ON THE ACQUISITION TRAIL

An essential guide to **purchasing a financial services business**
and the purchase process

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Pinsent Masons

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An essential guide to **purchasing a financial services business** and the purchase process

"Every exit is an entry somewhere else"
Tom Stoppard

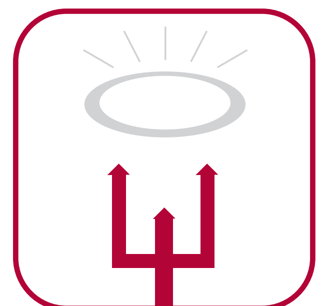
Many would argue that the financial services market is an emerging one which benefits from the most advantageous regulatory, commercial and business environment that has existed for some time. Whilst this environment may encourage many principals to plan their exit route, this, in turn, creates a wealth of opportunities for businesses or individuals on the acquisition trail – after all, "every exit is an entry somewhere else!" As principal, whether you own a small, medium or large financial services business, there may come a time when you may want to expand your business. One way to do this is by targeting appropriate businesses to buy. This guide has been prepared by Bankhall, in conjunction with solicitors Pinsent Masons, exclusively for Bankhall members and is essential reading for all prospective buyers of financial services firms, regardless of the size of the target firm or the amount of cash they have to spend. Central to the decision to buy another business is the need or the desire to expand, to increase revenues and profits, to maximise shareholder returns and the value of the business. Ultimately the acquisition may be with an eye on, in the long term, a disposal further down the track, perhaps even to flotation on the stock market.

A common method of entering the financial services sector is to buy the share capital of an existing firm, to buy a business as a going concern, or to buy key asset(s) from a firm to use within your own existing or to be created firm. This guide provides an overview of the key matters which should be considered generally by a buyer when preparing for any of these types of acquisition. It is tailored specifically to those matters that are of particular relevance to Bankhall members' businesses and applies to all the above types of acquisitions and the purchase of an equity stake by existing or incoming equity participants.

As a buyer, it will be important for you to have transparency regarding what you are buying and what risks and liabilities you could be taking on. The key considerations for a potential buyer are to have sufficient due diligence (financial, compliance, insurance and legal) on the target business to make an accurate assessment of the state of the business and to have comfort that there will be adequate protections in place to compensate you should the business or related liabilities turn out not to be as anticipated.

As the financial services sector is regulated, a buyer should be looking for evidence and comfort that all rules, regulations and best practice initiatives have been complied with, both to protect his reputation and investment and to minimise the risk of any problems or liabilities (whether relating to the period before or after completion of the transaction) arising or coming to light post-sale.

1. REGULATION – FRIEND OR FOE?



The Retail Distribution Review ("RDR") was launched in June 2006 and involves the FSA and industry and consumer representatives looking at the whole retail distribution chain, from product providers right through to those who advise and sell to the public. The RDR's specific aim is to identify and address the root cause of problems which, in the FSA's view, continue to emerge in the retail investment market.

The FSA has identified a number of themes in the RDR, which include the sustainability of the distribution sector. One of the concerns that led the FSA to launch the RDR was the apparent inability of many firms operating in the sector to create or retain value in their businesses.

Speaking at a conference in 2006, Managing Director Clive Briault said that the FSA wanted a “distribution sector that is here today, here tomorrow and here into the future. For that, we need businesses that are sustainable over the long term” and one of the FSA’s avowed aims for the retail market is to have “soundly managed and well capitalised firms who treat their customers fairly”. The FSA has continued to drive forward the major themes of the RDR with the publication of its Consultation Paper in June 2009.

The FSA has said that it has seen too many examples of firms, particularly in the advisory sector, with unrealistic long-term strategies for their business and unsustainable business models and these are unlikely to be consistent with the fair treatment of customers and part and parcel of sustainability is to consider expansion, growing your business, increasing your revenues and enhancing value through carefully planned and strategic acquisitions undertaken for sound business reasons and not as “knee jerk reactions”.

2. DON'T PAY OVER THE ODDS!

Business owners should challenge themselves on enhancing value in their businesses, to push the boundaries and think about expansion and growth. Do you need to increase the size of your customer base? Is there the possibility of acquiring an attractive book of business? Do you need more experienced advisers? What about diversification? Have you thought about doing business in other geographical areas?

And remember the FSA is very keen to encourage the financial services industry to become a sustainable profession with businesses that are in it for the long term.

The Retail Distribution Review

We cannot over emphasise the importance of keeping up to speed with what emerges from the FSA.

The RDR continues to be one of the FSA’s main strategic priorities. The five major themes of the RDR could be summarised as follows:

- the sustainability of the retail distribution sector;
- the impact of incentives;
- professionalism and reputation;
- consumer access to financial products and services; and
- regulatory barriers and enablers.

Whilst the regulatory framework creates particular complexities in the sale and purchase of financial services businesses, it is likely that it will also create a wealth of opportunities for parties considering an acquisition, as principals will be encouraged to plan exit strategies and implement a long-term plan to “groom” their businesses for sale.

Prudential rules for personal investment firms

A buyer should be aware of the requirements of the new prudential regime for personal investment firms such as IFA businesses.

This regime aims to simplify the calculation of capital resources, making it consistent for all firms and introduces the following:

- An “Expenditure Based Requirement” based on 3 months of annual fixed expenditure and raises the minimum capital resources level from £10,000 to £20,000; and
- A table of additional capital resources required to cover potential liabilities arising from PII policy exclusions.

Buyers should consider the effects of the new regime in relation to any potential acquisition.

Treating Customers Fairly ("TCF")

A target business that has ensured, and continues to ensure, that its customers are treated fairly and complies with the FSA's diktats in relation to TCF should be more attractive to a potential buyer. Such a business is, both in the short and long term, more likely to maintain and increase its customer base, to keep out of trouble with the FSA and again provide some comfort to a buyer in regard to how the business has been run and what liabilities come with it. This in turn will help protect the buyer's investment and reputation post-sale.

