BUSINESS SUCCESSION PLANNING (PART 2)

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It is increasingly common for family-run small medium enterprises to sell their businesses rather than to pass them on to their children. This could be due to them not being able to find a successor or realising that a sale was a better solution than to hand the businesses to their children, for various reasons

This write up is a brief outline of the legal aspects of disposal of a private limited company, from the perspective of the owner vendor (who usually is also the key executive) of the company.

Management buy-out

Before considering a sale to a third party, an option is to approach the management of the company and see if any of them would be interested in taking over the business as the new owner. Since the management would already have an intimate understanding of the company and the business, the transition process may be smoother. However, this could only be applicable if, apart from family members, the business is managed by non-family managers.

A management buy-out would ensure the continuity of the business, preserving any goodwill or legacies that the business owner has worked hard to build. The legal documents for the transfer are likely to be less complex, disclosures that are to be provided to a third-party buyer may not be required and the business owner may be able to sell the business without providing extensive warranties. Due diligence may not be necessary, or even if required, would be limited or qualified, as management would have been in control of the business. Nevertheless, it could be challenging to agree on the price with the management, as depending on the business, goodwill may be attached to the personality or particular skill of the original business owner. This is typically the case in small businesses, and with the exit of the original business owner, the value that was initially attached to the company or business may be reduced. In some cases, it may be possible for the original business owner to retain a small share in the business, but he or she will not play a part in the management of the business.

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An initial public offering may not work for small businesses where the owners have no desire to expand beyond the family network. However, with careful planning, family businesses, which may have started out small, may eventually grow and have enough market share or size to be listed on a stock exchange, if they meet the criteria for listing on the relevant stock exchange. If a listing is one of the main objectives, it makes sense that the small companies practise good corporate governance from the start, with transparency and communication between business owners, management and their investors.

Sale to third party purchaser

A potential purchaser may be interested in the target company for a variety of reasons—it may be for a piece of real property, certain infrastructure, or intellectual property owned by the target. In some cases, it may be preferable for the acquirer to purchase the shares of the target company instead of its assets; with a share purchase, it is generally not necessary to separately transfer items such as contracts that the company is a party to, reapply for licenses, or pay for stamp duty on the transfer of property, and the purchaser acquires the business as a whole.

If the transaction sought is a disposal of shares in the target company to a third party purchaser, the vendor would have to consider matters such as whether he would sell his entire shareholding or retain a certain percentage of the shares in the target company. If there are multiple shareholders, consideration and discussions may have to be held between the shareholders to determine if all or only some of the shareholders are selling their shares and if yes, whether they will be selling all or part of their shares in the target company. A review of the company's constitution and any existing shareholder agreements would be required, to determine if the sale may take place, and the presale procedures. Approvals and written consents from financial institutions may also be required for a sale of the assets or shares in the target company, and the vendor may have to ask for a release of any personal guarantees provided to these financial institutions.

Separately, a third party purchaser may be acquiring the company, with a view to list the target or simply to increase the size of its business for the purposes of listing another company within its group. This will have an impact on the decision of the shareholders in the target company, in relation to the disposal of their shares, i.e. whether they may be able to exchange their shares in the target company with new shares in the listed company. If there is more than one company within the vendor's group of companies, the vendor may also consider whether to restructure the business by amalgamating entities within the group prior to the proposed sale. This may be preferred if some of the companies in the group are no longer profitable.

Merger with another business

A business owner may wish to consider merging with another business, as part of his or her exit strategy. Upon completion of a merger with another business, he or she may opt to not play a part in the management of the business.

Non-Disclosure Agreement

Parties will likely need to exchange confidential information in order to engage in effective discussions. If the vendor intends to release sensitive information, such as its financial information, it is best to sign a non-disclosure agreement with the potential purchaser so that if the sale does not materialise, the risk of such a person disclosing the information to other parties is mitigated. In any case, a non-disclosure agreement should be in place prior to the commencement of any due diligence exercise.

Term sheet

As part of the initial negotiations, the parties may prepare and sign a term sheet or memorandum of understanding that sets out the basic terms for the sale, such as the asset to be sold (eg. the shares in the company or the assets of the company) and the price.

Usually, the term sheet would be a non-binding agreement, with an exclusivity period stating that the parties will only negotiate with each other for a period of 3 months. This is usually for the potential purchaser’s benefit so that the vendor cannot enter into talks with multiple potential purchasers at the same time. During the exclusivity period, the parties will refine the terms of the deal and negotiate the final sale and purchase agreement, the latter of which would be binding.

