Realising Your Investment: Selling a High Tech Company

Expert knowledge means success

Contents

1. High Tech – Does it make a difference?
1. Getting Ready to Sell – The different types of sale
2. Understanding the buyer's position
2. Controlling the negotiations
3. Finding a buyer
4. Second Hand Sale – Problem or Opportunity
4. Investigating problems
5. Case Study
6. Warranties and Indemnities
8. Further Information

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High Tech – Does it make a difference?

Are high tech companies unique? The mere fact that a company is high tech does not make any significant difference to the issues, which need to be addressed in the sale process by either the buyer or the seller. Being a high tech company does not make a company unique, just as every individual is unique. Every individual although unique will have some characteristics and features shared with other individuals. The same is true of companies. Some high tech companies will have more in common with companies in other sectors than they will with other companies in the high tech sector. It is this uniqueness which provides much of the challenge and is the source of reward and satisfaction to the professional adviser. To a potential buyer the qualities that make a company unique may add or detract from its value. They will therefore be matters, which will concern a buyer, and so matters which should also concern a prospective seller[1].

Much of the value of any successful business will be the value attributed to its intangible assets. If there is anything that all high tech companies have in common it is the extent to which their intangible assets are knowledge-based. If these assets are protected and secured effectively the value of the business is also secured. Conversely if the seller has failed to recognise the value of these knowledge-based assets and take appropriate steps to protect them they may prove to be not only intangible but also transitory. Such a seller can hardly expect a buyer to pay for assets he may never have the benefit of owning. What steps will be appropriate for a high tech company to take to secure its knowledge-based assets will depend very much on the particular circumstances. However, they are likely to include the usual range of protections of intellectual property. In addition, the contribution of key employees may need to be recognised. This might include having appropriate plans to deal with departures and having in place arrangements that provide an incentive for them to stay with the company.

Protection of intangible assets is not an issue that could be considered only in the context of a company sale. Even if there is no intention to sell a company a failure to protect and secure its intangible assets could result in severe damage to, or total destruction of the company's business. In consequence the income generated for the company's shareholders and its ability to pay its directors and employees would be diminished and possibly eliminated altogether. This is precisely why a prospective buyer will be concerned to see that this issue has been addressed and why, if your company has not already done so, it should begin addressing these issues now.

Getting Ready to Sell - The different types of sale

There are a number of methods of realising the value of your shareholding. All of these are different types of sale. All with the exception of a flotation (or what in the US is called an initial public offering or IPO) are variations on a theme and the process and legal documentation is similar for each of the variations. The most common are the trade sale, the management buy-out (MBO) and the management buy-in (MBI).

Which method is used will depend in part on the identity of the buyer. It will also depend on the buyer and seller's objectives. If the seller does not wish to have any continued involvement in the company as both a shareholder and director then a flotation will not be an appropriate method. Institutional investors and most other investors who might consider acquiring the company's shares on a flotation will understandably have reservations about the future performance of a company where its existing shareholders and senior management are seen to be abandoning ship. This illustrates that a seller will find it difficult to achieve his objectives if he has failed to understand the buyer's objectives and concerns.

Understanding the buyer's position

The nature of the buyer will inevitably have some effect on the buyer's objectives and the position it will adopt. A listed company may well be less concerned with the target company's balance sheet than a private individual. This is because a listed company's main concern will be to ensure that following any acquisition its earnings will be enhanced so that it can increase its dividends to shareholders. In contrast a buyer who is a private individual will be far more concerned about the risks associated with servicing the company's own debt and so much more concerned about the balance sheet. All buyers though will have common concerns which can and should be addressed well in advance of a sale by any seller. Any buyer will want a good return on their investment and therefore be concerned about future profitability and growth.

Company sales is one of the few areas of law in which the common law rule of caveat emptor still retains almost all its old force. This rule, which places almost all risk on the buyer, has in most other legal fields been limited by legislation, in some cases almost to the point of non-existence. Modern consumer law is a prime example of this. The buyer of a company, unlike a consumer, is assumed to be capable of looking after his own interests and not in need of the same level of protection. If a buyer ignores this rule he does so at his peril. A prudent buyer will therefore wish to investigate a potential purchase carefully to make sure that the company is worth the price to be paid. This process is called due diligence. In addition to investigating the target company a buyer will also want to diminish the impact of the caveat emptor rule by transferring some of the risk the buyer would otherwise be taking. The usual way of transferring risk is in the form of warranties and indemnities which the seller will be asked to give to the buyer.

