

*Principal*  
Richard H. Waxman  
Member: NY & FL Bars

Law Offices  
**RICHARD H. WAXMAN, P.C.**  
445 Central Avenue, Suite 362  
Cedarhurst, NY 11516  
(Phone) 516-374-3733  
(Fax) 516-706-2911  
(E-mail) [rwaxman@waxmanlaw.com](mailto:rwaxman@waxmanlaw.com)  
(Web) [www.waxmanlaw.com](http://www.waxmanlaw.com)

*Counsel*  
Timothy P. Fisher  
Member: NY Bar

S. Timothy Ball  
Member: NY Bar

Joseph Lichter  
Member: NY Bar

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

**PART II: CONTRACT OF SALE**

This is the second 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

**The Contract of Sale**

In this Newsletter we address the following subjects that are often covered in the contract of sale<sup>1</sup>:

1. Assets Purchased
2. Liabilities Assumed
3. Definite Price vs. Earn-out
4. Cash at closing vs. Payment Terms and Security
5. Representations and Warranties
6. Indemnities
7. Approvals and other Conditions
8. Employment Agreements for Sellers
9. Restrictive Covenants
10. Continued Employment of Key Personnel
11. Opinion Letters
12. Dispute Resolution

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<sup>1</sup> Generally, an Asset Purchase Agreement or Stock Purchase Agreement

1. Assets Purchased Since most transactions are structured as asset sales (as opposed to stock sales) we will first focus on the types of assets that are typically sold. Many transactions call for the sale of all or substantially all assets of the target company; whereas, many others call for the sale of expressly limited assets, such as a customer list and/or intellectual property. Generally, the assets sold may include any combination of the following:

- Finished Inventory
- Raw Materials
- Furniture, Fixtures & Equipment
- Intellectual Property
- Customer Lists
- Accounts Receivable
- Contracts
- Websites and Domain Names
- Phone and Fax Numbers
- Leases
- and many others

However, even in a sale of substantially all assets, cash and cash equivalents will often be excluded.

2. Liabilities Assumed Some transactions call for the buyer to assume some, or even all, of the seller's liabilities. Many others do not, in which case the contract will very clearly state that the buyer is not assuming any liabilities. One situation where a buyer might desire to assume liabilities is when the buyer intends to continue to buy goods or services from the former owner's vendors, and therefore wants to make sure that the vendors get paid for pre-closing purchases. In that case the purchase price may be adjusted downward, dollar for dollar, to compensate the buyer for payment of the seller's pre-sale obligations.

3. Definite Price vs. Earn-Out The purchase price is in most cases stated definitely in the contract; in other cases some or all of the purchase price is made dependent on events that occur following the closing. In most of those cases the purchase price is made dependent on the financial performance (gross revenues; net profits; EBITDA; and the like) of the target company for a stated period of time (often one or more years) following the closing. This must not be confused with situations where the purchase price is definite, but is paid over a period of time.

4. Cash at Closing vs. Payment Terms and Security Most buyers are unable or unwilling to pay the entire purchase price at closing and therefore, will seek financing from one, and occasionally both, of the following sources: (A) a bank or other third party lender or (B) the seller<sup>2</sup>. When some or all of the purchase price is seller financed, this is sometimes thought of as a purchase "over time." However, this is somewhat misleading since the buyer typically obtains title to the purchased assets at closing, notwithstanding that some or all of the purchase price will be paid over time. In these cases, the seller will require the buyer to secure the payment through some combination of the following instruments:

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<sup>2</sup> See Newsletter Part I "Pre-Contract Considerations" for additional discussion of this topic.

- A. Promissory Note In almost all cases, the buyer's obligation to pay the remaining balance of the purchase price will be evidenced by a promissory note. This is an instrument, which may or may not be negotiable<sup>3</sup>, in which the buyer promises to pay the balance and sets forth the payment terms, including payment schedule; interest rate (or rates if adjustable); default provisions; litigation clauses; and the like. A typical default provision known as an "acceleration clause" may provide for the entire principal amount to become immediately due and paying if the buyer defaults in paying an installment or otherwise breaches any term of the promissory note or other related documents.
- B. Personal Guaranty The seller may require the individual owner(s) of the buyer to personally guaranty all payments due under the promissory note. If there is more than one such owner, the guaranty obligation will often be made "joint and several" which means that each of the guarantors will be obligated for the full amount, not just his or her pro-rata share.
- C. Security Interest The seller may require the buyer to give the seller a lien on the sold assets (other than real estate) to secure payment of the note. This type of lien is usually manifested in two documents: (i) a Security Agreement which creates the lien and (ii) one or more Financing Statements (UCC-3) which are filed with the Secretary of State to perfect the lien (i.e. to give the world notice of the lien). The Security Agreement will typically give the seller a lien on all the buyer's (or at least the target's) assets, including accounts receivable and inventory.
- D. Mortgage A mortgage is a lien which is analogous to the security interest discussed above, but only applies to real estate. However, taking a mortgage may be problematic since it can be expensive to file (mortgage recording tax) and may violate the terms of existing mortgages.

