**Preliminary stages**

This section deals with the concerns of a seller or buyer contemplating a share sale or an asset sale, and the preliminary documents prepared for such sales

**Introduction**

In this section we will consider the following:

1. the concerns of the buyer and seller contemplating a share sale or an asset sale; and
2. the preliminary documents that are often put in place before work starts on the acquisition (and the reasons for them).

Before reviewing this Adapt material ensure that you have reviewed the induction materials which provides an introduction to the wider commercial considerations on a private acquisition.

**Concerns of the buyer**

A party interested in buying a company or business (the ‘**Target**’) will wish to learn all about the Target to ensure that it is:

* a worthwhile acquisition; and
* worth the consideration being paid.

The buyer acquires knowledge of the Target through the **due diligence process**. During the course of due diligence, legal, accountancy and other advisers will be engaged to investigate the Target on behalf of the buyer and to report back on their findings.

The due diligence process is expensive and time-consuming, so a buyer may not wish to embark on the process until it can be sure that:

* the seller is seriously committed to selling the Target at a price the buyer is prepared to pay; and
* the seller is not currently engaged in negotiations with one or more other potential buyers.

**Concerns of the seller**

Meanwhile, the seller will wish to ensure that:

* it obtains the best possible price for the Target; but that
* the commercial integrity of the Target is not compromised as a result of an aborted sale; and
* the disclosure of any information complies with any data protection or competition restrictions

The seller will appreciate that, in order to negotiate a good price for the Target, it must release confidential information relating to the Target.

If, however, the seller is going to release this information to the prospective buyer then it will want to know that:

* the buyer is seriously committed to the purchase and is not a time waster; or
* worse still, that the buyer is not an unscrupulous competitor seeking to obtain trade secrets for the benefit of its own business.

**Meeting the parties’ concerns**

The way in which the buyer and seller settle their respective concerns at the outset of a transaction will depend on whether the transaction is to be conducted as a **bilateral sale** or an **auction sale**. In this part of the knowledge stream, we will focus on bilateral sales.  
Note: You will learn more about the process of an **auction** during the second half of this knowledge stream.

The idea behind a bilateral sale is that the seller negotiates with just one buyer. In such a situation, the buyer may take the initiative in the due diligence process by sending the seller a due diligence questionnaire. The seller will make due diligence documentation available for the buyer's review (often via a data room).  We will look at this in later Topics. Before the seller is willing to release information, it is likely to wish to make sure that its concerns have been met.

In a bilateral sale, the parties often enter into preliminary documentation in the form of:

* heads of terms (sometimes known as heads of agreement, a memorandum of understanding, a letter of intent or a term sheet’);
* confidentiality provisions; and
* exclusivity (or lock-out) provisions.

**Heads of terms**

Heads of terms (which may also be referred to as heads of agreement, a memorandum of understanding or a letter of intent) are often used to set out the parties’ basic understanding of the key commercial terms and the structure of the deal. Heads of terms are merely an expression of the intention of the parties.

They act as a road map for the full form contract and, generally speaking, are **not legally binding** although they do have some moral force. There are some exceptions to this, for example, heads of terms could include a legally binding:

* Exclusivity agreement;
* Confidentiality agreement;
* Governing law and jurisdiction; and
* Provision for payment of costs and break fees if the deal does not proceed.

The exclusivity agreement and provision for costs allows the buyer to proceed with the transaction with some confidence.

There is no set rule in this respect who will produce the first draft of the heads of terms, if these are being used.

**Heads of terms - content**

The heads of terms are likely to include a combination of the following non-binding clauses and binding clauses:

Non-binding

* The structure of the transaction
* The purchase price
* The form of consideration
* Any conditions (e.g. consents)
* Timetable for completion
* Responsibility for drafting the contractual documentation

Binding

* Confidentiality
* Exclusivity/duration of negotiations
* Costs and break fees
* Governing law and jurisdiction

**Confidentiality agreements**

Before negotiations begin, and before the prospective buyer is given any sensitive information about the Target or the seller, the seller will ask the buyer to enter into a confidentiality agreement (also known as a **non-disclosure agreement**). Under the non-disclosure agreement in consideration for the seller providing the buyer with information regarding the Target and the seller, the buyer agrees to (and its advisers) keep such information secret. The seller will often want to ensure that even the fact that the Target is for sale is kept strictly confidential. Knowledge or even rumours, of a potential sale can have an unsettling effect on the Target’s employees, its customers and suppliers. This can undermine the Target’s goodwill. It may involve the loss of sales, key staff or the loss of customers to a competitor.

