If you’ve attended a BCMS masterclass, you already know that our process for selling a company includes an international research effort designed to give you multiple potential buyers. Having a choice helps the speed of the deal, its price, and its terms.

What the masterclass only touches on, however, is our diligence in negotiating with a buyer after you’ve agreed to a “headline price”.

As satisfying as it is to sign, a Letter of Intent is only the outline of a transaction. Real money is at stake during the difficult discussions that follow. We know this from completing more than 600 transactions in the last decade alone, usually with similarly experienced big-company deal teams across the table.

Authored by several of our senior advisors, this paper illustrates the typical “commercial considerations” of a successful Sale and Purchase Agreement that delivers the maximum value for your company.

Please contact your BCMS representative to discuss this topic as it relates to your particular situation.

This publication focuses on key commercial considerations that arise in deals between buyers and sellers. Deals with Private Equity will have additional complications and should be considered separately – please discuss this with your BCMS representative.
INTRODUCTION

Congratulations – you have reached an important milestone. You have negotiated the basic terms of a deal to sell your company. These terms likely include an understanding of the proposed purchase price and perhaps even the outline of your role after the deal is completed. The scanned copy of the letter outlining the terms arrives in your inbox from the Buyer, and you print and sign it.

Now the hard work begins.

BEFORE THE LETTER OF INTENT

Typically, negotiating with a buyer has two parts. In the first phase, you and the Buyer discuss the strategic and cultural fit between the two parties, and agree on the broad outline of a transaction as the outcome. This generally establishes the purchase price (sometimes expressed as a range of values) and the potential roles for ownership and senior management after the transaction closes, including “non-compete” restrictions on post-sale activities.

The two parties will often document their mutual understanding on these matters through a LETTER OF INTENT (OR “LOI”), which is a high-level summary of the transaction terms proposed by the Buyer, and often includes a timetable to reach the closing. It is in the Buyer’s interest to have a concise LOI, as that will accelerate their access to the confidential information regarding your company and provide them with greater flexibility in the later, more detailed negotiations.

The LOI can also take the form of a letter attaching a more detailed TERM SHEET. You may also encounter the term MEMORANDUM OF UNDERSTANDING rather than an LOI, especially if your transaction is structured as a merger of equals or a joint venture.
In return for the Buyer’s commitment to expend time and resources to conduct due diligence, they frequently receive a period of exclusivity so they can conduct their work without competition. The LOI is typically not binding on the parties, except for confidentiality and the period of exclusivity.

AFTER THE LETTER OF INTENT

The second phase, which begins immediately after the LOI is fully signed by the Buyer and the Seller, comprises negotiations that convert, and expand, the LOI into the AGREEMENT. This is a complex, detailed and customised document that can easily exceed 100 pages, including seemingly endless schedules and exhibits. The Agreement is where all of the outstanding questions from the LOI are documented, such as defining what in fact is being sold (equity, assets, real estate, etc.), describing a mechanism for adjusting the purchase price in the event of certain circumstances, detailing what happens to the company’s liabilities, and enumerating your own indemnification obligations for breaches of the Agreement.

Several of the components of a definitive Agreement are squarely legal matters, such as the choice of governing law, the dispute resolution process, and the deliverables required to close the transaction. The remaining elements, of which there are many – some obvious (such as the terms outlined in the LOI), some hidden – are what we refer to as COMMERCIAL CONSIDERATIONS.

Unfortunately, our experience is that many Sellers vastly underestimate just how fundamental these Commercial Considerations are to the final financial outcome of the transaction, and simply hand the LOI over to the lawyers to “write it up”, as if this were a mechanical process. When the negotiation of the definitive Agreement for the sale of a private company is delegated exclusively to your lawyer, they are often outgunned by the Buyer’s more experienced legal team. As a result, without sufficient attention and the right expertise, poorly managed negotiations can make the final payoff quite disappointing, expose the Seller to post-closing claims that were not anticipated, or lead to the deal coming apart altogether.

