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Items to Consider in Determining Whether to Sell Your Business in 2010 - Part 4 of 4

When a business owner has entered into a confidentiality agreement and a letter of intent ("LOI") and has provided a potential buyer with requested due diligence materials, it is time to document the sale of the business with the transaction documents, including a purchase agreement, a bill of sale, and many other items (often the transaction documents are negotiated on a parallel basis while the due diligence process is underway). This is the fourth client alert in a series of four generally describing (i) the tax changes that will occur on January 1, 2011 and in later tax years as a result of the recently enacted health care legislation, (ii) some of the steps a business owner should consider taking in order to prepare his or her business for sale, (iii) the sale process, and (iv) several key factors to consider in this process in an effort to maximize the after-tax benefits to the owners and to help ensure a smooth sales process.

The first alert focused on the upcoming tax rate changes that will occur in 2011 and the various tax issues that will drive some business owners to sell their businesses in 2010, as opposed to later years. The second alert focused on preparing your business for the sale process. The third alert focused on the situation where a business owner has found a potential buyer and is presented with a purchase offer and the issues that arise from that offer, including entering into a confidentiality agreement and the evaluation of an LOI. This final alert focuses on the sale process, basic transaction structures, and the core documents involved in consummating the sale of a business.

The sale of a business often takes one of three basic forms—a merger, "stock" purchase, or asset purchase. The structure of a transaction may result in very different tax effects on both the buyer and the seller (and these tax consequences may be different depending on whether your business is a C corporation, S corporation, partnership, limited liability company, or other form of entity). It is important to consult your tax and legal advisors early in the sale process to address these issues. Sellers will generally prefer a stock sale or merger over an asset sale for several reasons, including the ability to transfer the liabilities of a business and to potentially take advantage of the lower tax rates on capital gains that may result from a stock transaction, as opposed to an asset transaction. Furthermore, a stock transaction is sometimes administratively easier than an asset transaction in that many contracts of a business may contain prohibitions or restrictions on assignment to a buyer in an asset transaction. In a stock transaction, because the contracts stay with the business, permission to assign a contract usually is not required. On the other hand, permission may need to be obtained to transfer a contract in an asset transaction when that contract is "transferred" to the buyer. Additionally, in a stock transaction, it may not be necessary to apply for new licenses upon the sale of a business, while it is more likely to be necessary to obtain new licenses in an asset transaction. The operative documents in a stock transaction will be outlined in a stock purchase agreement and typically include disclosure schedules; these will detail specific issues affecting your business. By disclosing these items, you may be able to avoid liability to the buyer for problems that may occur in the business following the sale. Your advisors will explain these issues in greater detail. Additionally, employment agreements, non-competition agreements, and consulting agreements are common for a stock purchase transaction.

If both the buyer and seller are corporations, the parties may consider engaging in a tax-free reorganization if part of the purchase price is stock of the buyer. These types of transactions are governed strictly by statutes and regulations. Your legal and tax counsel can explain whether this is an option for your transaction and whether the net after-tax economic results are better for you.

Buyers will generally prefer an asset transaction for several reasons, including the potential stepped-up cost basis in the purchased assets, the ability to "cherry pick" the assets to be purchased, and the ability to avoid assuming all or some of the liabilities of the business being sold. The operative documents in an asset sale will be outlined in the asset purchase agreement, but usually include an asset purchase agreement, a bill of sale, disclosure schedules, and may include consulting and/or employment agreements for the selling owners of the business.

One of the most important issues for a seller to negotiate in a transaction, whether stock or asset sale, is the indemnification provision. An indemnity provision is an agreement where the seller agrees to protect (or "indemnify") the buyer from certain liabilities, events, or occurrences. Generally, a seller of a business is asked to indemnify a buyer for breaches of warranties or representations in the purchase agreement, certain pre-closing liabilities of the business, and other aspects of the business that may be unique to the transaction. As important as the language of the indemnity is the "cap" set forth in the indemnity provision (*i.e.*, the limit on the amount the seller could have to reimburse the buyer). This amount can range from a percentage of the purchase price to an unlimited amount. Without a "cap," one could sell his or her business and actually owe the buyer more than the purchase price if representations or warranties are breached (*i.e.*, you could end up paying someone to purchase your business!). Your legal counsel should help you negotiate this part of the transaction and the language in the ultimate purchase agreement, but many people elect to negotiate these terms up front in the LOI so no surprises arise later in the process.

This series of client alerts presents a broad overview of upcoming tax law changes and the process of selling a business. Each business is different and, as a result, the issues faced will be unique to that business. We have highlighted issues generally applicable to the sale of a business and areas of concern raised by potential sellers and buyers. Please call us with any questions.

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