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How to Buy or Sell a Business

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Summary

The decision to buy or sell a business requires careful consideration of the many factors involved. If you are a seller, these factors include preparing your business for sale and finding buyers. If you are a buyer, they include pricing and financing your purchase.

This Aid presents an outline to buying and selling factors as well as the necessary procedures for structuring transactions, negotiations and settlements.

1. Making The Decision To Buy Or To Sell A Business

The Decision to Sell

Business owners choose to sell for a variety of reasons:

1. **Retirement.**
2. **Partnership dispute.**
3. **Diminished interest in the business due to boredom or frustration.**
4. **Illness or death of one of the principals.**
5. **Sales and earnings have plateaued because the company lacks the working capital or management resources to grow.**
6. **Losing money.**

Selling a business is different than selling any other asset one owns, because a business is more than an income earning asset. It is a lifestyle as well. Therefore, the decision to part with it can be emotional. Personal ambitions should be weighed against economic consequences to achieve a properly balanced decision to sell or not to sell.

It is said that timing is everything, and certainly that old axiom is true as applied to the decision to sell a business. Intelligent business owners carefully plan out the decision to sell. They recognize that a business should be sold only after proper preparation and not because of sudden personal frustration or a short-term downturn in business.

The Decision to Buy

It is imperative that a potential business buyer carefully think through his motives for considering the purchase of a business and his criteria in selecting one. A buyer should consider his experience—both vocational and avocational—what he is good at and what he enjoys. If a buyer is interested in a business that has a product or service that is outside his area of expertise, then he should make certain that key employees will stay on after the change in ownership or that similar expertise can be hired.

It is equally important that a buyer identify the desired location(s) and the amount of money willing to be invested. If the money to be used is not in liquid form, the buyer should assess what the realistic possibilities are of obtaining the funds from outside sources. One should also decide on the size of the business in terms of sales, profits, and the number of employees.

It is important to determine if the desired business is to be one that is profitable and stable or one that is losing money and in need of new management. The more profitable and stable a business, the more it is likely to cost.

2. Preparing The Business For Sale

Nearly every privately-held business is operated in a manner that minimizes the seller's tax liability. Unfortunately, the same operating techniques and accounting practices that minimize tax liability also minimize the value of a business. As a result, there is often a conflict between running a business the way an owner wants and preparing the business for sale. Although it is possible to reconstruct financial statements to reflect the actual operating performance of the business, this process may also put the owner in a position of having to pay back income taxes and penalties. Therefore, plans to sell a business should be made years in advance of the actual sale. This will permit the time required to make necessary changes in accounting practices that demonstrate a 3 to 5 year track record of maximum profits.

Audited statements are the best type of financial statements because they are most easily verified by the buyer. However, it is not uncommon for a business's financial statements to be reviewed or compiled. Good financial statements don't eliminate the need for making the business aesthetically pleasing. The business should be clean, the inventory current, and the equipment in good working order.

Next, a valuation report should be prepared. The valuation report eliminates guesswork and the painful trial and error method of pricing that so many owners rely on. All too often, they arbitrarily decide on an excessive price for the business and then go to the expense and effort of developing prospective buyers, only to be unable to strike a deal. It is only after gradually lowering the price and repeating this folly several times that they learn what their business is really worth. Having a professionally prepared appraisal eliminates this problem.

Finally, a business presentation package should be prepared. All facets of the business should be addressed in this document. They include:

1. A history of the business.
2. A description of how the business operates.
3. A description of the facilities.
4. A discussion of suppliers.
5. A review of marketing practices.
6. A description of the competition.
7. A review of personnel including an organizational chart, description of job responsibilities, rates of pay, and willingness of key employees to stay on after the sale.
8. Identification of the owners.
9. Explanation of insurance coverages.
10. Discussion of any pending legal matters or contingent liabilities.
11. A compendium of 3 to 5 years' financial statements.

3. Finding Buyers And Sellers

The first step is to find a business to buy or find a buyer for the business.

Print Advertising

Business opportunity classified ads are a viable way to advertise a business for sale. Many ads are placed by intermediaries (business brokers or merger and acquisition specialists), but some are placed directly by business owners. The larger local newspapers are the best source of such ads for smaller, privately-held businesses. Sundays are generally the most popular days for these ads.

