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ABC'S OF SELLING OR BUYING A PRIVATELY OWNED BUSINESS:
An Outline for Every Seller and Buyer

PART I: PRE-CONTRACT CONSIDERATIONS

This is the first of three Newsletters that address the process of buying or selling a privately held business:

I. Pre-Contract Considerations
II. The Contract of Sale
III. The Closing and Post-Closing Considerations

I. Pre-Contract Considerations

In this Newsletter we divide the pre-contract phase into the following topics:

1. Brokerage
2. Valuation
3. Non-Disclosure Agreement
4. Letter of Intent
5. Purchase Money Financing
6. Stock Sale vs. Asset Sale
7. Real Estate Considerations
8. Due Diligence
9. Contract and Closing (Separate or Simultaneous)

1. Brokerage A business broker[1] is an individual or company that assists buyers in locating sellers and vice-versa in exchange for a fee. The fee, which is usually stated as a percentage of the "transaction value" (i.e. the total purchase price) is usually paid by the seller, although this may vary in some circumstances. A broker can be an effective means for a potential buyer to identify a business that may be for sale or for a seller to identify a business to

[1] A business broker is sometimes referred to as a finder; and, at least in certain spheres, it may be called an investment banker.

purchase. Since a business brokerage agreement must be written and signed to be enforceable[2] the broker will require its client to sign an agreement before making any introductions. This agreement may be a few simple lines or several pages of legalese; in either case the agreement can have serious financial ramifications, so it should be reviewed by counsel before signing[3].

2. Valuation A seller should have some idea of the value of the business before putting it on the market. The typical first source for such information is the company's accountant. Experienced accountants are often knowledgeable about pricing formulas in particular industries, which are often expressed in multiples of annual EBITDA.[4] For example, a valuator may state a formula for companies in a particular industry as something like "___ times weighted average EBITDA for the last ___ years." Be careful about slavishly following such formulas, since they are only guidelines. An experienced business broker can likewise be a useful valuation source.

Another source would be a professional business appraiser. While a professional appraisal can cost $15,000 or more, it can be worth the cost to the seller since: (A) it can help avoid selling for too little or creating unreal expectations on the high side and (B) it carries the imprimatur of an independent professional, particularly when the appraiser is credentialed by an organization like the American Society of Appraisers.

If the purchase will be bank financed, the bank may require that its own appraisers conduct a valuation of the target business[5]. Remember, however, that the bank has a different interest in the process. The bank only cares if the target (combined with any other pledged assets such as the buyer's existing business) constitutes sufficient collateral to secure the proposed loan. The bank has little interest, if any, in whether the seller receives a fair purchase price.

3. Non-Disclosure Agreements These are also referred to as "NDAs" or Confidentiality Agreements. NDAs are the primary vehicle for a seller to: (A) prohibit a buyer…especially a buyer that is in the same business… from utilizing the seller's confidential information[6] for buyers own purposes or (B) prohibit the buyer or others on the buyers "team" from disclosing the confidential information to third parties. Several years ago, a client of our office was approached by its largest customer for a possible acquisition. Without obtaining an NDA, the seller allowed its customer free rein to explore the seller's business operations. The customer then withdrew its offer, formed its own competing operation and stopped doing business with the seller…which soon went bankrupt. The lesson for sellers is to refrain from disclosing any confidential information until obtaining the prospective buyer's signature on a properly drafted NDA.

4. Letter of Intent or Transaction Memo A Letter of Intent (often referred to as an "LOI") serves one main function. That is to help confirm that the buyer and seller are "on the same page" as to the key business terms of the proposed transaction. Hopefully this takes place before anyone incurs the cost of preparing and/or reviewing formal agreements. It is surprising

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[2] At least in New York; see NY General Obligations Law Sec. 5-701-10

[3] One point of concern for sellers is that the agreement will typically obligate the seller to pay the entire fee at the closing, even if the purchase price is payable over time…and might never be paid at all.

[4] EBITDA stands for Earnings Before Interest, Tax, Depreciation and Amortization

[5] The term "target" means the company whose stock or assets are for sale.

[6] E.g. customer and vendor information, financial information, formulas and processes, etc.

how often a seller will incur the cost of preparing formal documents only to learn that the buyer understood the terms far differently…and there was no deal. Also, a Letter of Intent can include other terms, such as: seller's agreement to take the property off the market while the negotiations proceed; the parties' agreement to not disclose the pendency of negotiations; and other useful pre-contract obligations. Finally, for bank financed transaction, a bank will often refrain from commencing the underwriting process until an LOI is signed.

Sometimes the parties wish to outline the material terms of a proposed deal, without the formality of a signed LOI. This may be referred to as a "Transaction Memo" or some similar name. Although such outline lacks signatures it serves the same basic purpose as an LOI, which is to avoid the waste of time and money when the parties have not actually agreed to the basic terms.

5. Purchase Money Financing Many buyers simply cannot afford to pay the purchase price in a lump sum, or wish to avoid depleting their assets. Such buyers may seek bank financing for some part of the purchase price. First time buyers and sellers are often not aware of an alternate possibility, which is known as "seller financing." In that case, the buyer pays part of the purchase price at closing and the rest over time pursuant to a promissory note. The benefits can include: lower interest rate; eliminate bank fees; seller can earn a higher rate than by investing the purchase price; in a "down economy" banks may be reluctant to make small business loans; and it is almost always easier for the buyer to deal with the seller than with a bank, particularly if the seller is anxious to sell. The down side for the seller is the risk of collection, although that can be reduced through security devices like personal guaranties, escrowed stock, liens on real and personal property and the like.

