

Preparing a Business for Sale - Deal Structures

By Edward O'Rourke, Kester Cunningham John

This month Solicitor Edward O'Rourke from [Kester Cunningham John](#) looks at how the changing dynamics of the market for funds to facilitate mergers and acquisitions activity has led to a shift in the way deals are structured. Bank funded debt is now a rarity and the available cash to fund transactions is limited. This article focuses on trends in the private mergers and acquisitions market; further impacts are being felt in the public mergers and acquisitions area but are not explored in this article.

In the period immediately prior to the banking collapse of September 2008, the mergers and acquisitions market had become extremely seller friendly. Many transactions in the few years running up to September 2008 were being completed with the consideration payable to the seller being paid in full on completion. Sellers were able to take their cash and effect a clean break from the business with only potential warranty liability to keep them awake at nights. Some 10 years prior to this time back in 1998, with the previous recession still in the back of people's minds, deals were often more structured with consideration being paid in instalments, deferred considerations and earn-outs were common-place. This position was then eroded over the following decade so by the time the banking collapse occurred most deals immediately preceding the collapse were completed without any deferred consideration or earn-out requirements whatsoever.

The events of September last year resulted in the collapse of availability of bank funded debt. This in turn reduced the number of buyers who are able to make offers for businesses and thus switched the market from a sellers' market to a buyers' market.

The lack of funds which can be easily borrowed in order to fund transactions has given rise to those deals which are taking place being structured in ways which ease the immediate demand on the cash-flow of buyers. The return of deferred consideration and earn-outs is one way in which buyers are now looking to fund transactions. However, in addition to this, there also appears to be an increase in alternative deal structures such as share for share transactions and an increase in levels of joint ventures where asset swaps can be used.

The shifting in the balance of power towards the buyer and the increased use of deferred or contingent consideration provides the buyer with some clear advantages: spreading payments over a period of time, especially where those payments are linked to turnover or profitability of the business acquired going forward, this ensures that the buyer can obtain certainty that it is not over-paying for the business. Conversely, it is the seller who suffers from these arrangements as they no longer achieve the clean break that previous sellers were taking advantage of during the good times. Sellers are taking further risks with regard to securing the future payments for the sale of their business. This deferred consideration is leading to increased negotiations on security, loan notes and contractual protections such as guarantees or escrow arrangements in an attempt to provide sellers with some comfort. Sellers are, quite rightly, nervous of promises of future cash at a time when the ability to raise funds through traditional bank borrowing is severely hampered.

Sellers are also having to think long and hard about their continued and future involvement in the business they are selling. The switch from business owner to employee/consultant is a challenging one and should never be underestimated. Even if the sellers' deferred consideration is not being linked to a service/consultancy agreement, on an earn-out, the seller will need to give careful consideration to what involvement they will need in the future decisions of the business in order to protect the deferred element of their consideration.

Loan notes, an often used form of deferred consideration, will need careful drafting in order to give the seller rights to be involved in key decisions whilst the deferred consideration is outstanding. Furthermore, negotiations with the buyer as to what, if any, security will be made available in respect of the deferred consideration payments will add to the complexity of the deal.

With the pressures on financing looking like they may continue for a while yet, it is likely that further shifts will occur; it is not impossible to imagine the use of break fees and reverse break fees, which are more common in public mergers and acquisitions, becoming frequent in private transactions. Likewise the use of completion accounts are now common place in order to ensure a buyer is not overpaying.

The straight forward transactions of full cash on completion have, for the time being at least, largely disappeared. Deferred consideration, earn-outs, the security requirements, loan notes, completion account exercises etc are adding to the complexity of transactions and putting pressure on professional fees at a time when all parties are, understandably, fee sensitive. Even once bank funding is resumed it is likely to be some time before we see a return to the sellers' market as existed immediately prior to September 2008.

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