“Many Sellers vastly underestimate just how fundamental these Commercial Considerations are to the final financial outcome of the transaction.”

Whatever industry your company operates in, it is likely that it has never been critical to your success to understand the risks lurking in the drafting of an Agreement to sell a business.

Our purpose here is to help you identify the key Commercial Considerations embedded in an Agreement, so that you are better positioned to realise the greatest possible deal proceeds while assuming the least amount of risk.
When you make your final calculations, how you resolve Commercial Considerations will be worth real money.
PART 1: THE PROCEEDS OF THE DEAL

THE HEADLINE PRICE

The LOI most certainly will include an agreed-upon figure for what the Buyer is prepared to pay for your company. As an example, let’s say that this “Headline Price” (or, more technically, Total Enterprise Value, or “TEV”) is £25 million.

THE EQUITY PURCHASE PRICE

Often the Headline Price is described as a “cash-free, debt-free” amount. But very few businesses actually exist in this condition and this is unfortunately not the amount that will be transferred to your bank account at the closing. Converting this Headline Price to an amount that you will actually receive is the first Commercial Consideration. It is important to pay attention to what will be deducted from the Headline Price, which might include a very broad definition of the company’s outstanding indebtedness, loans from shareholders, overdue accounts receivable (for example, over 60 days), etc. See our Sample Transaction (page 7) for an illustration.

The next set of deductions relate to the costs of the sale itself, such as your own legal, advisory and accounting fees, and sale-related bonuses for senior executives or employees.

In the end, all of the amounts are deducted from the £25 million (pre-tax) Headline Price and you could wind up with far less. The amount after all of these deductions is referred to as the EQUITY PURCHASE PRICE.

PURCHASE PRICE ADJUSTMENTS

Now come additional changes which are termed PURCHASE PRICE ADJUSTMENTS (“PPAS”).

A common deduction of this sort, which we will cover later in this paper, is an amount placed in Escrow for a period of time to protect the Buyer in the event that the Buyer suffers a loss after closing based on a representation made by you that turned out to be untrue.

Another critical PPA is the WORKING CAPITAL ADJUSTMENT. This Adjustment is designed to account for the difference between (1) the actual net working capital level on the balance sheet of the company at closing and (2) the amount the Buyer and you have negotiated for what is appropriate for the company to maintain to support its operations in the ordinary course of events (this latter amount is known as the “Working Capital Target” or the “Working Capital Peg”).

Unfortunately, there is no standard, objective methodology for determining the Working Capital Target. Since any deviation from the Working Capital Target essentially represents an increase or decrease in the Closing Purchase Price, this area is often the battleground for extensive negotiations in the Agreement.

“The Headline Price in the LOI is far from what you may actually receive at closing.”
Reaching a resolution requires a detailed review of the company’s balance sheet, determining which specific line items should be considered part of working capital, what accounting methodology should be used to measure these line items, what has been the historical working capital requirements of the company, adjusting for seasonal or exceptional variations, and projecting what amount of working capital is likely to exist at closing.

The adjustment mechanism itself can come in many varieties, including a two-step adjustment in which there is an estimate at closing and true-up after closing, and will require extensive negotiation around how disputes regarding the calculation will be resolved and who will pay the costs of such resolution.

The final post-adjustment bottom-line number is the Closing Purchase Price. This is the amount of money that will be wired into the bank account of the Seller(s) at closing.

As discussed above, the Headline Price in the LOI is far from what you may actually receive at closing. The tradeoffs and decisions you and the Buyer make during negotiations will increase or decrease the final Closing Purchase Price. When you make your final calculations, how you resolve Commercial Considerations will be worth real money.

In this example, we illustrate the significant impact that some commercial considerations have on the proceeds at closing of a sale transaction.

