GETTING READY TO SELL A BUSINESS

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NOTICE

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INITIAL CONSIDERATIONS

Whether you have been in business for many years or just a short while, the decision to sell a business is one that can leave many people feeling overwhelmed. This booklet was written to highlight some of the larger aspects of planning for and putting a deal together to sell a business so that business owners walk into negotiations feeling prepared and ready for the transaction ahead.

Most business owners will have experience in selling large assets, usually a home, before they encounter a sale of their business. This experience, however, tends to create a misconception that selling a business should be as streamlined a process as selling a home.

Nothing could be further from the truth.

When selling a home, the owner is selling an entire asset, including the land, foundation, buildings, etc., for a single payment. In contrast, businesses are complex systems that are capable of being divided in numerous ways. For instance, if you were to envision your business as a house, you would need to expect that some buyers might be willing to purchase the entire parcel outright (house and land), while others might want to purchase only the house and relocate it, leaving the land and foundation with the seller.

Other purchasers might be willing to purchase the house and land but might want to have the heating system removed before closing if they deem the current system old and dangerous. As you can see, the ways that a buyer analyzes how it wants to divide up the purchase price in relation to purchasing different assets and liabilities of the business can create different transaction structures with varying levels of complexity. For this reason, business owners looking to sell a business should anticipate that the sale process is something that they will have to actively shape and negotiate.

Most advisors who work with business owners on selling their businesses – whether they be business brokers, lawyers, accountants, or personal wealth managers – will tell you that it is best to start preparing to sell your business at least 5 years before the actual sale. Why? The first reason is money. If you have an opportunity to look at the current value of your business before a sale becomes imminent, you can strategize with advisors on steps to take to increase the value of the business and get the best purchase price possible. The second reason has to do with preparedness. Preparedness has three main components: owner preparedness, management preparedness and legal preparedness.

Owner preparedness focuses on both the mental energy that the owner is willing to put forward in order to maximum the value of the business before sale as well as the owner's readiness to step back from the business once the sale occurs. Owner preparedness is a huge hurdle.

Management preparedness involves making sure that the best people are in the right positions for managing both the sale and transition of the business. Management preparedness can also include improving operating standards for the businessand abandoning "bad habits" – both of which shouldbe done well in advance of someone coming in to scrutinize how well and efficiently the business is run.

Finally, there is ***legal preparedness***. Legal preparedness focuses on whether existing documentation about the business conforms to good business practices. For example, are there personnel files for each employee with signed offer letters, performance reviews, confidentiality agreements, etc.? Have trademarks been properly registered and maintained? Does the business have an updated employee handbook? Are all shareholder loans properly evidenced with promissory notes? To the extent that you can demonstrate to a buyer that the business has taken its legal obligations seriously all along and is not simply creating a paper trail right before sale, you have the opportunity to create goodwill with a potential buyer that can help move the transaction along later. Legal preparedness will also aid in a smooth due diligence process (discussed later), which in turn can reduce negotiating time and costs of the transaction.

If you find yourself considering a sale of your business over a shorter period than 5 years, that's okay. If the business has been run efficiently and responsibly all along, the transition into the sale process can be done more quickly to meet the needs of the parties.

ASSEMBLING THE TEAM

For most business owners, the sale of a business only occurs once. Even serial entrepreneurs who may have started and sold several businesses have only a handful of experiences with selling a business and will not have the expertise to adequately analyze a potential sale from tax, legal, regulatory or accounting viewpoints, in addition to having an understanding of what is normal within his or her industry. For this reason, a team approach is best and as the business owner and leader of the team, you'll want to choose your team carefully.

Who should be a part of your team of advisors?

The makeup of the team will vary from business owner to business owner based upon each owner's own comfort level with handling different aspects of the sale process. Some roles and advisors that should be considered are discussed in this section.

Financial Planner

If you don't already have a solid understanding of how the sale of your business impacts your overall financial and retirement strategy, a conversation with a trusted financial planner is a good place to start. Knowing how much money from the sale needs to land in your pocket to fund the next chapter of your life will greatly inform which offers you decide to pursue and when. If the sale of the business will not improve your personal financial situation, then it is good to have a strategy for what comes next before the sale so that issues such as non-competition agreements can be carefully drafted to allow you to pursue new opportunities.

Valuation Expert

A business valuation is a set of processes and procedures that are used to estimate the current value of your business if it were to be sold. The valuation expert will look at a number of factors, both internal and external to the business, such as past sales of similar businesses within your industry, your company's financial statements, customer concentration, etc. A business valuation can cost several thousand dollars and can take several weeks to prepare, so if you have already been presented with an offer to buy your business, you may not have time for this. However, if you are still in the evaluation stage of selling your business, a business valuation can be a very useful tool in analyzing whether (A) the current value of the business supports your personal financial strategy and (B) there are steps that can be taken to try to increase the value of the business. For example, if the valuation report were to identify factors that negatively impacted the business value, such as customer concentration, aging receivables or bad debt, a business owner can employ new sales or operational strategies to improve those conditions before his or her intention to sell is made known to the public.

