Critical issues in M&A transactions for SMEs

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This chapter looks at number of critical issues that tend to arise, or should be borne in mind, in the course of a transaction:

- price and payment terms;
- completion balance sheets;
- earn-outs – seller's protections;
- warranties and indemnities;
- who gives warranties;
- limitation of seller's liability.

Price and payment terms

Clearly price is the most critical issue in any transaction, but the permutations for how it is to be paid or calculated, and in what form it is delivered, are numerous. For sellers, cash on completion understandably is king. Buyers naturally prefer to minimize their upfront commitment, and where possible pay much of the consideration in loan stock or shares, pay in stages or pay part of the consideration by reference to the future performance of the target (earn-out payments).

Taken from Reuvid, J (ed) (2007) *Mergers and Acquisitions*, Kogan Page, London, pp 169–75

In people businesses where the future revenue could walk out of the door, buyers are understandably reluctant to front-load the price. A seller therefore might have to take a view whether to sacrifice some of the upside if it insists on a cash-only deal – if indeed it has a choice.

The added attraction for a buyer of paying over time or in paper is the ability for a buyer to set off warranty or indemnity claims against the deferred consideration, even if this is in breach of the agreement itself. At the very least it gives the buyer added negotiating leverage.

The result of this tension is that, particularly in the services, media and IT sector, many transactions are not structured as outright sales for an upfront cash lump sum, but comprise a mixture of an initial consideration (perhaps adjusted by reference to a completion balance sheet) and earn-out payments based on future performance milestones of the target.

A seller should of course be aware that the value of deferred consideration payments depends on the solvency or the share performance of the buyer (if based on a fixed number of the buyer's shares). It should ensure that the covenants to make the deferred payments are as secure as possible: for instance where loan stock forms part of the consideration, that it is secured, that cash is placed in an escrow account or the commitment secured by a parent company guarantee. However, escrow deposits are usually not possible where future payments can only be determined at a later date.

Completion balance sheets

Where part of the initial consideration is to be determined or adjusted by reference to the net asset value of the target (or possibly some other balance sheet calculation) as shown in a completion balance sheet, a seller should seek to minimize the areas for accounting disputes.

A seller should remember that even if, as is fairly standard, it or its accountant has the opportunity to review and comment on the draft accounts (and in the final analysis have the matter referred to an independent expert), problems can arise in areas where values, income recognition or provisions are often matters of judgment. The new directors might, for example, take a completely different view of the value of stock or plant and machinery, and seek to write it down significantly.

Sellers' protections should therefore be applied to the determination of the completion balance, so that:

- The completion balance sheet is prepared on a basis consistent with the latest audited balance sheet;
- departures from GAAP should either be applied or adjustments agreed;
- values or provisions (or the absence thereof) which could be controversial should be set out.

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Earn-outs

Earn-outs (most commonly related to profits or turnover or other performance measures relevant to the particular business) need to be carefully drafted to minimize the areas of uncertainty or dispute. If the earn-out is related to profits or turnover, the parties need to consider carefully how the profit or turnover figure is to be identified and calculated. Similar protections should be included in relation to the calculation of the earn-out as are applied to completion balance sheets, referred to above.

In addition various general protections should be considered, such as:

- a provision that the buyer will not do anything that, intentionally or otherwise, reduces the earn-out (such as diverting business to another group company);
- a covenant that adequate resources and human resources will be devoted to the business of the target to maximize turnover and/or profits;
- if the earn-out is profits-based, not to do anything that will reduce profits (such as inter-group charges, non-arm's length transactions, salary increases above a certain level (or ignored above a threshold).

The difficulty is always to strike a balance between protections that seek to ring-fence the target's business, and protections that the buyer maintains impose undue restrictions on the future operations of the target.

Warranties and indemnities

Warranties are statements in the share purchase agreement assuring the buyer as to a whole range of matters which are relevant to the target's business, its assets and liabilities. In practice, although the warranties form the bulk of a share purchase agreement and often cause sellers great concern, claims for breaches of warranties tend to be rare. This is because well-advised buyers normally carry out a thorough due diligence exercise prior to finalizing a deal.

If anything emerges during the due diligence process which has or might have an impact on the business of the target, the price can be renegotiated or specific indemnities sought, backed up if necessary by a retention of a suitable amount placed in an escrow account.

Warranties are intended to:

- focus the mind of sellers to disclose matters that are inconsistent with the warranties, and provide another level of information gathering in addition to the due diligence process;
- provide the buyer with a remedy – a claim in damages – if the warranty later proves to be untrue and the buyer has thereby suffered loss.

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Too often sellers are confronted with a standard 40-page warranty schedule, much of which is inappropriate for the business being sold. Therefore, buyers should discuss with their lawyer which warranties are key to the target's business, and in light of this, adapt the standard schedule.

