

Navigating the sales process

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With your business ready for sale, the next step is attracting the interest of potential buyers and, with a suitor committed to negotiations to acquire, managing the process and fulfilling key requirements to closing the sale. In this article in our Start to Scale Essentials series, we cover the basic steps in a successful sale process.

Step 1: the IM

An Information Memorandum or IM is a sales document, or package of documents, which intends to give potential buyers information about the company and to help motivate, and guide, their bids. Given its importance in attracting potential buyers, it is often prepared with the help of a professional corporate finance adviser. The IM usually includes a description of the business and its history; historical and up-to-date financial information; information on the market opportunity; projections for the future; information about employees and any key assets (including intellectual property); a summary of the management structure; and information about major customers and suppliers.

Step 2: the NDA

An NDA or non disclosure agreement will usually be agreed between the company (and, often, the sellers) and potential buyers prior to the disclosure of sensitive or confidential information about the company (which may include the IM). This protects the confidentiality of information disclosed during negotiations, and ensures potential buyers cannot use the disclosed information for their own benefit should the transaction not proceed to completion.

Step 3: DD

Due diligence or DD is the process by which a potential buyer 'kicks the tyres' of the company in order to identify any matters that require further information or investigation or that could be used to negotiate (or renegotiate) the transaction terms.

The output of the due diligence exercise usually takes the form of due diligence reports. Due diligence reports, usually drafted by legal advisers and/or accountants prior to completion of a sale, can influence the warranties and indemnities in the final sale and purchase agreement (which we will discuss further below) as well as the price (if issues going to value are identified).

As part of the due diligence process, an online data room will usually be established to host all relevant documentation relating to the company. This assists both parties in the due diligence process and is a useful tool for tracking what has, or has not, been provided.

What if I am running a competitive auction?

In a competitive auction process, where there may be multiple interested parties, data rooms will often be used to provide potential buyers with limited, but sufficient, information in order to allow them to submit meaningful bids. Bids will then be analysed and a further, more detailed data room opened up to preferred prospective buyers. This ensures the information flow is kept tight and only serious, committed buyers receive the fuller information. We at Shepherd and Wedderburn, have developed our own in-house Hub data rooms for use in such scenarios, which allows us to manage the information sharing process for you.

Step 4: The transaction itself

The main agreement involved in a sales process is called a sale and purchase agreement (or SPA – the acronyms and jargon continue!). The SPA governs the sale and purchase of the share capital of the company and sets out terms applying to the transaction, including the parties, the price payable, how the transaction is structured; any restrictive covenants on the sellers, the indemnities, and the scope of, and any, limitations.

So, what are warranties?

Parties, dates to deliver certain items and restrictive covenants are usually well understood, but warranties (or their purpose) are often less so. Warranties are statements in the SPA relating to the company, its business, its assets, its accounts, legal compliance and much more. A buyer generally arrives at a value for the company based on these warranties and the accuracy of the information documented. If the warranty turns out to be untrue, and the value of the company falls as a result, a seller could be liable to pay damages.

So, how do I protect myself from claims under the warranties?

A seller's liability is limited to the extent that proper disclosure has been made against the warranties. The disclosure process aims to identify any potential areas where the warranties given in the SPA could be found to be misleading, untrue or potentially breached, and to disclose those to the buyer in order to seek to limit a seller's exposure. This is an area where having experienced (and skilled) advisors engaged can pay dividends in limiting your commercial exposure in the sales process.

Indemnities

An indemnity is a promise to reimburse the buyer in respect of a known issue should it arise. The purpose of an indemnity is to shift the risk of a particular event or matter to the seller(s) and allow the buyer to recover in full in relation to that particular event or matter. Indemnities are used where a warranty does not allow a buyer to recover which, for example, would occur where the buyer has knowledge of the circumstance or event.

Is there anything else we can do to de-risk the sale?

The SPA itself will contain limitations on a buyer's ability to make claims for breach of warranties. These will often be financial limitations (such as a minimum financial threshold that must be met before a claim can be raised) as well as time limitations (such as a longstop beyond which no claim can generally be raised). Again, negotiating the limitations in an SPA requires experience and, if you have not experienced a sale process before, it is important that you engage the right advisor to guide you on these.

Warranty and indemnity insurance can provide some comfort for the seller(s) by enabling them to insure against any unknown liabilities which may result from the warranties and tax covenant in the SPA. In return for placing this type of policy, the liability of the seller(s) will usually be significantly reduced (often, to very nominal values) under the SPA. This provides certainty for the seller(s) post deal.

How, when and what will I be paid?

There are various pricing structures to be considered when selling a company and the choice as to which one is used will be based largely on the commercial drivers of the parties and their respective negotiating strengths. Some of the options include:

Deferred consideration: the buyer and the seller agree a fixed sale price, though part of the agreed price is not paid upon completion and is instead deferred until a later date.

Earn-outs: the final purchase price is subject to (usually) the future performance of the company; a percentage of the purchase price is paid at completion, with the remainder payable if certain targets agreed in the earn-out are achieved. Earn-outs are often used to bridge a value gap between a seller and buyer (i.e. where the seller believes the future performance implies a higher value).

Completion accounts: the buyer sets a purchase price, though the amount is adjusted after completion, based on a set of accounts showing the company's true financial position at completion.

Locked box accounts: essentially a fixed-price deal is agreed based on the company's historical accounts. In this case, the buyer assumes the risk of a fall in value and the reward of an increase in value between the date of the locked box accounts and the date of completion. This provides certainty of price for the seller(s).

Each of the items in the above – transaction process, warranties, indemnities, consideration and protections – take years to master. We have sought to provide a basic understanding for founders of the items to be considered before embarking on such a process and what the likely process will involve. A sales process can be challenging and it is important that parties have the right representation at the outset if they are to navigate the often difficult waters of a sales process and achieve a successful outcome.

Shepherd and Wedderburn's corporate team combines industry knowledge and extensive experience with technical expertise, and is on hand to assist businesses at all stages of their growth journey. The team's Start to Scale initiative, comprising written guides, video content and in-person events, addresses some of the specific challenges affecting start-ups and scale-ups throughout their lifecycle to give entrepreneurs the insight they need to scale.

Visit shepwedd.com/start-to-scale for more information, or contact [John Morrison](#), Partner in Shepherd and Wedderburn's corporate team, at john.morrison@shepwedd.com.

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