Accountant

Accountants are extremely important to the sale process. Not only will they be providing current and past financial statements for potential buyers to examine, but as stated above, they can have a role with helping the business owner understand both the value of his or her business and the tax consequences of the transaction. An offer to sell your business for $10 million may, at first blush, seem very attractive. However, the amount of money that is distributed to the owners of the business after payment of taxes on the basis of whether the transaction is structured as a stock sale or an asset sale can be significant. Having an accountant who can provide that analysis is incredibly valuable to owners.

Investment Bank or Business Broker

An investment banker is a firm or individual who acts as an agent for a company and assists the company in positioning itself for sale, assessing the value of the business and strategy for approaching potential buyers and negotiating the business terms of the sale transaction. Investment bankers tend to work with publicly-traded companies or medium-sized to larger privately-held businesses. Business brokers provide similar services but tend to represent smaller businesses in local business markets. This group of advisors commonly works on commission based compensation arrangements, although certain services may be charged on a flat fee basis. They can be very useful in assisting a business owner in understanding the current acquisition climate in a particular area of industry or a particular geographic region and will often work to present several potential buyers to a business owner.

Attorney

Business attorneys will help with not only making sure that the business' legal documents are complete and up-to-date prior to the sale but will also assist with responding to due diligence requests, negotiating a letter of intent and the transaction documents on your company's behalf, and closing the transaction.

Other professionals may need to be involved along the way to deal with special issues. For example, if your business offers a 401(K) retirement savings plan for employees, the third party administrator of the plan may need to coordinate the termination of your plan and the transfer of accounts to a plan operated by the buyer.

No matter which professionals comprise your team of advisors, remember that each professional is going to be looking at the potential transaction on your behalf but with a very specific viewpoint. Sometimes advice from one or more of your advisors may appear to conflict with the advice from other advisors.

For instance, your accountant may advise you to try to structure the transaction as a stock sale for the best tax outcome but your attorney may advise you that there are liabilities of the business that would be unattractive to most buyers and that an asset sale may be more easily accomplished. Your job will be to take their advice, weigh it and then communicate to everyone on the team what your preferred approach is.

Good advisors will respect your role as the ultimate decision-maker and will encourage you to solicit input from other members on the advisory team so that you can make well-informed decisions. Advisors who try to take on the role of leading the team or discourage you from seeking the input of other advisors on the team should be viewed cautiously.

VALUATIONS

One of the more difficult parts of entertaining a sale of your business is knowing what exactly the business is worth. Some business owners may have a highly inflated view of the value of their business but most are just simply unsure. Some business owners may evaluate the value of their business well in advance of a possible transaction as they work with their financial planners and advisors to maximize value (and therefore purchase price). Others may not evaluate it until they are presented with an offer from an interested buyer.

Regardless, the valuation process is a critical component to negotiating the purchase price of a business and business owners should be familiar with some valuation basics.

What Factors Are Considered in Valuing a Business?

There are many factors that go into valuing a business. They include the following:

Financial Performance. Without a doubt, past financial performance of a business is evaluated in determining a value for a business. Poor past performance can negatively impact value. A solid earnings history can positively impact value and can sometimes help to prop up value if a business is currently experiencing a drop in earnings that is reasonably expected to be temporary in nature. Solid past performance coupled with a reasonable basis for assuming that favorable earnings will continue into the future is optimal.

Revenue Growth. Revenue growth is what gives a business opportunities to expand. Of course, growth must be planned carefully so that it is balanced with the operational and financial needs of the business. Revenue growth that comes with excessive expense can negatively impact business value just as much as lack of growth from year to year. Past revenue growth and its sustainability into the future are therefore included in the valuation analysis.

Control and Management. In valuing a business, some consideration will be given towards the people who control and manage the business. An experienced management team that works well together can positively impact value. Situations where the business owner has sole control and management of a business can negatively impact value if a buyer or a business appraiser reasonably concludes that there are not enough mechanisms in place to keep the business in good operational order once the owner steps away from the business.

Competition within the Industry. Competition within your particular industry will be considered in relation to your business' market share, revenue growth and profitability.

Economic and Industry Conditions. General economic conditions and industry trends can also have positive or negative impact on business valuation to the extent that they relate to your business' long-term growth prospects and competitiveness.

As you no doubt are concluding, determining a valuation range for a business is more of an art than a science.

