Business Advisor
a resource for business owners
FROM THE LAW OFFICE OF MARY HANSON

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About the BusinessAdvisor

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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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MISTAKES TO AVOID IN SELLING A BUSINESS

by Mary Hanson

Selling a business requires a great deal of advance planning. Many advisors recommend planning years in advance in order to have the time necessary to strengthen management, close unproductive locations or lines of business, clean up inventory, improve financial results, and meet financial standards that improve the saleability and purchase price of the business.

In addition to getting the business into shape for a sale, the business owner also needs to get prepared for the negotiations involved in a sale. A business owner must understand the issues involved in the transfer of the business to avoid mistakes in the steps taken, decisions made, and negotiations with buyers. If a seller is not prepared for the negotiation process, he or she will make mistakes that can result in a lower purchase price, higher taxes, additional payment obligations, increased liability to employees, customers, suppliers, or the buyer of the business, or increased risk that the buyer will fail to pay the entire purchase price.

Don't Make These Mistakes

Here is a list of "Don'ts" for the seller of a business:

- Don't be unprepared. Know the best structure for the sale of a particular business in advance of any discussions. Get the accountant's calculations of the tax consequences of an asset sale and a stock sale. Know the range of what the business might be worth and establish opinions on a minimum price. Identify the "must-have" issues and be prepared to inform buyers of the key requirements in the earliest stages of discussion.
- Don't be a passive participant in discussions with an interested buyer. If the buyer drives the discussions and all the terms proposed are the buyer's, then the final contract will be a pro-buyer agreement.
- Don't delay in rejecting unacceptable terms. The longer a seller allows a buyer to believe that proposed terms are acceptable, the harder it is to get the sales terms where the seller wants them. To a buyer it makes no difference whether the lack of communication of position is due to lack of understanding, lack of time, or an expectation that the terms could be changed. There is no good substitute for getting a business transaction on the right track from the beginning.
- Don't agree to SOME terms without having an agreement on ALL the important terms (and most of the minor terms). Don't agree to a purchase price without knowing whether the buyer will expect the seller to pay the sales tax resulting from the transaction, pay for termination of a lease, cover the cost of repairs of equipment, accept payments over 10 years without interest or collateral, or to accept a large portion of the payments as "earn outs" or contingent payments that may not be paid at all.

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- Don't negotiate one issue at a time. The only way to make reasonable trade-offs is by being able to address all the meaningful issues at the same time.
- Don't fail to disclose both important and unimportant information about the business. "Misrepresentation" is a leading basis for lawsuits and non-payment after the sale of a business.
- Don't fail to check out the reputation, credit-worthiness, and management capability of the buyer, even if the purchase price is to be paid in full at the closing. If a portion of the purchase price is to be paid by the buyer after the closing, a full review of the buyer's financial condition and ability to successfully operate the business is warranted.

The Seller's Homework

Prior to even the first discussions with an interested buyer, a seller needs to have done a lot of homework. The homework breaks down into two categories. One category is the reading and research needed to understand the basic issues that will arise in the sale of a business. The other category is the review of the business assets, contracts, financial condition, and tax circumstances of the business in order to determine what issues will present the greatest challenges and what courses of action or contract terms are necessary to assure the seller of a worthwhile sale.

Valuation. A seller needs to learn enough about business valuation to determine a price range for the particular business. The seller must find out how businesses are valued and have an understanding of how an interested buyer will calculate a purchase price.

A seller should find out what he or she will really receive from a sale after payment of obligations of the business. A seller's minimum price should anticipate all the expenses he or she will incur, such as legal fees and accounting fees related to the sale, purchases of insurance, payment of employment benefits, and taxes resulting from the sale, including capital gains taxes and also sales and use tax that become payable as a result of the transfer of assets.

Sale of Stock vs. Sale of Assets. If a business is incorporated the business can be sold as a sale of stock or as a sale of assets. A buyer most often seeks to make a purchase of assets, rather than of corporate stock, because of the liabilities in an entity that are transferred with a sale of stock. For many businesses the sale of assets results in high taxes as a result of taxes at both the shareholder and entity levels, so that the sale as proposed by the buyer may be unacceptable to the seller. If a seller must insist on a sale of stock because of the high tax impact, the seller must be prepared to establish this requirement in the earliest discussions with interested buyers.