Larger, privately-held businesses (so-called 'middle-market' companies) are more likely to be advertised in the *Wall Street Journal* on Thursdays. The *Wall Street Journal* produces several different regional editions of their paper. Businesses for sale in any one edition are most likely to be located in that region. Middle-market businesses may also appear in other publications. First Maryland National Bank's *First List* is one such publication, available by subscription only and published on a quarterly basis.

Business opportunity ads, whether for small or large businesses, usually describe the business in several short phrases, keeping its identity anonymous, and list a phone number to call or post office box for reply. The ad should be worded to demonstrate the business's best qualities, (both financial and non-financial) and many include a qualifying statement describing the kind of cash investment or experience required. A telephone number in the ad will draw more responses than a post office box number, but may not permit the anonymity o a post office box.

Trade Sources

Trade sources can be a viable source of information on businesses for sale. Key people within an industry or in companies on the periphery of the industry, such as sup pliers, often know when businesses come up for sale and may be aware of potential buyers. Every industry has a trade association and trade association publications can do a good job of communicating the sale of a business in their industry. If a seller thinks a buyer is likely to come from the same industry, the trade association's publications department should be contacted to see if classified advertising is permitted.

Intermediaries

Business opportunity intermediaries generally can be divided into two groups, 1) business brokers and 2) merger and acquisition specialists. The differences between these two groups are subtle, but in general, business brokers primarily handle the smaller businesses, and merger and acquisition specialists handle the larger middle-market companies. Both groups usually ask for a contract with a 180 day or more exclusive right to sell the business.

Business brokers charge a fee usually amounting to 10% of the purchase price. Merger and acquisition specialists also charge fees, although often the fee is well under 10% since the transactions they work on are much larger. Often, a good merger and acquisition specialist receives a portion of the fee in advance, paid as either a flat fee or an hourly fee. In exchange, the intermediary performs some tangible service such as preparing a presentation package for prospective buyers and a valuation report. Although it is sometimes paid by the buyer, it is more common for the seller to pay the intermediary's fee.

An experienced intermediary can offer assistance in (1) pricing the business, (2) setting the terms, (3) compiling a comprehensive presentation package, (4) professionally marketing the business, (5) screening potential buyers, (6) negotiating and evaluating offers, (7) making certain that proper legal steps are taken. The result can be a considerable saving of the business owner's or business buyer's time and effort.

4. Evaluating The Business

The first step a buyer must take in evaluating a business for sale is that of reviewing its history and the way it operates. It is important to learn how the business was started, how its mission may have changed since its inception and what past events have occurred to shape its current form. A buyer should understand the business's methods of acquiring and serving its customers and how the functions of sales, marketing, finance and operations interrelate. General information about the industry can be obtained from trade associations.

The business's financial statements, operating documents, and practices should be reviewed. A summary of the items to be reviewed follows.

Balance Sheet

Accounts Receivable

1. Obtain an accounts receivable aging schedule and determine if there is concentration among a few accounts.
2. Determine the reasons for all overdue accounts.
3. Find out if any amounts are in dispute.
4. Are any of the accounts pledged as collateral?
5. Is the reserve for bad debt sufficient and how was it established?
6. Review the business's credit policy.

Inventory

1. Make sure the inventory is determined by physical count and divided by finished goods, work in progress and raw materials.
2. Assess the method of valuation and why it was used. (LIFO, FIFO, etc.).
3. Determine the age and condition of the inventory.
4. How is damaged or obsolete inventory valued?
5. Is the amount of inventory sufficient to operate efficiently and for how long?
6. Should an appraisal be obtained?

Marketable Securities

1. Obtain a list of marketable securities.
2. How are the securities valued?
3. Determine the fair market value of the securities.
4. Are any securities restricted or pledged?
5. Should the portfolio be sold or exchanged?

Real Estate

1. Obtain a schedule of real estate owned.
2. Determine the condition and age of the real estate.
3. Establish the fair market value of each of the buildings and land.
4. Should appraisals be obtained?
5. Are repairs or improvements required?
6. Are maintenance costs reasonable?
7. Do any of the principals have a financial interest in the company(s) that perform(s) the maintenance?
8. Is the real estate required to operate the business efficiently?
9. How is the real estate financed?
10. Are the mortgages assumable?
11. Will additional real estate be required in the near future?
12. Is the real estate adequately insured?

Machinery and Equipment

1. Obtain a schedule of machinery and equipment owned and leased.
2. Determine the condition and age of the machinery and equipment and the frequency of maintenance.
3. Identify the equipment and machinery that is state-of-the-art.
4. Identify the machinery and equipment that is obsolete.
5. Identify the machinery and equipment that is used in compliance with EPA or OSHA standards and determine if additional equipment and machinery is needed to comply.
6. Should an appraisal be obtained?
7. Will immediate repairs be required and at what cost?