Valuation Methods

There are several valuation methods that can be used to value a business. There is no "one size fits all approach". Whether one value is used over another is typically driven by the circumstances of the sale (i.e., whether you are selling the business as a going concern or liquidating the assets), the overall health of the business and the type of industry you are in.

Asset-Based Valuation

This relatively simple approach focuses on the value of the business' assets if sold to a third party. The formula is basically:

Assets – Liabilities = Book Value

This number is also identified as "Owner's Equity" on your company's balance sheet. This method does not factor in goodwill of the business or other intangibles nor does it consider revenue growth. Therefore, it can have considerable limitations. For example, a startup business with operating losses could have negative book value but might still be worth a great deal of money based upon its intellectual property and market prospects.

Capitalization of Earnings Valuation

This method is based upon the historic annual earnings of the business. The starting point is for the business valuator to recast historical financials that show how the business would have looked without the owner's salary and perks over and above what a non-owner manager would be paid, non-operating or nonrecurring income/expenses, etc. The business valuator next determines earnings before interest and taxes (EBIT) of the recast financials and divides that number by a chosen capitalization rate. The "capitalization rate" represents the return a buyer requires on the investment in light of the market rate for other investments of comparable risk. For example, if the EBIT of a business is $250,000 and a buyer is looking for a return of 25%, the capitalization of earnings method would value the business at $1,000,000.

Future Earnings Valuation

If the buyer is a larger company and is looking to acquire a business for its future earnings potential, a future earnings valuation may be considered. This type of valuation requires a lot of projections and predictions about the future of a business and must be done carefully. The business valuator will look at the recast financials and create projected financials based upon these values for a period of 5 years or more. The projected financials may not assume any major changes as a result of the new owner. Once the free cash flow or earnings is determined for each future year, that figure is discounted back to the present to arrive at the net present value (NPV) of each year's free cash flow. These NPVs are added together to determine the total NPV of the company's future earnings.

Market-Based Valuation

Market-based valuations are primarily based upon the market price of similar businesses, of a similar size or location, selling at a particular point in time. The business broker will look up published standards for a particular industry and apply that multiple to your business' income. For example, if your business has gross annual revenue of $250,000 and the industry average for businesses of your size is 3.0x, the value of your business would be $750,000. Because this method is based upon industry averages, a business that leads its competitors and uses this method may actually set a price that is too low. However, for many small business owners who are looking for a reasonable approximation of value and do not wish to undertake the more complicated valuation methods, a market-based valuation approach may be suitable.

If you decide to engage a professional to assist you in determining a value for your business, make sure that the valuator has a clear understanding of the purpose for the valuation and takes the time to discuss the valuation method that is being used and why.

TRANSACTION TYPES

Along with understanding the value of your business, it is important to understand the types of sales that can occur when selling a business as each can have different tax and legal effects.

Stock Sale

In a stock sale, the buyer purchases all of the owners' stock or equity in the company and through this purchase acquires all of the assets and liabilities of a business. The purchase price goes directly from the buyer to the selling owners.

From a seller's perspective, a stock sale is typically preferred for two reasons. First, the transaction tends to be simpler because the starting point assumes that everything in the business (assets and liabilities) is being transferred. Second, if the owner has held an interest in the business for a long enough period of time, taxes on the purchase price will be assessed at the more favorable capital gains rate.

Conversely, buyers tend to disfavor stock sales because they assume all liabilities of the business created by the prior owners. Buyer also do not receive a "stepped-up cost basis" (discussed below) that can result in favorable tax breaks for the buyer.

A stock sale can be a good transaction type for companies that hold permits, licenses or other assets that are not easily transferrable to a new party. A buyer may also agree to a stock sale if it has a high degree of confidence that the company has been well-managed and that there is little risk of liability for actions taken by the prior owners. Stock sales are less desirable when there are potential claims against the business or its owners (e.g., taxes have not been paid or there are reports of employee misconduct) or when there are many owners of a business and the buyer does not want to engage in protracted negotiation of deal terms with multiple parties, especially if there is a chance that some owners will be difficult to negotiate with.

For businesses that operate as sole proprietorships, there is no stock or equity in the business and therefore no ability to structure the transactions as a stock sale. However, with enough advanced planning, a sole proprietorship can be converted into a limited liability company or another form of entity. If converted far enough in advance of the sale, the seller may be able to receive capital gains treatment on the sale proceeds.

Asset Sale

In an asset sale, a buyer will purchase all or substantially all of the assets of a business, such as equipment, furniture, computers, trademarks and other intellectual property, customer accounts, goodwill and the books and records that are required for operating the business from the legal entity owned by the seller. The seller, in this case, is the business and not the owners and the purchase price is paid into the business. The seller retains possession of the legal entity and most of its liabilities, including tax liabilities, lawsuits and loan obligations that arose prior to the closing date of the transaction.

