BusinessAdvisor

a resource for business owners

FROM THE LAW OFFICE OF MARY HANSON

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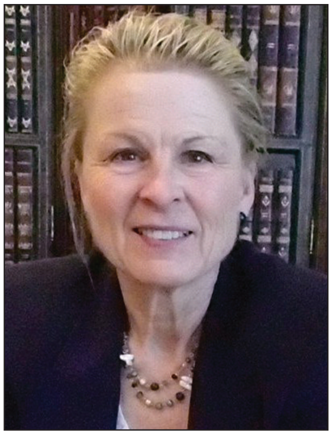

Mary Hanson

About the BusinessAdvisor

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

Mary Hanson has a law degree from the University of Wisconsin and an MBA from the University of Southern California. She has practiced business law exclusively for more than 30 years.

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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KEY STEPS FOR SELLING A BUSINESS

by Mary Hanson

A business owner planning to sell to sell his or her business needs to start planning months or years ahead of the desired sale. If the business needs a lot of work to make it more profitable or otherwise more attractive to buyers, more time is needed.

Even if the business does not need major improvements, advanced planning is necessary to achieve a successful sale. A seller's advanced planning typically improves the likelihood of a successful sale for a good price, on good terms, with lower taxes and less risk of non-payment.

Here are key steps for the successful sale of a business:

Identify key objectives. A seller needs to identify his or her goals in selling the business in order to define a successful sale and determine key terms for a sale.

Determine a sale price range. Before deciding whether to sell a business, the business owner needs to understand how interested buyers will value the business. Getting help from professionals who handle business sales and studying how businesses are valued are more helpful than getting an appraisal. A seller's appraisal is unlikely to persuade a buyer to pay a higher price, and a seller needs to be prepared to negotiate the price and terms based on perceptions of value.

Identify key terms. A seller's objectives may require that a sale include certain terms. If certain terms are absolute requirements, those terms need to be communicated at the earliest stages of discussions with potential buyers. For example, if a seller's reason for selling is to generate immediate funds for a different business, it doesn't make sense to engage in discussions of a potential sale based on payments over time.

Get tax advice. Prior to any discussions with interested buyers, a seller needs to know what the tax consequences of a sale will be. The tax consequences of a sale depend on the type of entity the business is, whether it has a high level of debt or highly appreciated assets, the tax basis of the assets held, whether there are substantial shareholder loans, and many other tax-related issues that require a tax specialist's review. If the only acceptable type of sale requires a certain structure, then the seller must make that structure one of the key terms to be discussed up front with interested buyers. For example, if the business is a C corporation with substantial built-in gains, the seller may need to insist on a stock sale.

Sale of assets vs. sale of stock. An incorporated business can be sold as a sale of stock or as a sale of assets. With a sale of stock, the individual shareholders sell their shares to the buyer and pay capital gains taxes on the gain based on their personal tax basis in the stock. In addition to the benefit of just one level of tax for the seller, the seller benefits from the transfer of all the liabilities as well as the assets. But sellers are best advised to anticipate buyers insisting on a purchase of assets.

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Buyers typically avoid the purchase of stock because of the many liabilities that a buyer takes on with the purchase of stock. All contracts, debts, obligations, and risks of audit or other problems of the corporation, whether based on future operation or past operation of the business, become the buyer's problems. No amount of due diligence and disclosure can reveal all possible sources of potential liability in an on-going business.

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 agreed upon liabilities assumed by the buyer become the buyer's.

If a seller must sell a business as a sale of stock because the taxes resulting from an asset sale are unacceptably high, the seller needs to make that requirement clear from the very beginning of discussions with buyers.

Identify potential buyers. Typically a business owner's best potential buyers are customers or competitors of the business and the business owner is in a good position to identify the best suited potential buyers in the industry. Having industry knowledge of each potential buyer's size, reputation, apparent financial success, staffing, product lines, and services offered can be valuable in identifying the most desirable potential purchasers of the business.

Check out potential buyers. Even when a seller knows a potential buyer well, a credit check should be obtained on any interested buyer before spending a meaningful amount of time negotiating with that buyer. Even when a buyer pays the entire purchase price up front, a seller can suffer if a sale is made to a buyer that experiences financial adversity and is unable to perform obligations assumed. Unless a seller obtains a release from the other party (such as a vendor, customer, lender, or landlord) to a contract, the seller remains liable if the buyer assuming the obligation fails to pay or perform the contract requirements.