A buyer must note that the FSA's initiative on TCF is not going to go away. Firms had until December 2008 to have completed their work on TCF in order to demonstrate to the FSA that they are consistently treating their customers fairly. The FSA now expects all firms to treat TCF as 'business as usual' and will continue to monitor firms' position on TCF through thematic work and assesments. Firms can expect to be referred for enforcement action if they do not meet the required standards. As a buyer, if you perceive any hint that a firm you are targeting is behind in, or is not implementing TCF, you should consider the viability of the business, the potential risks in acquiring it and the amount of resource and oversight which might be required post-sale to implement TCF and mitigate any action from the FSA. The FSA wants to ensure that "fair treatment of customers is central to corporate culture" and it is something that affects the conduct of a business from "cradle to grave" from the first contact with a potential customer, advice and a point of sale, right through to the handling a complaint. If a buyer is comfortable with the target business, it should consider using its failure to embrace such an initiative as leverage in seeking a price reduction for the business.

Principles based regulations

The same is true of the FSA's move towards principles based regulation. This is another strategic priority for the FSA which sees the FSA moving away from dictating through detailed, prescriptive rules and supervisory action on how firms should operate their businesses, towards "giving firms the responsibility to decide how best to align their business objectives and processes with the regulatory outcomes [the FSA] have specified". As with TCF, buyers should consider how a target firm has adjusted to and coped with this change. If a buyer concludes that significant resource, cultural change and oversight will be required to achieve this, the buyer should make a realistic assessment of the cost and resource required to do this and consider whether this has any impact on the decision to buy or the price.

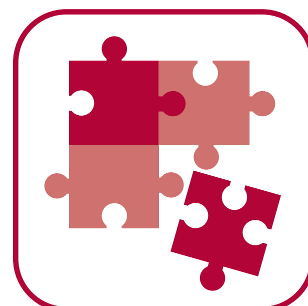
3. WHY DO YOU WANT TO BUY? ACHIEVING YOUR OBJECTIVES!

A buyer may seek to expand its business in many ways, one of which could be by an acquisition. An acquisition may be:

- Horizontal – the acquisition of a complementary business;
- Vertical – the acquisition of a supplier or distributor;
- Diversificatory – the acquisition of a business within a new market; and
- Geographical.

A seller may be selling for any one or more of the above reasons. Obviously, as a buyer it is essential to know and understand the rationale behind a seller's desire to sell, as the reasons for the sale can have a significant impact on the buyer's position in the negotiation process.

4. WHY IS THE SELLER SELLING? DO YOUR HOMEWORK AND GAIN INTELLIGENCE!



A seller may be selling for a number of reasons including:

- Voluntary reasons;
- Commercial reasons;
- Financial reasons; or
- Involuntary reasons.

A seller may be selling for any one or more of the above reasons. Obviously, as a buyer it is essential to know and understand the rationale behind a seller's desire to sell, as the reasons for the sale can have a significant impact on the buyer's position in the negotiation process.

5. WHO IS LIKELY TO BE INVOLVED IN THE DEAL? THE USUAL SUSPECTS.

- Buyer and Seller;
- Accountants;
- Bankers (or other sources of funding);
- Insurance brokers;
- Compliance consultants; and
- Lawyers.

There may well have been a great deal of negotiation between the parties and perhaps their financial advisers before solicitors are involved. Usually the solicitors will become involved when the heads of terms are being negotiated. Solicitors will play a major and indispensable role from this point and throughout the whole life of the deal until completion and beyond – make sure you get the right ones!

6. TYPES OF ACQUISITION

There are broadly two basic ways of acquiring a business: One is to buy the shares of the company which owns the target business or assets,(usually referred to as a share purchase); and the other is to simply buy the assets which make up the business, (usually referred to as a business or asset purchase). These two methods are fundamentally different.

On a share purchase, all the assets, liabilities and obligations are transferred to the buyer (even those that the buyer does not know about). However, if the assets are purchased, then broadly speaking, only the identified or "cherry-picked" assets and liabilities which the buyer agrees to take on are acquired. Sometimes the purchase will be simply of a database and income stream, where data protection, the treatment of commissions and the ongoing servicing of the client business will be key. This is explored in more detail later.

The key commercial difference between the two broad types of deal is that on a share purchase, the buyer acquires a company which owns a business, has employees and is running it as a going concern. An asset purchase will not automatically transfer contracts, self-employed advisers, employees, or existing trading arrangements to the buyer unless they are specified in the transaction documents or particular employment regulations apply (see below).

7. ISSUES THAT WILL INFLUENCE A BUYER'S CHOICE OF ACQUISTIION

Some or all of the following will influence the structure of an acquisition. For a number of the issues listed, the perspective of the seller and the buyer may very well differ. Whilst all purchases will involve a certain amount of management of risk between the parties, a buyer should seek to structure the deal to their own advantage, which may require skillful negotiations where this does not fit well with the objectives of the seller.

Liabilities – is "cherry-picking" as rosy as it sounds?

A seller will often prefer to transfer a company or group of companies lock, stock and barrel as all the liabilities usually then transfer to the buyer, whereas, by contrast, a buyer will most likely prefer an asset purchase where he can "cherry-pick" the assets he wants to buy and only take on known and quantified liabilities which he is prepared to accept. The most common example of cherry-picking in financial services businesses is where a buyer acquires the client list, sometimes accompanied by the right to receive trail commissions, the rest of the business being left behind. Data protection issues are paramount on these types of sale and are explored in more detail below. It is also important that on all asset deals or deals where parts of the client list are being transferred elsewhere, a list of clients to be transferred to the buyer is annexed to the sale and purchase agreement. This approach may suit a seller who has no employees, consultants, infrastructure or other assets in the business which could realise value. However, where this is not the case, a seller may well not be keen to sell on this basis and may seek to negotiate a share sale or the sale of all the assets of the business as a going concern. The buyer should carefully consider whether a share purchase is going to be an acceptable compromise if its initial aim was to cherry-pick assets and limit the liabilities he takes on.

A buyer should note that if he is too selective in cherry-picking he may not select enough of the business to constitute a “transfer of a going concern” and that he may have to pay VAT on any assets he buys. Tax advice should be taken at an early stage (see below).