6. Stock Sale vs. Asset Sale The distinction is simple:

Stock sale: Buyer purchases the seller's company.

Asset sale: Buyer purchases some or all of the property owned by the seller's company.

Buyers almost always prefer an asset sale for several reasons. First, when you buy the whole company it may come with unknown liabilities and problems; whereas, when you buy assets, you just buy the designated assets and do not acquire liabilities other than those that are clearly designated for assumption.[7] Also, an asset sale allows a buyer to "cherry pick" by buying certain assets and not others. For example, in many cases a buyer that is in a competitive business may only want the customer list and intellectual property, but has no need for assets it already has, such as machinery, inventory, real estate, etc. Finally, an asset purchase may provide tax benefits to the buyer, such as allowing the buyer to: (A) depreciate certain acquired assets that would not be depreciable after a stock sale and/or (B) carry certain acquired intangible assets on the buyer's balance sheet.

[7] Like most legal issues, this is not black and white…a careless asset buyer may unintentionally assume some or all of the selling company's obligations. That topic is beyond the scope of this Newsletter, but should be explored by every buyer.

There are a few situations where a buyer might prefer a stock sale, such as where the seller's company has a valuable and non-transferrable connection to an important customer, like a hard to get vendor ID number. Also, tax considerations, especially in transactions involving non-US entities, may mitigate in favor of a stock sale.

7. Real Estate Considerations Although, the target company (or its owners) may own the real property on which the business is conducted, there is also a good chance that the target leases that property. A buyer may wish to continue to operate the target company in the same place; or the buyer may wish to move it to its existing place of business or to some other place. For the many situations where the target is a tenant[8] (rather than the owner) and the buyer wishes to keep the business at the same place, certain issues must be addressed. The tenant seller may occupy its premises under a written lease or as a "month-to-month" tenant.[9] Although a lease might appear to give the seller the right to sub-let or assign the lease to the buyer, in many cases it would be advisable for the buyer to negotiate a new lease or at least to obtain the Landlord's written consent to the sublet or assignment before proceeding to closing. Also, unless the lease has a sufficient number of years remaining before expiration, the buyer will want to negotiate an extension before closing the acquisition.

8. Due Diligence

A. Due Diligence Subjects "Due Diligence" is the term used to describe the process by which a buyer and the buyer's representatives investigate some or all facets of the seller's business to try to determine more precisely the important details of the seller's business. The areas of investigation often include:

- Finances
- Taxes
- Operations
- Furnishings, Fixtures and Equipment
- Contracts
- Suppliers
- Vendors
- Inventory
- Legal Compliance
- Litigation and Claims
- Liens and Judgments
- Real Estate
- Environmental
- Intellectual Property
- Websites and Domain Names

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[8] If the purchaser intends to buy the real estate, the procedures for such a purchase are outside the scope of this Newsletter.

[9] "Month-to-month tenancy" is the term generally used to describe the situation where a lease has expired, and the tenant continues to occupy the space on a "month-to-month" basis.

Responsibility for the various topics is generally divided among the buyer's "team" which may include the buyer's owners and senior management, as well as buyer's accountant, lawyer and other specialists. For example, inventory, finances and taxes may be investigated by the accountant; legal compliance, litigation, claims, liens and judgments may be investigated by the attorney (with support from a "lien search company"); environmental, intellectual property and/or internet specialists may be brought in if there are specific and/or substantial concerns in those areas; and any and all subjects may be investigated by the buyer's ownership and senior management.

B. Due Diligence; Timing Due diligence can take place at any time from the onset of negotiations (at least after an NDA is signed) through the closing date. In cases where there will be a simultaneous contract and closing, the due diligence must generally be concluded before the contract and closing take place. In cases involving a separate contract and closing, some or all due diligence may be delayed until after the contract is signed. In those cases the contract will generally provide that the buyer may terminate the transaction if the results of the due diligence do not satisfy certain criteria, or simply if the buyer unilaterally elects to not proceed.

9. Contract and Closing (Separate or Simultaneous) The transfer of ownership of a business may be viewed as having two distinct phases:

(A) The contract[10] in which the seller agrees to sell the company or its assets (e.g. the Stock Purchase Agreement or Asset Purchase Agreement) and

(B) The closing, where the seller actually transfers title (to the target or its assets) to the buyer.

The sale of a private residence provides a helpful example. In a house sale: (i) first the contract is signed; (ii) then the buyer applies for a mortgage, obtains any necessary approvals, and conducts due diligence (e.g. engineer and termite inspections, etc.) and (iii) then the closing takes place.

In business acquisitions the contract and closing are often combined into one event, with the due diligence taking place earlier.

However, the contract and closing are typically separated in at least two types of business sales:

(A) When the purchase is financed by a bank, since banks will generally not commence the underwriting process which leads to a loan commitment letter unless and until there is a signed contract.

(B) When the seller is a franchise owner, since the franchisor will generally refrain from conducting the process for approval of the buyer and assignment of the franchise agreement until after there is a signed contract.

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[10] "Contract" is a broad term that includes many types of contracts and they are also referred to as "agreements." The contract in a business acquisition is generally called an Asset Purchase Agreement or Stock Purchase Agreement.

II Conclusion

If you have any questions about business acquisitions, or any other issues involving business or corporate law, please contact Richard Waxman at:

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