negotiations of the legal agreements. Provisions contained in heads of terms are usually non-binding, except for those that relate to confidentiality and exclusivity. Some of the key commercial terms usually covered in heads of terms include:

### CONSIDERATION STRUCTURE

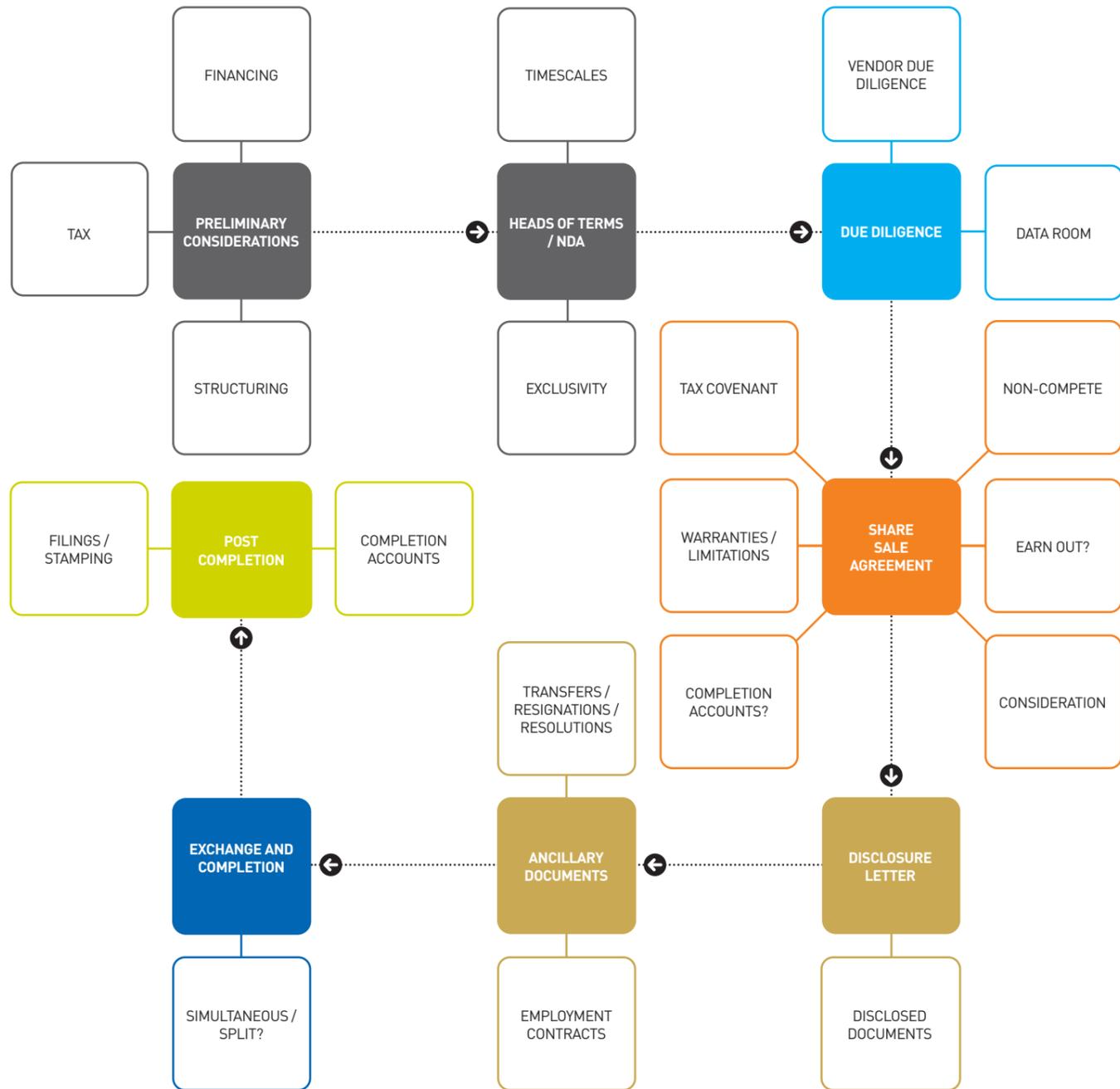
- Few deals involve just a single cash payment on completion. Where the headline price is based on some multiple of profits (probably the most common structure, although net asset-based valuations are appropriate for some businesses) there is usually some potential for adjustment and also, possibly, future payments.
- It is common for deals to be struck on the basis that the target will be **debt free** (no historic borrowings for a buyer to pay off), **cash free** (no excess cash in the business that the seller(s) would want to extract) and with a **normalised level of working capital** (enough cash, debtors, stock etc in the business so that the buyer can continue to operate the target as a going concern without having to make a big cash injection). This may be measured by completion accounts drawn up following the sale 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** basis may be used whereby the price is calculated on the basis of a set of pre-completion accounts that the buyer verifies and the seller(s) are restricted in the value (or 'leakage') they can extract from the business pre-completion. Where a locked box structure is agreed, sellers may receive interest or a payment linked to profits for the period from the locked box accounts date to completion.
- Earn-outs** are also common. Under an earn-out structure payment of all or part of the purchase price is linked to future performance of the business, usually based on its profits or turnover over a two-three year period following completion. Earn-outs can help bridge gaps in sellers' and buyers' perceptions of the value of the business and address a buyer's concern that performance may drop following completion of the sale.
- However, from a seller's perspective, there is a risk that this value will never be realised and consideration will need to be given to what protections can be put in place to prevent the business being run in a way that damages the chances of achieving the earn-out targets. The buyer may want payments to be dependent on some or all of the sellers (where they are individuals) remaining employed by the business.
- If part of the consideration is deferred, sellers should think about whether the buyer's financial strength is likely to be adequate for it to meet the deferred payments when they fall due and whether guarantees or security should be taken. Any security provided by a buyer would usually be subordinated to its bank debt.