Employment issues

As a buyer, you should pay considerable thought to employment issues on a share purchase where the company itself is bought lock, stock and barrel. The employees or self-employed consultants will remain employed or engaged by that company, which simply becomes owned by the buyer. This is not the case on an asset sale. In certain circumstances, specific employment regulations apply and employees are automatically treated as if their employment is, and has always been, with the buyer. The buyer and seller will usually request indemnities from each other that the regulatory process has been followed by each of them and both parties should seek advice on this at an early stage to avoid employment related claims arising as a result of the sale. In particular, both sides may be required to “consult” with the employees of the target business prior to the sale and the buyer must be able to provide the employees with the same or equivalent salaries and benefits as the seller post-sale.

Tax

Both parties will probably have very different objectives and it is unlikely that these can all be met within the same structure. Tax advice should be sought from your accountant at an early stage as you may be able to structure the deal in a way that will suit your own tax position. In particular, a buyer should note that he may have to pay Stamp Duty Land Tax on the property acquired and this will be an additional cost to be factored into the buyer’s calculations and budget. VAT may also be payable on an asset sale where insufficient assets are acquired to constitute a “transfer of a going concern”. Even where the transfer does constitute a “transfer of a going concern”, VAT may still be payable on any land which may be acquired as part of the sale and specialist tax advice should be taken in every circumstance. This could be costly to a buyer if he cannot recover any or the full amount of the VAT payable.

A partial sale

If the business for sale is a division of a larger business, it may be more practical to structure the sale as an asset based sale. Otherwise, it will be necessary to first set up a new company and transfer the division to that entity before proceeding with a share sale. This can add more time and cost to an acquisition.

Sale of an equity share

Where the deal is a purchase of an equity share of a business where there are other shareholders or partners, a share sale (or equivalent for a partnership) will be more appropriate. A shareholders or partnership agreement and tailored articles of association or membership agreement where the target business is a company or LLP will be required, in addition to the usual sale and purchase documents. These additional documents will require negotiation and, depending on the number of other shareholders or partners involved and their interests, a buyer may need to deal with a number of parties and their solicitors. This will add additional time and cost to the deal, but these are key documents which will govern the relationship of the equity stakeholders in the business going forward and therefore cannot be dispensed with or de- prioritised.

Consents

As previously stated, a buyer may well prefer the concept of an asset purchase rather than a share purchase. However, if third party consents are required to transfer assets or contracts and for any reason they are impracticable or even impossible to obtain, a share purchase may be the only practical way of acquiring the target business. A buyer should seek to understand what consents to the transfer of the assets are required at an early stage so this can be factored into the structure. Key consents relevant to the sale of financial services businesses are likely to be agencies with product providers and leases of property and vehicles etc., but there could be others. Consents required from the FSA are also considered below. A buyer should note that once he engages advisers to assist him with the acquisition, he will start to incur professional fees and charges. In the event a key third party consent cannot be obtained and the deal is aborted, the buyer will still be liable to pay these costs, so third party consents should be identified and sought as soon as possible in the process. Where this cannot happen for commercial reasons, a buyer should weigh up the risk of proceeding to the risk of incurring costs on a deal which does not come to fruition.

8. THE PURCHASE PRICE – HOW MUCH AND HOW IS IT STRUCTURED? COMMISSION CONSIDERATIONS

If the transaction is a purchase of the business and assets, included in the purchase will typically be goodwill, product provider agencies, customer contracts, real property, intellectual property, business names, client records, databases and employees etc.

It is perhaps an understatement to say that the purchase price is very important to both parties! Particular attention needs to be paid to the treatment of commission, contractually documenting the rights which are acquired by the buyer and which rights remain, if any, with the seller. For example, the buyer may acquire the right to receive renewal commission paid after completion of the sale. It is of course in both parties' interests that there should be absolute clarity about any cut off date in terms of the right to receive any commission income. There should also be absolute clarity regarding who is responsible for claw back and the ongoing servicing of the client's business.

Consideration also needs to be given to "work in progress" at completion. Who will have the right to commission income derived from "pipeline" business post completion (e.g. discussions with customers or prospective customers in respect of which applications/proposals have not been completed, or have been submitted to the life office but have not yet been accepted.) Of course, as the buyer you will seek to gain all, or as much as possible, of this commission income, with the flip side of this being that the seller will seek to do the same. If the right to recover commission is linked to business "written" at the date of sale, a clear definition of what this term means will need to be documented and a prudent buyer will carry out due diligence and obtain contractual protections against the seller manipulating certain factors to affect this.

The purchase price could be linked to commission received by the buyer in a given period (for example, 12, 24 or 36 months after completion) derived from the novated agencies, which is then accounted for and paid over to the seller on say, a quarterly basis. There might also be cash paid upon completion in respect of the other assets of the business. Thought needs to be given to claw back – how is it to be accounted for and treated after completion? This needs to be considered carefully and clearly spelt out in the sale and purchase agreement ("SPA"). For example, commission for a policy for which the customers' application was made pre-completion could be repaid by the seller in the event of claw back after completion. If the claw back is in respect of a policy where an application was submitted post-completion, then it could be paid by the buyer. These can be brought into account if the price is paid over time and linked into commission.

9. WHAT ABOUT CUSTOMER CONTRACTS? SECURING THE CROWN JEWELS!

This section relates closely to that on consents above. As a buyer, you may well prefer to acquire certain assets of the business through an asset purchase and you will generally want to take over the customer contracts (i.e. terms of business with clients) and ensure that the client base and client data, employment contracts and self-employed advisor contracts are transferred to you either on or immediately post completion. Thought needs to be given by both parties as to whether these can be transferred by the seller to the buyer and if so, whether any consents are required. A buyer should note that both the benefit (i.e. right to be paid etc.) and the burden (i.e. obligations to do certain things and have certain liabilities) will transfer to him from the date of completion if he takes these over. A buyer should carry out due diligence to make sure he can resource all these obligations and satisfy such liabilities post-sale.

It may be necessary to impose obligations on the seller to do all that he can (reasonable or best endeavours) to obtain any necessary third party consents post completion so as to transfer contracts to the buyer and the SPA will generally set out what will happen if he cannot do so. There may, for example, be an indemnity sought by a buyer from the seller in respect of lost commissions that would otherwise have been earned under the customer contracts which cannot be assigned.