If a sale is structured as a sale of assets the seller must be prepared for the consequences of such a sale. Since only the assets purchased by the buyer are transferred to the buyer, and typically the liabilities are left with the seller, the seller must determine the financial impact of existing payables, on-going contracts, and new obligations created in the process of selling. A seller can be left with liabilities that exceed the payment received for the business.

If a buyer agrees to assume certain liabilities, such as a lease, a seller needs to understand that he or she is still liable to the landlord or other party to the contract. An assignment of a contract is not a release, and if the

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buyer fails to fulfill the assumed obligations, the seller might still be sued for payment.

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 reported to the IRS on Form 8954. The allocation is the basis for calculating taxes resulting from the transfer of assets from the seller to the buyer, including capital gains taxes, sales taxes, and income tax resulting from depreciation recapture. 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 needs to obtain the advice of his or her tax accountant early in the sale process to anticipate tax consequences and be prepared to negotiate an allocation that is acceptable to the buyer.

Payment at Closing. A seller must know whether he or she will require payment of the entire purchase price at the closing. If a seller must take payments over time, he or she must determine the level or risk of non-payment he or she is willing to accept. The financial situation of the seller, the financial situation of potential buyers, and the number of potential interested buyers affects the seller's ability to require full payment at closing.

A seller takes a risk that the portion of the purchase price not paid at closing might not be paid if the buyer is unsuccessful in operating the business or the buyer has other financial problems.

Payment Terms. A seller has to determine how much of the purchase price he or she is willing to "carry," based on the buyer's credit and capability, the amount of the down payment, and the terms and security for payment of the entire obligation. As a minimum, a seller should get 50% of the purchase price at the closing, get a promissory note for the balance with payments over no more than 4 years. The promissory note should be secured by collateral that has some real value, such as a lien on real estate, vehicles, or equipment. The promissory note should include interest at a rate high enough to give the buyer an incentive to pay it off. Late payments should be subject to late payment fees, and the seller should be able to accelerate the obligation and sue for the whole amount in the event of serious default.

Guaranties. If the buyer is a corporation that is privately owned, the seller should require that the shareholders of the buyer corporation personally guarantee the promissory note.

Earn-outs. A seller should be very cautious with earn-outs proposed by a buyer. Rather than a firm, secured payment obligation, an earn-out is a payment (or payments) contingent upon some level of success of the seller's business after the closing. Since an earn-out depends upon operation of the business which is no longer under the control of the seller and accounting done by the buyer, there is a meaningful risk that the seller will not be entitled to the contingent payments. The amount of any earn-outs should be considered extra compensation on top of a fair purchase price, and limited to a small percentage of the purchase price of the business.

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Publisher's Note

Only the owner or owners of a business can make the final decisions on the issues involved in selling a business. While advisors can make recommendations on purchase price, risk of non-payment, and other issues, such as the payment terms discussed in the article, only the business owner knows his or her level of comfort with risk, need for money, and need to sell the business well enough to make the final commitments.

An advisor can recommend turning down an "unacceptable" offer, but a seller has to be prepared to make the decision to walk away. A seller should be informed enough and tough enough to be able to "Just say 'No,'" but only the seller can know when and if that point has been reached.

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Attorney/Publisher

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Seller's Representations and Warranties. A seller needs to expect that he or she will be required to provide representations and warranties that the books and records shown to the buyer are accurate, that the equipment is in working condition, that the assets will be transferred free and clear of liens, and that there are no unpaid taxes, lawsuits, employment claims, or potential claims against the business.

Indemnification. The typical agreement provides that the seller will reimburse the buyer for any claims or liabilities that arise from the operation of the business by the seller prior to the sale, and any loss that the buyer incurs if the representations and warranties are incorrect. A buyer can seek payment from a seller related to errors on financial statements, equipment failures, undisclosed liens, errors in inventory, and any other circumstances that are contrary to the representations made.

Liabilities. The seller must review all the existing payables, on-going contracts, new obligations, and potential claims for which he or she will still be liable after the sale. The seller needs a plan for dealing with such liabilities, whether they might arise from employment, product liability, taxes, contracts, loans, lines of credit, leases, environmental issues, or any other source. A seller has to anticipate that for a number of years after the sale of a business, he or she may face claims, demands, lawsuits, or tax audits related to the business prior to the sale. He or she needs to plan to maintain appropriate insurance for insurable risks and to have funds adequate to cover potential claims. BA