When the buyer is negotiating the terms of any purchase agreement one of the main objectives will be to diminish the impact of the caveat emptor rule as much as possible. A seller will naturally wish to resist this. However, there is a balance to be struck. A business purchased from a receiver or liquidator will be considerably cheaper than if the same business was purchased from its owners. This is because receivers and liquidators will not give the buyer any warranties or indemnities. If a seller wants to maximise the value realised on a sale the seller will have to accept some shift in the balance of risk. The caveat emptor rule and the seller's knowledge of the company being sold are potentially significant tactical advantages. Exploiting these advantages requires the exercise of control over the negotiating process and to exercise control the seller needs to be prepared.

Controlling the negotiations

The fundamental objective for the seller in the negotiation of a sale will be to obtain the maximum price on the best possible terms, essentially this means with minimal acceptance of risk. Most of the sale and purchase agreement will be taken up with warranties and indemnities, the main ways that a buyer transfers risk to the seller. As a general rule the buyer will be responsible for drafting the sale and purchase agreement and therefore have a significant degree of control over the document itself. Allowing for this, and the fact that the relevant bargaining strength of the buyer and seller may differ and therefore affect the scope of the warranties and indemnities which will be agreed the seller should still be in the best position to control the negotiating process. The reason for this is simply that the seller is in possession of and controls access to most information about the company and ought therefore to know more about the company than the buyer at all stages of the negotiations. A seller who does not exploit this advantage will usually end up with less favourable terms in the form of a lower price or more risk transferred to the seller and commonly both.

As with most things leaving the exploitation of this advantage to chance may mean that there is in fact no advantage at all. Its exploitation to best effect usually depends on thorough planning and preparation. Most of the work necessary to prepare for negotiations with the buyer is also likely to be of help in securing an acceptable offer from a potential buyer in the first place.

Planning for the negotiations is therefore something which ideally needs to be started before a buyer is identified and is usually best undertaken as part of the initial phase of marketing the company for sale.

Finding a buyer

In some cases the buyer may actually make the initial approach to the seller either directly or through an intermediary. This is most likely to be the case where the seller and buyer already know each other, for example where some or all of the existing management wish to buy the company (i.e. an MBO). This is also quite common where the buyer is a larger company operating in the same or a similar area of business as the seller's company, particularly where the buyer is looking to expand and grow. There are usually some advantages to a sale resulting from an approach like this. The most obvious is that the seller will not have had to engage the services of a corporate financier to broker the company sale and will not therefore have to meet the cost of the corporate financier's fees. This is the equivalent of selling a house without using an estate agent. Although there may be a saving on fees sellers are often not well prepared when an attractive unsolicited offer induces them to sell. The result is that the seller frequently fails to exploit the natural negotiating advantages a seller should have. In addition, the seller may not have taken some of the presale steps they might otherwise have taken to make the company appear more attractive. The result can often be that the seller gets less for the company than might otherwise have been the case and the terms of the sale will often be less favourable in other ways. It is understandable that a seller in these circumstances is not as well prepared as they would be if they had actively solicited an offer. However, it does perhaps illustrate that it is always worthwhile considering the effect the way in which a company's affairs are currently being conducted might have on the attitude of a potential buyer.

In many cases the seller will have to actively seek a buyer. In doing so the seller needs to comply with the requirements of the Financial Services and Markets Act (FSMA).

There are a number of provisions to control what are termed investment advertisements. Deciding whether something is or is not an investment advertisement is not always straight forward but they will always have the following features:

- an advertisement inviting persons;
- to enter (or offer to enter) into an "investment agreement" or;
- containing information calculated to lead directly or indirectly to persons doing so.

In this context the agreement to sell the target company's shares will be an investment agreement. In most cases it is possible for a seller to take advantage of a number of limited exemptions from the controls on investment advertisements imposed by the FSMA. However, these exemptions are fairly narrow and usually quite specific. It is therefore important for sellers to make sure that either they are not issuing an investment advertisement at all or that if they are that it falls within one of the exemptions or they comply with the requirements of the FSMA. Failure to comply with the FSMA can have some severe consequences. The penalty for a breach of the provisions relating to investment advertisements is a term of imprisonment of up to two years or an unlimited fine or possibly both. In addition, the seller will probably be unable to enforce the terms of the agreement with the buyer and the buyer will be entitled to recover the price paid together with compensation.