Similar considerations may apply to agencies with providers and the SPA should set out who is responsible for ensuring the novation of these to the buyer from the seller. On an asset sale, the SPA should contain a crystal clear provision that pre-sale liabilities remain with the seller, unless the buyer agrees otherwise, in which case this should also be made clear.

10. RESTRICTIVE COVENANTS - PROTECTING YOUR INVESTMENT

Restrictive covenants will be extremely important to any prospective buyer. In the event of a “clean break”, a buyer will generally ask a seller to enter into restrictive covenants preventing him from setting up competitive businesses in a stated area and/or within a stated time, from poaching employees and/or contacting clients.

A buyer must be aware that any restrictive covenants it asks a seller to enter into must be reasonable otherwise a seller may well be able to avoid their effect. A restrictive covenant which is too restrictive on the seller will not be worth the paper it is written on, so it is vital that buyers take advice from their lawyers on the drafting of these provisions, or accept their investment in the purchase is at risk.

11. OTHER ISSUES

FSA notifications and approvals

FSA approval is required for a proposed acquisition or change in control. The FSA will consider whether the proposed buyer is a “fit and proper person” to have control and ensure that the interests of consumers are not threatened. A buyer should do everything it can to ensure that it will meet with the FSA’s requirements so as to make the acquisition flow as smoothly as possible. As mentioned previously, if a buyer incurs legal and other costs in progressing with a purchase which the FSA blocks, the buyer will still be obliged to pay such fees even if the deal cannot go ahead! A buyer should therefore obtain comfort on this point as soon as possible.

Documentation

The main documents that will be involved in an acquisition are:

- Due diligence report;
- SPA;
- Disclosure letter and disclosure bundles; and
- Ancillary documents (including):
  (a) Tax deed (on a share purchase);
  (b) Loan notes (possibly);
  (c) Constitutional documents (board minutes and resolutions; and
  (d) On a sale of an equity share, a shareholders, membership or partners agreement and bespoke articles of association (as applicable to the legal status of the target business).

12. DUE DILIGENCE ("DD") – A BUYER’S BEST FRIEND!
ALWAYS RECOMMENDED, BUT SELDOM DONE THOROUGHLY ENOUGH!

This vital process is an exercise in investigating all those areas of the target business that will be of interest to you as a buyer and is of fundamental importance. In relation to financial services businesses, DD normally covers legal, financial, compliance and commercial issues and a prudent buyer should engage specialist advisers to carry this exercise out and report to him on the findings. Lawyers and accountants normally carry out legal and financial due diligence on behalf of the buyer as a matter of course, but they may not have the relevant expertise to cover the compliance issues. This is fundamental to acquisitions of financial services businesses so a buyer should ensure that compliance due diligence is carried out by specialists in this field. This is far too important an area to ignore or allow to be “dabbled in”!

Another important area of due diligence on the acquisition of a financial services business is insurance. Does the seller have adequate cover in place to cover claims relating to the period prior to the sale and will anything done as part of the sale affect this? Should the seller be required to take out run off cover and if so, for how long? As an alternative, should the buyer take on the liabilities and put insurance in place itself? The cost of the insurance should be factored into the deal and any gaps in cover should be identified so that these can be dealt with clearly, perhaps by way of indemnity cover or price retention (see below). In the event a particular liability may be about to crystallise in the business, should the timing of the sale be put back so that the buyer can have more certainty as to the cost and impact of the business rather than rely on contractual protections? An experienced and specialist insurance broker will be able to give comprehensive advice on these matters and a prudent buyer should take note of this. Claims from consumers have very real financial and reputational (let alone regulatory) consequences, so this issue is far from academic!

The DD process is usually engaged early on in negotiations between the parties. The process is an essential preliminary to contractual protections that a buyer will want, such as warranties and indemnities. The DD identifies levels and areas of protection needed by a buyer and also any risk that the buyer may want to avoid completely. As a buyer you will also use the information gathered through the DD process to decide on the feasibility of going through with an acquisition and to structure key issues such as the price and limitations on liability. Due diligence is a buyer's best friend and possibly the most important stage in the acquisition process. Well negotiated and drafted sale documents are essential to set out the terms of the deal and provide contractual protection to the buyer, but by themselves, cannot provide the buyer all the comfort he requires. There is no better way for a potential buyer to sleep at night, other than having a full understanding of what he is taking on!

Further, the DD process, and more importantly the information it reveals can be a crucial element of the buyer's bargaining power. There are various types of DD, for example, commercial, financial, compliance, insurance and legal, but below is a short breakdown of how legal DD is carried out:

- The buyer's solicitor will submit a DD questionnaire to the seller which will cover all aspects of the seller's business, including commercial contracts, litigation, employment, property, compliance, intellectual property, real data, data protection and its tax position. Other specialist advisers engaged by the buyer (eg.the buyer's accountants, compliance consultants and insurance brokers, should do the same in relation to their areas.. If the buyer's solicitor is not a financial services compliance expert (many are not), a buyer should consider engaging a specialist firm in this area;
- The seller will provide answers together with supporting documentation to the questions submitted to the advisers who issued the questionnaire(s); and
- The respective advisers will analyse the information received from the seller and produce a report to the buyer.

If the results highlight material areas of risk, or the nature of the responses indicates that the target business is disorganised and unable to provide substantive responses with well ordered supporting documents, a well advised buyer who decides to continue with the purchase will be looking for stronger warranty or indemnity protections and may even consider paying the purchase monies into a ring-fenced solicitors' account for a period of time or linking it to the performance of the business post purchase. The impression a seller makes on a buyer through the DD process can be fundamental to the terms of the deal. It can impact the price and how it gets paid and can influence the level of warranty and indemnity protection sought from a seller. Further, a seller who operates his everyday business on established and well organised business processes, administration and compliance will be a far more attractive prospect to a buyer who should be aware that a well advised seller will probably use these factors to strengthen his position on the price and contractual terms. Where the seller is looking to remain with the business following its sale to the buyer, the behaviour of the seller throughout the sale process and his ability to respond well to due diligence enquiries will provide the buyer with invaluable insight as to the attitude and skills of the individual in question. Not all sellers will realise that the process is in fact one long job interview and the buyer would be well advised to treat it as such!

