Selling a Business

Your complete guide to the business sale process.

Business. Less complicated

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Selling Your Business: an Introduction

Congratulations! You have created a successful business and now is the time to sell, or is it?

Firstly, the emotional part: you've worked hard and taken risks to build your business, you probably have some great, loyal employees, valued customers and reliable suppliers but are you at that stage in your life when you want to move on to something new or simply retire or cash in while the going is good?

What will happen to your employees, will their jobs be secure under a new owner? Are your customers going to be looked after? What are you going to do next (remember that a "cliff edge" retirement is bad for your health and longevity so make sure you have something else lined up to keep you busy*).

Secondly, the financial part: by selling now, are you going to miss out on future growth and several years of good profits and the opportunity to sell in the future for a better price?

Maybe there are some simple tweaks you can make to your business to make it more profitable and valuable?

At WSP Solicitors, we recommend drawing up a plan to sell your business with a 3 year lead time. The aim is to:

1. Sort out your compliance especially around taxation, Companies House records, any regulations specific to your business sector, employee records, etc. This will showcase your business as "safe" and speed up the sale process especially that part called "due diligence".

2. Prepare 3 years of forecasts matched with 3 years of accounts that delivered on those forecasts. This helps you sell your business on the basis of the future, not the past: by demonstrating that the business was forecast to grow and did grow, and so your forecasts now that it will grow further in the future are believable. Sell the future!

3. Build up a good relationship with your solicitors and accountants who should understand your business and you. The sale process can be lengthy and stressful, so you need good professionals by your side.

So, if you are still ready to sell, what is the process and what can you expect?

Read our guide to find out about:

1. Choice of structure – share sale or asset sale
2. Preliminary steps
3. Due diligence
4. Sale and purchase agreement
5. Price adjustments in share sales
6. Property
7. Warranties
8. Disclosure letter
9. Taxation matters
10. Ancillary documents
11. Completion
12. Post-completion

***Some studies have linked retirement to poorer health and a decline in cognitive functioning — at times resulting in as much as double the rate of cognitive aging. This leaves people at a greater risk of developing various types of dementia, such as Alzheimer's disease.**

1. Choice of structure

One of the first things that you should be considering when it comes to selling a business will be how the deal is structured. Ultimately, the choice of which structure will be influenced by legal, financial and personal considerations of the buyer as well as the seller.

The key differences between the two are (a) who is/are the seller(s) and (b) what is the buyer acquiring?

In a **share sale,** the sellers are the shareholders of the company, and the buyer acquires the shares of the company that in turn owns the trade and assets of the business. It is important to understand that the shareholders of the company are the sellers and not the company itself. The business can continue
to run on a 'business as usual' basis. The new owner acquires the company with all its assets, liabilities and obligations.

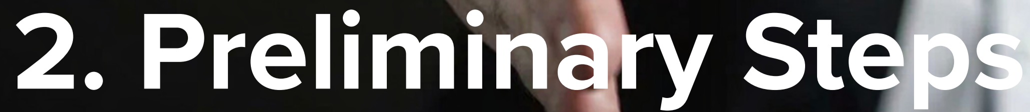
In an **asset sale,** the buyer acquires the assets which make up the business. Here the company is the seller rather than its shareholders. This is where the buyer acquires the assets, both tangible (property, land, machinery and stock) and intangible (intellectual property and goodwill).

	Share sale	Asset sale
Tax	The proceeds of the sale are paid directly to the company's shareholders (who are the sellers), which in many cases may result in a lower tax liability. The sellers may be eligible for Business Asset Disposal Relief (formerly Entrepreneurs' Relief) which allows them to benefit from a reduced rate of 10% capital gains tax on the gain they make when selling "qualifying assets" (in this case their shares in the company). To qualify the seller must be an officer (director or secretary) or employee of the company, own at least 5% of the shares and have held such shares for at least 2 years and the company must be a trading company (as opposed to an investment company). The rules are complex and expert advice must be sought.	The proceeds of sale go to the company (because the company is the seller) and then its shareholders need to think about how that money will be extracted from the company. Effectively, there could be a double tax charge with the company paying corporation tax on the sale proceeds and then the shareholders paying income tax on a dividend of those proceeds to them. A good rule of thumb is that sellers generally prefer a share sale for tax purposes.
Continuity and cherry picking	Is the buyer wanting to continue to run the business in the same way as the seller, so that from the outside looking in it looks like nothing has changed? If so, a share sale may be the best way to achieve this as employees, customers, suppliers and third parties will continue their relationship with the company (albeit under new ownership). The clean break that the sellers would get is favoured by sellers, but not always.	From the sellers' perspective, the thought of selling the company assets whilst keeping the liabilities will not be appealing. Alternatively, if the sellers only want to sell some of the company's assets or if they want to continue to trade after completion, a share sale may not be practical. An asset sale will allow a buyer to "cherry pick" only the assets it wants and leave liabilities behind, so it is often favourable for a buyer.

Due diligence	As part of the process of purchasing a business, the buyer will want to carry out some level of investigation and enquiry (known as "due diligence") on the business. The level of due diligence is likely to be far higher with a share sale, this is because liabilities are included as well as the company's assets.	There is likely to be less due diligence involved in an asset sale because the buyer can potentially leave behind most liabilities. However, there will be more negotiation and discussions surrounding what is and is not included and calculating the value of the
Practicality	For practical reasons, for sellers a share sale may be a simpler option as the company (and all its assets and liabilities) are transferred to a different owner. The sellers get a "clean break" (although see section 7 warranties of this guide). However, for a buyer a share sale is a riskier option because of the potential to acquire liabilities, both known and unknown.	Some assets are practically more difficult to transfer than others, particularly non-tangible assets or where there is a third-party involvement, for example, the transfer of a lease may need the landlord's consent.
Sale and purchase agreement	A share purchase agreement ("SPA") is usually a very lengthy and detailed document, often running to more than 100 pages. A large part of the SPA will be devoted to warranties which are contractual promises made by the sellers (personally) to the buyer about the company. These will cover the accounts, employees, assets, trading, property, taxation, intellectual property and many other aspects of the company. If any of the warranties are false the buyer may have a claim against the sellers.	An asset purchase agreement ("APA") is usually far shorter and less detailed than a SPA. This is because the buyer needs less protection against the company's liabilities as the buyer can negotiate simply to exclude such liabilities ("cherry-picking"). However, third-party approval (eg, from a landlord) often causes delays so preparation is key. There will often still be warranties involved but they will be specific to the assets that are being acquired and far less onerous for the seller.
Employees	The employees will remain contracted with the company and, therefore, there is no transfer of employment rights or Transfer of Undertakings (Protection of Employment) Regulations 2006 ("TUPE") to deal with. The employees are employed by the same company, albeit that company is now under new ownership	When a company sells its business as a going concern ("TOGC") meaning in simple terms that the business is to continue under the new owners, both the buyer and sellers must adhere to the application of TUPE. TUPE dictates that all employees of the business are automatically transferred to the buyer with their continuity of service, terms of employment and other employment rights intact. Dismissals that are made because of a TUPE transfer are likely to be automatically unfair leaving both the buyer and the seller at risk of employment tribunal claims.

So, when you are looking to sell your business, there is a lot to consider when choosing between a share sale or an asset sale. As a seller, it is worthwhile to consider tax implications and potential employment law liability. Typically, buyers favour an asset transaction (especially in smaller transactions) whereas sellers favour a share transaction, but unique circumstances and desired outcomes may result in a change of preferences. It is essential to consult an experienced solicitor and explore all your options before signing anything.

At WSP Solicitors, what we often see is a seller who has already signed heads of terms or a letter of intent agreeing to (say) an asset sale but, having done some investigations, it becomes clear that a share sale would be far more preferable. Then the seller has to go back and renegotiate the deal, and this often leads to the buyer seeking a price reduction or some other concession.



2. Preliminary Steps

Confidentiality

All business sales (asset sales and share sales) start with initial enquiries by a potential buyer and the disclosure of information about the business to be bought. This may include commercially sensitive information including financial performance and customer details. Even the fact that the business is for sale will probably be confidential. Accordingly, the seller must get the buyer to sign a confidentiality agreement or non-disclosure agreement ("NDA") which obliges the buyer to keep such information confidential.

Assuming the buyer remains interested and a price and other terms can be agreed then the parties should negotiate and agree heads of terms ("HoTs"), also known as letters of intent ("LoI") and memoranda of understanding ("MoU"). This is a document which sets out the main terms of a commercial transaction agreed in principle between the parties in the course of negotiations. HoTs evidence the future intentions of the parties wishing to take part in the transaction and have moral force but are not generally legally binding on the parties to conclude the deal on those terms or even at all. However, provisions relating to exclusivity, confidentiality (often repeated within the HoTs) and costs will usually be binding.

HoTs are commonly entered into at the very beginning of a transaction, once preliminary terms have been agreed and before the commencement of due diligence and the drafting of definitive agreements where the finer details are negotiated.