The difference between warranties and indemnities is that a breach of warranty will only give rise to a successful claim in damages if the buyer can show that the warranty was breached, and that the effect of the breach is to reduce the value of the target. The onus is on the buyer to prove the breach *and* the loss it has suffered. The buyer's loss is not always easy to prove. The principle is that the loss suffered by the buyer generally is the difference between the price paid for the target and the price that the buyer would have paid with the warranty breached. Some breaches of warranties (such as failure to disclose a litigation dispute with an ex-employee) might have little impact on the target's sustainable profits and hence its value and the price the buyer would have paid, whereas an overstatement of profits in the accounts or the failure to disclose a patent challenge might go to the heart of the company's valuation. A buyer might also have to prove that the breach had not been 'fairly disclosed' in the disclosure letter, or that it and its advisers were not aware of the matter at the time of the acquisition.

An indemnity, on the other hand, is a promise to reimburse the buyer in respect of a particular type of liability should it arise. The purpose of an indemnity is to provide the buyer with a pound for pound remedy, where a breach of an equivalent warranty may not give rise to the same level of damages and involve the buyer in establishing the level of damages it has suffered.

Indemnities are usually sought against tax liabilities of the target to the extent that they are not provided for in the warranted accounts have not arisen on profits arising in the normal course of business since the balance sheet date. Indemnities are also often sought for specific risks that have been identified in the course of due diligence. For example, if the target is involved in a dispute with a former employee who has alleged unfair dismissal and racial discrimination, it would be fairly common for the buyer to insist on an indemnity against the costs of defending the proceedings and a successful claim. In addition, the buyer might seek to withhold from the purchase price the maximum liability that could arise under the indemnity as security for payment. In these situations the seller should insist that the amount is paid into an escrow account operated on the joint instructions of its and the buyer's lawyers.

In practice, difficulties often arise in litigation over indemnities, with the buyer being keen to resolve outstanding disputes and to draw on the indemnity fund, and the seller keen to minimize the expense. Share purchase agreements ought therefore to set out precise rules as to how the litigation is to be managed, the costs and fees incurred and the mechanism for agreeing a settlement. Better still would be for the seller, if possible, to resolve outstanding litigation before a sale rather than be faced with a retention based on the worst case scenario.

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Who gives warranties?

Where the target is a subsidiary company or where it is owned exclusively by the executive team, the seller or sellers will be the warrantors. However, where there are a number of sellers, some of whom might not be actively involved in the business, or trustees, institutions or charities, the position is less clear-cut.

Shareholders who have not been involved in the business might either be reluctant to give any warranties, or at the very least, insist that their maximum liability is limited to their share of the consideration and to a proportionate part of any claim.

Trustees commonly either refuse to give warranties, or limit their liability to an amount not exceeding the after-tax consideration they receive. Where there are significant trustee sellers, discussions should take place with them at an early stage to see what, if any, level of warranty liability they will agree other than as to title. Sometimes the outcome is that sellers who have been actively involved in the business have to bear a greater proportion of the liability, that liability is layered, or a proportion of the consideration is retained for a period.

Where there are multiple sellers, a buyer will usually require that the liability of the sellers be joint and several. The effect of this is that the buyer can sue any one or more or the sellers for the full amount of the damages arising from the breach of warranty, and the seller who is sued for the full amount will be entitled to seek a contribution from the other sellers under the Civil Liability (Contribution) Act 1978. However, rather than leaving the court to decide what contributions are 'just and reasonable', sellers normally agree a contribution agreement among themselves. This sets out how the liability is to be apportioned and the decision-making process for handling a warranty claim.

Limitation of seller's liability under warranties

There are various standard and accepted ways for a seller to limit its liabilities under the warranties. The main ways are the following:

- *Disclosures:* to make disclosures in the disclosure letter written by either the seller or the seller's lawyer to the buyer or the buyer's lawyer. The purpose is to disclose specific items to the buyer which qualify the warranties and which would, if not disclosed, result in a breach of warranty. The matters disclosed should be sufficiently detailed that the buyer can reasonably assess the implications of the disclosure.
- *Time limits:* a variety of time limits within which a claim must be brought are invariably included, and this is a matter for negotiation. Two to three years tends to be the norm for notification of a claim (and then a period following which a claim must be brought or the right lapses), or a date which allows for one or two audits to be completed. Tax claims tend to be for seven years.

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- *Financial limits:* it is standard practice to include a variety of financial limits: minimum limits both for individual claims and the aggregate of claims (usually around 1 per cent of the consideration) below which a buyer cannot bring a claim; a cap normally equal to the consideration paid (though where the consideration is nominal and other obligations are assumed by the buyer, such as the repayment of a substantial shareholder's loan, the limit should reflect the level of commitment or risk being assumed by the buyer).

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