

A basic guide to the legal process

# Selling your business



# Introduction

Business founders and entrepreneurs are usually sophisticated, experienced individuals but the legal process of selling a business can still seem daunting and laden with jargon. In this briefing, we guide you through the legal process of a disposal once that initial “in principle” decision to sell has been taken and a potentially-interested buyer found.

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We use them for everything and think there is no better alternative. They understand their clients incredibly well.

- Client quote, Chambers UK, 2019

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# 1. Share Sale or Asset Sale?

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The disposal of any business will be structured either:

- as a share sale, where the Seller disposes of their shares in the corporate entity (which may be a Ltd or LLP), or
- as an asset sale, where the corporate entity itself will be the Seller of the business and assets that it holds.

Your legal advisers will assist you in determining which route is most appropriate (and the Buyer may well have a preference) but the principal difference is that a Buyer of shares will purchase the entire entity, including any liabilities (latent or otherwise) that sit within it. A Buyer of assets takes only those specified assets and will not usually take on any liabilities associated with the business.

The sale process is broadly similar for both types of transaction but for simplicity in this note, we generally refer to a Share Purchase Agreement (**SPA**), highlighting some key differences with a Business Purchase Agreement (**BPA**) where relevant. We also assume there is a single Seller but if there are multiple owners of the business, the process, risks and obligations that we discuss will usually apply to all them.

## 2. Key Documents

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The sale process will require the following key documents to be agreed.

### Non-Disclosure Agreement (NDA)

An NDA should always be entered into early in any negotiation process. Although the due diligence process - whereby a Buyer is provided with information relating to the Target - is controlled by the Seller, it will necessarily involve permitting access to significant amounts of sensitive and confidential information. A properly drafted NDA ensures the recipient cannot misuse that information and although the exact terms of the NDA may be negotiated, experienced purchasers will always expect to enter into one in some form or other.

### Heads of Terms

Before the detailed sale documents are drafted, the parties will usually agree a basic framework for the deal in a **Heads of Terms** document (often referred to simply as the **Heads**). Although this document may only run to two or three pages and is usually expressed to be non-binding on the parties, the Heads ensure that there is agreement in principle on all key terms of the transaction before significant time and money are invested in the full sale process. Whilst it may be tempting not to involve lawyers and accountants at this preliminary stage, the Heads are an important document that should have professional input before being signed. Tax advice at this early stage will also be important to ensure the deal framework gives the Seller the benefit of any available reliefs (such as Entrepreneurs Relief).

### SPA or BPA

This is the principal transaction document that structures the entire deal. It includes all the terms in detail and the operative parts are likely to be the subject of a significant amount of negotiation time. The SPA will also include certain **boiler plate** provisions that are not usually negotiated heavily, but which are designed to provide certainty on a variety of general legal matters (such as confirming the governing law applicable to the contract and the mechanism for determining any disputes which might arise under it). We look in more detail at the some of the principal terms of the SPA below.

### Disclosure Letter

Second only to the SPA in terms of importance (and negotiated alongside it) is the Disclosure Letter. This document is the main mechanism by which a Seller protects themselves against a **warranty** claim. It is used to “fix” the Buyer with knowledge about the Target and its business which may be inconsistent with the warranties; if a warranty given in the SPA is breached, providing the relevant matter has been fully and fairly **disclosed** to the Buyer in the Disclosure Letter, the Buyer is prevented from bringing a claim (because the Buyer has accepted that it is entering into the transaction with knowledge of the matter).

In addition to these key documents, there will be a potentially sizable suite of **ancillaries** required. This includes board minutes, shareholder resolutions, Stock Transfer Forms, Companies House filings and client communications, all of which are important to the transaction but which are not usually the subject of significant negotiation.

## 3. Timeline

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Although there can be considerable variation, where both Buyer and Seller are committed to a deal (and with a fully engaged team of supporting professionals) the process for a mid-market transaction will typically take from 6 to 8 weeks from signature of an NDA to formal execution of the deal (**Completion**).

