Considerations in buying or selling a business

This is the third in a series of articles on this subject.

Due Diligence

From a vendor's perspective, a sales process is disruptive, particularly to staff morale and continuity. During the due diligence phase, the vendor has no certainty that the deal will proceed. An "open" due diligence therefore carries with it the risk for the vendor that a prospective purchaser may withdraw from a deal subsequent to the vendor's staff already having bailed ship for fear of life under new ownership and what it may mean for them.

Likewise a prospective vendor may suffer at the hands of customers and suppliers who become unsettled. For these reasons, vendors often prefer a "closed" due diligence. How might they achieve this?

Essentially it means having a tight timetable with due diligence data stored offsite in a data room (often maintained by and at the lawyer's offices). Only once due diligence is largely complete and confirmatory responses have been given by the purchaser might the purchaser then have access to the vendor's management team. I have discussed due diligence in detail in an earlier article (see archives on my website).

Negotiating Warranties

On a share sale this is often the most difficult component of the negotiations. Caps and collars are, in my experience, the best means of managing this minefield. They are not the only limitations that a vendor should seek however. Others are:

a. for matters disclosed – usually by way of Disclosure Letter, which itself needs to be agreed;

b. Anything done by the vendor with the consent of the purchaser between signing and settlement;

c. Anything arising from a change in law after signing;

d. Anything triggered by an act, omission, transaction or arrangement of or on behalf of the purchaser.

Tax warranties usually entail a raft of specific exceptions. Please let me know if you would like further detail.

Hand in hand with warranties are the provisions dealing with bringing claims. The most important aspects here are "entitlement to contest" and a limitation period. Where a vendor accepts in writing that it is liable to indemnify the purchaser, the vendor is often granted the right to institute or defend proceedings against a third party, if a fact or circumstance gives rise to an indemnity claim by the purchaser. Often a purchaser will want to place a "reasonableness" test on this, so that the vendor may only initiate proceedings or defend them (in the name of the acquired company) where an independent legal opinion assesses the prospect as reasonable. Obviously that opinion needs to come from a suitably qualified barrister. A usual compromise is a covenant from the vendor that in the course of preparing and conducting any such proceedings, it will not do anything or make any admissions or statements which may or are likely to damage the business or commercial reputation and standing of the purchaser or the acquired company.

Regarding time limitations, a limit of anywhere from 18 months to 3 years is usual for claims not involving non-tax matters. For tax matters, the time limit usually mirrors the period within which the IRD may bring a claim. This is broadly 4 years from the end of the year of filing the relevant tax return.

Recent Experiences

Often, at least in a private setting, shareholder loans exist. These either need to be repaid (and the purchase price correspondingly reduced) or separately acquired. If acquired, the purchase price allocated to them needs to match the face value of the loans. Great care is needed to get this right; an adverse tax result will be borne by either the vendor or purchaser where it isn't.

Time and again this does not happen, and instead an amount is allocated to goodwill (unnecessarily).

Recently I have encountered problems with the interim period between the unconditional date and settlement. A purchaser will want safeguards against the vendor taking steps during this interim period that may undermine trading. A vendor on the other hand will want unfettered control, particularly if the final price depends on performance during that period.

In a recent example, the purchaser would not accept this. Instead the purchaser required full control, including over the target company's bank account. To accommodate this an interim management agreement was put in place. This provided its own mechanism to calculate profit during the period and a wash up on settlement.

Purchasers of shares need to take note of a recent tax change. Purchasers ignore this change at their peril and should modify the tax warranties they seek accordingly. The change concerns members of the same group of companies. The tax change means that companies in a group may become subject to a tax liability where a member of the group has previously made a loss offset. That tax liability may arise where the circumstances giving rise to the loss are subsequently reversed (this happens more often than you might think). Consequently, where a purchaser wishes to acquire shares in a company that is or has been a member of a group, the purchaser should enquire whether there have been any loss offsets in favour of the target (profit) company. A warranty should be sought to protect the purchaser against the risk of the loss offset being effectively clawed back by way of a tax assessment against the group (profit) company. The circumstances in which this might occur are detailed, but are not uncommon. Please let me know if you wish to receive details.