



Guide to Purchasing a Business

(An Overview of the Legal Issues)

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1. Preliminary Stages

This will largely concern negotiations over price. Before getting involved in detailed discussions, you may be asked to sign a confidentiality agreement as the vendor will be disclosing sensitive information to you. You should insist on the vendor signing a "lock out" agreement which will prevent the vendor from negotiating with other potential purchasers.

You should also structure the purchase so that it achieves the best outcome for both you and the vendor. One of the most important considerations is the stamp duty land tax that will be payable on any property to be acquired. This should be considered with your financial and legal advisers.

Sometimes "asset purchases" are seen as a cleaner way of buying a Business rather than buying a company that operates a Business. When a business is acquired by means of an asset sale, the assets to be acquired and the liabilities to be assumed can be specifically identified and all other assets and liabilities of a vendor can be excluded from the sale.

2. Due Diligence and Warranties

The purpose of the information-gathering process is for you to build as complete a picture as possible of the Business and the issues which will be relevant to the acquisition such as the nature and condition of, and title to assets, transfer issues and details such as timing and regulatory consents. The Business may consist of a number and variety of different assets including tangible assets such as land, machinery, vehicles, fixtures and fittings, raw materials, stock, work in progress and office equipment and intangible assets such as the benefit of contracts, goodwill and intellectual property rights.

In particular, you should focus early in the due diligence process on the key asset or assets which you wish to acquire and ensure that title can be effectively passed. Different businesses may be based on one or a combination of key assets such as:

- ♦ Property: for example, a hotel where the key asset is the building itself
- ♦ Employees: for example, a computer consultancy business or modelling agency
- ♦ Intellectual property: for example, a computer software company, record company or literary agency where the business is composed of copyright, or a pharmaceutical company whose patents are likely to be crucial
- ♦ Customers: for example, a manufacturer for a large retail outlet
- ♦ Licence from an area or channel franchise: for example, a television or radio company with an authority:

The information-gathering process will aim to find out information on a number of "specialist" areas which may impact on the negotiation process and, in particular, on the price you are prepared to pay and the protection you wish to seek from the vendor in the form of warranties and indemnities. Due diligence is, therefore, a crucial element of your bargaining tools.

Due diligence can also help you plan the integration of the new business and identify any consents (for example, for the assignment of contracts) and ancillary documents that are necessary.

The due diligence exercise generally comprises an assessment of the financial, legal and commercial status of the Business. It is typically carried out by your financial and legal advisers in conjunction with your own personnel. Depending on the nature of the Business, the purchaser may also need to involve experts such as environmental consultants and surveyors.

3. Employment

Where a Business undertaking is transferred to a new employer, the employees of that undertaking are transferred to the new employer no matter what a sale and purchase agreement states by virtue of the Transfer of Undertakings (Protection of Employment) Regulations 2006 ("TUPE").

Therefore, under TUPE, you take on responsibility for all employees working in the Business, including responsibility for all outstanding claims they may have against the vendor.

Therefore, you should insist that the vendor gives indemnities to cover all liabilities to such employees up to the date of completion. TUPE also provides that employees being transferred must be consulted prior to a transfer. You are also under an obligation to provide certain information to the vendor prior to completion.

4. Contracts

You should seek to identify the most important contracts of the Business.

Each contract should be reviewed carefully. Some contracts may have restrictions or even prohibitions on its assignment, for example, hire purchase contracts will usually have a prohibition on an assignment and the sale of the asset on hire purchase. In such a case, the third party's consent will be required for an assignment or you will need to novate the agreement.

If a contract does not expressly prohibit or restrict assignment, the benefit of the contract (i.e. the vendor's rights under the contract) but not the burden (i.e. the vendor's obligations under the contract) may be assigned by the vendor to you without the consent of the third party.

Pending the entering into of a new agreement with the third party to the contract, it is normal that you agree to indemnify the vendor for the future performance of such contracts.

5. The Sale and Purchase Agreement

The sale and purchase agreement is traditionally drafted by the purchaser and is the key agreement which documents the agreement between the parties to sell and purchase the Business and its assets at the specified price.

The main provisions of the agreement deal with:

- (i) the sale of the Business and assets;
- (ii) the calculation of the purchase price and its payment, including deferred consideration and security for any deferred consideration;
- (iii) the apportionment of liability in respect of the Business, its contracts and general outgoings;
- (iv) the VAT aspects of the acquisition; no VAT should be payable if the acquisition is a transfer as a going concern;
- (v) the apportionment of risk in relation to the transfer of employees;
- (vi) the warranties and any limitations on them;
- (vii) the delivery of the disclosure letter;
- (viii) non-competition covenants by the vendor; and
- (ix) any agreed pension arrangements.

