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Sell-side due diligence – it pays to know your business

During the sale of a business, any prudent buyer will want to know as much as possible about the target business. For this reason, sell-side due diligence ('SSDD') is crucial.

The SSDD exercise will give the seller a dummy run of the Buyer's due diligence process.

SSDD is carried out by a competent third party, authorised by the target company. SSDD is intended to reveal any weaknesses with the target company prior to the sale, allowing the seller to deal with any issues before they impact the price, efficiency, or prospects of any future transaction.

SSDD can cover a variety of different areas:

Commercial Contracts: the seller can assess the company's contracts, they can review the terms of such contracts, and can check to see if any of them contain change of control clauses.

Disputes: any litigation or complaints against the target business can be assessed and mitigated prior to any potential sale.

Employment: employment documents can be reviewed to ensure that they comply with employment law.

Finance: Is/are loan or facility documentation readily available? Consider how and when any charge registered against the company can be satisfied.

In most transactions, sellers are expected to provide warranty cover in relation to the target company. SSDD allows the seller to give such warranties with confidence, and assists in preparing the disclosure exercise against the buyer's Due Diligence.

Finally, SSDD gives the seller confidence to request a top price for the business by demonstrating a sound and reliable investment.

Daniel Southall
Solicitor

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THE TYRE KICK TEST

More business owners are opting to carry out vendor due diligence (VDD) before a sale, letting the experts sift through the books and contracts before taking the company to market. No one buys a business without at least 'kicking the tyres', so why not get the experts in to give a good pre-sale servicing?

It can be a bitter report to take in. Your accounting is not good enough. Contracts are out of date, poorly written, sometimes non-existent. You do not own your intellectual property. Your share options are a shambles. Thank goodness you stumped up the cash and grasped the nettle before anyone else did.

Increasingly, business owners looking to put their company on the market are opting for vendor due diligence (VDD). Also known as sell-side or vendor assistance, it is a deep-dive review of the firm designed to ensure that all is in order or to root out any hidden issues that might cause a buyer to ask searching questions, chip at the price, or even walk away from the deal altogether.

"More businesses are opting for VDD before taking themselves to market," says Ajay Dodhia, partner at Transcend Corporate Finance. "The problem is that the financial disciplines needed for the running of a business are not the same as those needed for a sale.

"For example, many SMEs are fixated by costs, and do not see the benefit of having a proper financial director or controller. That means the accounts, audit reports, balance sheet, directors reports, and financial records are not in complete shape, or at least not in a format that can be presented to a potential buyer. That's increasingly so following Covid, where finances can have fluctuated wildly: a buyer wants to see the wider, deeper aspects of the business to know that everything is in order."

One of the most important elements of VDD is that it gives the seller more control over the sale, rather than handing the initiative over to the buyer. It speeds up the sales process – cutting professionals fees. It minimises the disruption by removing a lot of the buyer's due diligence work.

Most of all, it stops the opportunity for a buyer to start chipping away at the price of a company as faults are uncovered.

"The main reason for a VDD is defensive," adds Austin Moore, of Austin Moore & Partners. "It rarely adds value to the

business, which can make it a difficult sell. However, it is important because it creates confidence among buyers that the business is all that it seems. If a lawyer or an accountant can find a fault during negotiations, they will often start to find others. One issue leads to another ten or 20 questions. If you can show that all is hunky-dory from day one it stops that drip, drip of questions and queries."

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>
> **Austin Moore**
> Austin Moore & Partners

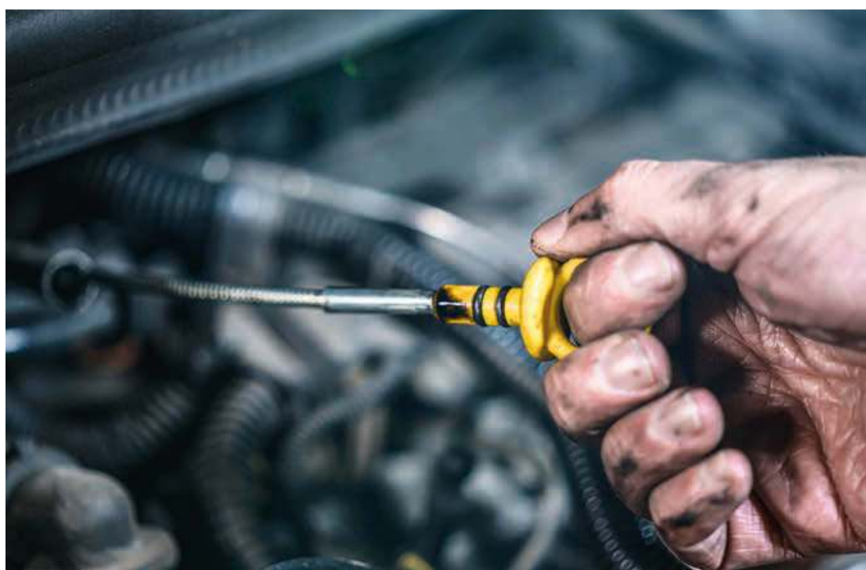
Who uses VDD?

