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Précis Paper

Buying and Selling Small to Medium Enterprises

A discussion of the key stages involved in buying and selling small to medium enterprises, from pre-sale through to post-sale, and what a good legal adviser needs to know, beyond simply the mechanics of drafting documents to effect sales

Discussion Includes

- Structure of a sale and purchase: share sale or asset sale?
- Structuring of a payment
- Conditions precedent
- Encumbrances
- Warranties, due diligence & indemnities
- Risk management solutions
- Guarantees, and when they are important
- What happens after completion?
- Takeaways for practitioners

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Buying and Selling Small to Medium Enterprises

1. In this edition of BenchTV, Ursula Hogben (Practice Leader, Legalvision, Sydney) and Anurag Verma (Practice Leader, Legalvision, Sydney) discuss the key stages involved in buying and selling small to medium enterprises, from pre-sale through to post-sale, and what a good legal adviser needs to know, beyond simply the mechanics of drafting documents to effect sales.

2. This discussion will cover:
   - Key elements for buying and selling small to medium size businesses
   - The structure of a sale and purchase
   - Key strategic points for practitioners
   - The different perspectives of vendor and purchaser
   - The structuring of a payment, and how it is made
   - The conditions precedent to completing a sale
   - Conduct in between signing and completing
   - Why seller or purchaser guarantees are sought
   - Risk and risk management (in particular, warranties)
   - Post-completion

<u>Structure of a sale and purchase: share sale or asset sale?</u>

3. The first thing that needs to be asked is: what exactly is the sale?

4. Sellers need to consider whether they are selling the company, or shares in the company, or selling certain assets. Similarly, purchasers need to consider what really interests them about a company (whether it be either the whole company, or its particular assets). This determines which path a purchaser or seller will go down - that is, a share sale path, or an asset sale path.

5. There is a significant difference between the share sale path and the asset sale path. Whichever path is chosen will ultimately determine everything else to follow.

Which path is more beneficial to a purchaser?

6. The answer is not crystal clear. It will depend on the commercial rationale for the acquisition. The rationale needs to be discussed with the vendor, because that will determine the purchase price.

7. The difference between the sale of a company and the sale of the assets of a company is what happens to the liabilities. When a purchaser acquires shares in a company, the purchaser is acquiring everything about that company, including its assets and its liabilities. Basically, the purchaser steps into the shoes of the former owner and continues to run the company.

8. The risk can be mitigated through the agreement of purchase and sale. Examples of potential liabilities include tax risks, workplace employee issues, and other even more common liabilities. A purchaser of assets in a company can cherry-pick those assets, and also which liabilities it will assume.

9. A purchaser will potentially pay more if it is buying 100% of a company through its shares. The calculation of the purchase price will be different if the purchaser is buying certain relationships, or acquiring the services of certain individuals.

<u>Structuring of a payment</u>

10. An important consideration relates to how the purchase price will be paid – for example, how much will be paid upfront, and how much will be paid over time.

11. The vendor needs to obtain tax advice – for example, if it is a share sale, there may be particular tax advantages and disadvantages; same goes for if it is an assets sale.

Upfront payment of the purchase price versus delayed payment of the purchase price

12. How much of the purchase price that a purchaser wants to pay upfront (that is, on the signing day) and how much of it that it wants to pay on a delayed basis, partly depends on the structure and tax advice, and partly depends on what type of business it is. This is called an 'earnout'.

13. There are some businesses where it makes sense to pay it upfront, and there are some (particularly from a purchaser's perspective) where the commercial rationale, in other words the value of the purchase, is closely tied to performance, in which case, a proportion would be paid upfront, and the rest would be paid depending on how the business is performing.

14. The purchaser wants the earnout to be based on the company's actual performance, so the purchase price set by the purchaser is based on their analysis of the business (what they think the performance of the business might in the future).

15. It is usually far more preferable to the purchaser to pay a certain amount upfront - enough to seal the deal - and pay the rest over time depending on performance, whereas a vendor would prefer to be paid in total upfront.