5. Representations and Warranties These are promises (often referred to short hand as "reps") made by the seller and/or its owner in the contract of sale as to the current state of the target company and its assets. Buyers are entitled to rely on these representations to determine whether it is wise to proceed with the acquisition. Buyers will insist that the contract includes representations as to many different subjects, often including:

- Finances
- Taxes
- Operations
- Furnishings, Fixtures and Equipment
- Contracts
- Suppliers
- Vendors
- Inventory
- Legal Compliance

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<sup>3</sup> i.e. readily transferred to a third party.

- Litigation and Claims
- Liens and Judgments
- Real Estate
- Environmental
- Intellectual Property
- Websites and Domain Names

This list parallels the topics that might be the subjects of the buyer's due diligence. However, the due diligence process can be time consuming and expensive, so buyers will often choose to rely on representations as to at least some of these topics, since it can sue the seller or its owner for damages if a representation turns out to be false.

Examples of typical representations for an Asset Purchase Agreement or Stock Purchase Agreement are set forth on the Appendix to this Newsletter.

Representations should not be confused with covenants. Reps are promises as to the current state of the target company and its assets; while covenants undertakings to take some action, or to refrain from some action, in the future<sup>4</sup>.

6. Indemnities and Hold Harmless These are like insurance policies written by the seller which require the seller to protect the buyer against certain stated contingencies, such as when a representation turns out to be untrue and causes financial damage to the buyer. An indemnity might provide that the seller need not indemnify the buyer unless the damages exceed a minimum amount...this is sometimes called a "basket." Also, an indemnity might be subject to a dollar limit...sometimes called a "cap."

7. Closing Conditions When the transaction calls for a separate contract and closing, the contract will often include "Closing Conditions" which each party<sup>5</sup> must satisfy for the transaction to close. Some closing conditions include:

- Successful completion of buyer's due diligence
- Satisfaction of liens on the seller's assets
- Satisfaction of seller's liabilities to third parties
- Buyer's bank financing
- Government approvals
- Franchisor approvals
- Landlord approvals and/or lease amendments
- Approval by seller's bank and/or other secured creditors
- Inventory confirmation
- Employment agreements for certain target employees

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<sup>4</sup> One important type of covenant is discussed in Section 9 below re "Restrictive Covenants."

<sup>5</sup> Although there are usually closing conditions to benefit both parties, the ones that benefit the seller are typically just "window dressing" and may be waived by the seller.

8. Employment Agreements for Seller's Principals Quite often, the buyer will employ the individual owner(s) of the seller for some period of time following the closing. The reasons may include:

- In an “earn out” a seller will often want to assist the target business in generating sufficient revenue or profits for the seller to, in fact, become entitled to the “earn out.”
- The seller may simply need a job...or at least an income stream.
- The buyer may want to have the former owner help run the target business during the post-closing transition period.
- Compensation paid to an employee is tax deductible; while purchase price payments are not.<sup>6</sup>As a result, the buyer may want to “convert” some portion of the purchase price to salary so it can be paid with deductible dollars

9. Restrictive Covenants Restrictive Covenants are promises by the seller and/or its owners to refrain from certain activities, often for a definite time period following the closing. They typically fall into two different categories: (A) those that protect the buyer from competition by the seller...sometimes referred to as a “non-competes” and (B) those that prohibit the seller from disclosing or using the target’s confidential information.

- Non-Compete Clauses A typical non-compete clause provides that the seller and its former owners will not engage in a business that might compete with the target business for a stated period of time following the closing. In the past, non-competes were typically limited to a geographical area where the target conducted its business; however, the growth of internet sales has vastly broadened geographical markets. As a result broader - sometimes world-wide - restrictions have become more prevalent. Sellers must note that while courts disfavor and are unlikely to enforce true non-compete clauses against an employee, they exhibit no reluctance to enjoin former owners, who were paid for the target business, from competing.
- Confidentiality Clauses An asset purchase typically includes the seller’s intangible assets including its trade secrets and other confidential information. In order to protect the value of these assets, the buyer will restrict the seller after closing from: (A) using the target’s confidential information or (B) disclosing the target’s confidential information to third parties.

