REAPING THE REWARDS

An essential guide for principals on general considerations and what to expect in **exiting a financial services business** and the sale process

CONTENTS

1. The Importance Of Planning For The Future
2. Money, Money, Money – Enhancing The Value Of Your Business
3. Why Does The Buyer Want To Buy?
4. Why Are You Selling?
5. Types Of Acquisition
6. Issues That Influence The Choice Of Acquisition
7. Grooming The Business
8. What Is Going To Be The Price For The Purchase & How Is It Going To Be Structured?
9. What About Customer Contracts?
10. Restrictive Covenants
11. Other Issues
12. Due Diligence
13. The Due Diligence Process: Financial Services Issues
14. Sale & Purchase Agreement
15. Warranties & Indemnities
16. Common Areas Of Warranty Protection
17. Who Gives Warranties?
18. Limitation Of Seller's Liability Under Warranties
19. Financial Limits On Warranty Claims Under The SPA
20. Security For Breach Of Warranty
21. Disclosure
22. Insurance Issues
23. Completion And Completion Accounts
24. One Final Word

bankhall®

Pinsent Masons

REAPING THE REWARDS

An essential guide for principals on general considerations and what to expect in **exiting a financial services business** and the sale process

"Every exit is an entry somewhere else"
Tom Stoppard

As principal, whether you own a small, medium or large financial services business there will come a time when you will want to exit the business. This guide has been prepared by Bankhall, in conjunction with solicitors Pinsent Masons exclusively for Bankhall Members and it is essential reading for all principals regardless of the size of your firm! The most common method of exiting a business is by selling it. This guidance note provides an overview of the key matters which should be considered generally on the preparation for and sale of any business. It is tailored specifically to matters that are of particular relevance to Bankhall Members' businesses and applies to the sale of the whole or part of a business and the sale of an equity stake to existing or incoming equity participants.

As part of Bankhall's commitment to helping your business, this exit strategy guide provides Bankhall Members with a "bird's eye" view of the issues they need to think about as part and parcel of planning a viable exit strategy. It considers grooming the business for sale and the sale process itself, which are the two key elements in ensuring a seller gets best value for his business and once the monies are in his pocket, he is able to enjoy the rewards! Bankhall has almost unrivalled experience in the sector. Pinsent Masons have excellent experience of advising the buyers and sellers of financial intermediaries. Together, we have brought that experience to bear on this guide.

1. THE IMPORTANCE OF PLANNING FOR THE FUTURE AND THE RETAIL DISTRIBUTION REVIEW

It is a well accepted principle that people do not set up businesses and invest a lifetime's hard work in them simply to benefit their health! Business owners do this to earn a living and to reap the benefits on exit. It is perhaps stating the obvious to say that businesses which are well run and own valuable assets are more likely to result in better returns for their owners on both counts. The sooner a seller establishes an exit strategy and starts to "groom" his business for sale, the better! Many advisers recommend a period of 2-3 years to plan for and work towards the sale by "grooming" the business, with an additional period of at least 6 months to complete the sale process. This may sound like a long time, but the investment in time and resource to do this should result in a guaranteed return on the price you can command and the overall terms of the deal. This is not a game of chance!

Launched in June 2006, the Retail Distribution Review ("RDR") 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 continued to drive forward the major themes of the RDR with the publication of its Consultation Paper in June 2009. 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 said that it has seen too many examples of firms, particularly in the advisory sector, with unrealistic long term strategies for their business, unsustainable business models and these are unlikely to be consistent with the fair treatment of customers.

Inherent in a sustainable business model (and one more likely to procure returns for the owner) is a viable exit strategy Further, those firms which are well run, compliant and have appropriate business plans are likely to survive and prosper in the long term, to maintain and increase their customer value and, ultimately, command a premium upon a sale or merger. And of course the owners of those businesses which are well organised and run prior to a sale are much less likely to be on the receiving end of warranty and indemnity claims from the new owners of the business after completion, claims which could significantly erode the value received on sale. Remember - the sale process does not end when the ink dries on the contract. There is no point selling the business if the seller is not then free to enjoy the proceeds and as this guide sets out, a large part of the negotiations relate to this. The trick is not only getting the money in the first place, but making sure it is secure once received!