This means that a seller may need to use some of the sales proceeds to pay any excluded liabilities of the business before dissolving the legal entity and ceasing business.

An asset sale allows the buyer to "step-up" the business' depreciable basis in its assets. By allocating a higher value for assets that depreciate quickly (like equipment) and by allocating lower values on assets that amortize slowly (like goodwill), this can reduce the buyer's taxes sooner and improve the business' cash flow during the vital first years following the sale. In addition, buyers prefer asset sales because they more easily avoid inheriting potential liabilities, such as product liability, contract disputes, product warranty issues, or employee lawsuits.

For sellers, asset sales generate higher taxes because while intangible assets, such as goodwill, are taxed at capital gains rates, physical assets can be subject to the higher ordinary income tax rates. In addition, if the entity that sold the assets is a C-corporation, the transaction faces double taxation. The corporation is first taxed upon selling the assets to the buyer. The stockholders are then taxed again when the proceeds transfer outside the corporation in the form of stockholder dividends.

Because a buyer is picking and choosing which assets it is buying and which liabilities (such as customer contracts or third party licenses) it wishes to assume, a lot of time may be spent on due diligence in order to confirm that the selected assets can be transferred with clear title. Likewise, since many contracts state that they cannot be assigned to a new party without consent, the parties will need to plan for obtaining the consent of those contracting parties prior to the closing.

Merger

A merger is the consolidation of two entities into a single entity, with the owners of the merging company receiving cash, stock of the surviving company, or some combination of both. The surviving company assumes all the assets, rights and liabilities of the merging company by operation of law.

Mergers are often structured as "triangular," where the buyer uses a newly- formed subsidiary that merges with the seller. By using the triangular merger structure, the buyer is able to contain the liabilities of the merging company from other assets of the buyer.

A merger is, in many way, like a stock sale in that all assets and liabilities of the business are transferred to the buyer. One key advantage of a merger is that it typically requires the consent of only a majority of the company's owners or stockholders. This makes merger a good choice when the merging company has numerous owners or stockholders.

Tax treatment of a merger will depend on its exact structure so input from tax professionals is especially important.

Shareholder / Management Buyout

For companies with two or more owners, there may be an agreement, commonly referred to as a buy-sell agreement, that determines whether a company must buyout a departing owner or whether a company has the right to buyout an owner when a certain event, such as the owner's death, occurs. The buy-sell agreement will cover not only when a triggering event has occurred that mandates the buyout of a departing owner but also how to value that owner's interest as well as the payment terms for the buyout.

Management buyouts (MBO) are similar in all major legal aspects to any stock sale by the owners.The particular nature of the MBO lies in the position of the buyers as managers of the company. In an MBO, the due diligence process is likely to be limited as the buyers already have full knowledge of the company available to them.

The sellers are also unlikely to give any but the most basic warranties to the management, on the basis that the management knows as much as or more about the company than the sellers do and therefore the sellers should not have to warrant the state of the company.

Employee Stock Ownership Plan (ESOP)

An employee stock ownership plan (ESOP) is a kind of employee benefit plan, similar in many ways to qualified retirement plans and governed by the same law (the Employee Retirement Income Security Act). The simplest way to use an ESOP to transfer ownership is to have the company make tax-deductible cash contributions to the ESOP trust, which the trust then uses to gradually purchase the owners' shares. Alternatively, the owners can have the ESOP borrow the funds needed to buy some or all of the owners' shares.

Shares are held in a trust for employees meeting minimum service requirements and allocated to employees based on relative pay or another formula, then distributed after the employee terminates. ESOPs cannot be used to share ownership just with select employees, nor can allocations be made on a discretionary basis.

Selling to an ESOP can have great tax advantages for the owners and for the business. However, because the ESOP is an employee benefit plan, a lot of formality is required for establishing the ESOP trust, determining the purchase price for the owners' shares and maintaining the ESOP throughout its existence. This expense needs to be weighed against the tax benefits and the practical benefits of allowing your employees, as a group, to own some or all of your business.

UNDERSTANDING THE TRANSACTION ROADMAP

The process for buying or selling a business generally follows the roadmap outlined below. A business owner should expect that this process may take only several weeks or sometimes up to a year to complete, depending on the size and complexity of the transaction.

Confidentiality / Non-Disclosure Agreement

Before you begin discussing a possible sale of your business with either an investment banker, business broker or an interested buyer, you want to have a non- disclosure agreement (NDA) in place. The purpose of the NDA is to ensure that any confidential or proprietary information about your business that is disclosed to a potential buyer will be kept in confidence by the potential buyer and will only be used for the purpose of evaluating and proceeding with a sale transaction.

An NDA can and should also restrict a potential buyer from making any public statements about the potential transaction to your customers, employees or other third parties so that these relationships are not impacted should the transaction not proceed.