The consequences of assuming that the investment advertisement provisions of the FSMA do not apply and getting it wrong are clearly to be avoided. The best way of doing this is to be certain of the position before taking any particular course of action.

The usual way of advertising for a buyer is to prepare an "information memorandum" on the company. This document usually contains a range of different information about the company. It will contain accounting information, information about the company's products or services and other information presented to show the company in the best light. Certain information of a sensitive nature will be excluded but will be disclosed at a later stage in the sales process. Excluded information will include details of customers and the names of key employees; it may also include the name of the company itself.

Corporate financiers will use their databases and market knowledge to identify potential buyers. Having done so they will then contact the potential buyers. At this stage limited information is provided which is not sufficient to identify the company being sold but will need to be interesting enough to arouse the interest of the potential buyer. If the potential buyer is interested enough to take matters further then before being sent a

copy of the information memorandum they should be required to sign a confidentiality agreement.

The confidentiality agreement places the potential buyer under an obligation to keep all information provided to them about the company in confidence. This obligation should also include keeping secret the fact that the owners of the company are considering selling it. If this becomes widely known it can have an adverse effect on the company's business. It may unsettle employees many of whom may start to look for work elsewhere and it can also have an unsettling effect on customers and suppliers who sometimes assume that a sale is being considered because the company is in distress.

Assuming the information memorandum generates sufficient interest there are likely to be a number of potential buyers identified. There are then a number of ways in which the sale process can be managed. The one that is most common is for a preferred bidder to be identified and for the seller to negotiate exclusively with this preferred bidder for a period of time to see if an agreement can be reached. Some bidders may insist on this, as they will be reluctant to invest the time and incur the expense of investigating the target company and negotiating with the seller while the seller is negotiating with other potential buyers. Generally, this approach is easier to manage and less costly as it does not involve simultaneous negotiations with several bidders.

Second Hand Sale - Problem or Opportunity

Any company being sold will have a corporate history. In the case of the sale of companies which have been used to carry on a family business for several generations that history can be quite extensive. The length of a company's history is not the main issue. It is the fact that it has a history that is the significant point. The sale of a company is in effect the sale of "second hand goods". As with all second hand sales the nature and history of the goods will have a significant impact on their perceived value and companies are no different.

A company's history may add to or diminish this perceived value. A seller should therefore be seeking to ensure that as far as possible a company's history is more of an asset than a liability. This is, of course, difficult to address at the time a buyer has been identified and for that reason is something that the owners of a business should address as an integral part of running the business. Some of a company's history will be undocumented or outside the knowledge of the seller. Any gaps in the company's history and the seller's knowledge may be exploited by a buyer to "talk down" the price by raising the spectre of unknown and unquantifiable liabilities or the prospect of major future expenditure. A seller should therefore be seeking to minimise any gaps in the corporate history and address any problems arising from the company's history if he wishes to sell on the best possible terms, including price.

Selling on the best possible terms will depend on the company being in the best possible condition at the time of the sale. To do this the seller needs to consider in advance:

- what information the buyer is likely to want;
- what problems there are that might concern a buyer;
- whether the sale itself might give rise to any problems.

Investigating problems

When the seller has identified what information is likely to be required by the buyer that information should be reviewed. This should reveal any problems that might concern a buyer or cause delay or embarrassment. It may also suggest ways in which the company can be more favourably presented or the sale structured to the seller’s advantage. Points that often need to be considered are:

- **Outstanding litigation or tax disputes** - if there is any outstanding litigation or any tax dispute, the best course may be to resolve it before the sale. Disputes often depress the price a buyer is prepared to offer. They may also have to be covered by an indemnity from the seller when his control of the litigation or dispute may be impaired. The seller's control may be impaired both because the buyer may require some control over actions

taken in the name of the company he then owns and because the seller would not have the same flexibility to deal with the dispute as when he owned the company.