2. MONEY, MONEY, MONEY ENHANCING THE VALUE OF YOUR BUSINESS ..... SOME THOUGHTS

Often, a "wealth gap" can result if the current value of the business is not as high as that required by a seller to reach the "aspirational" sale price. A seller may need to look at ways of filling the gap or achieving the price which he could otherwise command. There are several ways of doing this, some of which involve accounting issues beyond the scope of this guide, but sellers of financial services businesses should also consider the following:

Proposition

Business owners should constantly challenge themselves to focus on creating value by enhancing their proposition, including segmenting their client base, creating efficiencies through well-organised and compliant administrative processes and monitoring and addressing risks on an evolving basis. Whilst this may be a matter of good business and common sense, the FSA is also keen to encourage the financial services industry to become a sustainable and therefore valuable profession.

A seller should think about how he can increase turnover and enhance profits through concentrating on profitable work and analysing overheads – he should also make sure that employed or contracted advisers are tied in and that any valuable intellectual property rights are secured.

The Retail Distribution Review

We cannot over emphasise the importance of keeping up to speed with what emerges from the FSA. One of the methods of enhancing any P/E ratio used to value your business on a sale is to prove the business has growth opportunities and that it can keep up with regulatory change.

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;
- customer access to financial products and the clarity of the services;
- regulatory barriers and enablers.

Those organisations which keep up and move with the regulatory times are inevitably going to be a more attractive proposition for a potential buyer.

Prudential rules for investment firms

You should ensure that you are aware of the FSA's proposed requirements of the new prudential rules for personal investment firms such as IFA businesses.

The regime aims to simplify the calculation of capital resources 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 for any business or activity arising from PII policy exclusions.

Sellers should consider the effects of the new regime in relation to any potential sale.

Treating Customers Fairly

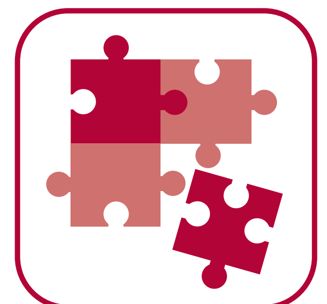
Ensure that you continue to treat your customers fairly and comply with the FSA's diktats in this regard. A business which treats its customers fairly is, in both the short and the long term, more likely to maintain and increase its customer base, to keep out of trouble with the FSA and again present a more attractive prospect for a buyer for which he is willing to pay a good price.

Be under no illusions: TCF is not a FSA initiative that is 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' positions on TCF through thematic work and assessments. Firms can expect to be referred for enforcement action if they do not meet the required standards. **Any perceived threats of this nature will affect the price and the extent to which the proceeds are at the disposal of the seller for a period after the sale.** The FSA wants to ensure that "fair treatment of customers is central to corporate culture" and is something that affects the conduct of a business from "cradle to grave" from the first contact with a potential customer, advice and the point of sale, right through to handling a complaint.

Principles Based Regulations – Subjectivity and Assumption: A business owner's nightmare!

The same is true of the FSA's move towards principles based regulation. This strategic priority for the FSA sees the FSA moving away from dictating through detailed, prescriptive rules and supervisory action on how firms should operate their businesses, towards [the FSA] *"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, you need to consider how you are getting to grips with this change, not only to keep out of trouble with the FSA, but also to get the best possible return on a sale.

3. WHY DOES THE BUYER WANT TO BUY? DO YOUR HOMEWORK AND GAIN INTELLIGENCE!



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

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

The rationale behind a buyer's actions is useful information for the seller to have because it assists the seller in knowing exactly what the buyer wants to do and therefore aids the seller in its negotiations with the buyer. A buyer would have probably already identified the target that it wishes to acquire and most probably made an assessment of the value of the target prior to the involvement of any of the seller's advisers. All the relevant information relating to these two points are essential for the seller and his advisers to have at an early stage.

Who is likely to be Involved in the deal?

- Seller and purchaser;
- Accountants;
- Bankers (or other sources of funding);
- Insurance Brokers; 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. The solicitors involved will play a major role from this point throughout the whole life of the deal until completion and beyond. A seller may also wish to seek advice on his own tax position (see later) and also seek assistance with finding a buyer in the first place.

4. WHY ARE YOU SELLING?

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 combination of the above reasons. Obviously, again, the reasons for a sale can have a significant impact on the negotiation process.