## 4. Regulatory Consent

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One factor which can have a significant impact on the transaction timeline is the need to obtain any regulatory consent. If the business is regulated, for example, by the Financial Conduct Authority (**FCA**), Care Quality Commission (**CQC**) or Department of Education (**DofE**), the transaction will necessarily be conditional on the regulator consenting to (or at least being formally notified of) the change of control. Because the process varies considerably depending on the regulator, we do not look in detail at the consent process in this note. However, where the sale is structured as a share sale, it will be usually be necessary to obtain approval from the relevant regulator and the Buyer is likely to require a contractual commitment from the Seller (in the SPA) to assist with the process. An asset sale will not usually require regulatory consent.

## 5. The Interim Period

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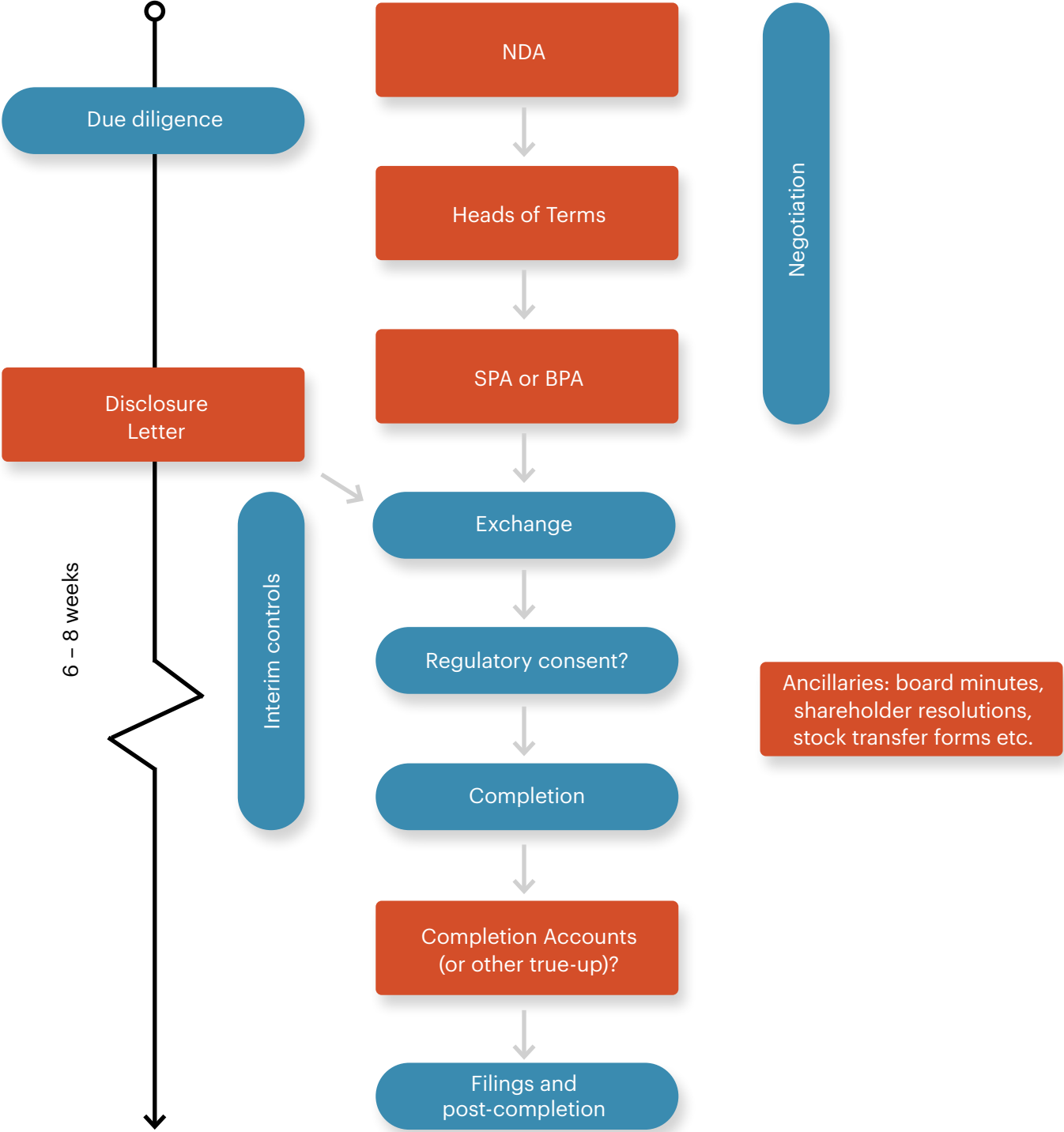
At the point that the SPA is signed by both parties (**Exchange**) they are then committed to completing the transaction, subject only to satisfying any agreed **Conditions**. The Conditions may include anything fundamental to the transaction from the Buyer's perspective. This could include obtaining regulatory consent, consent from a principal client or specific third party service provider or perhaps agreeing terms with key employees.