10. Continued Employment of Key Personnel Often a target is large enough to have a layer of senior employees (between ownership and the rank and file) that manage key departments of the target’s operation (e.g. senior officers and/or department heads) and/or provide other highly valuable services (e.g. top sales people). In those cases, the new owner may want assurances that such personnel will continue to work for the target after it is sold. One way to do this is through

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<sup>6</sup> However, purchase price payments do increase the buyer’s tax basis in the assets, which can save capital gains taxes if and when the assets are re-sold. In depth analysis of the tax ramifications are beyond the scope of this Newsletter.

an employment agreement. Although a court will not generally force an employee to continue work, it will enforce restrictive covenants. Thus, well drafted restrictive covenants<sup>7</sup> in an employment agreement can discourage key personnel from leaving by preventing them from taking business if they do leave for a competitor.

11 Opinion Letters In the past, the buyer would often require the seller's attorney to provide an opinion letter, which was, in essence, a limited guaranty by the seller's attorney that certain of the seller's representations were true. Since this could expose the seller's attorney to substantial liability, they would often charge a premium for an opinion. Good sense finally prevailed at some point in the mid-2000s when this practice more or less faded away. Today, if a buyer's attorney asks the seller to provide an opinion letter, the seller should decline.

12. Dispute Resolution Knowledgeable attorneys recognize that post-closing disputes may arise for some small percentage of transactions, and as a result, include provisions that establish the procedures in such event. These clauses typically fall into the following categories: (A) jurisdiction; (B) arbitration; and (C) choice of law.

- Jurisdictional Clauses. A buyer and seller will often be located in two different jurisdictions (states and/or countries). In the event of post-closing litigation, each of the parties would generally prefer to litigate in a court closest to its home. Jurisdictional clauses typically provide that all claims arising out of a transaction will be litigated in a designated jurisdiction. Since buyers will often have more leverage during the contract stage, buyers generally insist on a clause that designates the buyer's home court system as the exclusive jurisdiction.
- Arbitration. Arbitration clauses typically provide that all claims arising out of a transaction will be submitted, not to a court, but to a private dispute resolution tribunal such as the American Arbitration Association<sup>8</sup>. Sellers and buyers must note that arbitration is not the antithesis of litigation; instead it is a format for litigation that allows the parties to set the rules and procedures, which are typically constructed in a way to make the process less time consuming and less expensive than court litigation.
- Choice of Law. Sometimes laws will vary from jurisdiction to jurisdiction. In a multi-state transaction it may not be clear as to whose law will apply to resolve disputes. Therefore the contract will often designate the jurisdiction whose law will apply. Once again, since the buyer will often have more bargaining leverage, it will insist that its home state's law will apply.

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<sup>7</sup> While a true non-compete in an employment agreement will generally not be enforced, a court will enforce a provision in which the employee agrees to not solicit or accept business from a company customer for a reasonable period of time.

<sup>8</sup> For many years the American Arbitration Association was the dominant arbitration organization. However, in recent years, several competitor organizations have taken over a sizeable portion of the arbitration market.

## **Conclusion**

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

[rwaxman@waxmanlaw.com](mailto:rwaxman@waxmanlaw.com)

In case you have trouble reading this e-mail, we have attached a PDF copy in the banner of the covering e-mail.

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## APPENDIX

### TYPICAL REPRESENTATIONS

#### Financial Information

The financial information and tax returns listed on Schedule 2.8 are true, accurate and complete in all material respects and were prepared in accordance with the books and records of the Company. The financial information provided by the Company has been prepared in accordance with GAAP, consistently applied, and fairly presents the financial condition of the Company as of the dates indicated and the results of operations of the Company for the respective periods indicated. The Company has no material obligations, liability (including any Indebtedness), accrued or unaccrued, fixed, absolute, contingent or other, regardless of when asserted (“Liabilities”) which are individually or in the aggregate material to the business, results of operations or financial condition of the Company taken as a whole, except for (i) Liabilities adequately reflected or reserved against on the Company’s Financial Statements; (ii) Liabilities under the Company’s Contracts and (iii) Liabilities incurred since the date of the Company’s Financial Statements in the ordinary course of business and consistent with past practice not involving borrowings by the Company.