### WARRANTIES

- Where there are a number of sellers, who will be liable for warranties and indemnities and in what proportions? What limits and protections will apply?
- Will there be a retention or escrow as security for claims?
- Sellers should consider whether they want to negotiate key terms on these at the outset or agree a broad principle (eg that 'usual' limitations will apply) and negotiate the detail along with the main documents. This decision will depend on sellers' views of risk, the negotiating dynamic, and where the balance of negotiating power lies between buyer and seller(s) at different stages.

# PRIVATE COMPANY SHARE SALE PROCESS



## ONGOING EMPLOYMENT ARRANGEMENTS

- How long will any continuing sellers be required to work in the business?
- Will there be changes to existing terms?

## NON-COMPETE

- For how long will the seller(s) be prevented from working or engaging in a competing business?
- Restrictions that last for three years are not uncommon for major shareholders who will receive a large proportion of the consideration.
- Different considerations may apply to smaller management shareholders who won't receive enough from the deal to 'sit on a beach' for three years and will need to be able to earn a living.

## EXCLUSIVITY



Normally, when heads of terms are agreed, sellers will agree to give the buyer a period of exclusivity in which to negotiate the deal during which they will not discuss alternative deals with third parties. This protects the buyer from the risk of spending time and money on the purchase process only to find that the seller(s) later accept a better offer. The exclusivity period is legally binding and the seller(s) will, at least, be liable for the buyer's wasted costs if the exclusivity is breached.

From a seller's point of view, the exclusivity period should be framed in terms of a sensible timescale for the buyer to complete the transaction without prejudicing the seller's negotiating position – eg if the buyer tries to renegotiate terms late in the process when there may be fewer alternative purchasers in the frame.



**IT IS A GOOD IDEA FOR WOULD-BE SELLERS TO DO SOME OF THEIR OWN DUE DILIGENCE IN ADVANCE TO TRY TO IDENTIFY ANY ISSUES THAT MIGHT BE OF CONCERN TO A BUYER.**



## DUE DILIGENCE, WARRANTIES, INDEMNITIES AND DISCLOSURE

Buyers can protect themselves against nasty surprises and unknown liabilities in the target company in two main ways: first, via their due diligence investigations into the company and secondly, via contractual protections in the form of warranties and indemnities.