5. TYPES OF ACQUISITION

There are two 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. The other is to simply buy the assets which make up the business: this is usually referred to as a business or asset purchase. These two methods are fundamentally different. If it is a share purchase, all the assets, liabilities and obligations are acquired (even those the buyer does not know about). If the assets are purchased, then, broadly, only the identified (or “cherry-picked”) assets and liabilities which the buyer agrees to purchase are acquired. Sometimes the sale will be simply of a database and income stream, where Data Protection and the treatment of commissions will be key. This is explored in more detail later.

Finally, the key commercial difference is that on a share purchase the buyer acquires a company which owns a business and is running it as a going concern. An asset purchase will not automatically transfer contracts, employees, or existing trading arrangements to the buyer.

6. ISSUES THAT INFLUENCE THE CHOICE OF ACQUISITION: BEWARE THE PREDATORY BUYER!

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 buyer may well differ. Whilst all sales will involve a certain amount of management of risk between the parties, some buyers may seek to structure the deal solely to their own advantage, which can be very much to the detriment of the seller. Sellers should consider this next section carefully to make sure they do not become the victim of a predatory buyer!

Liabilities – Is "cherry picking" as rosy as it sounds?

The seller will often prefer to transfer a company or group of companies lock, stock and barrel, whereas, by contrast, the buyer may well have reasons for preferring an asset purchase, preferring to "cherry pick" assets and only take on known and quantified liabilities. The most common example of cherry picking in Financial Services businesses is where a buyer acquires the right to receive trail commissions, sometimes accompanied by the purchase of the client list – the rest of the business is left behind. Data Protection and the potential impact this may have on the value is explored below. This approach may suit a seller who has no other employees or infrastructure or other assets in the business which could realise value. However, where this is not the case, the seller could have lost the opportunity to get the best value for the business as a whole – e.g. what about the goodwill built up over the years? What about the value to a seller of a workforce consisting of talented, professional advisers capable of generating future business? What about the business premises? In this scenario, a seller may be left in a position of not realising the best return for his hard work and having to shut do wn the rest of the business, including disposing of property (leasehold or freehold) and making redundancies this may not necessarily be his idea of a retirement dream! A seller should make sure he is comfortable with selling the cherry picked assets and that he fully understands the consequences, time and costs involved in disposing of or shutting down the rest of the business.

Employment Issues

On a share sale, the company itself is sold lock stock and barrel. The employees or self-employed consultants remain employed or engaged by that company which simply becomes owned by someone else. 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 purchaser. The seller and purchaser will usually request indemnities from each other that the regulatory process has been followed by each of them, so on asset sales, the seller should take advice as early as possible on the steps he should take to avoid exposure, or, on a partial sale, losing staff he wants to keep.

Tax

The parties will probably have very different objectives and it is unlikely that these can be all 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 to suit your own tax position and may be able to benefit from certain tax reliefs.

A partial sale

If the business for sale is a division of the seller's 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 company before proceeding with a share sale.

Consents

If third party consents are required to transfer assets or contracts and for any reason they are impractical or even impossible to obtain, a share purchase may be the only practical way of acquiring the target business. A seller may wish to take early advice on how best to structure the sale to take account of their specific issues and realise the best value for the business.

7. GROOMING THE BUSINESS

There are a number of steps which the business owner may want to take in preparing for an exit:

- Consider as early as possible whether the current proposition is one which creates the most value in the business e.g. the customer journey and client segmentation, including ensuring that the client list is held on a database and that all consents have been obtained to allow the seller (and buyer) to use such databases to its maximum potential. Twenty-six cabinets of files is not an attractive prospect for a buyer! Bankhall Members have exclusive access to the client management solutions on Bankhall Online which can help with this.

- Consider a possible re-organisation or tidying up of the business and its administration.
- Consider the structure of the sale and the price (see below at section 8 on this point, specifically relating to commission considerations).
- Conducting a legal, compliance and/or accounting mini "audit" to ensure that existing contracts, procedures and accounts are in a good shape, for example, the checking of contracts to ensure there are no change of control provisions.
- Think about how to value the business and who you should instruct to conduct the valuation. Owing to their reputation and contracts in the market place, Bankhall and Pinsent Masons are well placed to put a seller in touch with many accountants and corporate financiers with specialist experience in this area.
- Consider any possible confidentiality issues that may arise.
- Consider whether any Data Protection issues are relevant and whether any client consents to being contacted for marketing purposes or for their details to be passed to a purchaser of the business should be obtained upfront to maximise the value of the client database or client lists (see below).
- Consider taking tax advice as soon as possible before the sale and purchase process begins.
- Consider whether or not to make a pre-sale dividend to mitigate any tax liabilities.
- Consider whether there are any potential competition issues that may result from the sale.

