Selling a business: Some issues may be more important than price

SELLING A BUSINESS

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Private business owners typically face a difficult decision when they want to "retire" from their business: Do they pass the business on to their sons and daughters, do they turn it over to the employees or do they sell it to a financial or strategic buyer?

A seller should take several considerations into account before deciding whether to effect an outright sale of a private business in an arm's-length, negotiated transaction with a financial or strategic buyer.

PURCHASE PRICE

The purchase price may not be the most important factor in the sale of a business.

Many business owners determine what they want for their business and when that price is met, they feel like the deal has been completed. In many instances, they are not aware of the intricate provisions contained in a standard stock purchase or asset purchase agreement. The fundamental question: Who will assume the risk of unknown liabilities?

The purchase price in the agreement isn't always the amount the seller gets to keep. The seller wants to simply say that it has given good title to its assets (or its stock in the event of a stock sale) to a buyer and that everything else is *caveat-emptor* (buyer beware).

From the seller's standpoint, the buyer can conduct all of the due diligence it wants, but the seller will not guarantee anything with respect to the business. In contrast, the buyer typically wants the seller to guarantee everything about the operation of the business prior to the closing and limit exposure to any risk from the activities conducted by the previous owner.

This allocation of risks is in the form of various representations and warranties. Usually 25 percent to 35 percent of the customary private business acquisitions involve post-closing indemnification claims brought by a buyer against a seller for breach of representations and warranties.

An indemnification claim, if successful, allows the buyer to reclaim part of the purchase price already paid to the seller at closing and offset against purchase price consideration that is still due and owing in the form of a future promise to pay, such as a promissory note or an earn-out.

If the seller was counting on the negotiated selling price to fund his retirement, indemnity claims based on poorly structured representations and warranties can seriously affect their standard of living by reducing the funds available.

REPRESENTATIONS AND WARRANTIES

The typical representations and warranties that a purchaser seeks in a standard purchase document cover such things as the legal existence, good standing, authority of the seller; whether there are unpaid taxes (including taxes withheld from employees that haven't been paid to the government); the existence and amount of liens, environmental issues, litigation, debts, and other liabilities; the condition and amount of real estate, inventory, machinery, receivables and other assets; the nature of employee benefits, contracts, warranties, permits and licenses, banking relations, powers of attorney; and the absence of undisclosed liabilities.

Perhaps the most potentially devastating representation and warranty that a seller is requested to give is to guarantee that there are no undisclosed liabilities pertaining to the business being bought, other than as disclosed in the financial statements and on a schedule.

If the seller agrees to make this representation and warranty, it is in essence guaranteeing (unless it is limited to seller's knowledge) that there is no liability in the business other than as disclosed prior to the closing date. Thus, if after closing any claim arises out of circumstances that existed prior to the closing, the buyer will have the right to seek indemnification and, in essence, effectively reduce the purchase price paid to the seller.

When considering whether to give certain representations to a buyer, the seller should be sure the buyer understands the meaning of each representation and that the seller has conducted thorough due diligence on the company so that there is adequate knowledge of the amount of risk, if any, associated with giving such a representation.

Further, whenever possible, a representation should contain a "knowledge" qualifier so that that the seller doesn't have to give back part of the purchase price for things he or she truly did not know. Third, the representations should contain a "materiality" qualifier so that a seller isn't required to pay the purchaser for unimportant defects in the representations.

TAKING IT TO THE BANK

Another important aspect in evaluating

SEE SELLING, PAGE 8

SELLING

FROM PAGE 7

a purchase price offer is whether the buyer pays the entire price in cash at the closing or whether the buyer pays a portion of cash at the closing and then pays the balance by either funding an escrow account (that may be offset against), delivering a promissory note (that may be offset against) or issuing stock (which is more likely to happen with a public company).

Buyers will typically attempt to collateralize their potential indemnification claims through an escrow and/or a note. In determining the amount and form of consideration to be received for one's business, a seller should not only look at the amount of the purchase price, but how much of the purchase price is no longer at risk and/or can be put in the seller's pocket at the closing.

This isn't an issue which is easily cured by the payment of interest on the amount held back. This is an issue about how much control the seller wants to retain over whether he gets to hold the stakes when a dispute breaks out.

The survival period of the representations and warranties made by a seller also impacts the purchase price calculation. The standard statute of limitations on a breach of contract claim is four years.

Customarily, a buyer will be willing to lower the survival period for representation and warranty claims to two to three years post-closing (in most instances, except perhaps title, taxes and environmental matters) and sellers typically can negotiate the duration of the survival period down to one to two years post-closing.

Additionally, in structuring or analyzing a business sale, the seller must factor in what type of indemnification basket and cap are being proposed. Buyers do not like caps (the maximum amount that may be recovered under all indemnity claims) because they can, theoretically, be exposed to liabilities that are in excess of the purchase price or the value of any assets acquired.

Sellers want to limit the maximum amount that they will be required to pay to remove uncertainty from the transaction and should always insist on a cap. After all, they are getting out of the business and will have no ability to recover losses.

Baskets (the aggregate dollar amount of claims that must be exceeded before the buyer may bring an indemnification claim) are used to avoid nuisance claims and bring finality to the transaction. The seller will want to negotiate a large amount, and, naturally, the buyer will want to negotiate a lower amount. The basket can be in the form of a deductible or a threshold.

For example, in a $10 million acquisition, a $100,000 deductible means that if the buyer has $200,000 in indemnification claims, it can only recover $100,000 (the amount in excess of the deductible). If there is a $100,000 threshold, and the buyer has a $200,000 indemnification claim, it can recover the entire $200,000 since it exceeded the $100,000 threshold.

EXPERTS CAN HELP

The issues mentioned are merely the tip of the iceberg with respect to the various types of factors a business owner should take into consideration when selling his business.

Although the price being offered is extremely important, perhaps just as important is what strings are attached to the price.

Clearly, everything else being the same unless tax considerations dictate otherwise, a seller would rather sell stock since the buyer will be taking over the entire company, including all known and unknown liabilities, whereas the buyer would rather buy assets and only assume certain specified liabilities leaving all other liabilities, whether known or unknown, with the seller. ■

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