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THE ENTREPRENEUR'S EXIT

Avoiding the Legal Pitfalls

The post-COVID bounce back in M&A deals has led a lot of entrepreneurs to consider selling their businesses. Business owners are aware that today's extremely healthy M&A market will not continue indefinitely and that the window of opportunity will soon begin to close.

This paper looks at the most common legal pitfalls encountered by entrepreneurs selling their businesses, as seen by the Corporate and Private Wealth teams at Forsters. These teams have decades of experience in advising entrepreneurs on business exits. They know the steps every entrepreneur needs to take to get a business in the best legal shape for an exit, as well as what they need to do to manage the tax bill on their gains and maximise the wealth they secure for their families.

CREATE

Forsters' advice comes under four headings:

- Get your business paperwork in order
- Deal with any difficult 'legacy issues' the business has
- Prepare your heirs' inheritance by getting your taxes in order
- Think about how to manage your own Capital Gains Tax bill

If you are thinking of selling your business, contact the team at Forsters outlined below or via enquiries@forsters.co.uk.

Forsters LLP 31 Hill Street London W1J 5LS DX: 82988 Mayfair T: +44(0)20 7863 8333

WWW.FORSTERS.CO.UK

GET YOUR BUSINESS PAPERWORK IN ORDER – BIDDERS WORRY THEY WILL BE BUYING PROBLEMS

A business with its paperwork in order reassures potential bidders – they will see it as lower-risk and more likely to result in a quick, clean transaction. The Corporate team at Forsters often advises entrepreneurs on how best to clean up their paperwork and make their businesses as attractive as possible. The five big issues they see most often are:

1 Renegotiate business debts if necessary – don't leave it to the buyer

Not having long-term control over the cost of debt of a target business can be an issue that puts off potential acquirers. Any loan renegotiations that need to take place should be concluded before you open the business's books to a bidder. Failing to deal with the problem risks them walking away or lowering their bid.

2 Extend the business's property leases if they are running out – it makes the business more attractive to an acquirer

A potential acquirer will likely be uncomfortable if a lease on a key property used by the business – an office, factory or retail site – is coming up for renewal shortly after the purchase. Having certainty over future costs is valuable, as is avoiding the disruption of relocating the business. It is well worth getting renegotiations with landlords underway a year ahead of your projected exit point.

3 Formalise any 'gentlemen's agreements' with staff, suppliers and customers

Another common issue that acquirers dislike is if a business has failed to formalise the agreements it has with its key staff, suppliers and customers. Far too many businesses still operate on long-forgotten 'gentlemen's agreements' with key staff. Senior team members who have been with the business for many years may not have formal contracts in place, creating a risk that they could quickly walk away from the business following an acquisition. Bidders will want to see that senior staff are contractually incentivised to stay with the business for at least 12 months and have oversight of the costs, including their pensions, bonuses, profit shares and any other remuneration.

The same goes for contracts with important customers - it is common to find formal arrangements that expired long ago and have continued on an informal basis. This creates the potential for key clients to be lost without notice periods, impacting turnover without warning.

This risk can impact a valuation or a bidder's willingness to move forward with a purchase. If this is the case in your business, rectify it before starting the sale process.

4 Update the shareholder register to avoid costly disputes

Another common issue, especially for startups in industries like technology, is the granting of equity to key staff. While this can be an excellent way to retain important contributors to business growth, if it is done informally and the shareholder register is not properly updated, it can trigger costly and avoidable disputes. If these informal grants of equity were made several years earlier, recollections of the details often differ between the parties and misunderstandings can become litigation when an offer is made for the business. Sit down with those key staff members as early as possible, formalise their stake in the business and update the shareholder register.

5 Make sure any IP the business holds is protected by patents and trademarks

More and more businesses are seeing the value of the intellectual property they hold make up a significant percentage of their valuation, but this IP only has real value if it is protected by patents and trademarks. Entrepreneurs have seen potential bidders walk away from negotiations after finding that IP the business relies upon is not protected, risking devaluing their investment in the future.

Taking advice from an intellectual property lawyer is vitally important if your business has proprietary systems or owns market-facing brands that form part of its value.

DEAL WITH ANY DIFFICULT 'LEGACY ISSUES' THE BUSINESS HAS

Bidders are always on the lookout for anything they might deem to be 'skeletons in the closet' for a business. During a business's early years, entrepreneurs often file issues away under 'to be dealt with later'. The Corporate team at Forsters say examples of this kind of issue that entrepreneurs may have to deal with before they try to sell their businesses include:

- **Ensure the business used furlough properly – and deal with it if there are any problems**

In the early days of the pandemic, there was plenty of confusion around the furlough scheme and a lot of businesses made claims that later turned out to be in error. HMRC is now hunting down businesses that owe money because of incorrect furlough claims. It is far better to deal with these issues proactively rather than waiting in hope that HMRC misses it. There are likely to be significant penalties for businesses that made claims HMRC deems to have been 'fraudulent' and there will be little sympathy for those who did not come forward to report it voluntarily. Acquirers will not be keen to purchase a business with a risk of this kind.