Sellers can protect themselves by carefully negotiating the contractual terms to try to limit the scope of what they warrant, as far as possible, to matters within their knowledge or control and by making full and frank disclosure so that the buyer can't later claim that there were problems which it wasn't told about.

### DUE DILIGENCE



Due diligence is a name given to a buyer's investigations of the target company (in the case of a share sale) and its business. This will usually begin once agreement in principle is reached and heads of terms are signed but before detailed legal documents begin to be negotiated, although it will often be ongoing until quite late in the transaction. Due diligence usually includes financial, commercial and legal due diligence and may include more specialist due diligence depending on the nature of the business. This guide focuses mainly on the legal due diligence process.

A buyer will want to obtain as much information as possible about a target company and its business to enable it to decide whether to proceed with the acquisition and, if so, on what terms. Any discoveries a buyer makes in the course of its due diligence investigations may lead to it seeking to renegotiate the price, requiring specific legal protections (in the form of indemnities in the acquisition agreement) or, occasionally, withdrawing from the process.

Good organisation is the key to a successful due diligence process. Business owners considering selling would be well-advised to think through how they would manage the due diligence process, even if they have not yet got as far as seeking potential buyers. It is a good idea for would-be sellers to do some of their own due diligence in advance to try to identify any issues that might be of concern to a buyer.

### VENDOR DUE DILIGENCE



Due diligence carried out by would-be sellers before selling their business is known as 'vendor due diligence' and can be done with greater or lesser degrees of formality. It may involve putting together a complete set of due diligence responses (based on a template questionnaire) and pulling those documents together into a data room for prospective buyers to review before or after making their final offers. This can be particularly useful where there are a number of interested parties and the seller(s) want to run a quasi-auction process that asks the would-be buyers for their best offers based on a full set of information.

At the most intensive level (though this is less usual) it may involve commissioning professional advisers to prepare detailed due diligence reports based on these materials. Alternatively, it may be a higher level exercise of considering and, if necessary, addressing potential issues and making sure that all the relevant documents can be supplied when they are needed. The sorts of things that may be considered at this higher level include:

### CORPORATE STRUCTURE

- Can the group structure be simplified or re-organised to help facilitate a more efficient disposal?
- Could minority interests frustrate the deal? Can those interests be acquired by the majority shareholders in advance of the sale? If not, there are methods to legitimately compel minority shareholders to sell along with the majority and early legal advice should be sought if this might be necessary.
- Have any share buy-backs been carried out correctly? Share buy-backs are commonly used as a means of enabling a company to return cash to shareholders, often where a particular individual has ceased to be involved with the company. However, failure to follow the statutory formalities to the letter can mean that the buy-back is void and the shares are still held by the person from whom they were purportedly bought back. Where this is an issue, it is best if it is identified and sorted out before the sale process gets underway.

## ARE RECORDS AND DOCUMENTS RELATING TO THE BUSINESS UP TO DATE?

- Are the company's filings at Companies House and its register of members and other statutory registers complete and up-to-date? Legal title to shares is evidenced by entry in the register of members of the company and a prospective buyer will want to ensure that the 'chain of title' to the company's shares (ie the record of share issues and transfers) is complete and accurate.
- Can all key documentation relating to the business be located? It is advisable to begin collating copies of all key, signed documentation relating to customers, suppliers, employees and any properties of the business in advance.

## CONSENTS

- Will any third party consents be needed for the sale? These may include customer, landlord and regulatory consents.
- Third parties wouldn't usually be approached until a deal looks certain but sellers should think about how they will deal with these when the time comes.

## INTELLECTUAL PROPERTY RIGHTS (IPRs)

- Is the intellectual property (IP) used by the business properly protected and, where relevant, vested in the company? In particular, where IPRs have been created for the company by external or internal consultants or contractors (eg software, branding, designs, website content, etc) they will not automatically be vested in the company unless appropriate contractual provisions are in place with those third parties.
- Where rights have not vested in the company, then this may need to be dealt with by means of appropriate assignments being drawn up and entered into before the sale process begins.
- Have patents, trade marks and domain names been properly registered?
- Are all necessary licences in place for third party IP used in the business?