Accounts Payable

1. Obtain a schedule of accounts payable and determine if there is concentration among a few accounts.
2. Determine the age of the amounts due.
3. Identify all amounts in dispute and determine the reason.
4. Review transactions to determine undisclosed and contingent liabilities.

Accrued Liabilities

1. Obtain a schedule of accrued liabilities.
2. Determine the accounting treatment of:
   —unpaid wages at the end of the period
   —accrued vacation pay
   —accrued sick leave
   —payroll taxes due and payable
   —accrued Federal income taxes
   —other accruals
3. Search for unrecorded accrued liabilities

Notes Payable and Mortgages Payable

1. Obtain a schedule of notes payable and mortgages payable.
2. Identify the reason for indebtedness.
3. Determine terms and payment schedule.
4. Will the acquisition accelerate the note or mortgage or is there a prepayment penalty?

5. Determine if there are any balloon payments to be made and the amounts and dates due.
6. Are the notes or mortgages assumable?

Income Statement

The potential earning power of the business should be analyzed by reviewing profit and loss statements for the past 3 to 5 years. It is important to substantiate financial information by reviewing the business's federal and state tax returns. The business's earning power is a function of more than bottom line profits or losses. The owner's salary and fringe benefits, non-cash expenses, and non-recurring expenses should also be calculated.

Financial Ratios

While analyzing the balance sheet and the income statement, sales and operating ratios should be calculated in order to point out areas requiring further study. Key ratios are the current ratio, quick ratio, accounts receivable turnover, inventory turnover and sales/accounts receivable. The significance of these ratios, the methods for calculating them, and industry averages are available through *Dun & Bradstreet* and *Robert Morris Associates*. Look for trends in the ratios over the past 3 to 5 years.

Leases

1. What is the remaining term of the lease?
2. Are there any option periods, and if so, is the option exercised only by the choice of the tenant?
3. Is there a percent of sales clause?
4. What additional fees (such as a common area maintenance or merchants association dues) are paid over and above the base rent?
5. Is the tenant or landlord responsible for maintaining the roof and the heating and air conditioning system?
6. Is there a periodic rent increase called for to adjust the rent for changes in the consumer price index or for an increase in real estate tax assessments?
7. Is there a demolition clause?
8. Under what terms and conditions will the landlord permit an assumption or extension of the existing lease?

Personnel

1. What are the job responsibilities, rates of pay, and benefits of each employee?
2. What is each employee's tenure?
3. What is the level of each employee's skill in their position and are they employed under an employment contract?
4. Will key employees stay after the business is purchased?
5. Are any employees part of a union, or is any union organizing effort likely?

Marketing

1. Are any of the products proprietary?
2. Describe any new upcoming products and projected sales.
3. What is the business's geographic market area?
4. What is the business's percentage of market share?
5. What are the business's competitive advantages?
6. What are the business's annual marketing expenditures?

Patents

A list of trade names, trademarks, logos, copyrights and patents should be obtained, noting the period of time remaining before each expires.

Taxes

1. Are FICA, unemployment, and sales tax payments current?
2. What was the date and the outcome of the last IRS audit?

Legal Issues

1. Are there any suits now or soon to commence?
2. What OSHA and EPA requirements must be met and are they currently being met?
3. Are all state registration requirements and regulations being met?
4. Are all local zoning requirements being met?
5. Review the articles of incorporation, minute books, bylaws, and/or partnership agreements.
6. What are the classes of stock and the restrictions of each, if any?
7. Has any stock been cancelled or repurchased?
8. Is the business a franchise? If so, review the franchise agreement.

Competitors

1. Who are the business's competitors?
2. What is their market share?
3. What are each competitor's competitive advantages and disadvantages?

All the factors identified in this section on evaluating a business have to be carefully scrutinized and weighed. Some factors will have a positive influence on the decision to buy. Others will have a negative influence. Seek out professional assistance if help is needed in interpreting the significance of the information. The important thing is to obtain all the information needed to make a decision. In most instances, all of the business records should be made available to the buyer. In some cases however, certain information may be withheld until a bona fide offer, contingent upon obtaining that information, has been made. If important information is unreasonably withheld, the likelihood of making the transaction work diminishes.