8. WHAT IS GOING TO BE THE PRICE FOR THE PURCHASE AND HOW IS IT GOING TO BE STRUCTURED? COMMISSION CONSIDERATIONS

If the transaction is a purchase of the business and assets, included in the sale typically will be goodwill, agency and customer contracts, any real property, intellectual property, business names, client records, databases, employees etc. Particular attention needs to be paid to the treatment of commission, contractually documenting the right to which commission is being acquired by the buyer and which rights remain with the seller. For example, the buyer may acquire the right to receive renewal commission paid after completion. There should be absolute clarity about any cut off date in terms of the right to any commission income and clawback.

Consideration needs also to be given to "work in progress" at completion. Who will have the right to commission income derived from "pipeline" business post-completion, i.e. where discussions with customers or prospective customers in respect of which applications/proposals have not been completed or have been completed but not approved by, or submitted to, the life office?

The purchase price could be linked to commission received by the buyer in a period, for example 12, 24 or 36 months after completion derived from assigned/novated agencies which is then accounted for and paid over to the seller on 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 clawbacks - how are they to be accounted for and treated after completion? This needs to be considered carefully and clearly spelt out in the share purchase agreement ("SPA"). For example, initial commission for a policy for which the customer's application was made pre-completion could be repaid by the seller in the event of clawback after completion. But if the clawback 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?

On an asset sale, the buyer will generally want the benefit of customer contracts (i.e. terms of business with clients), along with client base and client data and self-employed adviser contracts (employee contracts may transfer automatically under the employment regulations – see section 6 above) assigned to him either pre or immediately post completion. Thought needs to be given as to whether these can be assigned by the seller to the buyer and if so, how, by whom and are any consents required?

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 assign contracts and the SPA will generally set out what will happen if he cannot do so. There may, for example, also be an indemnity given by the seller to the buyer in respect of lost commissions that would otherwise have been earned under the customer contracts which cannot be assigned.

Similar considerations may apply to agency contracts with providers and the **SPA** should set out who is responsible for ensuring the assignment or novation of these from seller to buyer - should it be the seller or the seller and buyer jointly? (Some SPAs will set out an agreed form of letter to be sent by either or both of them to the relevant life office).

10. RESTRICTIVE COVENANTS

In the event of a "clean break", the buyer will generally ask the seller to enter into restrictive covenants preventing him from setting up competitive businesses in a stated area and/or within a stated time and from poaching employees.

The seller must consider whether or not these are reasonable and, depending upon what he proposes doing post-completion, can he accept them in the form proposed?

11. OTHER ISSUES

FSA Notifications & Approvals

FSA approval is required for a proposed acquisition or changes in control. The FSA will consider whether the proposed acquirer is a "fit and proper person" to have control and ensure that the interests of consumers are not threatened.

In the event the seller is retiring or ceasing to work in the financial services industry, he may need to be formally de-authorised by the FSA and may need to file certain forms with the regulator post-completion. You should bear in mind the fact that individuals do remain accountable to the FSA after ceasing to be approved persons and that the FSA may bring proceedings for a period of 2 years from the date it first becomes aware of any misconduct. A seller who has ensured his firm has the benefit of good compliance services and is run in a compliant and well controlled way will clearly be better placed to mitigate this risk.

Documentation

The main documents that will be involved in a deal are:

- Due Diligence report;
- SPA;
- Disclosure letter and disclosure bundle;
- Others (including):
  (a) Tax deed (on a share sale);
  (b) Loan notes (possibly); and
  (c) Constitutional documents (board minutes and resolutions).

12. DUE DILIGENCE ("DD") - ALWAYS RECOMMENDED, BUT SELDOMLY DONE THOROUGHLY ENOUGH!

This process is an exercise in investigating all those areas of the seller's business that would be of importance to a buyer. DD is normally conducted by a buyer and may cover legal, financial, commercial and environmental issues.
The DD process is usually engaged early on in negotiations between the parties. The process is an essential preliminary to contractual protections such as warranties and indemnities.