The SPA will provide for what happens in the interim period – following Exchange but prior to Completion. Because the Buyer is now essentially committed to proceed with the purchase, it will usually insist on **interim controls**. In broad terms these commit the Seller to continue running the business in the ordinary course and not to take any significant or material actions (such as changing the company constitution, issuing shares, dismissing employees or paying bonuses) without the Buyer's consent. The Buyer will usually have a right to rescind (to cancel) the purchase agreement if the interim control measures are breached (and the matter cannot be remedied) or if there is a Material Adverse Change (**MAC**) that impacts on the business during the period (which might include, for example, the cancellation of a key client contract).

Once any Conditions have been satisfied, this will usually trigger an automatic obligation on the parties to proceed to Completion within a defined period (typically five to ten working days).

Transaction structure and timeline

Key document (orange box)  
Process (blue rounded rectangle)



## 6. SPA concerns for Sellers

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As we have already seen, the SPA contains the full details of the transaction and the respective obligations of the parties. It will flesh out all of those matters which were agreed in principle in the Heads and provides the framework for the deal as whole. Where other documents are required to effect the transaction (such as the release of a property charge, consent from third parties or a consultancy agreement for the Seller) the SPA will make it clear by whom and in what form they are to be delivered at Completion. These documents are referred to as being in **agreed form**.

Although no elements of the SPA are superfluous, many can be left to negotiation between lawyers. Others will, however, be of particular concern to a Seller who will work closely with their lawyers to ensure they properly reflect what has been agreed with the Buyer. These include:

### Consideration: how much is the Buyer agreeing to pay?

This may be a fixed sum or a sum to be determined (by reference to a formula and based on agreed multiples of the business's revenues and/or profits.)

### Payment terms: how and when will the Consideration be paid?

Most Sellers would prefer to receive a single cash payment at the point of Completion. However, many Buyers prefer to be able to pay for the Target over time. This provides obvious cash flow advantages and the opportunity for the acquisition to be, in part, self-financing. If a Seller is willing to be paid out over a period of months or years then they may secure a higher price, albeit taking a risk on the Buyer's solvency over that period. The Buyer may also propose some form of **earn out** whereby the price paid depends partly on some measure of the Target's future performance - such as revenues or client retention. There is, of course, some risk for Sellers agreeing an earn out as they are no longer in full control of the business. In any event, any such arrangements must be carefully structured for tax purposes.

### Future role and post-completion obligations: what will be required of the Seller after completion?

Migration and handover of clients or customers can be important to a Buyer since the Target's value can be tied up in them. The Buyer will also want to ensure they fully understand the day-to-day workings of the business. Is the Seller willing to assist with the transition after completion and, if so, on what terms? Will they receive any payment for their contribution to the business post-exit? Some form of consultancy arrangement (whether full or part time) will often be entered into to ensure a smooth handover.

### Senior staff: how will the Target's main revenue generators be retained?

A Buyer will usually want to ensure the retention of principal employees. Indeed, these individuals are quite likely be more important to the future of the business than the Seller. The Buyer may wish to transfer their employment to a different company within a corporate group and/or onto their standard employment contract and the Seller's input may be needed to smooth this process (rather than simply present staff with a "done deal"). The SPA will set out the terms which will be offered (or confirm that existing terms will be maintained) and, perhaps, any bonuses which might be paid to ensure they are incentivised to stay. If the sale is structured as an asset sale the SPA will need to include a prescribed process under the Transfer of Undertakings (Protection of Employment) regulations (**TUPE**).