Why are HoTs useful?

HoTs are a useful tool in business negotiations, as they provide a launch pad to move a deal forward by removing the risk of the parties involved having a different understanding of the main points of the deal. The crucial terms of a transaction need to be established at an early stage to set a timetable for smooth delivery of the final agreement. Typically on a business sale the HoTs will record the purchase price, any mechanism to adjust the price, when the price is to be paid (including any deferred element), details of what is being bought and sold, planned time-scales for delivery and the conditions to be satisfied for the transaction to proceed, and confidentiality and exclusivity undertakings.

Advantages of using HoTs

1. Evidence of progress – using HoTs can show that progress is being made on a transaction. Having a signed document, irrespective whether it is binding or not, may be attractive to a business and shows moral commitment on both sides and that the transaction is worth pursuing.

2. Binding commitments – in some circumstances, HoTs will be binding, for example, provisions relating to confidentiality, exclusivity or the treatment of costs.

3. Focus on key issues – with complex transactions, HoTs can help to focus the negotiations on important issues, highlight major issues early on and bring out any misunderstandings. This helps to prevent wasted time and money by realising at an early stage if the transaction can overcome these issues and progress further.

4. Deal crib sheet – HoTs can provide a useful statement of key terms of the proposed deal which can be provided to those not directly involved in negotiations. They can be a useful tool when instructing external advisers, allowing further questions to be asked about the basis of the deal and highlight issues that the parties may not have previously considered.

5. Setting the price – on an asset sale the price is usually unambiguous, simply being the agreed value of assets and goodwill. There may be an adjustment for stock value which may fluctuate and any cash left behind for the same reason. However, on a share sale, things are far more complex. In essence all the buyer is buying are share certificates which represent shares in the company and (indirectly) any assets (subject to liabilities) that the company may have. The buyer will insist upon a mechanism to ensure that, pending completion of its purchase, those assets remain within the company and the liabilities do not grow.

Agreeing the price adjustment mechanism and ensuring it is drafted carefully and correctly can have a huge impact on the final price so getting it agreed in as much detail as possible at the earliest stage possible is essential. For a more detailed explanation please see section 5 (Price adjustments in share sales) of this guide.

Disadvantages of using HoTs

1. Unintentionally binding – HoTs can have an undesired effect of being found to be legally binding, which can limit flexibility in subsequent negotiations.

2. Competition law issues – if HoTs contain a provision to restrict, distort or prevent competition within the UK, they may be prohibited by Chapter I of the Competition Act 1998, irrespective of whether they are binding or not.

3. Neglecting the main agreement – if the parties start performing services or works under then HoTs, they may become too involved with the arrangements and provisions in the HoTs and forget or lose incentive to finalise the full agreement.

4. Expiry of HoTs and contractual vacuum – if HoTs are binding, there should be clear provisions about what happens when they expire. Failure to agree this will leave a contractual vacuum and cause uncertainty over what is in place and on what terms.

How do you draft HoTs?

Initially, you should consider what the key objectives are. What is the deal looking to achieve? There is no standard form for HoTs, they can vary from a simple letter to a more comprehensive agreement drafted by solicitors. There is no convention as to who prepares the HoTs for a transaction, although it is more common for this to be initiated by the buyer on a typical sale. If you are not sure about the implications of something that the buyer or seller is asking to remove or add, you should take professional advice. Even if the agreement is not legally binding, it can still commit you to something.

Confidentiality

The buyer will during its due diligence process be given access to confidential information about the business, for example, customer, supplier and employee details. The seller should never disclose this sort of information without HoTs in place with confidentiality provisions or a separate NDA (non-disclosure agreement) whereby the buyer, its employees and advisers are bound to keep information they receive confidential, use it only for the purpose of the proposed transaction and, if the transaction falls through, to destroy or return the information.

Exclusivity

A buyer will often ask that the HoTs include a period of exclusivity, typically no more than 3 months or so, during which time the seller must not negotiate with any other potential buyers. This is considered reasonable because the buyer is likely to incur significant costs in its investigation of the business during the due diligence process. The HoTs also may state that if the seller breaches the terms of the exclusivity, then it must pay a contribution to the buyer’s costs. However, such provisions are difficult to enforce.

Conclusion

The most important purpose of the HoTs is to ensure that the buyer and seller really have agreed on the terms of the sale and that there are no misunderstandings. Many times we are advised by clients that they have agreed a sale but when we discuss the HoTs between them and the buyer, it emerges that the parties are at cross purposes and there is a fundamental misunderstanding. It is best to flush out such matters at the earliest stage possible to avoid wasted time and costs.

3. Due Diligence

Due diligence (also known as “DD”) is the process whereby the buyers and their professional advisers investigate the business being acquired (the “target” business). The buyer wants to know (a) that the sellers actually own what they are purporting to sell and (b) what liabilities the buyer may be assuming.

The buyers will investigate the accounts, taxation, customer and supplier contracts, property, employees (including employment contracts and pensions), intellectual property (“IP”), information technology (“IT”), quality and compliance, etc. In addition, with a share sale, the sellers will want to check the history of the company and that the sellers are the bona fide shareholders.

Under the principle of caveat emptor (“buyer beware”) the buyer is potentially at great risk but by the due diligence process the buyer will be able to judge whether its proposed purchase of the business is a good deal or whether it should withdraw from the deal or try and renegotiate the price.

Due diligence is far more important (and expensive and time-consuming) in share sales compared with asset sales. This is because the risks to a buyer are greater in share sales and they tend to be larger transactions. In an asset sale the buyer can cherry-pick those assets which it wants to acquire and those liabilities it is prepared to assume and, therefore, the buyer need not investigate excluded assets and liabilities.

Key points about Due Diligence:

Purpose: Due diligence verifies assets and uncovers liabilities in a target business for potential buyers.

Investigation Areas: It covers accounts, contracts, employees, and more, including the history and shareholders in share sales.

Risk Evaluation: Helps buyers assess risks and make informed decisions, aligning with "buyer beware."

Share vs. Asset Sales: Due diligence is more rigorous and expensive in share sales due to greater risks and larger transactions; asset sales allow selective asset acquisition, reducing investigation needs.

The Due Diligence Process

Usually the due diligence is managed by the buyers' solicitors who will raise a legal due diligence questionnaire covering various topics. This is almost always supplemented by a financial due diligence questionnaire raised by the buyers' accountants. Sometimes, additional advisers will also become involved, for example, IT specialists where IT is specifically relevant to the business.

Responding to the due diligence is usually managed by the sellers' solicitors although often the sellers' accountants will deal direct with the buyers' accountants as this is more efficient.

Answers to the questionnaires with supporting documents will be provided by the sellers to their solicitors to check and then these are forwarded to the buyers' solicitors. This can be done in paper form or via email but the most popular method is to use a virtual data room ("VDR") which is a file sharing platform rather like DropBox.

At WSP Solicitors, when acting for sellers we always advise that only we have the authority to upload documents into the VDR. This ensures that we can check all information being provided to the buyers and maintain a "paper trail" which is crucially important when it comes to negotiating warranties and disclosure during the transaction process (see section 7 (Warranties) and section 8 (Disclosure Letter) of this guide).

In addition to asking questions of the seller, the buyers' advisers will undertake searches at Companies House, the Land Registry, etc. Also, if property is an asset of the target, the buyers' may instruct a surveyor to value and inspect such

Overview Due Diligence Process

Questionnaires & Advisors | Seller's Response | Communication | Virtual Data Room (VDR) | Additional Investigations

Due Diligence

Time and costs

The buyers are likely to spend a lot on the due diligence process (tens of thousands of pounds in large transactions) and, therefore, all parties should be keen to keep the process as efficient as possible. Accordingly, sellers with well organised businesses who can easily find and provide information requested will be at an advantage. Also being able to provide accurate and comprehensive information quickly will give buyers confidence that the business is well run and has nothing to hide.

At WSP Solicitors, we always speak directly to the buyers' advisers before the due diligence process starts to agree the procedures we will follow and limit the due diligence to the important issues and to ensure it is proportionate to the size of the deal. This saves time and costs. The quicker and more efficient the due diligence process, the more likely the deal is to progress and complete and avoid the risk of "deal fatigue". Deal fatigue is where the initial goodwill between buyer and seller when the deal is originally agreed and HoTs (heads of terms) signed is eroded due to the heavy administrative burden of providing and reviewing answers to questions and supporting documents. This can take a huge slice of the parties' day-to-day lives while at the same time the sellers will still need to be running the business effectively (and the buyers will want them to continue doing so rather than let the target business deteriorate).

Confidentiality

In most cases, the sellers will not themselves have ready access to all the information required and so will need to take senior employees into their confidence. Also, it is common for buyers to want to meet and speak with specific key employees, not least to gauge whether they will want to remain working for the target after they become the new owners. Unfortunately, it is then almost inevitable that the wider workforce and also customers and suppliers (and perhaps competitors) learn of the proposed transaction. Wherever possible it is best to delay involving employees for these reasons. However, we advise that it is better for sellers to tell their employees that a sale is happening rather than that information leaking out. It can, therefore, be a delicately balanced decision as to the timing of when to tell the employees and to prepare answers for the inevitable questions about whether there will be redundancies, will the business relocate, etc.