#### Tax Matters

(a) The Company has duly and timely filed all Tax Returns that it was required to file under applicable Laws and Regulations. All such Tax Returns were correct and complete in all respects and were prepared in substantial compliance with all applicable Laws and Regulations. All Taxes due and owing by the Company (whether or not shown on any Tax Return) have been paid. The Company is not currently the beneficiary of any extension of time within which to file any Tax Return. No written claim has ever been made by an authority in a jurisdiction where the Company does not file Tax Returns that the Company is or may be subject to taxation by that jurisdiction. There are no Liens for Taxes (other than Taxes not yet due and payable) upon any of the assets of the Company.

(b) The Company has withheld and paid all Taxes required to have been withheld and paid in connection with any amounts paid or owing to any employee, independent contractor, creditor, shareholder, or other third party.

(c) No foreign, federal, state, or local Tax audits or administrative or judicial Tax proceedings are pending or being conducted with respect to the Company. The Company has not received from any foreign, federal, state, or local Taxing authority (including jurisdictions where the Company has not filed Tax Returns) any written (i) notice indicating an intent to open an audit or other review; (ii) request for information related to Tax matters; or (iii) notice of deficiency or proposed adjustment for any amount of Tax proposed, asserted, or assessed by any taxing authority against the Company.

(d) The Company has not waived, extended, or requested, or agreed to waive or extend, any statute of limitations in respect of Taxes or agreed to any extension of time with respect to a Tax



assessment or deficiency. The Company has not executed any power of attorney with respect to any Tax, other than powers of attorney that are no longer in force. No closing agreements, private letter rulings, technical advice memoranda or similar agreements or rulings relating to Taxes have been entered into or issued by any Taxing authority with or in respect of the Company.

(e) The Company is not a party to, is not bound by and does not have any obligation under, any Tax sharing or Tax indemnity agreement or similar contract or arrangement.

### **Legal Proceedings and Compliance with Laws**

There is no, and for the previous twelve months there have not been any, Actions or Orders pending or threatened by or against the Company, or the assets, officers or directors of the Company. The Company is in compliance with all Laws applicable to it or any of its assets. The Company has not received any notice to the effect that, or otherwise been advised in writing that, it is not in compliance with any such Laws.

### **Contracts**

Each material Contract of the Company or which, as of the Closing, obligates, or subjects the Company to, any Liability, (including any such Contract that includes non-compete or exclusivity provisions), or would be reasonably likely to obligate, or subject the Company to, any Liability, is listed on Schedule 2.14. The Company has included in the Virtual Data Room a correct and complete copy of each Contract listed in Schedule 2.14. Each Contract is a valid and binding arrangement of the Company and of each of the other parties thereto. Each Contract is in full force and effect, and neither the Company nor any other party thereto is in default or breach in any material respect under the terms of any such Contract. No Contract requires prepayments, additional payments or increased payments by the Company as a result of consummation of the transactions contemplated by this Agreement. Except as set forth on Schedule 2.14, the Company has not entered into any Contract with an Affiliate of the Company.

### **Regulatory Matters**

The Company has operated and currently is in compliance in all material respects with the requirements of all federal, state, local or foreign regulatory agencies. To the Shareholder's Knowledge, the Company has not received any written notice or other written communication from any Governmental Authority alleging any material violation of any Laws by such entity relating to its business.

The Company possesses all certificates, authorizations, permits, clearances and approvals issued by any Governmental Authority necessary to conduct its business ("Permits"). Schedule 2.18 is a true and accurate list of all such Permits. The Company has no Knowledge that any Governmental Authority is considering limiting in any material respect, suspending or revoking any such Permit. Each filing or submission to any Governmental Authority in any jurisdiction made by the Company was true, accurate and complete as of the date made. The Company having made such a filing or submission has notified the Governmental Authority and all such

Governmental Authorities of any changes to such filing or submission as required by Law. There is no false or misleading information or material omission in any application or other submission made by the Company to any Governmental Authority.

**Accounts Receivable**

The accounts receivable of the Company: (a) are accurately reflected in the Company's Financial Statements and the Company's books and records; (b) are valid and genuine; (c) have arisen solely out of bona fide sales and deliveries of goods, performance of services, and other business transactions in the ordinary course of business; and (d) are not subject to valid defenses, set-offs, or counterclaims.