<table>
<thead>
<tr>
<th>Commercial Consideration</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Headline Price</td>
<td>£25,000,000</td>
</tr>
<tr>
<td>Overdue Accounts Receivable (&gt;90 days)</td>
<td>£500,000</td>
</tr>
<tr>
<td>Line of Credit</td>
<td>£750,000</td>
</tr>
<tr>
<td>Long-term bank debt</td>
<td>£4,000,000</td>
</tr>
<tr>
<td>Loan from majority shareholder</td>
<td>£1,000,000</td>
</tr>
</tbody>
</table>

**Transaction-Related Deductions**

<table>
<thead>
<tr>
<th>Service</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>M&amp;A lawyer</td>
<td>£100,000</td>
</tr>
<tr>
<td>Transaction accounting services</td>
<td>£25,000</td>
</tr>
<tr>
<td>Closing Bonus for non-shareholder CFO</td>
<td>£500,000</td>
</tr>
<tr>
<td><strong>Equity Purchase Price</strong></td>
<td><strong>£18,125,000</strong></td>
</tr>
</tbody>
</table>

**Purchase Price Adjustments**

<table>
<thead>
<tr>
<th>Adjustment</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Escrow</td>
<td>£2,500,000</td>
</tr>
<tr>
<td>Working Capital Adjustment</td>
<td>£500,000</td>
</tr>
<tr>
<td><strong>Closing Purchase Price</strong></td>
<td><strong>£15,125,000</strong></td>
</tr>
</tbody>
</table>

Read much more about the Working Capital Adjustment at:

[www.bcmscorp.com/working-capital](http://www.bcmscorp.com/working-capital)
DEFENDING YOUR PAYOUT

One strategy to protect the Headline Price is to include as much detail as possible in your Letter of Intent. While there will be pressure to move quickly to the due diligence / exclusivity phase, the more clarity you can obtain around economic issues such as the PPAs and the deductions to Headline Price while your leverage as a Seller is greater and your costs incurred to date smaller, the better the likely outcome will be. It will also help you avoid surprises and delays, which lead to additional legal fees and possible foundering of the deal.

Unfortunately, Buyers prefer LOIs to be more ambiguous, and for understandable reasons. In the early discussions, they don’t have as much information about your company available to them and strategically they don’t want to be accused of moving the goalposts later on when they propose changes. They will learn the details as they conduct their due diligence, but remember that’s something that begins well after a Headline Price has been established and during the exclusivity period, which weakens the Seller’s ability to hold its ground.

"Unfortunately, Buyers prefer LOIs to be more ambiguous, and for understandable reasons."

Most company owners prefer to sell equity. The capital gains tax treatment of a sale of equity is generally more favorable to a Seller than the sale of assets. A sale of equity (typically shares in a company or membership units in an LLC) is also “cleaner” for the Seller from a legal perspective as it involves the transfer of the entire legal entity, including its liabilities, to the Buyer. Consequently, if a Buyer agrees to acquire equity, the Buyer will expect a robust set of protections and disclosures in the Agreement because they are buying the entire history of the company, whether known or unknown.

The structure of the purchase usually involves a determination of whether the ASSETS of the company or its SHARES (“EQUITY”) are being acquired. Though this may appear to be a legal or technical question, in reality you will spend a lot of time with your advisors and accountants as you determine the best way for you to proceed.

In an ASSET SALE, you retain the legal entity and the Buyer acquires specifically identified assets, such as accounts receivable, property, plant and equipment, inventory, contracts, and intangibles such as intellectual property and goodwill. Buyers generally prefer to acquire assets because, in connection with the transaction, they are able to obtain an uplift in the base cost of the assets, which provides tax benefits to them over time. Also, in an asset transaction, the Buyer will typically identify the exact liabilities to be assumed, reducing their risk. That is less than ideal from your point of view, since it opens the possibility that you will retain responsibility for liabilities of the company after the closing.
The treatment of your contracts is a further consideration in selecting the appropriate deal structure. In an asset sale, it is likely that your contracts will require written consent from the counterparty (e.g. your customers and suppliers) in order for each contract to be assigned to the Buyer. This not only may create delays in the transaction, but also creates risk for the Seller in the event such consent is difficult to obtain. This could obviously be a significant issue if your business is concentrated with certain key large customers or key suppliers. In a sale of equity, while certain contracts may have a “change of control provision” requiring consent (such as a property lease), many normal course business contracts do not. These contracts would transfer to the Buyer without requiring consent of the counterparty.