- **Unwind any 'problematic' transactions from the company's history**

It's not particularly unusual for businesses to have long-buried compliance issues dating back to their early days as a startup. When the books are turned over to a potential bidder, those issues have a tendency to come back to the surface. If, for example, a director purchased a car for personal use through the business, it can be a significant red flag to an acquirer that there are other governance problems. Any business owner with issues of this kind would be well-advised to unwind any of these transactions before they put an M&A deal at risk.

PREPARE YOUR HEIRS' INHERITANCE BY GETTING YOUR TAXES IN ORDER

A key driver for many entrepreneurs to build a business in the first place is the desire to provide wealth and comfort to their families. A key part of being able to do this successfully is to prepare your personal tax situation to maximise your gains – and by extension, their gains – from selling your business. The Private Wealth team at Forsters say that the two big issues for entrepreneurs to be aware of here are:

- **Don't gift your children cash from the sale – you may overpay tax, and you will miss the chance to protect the money (e.g. from divorce)**

It is common for entrepreneurs to want to pass on some of the capital generated by the sale of a business to their children. Taking advice on the most tax-efficient way to do this is important. Completing the sale then gifting your children cash is rarely the best way. Capital Gains Tax savings can be made if shares are given to children before the sale.

Also, shares in a business typically qualify for Business Property Relief (BPR) from inheritance tax, which means that before the sale there is a unique opportunity to transfer assets into trust for the children. After the sale, a gift of cash into trust would suffer an immediate 20% inheritance tax charge. Having assets in trust can ensure that the children receive benefits only as and when they are ready, and can provide protection on divorce. An outright gift of cash offers no such protection.

- **Be careful about leaving too much cash in the business – your heirs will end up paying too much IHT**

As mentioned, one of the key tax reliefs available for entrepreneurs passing on shares to their children is Business Property Relief (BPR). But if there is too much cash in the business, the relief may be limited.

Make sure there is a solid rationale for the business holding cash, such as a planned programme of capital investment. Ensure this is documented and that your heirs stick to the plan.

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THINK ABOUT HOW TO MANAGE YOUR OWN CAPITAL GAINS TAX BILL

Capital Gains Tax can act as a significant deterrent to entrepreneurialism. Even the Government recognises this, having put in place tax reliefs like Business Asset Disposal Relief (formerly Entrepreneurs Relief) to encourage investment in business growth. The Private Wealth team at Forsters say that this relief is not the only way for entrepreneurs to reduce their CGT bills when they exit a business.

- **Planning to move abroad after selling your business? Consider doing it before that to reduce your CGT bill**

Many entrepreneurs plan a relaxing retirement overseas once they have exited their business. However, few consider the possibility of moving overseas before the sale of their business, which can offer significant tax advantages. If you become resident outside the UK for tax purposes for six years, you may not be liable to UK CGT on the sale of your business during that time. If it works for your personal circumstances, it may be worth accelerating your permanent move out of the UK to save yourself what is likely to be a very substantial tax bill.

- **Becoming a serial entrepreneur? Business Asset Rollover Relief can defer your CGT bill while you grow your wealth**

Business Asset Rollover Relief (BARR) allows an entrepreneur to defer the payment of a CGT bill by investing their capital gain into a new business. The CGT bill from the first business sale doesn't become payable until the second business is sold. That can be very powerful – if your second business is successful, your personal wealth may make the CGT bill from the first business relatively insignificant.

CONCLUSION

For an entrepreneur, making the most of the post-COVID bounce back in the M&A market is possible so long as you take the right advice. Just as when building the business in the first place, preparation is important. Your business didn't become successful by chance – it became successful through careful planning and wise decision-making. Apply the same approach to your exit and you give yourself the best chance of a smooth transaction and an optimal price.

The Corporate and Private Wealth teams at Forsters are here to advise entrepreneurs on every aspect of their business journey, from startup to growth and exit. To speak to the team please contact:

ALASTAIR LAING

Partner, Corporate

T: +44 (0)20 7399 4873

E: alastair.laing@forsters.co.uk

GUY ABRAHAMS

Partner, Private Client

T: +44 (0)20 7863 8524

E: guy.abrahams@forsters.co.uk

STUART HATCHER

Partner, Corporate

T: +44 (0)20 7399 4738

E: stuart.hatcher@forsters.co.uk

CATHERINE HILL

Partner, Private Client

T: +44 (0)20 7863 8525

E: catherine.hill@forsters.co.uk

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