## PROPERTIES

- Identify all premises used/owned by the business and check that the business is legally entitled to do what it is doing in those premises. Consider matters such as physical condition, planning permissions and environmental matters.
- Does the business possess all the licences necessary to comply with regulations? Are there any environmental concerns associated with the premises?

- Have all necessary health and safety, fire risk, asbestos, etc, assessments been carried out?

## EMPLOYEES

- Are all key employees effectively tied in to proper service agreements that contain appropriate restrictive covenants and adequate notice provisions? If there are any deficiencies, it can be much simpler to negotiate and sign any amendments before employees get wind of a possible sale.
- Have the legal requirements applying to employers generally been complied with?

## SHARE OPTION SCHEMES

- A buyer will want to be sure that all outstanding options will either be exercised or will lapse on (or as a result of) completion of the sale and that there is a binding process by which this will happen. It is a good idea to review option documentation and ensure that any options that have been 'promised' have been formally granted before the sale process begins and that the practicalities for ensuring exercise (which may include facilitating a 'cashless' exercise) have been worked out in advance.
- Have all statutory requirements been complied with and all necessary filings been made with HMRC in respect of any share option schemes? Our share incentives team finds that 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, which can result in a significant differential in tax treatment for option holders. Where this is an issue, it is best that it is picked up in advance as it will need to be carefully managed from an employee relations point of view.

## CUSTOMER/SUPPLIER CONTRACTS

- Are arrangements with key customers and suppliers properly documented and have all key contracts been renewed?
- Are the business's standard conditions of sale and purchase up-to-date and adequate?
- Even where the whole company is being sold (as opposed to a business and asset sale) there may be contracts with customers and suppliers that will require the consent of the other party for the relationship to continue following the sale. Other parties won't necessarily always be obliged to act reasonably in deciding whether to give their consent.



**BUSINESS OWNERS  
CONSIDERING SELLING  
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**ON A SHARE SALE,  
A BUYER WILL WANT  
TO BE CONFIDENT IT IS ABLE  
TO ACQUIRE 100% OF THE  
COMPANY'S SHARE CAPITAL.**

- It is a good idea to identify all agreements that could have a significant impact on the business if they were to terminate on sale, check whether they contain any change of control provisions and think about how any consent process be managed.

#### LITIGATION

- Can any ongoing or potential litigation involving the business be resolved or settled?

#### FINANCE

- Consider how existing bank facilities and other loans, grants, guarantees and security will be dealt with.

#### DRAG ALONG

- On a share sale, a buyer will want to be confident that it is able to acquire 100% of the company's share capital. If there are minority shareholders who are not closely involved with the business or other shareholders who, for whatever reason, the seller(s) cannot be confident will sign a share sale agreement (or a power of attorney appointing someone else to sign it on their behalf), then it may be necessary to rely on compulsory transfer provisions.
- Although there is a statutory procedure, it can be cumbersome and difficult to implement in practice and many companies' articles of association contain 'drag along' provisions whereby minorities can be compelled to sell on the same terms as the majority. It is a good idea for prospective sellers to review these and verify with their legal advisers that they are likely to be binding and effective. If there are problems, they are best identified in advance of any sale process at which point it may be possible to remedy them.

#### DUE DILIGENCE ACROSS BORDERS



Where the target business has subsidiaries overseas, due diligence should extend to 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 labour and employment, environmental and data protection issues and, in some jurisdictions, foreign ownership restrictions/ approvals.

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 sellers tend to raise this issue with the buyer. The parties should consider the time needed for such

approvals to be obtained and the consequences in the event such approval is not obtained in time.

#### WHAT TO EXPECT FROM THE DUE DILIGENCE PROCESS



If possible (and subject to confidentiality), a due diligence team comprising appropriate personnel should be formed, headed by a person with a good overview of the company or business.

A buyer's solicitors will produce a detailed legal questionnaire intended to cover as many aspects of the business as possible.