6. The Disclosure Process, the Questionnaire, the Warranties and the Disclosure Letter

- 6.1 The last thing you want is to have a claim against the vendor after completion. Nearly always, you will have negotiated the price before being able to carry out an extensive investigation of the Business. Before you become obliged to buy the Business, you need as much information as possible to verify the assumptions on which the price was agreed and to ensure that there are no horrors in the cupboard. Information goes to price, and most of it has to come from the vendor.
- 6.2 The disclosure process often starts with your solicitors sending out a questionnaire raising basic questions about the Business, the assets and liabilities, its properties, its contracts, its insurance arrangements, its employees, its intellectual property and its tax position. Answering the questionnaire involves a lot of work for the vendor, his accountants and solicitors.
- 6.3 There are no standard warranties, and no warranties are implied by law in the sale of a Business. It is the duty of your solicitors to ensure that full and adequate warranties are obtained and tailored to the particular deal.
- 6.4 Most clients gasp at the length of modern warranties. They find the length daunting and frustrating because of the time required to read, let alone to negotiate, the warranties. This attitude is understandable because clients

naturally have confidence in the deal they have struck and want to clinch it. Solicitors, on the other hand, are professional pessimists and assume that what can go wrong, will go wrong. Their duty is to protect the client against his own over-optimism.

- 6.5 The warranties provide a check list designed to produce information relating, for example, to the accounts of the Business, its assets and liabilities, its contracts, its employees, its properties and any litigation in which it may be involved. There is always a certain overlap between the information disclosed in answer to the questionnaire and the disclosures made in respect of the warranties.
- 6.6 Warranties have three main purposes for you:
- (i) to obtain disclosure;
 - (ii) to provide protection if some undisclosed liability arises; and
 - (iii) to shift the risk on to the vendor for unknown liabilities.
- 6.7 Let us illustrate this by considering a usual warranty - "No gratuitous payment has been made or promised in connection with the actual or proposed termination or breach of any employment.....". Suppose that the vendor has made such an agreement with employees - under TUPE, you will be responsible for this. You will obviously want to know if the vendor has granted generous termination provisions so that you may consider your potential liability to such employees.
- 6.8 You cannot claim for breach of warranty where the vendor has made a proper disclosure. The disclosure letter, which contains the disclosures, is, therefore, a crucial document.
- 6.9 Where the vendor makes an unwelcome disclosure, you will have various choices. You can accept it. You can insist on reducing the price. You can, in an extreme case, withdraw from the deal. You can, where appropriate, ask for an indemnity, which will shift the risk back to the vendor.

7. Indemnities

There are two main differences between warranties and indemnities:

- (i) You can claim under an indemnity where you knew at the time it was given that there might be a claim. You cannot sue for breach of warranty in such a case.
- (ii) Damages under an indemnity are easier to establish because an indemnity allows a specific sum to be claimed. Damages for breach of warranty are calculated by reference to the reduction in the market value of the relevant asset as a result of the liability, and, furthermore, you have a duty to mitigate loss. There is no duty to mitigate with a claim under an indemnity.

8. Limitations to Warranties and Indemnities

- 8.1 There are no standard limitations. The limitations have to be negotiated afresh for each deal.
- 8.2 There are nonetheless some usual limitations. The principal ones are:
- (i) a cap equal to the purchase price on the vendor's liability;
 - (ii) a threshold below which you cannot claim; this is usually approximately 1% of the purchase price;
 - (iii) that claims must be made within a certain period after completion.

9. Summary

After a deal the clients may find that warranties, indemnities and their limitations echo in the mind like a bad dream and think that too much time in the negotiations had been taken up discussing them. That is a mistake, because warranties and indemnities are intended to protect you against "nasties" that you would normally not have thought of and limitations and the disclosure process to protect the vendor. The happiest outcome is for the Business, after completion, to thrive and for the documents, over which there was so much struggle, to gather dust in the safe.

Appendix

List of documents normally required in the sale of shares:

Key:	Pur	:	Purchaser
	Ven	:	Vendor
	PSol	:	Solicitors to Purchaser
	VSol	:	Solicitors to Vendor
	PAcc	:	[Purchaser's Accountants]
	VAcc	:	[Vendor's Accountants]

1. Preliminary

1.1	Heads of agreement	Pur/Ven
1.2	Lock out agreement	PSol
1.3	Confidentiality undertaking	VSol
1.4	Legal due diligence questionnaire	PSol
1.5	Financial due diligence	PAcc
	◆ audited accounts	
	◆ management accounts	

2. Sale and Purchase Agreement

2.1	Agreement between Vendor and Purchaser	PSol/VSol
2.2	Ancillary documents to transfer assets, e.g. transfer of property and intellectual property rights	PSol/VSol

3. Disclosure letter

VSol

4. Obtain any consents

PSol/VSol

Contacts

If you have any queries please do not hesitate to contact a member of our dedicated team:

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