SPEAKMAN LAW

Issues on selling a Business

This is the first in a series of articles that will appear in my newsletters identifying discrete issues in selling a business. This article deals with pricing and retaining trade secrets.

The price is invariably the key element in any sale and purchase arrangement. Critically important therefore are the components that go to make up the price. Some thoughts on that score follow.

Agreement on price ultimately requires the purchaser to be satisfied about the vendor's predictions for future profitability. It also requires common ground as between the vendor and purchaser about the existing state of affairs of the business.

Past results are the usual barometer for future profitability. They are not definitive however. Past results are the reflection of prevailing market conditions for the vendor. A purchaser must consider the susceptibility to a change in those conditions. Obvious examples are prevailing interest and exchange rates. Other examples are the depth of competing products in the market and barriers to entry (IP protection is of great assistance here). Another, less often considered example, is the regulatory environment. Exports that are assisted by tariff exemptions in the recipient jurisdiction are susceptible to customs law changes in that jurisdiction, similarly, all businesses are affected one way or another by the local tax system, hence potential for changes in that regard need to be considered. Removal of depreciation allowances on commercial buildings is perhaps the most pronounced recent example. What might happen if limitations were similarly placed on interest deductions? Thin capitalisation rules already do that; they could very easily be extended to selected industries such as property speculation. A purchaser will need to be aware of and make their own assessment of risk in these respects.

A common method to address the risks concerning future profitability is to structure part of the purchase price as an earn out. In this way a portion of the purchase price (perhaps as much as 25%) only becomes payable if the forecasted profits hold true.

Earn outs are particularly attractive for a purchaser but are problematic for a vendor. They are problematic for a vendor because their payment becomes dependent on the purchaser not taking any actions post settlement that reduce profit during the earn out period. A purchaser might for example invest heavily in new staff. The result, in the short term, would invariably be a reduction in profit. Or the purchaser might open a new branch. Or it might reduce customer prices in order to win future business. A vendor who has agreed to part of the purchase price contingent on an earn out threshold being met will be vitally interested in all of these matters. Appropriate protections are therefore required. These can be very difficult to negotiate. They are made easier if the earn out is based on gross profit and not net profit.

Retaining trade secrets is often critical during the negotiation and due diligence phases of an agreement. A natural concern for a vendor is commercially sensitive information about the vendor's business having been given to a competitor in the course of a failed sales process. What can be done about that?

A comprehensive non-disclosure agreement (**NDA**) and robust intellectual property (trade mark) protection are obvious steps. Aside from that, staged release of key information is usual. In this way delivery of information about the business that is particularly sensitive is withheld from a prospective purchaser until the vendor is sufficiently confident of the purchaser's commitment. Possibly this might include delivery of that information post a sale and purchase agreement becoming unconditional with provision for price adjustment as necessary, based on delivery of the final information. This would be most unusual, but is feasible. Another option is a liquidated damages clause in the NDA. Such a clause might stipulate an immediate damages payment of a fixed sum for breach of the NDA. The thinking here is that the specified sum might be sufficiently high to dissuade a prospective purchaser from any act which may give hint of any breach.