Sellers' solicitors will usually co-ordinate the provision of responses to the questionnaire and should be provided with a copy of the questionnaire as early as possible. The person in charge of the due diligence team at the company should then divide the questionnaire up into its constituent parts (such as finance, employment, properties, etc) and organise their team to begin working on the responses.

Copy documents to be provided in response to the questionnaire should be checked before they are provided to ensure that they are complete copies and, where applicable, have been signed. It is helpful if these can be supplied clearly labelled and, as far as possible, numbered and ordered by reference to the numbering of the questionnaire. Sellers' solicitors will review the responses and provide a copy to the buyer's solicitors.

The responses and documents will usually be made available to a buyer and its advisers via a secure online data room managed by the seller(s) or their solicitors. Our firm has its own online data room solution or, alternatively, there are specialist third party providers. It is usually better to avoid general cloud document-sharing solutions as they may not be secure or offer adequate functionality (which can mean that the due diligence process is more time-consuming and difficult for all parties).

Working in this organised way ensures that each side has access to a complete and well-presented set of relevant documents. Carrying out a controlled due diligence process also facilitates the disclosure exercise in due course.

## WARRANTIES AND INDEMNITIES



### WHAT ARE WARRANTIES?

Warranties are contractual statements (essentially promises about a state of affairs) made by sellers to a buyer in the acquisition agreement. They relate to all aspects of the business and assets (and the target company itself, on a share sale) including customers, suppliers, IT systems and financial, employment, pensions, property, environmental & sustainability and IP matters.

Warranties may give rise to liability for a seller if they turn out to have been inaccurate or misleading at the point in time when they were given and, as a consequence, the company or business is worth less than it would have been if the warranties had been true. They therefore function as a method of adjusting the purchase price retrospectively.

In addition, sellers face potential criminal liability if they make any statements they know to be false, or conceal any facts with the intention of inducing someone to buy shares in a company; or if they engage in conduct that creates a false or misleading impression as to the value of those shares. These offences could be committed if a seller fails to disclose known inaccuracies in the warranties. The importance of full disclosure in protecting sellers cannot, therefore, be underestimated.

The warranties are customarily set out in a lengthy schedule to the acquisition agreement. Each warranty statement contains a particular assertion. For example, a warranty might state that *'the Company is not involved in any dispute with any of its customers'*. If a seller is aware that the target is in dispute with one or more of its customers, it will not want the warranty to be given in this form as it would then be exposed to a claim for breach of contract by the buyer.

The most obvious way of addressing this problem would be for the warranty itself to be amended, for example, to say that *'the Company is not involved in any dispute with any customer, except X Limited'* and then go on to describe the nature of this dispute. However, the warranty would need substantial amendment if the target is involved in a number of disputes with different customers and a reference to each of these disputes would need to be included.

To avoid warranty schedules becoming extremely cumbersome, the usual practice is for the warranty to be qualified in a separate document known as the **'disclosure letter'** drafted by sellers' solicitors and setting out details of all known inaccuracies in the warranties. In this way, warranties also function as a means of buyers eliciting information from sellers about any known problems that might not have been identified in due diligence.

### WHEN ARE WARRANTIES GIVEN?

Sometimes there will be an interval of time between the date on which the acquisition agreement is entered into (known as 'exchange of contracts' or simply 'exchange' or 'signing') and the date on which the acquisition completes and ownership passes to the buyer (known as 'completion'). This may be the case where a third party needs to consent to the transaction (for example, a regulatory body or the shareholders of buyer or seller), or where the buyer is a publicly traded company that is issuing shares to the seller(s) which need to be admitted to trading on the relevant stock exchange.

Warranties are given at exchange and, where there will be an interval between exchange and completion, they are usually repeated at completion (and sometimes are deemed to be repeated on each intervening date). Often, buyers will be agreeable to sellers updating the disclosure letter at completion to include any matters or circumstances that have arisen since exchange (but not any that existed at exchange but which the sellers failed to disclose at that point).