With an NDA in place, the seller will start exchanging preliminary information with the buyer, such as financial statements, tax returns and high level customer or sales history.This initial information will help the parties assess the value of the business and any big issues that need to be addressed in the next stage of the process: preparing a letter of intent.

During this initial exchange of information, there is no binding commitment on either side to move forward with the sale. For the seller, in addition to providing basic information about the business, this is the time to do some high level evaluation of the buyer. If the buyer is not known to you already, you may want to make some inquiries as to their reputation in the industry both directly with the buyer and as well as with other sources within the industry.

Letter of Intent

The letter of intent (LOI) is a written agreement that outlines the preliminary understanding between the parties for purchasing the business. The LOI will commonly address:

- The structure of the transaction (i.e. whether a stock sale, asset sale or merger);
- The purchase price (or a methodology for determining the purchase price) and payment structure;
- The timeline for due diligence and closing of the transaction;
- Conditions or issues that need to be addressed before the closing occurs, such regulatory approvals, separation of certain assets from the business or resolution of existing audits, investigations or lawsuit;
- Non-competition covenants;
- Transition assistance;
- Payment of broker fees; and
- Indemnification obligations.

Most LOIs are written to be non-binding, meaning that should either party become dissatisfied with the process, or with additional information that sheds unfavorable light on the potential transaction, negotiations can be terminated and either side can walk away from the deal. Of course, there are some aspects of the LOI that the parties might want to be binding, such as any confidentiality obligations or any promises by the seller not to negotiate with other potential buyers while the LOI is in effect. In those instances, the LOI should include a provision that specifically identifies which obligations are binding on the parties.

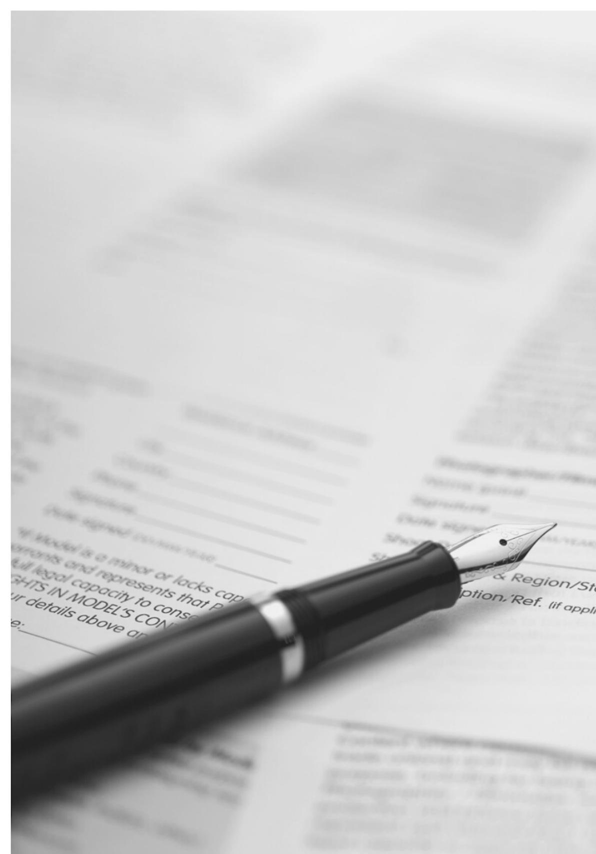
In some instances, the parties may, after exchanging a few emails about purchase price and some basic deal terms, skip the LOI step and move directly into due diligence and drafting of the definitive transaction documents.

Due Diligence

Due diligence is the in-depth investigation and analysis of a company done in preparation for a transaction. During this stage, a buyer will be reviewing significant customer and vendor contracts, carefully analyzing financial statements and examining just about every facet of the business. Expect to share all entity governance documents, agreements between owners, registered and unregistered intellectual property, salary history and benefits information for employees, equipment leases, real property leases, software licenses, insurance policies and claims history and anything else that may be relevant to understanding how the business is currently operating and has operated in the past.

Some due diligence may be done on-site, with the buyer's representatives coming to review inventory, equipment and the physical plant in person. Other due diligence items will be transmitted electronically. As the seller, expect that you'll also need to obtain materials from the company's accountants and lawyers in order to respond to certain due diligence requests. Most due diligence periods range from 30 to 90 days from the date when the LOI is signed but this period can be shortened or extended as the parties require.

Responding to due diligence requests can be quite time-consuming and many business owners find it to be both stressful and a distraction from time needed to actually run the business. This is especially true for owners who have been in business for a long time and have not been very good about maintaining neat and organized files of their key contracts and documents. For business owners who are thinking about selling their business but have not been approached by a buyer yet, consider reaching out to your lawyer and asking them for some assistance in evaluating the existing state of your business documentation so that you can get organized well before you get into the sale process.