The obligations in the confidentiality agreement will generally survive even if the transaction subsequently does not complete. It is more common to see confidentiality agreements with a **fixed duration**, with the duration depending upon the nature of the information the agreement is intended to protect. It is common to see this set at 2-3 years though for certain key confidential information, such as know how, this may be longer.

The buyer will usually also ask for confidentiality undertakings from the seller in so far as the seller obtains any confidential information relating to the buyer during the course of the negotiations.

**Confidentiality agreements: Target and other parties**

The confidentiality agreement will be entered into between the potential buyer and the seller. Often the Target may also be a party to the confidentiality agreement in order that the Target can enforce the obligations it contains.

Alternatively, if the Target is not a party to the agreement, then they will still have rights to enforce the agreement under the **Contracts (Rights of Third Parties) Act 1999** provided:

1. the agreement expressly says they can; or
2. the term purports to confer a benefit on them.

In the latter case the Target can enforce the agreement unless the agreement expressly excludes this right.

A potential buyer will need to involve others in the process of evaluating the Target. This will generally include senior employees of the buyer and its professional advisers, banks and consultants. This may result in confidential information being passed on to these other parties.

The seller will often require the potential buyer to procure that these parties are also bound to treat the information as confidential. The seller may even require these third parties to enter into confidentiality agreements with it, before they receive any confidential information but such third parties may resist entering into direct confidentiality obligations with the seller.

**Exclusivity / lock-out agreements**

Given that a due diligence investigation is an expensive and time-consuming exercise, a prospective buyer is likely to want some form of protection against losing out to a rival bidder. Whether or not the buyer is able to secure this protection will depend on the strength of the buyer’s bargaining position. If the buyer is able to obtain protection, this will take the form of an **exclusivity** agreement, also known as a lock-out agreement.

Case law has shown that an agreement attempting to bind the parties to negotiate in good faith (in effect a lock-in agreement) would be **unenforceable** as it lacks certainty.

For a lock-out agreement to be enforceable it needs to be certain (so, for a fixed and specified period) and supported by consideration or made under seal (by deed).

In addition to the contractual protections of an exclusivity agreement the buyer may seek to cover the costs of due diligence buy including a break fee arrangement.

Break fees

As further protection for one or both of the parties, they may enter into a break fee agreement.

* Break fees are a common feature of mergers and acquisitions in the US and they are sometimes seen in UK private M&A transactions.
* Traditionally, break fee agreements provided for a fee to be paid to the buyer if a specified event occurred which prevented the proposed purchase of the target from completing.
* Nowadays, break fee agreements may work both ways - with each party agreeing to pay the other party if the first party fails to complete for specified reasons. The extent of payment, and the trigger events, will depend on the bargaining strengths of the parties concerned. Though any amount set should not amount to be an unenforceable penalty.

**Summary**

* A potential buyer will require some protection before they incur the considerable expense involved in the due diligence exercise and in the negotiation of the terms of a corporate transaction.
* Equally, a seller will want some reassurance about the prospective buyer’s commitment to the acquisition before it releases confidential information about the target to the prospective buyer (and any parties engaged by the buyer with regards to the potential acquisition).
* The way in which the parties settle their respective concerns will be to enter into some or all of the preliminary documentation in the form of: heads of terms; confidentiality provisions; and lock-out or exclusivity provisions.
* The exclusivity and confidentiality provisions may be contained in separate agreements but they are sometimes included in the heads of terms. In the latter case, it is important that the heads of terms expressly states that these provisions are legally binding (because generally the heads of terms will not themselves be legally binding).