Even though the use of VDD has grown, many businesses do not use it, either because of cost or the situation.

The VDD process is not cheap or quick. Pundits say the process typically takes a month, and needs perhaps three to six months more to rectify any issues found. Keith Spedding, partner at law firm Shakespeare Martineau, says that it is mainly used when the business is set to go through an auction, rather than a one-to-one sale. The VDD report, above all, is a marketing document. It is also not used during an "accelerated acquisition" or an administration process.

In addition, the scope of VDD has grown. It goes beyond just a look at the books and contracts, and can now include issues such as ownership of intellectual property, signing up to General Data Protection Regulation (GDPR) rules, insurance cover, compliance issues such as waste and financial services – for example a wealth adviser may need permission from the Financial Conduct Authority for a deal to go ahead, even for services it rarely offers.

Pundits say that issues such as sustainability and diversity may soon be added to the list of issues to be investigated. The other issue is simply cost. Having a team



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Beginning of the end

Completing the sale of your business is rarely the end of the affair. A seller's ongoing involvement may include:

- **Handover** Sellers who took an active role in the business should expect a period in which they facilitate the transfer of client relationships and management responsibilities. This can vary from a three-month ad hoc consultancy to longer term employment. Time commitment and remuneration are obvious issues, but sellers should consider how comfortable they will be when they no longer call the shots.
- **Deferred Payments** Protecting any deferred payments can include security over assets, guarantees, information rights and a veto over decisions that affect buyer's ability to make payments, such as extraction of value from the group via dividend, remuneration or asset transfers.
- **Earn Out** Where part of the price is dependent on future performance, sellers will want the ability to affect future decisions, to continue to contribute and to add-back buyer charges.
- **Retained Equity** Sellers often retain an equity interest and acquisitions structured in tranches are increasingly common. A primary issue is ensuring a clear exit route, whether through a put option or an ability to influence future sale. The details of the ongoing shareholder relationship should be hammered out.
- **Restrictions on Activities** Buyers will wish to restrict sellers from being involved in competing businesses or from dealings with customers, suppliers and employees. The common assumption that those restrictions will not be enforceable is incorrect, provided the restrictions are proportionate.
- **Warranties** Sellers can expect to give warranties as the state of the business' finances and trading at the point of sale, but not its future performance. Qualifying and limiting those warranties is a key part of the lawyer's role.

For these reasons, completing the sale is the start of a next stage, where control and influence will be governed by the quality of legal documents.

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of professionals rooting through the books does not come cheap: a VDD report for a typical SME may run well into five, possibly six figures. Spedding says that makes it uneconomical for a deal size of below £5m as the vendor is unlikely to recoup the cost, even when extra negotiating time and the danger of chipping are factored in.

What issues can a VDD throw up?

Many, varied and unexpected is the simple answer. If a sell side due diligence report finds that all is well, and the company's paperwork and figures just need a little regularising and formatting, consider yourself lucky. However, some of the main issues that are often be revealed are:

DATA

"A classic that I see regularly in VDD investigation is GDPR," says Spedding. "Three years on and a lot of businesses think that it simply does not apply to them. Yet most don't realise just how much personal information on staff, customers and suppliers they hold, and they need to register. The irony is that it only costs £70 to register and takes no time, but it is a major issue if left unattended."

> "Unsigned agreements are more common than a lot of people suppose, even in sectors you'd think were quite sophisticated."
>
> **Keith Spedding**
> Shakespeare Martineau

OWNERSHIP

It may sound obvious but one of the main issues a VDD needs to sort is just who owns the business. The issue has been complicated by the success of the Enterprise Management Incentive (EMI), which gives deferred share options to

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employees without any tax bill arising until the shares are sold. EMI rules are quite strict – options need to be exercised within ten years, they can be made to lapse if certain events arise, for example if the employee leaves the employment or the business is sold, when they have to be exercised. However, a high proportion of them are not even formally registered.