- **Dealings with connected parties (e.g. directors, major shareholders, their associated companies or families)** - if the company uses assets, services or facilities of connected parties of the seller or vice versa, these arrangements may have to be ended. This may be with or without any necessary transfers to or from the company. Alternatively, if it is not already the case these arrangements may have to be put onto a satisfactory arm's length basis. In some cases it may be necessary for the seller to make it a requirement of any sale that the buyer is able and willing to supply such assets, services or facilities. These matters are especially relevant where a subsidiary in a group of companies is being sold.
- **Records** - corporate and other statutory records of private companies are often not properly completed and up-to-date. This is partly because of the complexity of the Companies Act 1985 and other relevant legislation. Potential problems and embarrassment can be avoided if these are written up and it is ensured that the company's file at Companies House is in order. It is also important to ensure that all certificates for shares being sold and shares in subsidiaries are available, as are all title deeds and other documents relating to properties;
- **Third party consents** - it is important to identify what, if any, third party consents will be required for the transaction. It may be that some consents can be obtained, at least in principle, before a buyer is identified but in most cases this will not be possible, although it will still be useful to have identified what consents are required, both to be able to seek them speedily and to determine what conditions to the sale are required;
- **Balance Sheet** - it is sometimes found that the company's management have taken an extremely conservative view of contingent liabilities and greater provisions have been made than were necessary. Some assets may have been written down to the extent that, although they have a considerable market value, they have a low or nil value in the balance sheet. If identified at the outset regard can be had to these issues when negotiating the price.
- **Accounting Warranties** - the two accounting warranties that tend to cause most problems during negotiations relate to stocks and debtors. When negotiating the wording of these warranties it helps to know what the position actually is and if there are any problems relating to stocks and debtors.
- **Tax or other reconstructions** - the seller will want to minimise tax and to consider whether any action should be taken prior to the entry into of arrangements, or even negotiations, with any buyer or at the time of the sale, which could mitigate his tax liabilities. These might have to be explained to prospective buyers at the start of any negotiation.

Most corporate lawyers are familiar with the consequences that can flow from the seller failing to investigate their own company thoroughly before a sale. These are not confined to the seller merely being embarrassed during the course of negotiations or getting less favourable terms for the sale.

Corporate law can be extremely complex. In part this is because much of the relevant law has its roots in a time when social standards and expectations were very different. Whether this complexity is justified or not shareholders and the directors of companies are left to deal with it.

The following case study illustrates just how easily the seller of a company can suffer adversely because of a failure to conduct thorough presale investigations and take appropriate action in the light of the investigations.

Case Study

The shareholders of the company were also the directors. The company wished to acquire some property, which the directors believed could be sold together with some of the company's existing property at a substantial profit. However, the company did not have the financial resources to acquire the property itself. The directors agreed amongst themselves that some of them had the means to acquire the property, which could then be sold with the company's property at a profit for all.

In order for the relevant directors to be legally entitled to keep this personal profit they should formally have declared their interests in the arrangements and the shareholders (who were the same individuals) should have passed a shareholders' resolution ratifying the arrangements. They failed to do so. When the

company was sold the new owner successfully sued the directors who had to hand over to the company all the personal profits they had made.

Even if the directors had not taken appropriate advice at the time they entered into the transaction any competent lawyer involved in a presale investigation should, given the relevant information, have been able to advise about what steps were necessary before selling the company.

Warranties and Indemnities

If a seller wishes to maximise the value realised on the sale of a company, he will have to accept some of the risk which would fall on the buyer under the *caveat emptor* rule. The way in which this is done is by the seller giving the buyer certain warranties and indemnities. Warranties and indemnities are the main sources of a seller's potential liabilities under a sale and purchase agreement. Warranties and indemnities are fundamentally different in nature and the damages awarded for breach of a warranty and under an indemnity claim will usually be very different.

- **Warranties** - Most warranties in a sale and purchase agreement take the form of a simple statement of fact. For example: "All insurable assets owned by the Company are insured to their full replacement value".
  If the statement is untrue, and the seller has not disclosed to the buyer that it is untrue and in what respect, the seller will be in breach of warranty. On discovering this, the buyer may consider action to recover damages. The aim in awarding damages for breach of warranty is to place the buyer in the position he would have been in if the warranty had been true. Generally, this will mean that damages will be the difference in the value of the shares acquired if all the warranties were true and the actual value given the breach of warranty. The relevant time for determining the value is the time when the shares were acquired. In many cases the difference in the two values will be negligible. The fact that not all a company's insurable assets are insured to their full replacement value may have little or no impact on the value of the company as a whole. In the case of other warranties and breaches of them the effect on the value of the company may be substantial. This illustrates that the primary function of a warranty is to underpin the value of the company being acquired and uphold the basis of the bargain struck between seller and buyer.
- **Indemnities** - An indemnity differs fundamentally from a warranty in that an indemnity is an agreement by one person to reimburse another in respect of any loss suffered by that person as a result of specified circumstances. Taking the example given above if the buyer discovers that some of the company's assets are not insured to their full replacement value then if he had an indemnity he could claim the cost of obtaining such insurance. If the lack of insurance on the stated basis is discovered when an asset has been lost the indemnity claim may also include the cost of the asset to the extent that that cost has not been recovered from an insurer.

