

Company & Minority Shareholding Buy Backs

Guide 10

Avondale Business Guides Series

Company Buy Backs and Minority Shareholding Buy Backs

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This Guide is not intended to be definitive, and the accuracy of its contents can not be guaranteed. Professional legal and financial advice from your regulated advisors should be taken on all aspects of transactions.

Introduction

What happens when a shareholder wants to exit? How can a value be arrived at for a minority shareholding and what is the best way to structure a deal? If there is no shareholders' agreement stating that shares should be valued pro-rata to 100% negotiations can become intense. Even if there is the 100% valuation, this may not suit the buying party who might struggle to match the 'open market' rate, nor feel that this reflects the sweat equity that has led to the parties' current position. Further more how can the buying party afford the shares?

This situation can quickly lead to shareholder disputes. These are akin to the breakdown of a marriage in that no one sets out in a business venture or marriage hoping that it will fail. In some circumstances the breakdown of a marriage and a dispute between shareholders are one and the same. With blood, sweat and tears invested in both a business and marriage it is no surprise that emotive as well as financial concerns enter the fray making for what is often a testing process. But what solutions are there to enable shareholders to exit a business at the end of the working relationship that avoid the expensive vagaries of the court process?

- The sale of the business to an external buyer is certainly an option. Trade buyers can usually pay more than the incumbent parties can afford. Both parties gain from a tax beneficial position and non-instigating party may even be able to look at other ventures and continue trading in some way after a deal. Many of course are reluctant to do this and therefore a buy out may be the best option. See our guide to valuations and sales.
- Winding up the business is often an undesirable option as goodwill will not be realised benefiting neither party
- A company buy back may be the most attractive as in the best scenarios it allows one of the conflicting parties to exit whilst realising the true value of their stake in the business. See below.
- Employing an adviser to arbitrate valuation and negotiation between the parties.

Company Buy Backs

If an internal buy out is to be struck the company buy back is potentially an excellent prospect. The concept of a company buy back is not a difficult one: The company is simply buying back one of the parties' shares which are then cancelled, leaving the other party (or parties) as the only remaining shareholder(s). Of course it is dependent on one of the parties being prepared to allow the other to continue the business and benefit from the goodwill that the business may have built up over time (i.e. where one party is not intending to work in the particular industry of the company any more and only wants to see a return on their investment of time or money, or where one of the parties does not believe there is much goodwill invested in the business itself).

A key advantage to structuring a deal in such a way is that because the company is purchasing the shares, a larger sum for the shares is often more achievable than if an individual were to purchase the shares. Secondly, the remaining shareholder(s) do not have to extract the available funds from the business (thereby incurring tax charges) in order to pay the outgoing shareholder(s) as they may have to if they were to purchase the shares personally.

Logic may indicate that a company buy back is the best solution but bringing both parties to the table to begin reasoned negotiations can be difficult. With so much of the individual poured into the business, emotive and personal issues may prevent the parties being able to resolve the issue themselves. At this point skilled advisers may often be introduced to break the deadlock.

A key part of the adviser's role at this stage is to highlight the potential problems that will arise if the parties fail to reach an agreement. Compromise may be unpalatable to the parties but it may be the only way to salvage value from a mutually destructive situation. Of course, a shareholders' agreement at the birth of the business might well have resolved at least some of the potential areas for dispute. But this is not often high on the list of priorities of new business partners, particularly if they are (or perhaps the word "were" is more appropriate by this stage) married as well.

Legal Requirements

Assuming the parties are able to broker some form of broad agreement through their advisers, the adviser will need to ensure that the structure of the deal meets the requirements of company law.

There are some important procedural formalities to follow when effecting a buy back. The Companies Act 1985 lays down a specific procedure of a company buy back of shares in section 164. Key points to be aware of are:

- the company's articles of association must give it the authority to effect the purchase. If they do not then the shareholders will have to pass an appropriate special resolution enabling it to do so;
- a special (and preferably written) resolution must be prepared confirming the company's authority to effect the buy back;

- where an extraordinary resolution is used, the company's proposed buy back 'contract' must be filed at its registered office for 15 days prior to the resolution being passed/contract being entered into (using a written resolution makes this unnecessary).
- the shares must be fully paid up;
- payment for the shares should be made out of distributable profits. The purchase may also be made out of capital (but it requires still more stringent formalities).

Failure to observe the Companies Act requirements may make the buy back void and legally unenforceable. Additionally the company could find itself liable to a fine, and the company's officers liable to both a fine and imprisonment.

Another issue that must be carefully considered is whether there are in fact sufficient distributable profits from which to affect a buy back. This must be clearly established before the transaction proceeds. Often the business owners or their accountants suggest that the company pays the outgoing shareholder money over a period of time. Although in fact there is nothing in the legislation to prevent staged payments for the company's shares, it is usually the case that the consideration will have to be paid in full and at the point of sale. If there is any suggestion that the parties want to pay in stages, a company buy back may well be inappropriate. The outgoing shareholder would have to be asked to take a probably unacceptable risk that if the company does not have distributable profits at the time a payment is due they could be left without a legal remedy to insist on the company making the payment.

Tax and the buy back

Tax concerns are also often the biggest factor in the decision to use a company buy back of the outgoing partners' shares. Providing certain conditions are met the proceeds received from the buy back may be treated as a capital transaction (liable to capital gains tax, which can be useful if the parties qualify for Capital Gains tax relief). However, clients are well advised to take specialist tax advice on the precise tax implications of a buy back and to do so in good time before the transaction is too far advanced. It is usually also advisable to seek revenue clearance on this type of transaction and this must be factored in to the planning of the timing of a deal. The Revenue can take up to 28 days to reply to a request for clearance.

Employing an adviser

Understanding the issues, which may be broad and complex, commercial or personal, is essential to handling a successful share buy back. Avondale can assist both with valuations and negotiations. Utilising expert advice usually avoids disputes escalating. Skilled arbitrators create a buffer between the parties to enable a commercial reality to set in. Through their expertise in this area Avondale have a history of resolving potential disputes and delivering successful transactions through practised and sensitive share buy back negotiations. Fees vary from project to project so please contact us for a full understanding of how Avondale can assist in adding value in this area.

Financial advice regarding the specifics of a company buy back should be taken from your usual regulated advisors.

For further information regarding our services, please contact us on 01737 240888 or e-mail us at reigate@avondale-group.co.uk

Tax

The Capital Gains Regime is changing dramatically in April 2008. At the time of writing the full details are not known (Feb 08) and therefore we have left any references to the previous regime in these guides pending further edits when all the details are known,

New Regime (post April 2008): Tax considerations when selling a company are complex but need to be understood as they have a huge bearing on the sale and the amount of cash you will either pay or come away with. Ideally planning should take place before signing heads of agreement. There are various ways in which tax charges can be mitigated, or even eliminated. Here are some examples of the things that vendors might need to look at:-

- Be clear about what you are selling.
- Check your entitlement to Entrepreneur's relief which reduces the 18% Capital Gains Tax to 10% on the first £1 million capital gain.

To contact a specialist tax adviser please contact your local Avondale office.

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