Due diligence reports

Once the due diligence process is completed, the buyers' advisers will submit due diligence reports to the buyers. These reports usually highlight areas of concern which the buyers will then raise with the sellers to give further explanation. In turn this can lead to the price being renegotiated. Serious areas of concern ("red flags") may mean the transaction falls apart.

4. The Sale & Purchase Agreement

The agreement setting out the terms of the business sale will almost always be drafted by the buyer's solicitors although the agreement will be subject to much negotiation. In a share sale/purchase deal the agreement is a share purchase agreement (SPA) and in an asset sale agreement it is an asset purchase agreement (APA) or business purchase agreement (BPA).

The form of the agreement

In each case the agreement is broken down into several distinct parts and there are a lot of similarities between SPAs and APAs. Generally, WSP's preferred format is as follows:

1. The date of the agreement
2. The parties: the buyer(s) and the seller(s) (and any guarantor(s).
3. The "recitals": a brief description of the transaction.
4. The definitions.
5. A statement that the buyer is buying the shares or the business and assets and that the seller is selling them.
6. The price and any mechanism to adjust the price.
7. Completion: when and how the transaction will be formally completed and become binding and the price payable (this may include part of the price being deferred and/or contingent on the future performance of the business being sold).
8. Any specific clauses relevant to the particular transaction.
9. Protection of goodwill: to prevent the sellers setting up in competition or poaching employees and customers.
10. Warranties: contractual promises about the company whose shares are being sold and/or its business and assets. The warranties can be very extensive, especially in a share sale where they may run to 20 or more pages and are usually set out in a separate schedule.
11. Boilerplate: several clauses setting out such things as how to vary the agreement, third party rights, the choice of law applicable to it, etc.
12. Schedules to the agreement: these might include some basic information about the shares/business, the documents that the seller needs to deliver on completion, the warranties, the tax covenant, etc.
13. The signatures of the parties, known as execution clauses.

Drafting the sale agreement

Negotiations on the drafting of the sale agreement will often be very intensive and time-consuming so a well drafted and, most importantly, a fairly even-handed first draft is always a good starting point. If the buyer's solicitor starts off with a heavily pro-buyer draft that will not only slow the sale process down significantly (and potentially increase costs) it is also likely to annoy the seller and erode goodwill. The aim of a good agreement is to accurately record what the parties have agreed and create a fair balance of risk between them.

Well drafted heads of terms (HoTs, see section 2 (Preliminary Steps) of this guide) which clearly record the main terms that have been agreed will help with the first draft.

The sale agreement will include reference to numerous other documents which will be needed for the transaction (see section 10 (Ancillary Documents) of this guide) and all of these too are usually drafted by the buyer's solicitors. The exception is the Disclosure Letter (see section 8 of this guide).

Our approach to drafting and agreeing the sale agreement.

Our approach to drafting and agreeing the sale agreement is to be in close contact with the other party's solicitors and discuss the terms that have been agreed and how best to incorporate them into the sale agreement. We want to ensure our client gets the best deal possible, but we also want to ensure our client gets the deal done and on time and within budget.

We also warn clients that the sale agreement will potentially be a very long agreement and SPAs can easily run to over 100 pages although APAs tend to be a lot shorter and less than 30 pages is quite common. This is because an asset sale is a far less risky transaction for a buyer so the buyer will accept fewer warranties

Timetable to completion

The buyer's solicitor will often not start the drafting of the sale agreement until the due diligence process is well underway and the buyers have been supplied with most of the information they have requested and had at least some preliminary advice on their findings from the due diligence process. If any potential "red flags" have been raised then the buyers may ask their solicitors to hold off drafting pending further investigation.

Once the sale agreement has been drafted and the solicitors are confident it is going to be agreed then the other ancillary documents will be drafted. These are usually in fairy standard form and not controversial.

In the background numerous other tasks might be being undertaken such as:

1. Investigating title to any property of the seller including local authority and Land Registry searches, valuations and surveys.

2. Speaking to key employees, customers and suppliers (although this is fraught with danger for the seller who may upset employees (who often assume a sale will lead to redundancies) and customers (who often assume prices will increase or service levels will deteriorate).

3. Investigating other aspects of the business such as checking the IT systems, checking intellectual property rights (patents, trademarks, etc.), the company's

Unlike contracts for the sale of property there is not usually a time gap between exchange of contracts and completion (known as "simultaneous exchange and completion"). Therefore, neither the buyer or the seller has any certainty that the deal will happen until it actually does happen. There is, therefore, always the risk that the deal will fall apart at the last moment although this is extremely rare.

Occasionally there is a gap between exchange and completion, eg, if there are certain conditions to fulfil before completion can happen, eg, the approval of the deal by a government body, the consent of a landlord to the assignment of a lease or a key supplier/customer to a change of control, etc.

5. Price Adjustment in Share Sales

Deal structure

Consideration may be paid in many ways, and it is often also adjusted post-completion as a means of reflecting true value for a buyer.

In share sales it is almost always essential to have some form of price adjustment provision in the sale agreement otherwise the headline price agreed between the parties is almost meaningless and the buyer is at great

From the seller's perspective, the most advantageous scenario would be for the buyer to pay the purchase price in full on completion, without any subsequent adjustment. Whether this is feasible and/or desirable for the buyer depends on the amount of cash it has at its disposal and whether it is confident that the price it agrees to pay on completion reflects the true value of shares or assets it will acquire. If not, the buyer will look to include a right to subsequently adjust the consideration or defer at least some of the payment to a later date.

There are two main different types of share sale:

1. Completion accounts: the purchase price will be adjusted by reference to a set of accounts prepared following completion but by reference to the date of completion; or

2. Locked Box: the buyer will determine the purchase by reference to a recent set of accounts than the last audited accounts (eg, the last audited accounts, more recent management accounts or a specific set of accounts prepared for the purposes of valuation).

It is important to identify the type of deal because it will impact on the way in which the buyer seeks protection from the seller in respect of the target company's historic liabilities including tax (and will result in an adjustment to the general risk allocation principle that the seller is liable for all tax of the target company arising on or before completion).

Completion accounts

Completion accounts are a set of accounts that are drawn up following completion to show accurate and up-to-date specific financial information about the target company or business being acquired as at completion. They are prepared for the specific purpose of determining the value of the relevant assets at completion.

Completion accounts are appropriate where there are likely to be significant changes in the financial position of the target between the date of the target's audited accounts and the completion date, or where there are daily fluctuations in the assets (eg, stock), profits or working capital of the target (so that the financial condition of the target cannot be ascertained upon completion) which must be taken into account in determining the purchase price. They are also designed to ensure that assets (or other value) are not extracted by the buyer prior to completion.

Net asset adjustment: this is the simplest structure whereby the buyer and the seller agree a net asset target for the target company as at completion. This is agreed as a set figure before completion often based on the most recent annual accounts with appropriate adjustments for the period from the date of such accounts to the date of completion. To the extent that the net asset position of the target company at completion is less than the net asset target, the purchase price is reduced accordingly, usually on a £ for £ basis. It is sometimes also agreed that to the extent that the net asset position of the target company at completion is greater than the net asset target, the purchase price is increased accordingly, again usually on a £ for £ basis. However, buyers may resist this where they have a set budget for the acquisition and do not want to have to find extra funding post-completion.

Cash-free/ debt-free

Somewhat more complicated, this structure is designed to give sellers the benefit of any 'excess' cash in the target/business while at the same time reducing the price payable by the buyer by an amount equal to any institutional debt within the target business.

Form of completion accounts

It is essential that the form of the completion accounts including who is to prepare them, timescales and what accounting policies are to be used are agreed before completion and clearly set out in the sale agreement.

Once the completion accounts are prepared and agreed, the sale agreement will include a mechanism for the consideration to be adjusted to take account of the difference between the estimated figures used to calculate the consideration paid on completion and the amount set out in the completion accounts (increasing or decreasing the purchase price accordingly).

The main advantage of completion accounts is that they effectively defer questions of valuation until after completion (thereby avoiding potential delay or protracted negotiation pre-completion) and provide an accurate picture of value in the specific area of concern for the buyer.

The main disadvantage is that there is significant scope for dispute (if the completion accounts provisions are not property thought out and negotiated carefully). Also, there may be a considerable delay in ascertaining the purchase price (as relevant information will need to be collected, assessed and incorporated into the completion accounts) and there will be additional cost to the process as both parties will instruct their respective accountants to prepare or review the accounts, with an independent accountant potentially required if the parties are in dispute.

