Selling Your Business: It's More Than Price!

There are many factors a private business owner should consider when selling his or her business. Although the purchase price being offered is important, the fundamental question is "Who will assume the risk of unknown liabilities?" Yet, many business owners determine the price they want for their business and when that price is met, they feel like the deal has been completed.

For example, a business owner is not typically aware of the intricate provisions contained in a standard stock or asset purchase agreement. These include, but are not limited to the strength of the representations and warranties being requested from the seller, the survival time for such representations and warranties, the amount of purchase price withheld that may be subject to indemnification claims by the buyer, and the basket and cap on indemnification.

Representations and Warranties

The purchase price in the agreement isn't always the amount the seller gets to keep. The seller wants to simply warrant that it has transferred 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 (i.e. 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 other than title and very few other matters. In contrast, the buyer typically wants the seller to guarantee everything about the operation of the business prior to the closing and limit his or her 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.

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 to the purchase agreement. 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 that the seller did not disclose, 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 grant certain representations to a buyer, the seller should be sure he or she understands the meaning of each representation and most importantly that the seller has conducted thorough due diligence on his or her own company so that he or she has 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 the seller is not on the hook for things that he or she truly didn't know, or worse, couldn't have known even after thorough investigation. Representations should also have a "materiality" qualifier which will prevent a buyer from seeking indemnification claims for immaterial defects in the representations.

Indemnification Claims

An indemnification claim typically involves a buyer asserting that the seller should reimburse the buyer for damages or losses incurred by a buyer as a result of a breach of a representation or warranty by the seller. Usually 25%-35% 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/or offset against purchase price consideration that has been withheld in the form of an escrow, or 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 or her retirement, indemnity claims based on poorly structured representations and

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warranties can seriously affect their standard of living by reducing the funds available for the golden years.

Closing Price

Another important aspect in evaluating a purchase price offer is whether the buyer pays the entire purchase price in cash at the closing, or whether the buyer pays a portion in cash at the closing and then pays the balance by either funding an escrow account, delivering a promissory note, 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. Keep in mind that this isn't a time value of money 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 or she gets to hold the stakes when a dispute breaks out.

Survival Time

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 4 years. Customarily, a buyer will be willing to shorten the survival period for representation and warranty claims to 2-3 years post-closing (in most instances, except perhaps title, taxes, employee benefits, and environmental matters) and sellers can often negotiate the duration of the survival period down to 1-2 years post-closing.

Basket and Cap

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 a cap, which tends to be 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 basket amount, and naturally the buyer will want to negotiate a lower basket amount. The basket can be in the form of a deductible or a threshold. For example, in a $10,000,000 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), whereas 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.

Assets vs. Stock Sales

As far as structure is concerned, a seller generally 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. The tax impact on a seller resulting from the different tax treatment of an asset sale versus a stock sale should also be evaluated.

Benefits of Professional Assistance

There are numerous issues involved in selling a business. Due to the complexity of such issues, business owners are well advised to seek tax, legal, accounting and financial counsel to assist them in evaluating not only the offer price being submitted by a buyer, but also the other issues involved in structuring a transaction.

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