Lastly, when you have minority shareholders, or perhaps dissident shareholders, the structure of the deal will be an important consideration as it will define the nature and timing of the approval process required for the deal to be completed. Each shareholder has their own set of tax considerations, after all.

EMPLOYMENT-RELATED CONSIDERATIONS

Employment considerations relate to the conditions under which you will have continued involvement with the company following closing. This may be as a full-time executive, part-time consultant or board member, or perhaps no role at all.

As you and your advisors negotiate the terms of your future role with the company, do not lose sight of the fact that there is a direct relationship between your compensation and the purchase price for the company. In the Buyer’s analysis, your compensation is a key assumption in the Buyer’s financial model. If the projections that you present to the Buyer reflect annual compensation for you of £100,000, but you are focused on earning £200,000 per annum under new ownership, that incremental amount will serve to reduce the cash-flow of the company and will likely reduce the purchase price. As a Seller, your analysis will be to determine which is more advantageous, to receive (a) your pro-rata share of the higher purchase price (and perhaps taxed as a capital gain) assuming you do not receive incremental compensation, or (b) a higher annual compensation amount (taxed as ordinary income).

In addition, you should expect your employment agreement to address other key matters, such as severance (what will you be paid, if anything, if your employment is terminated after the closing but before the end of the agreement), termination (on what basis your employment can be terminated post closing), and non-competition provisions (what limits will exist on your activities after termination).

Purchase Price, salary and benefits, severance packages and non-competes all touch one another, and you’ll need to explore a number of possible scenarios with your advisors to make sure you get the arrangement that works best for you.

“When you have minority shareholders, or perhaps dissident shareholders, the structure of the deal will be an important consideration as it will define the nature and timing of the approval process required for the deal to be completed...”
A VIRTUAL DATA ROOM FACILITATES THE DEAL

Successful negotiation of commercial considerations is easier when the parties have easy access to the facts about your business. An online “data room” is the remedy. It provides secure and controlled access to the canonical documents about your company, and as such takes the information-production friction out of the process.

In the past, data rooms consisted of a physical location – often at the office of a company’s lawyers – where a massive volume of documents required by a potential buyer’s due diligence process was placed in cardboard file boxes. Upon reasonable notice and during business hours, a potential buyer could examine the documents while monitored by the seller (or its representatives). To make copies a, written request would be provided by the potential buyer.

Today, a data room usually means a virtual or digital data room on the seller’s advisor’s server (or in the cloud) where information relevant to the company for sale is uploaded, organised, indexed and stored. When first introduced, virtual data rooms incurred significant cost – tens of thousands of pounds for a large deal – but costs have fallen significantly. BCMS clients are provided with a robust virtual data room free of charge.

The benefits are numerous. Large quantities of documents can be stored and easily organised. Indexes can be created automatically. Multiple potential buyers can access the information without being aware of other parties. Information can be uploaded to an internal-only area for review before sharing with potential buyers. Data rooms can be locked down and secured electronically. Since the data room automatically tracks usage, you get insight into what each potential buyer is reading, when they read it, and for how long.
In the current economic environment, from the Buyer’s perspective, cash is generally the preferred form of consideration as it represents an inexpensive source of funds in a low-interest-rate environment.
PART 2: BALANCING RISK, LIQUIDITY AND PRICE

TYPES OF CONSIDERATION

As we previously discussed, you may now have a better understanding of how the ultimate proceeds from the transaction depend on several factors after you have agreed a Headline Price in the LOI. So, the next Commercial Consideration to review is the form of consideration you will be receiving. Simply put, rather than how much you will be receiving, this refers to the type of payment you will be receiving and when you will be receiving the payment. Even if you touched on it in the LOI, you will certainly detail the specifics in the Agreement.

