BusinessAdvisor

a resource for business owners

FROM THE LAW OFFICE OF MARY HANSON

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About the BusinessAdvisor

The Business Advisor is written and published by Mary Hanson, a business attorney in Torrance, California.

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She provides legal services related to owning, operating, buying, selling, and structuring businesses. Her clients are business owners in many different industries. She handles corporations, LLCs, new businesses, new ventures, and a broad range of contracts and business decision-making.

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STEPS FOR SELLING A BUSINESS

by Mary Hanson

A business owner planning to sell or hoping to sell his or her business needs to start planning well ahead of any potential sale. Failure to plan may result in higher taxes, greater liability, greater risk of non-payment, and delays in making a sale.

Here's my list of steps for a seller to take for a successful sale:

Get tax advice. The most important step for most sellers is getting tax advice. The tax consequences of a sale often shape the type of transaction that is acceptable. If a business seller spends two months negotiating the wrong type of sale and then gets tax advice that makes the negotiated transaction unacceptable, two months of negotiation have been wasted. The potential buyer may no longer be interested (or may no longer be on speaking terms with the seller).

Sale of assets vs. sale of stock. After finding out the tax consequences of different structures, the seller needs to plan the structure of the sale. If the business is incorporated the sale of a business can be accomplished as a sale of stock or as a sale of assets. For many businesses the sale of assets results in high taxes. The corporation pays tax on the capital gain between its tax basis on the assets and the sale price. And then the shareholders pay capital gains taxes on their gains when the funds are distributed to the shareholders.

Even sellers who are not affected by double taxation may face potentially burdensome tax consequences and need to make tax planning a key element in planning for a sale.

A buyer is most often advised to make a purchase of assets, not of corporate stock. From a buyer's standpoint the purchase of stock is a daunting proposition full of potential liability. All corporate liabilities, debts, obligations, and risks become the buyer's problem. No amount of due diligence and disclosure can reveal all possible sources of potential liability in an on-going business.

From a seller's standpoint, the sale of stock may be the only acceptable avenue because of the tax consequences. In addition to the tax benefit the sale of stock results in the transfer of many liabilities which significantly benefits the seller. Although the seller may still have liability from personal guarantees and other avenues of personal liability, a broad range of potential liability is transferred with the transfer of shares of stock.

In a sale of assets (rather than the sale of shares of stock), only the agreed upon assets are purchased by the buyer and only the liabilities assumed by the buyer become the buyer's. A seller can be left with liabilities that exceed the purchase price for the business.

Allocation of purchase price. When a business is sold as the sale of assets, the total purchase price must be allocated to the various assets transferred. The allocation is used to determine all taxes arising from the sale, including capital gains, sales

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taxes, and income tax. The purchase price must be attributed to, for example, fixtures, equipment, vehicles, inventory, customer contracts, trade names, and goodwill.

The tax consequences of the allocation result from the business's tax basis in the assets and the particular circumstances of the business and the individual owner or owners. The seller should obtain the advice of his or her tax accountant on this issue in the early stages of planning a sale.

Even if a purchase price has not yet been proposed, a good tax advisor should be able to provide valuable guidance regarding the tax consequences and tax challenges related to the allocation of the purchase price.

Determine a price range. Before entertaining offers, a seller needs an understanding of the possible price range for a sale of the business. Reading up on how businesses are valued would be more helpful than an appraisal. The seller needs to have an understanding of how potential buyers will be viewing the business. A set number without analysis and education doesn't help. No buyer is going to be persuaded by a seller's appraisal. The seller needs to be prepared to negotiate the price and terms of a sale.

Determine requirements and qualifications. A seller needs to determine the type of deal he or she is looking for. Does the business owner want a consulting agreement or a job with a buyer? Is the seller looking for certain employment benefits? Is the business owner looking for some type of opportunity or just an exit from the business? A seller needs to be pursuing (or at least recognizing) the right type of buyer to pursue his or her goals.

Identify potential buyers. Typically a business owner's best potential buyers are customers and competitors of the business. A seller should identify potential buyers already known within his or her industry. Parties with an existing knowledge of one another should have an advantage in understanding the objectives of an acquisition. The seller may benefit from existing knowledge of the buyer's reputation.

Determine acceptable terms. A seller should be prepared to initiate negotiations with any "must have" or "deal breaker" terms. Key terms regarding the sale of stock, payment terms, covenants not to compete, and services to be provided by the seller should not be left for future negotiation unless they are unimportant to the seller. The seller must have identified in advance his or her stance on issues of critical importance to him or her. If it's a key point, it needs to be part of the earliest negotiations.

