

Guide to: Protecting Yourself When Buying a Business

The principle of “caveat emptor” or “buyer beware” is a fundamental part of English contract law. The principle essentially puts the onus on the buyer to make sure they have assessed the quality and suitability of what they are buying before a purchase is made as if they have failed to do so, there will be no route of redress against the seller.

While the principle may not apply all the time, it will apply when buying a business. It is therefore important that a buyer of a business takes steps to protect its position.

There are many different aspects to consider when buying a business and this article will briefly highlight some of the key considerations for a buyer when acquiring a business.

Due diligence

On any acquisition, once the outline terms have been agreed, a prudent buyer should gather as much information about the target business as possible before becoming bound to complete the purchase. This is typically known as due diligence and is intended to provide the buyer with essential information about the target business (including in relation to its legal, financial, trading and tax affairs).

A properly conducted due diligence exercise should enable the buyer to make an informed decision whether to proceed with the proposed acquisition or not. The results of due diligence should also enable the buyer to identify any specific areas of concern for which enhanced protection may be needed (see comments about indemnities below) and may also prompt the buyer to seek to renegotiate the terms of the purchase (if deemed necessary).

In addition to enabling the buyer to evaluate the potential risks and rewards of the proposed purchase, a due diligence exercise should also give the buyer vital management and operational information which can be used to plan for the post-completion period.

Warranties and indemnities

A prudent buyer should seek to readdress the harshness of the “buyer beware” principle by including contractual protection in the acquisition agreement. Such contractual protection typically comes in the form of warranties and indemnities which provide vital protection for a buyer should the target business not turn out to be as expected.

In summary, warranties are statements of truth given at completion (usually by the seller) about the state and affairs of all aspects of the target business. They protect the buyer because any statement that is found to be untrue or inaccurate should give the buyer a basis to claim for damages.

The process of negotiating the warranties will usually give the seller the opportunity to make disclosures against any warranties which may not be accurate or true. A seller’s disclosures should be carefully reviewed as, generally speaking, a buyer will not be able to bring a warranty claim in relation to circumstances which have been disclosed by the seller.

The purpose of warranties is therefore twofold. Firstly, they encourage the seller to provide upfront details about any issues affecting the target business before the buyer commits to the purchase (which may not have been revealed during due diligence). Secondly, they give the buyer a basis to claim for damages in relation to any warranties which prove to be untrue which can be viewed as a retrospective price adjustment mechanism.

As part of the negotiation of the warranties, a seller will usually seek to include various limitations designed to mitigate liability under the warranties. These can include time limits to bring claims, claim limits, overall liability caps etc. It is therefore important that any limitations the seller seeks to impose are carefully reviewed and negotiated.

An indemnity differs from a warranty in that it gives the buyer an enhanced basis to claim against the seller. Indemnities are typically included in relation to specific areas of risk which have been identified (often discovered during due diligence). An indemnity is essentially a promise from the seller to reimburse the buyer on a pound-for-pound basis in respect of a particular liability. A claim under an indemnity therefore overcomes the issue of establishing loss which can arise with warranty claims.

Other advantages of indemnities over warranties are that any warranty limitations typically do not apply and (unless agreed otherwise) the buyer will not be under an obligation to mitigate its loss.

In summary, indemnities offer more protection for a buyer compared to warranties but they are usually one of the most heavily negotiated aspects of an acquisition agreement.

Restrictive covenants

When buying a business, the buyer will ordinarily want to ensure that any seller is prevented from carrying out certain activities after completion which could adversely affect the value of the target business going forward. A buyer will therefore often seek restrictive covenants from sellers which are designed to preserve the goodwill of the target business being purchased.

A restrictive covenant is a promise not to engage in certain activities and the types of restrictive covenants which a buyer would usually seek from a seller include: -

- A restriction on soliciting and dealing with customers, employees and suppliers of the target business.
- A restriction on being engaged or involved with a competing business.
- A restriction on using certain names or logos connected/associated with the target business.
- A restriction preventing the seller from holding themselves out as connected to the target business.
- An undertaking not to use or disclose any confidential information about the target business or its customers.

Restrictive covenants need to be carefully drafted as they are only enforceable to the extent that they do not constitute an unreasonable restraint of trade. There must be a legitimate business interest to protect and the restriction must be reasonable in scope. Reference is often made to the

duration of the restriction and the geographical area in which the restriction operates to ascertain its reasonableness.

Legal Support

This guide sets out just some of the important considerations for the buyer of a business. If you are buying a business then it is important to ensure that proper legal advice is taken to protect your position and the value of the goodwill of the business being purchased.

This guide is provided for general information purposes only and does not constitute legal or other professional advice.

BHW Solicitors is the leading specialist commercial law firm in Leicester and the East Midlands.

We provide the best legal, commercial and strategic advice to businesses of all types and sizes, from start-ups to household names.

T: 0116 289 7000 E: info@bhwsolicitors.com W: www.bhwsolicitors.com

1 Smith Way, Grove Park, Enderby, Leicestershire, LE19 1SX