While a Seller’s preference is almost always to receive cash in a “lump sum” at closing, in our experience the form of consideration in most private company sale transactions comprises one or more of the following:

- Cash at closing.
- Cash, deferred through a performance-based earnout.
- Shares in the acquiring company.
- Cash placed in escrow (or a “holdback”) for a period of time.
- A Loan (“Note”) financed by the Seller.

In the current economic environment, from the Buyer’s perspective, cash is generally the preferred form of consideration as it represents an inexpensive source of funds in a low-interest-rate environment. Nonetheless, some Buyers may propose to fund some or all of the consideration in shares in certain circumstances, including when their ability to raise financing is challenged or when they are looking for you to continue to be invested in the company.

EARNOUT PROVISIONS

Earnout provisions provide the Seller with the opportunity to receive a higher purchase price after closing, assuming the company achieves pre-defined goals, often based on revenue or profit targets.

Earnouts seem to have a bad reputation among sellers – and we believe this is unwarranted. Most frequently we hear that earnouts are regarded as part of an elaborate “smoke and mirrors” tactic, in which the Buyer agrees to an attractive Headline Price in the LOI and then later on reveals that to obtain the Headline Price, a totally unrealistic, multi-year earnout needs to be achieved and the actual cash at closing is relatively small.

While there certainly are unscrupulous buyers out there, in our experience, a well-crafted earnout has a legitimate place in structuring a sale transaction. It is true that earnouts are complicated and it is also true that earnouts serve to de-risk the transaction for the Buyer.
However, provided that they do not represent a disproportionate amount of the total purchase price, an earnout can serve to bridge a valuation gap between the Buyer and Seller, especially if there isn’t a consensus on the projections for the company. For you, it is important to consider that the projections used to market the company may be used by the Buyer as the benchmark for the earnout.

Generally speaking, a Seller will prefer that the metric of the company’s performance to be used in the earnout – and thus the basis for determining whether additional purchase price is paid – will be something under their control. Revenue would be ideal in most circumstances. The reason for this is that after the closing it may be more challenging to control the costs of the company and the ability to measure performance (and avoid disputes) will be easier. In addition, the Buyer may place additional costs on the business; changing operations in a way that adversely affects the business’s ability to generate revenue or income, among others. In contrast, the Buyer may prefer to use operating income or EBITDA because such a metric will better reflect to them the true performance of the company, including expenses.

“An earnout can serve to bridge a valuation gap between the Buyer and Seller.”

Irrespective of what metric is selected, it will also be important for you to understand your role in managing the company after the closing and your level of autonomy in decision making. While the amount of the earnout and the metric used in its measurement is important, stay focused on ensuring that you have the ability to actually deliver the performance and meet the earnout hurdles.

SHARES IN THE ACQUIRING COMPANY

As mentioned earlier, Buyers will sometimes offer to pay all or a portion of the purchase price with shares in the newly combined company.

If the Buyer proposes to acquire your firm for 100% shares, there are a number of key considerations.

The first is liquidity. You will want to determine your ability to convert the shares you receive into cash. The Buyer may very well place restrictions on your ability to do so, including when you can sell the shares and to whom you can sell the shares. You will thus need to be comfortable trading one illiquid asset (ownership in your company) for another potentially illiquid asset. The value of your shares would also be diluted when new shares are issued, so you’ll want to know the legal provisions surrounding new issues.

Another consideration is how those shares will be valued at closing. You and your advisors should undertake an analysis of the value of the shares and essentially conduct the same sort of detailed due diligence on the Buyer that they are conducting on you, the Seller.

