

Selling Unquoted Companies

"Different sellers - different interests - different solutions"

Expert knowledge means success

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Note: This publication has not been updated since it was last published. Some of the hyperlinks may have changed and may need updating. In addition, some of the information in this publication may be out of date.

Introduction

This publication¹ looks to potential issues facing the selling shareholders. It ignores the problems arising from the status of the purchaser, for example, where the purchaser is a listed company which therefore requires shareholder approval; whether notification to or consent is required from the Stock Exchange; or whether the guidelines promulgated by the Association of British Insurers will apply to the deal.

City Code on Takeovers and Mergers

The history of the Company over the last few years should be reviewed, if:

- is a public limited company, although unlisted;
- it is a private company, which has been listed in the last 10 years;
- there have been dealings in the Company's equity share capital advertised in a newspaper on a regular basis for a continuous period of at least 6 months in the 10 years prior to the relevant date;
- the equity share capital been subject to a "marketing arrangement" (sec. 163(2)(b) Companies Act 1985) at any time during the 10 years prior to the relevant date;
- the Company has filed a prospectus for the issue of equity share capital at any time during the 10 years prior to the relevant date;

If so, then in each case the City Code will apply.

The relevant date is the date on which an announcement is made about the proposal.

The City Code on Takeovers and Mergers is a binding set of rules that apply to listed companies in the United Kingdom, such as those trading on the London Stock Exchange. Many of its provisions are mirrored in the EU Takeover Directive.

The Shares

The spread of shares between shareholders to establish where control lies, whether the matter can be dealt with by agreement, whether the Financial Services Act will bite, and whether any rogue shareholders or group of shareholders can spoil the party should be considered. It is on these aspects that this paper focuses.

Due diligence

Warranties and Indemnities

The structure of the deal, usually for the tax benefit of the selling shareholders, will be that the Company's shares, rather than its assets, will be sold. Where the shares to be acquired represent all the shares in the capital of the Company, the rights attaching to the shares have little or no importance, except between the shareholders themselves. Then the purchaser's attention will focus not so much upon the shares that are being bought but upon the Company itself.

Although due diligence enquiries and investigations will go some way to establish whether or not the Company has the title to all its assets, these cannot conclusively establish the extent of the liabilities of the Company. Therefore the purchaser will require warranties and indemnities from the selling shareholders in respect of the Company's affairs.

It is a matter of great importance as to whether the selling shareholders should give those warranties and indemnities either jointly and severally, or severally, or indeed at all.

Insurance

It is possible to insure the liability of the selling shareholders under the warranties and indemnities.

Availability

A number of specialist firms offer warranty and indemnity insurance. As in all contracts of insurance, the proposal form and the answers to the questions on it will be construed "as a matter of the utmost good faith".





All insurers will require sight of the Sale Agreement, the Disclosure Letter, the Tax Indemnity, the latest audited accounts of the Company or, if different, the accounts on which the sale is based, a copy of any investigating accountants' report, if it is available, and details of any side agreements relating to any of the above. The questions on the proposal form are quite searching, for example:

- "Do the warranties and indemnities relate to a period prior to the date of acquisition by the Vendor?"
- "Are there any warranties or indemnities in respect of the following matters":
 - events taking place after completion?
 - the net asset value of the Company at a status date?
 - any unaudited accounts?
 - the collectability of any debts?
 - the working capital of the Company?
 - the adequacy of insurance cover?
 - the level of funding of pension schemes?
 - the state and condition of any properties or structures?
 - environmental matters?"
- "What is the procedure adopted to check the accuracy of each warranty given?"
- "Are any warranties included which the proposers are incapable of verifying as being factually correct?"
- "Have the Purchasers refused to accept any disclosure or insisted on deleting anything from the Disclosure Letter?"

Costs

Acceptance of risk is dependent on the quality of the up-front information provided by the selling shareholders. Costs may approximate to 1% to 1.5% of the sale price but may be more; thus a £5million sale would incur minimum insurance costs in the region of £50,000. If the selling shareholders wish to insure on a "first loss" basis i.e. the first £3million of a £5million deal, the premium would reduce but not on a pro rata basis. It might therefore cost £35,000 to £40,000. Usually, there are excesses which start at a minimum of £10,000.

Procedure

The documents must be submitted to lawyers acting for the underwriters along with a fee of £3,000 to £4,000. Once the documents have been approved the underwriters will come back with a quotation with an excess of £10,000. If the matter proceeds, the sum paid on account to the lawyers will be deducted from the premium.

Exclusions

There are of course exclusions and any suggestion of fraud will negate the policy. Bad debts are also excluded, the failure of obligations incurred prior to completion are excluded, tax avoidance and tax reduction schemes are excluded, as is the inadequacy of any pension funding and year 2000 and environmental problems.

Different types/categories of Vendor

There are several different possible types or categories of vendor. Each of these requires different considerations:

Sole seller/sole director

Sole sellers or sole directors can give clear instructions - but due diligence often reveals idiosyncrasies in a one-man company.

All sellers are directors

The position to be considered here will vary:

- If all selling shareholders are to retire from the Company on completion of the sale, one approach is taken.
- If some retire and some are to stay, there are therefore differing interests that have to be accommodated.

The attitude to the agreement of each selling shareholders or group of selling shareholders will be different. The buyer will not want to be put in a position to enforce warranties against those important to the business in the future and continuing to work in the business after the sale.

