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Small Business Legal Services

Buying and Selling a Small Business: Part 2 - Analyzing the Sale and Closing Provision of the Purchase Agreement

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We are continuing our review of Purchase Agreements in the sale of small businesses. By way of background, the relevant provisions of such agreements are:

1. Introduction
2. Sale and Closing
3. Representations and Warranties
4. Preclosing Covenants
5. Preclosing Conditions
6. Postclosing Covenants
7. Remedies and Indemnification
8. Miscellaneous

Part one of this series briefly summarized each section and looked at the relatively simple introductory clause to a purchase agreement. This installment will analyze what is generally the second part of a purchase agreement.

Part 2. Sale and Closing.

In brief, this section will establish the logistics for the closing and what the price and terms of payment will be. The structure of the sale (asset or stock purchase) will be determined as will the form of consideration (cash, promissory notes, stock, or a combination). The primary components of the Sale and Closing section are as follows:

a. Assets and Liabilities Subject to Sale

In an asset sale, the agreement will detail the assets to be sold to the buyer and those that will be retained by the seller. A common, yet not exhaustive, list of such assets will include:

- Real property;
- Personal property;
- Inventories;
- Accounts receivable;
- Contracts;
- Intellectual property;
- Insurance benefits;
- Seller claims against third parties;
- Cash and short-term investments;
- Shares of capital stock held in treasury; and

- Minute books and stock records.

Similarly, an asset purchase agreement will specify the liabilities buyer will assume and those the seller will retain. The following is a non-comprehensive list of liabilities that will be included or excluded in the sale to some degree:

- Accounts payable;
- Liability to customers under warranty agreements;
- Liability under contracts;
- Tax liabilities;
- Environmental, Health and Safety liabilities;
- Liabilities related to employment and employees;
- Shareholder liabilities;
- Liabilities related to indemnification of directors and officers; and
- Liabilities related to compliance with legal regulations.

Due to the nature of a stock purchase, a stock purchase agreement will not provide as much detail as an asset purchase agreement in this section, but will identify the number and price of shares that will be sold. This determination is generally straightforward, but can be complicated somewhat when stock options and warrants are involved. In these situations, the parties will need to determine whether such options will be assumed by the buyer and included as part of the transaction, which may require an increase in the price paid.

b. Consideration.

There are three typical ways a business buyer can pay the agreed-upon purchase price in an acquisition, with cash being the prevalent means of payment in a small business transaction. Cash is often desirable and works well because of its simplicity. However, payment in cash will need a well-funded buyer and will also result in an immediate taxable gain for the seller.

A promissory note from the seller to the buyer will often be used in conjunction with cash (ie, the buyer pays a down payment and the seller finances the remaining amount of the purchase price). A note may be advantageous for both parties, as it frees up cash for the buyer and enables a sale in instances where the buyer is unable to secure the full payment in cash. Further, the seller may receive some tax benefits if offering a note. If the purchaser is an entity such as an LLC, partnership or corporation, and the seller is providing financing, it is usually a good idea to have its principals personally guarantee the note.

A third means of payment arises when the buyer is a corporation and offers stock as either a full payment, or in conjunction with the other forms of consideration set forth above. Buying with stock, however, imposes numerous additional burdens on the sale, and introduces both tax and valuation issues into the transaction.

Regardless of the form the consideration takes, the purchase price will often be reliant on earnouts. An earnout provision makes some of the payment to the seller contingent upon the purchased company reaching certain financial goals in a specified time after the closing. Earnouts are a way to overcome a stalemate when the parties disagree on the company's valuation. Using earnouts, however, creates the very real danger of a future dispute regarding the contingent payment.

Another form of contingent payment arises when the parties agree on the value of the company, but there is a substantial period of time between signing the agreement and the closing date. In contrast to earnouts, this provision is not dependent on future business operation but rather protects the parties from a fluctuation in the value of the assets from the time the agreement is signed until the time of closing. While this amount can be substantial in sophisticated transactions between large companies, the difference in price with smaller business is often too insignificant to be worth the trouble.

Finally, the consideration section may utilize a cash (or stock) holdback provision. Used by buyers with strong bargaining power, such a clause enables a purchaser in a seller-financed transaction to divert note payments for seller's breach of Representations and Warranties.

c. Allocation of Purchase Price.

In an asset purchase agreement, the buyer and seller will need to allocate the purchase price. This important provision determines the parties' tax consequences from the sale by establishing the seller's gain/loss on each asset and the buyer's basis for each purchased asset. Misallocating prices can have adverse consequences on both parties and, because it affects the depreciation of assets for the buyer, can be felt for years after the transaction closes. There have been instances where a buyer has reported depreciation deductions on its tax returns based on asset appraisals that were different than what the seller reported. Where the amounts are substantial, this will raise the suspicion of the IRS, and courts have held that, regardless of the buyer's good faith appraisal estimate, the price allocated to assets in the purchase agreement control.

d. Closing.

This provision will set the date, time and location of closing and will establish the obligations of the parties as of closing. It will state what the seller shall deliver to buyer at closing, which may include:

- Bill of sale for personal property;
- Assignment of assets such as contracts, leases, and intellectual property;
- Deeds for property;
- Employment agreements for retained employees;
- Noncompetition agreements;
- Certifications of no material adverse change between the date of signing the agreement and closing; and
- Resolutions and consents of the seller's board of directors approving the transaction.

Buyer's obligations to deliver at closing include:

- Cash payment;
- Promissory note;
- Assignment and assumption agreement;
- Employment agreements;
- Noncompetition agreements;
- Certification of accuracy of buyer's representations and warranties in the purchase agreement; and
- Resolutions and consents of the buyer's board of directors approving the transaction.

Our next article will look at what is generally the most substantial section of a purchase agreement, the Representations and Warranties.

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