Mergers and Acquisitions: an introduction to the role of your legal team

1. Preparing for the deal

A substantial amount of preparation is required for any merger or acquisition before the main documents are drafted. The overall deal structure should be considered carefully; changing the deal structure down the line may be time-consuming and costly, and could weaken your bargaining position.

The deal structure is likely to be heavily influenced by the information gathered as part of the due diligence process. The due diligence process will also highlight other key questions that should be addressed early on, such as potential tax implications, third party consents required and the transfer of employees. The agreed deal structure and key terms are commonly set out in a preliminary document, the heads of terms.

It is usual for each party to involve their legal teams (as well as any other professional advisers, including accountants or tax advisors) at an early stage of any transaction, in particular in the due diligence process, as issues will certainly need to be looked at from a legal viewpoint.

a. Deal structure

- An acquisition can be structured either as a purchase of the shares of a company (**share sale**) or as a purchase of a collection of assets that make up a business (**asset sale**). The general rule is that a buyer will favour an asset sale as it can 'cherry-pick' the assets which it acquires, while a seller will prefer a share sale as all the liabilities of the company automatically transfer to the buyer along with the assets (and therefore sellers have no ongoing responsibility other than under the sale documentation).

- Another key element of a deal's structure is when and how the purchase price is to be paid. A seller will often prefer to be paid in full at completion, but a buyer may prefer deferred payments or earn-outs (where the seller receives additional consideration based on the performance of the target business). In terms of form of payment, a cash-light buyer may offer loan notes or shares as part of the purchase price, and a seller may be able to negotiate a higher price if it accepts such non-cash (and potentially riskier) payment.

b. Preliminary documents

- **Heads of terms** – this is usually a non-binding agreement that sets out the key terms of the deal. Having a document of this kind should help to reduce the scope for disagreement later on and provide important guidance to the legal teams on the parties' commercial goals.

- **Confidentiality agreement** – it is usually advisable, given the confidential nature of commercial information and the risks associated with leaks of such information into the market, to have this agreement in place, also known as a non-disclosure agreement (NDA).

- **Exclusivity agreement** – this prevents the seller offering the company/business to a third party for a certain period of time. However, a seller should only agree to a request for such a document if it is based on genuine commercial reasons, such as for an offer over market value, and if it has a realistic duration to achieve completion of the deal.

c. Due diligence

- The buyer should carry out legal, commercial, tax and financial due diligence for the buyer and the professional team investigate the target business/company. This process is essentially a fact-finding exercise to identify risk areas and matters which may reduce the value of the business/company.

- The process usually begins with the buyer issuing a questionnaire, requesting sight of particular documents and asking specific questions. For example, the buyer of a publishing house will request a full list of book titles clearly indicating whether the copyright for each title is owned or licensed. Specific questions may focus on what trademarks the business owns, how and where it stores its data and the

shape of its IT systems, as well as more general business questions concerning employees and property arrangements. The seller's answers form the basis of the warranties set out in the main agreement (see below), and therefore the due diligence process is a key part of the risk-allocation exercise that will take place during legal negotiations.

- A proper due diligence process will be lengthy and realistic provision for it should be made in the transaction timetable.

Key questions to consider at this stage:

What are the tax implications of the deal?

- Tax advice should be sought to ensure that the deal structure is tax efficient, in particular the way in which the consideration is structured.

Are any third party consents required?

- For example, from banks, landlords, shareholders, or regulatory or competition authorities. Certain business contracts, such as those between publishers and authors, may also require consent of the other party before a contract can be transferred to the buyer. All necessary consents should be identified by the due diligence process and conversations should begin early with any relevant third parties to ensure obtaining such consents do not hold up completion of the deal.

Are transitional services required post-completion?

- The seller may be required to continue to provide services on behalf of the buyer post-completion, for example payroll or IT functions. These should be set out clearly in a transitional services agreement, which should be negotiated alongside the other transaction documents.

Is the transfer of any employees governed by statute?

- If the business is being transferred as a going concern, legislation regarding the transfer of employees (TUPE) may apply; TUPE does not apply to a share sale. Sufficient time for an employee consultation will need to be included within the transaction timetable, clearly setting out who is responsible for each stage of the employee consultation process.

2. Documenting the deal

Once the buyer is content with the answers provided as part of the due diligence process (and any necessary amendments to the deal structure and/or price have been agreed to reflect the problems identified), the legal teams on each side will start to negotiate the deal documents.

The primary negotiated document will be a share purchase agreement, in the case of a share sale, or an asset purchase agreement, in the case of an asset sale. Various other ancillary documents, in particular a disclosure letter, will also be necessary.

a. Main agreement

Typically, a purchase agreement has several important and inter-related sections:

- **Purchase price**

- **Warranties and indemnities** – these provide protection to the buyer in the event that the company/its business and assets are later found to be worth less than was understood at the time of completion and, as such, they are often heavily negotiated. Warranties are statements of fact about the business/company on which the buyer can rely; if these are found to be untrue, the buyer can sue for damages. An indemnity is a promise given by the seller to reimburse the buyer in respect of a particular

type of liability, should it arise; indemnities are often given with respect to specific issues which arise out of the due diligence process.

- **Limitations** – as well as negotiation of the warranties and indemnities themselves, the seller will seek negotiation of liability caps and time limitations with respect to any claims the buyer may bring.

- **Restrictive covenants** – these limit the right of the seller to compete with the buyer or deal with specific third parties post-completion for a limited period of time (usually up to three years).

b. Disclosure letter

- Disclosures are used by the seller to qualify the warranties. If a warranted fact turns out to be incorrect, the buyer has a claim for breach of contract. However, there will be no claim if the facts which give rise to the breach were disclosed in a separate document called the disclosure letter. For example, a warranty may be given by a selling publisher that it is the owner of all of the copyright for its titles. If, in fact, the publisher is only a licensee for two of its titles, this should be set out in the disclosure letter; if not, the buyer could claim for any loss it incurs, such as the amount of the annual licence fees. Disclosure is an important process because even if the buyer has previously been provided with such information during the due diligence process, this may not be a sufficient defence against a claim for breach of warranty.

- The disclosure letter is a key document for both parties. If a seller makes inadequate disclosures, the buyer may make a claim for breach of warranty. If a buyer does not adequately review the disclosure letter, there may be some unwelcome surprises after completion; no matter how thoroughly due diligence is performed, the disclosure letter almost always throws up something previously unknown. In fact, a disclosure can often lead to a renegotiation of commercial terms.

C. Ancillary documents

- As well as the main purchase agreement and the disclosure letter, there will be a substantial number of ancillary legal documents. These vary depending on whether the transaction is a share sale or an asset sale.

3. Signing, completion and post-completion

If there are conditions that need to take place before completion, there will be a period between signing of contracts and completion. Otherwise, signing and completion will be simultaneous. Both signing and completion are normally orchestrated by the legal teams of each party.

A number of actions will be required by both parties and their legal teams following completion, including:

- Filings at Companies House;
- Paying Stamp Duty Land Tax, stamp duty (in the case of a share sale) and any other relevant taxes; and
- Announcements/notifications to third parties - for guidelines on how to manage this process, please see the BIC note “Acquisitions and Divestments Best Practice Guidelines”.

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