To avoid lengthy and potentially divisive post-completion negotiation, the following key areas must be clearly provided for in the completion accounts provisions of the sale agreement:

1. The accounting policies applicable to the preparation of the completion accounts;
2. Clear definitions for cash and debt;
3. How debtors (including provisions for bad and doubtful debts) and intra-group invoicing will be treated; and
4. How fixed assets (historic or otherwise), stock (including slow moving or obsolete stock), work-in-progress and long term contracts will be valued.

Locked box

The 'locked box' concept is a significant variation of the completion accounts approach. In such transactions, the buyer looks to value the target by reference to a specified date before the completion date.

The price is calculated based on a historical balance sheet date agreed by the parties, and the price is not adjusted post-completion. This is known as the 'locked box date'. From this date onwards, the economic risk and reward for the target effectively pass to the buyer, even though the completion date is sometime later.

There is, of course, the risk that the seller who still has control of the target will manipulate the locked box position. Therefore, the buyer will insist on the seller giving covenants or warranties in the sale agreement to the effect that, in the period between the locked box date and completion, the seller will not strip cash or other value out from the target (known as ‘leakage’ from the locked box) or artificially inflate external debt. The sale agreement will generally give buyers between up to six months to make a leakage claim on a £ for £ basis against the relevant covenants and/or warranties. Typically, leakage includes:

1. dividends; and
2. transactions with connected persons (such as payments made to, assets transferred to, or liabilities assumed for the benefit of directors or shareholders or family members).

Certain leakage is usually permitted, and is usually confined to trade debt incurred in the ordinary course of business and payment of historically normal levels of remuneration.

Earn-out

An earn-out is an arrangement where part of the purchase price is calculated by reference to the future profits and performance of the target for a specified period following completion (known as the 'earn-out period'). With an earn-out, the buyer will pay a proportion of the purchase price in cash on completion with the balance paid on a series of set dates post-completion.

An earn-out is not a price adjustment mechanism as such (generally it may be used as an incentive for sellers who stay with the target post-completion to keep performing) but is does have the effect of changing the final overall purchase price that the sellers may receive.

The buyer will want to ensure that the sellers cannot manipulate the earn-out earnings/profits and thereby increase the amount payable to them under the earn-out. The sale agreement will, therefore, usually include restrictions on the sellers' control over the business post-completion, in order to restrict the seller's ability to maximise short term earnings/profits.

The seller also takes a risk with an earn-out, as it will be in the interests of the buyer (purely in terms of minimising the consideration ultimately payable) to keep earnings or profits (whichever is the basis for the earn-out) as low as possible during the earn-out period. In order to ensure that the seller maximises the amount of the target's earnings/profits under the earn-out, the sale agreement will usually impose obligations on the buyer to conduct the business in a particular way. However, the buyer is unlikely to accept conditions which limit its flexibility in operating the business.

It is also quite common to have "good leaver/bad leaver" provisions when an individual seller continues to be involved in the business following completion so that, if sellers leave in certain undesirable circumstances (bad leaver) such as before a pre-agreed period or due to dismissal for misconduct, etc . then they lose all or part of the earn-out consideration.

WSP recommends that earn-out provisions are only used when necessary and appropriate and that they are kept as simple as possible. Ideally earn-outs should be based on values which are easier to calculate and less open to manipulation, e.g., based on revenue rather than profit.

Tax considerations

Earn-outs may have stamp duty implications for the buyer (in a share purchase transaction) if the consideration amount attributable to the earn-out is dependent on events after completion which are not certain.

The earn-out often has tax issues for sellers too, because they may become liable to pay capital gains tax by reference to the whole amount of the consideration payable under the sale agreement (including the deferred element under the earn-out), even though the right to receive the deferred element is contingent. However, as long as the deferred element is properly structured, a seller should be able to defer crystallising any capital gain.

The form of post-completion price adjustment mechanism should be agreed at the earliest stage of the sale process and recorded in as much detail as possible in the heads of terms. Further, great care must be taken in drafting the relevant provisions especially the accounting policies to be used in the completion accounts as this can materially affect the purchase price finally payable.

6. Property

On an asset sale, the buyer acquires the business as a going concern and is able to pick and choose which parts of the business (assets) it acquires and which liabilities it assumes. In respect of properties owned, used or occupied by the business which the buyer wishes to acquire, they must be conveyed, assigned or transferred to the buyer. Freehold properties owned by the sellers may be transferred (”sold”) to the buyer or sometimes the sellers will lease them to the buyer. With leasehold properties (currently leased by the sellers as tenants) the current lease may be transferred (“assigned”) to the buyer or sometimes the buyer will deal direct with the landlord and negotiate a new lease to come in to effect on completion of the purchase of the business.

With a share sale, the target company remains the owner/tenant of the property and, therefore, there is no need to assign leases or sell freeholds. Accordingly, the property aspects of a share sale can be more straightforward than an asset sale. There is, of course, still the need to investigate title to the properties and carefully check the terms of leases. In addition, on very rare occasions, a lease may contain a “change of control” clause which gives the landlord the right to terminate the lease where the ownership/control of the tenant changes (i.e., when the shares of the tenant are sold to the buyer). In such cases, landlord’s agreement to such change of control will be required in similar manner to an assignment of the lease.

Leasehold properties

A lot of businesses operate from leasehold premises and an asset sale would include transferring the lease into the buyer's name. In the majority of cases, landlord's consent to a transfer of the lease is required. There are multiple things to consider with leasehold properties:

1. Assignment (or "alienation") provisions: the lease must be carefully checked to ensure that the conditions to assignment are complied with. If a lease has an absolute prohibition on assignment, the buyer may require a deed of variation from the landlord or request to withdraw the property from the purchase.

2. Pre-emption rights: in rare instances, the landlord has a pre-emption right requiring the property to first be offered back to the landlord, if they decline to exercise their right, the lease can then be assigned to the buyer.

3. Landlord's consent: most commercial leases require the landlord's prior written consent to be obtained before an assignment. Practical points to consider when landlord's consent is required:

a. Confidentiality: if the transaction is confidential, consent can only be applied for once the sale agreement is exchanged. Therefore, the sale agreement would have to be made conditional upon the landlord giving consent. This obviously adds a lot of uncertainty to the transaction.

b. Timing: if the transaction timescale is tight, it may not be possible to have all of the consents in place prior to completion.

c. Costs: it is important to determine who will be responsible for costs, such as Land Registry fees. The landlord's solicitors' costs are usually payable and these are usually borne by the seller (tenant).

d. Applicant: the tenant is responsible for obtaining consent, so the seller is most likely to make the application.

e. Indemnity: the seller should insist on a full indemnity from the buyers against any breaches of the terms of the lease from the date of assignment and the buyers should insist on a full indemnity from the seller against any breaches of the terms of the lease before the date of assignment. This is particularly pertinent to dilapidations, ie, where the seller has allowed the property to fall into disrepair, if the buyers subsequently vacate the property, they may face a claim by the landlord for tens of thousands of pounds to put the property back in a good condition. If the buyers are aware of an existing lack of repair then they should look to get that costed and the price for the business reduced accordingly. For the seller the risk is that after the assignment the buyers let the property fall into disrepair and then the landlord may have a right of action to claim against the seller as the previous tenant.

f. Conditions: the landlord may agree to give consent but only if the buyer pays a rent deposit or, where a limited company, the directors of the buyer give a personal guarantee.

4. Use: the buyer will need to check whether the permitted use of the property is sufficient for its purposes. If not, an application to the landlord for permission to change the use may be required. The buyer should also check other relevant clauses such as the nuisance provisions and restrictions on planning applications.

5. Alterations: the buyer may intend to carry out alterations that require landlord's consent. The terms of the alterations clause in the lease should be checked as appropriate plans and specifications may need to be prepared and, depending on the works, planning permission may be required. There may be prohibitions on applying for planning consents.

6. Personal rights: where an existing lease is assigned, any personal rights or options will be lost, unlike the situation where a transaction proceeds by way of a share sale (because the company being acquired remains the tenant).

Due diligence

Depending on timescales, a full investigation of title may be carried out (in both asset sales and share sales). The buyer can limit its risk and the scope of investigations by insisting that the seller gives comprehensive property warranties or indemnities instead. Also, the buyer may insist upon the seller providing a certificate of title.

Certificate of title

If the seller's solicitor is to supply a certificate of title, it will confirm that, subject to any problems outlined in that certificate, the title to the properties is good and marketable. The seller will also be asked to warrant that its contents are true and accurate.

Taxation and registration

Where the properties are to be transferred on completion, a transfer deed will be completed. Both a new lease and a property transfer are likely to give rise to a stamp duty land tax liability which must be paid before the transaction can be registered at HM Land Registry.

How should the asset sale agreement deal with the properties?