The DD identifies levels and areas of protection needed by a buyer and also any risks that the buyer may want to avoid completely. A buyer 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 (see sections 18, 19 and 20).

Also, 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 and legal, but below is a short breakdown of how legal DD is carried out:

- The solicitor for the buyer will submit a DD questionnaire to the seller which will cover all aspects of the sellers business, including commercial contracts, litigation, employment, property, compliance, intellectual property and its tax position;

- The seller provides answers together with supporting information to the questions submitted to the buyer's solicitors; and

- The buyer's solicitors 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 indicate that the target business is disorganised and unable to provide substantive responses with well ordered supporting documents, a buyer is more likely to require stronger warranty or indemnity protections and even consider paying the purchase monies into a ring-fenced solicitors account for a period or linking it to the performance of the business post-sale (see sections 18, 19 and 20). The impression the seller makes to the buyer in the DD process can have a significant impact on the seller's ability to get a good price for their business, receive the monies as soon as possible and keep it in his pocket post-sale without concern. Sellers who operate their everyday business on established well organised business processes, administration and compliance will be much better placed in this regard than those that don't. It is never too soon to start! Collating responses can be time consuming, but it is essential that this is managed effectively.

In some circumstances, a seller may not be retiring or exiting completely and may also wish to remain employed or engaged in the business post-sale. Sellers in this situation should be mindful to create a good impression on the buyer and being able to manage the sale process effectively, including demonstrating that the target business was well run, responding well to due diligence and providing comprehensive disclosures (see section 21) will be key to this.

13. THE DUE DILIGENCE PROCESS: FINANCIAL SERVICES ISSUES

As part of the preparation for sale, this section deals with which particular financial services related documents and information the buyer is likely to want to see and have access to. Therefore, a seller should look to be bringing these together at an early stage of the negotiation process:

- The 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 all FSA permissions and authorisations, including for those individuals in the firm exercising Controlled Functions;
- 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 the 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 firm handles client money in compliance with FSA requirements and 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 procedure 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.);
- Customer contracts. The buyer may, depending on the number, also require access to a sample of the seller's client files which he will use to assess for example the quality of the 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 firm's policy on fee and commission disclosure;
- Details of all other of the firm's commercial insurances; and
- Information to enable the buyer to make an assessment of the size of the indemnity risk and how this tails off.

Before disclosing any information or documentation to a buyer, the seller should put in place a robust confidentiality agreement obliging the interested 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.

14. SALE AND PURCHASE AGREEMENT ("SPA")

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

The agreement will deal with such things as:

- Price – including form of payment and the timing of payment;
- Warranties and indemnities (these are always heavily negotiated);
- Limitations on the seller's liabilities;
- Restrictive covenants; and
- Other issues:
  (a) Intellectual property;
  (b) Employment;
  (c) Pensions;
  (d) Property;
  (e) Any conditions – eg competition/shareholder approval; and
  (f) Whether for any reason there should be a gap between exchange of contracts and completion.

Concurrently with the drafting and negotiating of the SPA, there will be a continuing obligation on the seller to provide disclosure (see below).

15. WARRANTIES AND INDEMNITIES

What are warranties?

Warranties are contractual statements contained in the acquisition agreement 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 acquisition agreement, 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 the 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 the 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 the buyer with a good picture of the value 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 the buyer with a remedy if the statements made later prove to be incorrect and the value of the company is thereby reduced. Warranties can 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 is made against them, the effect of the warranties should be to flush out potential problems.

16. COMMON AREAS OF WARRANTY PROTECTION

There are two types of warranties that will be sought by a buyer: general warranties and specific warranties.

General warranties

General warranties sought by a buyer (which will often be rejected by a seller) are aimed at giving the buyer comfort that:

- It has been provided with all the information that it ought to have been provided with to make a proper assessment of the acquisition; and

- There is nothing which the seller knows that would, in the ordinary course, affect the buyer's decision to acquire the target company or business. A seller would often legitimately argue that these are matters for a buyer and not matters that should concern a seller.

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 most usual:

- Accounts;
- Compliance and other FS/regulatory matters;
- Post balance sheet date events;
- Financing and banking;
- Real property;

- Litigation and complaints;
- Commercial contracts;
- Employees;
- Pensions; and
- Tax.