### Warranties and indemnities: what assurances will be given about the Target?

However much due diligence they undertake, a Buyer will expect the Seller to provide contractual assurances, in the form of warranties, as to the state of the business being acquired. Warranties will cover a broad range of business risk areas – accounts, staff, litigation, data protection, tax and compliance, computer systems etc. – and usually in some detail (the warranty pages of an SPA will regularly account for half of its volume). Every Seller will need carefully to consider each warranty to understand the assurance they are giving and whether any disclosure against it might need to be made against it in the Disclosure Letter. Sellers may be asked to give certain critical warranties on an **indemnity** basis (that is, an agreement to pay on a pound-for-pound basis, any costs to the Buyer or the Target that arise as a result of any breach.) There may be other material issues identified during the due diligence process for which the Seller agrees to take on the risk by indemnifying the Buyer.

### Restrictive (Protective) Covenants: how and for how long should the Seller be "out of the market"?

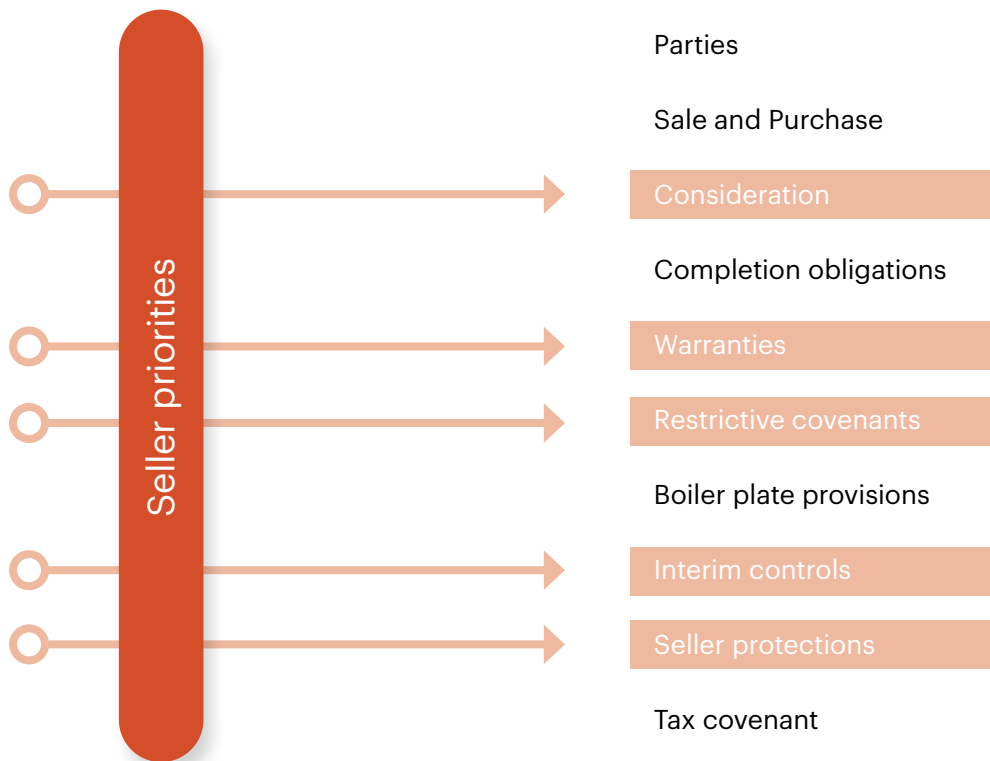
Having just paid to acquire their business, a Buyer will usually want to ensure that a Seller is not in a position to compete with it. The Seller will typically agree not to start a new, competing business or to approach clients or staff of the Target, for a certain period and/or in a certain geographical area after Completion. If the Seller is retiring then these provisions will not be contentious. However, if a Seller intends to continue working in some form of other, careful thought needs to be given to the scope of these restrictions.