It is not unusual for conflicts to arise post-sale where sellers remain in the business purchased by the buyer. The seller will no longer be the boss and this can sometimes be a difficult cultural change to get to grips with. If a buyer detects any possibility that the seller may find it difficult making the transition post-sale, or that his behaviour during the sale process indicates that he may not embrace the business culture adopted by the buyer, the buyer should think carefully about the practicalities of this. A buyer will want to focus on making the most of his investment and running his new business and will not want this to be affected by any distractions or issues caused by an unhappy seller still working there. A buyer should however bear in mind that the sale process is often a stressful and time-consuming one for the seller and can also have an "emotional" impact. A buyer should therefore weigh up whether any behaviour of the seller is simply attributable to this stress or whether it is an indication of problems to come.

13. THE DUE DILIGENCE PROCESS: FINANCIAL SERVICES ISSUES

As a buyer, there is likely to be particular financial services related documentation that you will want to see and have access to in preparation for an acquisition. Therefore, you should ensure that a seller is bringing these documents together at an early stage of the negotiation process:

- The target firm's PI policy for the current year and correspondence with insurers in the last three years (for example, notification of claims, material/relevant solicitors' correspondence and details of claim settlements);
- Details of any ongoing or concluded FSA investigations, enforcement or disciplinary action for the business or individuals in the last three years;
- FSA correspondence, for example, with the firm's supervisory contact and information concerning Arrow visits in the last three years. (It may be that a buyer will require discussions with the compliance officer or complaints handler);
- Copies of all returns made by the firm to the FSA in the last three years (RMARs etc);
- Details of how the target firm handles client money in compliance with FSA requirements and the latest client money report from auditors;
- Details of the firm's systems and controls put in place to identify and manage conflicts of interest;
- The compliance manual and details of compliance training given to those involved in advising customers, together with details of how they are monitored and supervised;
- Complaints history, complaints log, complaints procedures and details of all complaints for the past three years;
- Correspondence with the Financial Ombudsman Service in the last three years, including details of settlements, adjudications and awards;
- Details of the range of products sold with particular emphasis on high risk areas, such as sales of products such as SCARPs, splits, FSAVCs, endowments, PPI, Income Drawdown, PFW, etc. (including the number of policies sold in the past three years for product categories, value, etc.);
- A buyer would be well advised, depending on the number, to ask for access to a sample of customer contracts and files which a buyer should use to assess, for example, the quality of the target firm's processes, compliance with TCF and assess whether any claims/complaints may emerge in the future;
- Contractual arrangements with product providers, including details of commission organised by insurer and product description, as well as any recent/proposed changes, for the last three years;
- Details of all ARs and IARs appointed by the company, together with the terms upon which the persons are engaged and details of any ARs who have been suspended, including the reason for such suspension;
- Details of the target firm's policy on fee and commission disclosure;
- Details of all other of the target firm's commercial insurances; and
- Information to enable a buyer to make an assessment of the size of the indemnity risk and how this tails off.

It is very likely that a seller will seek to put in place a confidentiality agreement obliging a buyer to keep all information confidential and prohibiting them from using it for any purpose other than evaluating whether he wishes to proceed with the transaction. The buyer cannot therefore use the due diligence process as a "fishing expedition" to obtain commercially sensitive information about competitors and should bear this in mind.

14. THE SALE & PURCHASE AGREEMENT ("SPA")

The SPA is the principal contractual document regarding the acquisition of shares in a company or group, or the assets of the target business. The SPA can often run to 100 pages or more with many of those pages comprising the warranties. This document is the key agreement between the parties and is traditionally drafted by the buyer's solicitors. (except on an auction sale where a seller has many interested buyers and is in a position to select the best offer). Two very important areas covered in the SPA are the warranties and indemnities (see below).

The SPA will deal with such things as:-

- Price – including structure of payment and the timing of payment;
- Warranties and indemnities (these are always heavily negotiated between the parties);

- Limitations on the seller's liabilities;
- Restrictive covenants; and
- Other issues:
  (a) Intellectual property;
  (b) Employment;
  (c) Pensions;
  (d) Property;
  (e) Insurance;
  (f) Any conditions – e.g. competition/shareholder approval;
  (g) Whether for any reason there should be a gap between exchange of contracts and completion; and
  (h) Logistical issues regarding obligations of the parties (i.e. what each party must physically do to perfect the transfer).

In parallel with the drafting and negotiating of the SPA, there will be a continuing obligation on the seller to provide disclosures up to the point of completion (see below).

15. WARRANTIES AND INDEMNITIES

What are Warranties?

Warranties are contractual statements contained in the SPA which take the form of assurances from the seller as to the condition of the target company or business and, in particular, any existing liabilities.

Warranties often account not only for half of the SPA, but also for much of the time spent in negotiations. The main reason for this is that the principle of “buyer beware” (“caveat emptor”) applies, the law providing no statutory or common law protection for a buyer. This facilitates the need for extensive contractual statements in the form of representations and warranties.

On a share purchase, warranties are particularly important because a buyer acquires a ready packaged entity complete with all of its assets, rights and liabilities, both past and present. If the earlier due diligence exercise carried out is thorough, then it should provide a buyer with a good picture of the target company and allow it to agree a price based on its knowledge and expectations. Warranties should not be seen as a substitute for the due diligence process: the two are complimentary.

Warranties serve two main purposes:
- To provide a buyer with a remedy if the statements made later prove to be incorrect and the value of the target company/business is thereby reduced - warranties act to provide a form of retrospective price adjustment; and
- To encourage the seller to disclose known problems to the buyer. Because the seller’s liability under the warranties is limited to the extent that proper disclosure (see below) is made against them, the effect of the warranty should be to flush out potential problems and provide the buyer with information.

16. COMMON AREAS OF WARRANTY PROTECTION

A buyer will seek two types of warranties: general warranties and specific warranties.