Some other key warranties relate to insolvency and winding up.

17. WHO GIVES WARRANTIES?

The seller(s) of the shares or assets will normally give the warranties. If a company is selling all of its assets, a guarantee from an individual may also be required.

18. LIMITATION OF SELLER'S LIABILITY UNDER WARRANTIES

It is normal practice for a seller to seek to limit its liability under the warranties not only by cutting back the wording of the warranties themselves but also by specifying certain financial and time constraints. This helps provide the seller with comfort that once the purchase monies are in his pocket, only a set amount remains at risk for a set period of time afterwards (although often, this can be the full amount paid – see section 19). Examples of these are:

- Certain warranties are only given on matters of which the seller is actually "aware". (i.e. "so far as the seller is aware");

- Disclosure (warranty liability is limited by disclosure through the disclosure process). This qualifies the extent to which the warranties can be given. (e.g. 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 period 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. 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.

19. FINANCIAL LIMITS ON WARRANTY CLAIMS UNDER THE SPA

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

- A minimum financial limit for individual claims (individual de minimis limit);
- 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 received. This cap is key to a seller's understanding of how much he may potentially have to repay to the buyer in the event of a claim during the period referred to in section 18 above, and in some cases dictates how much of the purchase monies a seller will be comfortable in tying up before expiry of such period.

20. SECURITY FOR BREACH OF WARRANTY

Warranties and indemnities are only as good as the ability of the seller who gives them to pay out in the event of a claim. If a buyer has any doubts about the credit worthiness of a seller, it may want to take some sort of security for any possible breach of warranty. Methods available to a buyer to obtain security for any breach of warranty include:

- Obtaining 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 bank account where part of the purchase price may be deposited until the warranty limitation period has expired (an "escrow account");
- 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 claims in that period.

With the advent of warranty insurance cover, a buyer may be willing to forego the aforementioned methods if the seller has taken out such insurance although this is relatively rare and such cover is often expensive.

Specific financial services related warranties

Generally the seller is expected to give warranties along the following lines:

- That neither the business to be sold, nor its principals, directors, officers or employees, has been, and is not, subject to FSA investigations, enforcement or disciplinary process and that none are threatened by the FSA (and that no matter or circumstance exists which might give rise to such proceedings);

- Neither the business, nor its principals, directors, officers nor employees have been subject to any regulatory fines, censures or penalties etc. and that there are no outstanding issues with the FSA;

- That the business has complied with and conducted its business in accordance with all relevant FSMA/FSA rules, 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 reviews which are required on an industry-wide basis;

- That all claims and circumstances that could give rise to claims have been notified to PI insurers and that no facts or matters exist which would entitle PI insurers not to pay a claim made under the policy.

The disclosure process will apply to such warranties, giving the seller the opportunity to make the buyer aware of the extent to which such matters do exist and thereby limit the seller's liability under such warranties to that extent.

What are indemnities?

The difference between a warranty and an indemnity

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 in damages if the buyer is able to show that there was firstly a breach, and secondly that the effect of the breach was to reduce the value of the company or business acquired. The Buyer will also have to get past any limitations negotiated (see sections 18 and 19) which may make it difficult to bring a warranty claim successfully.

An indemnity is a promise to reimburse the 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 business acquired is reduced by the breach in question. Therefore, the purpose of an indemnity is to provide a guaranteed 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. (E.g. a buyer buys the shares of ABC Limited. The seller gives a warranty that the company owns a fleet of 10 cars when in fact, it only

owns 9. The shares in ABC Limited are unlikely to be de-valued 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).

Indemnities are most appropriate where cover is required for specific risks which are of particular concern to a buyer, (for example, where a target company is involved in any unresolved litigation the buyer may require the seller to bear the risk and pay all costs and make good all losses) of the outcome of the litigation in the form of an indemnity. The due diligence process or disclosures offered against particular warranties should alert the buyer to areas where a warranty is simply not enough. Risks commonly covered by indemnities include:

- Specific litigation or complaints;
- Data protection;
- Environmental risks;
- Doubtful book debts;
- Repayment of loans by the target company;
- Product liability claims; and
- Litigation for infringement of intellectual property rights.

FS indemnities

The buyer may require 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.