Any disclosures made in any updated or supplementary disclosure letter will not operate to qualify the warranties given at exchange (so preserving a buyer's ability to sue if there were any undisclosed inaccuracies in the warranties at the point when the contract was entered into). It is vital therefore, from a seller's point of view, that any known inaccuracies in the warranties are disclosed in the original disclosure letter that they deliver at signing.

### WHAT ARE INDEMNITIES?

Where known liabilities are revealed to a buyer as a result of either the due diligence or disclosure exercises, it will usually require the seller(s) to give a specific indemnity in respect of the matter concerned in the acquisition agreement.

Indemnities are undertakings given by sellers to meet a specific potential or unquantifiable liability of the target company, or which the buyer may otherwise assume in the context of a business sale. An indemnity obliges a seller to make a payment to the buyer if and when the liability to which the indemnity relates crystallises.

By way of example, a seller may have disclosed that the target company owns an area of contaminated land that needs to be cleaned up and the cost of doing so is unknown. The buyer may not have recourse under the warranties because the seller has disclosed full details of the problem in the disclosure letter. However, the disclosure made by the seller would alert the buyer to the fact that the circumstance exists and that it should require an indemnity to cover the cost of remediation.

**INDEMNITIES CAN BE ONEROUS AND SO SHOULD ONLY BE OFFERED WHEN THEY ARE CLEARLY NEEDED AND NOT, FOR EXAMPLE, FOR ISSUES THAT WOULD BE CONSIDERED TO BE NORMAL BUSINESS RISKS.**

From a seller's perspective, indemnities can be onerous and so should only be offered when they are clearly needed and not, for example, for issues that would be considered to be normal business risks. Their precise scope and terms will need to be carefully negotiated.

### WHAT IS THE DIFFERENCE BETWEEN A WARRANTY AND AN INDEMNITY?

It is important for sellers and buyers to be aware of the distinction between a warranty and an indemnity. A warranty is a contractual statement made by sellers regarding the state of the target company or business, whereas an indemnity is a promise by sellers to reimburse a buyer for a specific liability if the need ever arises.

A breach of warranty will only give rise to a successful claim if a buyer is able to demonstrate that the warranty was untrue, the seller(s) did not make an adequate disclosure in the disclosure letter and, as a consequence of the breach, it has suffered a loss in terms of the company or business being worth less than it would have been had the warranty been true.

An indemnity, however, is a contractual promise to reimburse a buyer upon the happening of a specific event, irrespective of whether a target company or business can be shown to be worth less as a result of that event.



**IT IS IMPORTANT THAT ANY KNOWN INACCURACIES IN THE WARRANTIES ARE FORMALLY RECORDED IN THE DISCLOSURE LETTER EVEN IF SELLERS KNOW THAT THEY WERE IDENTIFIED IN THE BUYER'S DUE DILIGENCE.**

### TAX INDEMNITIES (OR TAX COVENANT)

In the context of a share sale, it is conventional for a specific set of indemnities (often known as a tax covenant) to be given by sellers to a buyer to cover any historic tax liabilities of the target group. This means that sellers will generally be liable for any pre-completion tax liabilities, known or unknown, subject to an agreed set of exceptions. For example, usually a seller will not be liable for tax liabilities provided for in the company's accounts or which are taken into account in the calculation of the purchase price (eg by being provided for in a set of completion accounts).

### WHO GIVES WARRANTIES AND INDEMNITIES?

In the case of a share sale, either all or a sub-set of the sellers of the target company will give warranties to the buyer. Institutional shareholders such as private equity funds customarily do not give warranties. Likewise, sometimes other shareholders who are not involved in the day-to-day running of the business (eg spouses of director shareholders, trustee sellers, business angel investors or former employees) may be able to resist giving full form warranties. Instead, they usually only warrant that they own the shares being sold and that they have capacity to enter into the transaction.

If this position is acceptable to a buyer, it will probably want to ensure that any shortfall in cover is made up by those who do give warranties. This can lead to some difficult issues but ways to address these may include the use of retentions or warranty and indemnity insurance.