A seller needs to anticipate the terms to be proposed by a buyer. A seller needs to be prepared to say "No" or "Yes, if …" in response to terms proposed by the buyer. Lack of preparation means the seller may unknowingly accept unacceptable terms.

A key term for some sellers may be a seller's contingency that the seller can back out of the deal if the sale is not concluded by a certain date. Some sellers have timing issues because of health issues, tax consequences, or other personal circumstances. A seller may want the right to back out and entertain other offers if a timing deadline is not or cannot be met. Even if timing isn't essential, most sellers need to, at some point, be free to sell the business to another buyer rather than being contractually bound to wait for one buyer.

Don't commit. A seller should not commit to a purchase price or any single term by itself. All terms need to be negotiated together to assure that the whole deal is acceptable.

For example, a purchase price should be adjusted (up or down) depending on the various negotiated terms of purchase. If a seller agrees to cover product warranties and other liabilities, the price should go up. If the buyer assumes certain liabilities, the price should go down. If the seller agrees to take payments of the purchase price over time the price should go up. In any event, the purchase price should not be set until all important terms are negotiated.

Avoid letters of intent. A seller should avoid signing a letter of intent (an agreement preliminary to a formal agreement) unless it meets a specific objective of the seller. A better approach may be to negotiate the full formal agreement as the first and final document. A letter of intent is often used by a buyer to lock a seller into negotiating only with that potential buyer, preventing the seller from considering better offers from other suitors (or other offers from better suitors).

Entertain offers simultaneously. The best sales are often accomplished when a seller has a number of interested suitors. A common mistake made by sellers is entertaining interested buyers sequentially one at a time. The best offers of price and terms are made when an interested buyer fears losing out to another suitor willing to offer more or better terms.

Plan disclosures. A seller needs to anticipate disclosing information to interested buyers. An experienced buyer will insist on reviewing a great deal of confidential information. A seller needs to have a plan to meet the challenge of providing enough financial and other information to interest a buyer without providing information that can harm the seller's business if the sale is not made.

While a nondisclosure agreement (a confidentiality agreement in which the potential buyer agrees to hold information about the business confidential and not to use such information) should be signed by every potential buyer, such agreements cannot be relied upon to protect the information disclosed. Usually too many employees and other agents of a buyer will have access to disclosed information. And in any event enforcement of nondisclosure agreements is difficult. Even proving a breach of the obligation of confidentiality can be an insurmountable challenge.

A seller needs to plan how to control the information disclosed and the manner of disclosure, with careful consideration of the importance of different types of information. Releasing general information early on and more detailed information later may serve the seller's interests. Withholding certain key information until close to the closing of the purchase transaction should also be considered.

Plan payment terms. A seller needs to know whether he or she will entertain any offers that don't provide for payment of the entire purchase price upon closing. If the seller is willing to accept a down payment and payments over time, the seller needs to decide the

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Publisher's Note

A seller may think that there is little he or she can do without a buyer and a buyer's proposal. It is true that the seller does not have control over a buyer's actions, but the lack of control over negotiations makes it more important for the seller to have a solid understanding of his or her goals and of the pitfalls for his or her business.

With planning, a seller can steer negotiations in favorable directions, avoid the worst problems, and accomplish important objectives. The seller can avoid costly mistakes and disruptive U-turns in negotiations.

In my experience a seller will rarely be able to accomplish a "re-do" if a major problem is discovered late in negotiations. More often a seller has to choose between seeing the potential sale fall apart or concluding the transaction with problems the seller would have preferred to avoid.

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circumstances under which that would be acceptable. Acceptable payment terms and collateral need to be anticipated and requirements for determining the credit-worthiness of the buyer need to be established.

Liabilities. If the sale is a sale of assets, the seller must review the liabilities that might remain with the seller after the sale. The seller should have some plan for dealing with liabilities, whether arising from employment, product liability, taxes, accidents, contracts, environmental issues, or any other business source. The terms of the purchase agreement can provide the seller with some limitation of liability, both by limiting liability to the buyer and by having liabilities assumed by the buyer.

The seller should anticipate negotiations toward the goal of having the buyer pick up obligations under agreements related to the on-going business, such as advertising agreements, equipment leases, facility leases, vendor contracts, customer contracts, warranties, etc.

Even if a buyer agrees to "assume" liabilities, such as a lease or other contracts, a seller is still liable to the other party to the original obligation, unless that party has specifically released the seller from the contract or from specific obligations. If the buyer fails to perform the "assumed" obligations, the seller can be sued by the other party to the contract.

A seller should consider resolving problematic contract matters prior to entering into negotiations with an interested buyer. BA