The indemnity will generally cover not only any compensation that the buyer has to pay customers (for example, as a result of an FOS or Court award or earlier settlement), but also the costs (legal or otherwise) of dealing with the claim/complaint.

If the buyer has 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.

If the pre-completion claims/complaint were of such a volume, or for example related to a specific product, and the FSA required the buyer to carry out a past business review, then the indemnity may extend to the costs associated with such review (as well as any compensation that has to be paid by the buyer as a result).

The indemnity could cover the buyer's costs of having to deal with an FSA investigation, and enforcement/disciplinary process, that arises post-completion but which relates to conduct of the business pre-completion.

The buyer may ask the seller for an indemnity to cover the costs of remedying pre-completion breaches of 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).

The buyer may require the seller to give him an indemnity that he has complied with the Data Protection Act 1998 in respect of client and other personal data held by the business. This is particularly relevant on asset sales and even more so when the buyer has "cherry picked" the client list, leaving the rest of the business behind. On an asset purchase, if a large part of the value of the acquisition to the buyer is the ability to market to the clients, a seller will not have certainty that he can legally transfer the client list to the buyer unless the consent of the client is obtained in advance. The buyer may also request the seller to enter into joint correspondence with such clients explaining that the buyer has bought the business. Where the buyer wishes to send marketing information to the clients by SMS or email or contact the client by phone or in person with regards to mortgages, the client must provide prior consent to this and must also be provided with the opportunity to "opt-out" of receiving marketing in any other format. What if some of the clients do not want to be contacted by the buyer so the value to the buyer of the client list is eroded? The buyer may well request an indemnity to cover this, 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. The purpose of the Data Protection legislation is not to prevent the sale of companies or businesses as going concerns, but this is much more of an issue where the "cherry picking" is restricted to a client list and right to receive trail commission. Data Protection is a relatively technical area of law and a prudent seller seeking to maximise the sale price may be wise to take advice on this as early as possible before the sale process even begins.

As mentioned previously, where circumstances such as those above exist, the buyer may also seek to put in place additional cover for such eventualities by allowing for payment of 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 payment or paying the purchase monies into an escrow account where it cannot be accessed by the seller for a period of time. Where any such circumstances exist, a seller may therefore wish to consider the timing of a sale until there is more certainty around the cost or risks to the business relating to those or other material matters.

21. DISCLOSURE

The disclosure letter is a key document in any private acquisition. If a seller makes inadequate disclosures, it may well find itself on the receiving end of breach of warranty claims which it could have avoided. If, on the other hand, a buyer fails to review a disclosure letter properly, it may be in for some nasty surprises. Disclosure is one of the key protections available to the seller.

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. Clearly a full and proper disclosure exercise is in both parties interests. The disclosure letter normally takes the form of a letter from the sellers to the buyer and is usually divided into two parts, being "general disclosures" and "specific disclosures (as the warranties are). The disclosure letter will have attached to it copies of the documentation being disclosed, these documents making up the disclosure bundle.

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 a buyer would normally make.

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 will 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 employment or consultancy contracts used by the target company).

22. INSURANCE ISSUES

The most important insurance issue on sale will be the PI arrangements. The seller may very well remain responsible for the PI claims that have been notified pre-completion to PI insurers. The seller must be careful to ensure that the transaction does not in any way affect the coverage afforded to such claims by PI insurers. The relevant insurers should be brought "into the loop", via the firm's lawyers or brokers, as early as possible so as to ensure that the transaction does not, inadvertently, jeopardise the handling and coverage of the claims.

Also, the seller will need to consider what will happen to arrangements for PI post-completion.

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, but this should be an issue very high on a buyer's due diligence list and just some of the items that will need careful thought and addressing include the following:

- Have the seller's PI insurers accepted liability for claims notified to them prior to completion? If not, why not?
- 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)? It is not uncommon for run off cover to last for at least 6 years, but this varies from business to business and recommended periods of cover may be subject to change. The seller should seek advice on this from a broker as early as possible so this can either be factored in to the structure of the sale, or the cost can be planned for in the long term.

- 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 be required to give the buyer an indemnity? If so, for how long and for how much?

- 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? Can they be assigned to the buyer? Will they come to an end? Is coverage required post-completion? 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?

The key message here is for the seller to involve his insurance broker as a key member of the transaction team so as to ensure that all relevant insurance issues are covered off and adequately provided for/dealt with in advance of the transaction.