It is not usually reasonable to ask directors of the target company who have no shares to give warranties, regardless of whether or not they have detailed knowledge of the business.

Where only the business and assets (or part of them) are being sold, it is the selling company that will normally give the warranties. In these circumstances, where there is a risk that sale proceeds could be divided out to shareholders, the buyer may well require some form of security to be given for warranty claims.

### LIMITATIONS ON WARRANTY LIABILITY

If there are a number of sellers, a buyer will usually request that the warranties are given on a 'joint and several' basis. This means that the buyer may pursue any one or more of

the warrantors in relation to the full amount of a warranty claim. Understandably, individual warrantors will wish to limit their liability to their share of the sale proceeds. It is common practice and usually acceptable for an individual seller's liability to be limited in this way although this may be resisted if the sellers are closely connected to each other, for example, husband and wife. Sometimes, depending on the relative bargaining strengths of the parties and the circumstances, lower financial caps can be agreed and/or a proportionate liability for claims. Sellers will also usually benefit from other limitations on warranty liability such as time limits and exclusions for small claims.

### WHAT TO EXPECT FROM THE DISCLOSURE PROCESS?



The purpose of the disclosure exercise is to ensure that, as far as possible, sellers are not exposed to the risk of warranty claims by ensuring that the buyer has full knowledge of any inaccuracies in the warranties. To the extent that adequate disclosure of a matter is made, a buyer will have no claim against the seller(s) in respect of it under the warranties.

The more thorough the initial due diligence process, the less likely there will be any surprises later in the disclosure exercise and the easier that process will be. However, it cannot be assumed that because an issue has been disclosed in due diligence it need not also be expressly disclosed in the formal disclosure letter. On the contrary, it is important that any known inaccuracies in the warranties are formally recorded in the disclosure letter even if sellers know that they were identified in the buyer's due diligence.

Seller's solicitors will coordinate the disclosure exercise. They will put together a first draft of the disclosure letter containing certain standard or 'general' disclosures of matters of which any reasonable buyer ought to be aware (eg contents of accounts, some standard searches of public registers). They will then need to meet with any relevant sellers and members of the management team of the business (probably the due diligence team) to identify what specific disclosures need to be made against particular warranties. For example, if there is a warranty that there are no disputes with customers, the specific disclosures would give details of any known disputes.

Depending on the number of warranties involved, this can be a lengthy process and the time necessary to complete it should not be underestimated. However, as stated elsewhere in this guide, the disclosure letter is a key document from a seller's point of view.

Once the draft disclosure letter has been prepared, it will be sent to the buyer's solicitors and is usually the subject of some negotiation. Negotiation of both the warranties and disclosures against them will often be ongoing in tandem. Matters referred to in the various drafts of the disclosure letter frequently prompt additional enquiries from the buyer and it is usual for the due diligence and disclosure processes to continue right up until the point in time that the acquisition agreement is signed.

It is vital that sellers keep their solicitors informed of any changes that occur in relation to the company or business, including any changes to its tax position, so that appropriate amendments can be negotiated to the draft warranties, tax covenant and disclosure letter before they are entered into.

As sellers' solicitors are not involved in the business day-to-day, they will not be aware of any changes that may have an impact on the transaction documents so they are reliant on sellers to keep them informed to enable them to negotiate adequate protections for the sellers in the acquisition agreement. Sellers should also think about whether any additional disclosures may be required as the draft warranty schedule evolves and keep their solicitors informed.

#### LITIGATION RISK



The provisions in an acquisition agreement that are most likely to give rise to disputes are those on warranties, indemnities and limitations on liability. In a cross-border sale, arbitration tends 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. Arbitration is also often a confidential process as opposed to open court.

**IT IS VITAL THAT SELLERS KEEP THEIR SOLICITORS INFORMED OF ANY CHANGES THAT OCCUR IN RELATION TO THE COMPANY OR BUSINESS SO THAT APPROPRIATE AMENDMENTS CAN BE NEGOTIATED TO THE DRAFT WARRANTIES, TAX COVENANT AND DISCLOSURE LETTER.**

#### 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 August 2022.*

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