### Seller Protections: how, for how long and for how much should a Seller be “on the hook”?

A well advised Seller will not agree to warrant the state of the Target without limit in either time or money. Most Sellers are prepared to give the Buyer a period of time in which to discover any warranty breach and to bring a claim for that breach. However, the SPA will set a time limit on this (usually between 18 and 36 months for most commercial warranties) as well as a financial **cap** (to ensure claims cannot exceed the purchase price paid) and various **de minimis** thresholds (to ensure Sellers are not subject to a barrage of trifling claims). Numerous other protections will be included but these timing, cap and de minimis limits are usually the main sticking points and often the subject of some negotiation.

### Main SPA terms



## 7. Due diligence, disclosure and warranties

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We have separately touched on the due diligence process, the Disclosure Letter and the warranties. A proper understanding the interplay between the three elements is critical if a Seller is to be properly protected. The formal disclosure exercise is sometimes seen by Sellers as a laborious and time-consuming one which repeats much of what has already been said in due diligence. To be fair, there is some truth in that. Nonetheless, the process must be undertaken diligently, ideally in consultation with senior or specialist staff, if it is to serve its purpose.

To explain each element in more detail:

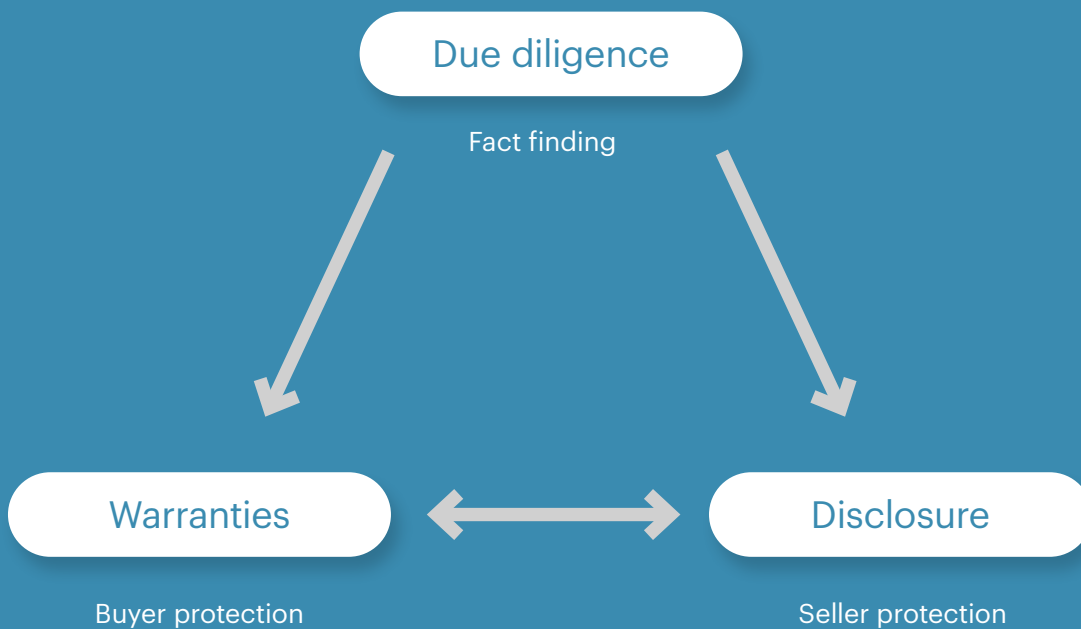
- **Due diligence** is the fact-finding process that is undertaken at the beginning of the purchase. The Seller will usually be asked to provide a **data room** (physical or virtual) of all key company information (client or customer lists, contracts, intellectual property, staff details, accounts etc.) and to make it available to the Buyer and its advisors. During the due diligence process the Buyer will usually ask several rounds of questions relating to all aspects of the business. This process will often continue up to the point of Exchange, as a Buyer will want to know as much as possible about the Target.
- During the due diligence process the Buyer may uncover areas of concern or where it feels insufficient information is available. These will inform the Buyer's approach to the SPA and the **warranties**. For example, if there is a lack of information on the Target's bespoke IT system, a Buyer might request a specific warranty relating to it. They might ask for assurance that the software is up-to-date and that the developer still provides maintenance services. In the event of a breach of the warranty i.e. if those facts were not true, the Buyer would be entitled to bring a claim for any loss of value it suffers as a result.
- However, the process is fair to both sides and the Seller is afforded the opportunity formally to fix the Buyer with knowledge relating to the Target by way of **disclosure** of matters which they know are not consistent with the warranties. Provided that a matter is fully and fairly disclosed to the Buyer (in the Disclosure Letter) then the Buyer is given the chance to consider its impact before committing to the purchase. In our example above, the Seller may choose to disclose that the software developer went into liquidation some time ago, meaning the software has not been recently updated and no alternative maintenance provider has been found. If the deal proceeds, having gone into it with their "eyes open" the Buyer could not later bring a claim for breach of the warranty. Of course, some matters, once disclosed, may be serious enough to prompt a Buyer to reduce their offer (perhaps by the amount it would cost to adopt and implement a new software system) or even to walk away from the deal (if the software was so deficient it had led to systemic and serious breaches of the law). Nevertheless, it is rare for lawyers to recommend adopting anything other than a full and frank approach to disclosure.