23. COMPLETION AND COMPLETION ACCOUNTS

Once all the due diligence and disclosure is done and all the negotiations are settled the parties reach completion where all the documents are signed and, most importantly for a seller, the consideration money for the business is agreed on and paid, normally in accordance with completion accounts.

Completion accounts are accounts of the target company drawn up at or shortly after completion of the acquisition which will form the basis for determining the final amount of consideration payable under the acquisition agreement (either a SPA or asset purchase agreement). In order to minimise possible disputes, the Seller and Buyer should set out in a schedule to the acquisition agreement 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.

Finally, there will 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 could be a reasonably short meeting to sign documents and check disclosure documents can sometimes turn out to take many hours, even days.

24. 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 sale of a business is likely to be a "deal of a lifetime" for most sellers. Having spent many years building up a valuable business, a prudent seller will instruct advisors who can help him realise that value and protect his interests on such a life changing transaction so he has more comfort that the purchase monies, once in his pocket, will remain his to enjoy.

The particular complexities of financial services businesses are not applicable to other industries (e.g. issues regarding trail commissions, clawbacks and regulatory matters do not arise on the sale of a grocery store). To get the best value and advice on such matters, a corporate lawyer and accountant with knowledge of the sector will be key. Sellers will not get their money's worth from their professional fees if they instruct advisers without this knowledge and expertise.

Through its 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. The sale process is time consuming and can be a stressful experience, so the seller should consider early on how he will manage this without detriment to the day to day running of his business and ultimately the price!

A good corporate lawyer will not only help get the best value for the 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.

This update has been produced by Bankhall and Pinsent Masons. This update does not constitute legal advice. Specific legal advice should be taken before acting on any of the topics covered in this bulletin. This guide is property of Bankhall and should not be copied or given to any third party without Bankhall's written consent.

Pinsent Masons

www.pinsentmasons.com

LONDON DUBAI BEIJING SHANGHAI HONG KONG SINGAPORE
OTHER UK LOCATIONS: BIRMINGHAM BRISTOL EDINBURGH GLASGOW LEEDS MANCHESTER

T 0845 300 3232

About Pinsent Masons

Pinsent Masons is an established, full service law firm with truly international reach, a reputation for delivering both world class service quality and excellent value. The firm ranks in the UK top 15 and is in the Global 100 of law firms and has well over 1,000 partners and other lawyers worldwide.

Pinsent Masons office network in the UK includes Birmingham, Bristol, Edinburgh, Glasgow, Leeds, London and Manchester. Pinsent Masons international office network includes Dubai, Beijing, Shanghai, Hong Kong and Singapore.

The firm also has a strategic alliance with Salans, a leading international law firm with over 750 lawyers across 21 or more locations in Western and Eastern Europe, Asia and the United States.

© Pinsent Masons 2009

Pinsent Masons LLP is a limited liability partnership registered in England & Wales (registered number: OC333653) and regulated by the Solicitors Regulation Authority. The word 'partner', used in relation to the LLP, refers to a member of the LLP or an employee or consultant of the LLP or any affiliated firm who is a lawyer with equivalent standing and qualifications. Singapore location in association with MPillay. A list of members of the LLP, and of those non-members who are designated as partners, is displayed at the LLP's registered office: CityPoint, One Ropemaker Street, London, EC2Y 9AH, United Kingdom. We use 'Pinsent Masons to refer to Pinsent Masons LLP and affiliated entities that practise under the name 'Pinsent Masons or a name that incorporates those words. Reference to 'Pinsent Masons is to Pinsent Masons LLP and/or one or more of those affiliated entities as the context requires. For important regulatory information please visit: www.pinsentmasons.com

bankhall®

Bankhall PMS Limited
The Southmark Building, 3 Barrington Road, Altrincham, Cheshire, WA14 1GY

Bankhall is a trading style of Bankhall PMS Limited a company registered in England and Wales with number 2785381 which is authorised and regulated by the Financial Services Authority under number 164877. Registered office: Pixham End, Dorking, Surrey RH4 1QA. VAT number: 750012975.

bankhall® is a registered trademark of Sesame Bankhall Group Limited (a company registered in England and Wales with number 3573352. Registered office: as above).

CAS – 128386 - ZAYC