The properties must be specifically referred to in the agreement as assets to be transferred to the buyer on completion. The provisions of the agreement largely reflect those used in a standard property transaction but there will also be some special conditions set out which deal with the properties, covering:

1. The agreed form of assignment, or transfer (including any indemnities to be provided).

2. If leasehold properties are involved, provisions covering landlord's consent to assignment and what happens where consent is not obtained. It is common for the business sale to be conditional upon the landlord giving any necessary consents for the transfer of leases and for both buyer and seller to agree to use all reasonable endeavours to obtain such consents. If consent is not granted, then the buyer and the seller should be given the option to rescind the sale agreement.

3. Apportionments of rent and other outgoings.

4. The granting of any leases or licences required.

5. How the properties are dealt with between exchange and completion.

6. The assignment of third-party contracts.

7. The tax treatment, for example if the sale is a transfer of going concern and therefore VAT is not chargeable.

Pitfalls

For landlords, giving a tenant consent to assign a lease is a low priority matter whereas for the seller (and the buyer) getting that consent may be crucial to allow the business sale to go ahead. Therefore, like all third parties whose consent is needed, landlords should be approached at the earliest opportunity.

7. Warranties

A warranty is a contractual statement or assurance/promise that a certain state of affairs exists about the company and its business or assets. Warranties are particularly important in share sales and are given by the sellers (shareholders) in the sale agreement to provide protection for the buyer against the risk of unknown liabilities. They aim to give a snapshot of the target company as at exchange and completion of the sale agreement.

In asset sales, because buyers can to a great extent pick and choose what assets they buy and what liabilities they assume, warranties are somewhat less important and certainly less extensive. Accordingly, for the purposes of this section, we shall mainly concentrate on warranties in the context of a share sale.

Warranties in share purchase agreements can be extensive (often running to 30+ pages) and are likely to cover all aspects of the shares, the target company and the business. For example, there may be warranties on:

- The ownership of the shares
- The legal structure and administration of Commercial contracts the company
- The accounts and finances of the company
- Property owned by the company
- Employees and their pensions
- Environmental matters
- Insurance
- Intellectual property
- IT
- Tax

The buyer should expect the seller to expand on each of the above points with differing degrees of detail.

The purpose and effect of warranties.

Warranties aim to allocate risk and liability between the seller and buyer. Specifically, they:

1. Encourage sellers to make disclosures against the warranties to avoid the risk of being claimed against at a later date.
2. Allow buyers to find out information about the target company through disclosure that will enable them to decide whether to enter into the share sale transaction or look to renegotiate the price if something onerous about the company comes to light.
3. Provide buyers with a mechanism (a warranty claim) to adjust the consideration for the shares after completion to what it should have been at completion if the parties had known all the relevant facts at that time.
4. Enable the buyer to seek further protection by way of indemnities for known liabilities or, in extreme circumstances, withdraw from the acquisition.

Encourage sellers to make disclosures

Allow buyers to find information

Provide mechanism for warranty claim

Enable buyer to seek indemnities or withdraw

Remedies for breach of warranty

If a warranty is found to be inaccurate, untrue or misleading and as a result the value of the target company is reduced or the buyer otherwise suffers some loss, the buyer can claim contractual damages to the extent that it can prove loss resulting from the breach of warranty. The buyer's remedy for breach of warranty will be in damages, unless the agreement specifically allows the buyer to terminate the agreement.

Measure of damages for breach of warranty

Under contract, damages for a breach of warranty will put the buyers in the position they would have been in if the warranty had not been untrue. In a share sale, the amount of damages will usually be the difference in the market value of the shares with and without the breach of warranty, which is usually the purchase price paid by the buyer. This will depend on a number of factors, such as the type of business acquired, which warranty has been breached and the basis on which the purchase price was calculated. However, this can only be for an amount that is considered as fair and reasonable to arise naturally. The case of Hadley v Baxendale sets out the principle for the amount of damages recoverable for a breach of contract, known as the principle of remoteness of damage.

However, buyers ought to be aware that making a warranty claim is by no means straightforward and the sale agreement will usually contain detailed provisions as to how such claims are to be conducted and how damages are to be measured.
A simple example of a warranty that the seller might give in relation to the target company is:

'The Company is not engaged in any litigation, arbitration, mediation, dispute resolution or criminal proceedings and there are no such proceedings pending, threatened or expected, either by or against the Company'.

If this is a true, accurate and not misleading statement at the time at which it is given, the warranty simply acts to provide comfort to the buyers on the matter, given that otherwise the seller would be in breach of warranty and liable to be claimed against by the buyers.

If the warranty were to turn out to be untrue, e.g., a former employee has taken the target company to an Employment Tribunal claiming damages for unfair dismissal, then the buyer (depending on the precise wording of the sale agreement) could claim against the seller for diminution in value of the shares as a result of the Tribunal claim or the costs of that Tribunal action and any damages payable to the employee.

To mitigate against that risk, the sellers could disclose the Tribunal claim to the buyer and then the parties can assess the risk and agree a price adjustment to reflect it (before completion of the deal).

This is a very simplified example and actually claiming under the warranties is not straightforward with the onus on the buyer to prove breach, causation, loss and quantum of damages.

Reducing the seller's risk of claims under the warranties

Although in the first instance the warranties will be drafted by the buyers' solicitors, they will be heavily negotiated and in most transactions the seller will:

1. Seek to have certain warranties deleted from the agreement. This is likely to be unacceptable to the buyer as they will then have no comfort or protection in relation to the matters covered in the warranties.

2. Negotiate an amendment to the wording of the warranty. A buyer is likely to resist such 'watering-down' of the warranties, as there is generally a preference that these remain clear and that any disclosures be made in the disclosure letter.

3. Disclose details of the facts and circumstances that make the warranty untrue in the disclosure letter (see section 8 of this guide). This will limit the liability of the seller as no warranty claim can generally be made by a buyer in relation to a matter that is sufficiently disclosed in a disclosure letter.

4. Ensure that the sale agreement contains "limitations on warranties" (sometimes known as "seller protection").

Limitations on warranties

It is standard practice to agree certain limitations on sellers' liabilities under the warranties and the most common are as follows:

1. Time limits: the buyer must make any claims under the warranties within a certain period of time following completion (1 to 3 years is common although for tax related claims 7 years is usual).

2. Individual de minimis: this means that any claims under a certain (low) amount are disregarded for all purposes. Depending on the size of the deal anything up to 0.1% might be negotiated. As a very rough guide, on a deal for up to £1 million, £500 to £1,000 might be agreed.

3. Aggregate de minimis: this means that until the total amount of claims exceeds a certain amount, no claims can be made. As a rough guide again, on a deal up to £1 million this might be up to 1% (£5,000 to £10,000 might be agreed). Once this threshold is breached it is usual for the whole amount to be capable of being claimed rather than just the excess.

4. Overall limit: it is usual to limit the total amount claimed to the purchase price.

5. Exclude "double counting": meaning the buyer can only recover once for the same loss (even though the same event may be a breach of several warranties or other provisions of the sale agreement).

6. Knowledge: where the buyers have knowledge of the breach or the circumstances in question prior to completion then they cannot claim. At first sight this seems reasonable but is in fact controversial and usually hotly contested during negotiations. For a more detailed explanation please see section 8 (Disclosure Letter) of this guide.

8. Disclosure letter

The disclosure letter is an important safeguard for sellers because, if properly prepared, it reduces the seller's risk of warranty claims. It is important to understand the nature and scope of the disclosure exercise by a seller in connection with the sale of shares in a company or the sale of the company's business and assets (the target). The disclosure process is a fundamental part of the sale transaction, and the parties should not underestimate the time and resources required to carry it out effectively.

Within the sale agreement sellers will be required to give warranties to the buyer (see section 7 (Warranties) of this guide). Sellers need to review each warranty in detail with their advisers and consider what disclosures they need to make against each warranty, as inadequate disclosures may mean that the sellers are exposing themselves to breach of warranty claims.

Many warranties are "standard" but others will be specific to the transaction and may arise because of information gathered by the buyer during its due diligence (please see section 3 (Due diligence) of this guide).

The seller's solicitors co-ordinate the disclosure exercise and draft the disclosure letter in conjunction with the seller and its management team. This can be a time-consuming process.

The disclosure exercise is usually started early on in the transaction and is carried on at the same time as the sale agreement is negotiated. Often buyers raise additional queries arising from the disclosures, and so both due diligence and disclosure may continue up until the sale agreement is signed and completed.

The purposes of disclosure

The disclosure exercise and the disclosure letter have two main purposes:

1. Limiting the seller's liability

The seller gives warranties to the buyer in the sale agreement. Warranties are contractual promises: statements or assurances concerning various aspects of the target's business, assets and liabilities. Should a warranty prove to be untrue, this will give rise to a claim for breach of warranty entitling the buyer to claim damages against the seller.

The way that the disclosure process is linked to liability under the warranties is that in the sale agreement it will state that the seller will not be liable for warranty claims to the extent that the matters or circumstances constituting the breach are disclosed in the disclosure.

Where, for example, the seller gives a warranty that the target is not involved in litigation, the disclosure letter will set out details of any litigation in which the target is involved. If the buyer accepts this disclosure, such disclosure will operate to exclude the seller from liability under the warranty to the extent that the matter has been disclosed in the disclosure letter.