INSURANCE

It is now almost impossible for a seller to get insurance for a deal: the market has now wholly moved towards supporting the buyer. However, the seller can make two major steps: the first is by negotiating a limit to their liabilities with the buyer, even as low as token £1. The second is to allow

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>
> **Ajay Dodhia**
> Transcend Corporate Finance

the buyer to take out insurance but agree to pay part of the premium. It is not the personalised cover many would like, but better than nothing.

CONTRACTS

A surprising number of business deals, particularly among SMEs, are completed on little more than a handshake, with the parties agreeing verbally what will take place and putting the sketchiest of details down on paper, which often quickly go out of date. However, the old phrase 'a verbal contract is worth the paper it's written on' comes to the fore.

"Unsigned agreements are more common than a lot of people suppose, even in sectors you'd think were quite sophisticated," says Spedding. "Many still operate on trust and handshake rather than a formal contract. Sadly that's of little use when the seller leaves."

DIGITAL

Many businesses may have failed to ensure they actually own their domain name, which may have been registered years ago by an IT manager – often long departed – in their own name simply because they were asked to do it. Legally that manager, wherever they are, still owns it. Similarly, a business's website is often owned by the digital agency that designed and built it because it was never asked to sign over the copyright. All done in good faith, and perhaps at a time when digital was barely a flicker on a first generation Apple Mac, yet a buyer will want to be assured their purchase owns and controls its access to the digital world and online customers.

IP

Intellectual property is regularly missed from a quick sweep of a business's assets and liabilities, often because it does not appear on the books or on many contracts. Yet it is becoming an increasingly important part of a business's value.

IP ownership often goes beyond the typically perceived issues such as patents and brands, and into the very fundamentals of the business. For example, who owns the databases? Who owns the tooling at a manufacturer? Is it the company or its customer, and who gets control of it when a crisis hits?

Some IP exists on creation and does not require registration to secure protection – including copyright, unregistered trademarks and goodwill, unregistered design rights and database rights.

Other forms of IP are registrable, meaning the owner has to apply to a government authority for rights over patents, registered trademarks and registered designs. Often they are also limited geographically with separate rights existing independently in each country.

Rights frequently require the payment of an annuity to keep them in force so the question needs to be asked if the

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Four things to look for when picking your legal team

1. Probe their experience
When choosing your lawyer do not be afraid to ask what experience they have in business sales and acquisitions. Ask them for recent examples of deals that that have worked on and get them to talk you through the process of the transaction and how it works, as it will give you a sense of their experience level.

2. Keep costs down by appointing your lawyer at an early stage
Good corporate lawyers will add value during the negotiation stage and provide useful input to assist in the negotiation of the deal and the Heads of Terms if necessary. They can also put confidentiality or exclusivity agreements in place that will safeguard important information about your business and its use during the sale process.

3. Commercial, approachable and jargon free
Most corporate lawyers should have the appropriate level of technical expertise to deal with the legal issues in a business sale transaction. Selling your business is a huge thing for any owner- it is a complicated matter and it is essential that your solicitor is approachable and that they can communicate things to you effectively and free of legal jargon.

4. Transparency on legal costs
If the legal side of things is not dealt with properly it could leave you with considerable potential liability in the future. Bear this in mind and don't just go for the lowest quote. Look for an experienced, personable, and responsive person to act on your behalf and if they are the right person then they will add value during the process.

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Managing your wealth pre and post business exit

You may have an idea of what your business is worth, but have you considered how much is required to maintain your desired lifestyle at exit? Involving a financial adviser in the early stages can help optimise your financial position when the time comes.

Preparing for exit

With a transaction as life-changing as selling your business, your personal and business plans must be consistent. With specialist lifetime cashflow modelling software, a financial adviser can incorporate income, expenditure and financial obligations to clearly show the financial impact of a decision to sell now or in the future.

Armed with the knowledge of how much your business needs to be worth, you may decide to exit sooner than originally thought. Conversely, your plans may need to be deferred or your post-exit lifestyle adjusted.

No business owner should consider selling their business without this clarity.

Your retirement fund

Maximising pension contributions over many tax years prior to your exit is key, this can reduce personal and corporation tax liabilities, while providing a fund separate to your company's performance and risks. A financial adviser can help invest your fund according to your ethical and personal preferences or even assist with acquiring a commercial premises to save tax and fund the expansion of your business ready for exit.

With 25% of your fund available tax-free under current legislation, there is flexibility on how your income can be drawn tax-efficiently throughout retirement. Your pension fund is considered outside of your estate and is not liable to Inheritance Tax (IHT) at 40%, therefore drawing from other available capital in the first instance can help maximise the wealth you pass to future generations.

