Business Advisor
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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ISSUES IN THE SALE OF AN INCORPORATED BUSINESS

by Mary Hanson

Most small businesses are sold as asset sales rather than as sales of stock. The main reason is that a purchaser wants to purchase only the assets desired and leave the seller with the liabilities of the business. In addition, a buyer typically benefits from a new schedule of depreciation based on the purchase price attributed to the assets.

In contrast, when a business is sold as a sale of stock, all assets and liabilities of the corporation are transferred with the stock. Payables, receivables, bank accounts, vendor accounts, debts, leases, work in process, vehicles, personal computers, cell phone contracts, memorabilia, obsolete inventory, hazardous waste, and all manner of corporate assets and liabilities are transferred to the buyer with the transfer of stock.

Despite the predominance of asset sales, stock sales are not uncommon. A buyer may wish to purchase stock in order to acquire a contract, permit, personnel, intellectual property, or something else owned by a corporation that is not amenable to transfer without the purchase of stock. A seller may insist on a sale of stock if the corporation is a C corporation and the tax consequences of an asset sale are unacceptable.

When a small business is sold as a sale of corporate stock, buyers, sellers, business brokers, escrow agents, attorneys, and other participants in the sale can get off track on a number of issues. Business brokers and escrow agents expect the stock sale to be more like an asset sale and sometimes expect sale terms appropriate only for an asset sale. Sellers tend to regard the corporate assets as their personal assets and make plans that involve corporate assets or bank accounts after the sale. Buyers may underestimate the nature, range, and level of liabilities that will become the responsibility of the buyers.

No matter how infrequent sales of stock may be, individuals involved in any way in the sale of a business through a transfer of stock need to be prepared to recognize the issues involved and avoid the common mistakes.

The concept of the sale of stock is quite simple and clear. However, missteps are taken and delays are incurred when the individuals involved do not accurately anticipate the details of the transfer of control of a corporation. Here are a number of points to help avoid errors in the transfer of ownership of a corporation:

- After a transfer of stock buyers have the right to control all corporate assets including bank accounts, payroll accounts, and vendor accounts. If individual sellers are personal guarantors on accounts, they continue to be exposed to liability after the transfer of stock. Individuals need to take action to obtain releases, close accounts, or modify accounts to eliminate personal liability on any account on which they have personal guaranties. Bank lines of credit, vendor accounts, merchant accounts (for credit card processing), credit cards, utilities, and leases often involve personal guaranties. The transfer of stock does nothing to automatically terminate personal liability.

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"...when a business is sold as a sale of stock, all assets and liabilities of the corporation are transferred with the stock."

- If any business assets – such as vehicles, utility accounts, leases, tools, and equipment – are held personally rather than by the corporation, the seller and the buyer need to agree on steps to take to transfer necessary assets into the business.
- After a purchase of stock buyers may close corporate bank accounts or continue to use the accounts with different individuals authorized to sign checks and make withdrawals. Corporate bank accounts are transferred with the transfer of stock. A selling shareholder has no right to a corporate bank account after transferring stock. If a selling shareholder does continue to have access to or signature authority on a corporate bank account, such access or authority can be cut off at any time by the buyer, who has legal control over a corporation's assets after the purchase of stock.
- After a transfer of stock a seller will no longer be able to pay payables, repay loans, reimburse expenses, or make any other payments or transfers from a corporate bank account. Checks written prior to a transfer of stock may bounce if the buyer closes the account or transfers funds from the account before checks clear.
- Buyers and sellers need to co-ordinate on all financial matters of the corporation. The potential of an overdrawn bank account and/or unauthorized payments are just a couple of problems that can occur from lack of communication and lack of anticipation by buyers and sellers of stock. A buyer or a seller can get either a windfall or a brutal surprise if cash type assets increase or decrease substantially from the time a purchase price is agreed upon to the time the corporate ownership has been transferred.
- When large businesses are sold as sales of stock the issue of cash and cash equivalents is handled by referring to a target working capital number using the balance sheet numbers before and after the transfer of stock. Small businesses often do not have reliable or meaningful up-to-date balance sheet information, and should avoid using working capital formulas based on balance sheet entries. Both buyers and sellers need to be aware of the potential problems related to cash and cash equivalents and should agree to terms that adequately address the relevant categories of assets. Deposits, gift certificates, work in process, inventory, accounts receivable, and accounts payable should be carefully calculated, discussed in detail, and agreed upon to avoid surprises after the transfer of stock.
- In stock sale agreements sellers often state that all cash will be removed from bank accounts prior to the transfer of stock. Sellers need to plan how cash will be used and also need to disclose to buyers whether the funds will be paid out as compensation or as a dividend to shareholders.
- A selling shareholder needs to consider what items he or she regards as personal items or otherwise wishes to remove from the corporation prior to the sale – and must include such disposition in the agreement for purchase and sale of stock. A buyer expects to take over all assets represented in the corporate financial statements and tax returns unless otherwise set out in the purchase and sale agreement. Individual sellers need to plan how to get assets regarded as personal assets (such as automobiles and cell phones) out of a corporation with the most appropriate tax treat-

ment. The disposition of even insignificant assets should be disclosed to the buyer. Collectibles, memorabilia, artwork, laptops, personal computers, and personal items used, displayed, or stored at a corporate location need to be addressed.