2. Extracting information and price adjustment

From the buyer's perspective, the disclosure exercise aims to extract disclosure of information related to the warranties before the transaction is completed. This information may or may not have been provided to the buyer during due diligence.

Disclosure is important as it enables the buyer to renegotiate and adjust the price before completion, to restructure the transaction and to consider other specific protections (such as including indemnities in the sale agreement to transfer risk for specific matters to the seller). In extreme cases, if information disclosed raises serious concerns, the buyer may withdraw from the transaction. The warranties also provide the buyer with a mechanism to adjust the price after completion if unknown liabilities arise and the buyer suffers loss.

The disclosure letter

The disclosures are set out in the disclosure letter, which is a letter written by the seller (or sometimes the seller's solicitors) to the buyer. The draft disclosure letter will be continually updated throughout the transaction.

Most importantly for sellers, the disclosure qualifies their liability under the warranties.

Certain basic matters will always be generally disclosed, including information that is in the public domain or available from an inspection or search of public registers (for example at Companies House or the Land Registry) or the target's statutory books (in the case of a share purchase). The seller may also try to generally disclose information contained or referred to in the target's audited accounts and management accounts, information in the virtual data room and information and correspondence provided to the buyer's advisers. The seller's first draft will usually include very wide general disclosures and these will be subject to robust negotiation.

The disclosure letter will then set out disclosures against specific warranties in the sale agreement (specific disclosures). These are matters that, if not disclosed, could constitute a breach of warranty.

The sale agreement will state the seller will not be liable to the extent that the matter giving rise to the warranty claim is disclosed in the disclosure letter.

It is important to note that, in nearly all cases, the disclosures only qualify the warranties and do not qualify the tax covenant or any specific indemnities.

The specific disclosures will cross-reference specific documents (provided to the buyer in due diligence) and, therefore, copies of those documents should be available with the disclosure letter. As virtual data rooms are more commonly used, this will be in electronic format eg, a USB. It is crucial for the seller to keep an accurate record of everything supplied to the buyer and its advisers during the due diligence and disclosure process (see part 3 (Due diligence) of this guide).

Standard of disclosure

The buyer and the seller will need to agree a "standard" of disclosure. This will vary from transaction to transaction, but some common agreed standards being 'full and accurate', 'full, accurate and specific', 'fair' or simply that the matters are 'disclosed' against the warranties. A common compromise is for **disclosure** to be 'fair'. To be effective (in qualifying the warranties) the disclosure must meet this "standard".

"Fair" disclosure (or "fairly" disclosed)

"Fair" disclosure will normally be defined in the sale agreement (e.g. 'with sufficient detail to identify the nature and scope of the matter disclosed').

The scope of the definition of "fair" has been considered in a number of court cases and will depend on the circumstances of the transaction. Generally, "fair" means disclosure that is:

1. Given in sufficient detail to identify the nature and scope of the matter disclosed, to enable the buyer to form a view whether to exercise any of the rights conferred on the buyer by the contract;
2. Full, clear and unambiguous so as to effectively bring the potential breach of warranty to the attention of the buyer; and
3. Sufficiently precise, so that it is fairly and clearly apparent from the disclosure that it would qualify the particular warranty.

Courts do not look favourably upon "deemed" disclosures of all matters 'set out or referred to' in the disclosure letter. Mere reference to a generic source of information is not fair disclosure, especially when the information is complex and would require the buyer to look through that information to determine its relevance as against the relevant warranty being disclosed against.

However, provided that the disclosure is adequate and made in accordance with the standard agreed in the sale agreement, the seller can avoid liability to the buyer for breach of warranty.

Buyer knowledge

Buyers normally include a clause within the sale agreement to the effect that, subject to matters disclosed in the disclosure letter, the buyer's knowledge of a matter (whether actual, constructive or imputed) that could give rise to a warranty claim will not affect its ability to bring a warranty claim, ie, the buyer's knowledge is disregarded. Such a clause will typically be objected to by a seller. However, at WSP our experience is that most buyers insist upon such a clause, and this is reasonable. Our reasoning is that the sale agreement will also usually have a clause stating that the buyers are only able to rely on the warranties (and not any other information they may have been provided with or found by themselves). Then the respective positions of the buyer and seller are clear: (a) the buyer is relying solely on the warranties in the sale agreement subject to the disclosures in the disclosure letter and (b) the seller is liable only for the warranties in the sale agreement (as qualified by the disclosure letter). So, no extraneous knowledge, documentation or "he said/she said" needs to be considered and the parties' rights and liabilities are neatly and clearly set out in writing in the sale agreement and the disclosure letter.

Deliberate non-disclosure

Occasionally sellers may be reluctant to make a disclosure because they fear that it will be a “red flag” to the buyer who may withdraw from the transaction or seek to reduce the purchase price. The sellers may calculate that disclosure will automatically cause them loss (in the form of a reduced purchase price) whereas if they do not make the disclosure they may “get away with it”, e.g., if the buyer does not become aware of the matter until after the end of the warranty period (the time limit, usually between 1 and 3 years, during which any claims for breach of warranty must be made).

However, the risks of such an approach are great:

1. The sellers may incur criminal liability under section 8 of the Financial Services Act 2012 for making a misleading statement (the criminal act being to dishonestly conceal material facts in connection with a statement made by them, where the statement is made with the intention of inducing another person to enter into the relevant agreement);

2. The sale agreement usually states that limitations on warranty claims, e.g., time limits, financial limits, etc. (see part 7 (Warranties) of this guide) will not apply where there is fraud, dishonesty or wilful concealment and, therefore, not only may the sellers be liable for a breach of warranty they will lose the benefit of those limitations and so may end up paying more in damages; and

3. If there is an ongoing relationship between buyer and seller, e.g., an earn-out or the seller continuing to work in the business, such relationship is likely to be undermined, perhaps terminally by the dishonest non-disclosure.

In asset sales, where the buyers can, to a large extent, pick and choose which assets they want to buy and which liabilities they are prepared to assume, the number and scope of warranties is usually far less than in a share sale and it therefore follows that the disclosure exercise is less intensive. Indeed, in many asset sales there will not be a disclosure letter at all.

9. Taxation matters

In share sales, ownership of the target company owning the target business is transferred to the buyer. Unlike an asset sale, the target company retains its assets and continues to operate its business (albeit under new ownership).

There are tax advantages and disadvantages of a share sale for both parties.

IMPORTANT: WSP Solicitors does not advise on taxation matters and, therefore, what follows is a summary which is not a substitute for, and you should obtain, expert advice from a suitably qualified and experienced accountant or tax adviser.

The tax consequences of a share sale are usually less complex and onerous for a seller than those of an asset sale. **As a result, from a tax perspective, a seller will normally prefer to sell shares in a company.**

From the buyer's perspective, a share purchase will transfer the target company, complete with its tax history and its tax liabilities (including contingent and potentially unexpected liabilities). This is why a buyer should always conduct a due diligence exercise and any concerns identified should be addressed by including appropriate warranties and/or specific indemnities in the sale agreement and/or, depending on the nature and quantum of the liabilities, be reflected in the purchase price.

The main tax considerations

The key tax advantages for a seller in a share sale include a clean break from historical and ongoing responsibilities, potential tax reliefs like BADR and SSE, and the avoidance of "double taxation" that occurs in asset sales.

The main tax advantages of a share sale for the seller:

1. Disposal of the company complete with all historical and continuing. Essentially, the seller is able to “walk away” completely. The price the seller pays for passing over responsibility for the company's history to the buyer is, subject to the relative negotiating power of the parties, the provision of enhanced contractual protection for the buyer in the form of tax warranties and a tax covenant.

2. The availability of business asset disposal relief (formerly entrepreneurs’ relief) (“BADR”) for individuals selling or, if the seller is a company (“corporate seller”), the substantial shareholdings exemption (“SSE”). Share sales are especially attractive to corporate sellers where the conditions for the SSE are satisfied as any gain realised on the sale of the shares will be exempt from corporation tax on chargeable gains. There is no equivalent exemption for the disposal of assets (and, in addition, the disposal of individual assets can trigger balancing charges for the seller where the level of capital allowances claimed prior to the sale result in the tax written down value of the relevant asset being lower than the consideration received on sale). Although the principle underlying SSE is relatively simple, the rules are complex and the conditions can be easily failed inadvertently. Care and vigilance is required, in order to ensure that the SSE will be available on an anticipated sale of shares. Where there is any doubt, it may still be possible to avoid immediate tax charges arising on the sale by deferring any gain through structuring the deal as a reconstruction (eg, selling the shares in exchange for shares issued by the buyer) because where the applicable conditions are met, the gain on disposal is rolled into the new shares in the buyer which have been acquired with the result that the tax charge is deferred until those new shares are themselves sold.