However it is structured, a deal that includes shares in the Buyer, or “rollover” shares in the combined company, results in your having an ongoing financial interest in the company after the closing. That means you’ll have to negotiate your rights as a shareholder, which may not prove very satisfactory. For one thing, you’ll be a minority shareholder, and at a disadvantage when it comes to obtaining and protecting your rights and influence. These provisions will be documented in a Shareholders Agreement or similar document that applies to you after the closing.
SELLER NOTES

Another way that Buyers can close a valuation or financing gap is by using a Seller Note (or “Vendor Loan”). Sellers should proceed with caution when this is proposed as it may, though not always, be a red flag because it signals the Buyer can’t secure the required financing to complete the transaction.

In this scenario, you would be financing a certain amount of the purchase price, essentially lending the Buyer the funds. The good news can be that as the owner of the company, you will have a view as to the creditworthiness of the borrower, but you will inevitably need to negotiate provisions to protect you in the case of default. It is typical that a Seller Note is highly subordinated debt, which means that you will need to evaluate your position in the event of a default on the Note; it is preferred for the Note to be secured with some kind of collateral or guarantee. It should fit with any other debt the Buyer needs to acquire and run the business and fulfill their obligations to you.

IF THE BUYER REQUIRES FINANCING

Every transaction is based on a fundamental premise: the transaction cannot close if the Buyer can’t obtain the money they need to pay the Purchase Price. That’s why it’s critical to question the Buyer early on about how they propose to pay for your business – through cash, external financing, a Seller Note, capital from an investor group, or some other means. Their approach will directly impact the structure of the deal by influencing whether you need to accept a note, shares or an earnouts. Those things, in turn, will influence the price they eventually pay.

If the Buyer requires funding from external sources to complete the transaction, you’ll want to become intimately familiar with their process to establish the likelihood they will in fact obtain the required capital, as well as the expected terms, and the timetable and milestones. Your M&A advisors will question the Buyer well in advance to ensure the financing process does not slow down the overall transaction and that they can deliver on the terms in the LOI.
This helps maximise your protection if the Buyer runs into financial troubles down the road. Finally, do the best you can to give your Note priority over as many other obligations as possible.

**ESCROWS**

Escrows are a common feature of definitive Agreements. In essence, escrows are “neutral” money that’s been set aside in a separate financial account so that if any claims are made against the Buyer by reason of a representation by the Seller in the Agreement being untrue, then the monies (either a portion or all) held in the escrow can be returned to the Buyer to compensate the Buyer for losses. The money is controlled by a third-party escrow agent, who releases it to you only when specified obligations under the Agreement are met. The account can represent up to 20% of a transaction’s value, though it averages around 10%. It typically remains open for 12 to 24 months, covering the same lifespan as the representations and warranties included in the Agreement.

Escrows differ significantly from “holdbacks,” which follow the same principle but allow the Buyer to keep the reserved money in their own account. Buyers like holdbacks because the holdbacks put the Buyers in a stronger position should disputes arise. That’s a big reason we strongly resist accepting them in almost all cases.

**CONCLUSION**

The combination of complexity and high stakes involved in negotiating the Commercial Considerations are generally not understood by Sellers until too late in the process. Accordingly, it can be extremely beneficial for company owners to have experienced advisors working with them throughout the transaction process, industry veterans who understand how these considerations work and how they impact each other.

The best advisors have years of experience in the private market and have witnessed how transactions proceed after closing. They deploy this knowledge to your benefit to make sure your interests are protected and you end up with the most favourable deal possible.

As described in this paper, negotiating the sale of a company isn’t a pro-forma process. It requires more than a boilerplate agreement with a few blanks to be completed. However, with the right advisors at your side, you will be better positioned to secure an agreement that sells your company on the most favourable terms while protecting your financial interests and long-term goals.
Discuss your business, its potential suitability for a sale transaction and the options available to you at an individual consultation with a senior BCMS advisor. You’ll be able to discuss your position in complete confidence, and meetings can be arranged at a time and location convenient to you.

To schedule, visit www.bcms.com/gb or call 0118 207 9800