Buying and Selling a Closely Held Business – Key Considerations

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Businesses are bought and sold every day. However, for many closely held business owners, the purchase or sale of a business can be a once in a lifetime transaction. Whether you have grown your business through acquisitions, or have never engaged in a business purchase or sale transaction, this article will set forth some of the more important legal considerations for both buyers and sellers.

While an attorney can advise a buyer or seller on these legal considerations, a party preparing to engage in a purchase or sale transaction may also wish to consult with one or more other professionals. For example, a certified public accountant or other valuation professional may be engaged to value the business being bought or sold; a broker may be engaged to assist in finding a buyer or seller for the business; a financial planner may be engaged to assist the seller in investing his or her newfound wealth; and a banker may be engaged to assist the buyer in obtaining financing for the purchase price.

Identify What is Being Bought or Sold

The first step in analyzing any purchase or sale transaction is to determine what exactly is being bought or sold. Closely held businesses are typically acquired through "asset acquisitions" or "stock acquisitions". In an asset acquisition, the buyer acquires specific assets and liabilities of the target business (the "target"), and in a stock acquisition, the buyer acquires the actual equity interests of the target (i.e., the buyer steps into the shoes of the seller as a shareholder of the target). Below are some key distinctions between the two techniques:

Asset Acquisition:

- Buyer can choose which assets and liabilities to acquire and which assets and liabilities to exclude.
- Upon closing on the transaction, the seller retains any assets and liabilities which the buyer chose to exclude.
- Buyer receives a "stepped-up" basis in the acquired assets for income tax purposes in an amount equal to the purchase price, and can fully depreciate the acquired assets over time.
- Seller must recognize ordinary income (generally taxed at higher tax rates than capital gain) on any assets which had previously been depreciated.

Stock Acquisition:

- Buyer acquires all assets and liabilities of the target.
- Upon closing on the transaction, seller does not retain any assets or liabilities of the target.
- Buyer receives a "cost" basis in the acquired stock in an amount equal to the purchase price.
- Buyer receives a "carry-over" basis in the target's assets. This means that the buyer cannot depreciate any of the target's assets if the seller had already fully depreciated them.
- Seller recognizes capital gain on the sale of the stock ("long term" capital gain if the stock was held for 12 months or more).

Buyers typically prefer asset acquisitions due to the favorable income tax treatment afforded to them and the fact that they can choose which assets and liabilities to purchase and exclude. However, sellers typically prefer stock acquisitions due to the favorable income tax treatment afforded to them and the fact that there are no unwanted assets or liabilities retained following closing.

Compensating the Seller

Once the parties determine whether assets or stock will be acquired, they must determine how the seller will be compensated. Generally, the seller will be compensated through one or more of the following: (a) the payment of cash at closing; (b) delivery of a promissory note payable over time; and (c) the right to receive payment in the future if

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certain events occur or if the target business achieves certain financial metrics following the closing.

Cash
Cash is the simplest form of consideration and is generally the preferred method of payment for the seller.

Seller Financing
If the buyer does not have sufficient funds (or cannot obtain sufficient commercial financing) to pay cash at closing, the seller may agree to finance some or all of the purchase price for the buyer. While many sellers are agreeable to seller-financing to accommodate a sale, caution is warranted. The worst result possible is that the buyer defaults on the loan and the seller is left without a business or payment. Below are some key considerations for the seller when agreeing to a seller-financing transaction:

- The loan should be secured by a <u>first lien</u> on collateral which has a value greater than the outstanding balance of the loan. This collateral can be in the form of real property, marketable securities, or the actual assets being sold. The collateral can come from the business itself or the buyer's personal assets (including an assignment of proceeds from life insurance insuring the buyer's life).
- The buyer should be required to maintain casualty insurance with respect to the collateral in an amount equal to, or greater than, replacement value.
- If the buyer is an entity, the individual owners of the buyer entity (and their spouses) should be required to guaranty the loan.
- If there is any individual critical to the operation of the target business, the buyer should be required to obtain life insurance for that individual in an amount sufficient to satisfy the balance of the promissory note in the event of the key individual's untimely death.