General warranties

As a buyer you should seek general warranties (though these may often be rejected by a well advised seller) aimed at giving a buyer comfort that:-
- all the information required has been provided to enable the buyer to make a proper assessment of the acquisition; and
- there is nothing that the seller knows that would, in the ordinary course, affect a buyer’s decision to acquire the target company or business. A buyer should note that a seller will often (legitimately) argue that these are matters for a buyer to get himself comfortable with and are not matters that should concern the seller. In reality, although the seller’s argument may be legitimate, a buyer must ensure that it gains sufficient information to feel comfortable with the proposed acquisition.

Specific warranties

Specific warranties cover every aspect of the company or business being acquired. The following list of areas that specific warranties normally cover is not exhaustive but includes the ones most commonly sought:-

- Accounts;
- Compliance and other FS/Regulatory matters;
- Post balance sheet date events;
- Financing and banking;
- Real property;
- Litigation and complaints;
- Commercial contracts;
- Employees;
- Data protection;
- Pensions; and
- Tax.

Some other key warranties that will normally be sought by a buyer relate to insolvency and winding up.

Who gives the warranties?

The seller(s) of the shares or assets will normally be required by a buyer to give the warranties.

A buyer should consider whether any third party or parent company should be called upon to provide a guarantee to the buyer to provide comfort that the buyer's claim will be paid out in the event of a breach of contract. This may be desirable if a company is selling all its assets so may not have any money or means of realising cash to pay out in the event of a claim. If the seller is an individual there may be a concern that they may not have the means to cover the cost of a claim should it arise. This is explored in more detail below.

Limitation of a seller's liability?

The limitations on warranties and indemnities will be very important for both the buyer and the seller in any transaction. It is normal practice for a seller to seek to limit his liability under the warranties, not only by cutting back the wording of the warranties themselves, but also by specifying certain financial and time constraints. It is however normal practice for a buyer not to accept any financial limitations on indemnities (see below regarding the difference between warranties and indemnities). As a purchaser, you will want to prevent or scale back as much as possible, any limitations sought by a seller. Though a buyer will inevitably agree to some limits on a seller's liability, a prudent buyer should seek to minimise these as far as possible.

Examples of common limitations are as follows:

- certain warranties are only given on matters of which the seller is actually aware (ie "so far as the seller is aware"); and
- disclosure (warranty liability is limited by disclosure through the disclosure process – see below). This qualifies the extent to which the warranties can be given (eg. a warranty can state that there are no outstanding customer complaints against the business and the disclosure letter and bundle can then cross-refer to this and provide details of any complaints which are outstanding); and
- limits on the time periods in which a buyer can bring warranty claims.

In the absence of agreement, the normal period during which a buyer can bring a warranty claim is six years, unless the agreement is executed as a deed, in which case the period is extended to 12 years. Normally however, an expiry date of between 18 months and three years will often be agreed for non tax warranties and six or seven years for tax warranties. As stated previously, this date will be key for a seller wishing to have comfort that he no longer needs to have funds available to settle any claims should they arise post completion, and likewise for a buyer, to provide comfort that he will have some recourse against a seller for as long a period as possible should any unexpected or undisclosed issues arise.

Financial limits on warranty claims

From a buyer's perspective, there is no logical reason why his right of recovery against a seller should be subject to any financial limits. However, unfortunately for a buyer, it has become market practice to include certain seller protection provisions within the SPA. The most usual of these financial limits are:-

- the minimum financial limit for individual claims (individual "de minimis" limits);
- a minimum financial limit for aggregate claims (referred to as an "aggregate de minimis limit", "cushion" or "threshold"); and
- an overall financial limit (or "maximum cap"). Commonly, liability will be capped at the total price paid.

Security for breach of warranty

Warranties and indemnities are only as good as the ability of the seller who gives them – otherwise they are only worth the paper they are written on! A major concern for a buyer is that the person giving the warranties is able to pay out in the event of a claim. If a buyer has any doubts about the credit worthiness of a seller, he may want to take some sort of security for any possible breach of warranty. The methods available to a buyer to obtain security for any breach of warranty include:

- obtaining either a guarantee from a wealthy third party connected to the seller, a bank guarantee from the seller (if an individual) or a guarantee from the seller's parent company (if the seller is part of a group);
- opening a joint ring-fenced bank account (often a solicitors account) where part of the purchase price may be deposited until the warranty limitation period has expired (an "escrow account");
- payment of part of the price may be held back until the warranty limitation period has expired; and
- If part of the price is to be paid after completion, the buyer may insert provisions in the agreement allowing him to set off such deferred payments against warranty/indemnity claims in that period.

As a buyer, you may be willing to forego the aforementioned methods if the seller has taken out warranty insurance cover. However this would be entirely down to the transaction and your view of the acquisition. A buyer should note that it is very rare for a seller to take out this type of cover and it is usually prohibitively expensive.

17. SPECIFIC FINANCIAL SERVICES RELATED WARRANTIES

As a buyer you should generally be looking for a seller to give warranties along the following lines:

- That neither the business to be sold, nor any of its principals, directors, officers or employees has been, and is not, subject to FSA investigations, enforcement or disciplinary processes and none are threatened by the FSA (and no matter or circumstance exists which might give rise to such proceedings);
- That neither the business/company nor any of its principals, directors, officers or employees has been, and is not, subject to regulatory fines, censures or penalties etc. and that there are no outstanding issues with the FSA;
- That the business/company has complied with and has conducted its business in accordance with all relevant FSMA/FSA rules and regulations, that all appropriate authorisations/permissions to enable it to carry on its business are in place and that the FSA has not threatened the withdrawal of these;
- That the seller has not had to undertake any past business reviews (e.g. Pension Review, FSAVC, endowment mis-selling etc. Save for any such reviews that have been required on an industry wide basis); and
- That all claims and circumstances that could give rise to claims have been notified to PI Insurers, that no facts or matters exist which would entitle PI Insurers not to pay a claim under the policy.

Of course the disclosure process will apply to such warranties, giving the seller the opportunity to make a buyer aware of the extent to which such matters do exist, thereby limiting the seller's liabilities under such warranties to that extent. Disclosures can become the subject of lengthy negotiation as a well advised buyer will only accept disclosures which are specific enough so specify exactly the extent to which the warranties in question are being qualified. General, woolly statements by the seller should not be accepted and the drafting and negotiation of warranties and disclosures is a specialised job. It should also be noted that not all these warranties will be appropriate where only a few assets are to be acquired.