3. For individual sellers, BADR may be available to reduce the tax liability arising on the disposal (by applying a 10% rate of capital gains tax ("CGT") to certain qualifying gains subject to a lifetime maximum limit of gains of £1m) provided certain conditions are satisfied. A brief summary of BADR is set out below.

4. No "double taxation". The sale of shares means that any tax charges will arise only at the shareholder level (ie, the owners of the target who are selling their shares). In the case of a corporate seller which is entitled to the SSE, no tax liability will arise. In contrast, in an asset sale (where the company disposes of its business and assets), the company will be taxed according to its own circumstances **and** the net proceeds will then need to be extracted from the company to the shareholders (eg, by way of a dividend) which may, subject to their personal circumstances, trigger additional tax charges

However, occasionally a share sale may not be the best route for the seller. In certain circumstances, a share sale may actually be disadvantageous for a seller from a tax perspective. This is especially relevant to corporate sellers rather than individual sellers.

The main tax disadvantages of a share sale for the for seller:

1. SSE automatically applies where the conditions for it are satisfied and, where it does so apply, gains realised on a share disposal are not chargeable gains and losses realised are not allowable for tax purposes (so they cannot be used to reduce or eliminate other chargeable gains). Where a capital loss is expected to arise on the sale, therefore, the application of the SSE is likely to be disadvantageous. In comparison, losses realised on the sale of assets will be allowable for tax purposes. Also, if the assets' tax written down value (accounting for the amount of capital allowances claimed) exceeds the price obtained for their sale, balancing allowances may be available.

2. De-grouping charges. Where capital assets have been moved intra-group on a tax neutral basis within a period of six years prior to the share sale, de-grouping charges may arise which will increase the gain (or reduce the loss) realised on the sale. Where the SSE is not available, the seller's tax charge triggered by the sale will be increased.

3. Clawback of Stamp Duty Land Tax or group reliefs. Where such reliefs have been claimed within the seller group within a period of three years prior to the share sale, the relief can be withdrawn retrospectively, so that the tax relieved is clawed back as a result of the company being sold out of the seller's group.

Business Asset Disposal Relief ("BADR")

This is the most commonly used relief against CGT by individual sellers. In very basis terms:

Asset sale: if you are selling all or part of your business, to qualify for relief, both of the following must apply for at least 2 years up to the date you sell your business:

1. You are a sole trader or business partner; and
2. You have owned the business for at least 2 years.

The same conditions apply if you are closing your business instead. You must also dispose of your business assets within 3 years of closure to qualify for relief.

Share sale: if you are selling shares, to qualify, the following must apply for at least 2 years up to the date you sell your shares:

1. You are an employee or director/company secretary of the company (or one in the same group);
2. The company's main activities are in trading (rather than non-trading activities like investment) or it is the holding company of a trading group;
3. The business must be a 'personal company'. This means that you have at least 5% of both the shares and the voting rights;
4. You must also be entitled to at least 5% of either (a) the profits that are available for distribution and assets on winding up the company or (b) disposal proceeds if the company is sold.
5. If the number of shares you hold falls below 5% because the company has issued more shares, you may still be able to claim BADR. You need to choose or 'elect' to be treated as if you had sold and re-bought your shares immediately before the new shares were issued. This will create a gain on which you can claim Business Asset Disposal Relief.

IMPORTANT: WSP does not advise on taxation matters and, therefore, the above summary of BADR is not a substitute for, and you should obtain, expert advice from a suitably qualified and experienced accountant or tax adviser.

Tax warranties

1. are statements of fact made by a "warrantor" (usually the seller) to a buyer about the state and condition of the target company's tax affairs as at a specified date;

2. extract further information via warrantor disclosure against the tax warranties and so support the buyer's due diligence;

3. give protection (subject to applicable exclusions) against both unknown tax liabilities of the target company relating to periods before the sale and post-completion tax liabilities of the target company (to the extent not covered by the tax covenant) caused by pre-completion events.

The seller can eliminate its liability under warranties by making full disclosure against them.

The buyer is required to prove and mitigate any loss which is the subject of a tax warranty claim.

For further information on warranties please see section 7 (Warranties) of this guide.

Stamp duty

A sale of shares in a UK registered unlisted company will usually be recorded by a stock transfer form ("STF"). The STF (and not the sale agreement) will attract a charge to stamp duty of 0.5% of the value of the consideration paid rounded up to the nearest £5 (unless an exemption or relief applies).
A transfer of shares held in uncertificated form (eg, CREST) is paperless but will, instead of stamp duty, attract Stamp Duty Reserve Tax also at 0.5% of the consideration, but rounded up to the nearest penny (unless an exemption or relief applies).

Tax covenant

1. is a contractual promise by the seller to pay to the buyer (subject to agreed exclusions) an amount equal to any tax liability of the target company (or its group) covered by the tax covenant; and

2. allocates liability for any unexpected tax liabilities arising in the target company (or group) by making the seller liable (subject to exclusions) for those tax liabilities occurring (or treated as occurring) on or prior to a specified date, with the buyer then being responsible for the period following such date.

It is usually faster and easier to make a claim in respect of a tax liability under the tax covenant than under the tax warranties.

10. Ancillary documents

In addition to the asset or share sale agreement and disclosure letter, a number of 'ancillary' documents may be required to be prepared and negotiated, depending on the particular circumstances of the transaction. The scope of ancillaries can be small for a more straightforward asset sale transaction but, if you have complex share sale transaction, the number of ancillaries can be significant. So, when the big day arrives and everyone is ready to complete the deal, these ancillary documents will need to have been drafted (invariably by the buyer's solicitors) and be in agreed form.

Asset sale ancillary documents

Examples of ancillary documents in an asset sale include:

Novation or assignment of key contracts

Novation is a mechanism where the seller transfers all its obligations and rights under a contract to a third party, usually through a deed drafted to allow the benefit of a contract to be passed to the buyer. The original contract is extinguished and a new one is formed between the buyer and the remaining party to the original contract. So, if the business being acquired has a key customer on a long term contract, the buyer may want that contract novated to itself to ensure that it continues. An assignment is slightly different in that only the benefits of the contract are passed to the buyer and so the seller remains liable under the contract to the customer.

New employment contracts for key employees

The buyer may be required to draft formal agreements for new employees being brought into the business in senior positions, such as the seller may be employed or contracted for a certain amount of time for smooth transition of the business or a new employee hired by the buyer or, more likely, an existing key employee. The buyer will often be worried that the change of ownership will trigger senior employees to reflect on their own position, especially if they have concerns about their "new boss". So the buyer may seek to enhance such employees' remuneration package to incentivise them to stay and also seek to include "restrictive covenants" in their new contract of employment to limit such employees' ability to leave, set up in competition and perhaps poach customers and other employees.

Assignments of leases

It is common for the seller's business premises to be leased and so the buyers will want the lease assigned to them. Most leases contain a prohibition against such an assignment without the landlord's prior consent which usually comes with strings attached: the landlord's solicitors' costs are to be paid (usually by the current tenant (the seller)) and, if the buyer is a limited company and is less financially strong than the sellers, the landlord may require personal guarantees from the buyer's director. Please refer to section 6 (Property) of this guide for more details.

Board minutes

Where the buyer and/or the seller is a limited company, it is advisable to have minutes of a meeting of its directors (a board meeting) whereby the relevant company is authorised by its directors to enter into the transaction.

Share sale ancillary documents

Examples of ancillary documents in a share sale include:

Board minutes and member resolution

As for an asset sale it is advisable to have minutes of a board meeting to authorise entering into the transaction. In addition the target company must have a board meeting too. The target company's board minutes are a key document as they will describe, in the correct order, all the actions to formally effect completion of the transaction, approve the transfers of the shares from sellers to buyers and approve the buyers as the new shareholders of the target company. Other matters to be recorded in such minutes would be the resignation and appointment of directors, the adoption of new articles of association by the target company, change of registered office address and change of bank.

In more complex transactions there can be many other actions to take and record, e.g., a pre-completion dividend, restructuring the share capital of the target company and entering into a shareholder agreement and/or making a loan or post-completion dividend from the target to the buyer (perhaps to fund the purchase). These actions may in turn give rise to the need for shareholder resolutions to approve them and filings at Companies House.

Stock transfer forms.

A pre-printed standard form used to record the transfer shares in a company from an existing shareholder to a shareholder. The transferring shareholder fills in and signs the form to complete the share transfer. A stock transfer form should include the details of the buyer and seller, the number and type of shares being transferred, the agreed price and the date of the transfer. Stamp duty at 0.5% of the price (if over £1,000) is payable by the buyer within 30 days of completion. The completion of a stock transfer form has the effect of transferring the beneficial ownership of the shares to the buyer. Beneficial ownership is rather like the beneficiary under a trust. However, legal ownership of the shares (including the right to vote and received dividends in respect of the shares) does not pass to the buyer until the stamp duty is paid and the buyer is entered into the register of members within the statutory books of the target company. Therefore, while stamp duty is being dealt with there can be a delay. This gives rise to the need for the next document.