So, this interplay between the warranties and the Disclosure Letter performs a dual function, both of flushing out information of concern to the Buyer and of providing a degree of protection to both parties.

As a general and important rule, nothing disclosed in due diligence is necessarily taken as formally disclosed for the purposes of qualifying the warranties. That can be frustrating to Sellers who will often argue that everything they have already provided to the Buyer in the due diligence phase should be deemed disclosed. But Buyers will usually resist this approach, requiring disclosures to be more specifically tailored to the warranties – hence the element of repetition that may be required.

## Due diligence, disclosure and warranties

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## 8. Completion and post-completion

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Following satisfaction of all Conditions, lawyers for the Buyer and Seller will then coordinate to ensure all signed documents and other **deliverables** (company books, banking fobs, chequebooks) required to complete the purchase are handed over (or in the control of the lawyers who can give an **undertaking** to do so on behalf of their clients). At this point, any Completion payment due is paid to the Seller and the deal is formally concluded. Although there can occasionally be last-minute delays, Completion is usually a relative formality because all deliverables are known at the time of Exchange and will have been prepared during the interim period.

The final steps in a share sale are usually:

1. Updating the Target's statutory books.
2. Filing of the various Companies House forms and other statutory notifications to reflect the new ownership and control of the Target.
3. The production of **completion accounts** or other accounting "settle up" process. Although there are a variety of pricing structures available (**locked box** and completion accounts being the two most common) accounting input is required in the post completion phase to ensure that the correct price is being paid for the Target regardless of, for example, temporary cash fluctuations within the business.

In an asset sale Completion is usually focussed on effecting the transfer of key contracts (whether clients/customers or suppliers) and perfecting the Buyer's title to all of the assets being acquired (by, for example, assigning leases and transferring domain names).

## 9. Conclusions

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This note is only a summary of the key steps in the sale transaction. Even the simplest of commercial transactions is not without its potential pitfalls. Corporate advisory, legal, tax and accounting input should all be sought at an early stage and will add both value and protection for Sellers.

Businesses are usually acquired by larger entities – whether trade buyers or repeat acquirers such as private equity firms. The bargaining power between Buyer and Seller will often be unequal and a clear understanding of their own deal strategy, priorities and red lines at an early stage will greatly assist Sellers in the negotiation process.

Farrer & Co's Corporate team specialises in mid-market private company transactions for founders, family businesses and entrepreneurs. We would welcome the opportunity to discuss any aspect of this briefing note with you.