Transaction Documents

The point at which transaction documents that make the sale effective get drafted and negotiated can vary depending on how the overall sale process is structured. In many cases, a buyer will want to complete the due diligence process or be well through the due diligence process before authorizing legal counsel to draft transaction documents. This approach allows the buyer to bring issues arising from due diligence (such as the need to obtain third party consents in order for contracts to be transferred) into the earliest drafts of the transaction document for subsequent negotiation.

If the sale process is structured as a bidding process, the seller may propose the form of agreement that it would find acceptable and ask bidders to submit their bids, along with any revisions to the form agreement, during the bid process, prior to the final selection of the buyer, and well before due diligence will begin.

In other situations, the due diligence process and the drafting/negotiation of transaction documents may happen concurrently. This is frequently the case when the parties are pursuing an expedited timeline for closing the transaction (for example, if the transaction needs to occur by a particular date, such as December 31st).

The exact form of the transaction documents and the quantity of documents will depend on the type and complexity of the transaction. In addition to the operative sale document (whether that be a stock purchase agreement, asset purchase agreement or plan and agreement of merger), there may be non-competition agreements, employment or transitional services agreements, third party consents, termination agreements and corporate governance documents to authorize the transaction, as well as exhibits and disclosure schedules.

The negotiation of the transaction documents tends to be the most stressful part of the process for business owners. They are trying to digest the contents of lengthy legal documents while also deciding, based upon the advice of their advisors, which deal points contained in the documents need negotiation and how to strategize the negotiation to obtain as many satisfactory resolutions of those deal points as possible. In addition, they need to maintain a productive tone throughout the negotiations so that conflicting viewpoints do not end up frustrating the parties and killing the deal or damaging their working relationship with the buyer to such a degree that transitioning to post-closing activities (such as employment with the buyer) becomes awkward.

Remember that the sale of a business is a highly negotiated transaction. Even if you are in an industry with a lot of other competitors, the way that you have run your business will be different from others in the market. Tolerance for risk is also different from seller to seller. Accordingly, there is no “one size fits all” document for selling a business and it is important to take the time to negotiate the transactions documents so that they truly represent the deal that was struck between the parties.

Closing

Following the closing of the transaction and any celebratory moments that follow, there will be some amount of post-closing activity. Final tax returns may need to be filed. State filings to dissolve the business entity may be required as well as filings with the U.S. Patent and Trademark Office to transfer intellectual property. Physical assets may need to be moved or IT systems may need to be integrated into the buyer's system. While some of these activities, such as the filing of tax returns, will need to adhere to deadlines, other activities may occur at a less frantic pace than the sale process. Regardless, good communication between the buyer and the seller remain key to completing post-closing activities and is why maintaining a productive negotiating tone during the sale process is so important.

COMMOM TRANSACTIONAL ISSUES

As discussed in previous sections, there is no "one size fits all" set of deal terms or documents that will fit every business sale. Therefore, this section is not an attempt to summarize all issues or points of negotiation that may come up in a transaction. Rather, this section highlights some common transactional hurdles that occur in transactions involving the sale of a business.

Payment of the Purchase Price

As the seller of a business, you will want to receive as close to the full purchase price in cash at the closing. However, that option may not be available to you based upon the financial wherewithal of the buyer and you will need to decide whether accepting payment over time (also known as "seller financing") is an acceptable alternative.

If you are willing to offer some amount of seller financing in order for the sale to move forward, you will want to consider the following terms:

- The length of payment period;
- The interest rate over the payment period;
- What type of security can be offered to secure payment in full if the buyer fails to make scheduled payments (e.g., a blanket lien on all of the buyer's assets, a lien on specific assets or collateral of the buyer, or a stock pledge)

- If the buyer is a business entity, whether to require a personal guaranty of payment from the buyer's owners; and
- Whether the payments owed to you are required to be subordinated to any debts owed to the buyer's financial institutions

Earnout

An earnout is a contractual obligation of the buyer to pay additional compensation to the seller based upon future financial performance of the business following the sale. Earnouts are commonly used when the seller has reasonable belief that the business' revenue will continue to grow over the time due to strategies put into place by the seller but the buyer is unwilling to pay for that anticipated increase in value upfront at the time of sale.

Before agreeing to an earnout, the seller will want some assurances from the buyer as to how it plans to continue the business following the closing. Changes in strategy following the sale could negatively impact future revenue and the seller will want to have some understanding of the buyer's plans, especially if the key principals of the seller will not be continuing with the business following the closing. If the seller believes that the key principals are an integral part to achieving the financial measures for future payments, then termination provisions in the principals' employment agreements with the buyer will want to be considered carefully so as to avoid a separation of the key principals from the business except under specific circumstances (such as gross negligence or intentional misconduct).