In a seller-financing transaction, the key for the seller is to anticipate what could happen post-closing which would impair the buyer's ability to repay the seller. While no method is foolproof, the seller can generally protect itself by ensuring that (i) the loan is sufficiently collateralized, (ii) the individual owners of the target business have "skin in the game" through personal guaranties, and (iii) the assets and key personnel of the target business are sufficiently insured.

Future Payments
If the parties are having trouble bridging a "valuation gap" with respect to the target business, the buyer may agree to make additional payments to the seller post-closing if certain events subsequently occur or if the target business subsequently hits certain financial metrics. This is known as an "earn-out."

As a very basic example, the seller may argue that the target is worth $12 million because the target's projected EBITDA (earnings before interest, taxes, depreciation and amortization) for the upcoming year is $2 million, and companies in the target's industry typically sell for six times EBITDA. However, the buyer may reject such a proposal because the target's historic EBITDA is only $1.5 million per year. In this instance, the buyer may agree to pay $9 million at closing ($1.5 million times 6), and an additional $3 million after one year if the target actually achieves its EBITDA target of $2 million that year.

Breach of Contract: Recourse to Buyer
Another key negotiating point in any purchase and sale transaction is defining the responsibility of the seller to indemnify (or "make whole") the buyer in the event that the seller delivers a "false bill of goods" to the buyer. For example, it is customary in any purchase and sale (whether an asset acquisition or a stock acquisition) for the seller to make various "representations and warranties" regarding the target business. Such representations and warranties change from transaction to transaction, but generally include statements that:

- The target business has good title to its assets, free and clear of any undisclosed liens.
- The target's financial statements which were previously provided to the buyer are true, correct and complete.
- The target business does not have any undisclosed tax, pension or environmental liabilities.
- The target business is not currently involved in any undisclosed litigation.
- The target business is not in breach of any contract being assumed by the buyer.

In the event that one or more of the seller's representations turn out to be false, it is important for the buyer to have recourse against the seller. For example, if the seller

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represented that its assets were free and clear of liens, and the buyer later learns that the assets are subject to a $10,000 lien, the buyer would want to have recourse against the seller to discharge the lien at the seller's sole cost and expense.

On the other hand, the seller generally wants to limit its post-closing responsibilities, and may rationalize that the buyer should purchase the assets or stock "as is" because the buyer had ample opportunity to perform due diligence. Below are typical negotiating points made by the buyer and seller in a purchase and sale transaction:

Buyer Negotiating Points:

- A portion of the purchase price payable by the buyer should be set aside with a third-party escrow agent for a period of time. If it turns out that the seller made any false representations, the buyer would make itself whole out of the escrow account proceeds. If no false representations were made, the seller would be entitled to the escrow account proceeds after a certain period of time.
- If the seller is an entity, the individual owners of the seller should personally guaranty the seller's indemnity obligations.
- If it turns out that the seller made any false representations, and if a portion of the purchase price was seller-financed, the buyer should be able to offset payments due under the seller note in order to make itself whole.

Seller Negotiating Points: In addition to rejecting all of the buyer's requests, the seller may negotiate:

- The seller's indemnification obligations should lapse after a specified time period (e.g., one year from closing).
- The seller's indemnification obligations should be limited to the dollar amount received in the transaction (this would prevent the seller from going "under water" in the transaction).
- In the event of a breach, the seller should not be liable to the buyer for any lost profits, consequential damages or other indirect damages.

Ultimately, representations, warranties and indemnification provisions are designed to allocate the risk of a breach of contract between the seller and the buyer. The parties should carefully consider the impact of these provisions.

Conclusion

The buying and selling of a business is a significant event for the parties involved and often is a once in a lifetime experience. While this article outlines important legal issues that arise in purchase and sale transactions, each transaction is truly unique. Therefore, buyers and sellers are wise to have a competent team of professionals advising them each time.

Sal is an attorney in the Mergers and Acquisitions Practice Group of McNees Wallace & Nurick LLC. He has assisted clients in negotiating and documenting a broad range of purchase and sale transactions on behalf of buyers and sellers, and has worked on transactions ranging from $200,000 to $200,000,000 in size.