16. It is important to inquire into how the business makes money i.e. a bricks-and-mortar, manufacturing type business is essentially ready to go, and ready to make money, from the day of purchase, whereas a heavily professional service-based business is heavily reliant upon the employees themselves, and if those employees leave, the value of the company suffers.

17. As lawyers, it is very important to understand all these things, in order to effectively communicate with the purchaser or vendor, and by extension, accurately reflect their wishes in the drafting of the legal documentation.

18. Another important commercial consideration for the vendor is the value of the business to the purchaser, So a vendor's understanding of the potential purchaser, and what that purchaser might be able to make from the business, is crucial to the vendor's ability to maximise the sale price.

19. The earnout really helps to manage the commercial risk, and partly shift the risk back to the vendor.

<u>What happens between the signing of the contract, and its completion?</u>

20. One of the most important considerations is whether there are any conditions attached to the sale. For example, there is a period between signing and settlement, the details of which are very important to understand, because unlike a property, for example, a company is essentially a 'living creature'.

Conditions precedent

21. It is important to consider whether or not there should be a gap between the signing of the contract and completion, and if there should be a gap, whether there should also be conditions precedent to completion. For example, there may be a contract that is so material to the value of the business that the purchaser would want to ensure that it is assigned or novated across prior to completion. This forms an essential part of the purchaser's exercise in due diligence.

22. The purchaser has an interest in regulating the conduct of the vendor, and imposing restrictions upon what it can do with the company in the period between signing and completion.

23. It really becomes a dance of negotiation between the vendor and purchaser around what that final list of restrictions is going to be. The task of the lawyer is to understand the nature of the business and the relevant risks, and to translate that into conditions precedent.

Encumbrances

24. It is also important to inquire into whether or not any encumbrances exist over the assets. Encumbrances must be dealt with. An option to address encumbrances is to include a no material adverse change clause.

25. Material adverse change clauses are controversial, and most vendors do not like them. If a material adverse change clause is necessary, it must be drafted in specific relation to the business. If a vendor does not agree to a material adverse change clause (which is not unreasonable), the purchaser might impose additional restrictions upon what the vendor can do in the period between signing and completion to protect their interests.

26. So usually there will be a positive statement about conducting business in the ordinary course, but then also some qualifications around what that means. The moment conditions are introduced, a lot of complexity is brought into the structure and the document, because there are a lot of unknowns.

27. Parties sometimes prefer to just delay signing instead of having a conditions precedent regime. The difficulty with this is, however, that the unsigned purchase agreement is not a legally binding document. It is critical that lawyers advise their clients about this. Due diligence is a huge aspect of a sound business.

28. The difficulty for the vendor lies in how to, on the one hand, show how enticing the business is, and on the other, protect the business's confidential information. There are two key ways to address this difficulty, including:
    - Having strong confidentiality agreements
    - Limiting who the information goes to (e.g. it goes to the M&A team, not the sales team)

Warranties, due diligence & indemnities

29. It is not abundantly clear how due diligence interacts with warranties. In an ideal world, there would be unlimited time and money to conduct due diligence for as long as and at as much

expense as is desired, which means that there would be almost no need for any warranties, because everything would be known, and consequently, would be able to be accounted for in the purchase price.

30. Unfortunately we do not live in an ideal world, so we do the best with what we have got. The warranties effectively act as a security blanket.

31. Clients often ask: what are warranties, and why are they so important? This simple answer is: warranties are basically promises about the current state of the business. The understanding of the current state of the business is what the purchaser has based its buying decision upon.

32. Some classic warranties include:
    - That there is no litigation in the business
    - That the company actually owns the assets/shares
    - That the business is being conducted in compliance with all relevant licences and regulations
    - That the financial statements are correct
    - That the company has been paying appropriate tax

33. It is important to note that everything that a purchaser does know, arising from due diligence, is a disclosure against the warranties. In other words, any information that a purchaser becomes aware of by way of an exercise in due diligence, cannot be used by that purchaser against the vendor to claim a breach of warranty where that warranty is contrary to the information that has surfaced as a result of the exercise in due diligence. The purchaser can address this by assessing the risk, and the likelihood of it eventuating, and translating it into an indemnity.