- If a vehicle – or other asset, including cash – is distributed to a shareholder as a dividend, the tax consequences to the shareholder are usually desirable. However, the tax consequences of the distribution can be an unpleasant surprise for the buyer of the corporation. Dividends are not deductible to the corporation and the corporation's taxable income is increased by the amount of such distributions taken by a selling shareholder. The buyer is likely to end up paying taxes on the seller's "dividends."
- Unless some tax steps are taken or some arrangement is made and accounting is done, either the buyer will pay the taxes for the entire year of sale (for a C corporation) or the income taxes will be prorated over the year (S corporation taxes are prorated among all the shareholders based on their percentage ownership and the number of days out of the year that they were shareholders). The buyer of a C corporation needs to address this issue with careful due diligence and with contract provisions that address the payment of taxes. With an S corporation, both buyers and sellers need to understand how they will be affected by taxable corporate activity throughout the year of sale.
- After the transfer of stock sellers will no longer have the ability to file a corporate tax return. Buyers will be responsible for filing the tax returns due after the sale. Selling shareholders will have no right or ability to amend a tax return, correct erroneous tax information, or make sure corporate returns are timely filed.
- After the transfer of stock the buyers will have control of past financial records, corporate records, bank records, payroll records, insurance records, employment records, client records, correspondence, etc. The buyer becomes the owner in control of the corporation that is entitled to all the corporate records. Sellers need to make their own copies of corporate records in order to be prepared for any type of claim, lawsuit, audit, warranty, or contract issue that might arise in the future related to seller's operation of the business.
- After the transfer of stock the buyers of corporate stock need to name new officers and directors of the corporation. The "old" officers and directors of the corporation will want to be certain their names have been removed from the list of officers and directors reported to the Secretary of State. The old owners will have no legal ability to report the changes after they have resigned as officers.
- State agencies (the Employment Development Department and Board of Equalization) look to a corporation's last filed Statement of Information to identify individuals personally liable for unpaid payroll taxes and unpaid sales tax. When new owners do not file a Statement of Information to report the changes in officers and directors, the sellers personally are exposed to liability for taxes the new owners fail to pay.
- Since there is no letter of resignation or other communication that sellers can submit to agencies to relieve the prior officers of liability, sellers should insist on filing the

"A selling shareholder has no right to a corporate bank account after transferring stock."

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Publisher's Note

There are many other mistaken notions that show up in sales of stock. One is that bulk transfer laws somehow apply to a sale of stock. They do not. The bulk transfer requirements of an escrow and payment of claims through escrow only apply to a sale of assets. A related issue is that state agencies will not issue tax clearances (which protect buyers of assets from liability for unpaid sales tax and unpaid payroll taxes) because, in the typical sale of stock, the business is not closed.

Another issue is the use of personal guaranties. Since buyers and sellers are typically individuals, a personal guaranty from an individual buyer or seller usually adds nothing to the transaction. Additionally a seller getting any kind of payment from the corporation as well as from the buyer needs to be certain that appropriate agreements correctly name the parties intended to be obligated to pay.

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updated corporate information – with the buyer's information and consent – to be assured that state agencies will not turn to the sellers rather than the buyers as the responsible individuals after the transfer of stock.

- Employees are not terminated or transferred to a different payroll when a business is sold as a sale of stock. The corporation is the employer, and nothing changes for the employee, other than the ownership of the corporation and any changes in officers and managers. Termination benefits and accrued vacation payments are not triggered by the transfer of corporate stock.
- Although contracts and obligations are typically assumed to be transferred with a purchase of stock, a "change of control" resulting from a transfer of stock can terminate a valuable right, either as a result of contract terms or the operation of law. Buyers and their advisors cannot assume that all contracts, permits, leases, exemptions, and other valuable rights will automatically continue after transfer of stock. Contracts, permits, and any other rights desired by a purchaser need to be reviewed to determine whether they are affected by a change of control.

The participants in the sale of a business as a sale of stock can avoid mistakes and missteps by clearly considering that buyers purchasing a corporation will own the corporation, and that the corporation's assets and liabilities will remain unchanged unless steps are taken to make changes at the corporate level. BA