18. WHAT ARE INDEMNITIES?

Warranties should be distinguished from indemnities. A warranty is a statement by the seller about a particular state of affairs of the target company or business at a given point in time (usually at the point of completion). A breach of warranty will only give rise to a successful claim for damages if the buyer is able to show that there was firstly a breach, and secondly that the affect of the breach was to reduce the value of the company or assets acquired. A buyer should also remember that he will have to get past any limitations negotiated (see above) which may make it difficult to bring a warranty claim successfully.

In contrast, an indemnity is a promise to reimburse a buyer in respect of a particular type of liability, should it arise, on a pound for pound basis, whether or not the value of the company or assets acquired is reduced by the breach in question. Therefore, the purpose of an indemnity is to provide a guarantee remedy where a breach of warranty may not give rise to a claim in damages, or to provide a specific remedy which might not otherwise be available at law. (Eg. A buyer buys the shares of ABC Limited. The seller gives a warranty that the company owns a fleet of ten cars, when in fact it only owns nine. The shares in ABC Limited are unlikely to be devalued by this, so a warranty claim would not be possible. However, if this promise was given as an indemnity, the effect on the value of the shares would be irrelevant and the seller would have to pay the buyer the price of the missing car.) Market practice dictates that indemnities are only given for specific matters and the majority of the protection will be given by way of warranties instead. This again highlights the importance of the due diligence and disclosure exercises to make sure the buyer has sufficient information to identify areas where indemnities are required.

Risks commonly covered by indemnities include:

- Specific litigation or complaints;
- Data protection and confidentiality;
- Environmental risks;
- Doubtful book debts;
- Repayment of loans by the target company;
- Service liability claims; and
- Infringement of intellectual property rights.

FS indemnities

A buyer should be asking the seller to give him an indemnity in respect of customer complaints/claims that are made after completion, but which relate to advice/recommendations given by the seller to customers prior to completion. A buyer should check that the seller has adequate insurance in place to cover these. Properly drafted, this indemnity will generally cover not only any compensation that the buyer has to pay customers (for example, as a result of a FOS or court award or earlier settlement), but also the costs (legal or otherwise) of dealing with the claim/complaint.

If, as a buyer, you have agreed to put PI insurance in place that covers post completion claims/complaints (arising from the seller's pre completion business), then the indemnity may cover any deductible/excess imposed by the PI Insurers. A buyer should seek to ensure that the indemnity is drafted widely enough so as to cover any of the buyer's costs of having to deal with an FSA investigation and enforcement/disciplinary process that arises post completion but that relates to conduct of the business pre completion. Also (and this may depend on what has been discovered through due diligence and disclosure processes), the buyer may ask the seller for an indemnity to cover the cost of remedying pre completion breaches of the FSA rules that emerge post completion (for example, having to take remedial steps within the business to correct those breaches; dealing with the FSA and compensating any customers who have lost out as a result). Again, where only a handful of assets are "cherry picked" all these indemnities may not be required.

19. INSURANCE ISSUES

The most important insurance issue on sale will be PI arrangements. This area is complex, highly technical and calls for specialist broker and legal input at an early stage of the deal. The detail is beyond the scope of this Guide. It should also be an issue very high on the agenda during due diligence and just some of the items that will need careful thought and addressing include:

- Have the seller's PI insurers accepted liability for claims notified to them prior to completion? If not, why not?
- What does the seller's PI claims history tell you about the way in which they have conducted their business? Does it hint at systemic weaknesses in the business that might affect the purchase price or even the decision to acquire the business at all?
- Who will be responsible for paying any excesses for claims notified pre completion that fall for payment post completion?
- Will claims made post completion, but relating to advice given pre completion, be covered by the buyer's PI or will the seller put run off cover in place (if so, how much, with whom and for how long)?
- If a post completion claim is not covered by the buyer's PI for any reason (e.g the insurers refuse to indemnify), will the seller's give the buyer an indemnity? If so, for how long and for how much?
- If the buyer's PI is going to cover the acquired business, have you/your brokers told your insurers about the deal, and have they accepted responsibility for the new business so as to ensure there are no coverage gaps when the deal completes?

There will also be other insurance issues to address on a deal as a typical business may have at the very least public and employer's liability insurances, motor insurance, buildings and contents, business interruption, directors and officer's liability insurance and fidelity insurance. What is going to happen to these policies on completion? Will they come to an end? Is a return of premium due? What about any claims that have been notified pre completion but are yet top be concluded: who will receive the proceeds of any pay out? It is key here to involve your broker as a key member of the deal team from an early stage.

20. DATA PROTECTION - A TECHNICAL AREA, BUT ONE WITH VERY PRACTICAL, FINANCIAL AND PERSONAL CONSEQUENCES!

A very important consideration for a buyer, especially when conducting an asset purchase and even more so when the buyer has cherry picked the client list, is the effect of the Data Protection Act 1998 in respect of the client list and other personal data acquired by the buyer. As a buyer, you should require the seller to give an indemnity that he has complied with the Data Protection Act 1998 and related legislation in this regard. On an asset purchase, if a large part of the value of the acquisition to you as a buyer is the ability to market to the clients you will want assurances that the seller can lawfully transfer all client data to you and on asset and share purchases, you will want comfort that you have the legal right to market to such clients in the manner you want to. Due diligence on this will be key and as this is a specialist area, a buyer should ensure he is advised by experts. On an asset sale, you should also consider requesting that the seller enters into joint correspondence with such clients explaining that the buyer has bought the business and that the client base has transferred to the purchaser. This can be used as an opportunity to ask clients for consent to being contacted by e-mail/sms (see below) and to also give them the chance to "opt out" of being contacted by the buyer in future. If, once you have bought the business, you wish to send marketing information to the clients by SMS or e-mail or contact the client by telephone or in person with regards to mortgages, the client must expressly agree to this by providing their own "prior consent". As a buyer you should seek an indemnity to cover the risk that some of the clients may not want to be contacted by you and that this may erode the value of the assets bought. A buyer should also seek an indemnity to cover any other data protection claim relating to the period pre completion, or seek to hold back some of the purchase price or hold it in escrow (see above). A buyer may seek to put in place additional cover for such eventualities by allowing for payment of a part of the purchase monies to be deferred until expiry of a period after completion and for any indemnity claims to be set off against future payments. Data Protection issues can seriously affect the value of a financial services business so it is vital that a buyer is properly advised in this area! Breaches of the Data Protection legislation can also result in serious personal consequences for individuals, including in some cases, unlimited fines and even imprisonment, as well as unlimited fines and censure against companies – can you afford to get this wrong?