If an earnout concept is acceptable to the seller, the earnout formula that is used to determine the amount of the payments going to the seller will also need to be carefully considered. Both parties will want to make sure that they are using the same accounting assumptions in order to reduce the potential for disagreement. The seller may also want to negotiate to receive periodic sales reports and audit rights to verify the buyer's calculations of the earnout payments. Finally, the parties will want to consider a simplified dispute resolution procedure in the event of disagreement in the calculation of payments.

Escrow

In larger transactions, the buyer may seek to put a portion of the purchase price in escrow for a certain period of time following the closing, rather than paying the purchase price to the seller in full. By using an escrow, the buyer is assured that should there be claims against the business that the seller is responsible for, the buyer has access to funds that can be used to satisfy those claims. Once the escrow period has expired, any remaining funds in the escrow account are released to the seller.

The amount of the purchase price that is put into escrow, as well as the length of the escrow period and the process for notifying the seller of claims against the escrow funds, are all terms to be negotiated between the parties.

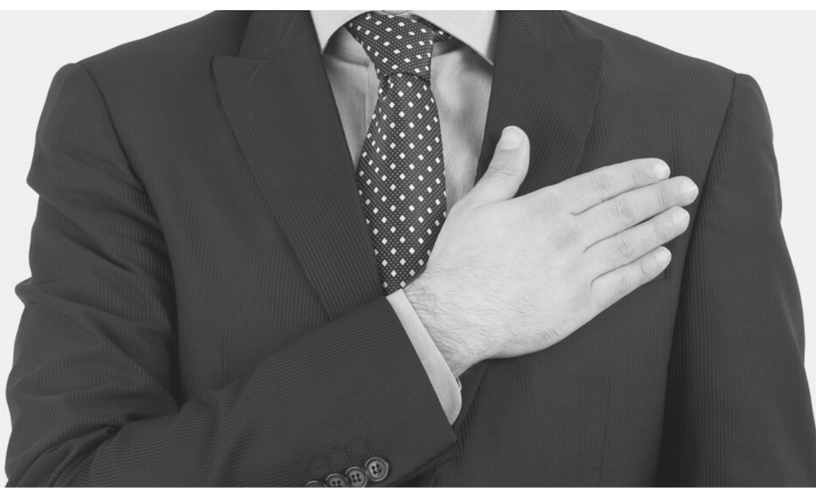
Representations, Warranties and Disclosure Schedules

It is common for a buyer to require that the seller make a number of representations and warranties about the business at the time of the closing. These representations will include both some basic statements (such as the seller has the authority to sell the business) as well as some detailed statements about how the seller has operated the business, including financial representations, representations as to outstanding or threatened litigation and representations about the business' assets and key contractual obligations.

If the purchase price for the business is relatively modest, the seller may be able to negotiate that the sale of the business occur on an "AS IS" basis whereby the seller will not be expected to make any representations about the assets or liabilities of the business.However, for transactions of moderate or significant size, representations and warranties about the business should be expected.

When reviewing this section of the purchase agreement, each representation and warranty should be read carefully and should be agreed to only if absolutely true. If a representation cannot be truthfully made, then the seller's attorney will need to propose alternate language that makes the statement true or may need to attach a disclosure schedule to provide additional information that explains any exceptions to the statement.

For example, a buyer may ask for a representation that all tax returns of the business have been timely filed and paid and that the business is not currently under audit. However, there may be legitimate business reasons why a seller cannot make that representation if, for instance, it is currently disputing an assessment made by a state or local taxing authority or if it is under audit for a previous tax year. In such case, a disclosure schedule will be added to the purchase agreement to explain what tax is currently under dispute, the amount of the liability and the status of the dispute, or which tax years are under audit.



The buyer may also ask the seller to include additional information pertaining to certain representations and warranties on disclosure schedules. For example, in connection with a representation by the seller that it has properly maintained the trademarks and other intellectual property of the business, the buyer may require that all registered trademarks, copyrights and patents be listed on a disclosure schedule that will be attached to the purchase agreement.

As you no doubt are coming to understand, review of representations and warranties contained in a purchase agreement should be done with great care. Failure to provide accurate and truthful information can result in a breach of the purchase agreement and is often an indemnification trigger that can result in the seller paying some of the purchase price back to the buyer.

Indemnification

An indemnification provision is a contractual obligation undertaken by one party (the indemnitor) to cover the losses of another party(the indemnitee) that were caused by the indemnitor. These losses can be either directly caused by the indemnitor, such as in the case of a breach of the purchase agreement, or from a third party that are attributable to the actions of the indemnitor, such as a customer making a purchase prior to the sale of the business claiming that a good was defective.