What to do with the proceeds post-sale?

Reinvestment across multiple tax wrappers for you and your spouse is vital to reduce your future Income and Inheritance Tax liabilities. ISAs, Pensions and VCTs are treated differently for Capital Gains and IHT purposes and a financial adviser will use these tools to carefully structure a tax-efficient retirement and IHT plan.

A post-sale review of your consultancy and earn out remuneration as well as your asset position should be undertaken to ensure tax-efficiency.

You may have personal mortgages or liabilities that could be repaid. Equally, leaving this debt within your estate could be useful in mitigating IHT.

The intricacies of investing

Business owners who have been hands-on in growing their businesses often find it difficult to relinquish control of the proceeds. However, a professionally-managed and globally-diversified investment portfolio containing equities, bonds, property and cash can ensure inflation-beating growth to sustain an ongoing income in retirement.

Prior to sale, business assets do not form part of your taxable estate, however, they will do once the shares are sold. Estate planning tools such as Gifts and Trusts can ensure monies are free from IHT after 7 years, while investments into Business Property Relief (BPR) qualifying companies provide IHT relief after just 2 years, meaning your hard earned wealth and assets can pass through the generations free from tax upon death.

The old cliché "my business is my pension" is very pertinent.

You have been an expert in controlling your business' future and profitability; however, on exit, handing over the reins to a trusted financial adviser to invest the proceeds wisely and responsibly can ensure you fully enjoy the fruits of your labour.

Jamie Ellis Dip PFS
Financial Adviser, Jerroms Financial Planning

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Article written pre-Autumn 2021 Budget

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annuities are up to date. Tech-driven business are likely to have know-how associated with the practical knowledge that a skilled employee has about a particular product or process.

The business may also have trade secrets or confidential information, which by their very nature are not publicly known or registered, but still add value to the business.

"Businesses should review agreements that might affect ownership such as employment contracts, research, consultancy, and commercial agreements, such as for commissioned works, to check the provisions concerning IP ownership," says Kerry Rees, life science partner and patent attorney at HGF.

"Businesses should do all they can to get their house in good order. Is there a written down IP strategy that identifies the IP? Also, the processes in place to capture IP, how that is registered and who is responsible for the IP capture and registration process as well as how IP policies are communicated through the organisation so that potentially important IP is not lost. Then there's what is the position on third party rights, freedom to operate, and enforcement?

"A written strategy is more likely to instil confidence in the purchaser rather than not having anything. It could devalue a company or undermine a purchaser's confidence if the registered owner/applicant is wrong, or if a business believes it owns an IP right when it does not. When enforcing an IP

right, it's also essential that the ownership is correct. Getting it wrong can be hugely problematic at this stage."

POST-SALE RESPONSIBILITIES

It's done. You've sold the business, stashed the cash. Now is the time to walk away from a life's work. Or maybe not.

A couple of decades ago it was common for a seller to be given a consultancy role to help with the handover – introducing clients to the new owner, filling in on the background of some products, and being available at the end of a phone in case a vital file could not be found. If turning consultant, the seller should consider taking out some professional indemnity cover, as they will no longer be an employee of the business and covered by its insurance or limited liability.

> "Often in an owner-managed business much of the know-how and key relationships are held by the shareholder."
>
> **Gary Hyem**
> FRP Corporate Finance

Increasingly though, buyers want the seller to stay either as a proper consultant, a director or even retaining a stake in the business as an earn out. "We're seeing more deals that adopt structures with no break in the relationship between exiting shareholders and the acquirer," says Gary Hyem, director at FRP Corporate Finance.

"It comes partly from a post-Covid world where owner-managers want to de-risk and bring in external investors, and also where the logical transition is to sell to an up-and-coming management team who will benefit from the experience of the current owner being retained.

"Often in an owner-managed business much of the know-how and key relationships are held by the shareholder. So, to de-risk the deal it often makes sense for the seller to be retained. If they stay for three years or more, it's reasonable they should be motivated by keeping a slice of the equity and sharing in the upside."

One of the reasons buyers like to keep the seller on the books is to stop them setting up a rival company. Many buyers insist on the vendor signing an agreement, promising not to compete, or to poach clients, suppliers or staff.

However, it is difficult to prove that people and clients have not 'elected' to follow the former boss rather than being actively sought. An agreement needs a legal ruling to enforce, and the courts do not like wide-ranging, open-ended commitments that stop someone from earning a living in their chosen profession. Often a no-compete is strongest when it is time-limited and specific about geographies of sectors. ■

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