Due diligence exercise

Due diligence by purchaser

Unless the sale is to management, the prospective purchaser would usually wish to undertake a process of due diligence during which time the purchaser’s in-house or professional advisors would conduct investigations into the target company, typically from the financial, tax and legal angles. The areas covered by the legal team depend on various factors including the value of the transaction, the purchaser’s interests and concerns and the industry the target is in.

However, typically, a legal due diligence report for a share acquisition would cover the corporate secretarial records of the target company, existing shareholder agreements, licenses and permits, financing agreements, the major contracts which include its lease agreements, employment contracts for key employees, intellectual property, litigation and winding up searches. Studying these would give the prospective purchaser a better idea of the structure and value (assets and liabilities) of the company that it will be buying into.

Vendor-initiated due diligence

A well-prepared vendor may consider preparing a comprehensive and well-organised data room for inspection by prospective purchasers. Apart from speeding up the process, a lack of documentation to substantiate a vendor’s claims may well negatively colour a potential purchaser’s impression of the target company.

It may be worthwhile for a vendor to undertake vendor-initiated due diligence prior to any inspection of the business by prospective purchasers or their advisers. This exercise will be similar to that undertaken by a prospective purchaser and would be useful for the vendor to take stock of the business and/or rectify any irregularities. For example, the company may not be aware that certain licenses are required for the running of the business, or that they may have not been renewed, or that the company may not have properly registered or documented its ownership of intellectual property rights. A vendor initiated due diligence may uncover the need to properly document certain commercial arrangements, and in some cases, may even uncover fraud by management or employees. It is not uncommon in small businesses that certain commercial arrangements may not be properly documented, and the vendor may not be aware of the need for such documentation prior to a due diligence exercise.

Full disclosure

Although due diligence is usually undertaken by the prospective purchaser in order to discover deal-breakers or bargaining chips, it is also in the interests of the vendor to disclose information since whatever is fairly disclosed would be an exception to the representations and warranties contained in the sale and purchase agreement. Standard representations and warranties include but certainly are not limited to the following: (i) the company is compliant with all applicable laws and regulations and (ii) the company is not involved in any litigation or other claims. The vendor's lawyers may prepare a disclosure letter setting out the specific exclusions, for example, that there is an on-going dispute with a former employee so that the vendor cannot subsequently be made liable for losses arising from that dispute.

Sale purchase agreement

The content of the sale-purchase agreement varies vastly from a deal to a deal. Ultimately, the commercial terms would also depend on the bargaining power of the respective parties and on the result of the negotiations (which usually run concurrently with the due diligence exercise). It is recommended (from the vendor's perspective) that the vendor's lawyers prepare the first draft of the sale-purchase agreement and that the purchaser's lawyers review the draft and propose amendments. Nevertheless, it is common practice that the purchaser's lawyers prepare the draft of the sale and purchase agreement, and would control the drafting and finalisation of the sale and purchase agreement.

One common term that one can expect to be negotiated between the parties would be the non-compete and non-solicitation clauses, whereby the vendor is expected to agree to not compete with the target company or solicit any of its employees for a certain period of time after the sale.

Vendors and purchasers should also consider how payment is to be made, in various tranches, subject to any price adjustment mechanism based on profits, say, or at once upon completion, and whether there is a need for monies to be held in escrow.

Ancillary documentation

Depending on the transaction, ancillary documentation may be required. These would include resignation letters from current directors, new employment contracts with key employees (for example, an agreement for the previous owner to be employed as a consultant for a certain period of time after the sale), guarantees from the vendors, or share charges over the shares. If the sale does not involve a hundred percent disposal of the shares, a new shareholders' agreement may also be necessary to govern the relationship between the existing shareholders and the incoming shareholders. These ancillary documents would likely be referred to in the sale and purchase agreement, and their execution would be conditions precedent for the legal completion of the transaction, which is when the assets or shares are transferred in exchange for payment—failure to perform the conditions precedent would entitle the purchaser to withdraw from the deal. It is also not uncommon for loans from business owners or related companies to be extended to the target company for its business operations. These loans must be settled prior to the completion of the disposal and may be settled via the capitalisation of shares in the target or otherwise.

While most of the documentation would be prepared by the lawyers, the corporate secretary of the target company may also be involved in preparing share transfer forms, stamping, issuing share certificates, and making necessary filings with ACRA.

Conclusion

These are just some of the issues which a business owner may consider when exiting a family business, where no successor has been identified. A sale and purchase transaction between friendly parties (for example, a management buy-out) can be relatively simple, while another transaction (for example, with a third party buyer) can be a lengthy and arduous process involving a large amount of documentation and due diligence. Experienced legal and tax advisers can help devise the optimum structure for the disposal and address the challenges of executing a successful transaction.