Unless negotiated by the seller when contemplating a letter of intent, most indemnification provisions in a purchase agreement will be quite broad. No limitation is set on the amounts that a seller might have to reimburse a buyer which means that the entire purchase price, and perhaps more, could be at risk. It is therefore not uncommon for the parties to negotiate "caps" and "baskets" relative to the seller's indemnification obligation.

A "cap" is the maximum amount of the indemnification obligation owed to the buyer. This can be expressed either as a flat dollar amount or as a percentage of the aggregate purchase price. In more sophisticated transactions, the parties may negotiate several "caps" depending on the types of risks that remain with the business or may negotiate that certain liabilities be exempt from the cap entirely. For instance, for a business that is being sold for $1 million, the parties may agree to cap the indemnification obligation at $200,000 for most third party claims and breaches of the representations and warranties. However, the cap may not apply to certain types of claims, such as environmental spills occurring prior the closing or claims of intellectual property infringement.

Once the closing occurs, the seller wants to have some peace of mind in knowing that it is not going to be troubled by numerous small indemnification claims that don't materially impact the buyer's ability to continuing operating the business. A "basket" is the minimum dollar amount in claims that a buyer needs to reach before exercising its indemnification rights against a seller. Think of it as a deductible.

Non-Competition Agreement

It is reasonable for a buyer that has paid a good amount of money to acquire a business to require that the former owners of the business agree not to compete with the ongoing business. Sellers should therefore expect that the transaction documents include covenants by all owners of a business not to compete or interfere with the employee and customer relationships of their former business.

Unlike employee non-competition agreement which must be limited in scope and time, non-competition agreements in sale transactions can be quite a bit broader. For instance, it is not uncommon for a non-competition covenant for a business sale to last for 5 years or more. For this reason, business owners will want to review non-competition covenants carefully during the negotiation process, especially if the business owner is not planning to retire and is entertaining other business opportunities.

For sellers that have agreed to receive payment over time, additional consideration should be given to termination of the non-competition agreement if the buyer fails to make regularly scheduled payments. After all, if the seller is using the sale proceeds to fund retirement or a different business opportunity and the buyer is depriving the seller of the monies to do so, then why should the buyer continue to enjoy the protections of the non-competition covenants?

Transition Assistance

The buyer of a business may want to have access to the former business owners following the sale of the business in order to answer questions about past business practices or to make introductions to key customers or vendors. These transitional services may either be included as part of the purchase price for the business or may be paid for over and above the purchase price, generally at an hourly rate for a minimum number of hours or weeks.

For the sellers, it is generally a good idea to try to be as clear as possible about the expectations for transitional services with a clear cutoff date so that they do not find themselves "working" for the business following the closing if that is not what the sellers wanted to do. This desire for clarity, however, should be balanced against the practical needs of a buyer needing access to the former owners from time to time in order to answer reasonable questions about the business.

POST-CLOSING OBLIGATIONS

While negotiating the transaction documents and preparing for closing, it is often the case that tasks will be identified that will need to be addressed following the closing. For example, if the transaction is structured as an asset sale, the entity selling the assets may need to change its legal name in order to allow the buyer to continue the business under the original name of the seller. In addition, third party consents that were not obtained prior to the closing but are still needed may need to be pursued. Final tax returns may also need to be filed. If collateral is being used to secure payments to the seller, UCC filings may need to be recorded. All of these examples of post-closing obligations should be undertaken as quickly as possible following the closing and can be done with the assistance of legal counsel and accountants.

Other post-closing issues, such as releasing announcements about the sale of the business, operational integration of business systems and introductions to customers will need to be addressed by the new and former business owners and management team on a timeline that makes the most sense from a business standpoint. How much time and attention will need to be given to post-closing integration matters will vary from transaction to transaction. If both sides have maintained a respectful and productive dialogue throughout the transaction process, post-closing integration matters tend to go more smoothly and the former business owners tend to walk away from their former business feeling satisfied. Highly contentious negotiations that leave the former business owners feeling distrust for the buyer tend to create obstacles for post-closing integration that can be difficult to overcome. Making good use of your advisors during the sale process can be a big help in making sure that the transaction process ends on the right note.

ABOUT US

Abridge Law is a boutique business law practice serving clients in Massachusetts and New Hampshire.

At Abridge Law we are committed to delivering outstanding services to our clients by breaking down the barriers of the traditional attorney-client relationship. Our firm structure and pricing model are highly optimized so that we can deliver top notch legal services to clients of all sizes and budgets.

Our Mission:

Our mission is to provide every mid-sized and small business with the legal support that it needs to operate with confidence and to reimagine legal service delivery in ways that delight our clients and better align our interests with theirs.

Our Values:

- We are solutions focused
- We are humble
- We are approachable
- We strive for excellence every single day
- We are professional and respectful
- We celebrate success
- We are innovative
- We have fun

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