  In most cases, indemnities will present a much greater risk to the seller than warranties. In the case of a company sale the seller will be expected to indemnify the buyer against certain tax liabilities, principally unquantifiable historic tax liabilities although other tax liabilities may also be covered. A buyer may also want other indemnities in respect of specific problems it has identified or which have emerged as a result of a disclosure against a warranty. Potential environmental liabilities are often the subject of requests for indemnification, which often give rise to difficult negotiations. Reducing the risk of liability under a warranty or indemnity

  In seeking to reduce the risk of suffering a warranty or indemnity claim the seller's first and best line of defence is to limit the scope of the warranties and indemnities given to the buyer. This is essentially a matter of negotiation and skilled drafting. A seller eager to minimise his risk should therefore be seeking to exploit the advantages he has as seller to control the negotiating agenda. A seller who is well prepared at the outset and adopts a proactive rather than reactive approach to the negotiating process will almost always secure that the sale and purchase agreement contains fundamentally more favourable terms.

Once the warranties and indemnities which are to be contained in the sale and purchase agreement have been agreed, there are a number of further provisions which can be included to protect the seller and which are usually acceptable to a buyer. The first of these is to provide that the buyer must bring a claim against the seller within a specified period of time. The time period usually differs depending on the nature of the claim

concerned. These time limits are typically:

- 7 years for claims relating to tax;
- 3 - 7 years for claims brought under an environmental indemnity;
- 1.5 - 3 years for most other claims.

In addition to the agreement of time limits for bringing claims a monetary cap on the seller's liability is usually agreed and no well advised seller should proceed on any other basis. In most cases this is set at the price paid for the company. A buyer will usually concede that no claims should be brought until a threshold in terms of all claims has been exceeded. The precise level of this threshold is the subject of negotiation but will generally be a substantial sum. It is usually acceptable to the buyer as he has little to gain from pursuing claims with a low aggregate value where the costs incurred in doing so are likely to exceed the amount in dispute. For a similar reason the buyer may also be prepared to concede that any claim which has a value below an agreed level will not be pursued.

Apart from seeking to minimise the scope of the warranties and indemnities contained in the acquisition agreement the most effective means of reducing the seller's risk is through the process of disclosure. However, a buyer will not usually be prepared to concede that disclosure should enable a seller to avoid liability under an indemnity. Disclosure is therefore usually only of benefit in avoiding liability under a warranty. If the seller discloses through a "Disclosure Letter" to the buyer that a warranty is untrue and states in what respect that warranty is untrue the buyer will not be able to claim later that the facts disclosed amount to a breach of warranty.

Preparation of the disclosures is just one further area which benefits from thorough presale preparation provided those preparations contain some consideration of the warranties which are going to have to be given and the matters which will need to be disclosed against them. Addressing this issue early avoids some of the risk of making a material non-disclosure because the entire exercise is conducted in the highly pressured final stages of the transaction. It also minimises the risk of last minute delays.

- **Insurance** - Insurance against liability under warranties and indemnities is one further way in which a seller may choose to protect himself. A seller who has taken out such a policy may also find that a buyer is less inclined to seek to retain some of the price until all prospect of a warranty or indemnity claim has passed. This may be up to seven years into the future. However, the seller should be aware that an insurer will not cover all risks. Insurers will exclude liability under warranties that look to the future (for example, a warranty that all debts will be recovered). They will also exclude liability relating to any matter within the seller's own knowledge at the date of the agreement and for fraud or dishonesty. There are also a number of further areas likely to be excluded including environmental liabilities and adequate funding of pension schemes. The insurer will also want its own advisors to review the sale and purchase agreement and associated documents before it will issue cover and the costs of this will be borne by the seller.

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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.

Reference:

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