Second and third generation companies

These companies often have either:

- some family members working in the business;
- a number of family members training in the business but who will not stay;
- a number of people within the family dependent upon dividends and pensions.

These sales are charged with emotion.

In typical circumstances, there may be between 15 and 30 shareholders.

The best practice is to procure shareholders, having had the intended sale explained to them in a meeting, to sign an "acceptance agreement" confirming that in consideration of each other shareholder signing the same document, they will sell at the intended price or at such other price as a negotiating team may agree, being not less than, say, 15% in value. If the value, not necessarily cash, reduces beyond 15% then the negotiating team can undertake to revert to shareholders.

At the same time, forms of wide proxy should be taken as, clearly, not all shareholders will want to or be able to attend the completion signing.

In these cases it is usual for the executive directors to give the warranties and tax indemnities.

In turn, they will procure a contribution agreement by which each shareholder agrees to make good to them his proportionate share of any claims.

As an alternative to this, the cost of insurance can be charged pro rata to each shareholder.

Venture Capital/Institutional Investors as sellers

The approach by venture capital/institutional investors varies:

- Some venture capitalists want to remain in as shareholders for as long as is necessary;
- Others want to induce an exit within a pre-planned time frame - this often leads to conflict between the institutional investors' interests and those of other shareholders.

Where institutional investors are minority shareholders, the investment agreement will invariably have contained words to the effect:

"on any disposal of shares in the Company, we shall not be required to:

- give any warranty or indemnity to any party except a warranty as to the title of our shares; nor
- appoint any party (including any sponsor to the Company) as our agent in connection with the sale of our shares"

Institutional investors will also point to another typical clause in the investment agreement:

"No shares may be transferred if a controlling interest in the Company would be obtained by":

- persons who are not shareholders at the date of this investment or by any company unless the proposed transferee offers to purchase our shares at the greater of:
 - the price we have paid, or
 - a price per share equal to that offered for other shares plus in each case an amount equal to accrued dividends grossed up at the rate of corporation tax; or
- a company in which the shareholders of the Company have a controlling interest."

Thus, if the directors (other than any non-executive appointed by the institutional investor) are required to give the warranties and indemnities, the institutional investor's attitude is that was always part of the deal and they should not be required to contribute, nor receive a variable price.

Insurance at a specific cost per share may provide the solution. Alternatively, substantial retentions, with the directors taking the additional risk may be considered; or possibly a differential price for those giving and those not giving warranties and indemnities may be considered.

3i, a leading venture capitalist organisation, has said that it considers each case on its merits but that its starting position is as outlined above. It does, however, concede that in relation to its more recent "bought deals" where it purchases a company on a management buy-out or buy-in and takes a substantial majority stake which it then syndicates to other institutional investors, it may have to reconsider its position.

Trustee shareholders

Shares are transferred to trustees for a number of reasons often to seek benefits; often to protect capital value; sometimes to put "growth" assets into such a vehicle.

On the sale of a company, the trustees will be concerned not to incur personal liability and will equally be concerned to act, as is their duty, in the best interests of their beneficiaries.

The purchaser on the other hand will want to seek warranties and indemnities from the trustees as from any other shareholder, but will need to ensure that the trustees have the capacity to give them; because, if the trustees

act in breach of trust, the beneficiaries of the trust fund may be able to claim that the trust assets should not be available to meet the claim, leaving only personal claims against the trustees.

Trustees should seek to avoid giving warranties and indemnities because they are unlikely to have detailed knowledge of the affairs or business of the Company. They should not expose the trust fund to risk.

Trustees should be satisfied that they have specific power to give warranties and indemnities under the trust deed and, if not, whether the general law permits the sale. If the trustees have a wide power to sell assets and to do all things necessary or desirable in connection with the sale, then they have an implied power to give warranties.

If there is no power, then a possible solution is for all beneficiaries to consent to the giving of warranties, or to waive their rights, but all the beneficiaries must be of full age.

Again, insurance may help. Alternatively, the beneficiaries may give the trustees a full indemnity, but this solution is not ideal.

Trustees should be unwilling to give warranties and indemnities on a joint and several basis. Tax considerations may mean that joint and several covenants so given amount to a benefit to the settlor if he, too, is a shareholder in the Company. Also, trustees can be criticised if they allow the trust funds to be used to satisfy claims against non-beneficiaries.

Trustees must limit their liability to the extent of their ability to indemnify themselves from the trust funds in their hands from time to time, and it is usual for a purchaser to accept a clause of this nature. This will not be the case where the trust is of foreign jurisdiction. Substantial retentions by a purchaser as security against liabilities

under the warranties and indemnities will be required. The trustees may also be required to retain funds (i.e. not to distribute to beneficiaries) for a specific period, or permitting distribution only where the recipient enters into a direct deed with the purchaser underwriting the obligations.

The trustees may also be required not to exercise any power to add beneficiaries to the trust and not to charge the trust assets.

Such undertakings by the trustees may constitute a restriction of their powers. The rule of equity is that a 'fiduciary' cannot bind himself as to the manner in which he will exercise a discretion in the future, although a number of cases give comfort.

Conclusion

In structuring and seeing through the sale of shares in an unquoted company a number of differing interests have to be reconciled or accommodated. It is always wise to anticipate matters, and essential to consult an experienced practitioner.

Further Information

This guide is for general interest - it is always essential to take advice on specific issues. We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

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