21. DISCLOSURE

The disclosure letter is a key document in any private acquisition. A buyer must ensure that the disclosure letter is properly reviewed and that questions are asked where necessary if he is to ensure that he is not going to be in for a nasty surprise in the future! If the seller makes inadequate disclosures and a claim arises he may well find himself on the receiving end of a breach of warranty claim.

22. WARRANTIES AND THE DISCLOSURE LETTER

Warranties and disclosures must be considered together. If a warranted fact turns out to be untrue, the buyer has a claim for breach of contract regardless of whether he relied on the warranty in question. However, no claim will lie if the facts which give rise to the breach were disclosed. A full and proper disclosure exercise is therefore in the interests of both parties. The disclosure letter normally takes the form of a letter from the seller to the buyer and is usually divided into two parts: “general disclosures” and “specific disclosures”, (as per the warranties). The disclosure letter will have attached to it copies of the documentation being disclosed, such documents making up the “disclosure bundle”.

23. GENERAL DISCLOSURES

These disclosures cover certain matters which appear in public records and/or of which the buyer ought to be aware on the basis of pre-contract enquiries or searches actually made, or which the buyer would normally make.

24. SPECIFIC DISCLOSURES

These specifically disclose actual matters which, if not disclosed, would constitute a breach of warranty. The specific disclosures are produced by reference to the warranties themselves. Therefore, warranties are a prompt for the disclosures and because the seller would be concerned to avoid liability for breach of warranty, they serve to flush out information. Also, certain warranties will specifically require information to be listed in the disclosure letter (for example, all employee or consultancy contracts used by the target companies). The disclosure exercise, along with the due diligence process, are the best tools available to the buyer to obtain information and comfort about what he is looking to buy. As mentioned above, the buyer should obtain specialist advice on the wording of the disclosures to make sure that his ability to bring a warranty claim is only limited to matters which have been clearly and specifically documented in the disclosure letter. Wording which is too wide or general can restrict the buyer’s ability to bring a claim to an extent which is not fully understood at the time of completing the deal if the wording is not sufficiently “tight”.

25. COMPLETION AND COMPLETION ACCOUNTS

Once all the due diligence and disclosure is completed and all the negotiations are settled, the parties reach completion where all the documents are signed and the purchase price (or initial part of it – see above) is paid to the seller. In some circumstances, the purchase price is settled at the point of completion in accordance with the “completion accounts”.

Completion accounts are accounts of the target company drawn up at, or shortly after, completion of the acquisition. These will form the basis for determining the final price payable under the SPA. In order to minimise possible disputes, a buyer and seller should set out in a schedule to the SPA the principles on which these accounts are to be drawn up, specifying who should prepare them, who should bear the cost of their preparation and how any disputes that may arise should be resolved. Prudent buyers should ensure that they instruct solicitors and accountants experienced in this area

to advise on these. Completion accounts are commonly used on share sales, but can be useful tools in the acquisitions of financial services business acquisitions whatever the structure owing to the particular accounting complexities around income streams, commissions and clawback. As they are used to calculate the price, there is no room for error!

To finalise the transaction, there will usually be a completion meeting at which the parties and their advisers will complete the deal by the parties signing the relevant documents. However, it is not uncommon for negotiations to be ongoing at the completion meeting. This means that what in essence should be a reasonably short meeting to sign documents and check disclosure documents can sometimes turn out to take many hours, even days!

Finally, the buyer will need to run the business post-sale and may need to integrate the assets/business brought into his existing operations, or in the case of a share sale, the company bought into his group. Important consideration should be given to practical matters, including changes required to and the use of stationary, business cards, invoices, direct debits, standing orders, insurances and employment issues (e.g. pay roll) etc. and a buyer should gear up for these in advance of completion to avoid unnecessary disruption or confusion. This may sound obvious, but the sale process can be long and demanding and it is easy to forget the practicalities in the “excitement” of the legals!

26. ONE FINAL WORD – GETTING YOUR MONEY'S WORTH FROM YOUR LAWYERS AND ACCOUNTANTS AND OTHER PROFESSIONAL ADVISERS

The professional fees involved in any transactions such as these are material. However, the purchase of a business for a buyer will mean the investment of a great deal of money and time. A sensible buyer should therefore seek to gain the best advice possible from specialist advisers to ensure that he is purchasing a proposition which offers value for money, no nasty surprises, that his interests are protected and that all his commercial objectives in making the acquisition will be satisfied.

The particular complexities of financial services businesses are not applicable to other industries (eg. issues regarding trail commissions, liabilities, claw backs and regulatory matters do not arise on the sale of a grocery store) and corporate acquisitions of any type of business is a specialised job. To get the best value and advice on such matters, a corporate lawyer, accountant, compliance consultancy and insurance broker with knowledge of the sector will be key. A buyer will not get his money’s worth from their professional fees if they instruct advisers without this knowledge and expertise. In the same way that one would only trust a specialist surgeon to operate on a brain injury, a buyer should only trust professional advisers with experience of transactions in the sector on such important and life changing transactions as this!

Through their reputation and connections in the market, Bankhall can put you in touch with the people who can genuinely provide you with value for money and help you with this. Pinsent Masons has given legal advice to many buyers and sellers of financial services businesses. The investment in skilled and experienced advisers in the sector is literally worth its weight in gold! The cheapest is definitely not the best in these situations.

A good corporate lawyer will not only help get the best price for a business and protect his/her client’s interests through skilful negotiations, but will also project manage the transaction and guide his/her client through the process.

We wish you all the best in planning an acquisition and look forward to working with you and your new venture in the future!

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