## 10. Meet the team



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### Jonathan Haley

Partner, Key Contact for Corporate  
+44 (0)20 3375 7552  
[jonathan.haley@farrer.co.uk](mailto:jonathan.haley@farrer.co.uk)

### Marie Bates

Partner  
+44 (0)20 3375 7525  
[marie.bates@farrer.co.uk](mailto:marie.bates@farrer.co.uk)

### David Fletcher

Partner  
+44 (0)20 3375 7117  
[david.fletcher@farrer.co.uk](mailto:david.fletcher@farrer.co.uk)

### Anthony Turner

Partner  
+44 (0)20 3375 7460  
[anthony.turner@farrer.co.uk](mailto:anthony.turner@farrer.co.uk)

### Tom Bruce

Partner  
+44 (0)20 3375 7192  
[tom.bruce@farrer.co.uk](mailto:tom.bruce@farrer.co.uk)

### Richard Lane

Partner  
+44 (0)20 3375 7548  
[richard.lane@farrer.co.uk](mailto:richard.lane@farrer.co.uk)

### Simon Ward

Partner  
+44 (0)20 3375 7242  
[simon.ward@farrer.co.uk](mailto:simon.ward@farrer.co.uk)

# 11. Glossary

<b>Agreed form</b>	a document which the parties indicate they have agreed the form of (usually by initialling a copy) but which has not yet been signed or delivered
<b>Ancillaries</b>	an umbrella term for supporting documentation such as board minutes, shareholder resolutions, Stock Transfer Forms and Companies House filings that are required to effect a transaction
<b>Boiler plate</b>	a general term for the suite of clauses in the SPA or BPA dealing with legal matters that are not usually core to the transaction
<b>Business Purchase Agreement / BPA</b>	the principal transaction document where a Buyer agrees to buy and a Seller agrees to sell a business and assets
<b>Cap, collar and / or de minimis</b>	financial limits put on warranty (and other) claims that a Buyer may bring against a Seller
<b>Completion</b>	the point at which the deal is legally concluded and ownership of the Target transfers to the Buyer
<b>Completion Accounts</b>	a common pricing mechanism requiring the compilation of a set of accounts at the point of Completion, with a balancing payment, to ensure the correct price is paid
<b>Consideration</b>	the price (whether in cash, shares or loans) to be paid by the Buyer for the Target
<b>Data room</b>	the (physical or virtual) collection of documents and data made available to a prospective Buyer and its advisers for the purpose of undertaking due diligence
<b>Deliverables</b>	a general term for documents and physical items to be delivered by either party at Completion
<b>Disclosure</b>	the formal process by which a Buyer is fixed with knowledge of matters that are inconsistent with the warranties
<b>Due diligence / DD</b>	the initial process of investigation into the Target undertaken by a Buyer (with separate processes being undertaken for legal, financial and regulatory aspects)
<b>Exchange</b>	the point at which the SPA is signed and the deal becomes binding on the parties, prior to Completion
<b>Heads (of Terms)</b>	a (largely non-binding) document setting out the key terms of the proposed transaction

Indemnity	an undertaking given by a Seller to a Buyer to pay in full for any loss or costs incurred or associated with a particular matter
Locked Box	a pricing mechanism whereby the value of the Target is fixed at the date of Exchange rather than Completion (and an alternative to the Completion Accounts mechanism)
Material Adverse Change / MAC	an event or circumstance which has a material negative impact on the Target or its business and which may give rise to a right to rescind the SPA
Share Purchase Agreement / SPA	the principal transaction document where a Buyer agrees to buy and a Seller agrees to sell shares in the Target
Target	a corporate entity (or its business) being acquired by the Buyer
Undertaking	a binding commitment given by a solicitor to do or cause something to be done (usually used to facilitate Completion if payments, documents or other deliverables are not physically in the hands of the parties at that time).
Warranty	an assurance given by a Seller to a Buyer as to the state of the Target or any part of its business

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Excellent market knowledge, very commercial, pragmatic and practical advice.

- Corporate M&A, Legal 500 2020

Farrer & Co LLP  
66 Lincoln's Inn Fields  
London WC2A 3LH  
+44 (0) 20 3375 7552  
[jonathan.haley@farrer.co.uk](mailto:jonathan.haley@farrer.co.uk)  
[www.farrer.co.uk](http://www.farrer.co.uk)

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