34. So warranties, due diligence, and indemnities, all operate alongside each other. In relation to warranties and due diligence, practitioners are advised to *disclose*, because what is not disclosed, might be cause for a warranty claim, and what is disclosed (as drafted into the contract), cannot be claimed against.

35. The reality is, though, that disclosure and diligence eat up a lot of management time.

<u>Risk management solutions</u>

36. Some key risk management solutions include:

- Good thorough disclosure against all of the warranties
- Caps on what warranty claims can be

- Caps on liability under the warranties (which can be done on a time limit basis or an amount limit basis)

37. These risk management solutions are very important in helping to quantify and manage the vendor's risk. When acting for a purchaser, practitioners should push for the longest time period and the highest quantum possible (all the while knowing full well that the vendor will not agree to it).

Guarantees, and when they are important

38. A purchaser wants to know that if it were to make a claim against a vendor, the vendor actually has money. It is common to see purchasers seeking vendor guarantees, because the purchaser wants certainty that there are going to be assets available if they want to make a warranty claim.

39. Two common solutions to this are:
    - A request for personal guarantees
    - A request for the money to be escrowed

40. Choosing between the two options is deal-specific. Guarantees tend to be a very hotly-negotiated part of any transaction, because they expose someone else to a risk for which he or she might have to pay.

<u>What happens after completion?</u>

41. Some vendors leave the business straightaway; some vendors ask to stay in the business for a period of time (usually in a key position).

42. Where vendors exit the business straightaway, restraints of trade are applicable. Restraints of trade are also hotly-negotiated. Restraints of trade do not always necessarily apply to only people, they can also apply to the vendor itself as a company.

43. Practitioners have to draft restraints of trade with great precision, in order to ensure that they are firstly enforceable, and secondly, actually mean something. Whether or not a restraint is reasonable is very fact-specific.

Takeaways for practitioners

44. The important theme that underlies the entire process, from pre-sale (structuring the sale as either a share sale or an asset sale), through to post-sale (restraints of trade), is that the legal adviser needs to know a lot more than simply how to draft the document to effect the sale.

45. A good legal adviser:

- *Really* understands the commercial rationale behind the sale, and what the incentives of both parties are. Such understanding helps frame how the payment of the purchase price is structured, and whether or not an earnout is appropriate or applicable, and if it is appropriate, how to minimise the risk (if acting for the vendor), or how to ensure overpayment does not occur (if acting for the purchaser).
- Understands where the real risk points in the business are, and ensures that any indemnities or warranties actually hit those points (when acting for the purchaser).
- Understands what the dynamic is between the purchaser and the vendor, and is thereby able to trade points (in other words, compromise).
- Pays close heed to industry-specific considerations.

46. In sum, any legal adviser can draft documents to effect a sale. But a good legal adviser is one *who understands the commercials behind the sale*.

BIOGRAPHY

<u>Ursula Hogben</u>

Practice Leader, Legalvision, Sydney

Ursula is a Practice Leader in LegalVision's General Commercial team, and also serves as LegalVision's General Counsel. She has over 15 years' experience in corporate law and investment banking, including in Asia, the United States and Australia. Ursula has qualifications in New York, Hong Kong and Australia. Ursula uses her experience to assist startups to launch and scale, including advising on structuring, capital raising, shareholders agreements and co-founder and investor negotiations. Ursula also assists online businesses and SMEs with commercial arrangements for launch and growth. Ursula is active in startup and SME communities, including as a member of industry panels, as a presenter, and writing for national business and startup publications.

<u>Anurag Verma</u>

Practice Leader, Legalvision, Sydney

Anurag specialises in corporate advisory, from assisting startup founders and investors, to business structures, to the sale and purchase of shares. Before joining LegalVision, Anurag spent three years in the Corporate team at Linklaters London and two and a half years in the Corporate team at Allens Linklaters. He has a Masters in Law and Finance from the University of Oxford.

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