When a sale will involve payments over time, it is essential that the buyer have creditworthiness, financial resources, and the ability to run the business profitably and avoid financial distress.

Don't make piecemeal commitments. A seller should not commit to a purchase price or any other important term by itself. All terms need to be negotiated together to assure that the whole deal is acceptable to the seller. A seller needs to avoid giving in to a buyer's demand for a low purchase price and then being pressured to accept terms that impose liabilities and expenses on the seller.

The purchase price should reflect the risks, benefits, and disadvantages each of the parties takes on in the negotiated terms of purchase. If a seller agrees to take payments of the purchase price over time the price should be higher. If a buyer agrees to take on certain risks of the business, the purchase price should be lower. The price needs to be negotiated to fit the agreement terms with regard to product warranties, customer retention, the condition of equipment, vehicles, materials, and inventory, assumption of obligations by the buyer, representations and warranties of the seller, and any other terms that change the allocation of risk between the parties.

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

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letter of intent is often too brief to be meaningful for a seller and only beneficial to the buyer. A letter of intent or memorandum of understanding 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). The better approach for a seller is usually to negotiate all terms and only sign an agreement that is complete and acceptable, with no important issues left for future negotiation.

Entertain offers simultaneously. A seller's best price and terms are obtained when a seller has a number of interested suitors. A common mistake made by sellers is entertaining interested buyers serially 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 a higher price 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 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 concluded.

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 many individuals, as employees or other agents of a buyer, will have access to disclosed information and a discloser of information won't even know if confidential information has been improperly used. And in any event enforcement of nondisclosure agreements is difficult. Even proving a breach of the obligation of confidentiality can be an insurmountable challenge.

Releasing general information early on and more detailed information later should be workable for most situations. For the seller's protection, disclosure of key confidential information should be delayed as long as possible.

Sellers will also need to disclose negative information about the business prior to completing a sale. Sellers need to anticipate that purchase agreements will contain representations and warranties by the sellers (often by both the selling entity and individual owners), with language holding sellers liable for failure to disclose relevant information, for inaccuracies in information disclosed, and misrepresentation of facts regarding the business. Sellers protect themselves from claims of misrepresentation, breach of warranty, or even fraud by documenting the disclosure of (and a buyer's receipt of) negative information.

Address retained 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 continuing liabilities, such as liabilities arising from product liability, taxes, lawsuits, employment, contracts, loans, environmental issues, or compliance with laws.

The seller should try to negotiate sale terms that include the buyer's assumption of obligations such as

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Publisher's Note

Before any discussions with potential buyers, a business owner planning to sell a business should start cleaning up problems and resolving matters that might be distracting, challenging, or unattractive in a sale situation. Since the business financial statements will be reviewed by interested buyers and their advisors, matters affecting the financial statements should be addressed early on. The business could benefit from correcting errors, improving the way financial results are reported, cleaning up inventory problems, and making changes that actually improve the business in ways reflected in the financial statements.

The potential seller should settle claims, close out contracts, fix equipment, update software, pay off debts, sell unneeded equipment, inventory, vehicles, and materials, make cosmetic improvements in offices, and clean up unattractive storage rooms, work spaces, and manufacturing floors. Licenses, filings, registrations, and permits should be checked and updated where appropriate.

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facility leases, customer contracts, vendor contracts, advertising agreements, equipment leases, and product warranties.

Since a seller remains liable for leases and other contracts assumed by a buyer, the seller can be sued by the other party if the buyer doesn't pay or perform. Sellers need to determine the best approach for all contracts and liabilities of the business, including the risk associated with a buyer's assumption of the seller's contracts and other obligations.

A seller should try to negotiate with landlords, vendors, and leasing companies to obtain releases from on-going contractual obligations. And a seller should review and consider all insurance coverage available to address insurable risks.

Plan payment terms. A seller needs to determine whether he or she will entertain any offers that don't provide for payment in full upon closing. If the seller is willing to accept payments over time, the seller needs to consider how much of a down payment should be required and what payment terms, collateral, and personal guaranties are needed.

Promissory note terms. A seller is best served by receiving a promissory note in payment, rather than payment terms as part of the purchase contract. The seller's attorney should draft the promissory note, including an interest rate that encourages payment, a payment schedule, a reasonable maturity date, late payment fees, payment of any attorney fees and costs of collection, a list of events of default, and the right of the seller to demand payment in full upon default by the buyer. BA