A power of attorney from the seller in favour of the buyer pending registration.

A power of attorney is granted by a selling shareholder to the buyer to enable it to control the rights attaching to the sale shares pending formal registration of the transfer and the buyer being entered into the register of members. This is because, until the buyers are registered as the new shareholders (which may take a few weeks), they cannot vote or receive dividends. Any delay may be problematic if, for example, a dividend is required to be paid immediately after completion. The power of attorney provides that the buyer can indeed vote and receive dividends despite not yet being the legal owner of the shares.

Indemnity for lost share certificate

In many cases the sellers have lost their share certificates (or were never issued with one) so buyers will require an indemnity in the form of a signed statement from the relevant seller. The purpose of a lost share certificate indemnity is to protect the buyer from any loss arising from the use or misuse of the original certificate if it is recovered although this is very unlikely with unlisted companies.

Shareholder resolutions

Often the buyer will want to amend the articles of association of the target company or even change its name. Although these matters will be recorded in the board minutes, they need to be approved by the shareholders and, therefore, resolutions of the shareholders will be required.

Target officers' resignations

If the sellers are exiting the business either as employees or directors, they will be required to resign from any employment and/or directorship they currently hold. This can be in the form of a directors' resignation letter or an employee resignation letter. Sometimes, the buyers will want to go further and have the sellers enter into formal settlement agreements to prevent the sellers claiming wrongful or unfair dismissal. Such agreements guarantee the buyers protection against such claims but do require the sellers to take independent legal advice and have the agreement countersigned by a solicitor which will delay the transaction and add costs. This is a complex area of law and each case must be decided upon its own particular facts.

Statutory Books

The target company's statutory books must be updated so to correctly record the transfer of the shares and the new shareholders, directors and person(s) with significant control (PSCs).

Companies House forms

There is no need to immediately notify Companies House when a share transfer takes place. This information can be updated when the target company's next confirmation statement is due. However, changes to the PSC register and new directors must be reported separately, on the relevant Companies House forms as soon as possible and in any event before the next confirmation statement is filed. Filings can generally be done online provided you have the target company's online filing code.
In addition, certain shareholder resolutions and any new articles of association will need to be filed.

Signing powers of attorney for any signatories not available at completion

There is potential for delay or even the loss of a deal where any signing party is unavailable to sign when a deal is scheduled to complete. A party may grant a power of attorney to their solicitor or another individual to allow that person to sign a document or take certain actions on their behalf. Where there are many parties who are not all local then a power of attorney can save a lot of time. In addition, an increasing number of transactions are completed by parties signing remotely using electronic signatures.

Tax covenant

Please refer to section 9 (Tax matters) of this guide.

Other ancillary documents

Release of charges

A deed of release is typically required by the buyer to ensure that certain obligations and liabilities owed by a target company or a seller which is a limited company to a lender (eg, to a bank under a loan agreement, debenture or mortgage) are irrevocably and unconditionally discharged and any security provided for those obligations and liabilities is released.

Press and trade announcements

Usually, a written statement on the change of ownership is sent out to the customers, suppliers, media contacts and trade contacts of the business. The document usually covers the name of the parties involved, pivotal details about the deal and the effect the acquisition is expected to have on the business goals and strategy. This can be a good opportunity to allay any customer or supplier concerns and to promote the business.

Completion statements

The solicitors for each party will prepare a statement setting out the completion date and an account of all money paid and received and professional fees. Such a statement will often be needed (perhaps years later) for taxation purposes, eg, to evidence the price paid for the shares to calculate future capital gains tax liabilities.

Completion & post-completion

Completion

So, the big day has arrived and the sale and purchase agreement and all ancillary documents (please see section 10 (Ancillary documents) of this guide) have been agreed and final "execution" copies are ready for signing, dating and completing.
Sometimes the buyer's solicitor will have prepared a list of documents and/or a completion agenda listing everything that needs to be signed and done on the completion date.

Completion mechanics

Most importantly the exact "mechanics" of completion will have been agreed. When acting for sellers, WSP prefers to receive the purchase money during the morning of completion. This is because if there is any delay in getting everything signed during banking hours, we have the money in our client account rather than having to wait overnight for the buyer's solicitors to send it to us which can make clients nervous!
We will have given a written undertaking to the buyer's solicitors to hold the money to their order and to return it to them upon demand (in the event that completion does not take place).

Once all the documents are signed (which can be a lengthy process) the buyer's solicitors will want time to check that they have everything properly signed and witnessed as appropriate. Just as we will be holding the money to their order, the buyer's solicitors will be holding the signed documents to our order.
Once the buyer's solicitors are satisfied that they have everything, there will be a telephone call between the solicitors (clients sometimes join the call but not always) and agree to formally complete the transaction. Then the seller's solicitors release the signed documents which the buyer's solicitors date and the buyer's solicitors formally release the purchase money to the seller's solicitors. These actions are invariably confirmed via email.

The seller's solicitors will then send the sale proceeds to the seller(s) usually less their fees.

Face-to-face completion meetings are a rarity nowadays and completions are usually done over the telephone and documents are increasingly electronically signed remotely.

Transferring money

Payments are almost invariably made online and, therefore, it is essential to ensure that this is a secure process. It is important to know that email is not secure and there are numerous cases where the email accounts of solicitors and their clients have been hacked and false bank account details have been sent. Therefore, WSP follows strict procedures to minimise the risk of fraud and other loss.

Any solicitors' bank account details that we receive will be verified. This might be by calling the solicitors and speaking with their accounts department (ensuring the telephone number is genuine by checking it matches the number we have been using throughout the transaction, on the solicitors' website and via The Law Society). Where we have had previous dealings with the solicitors we will also be able to check via our existing records.

We also want to safely send the net sale proceeds to our clients so early on in the transaction we will have verified our clients' bank details via post (then verified by telephone) or in a face-to-face meeting. These details are also checked internally by our accounts department and then by a senior colleague within WSP but unconnected to the transaction.

Post-completion

Both the buyer's and the seller's solicitors will provide their clients with a final completion statement (see section 10 (Ancillary documents) of this guide).

Buyer's solicitors

For the buyer's solicitors there will invariably be a lot of post-completion actions to undertake as follows.

Filings at Companies House

On a share sale there will various filings at Companies House to be made, eg, the resignation and appointment of directors, change of registered office address, notification of a change in the person(s) with significant control (PSCs), resolutions (eg, to adopt new articles of association), etc. These often have prescribed time limits although Companies House does not (currently) impose fines for late filings. Most filings can be done online provided that the buyer has the target company's online authorisation code.

Stamp duty

Stamp duty is payable on the stock transfer forms at the rate of 0.5% (rounded up to the nearest whole £5). This must be done within 30 days of completion. HMRC does impose penalties for late filings. Stamp duty can be dealt with online.

Bibles

It also falls to the buyer's solicitors to produce copies of the signed documentation (known as "bibles"). These can be incredibly useful to refer to post-completion, eg, in the unfortunate event that there is a warranty claim.

Post-completion transactions

Sometimes the buyers will want to make various changes to the target company and it is common to do this immediately after completion. A common action is that the buyers will want the business and assets of the target company to be transferred ("hived") up to a holding company or across to another company in the same group of companies.

There may also be a post-completion dividend paid up to a corporate buyer.

Buyers and sellers

Often the parties have had discussions about how best to announce the transaction and this may be by a pre-agreed press release and announcements to customers, suppliers and employees. With employees it is often best that such announcements are first made face-to-face (where practical) with both the buyer and the seller present to demonstrate continuity and to be available to answer questions. Often a change of ownership can be very worrying for employees who may fear changes to working practices or even redundancies.

Completion accounts

In most share sales (and occasionally in asset sales) there will be some form of price adjustment mechanism (please see section 5 (Price adjustments in share sales) of this guide).

Depending on what has been agreed under the terms of the sale agreement, one of the parties will prepare draft completion accounts within a certain time following completion (usually within about 90 days) and submit them to the other party who will have a period of time to either agree with them or raise objections to them. Our experience at WSP is that although this process has the potential to be contentious, it rarely is. If the parties cannot agree the completion accounts then the sale agreement will usually provide for an independent accountant to determine them.

Once agreed or otherwise determined, the seller will pay any extra consideration due to the buyer or the buyer will refund part of the consideration already paid (as the case may be).

Congratulations!

The sale process is potentially complex and often stressful but once completed is a worthy achievement and congratulations are in order.

Buying or selling a business is often a life changing experience and there are many potential pitfalls. Which is why it is crucial to be guided throughout the process by solicitors who are not only skilled and experienced but who also genuinely care about you and your business.

At WSP we care about and value every client and every business. We genuinely believe in the power of business and business people to create value, provide much needed goods and services, create jobs, contribute to the economy, environment and local community and pay taxes to fund the public services that we all rely upon. For these reasons we are proud to have acted for numerous business owners buying and selling businesses.

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