5. Financing The Purchase

A buyer's source of financing depends in part on the size of the business being purchased. The vast majority of businesses (and particularly the smaller businesses) are purchased with a significant portion of the purchase price financed by the owner. The buyer, however, still must make a down payment and be sure that adequate working capital sources are available.

If the funds needed for the down payment are not readily available, the buyer must look for financing from an outside source. To grant such financing, an institutional lender is almost certain to require personal collateral for the loan as well as a compendium of financial and operating data of the business to be acquired. It is rare indeed to be granted a loan to purchase a smaller, privately-held business when the loan is secured only by the assets of the business. The most attractive types of personal collateral from the lender's point of view are real estate, marketable securities and cash value of life insurance. In addition to personal collateral, it must also be demonstrated to the lender that the buyer is of good character, has a clear source of repayment, and has a good business plan. The most common sources for such loans are financial institutions such as banks and consumer finance companies.

The chances of obtaining outside financing improve as the size of the business being acquired increases. Not only does the willingness of the lender to participate in the transaction increase, the number of potential lenders increases as well. Banks, insurance companies, commercial finance companies and venture capital companies all may be interested in lending money for an acquisition of some size. Again, the borrower must be of good character, have a clear source of repayment and have a good business plan.

Lenders for larger transactions may or may not require personal collateral from the purchaser; however, they will require a personal guarantee. Collateral for larger loans generally will consist of a first lien security interest in the tangible assets of the business such as accounts receivable, inventory, equipment and real estate. The lender will set loan conditions and restrictions regarding certain activities of the business. In the case of insurance companies and venture capitalists, the lender may insist on an equity position in the business and a role in major management decisions. Insurance companies typically only participate in transactions above $10 million. Commercial finance companies make loans on much the same basis as banks. While the interest rate such companies charge is usually higher than that charged by a bank, they are often willing to take more risk.

It is rare for a privately-held business to be acquired without leveraging the business's assets in some manner, pledging them as collateral for a loan made either by the owner of the business or an outside lender. The owner has a strong incentive to provide financing if he feels it is necessary to get the price he wants for the business and has confidence in the buyer. An outside lender must be convinced that the loan's risk of failure is minimal and represents a profitable transaction. Institutional lenders are generally conservative and concentrate rate primarily on repayment. To obtain outside financing it is important to be well prepared and have the information that a lender needs to make a decision. This data should be submitted in the form of a loan proposal and should contain the following items:

1. Purpose of the loan
2. Amount required
3. Term desired
4. Source of repayment
5. Collateral available
6. History and nature of the business
7. Age, experience and education of management
8. Key advisors
9. Product
10. Market area and method of distribution
11. Major customers
12. Suppliers
13. Competition
14. Facilities
15. Employees and unions
16. Three years of business financial statements
17. Three years of business tax returns
18. Current personal financial statement
19. Proforma business income statement, balance sheet and cash budget (for at least three years)

In instances where obtaining bank financing on a standalone basis is not possible, a SBA guarantee or underwriting by a state or municipal economic development agency may be available.

6. Pricing The Business

Determining the value of a business is the part of the buy-sell transaction most fraught with potential for differences of opinion. Buyers and sellers usually do not share the same perspective. Each has a distinct rationale, and that rationale may be based on logic or emotion.

The buyer may believe that the purchase will create synergy or an economy of scale because of the way the business will be operated under new ownership. The buyer may also see the business as an especially good lifestyle fit. These factors are likely to increase the amount of money a buyer is willing to pay for a business. The seller may have a greater than normal desire to sell due to financial difficulties or the death or illness of the owner or a member of the owner's family.

For the transaction to come to conclusion, both parties must be satisfied with the price and be able to understand how it was determined.

Factors That Determine Value

The topic of business evaluation is so complex that any explanation short of an entire book does not do it justice. The process takes into account many, many variables and requires that a number of assumptions be made. Shannon Pratt,* a noted business valuation expert, names six of the most important factors:

1. Recent profit history.
2. General condition of the company (such as condition of facilities, completeness and accuracy of books and records, morale and so on).
3. Market demand for the particular type of business.
4. Economic conditions (especially cost and availability of capital and any economic factors that directly affect the business).
5. Ability to transfer goodwill or other intangible values to a new owner.
6. Future profit potential.

The six factors named above determine the fair market value. However, businesses rarely change hands at fair market value. The reason is that three other factors often come into play in arriving at an agreed upon price. Pratt identifies them as follows:

1. Special circumstances of the particular buyer and seller.
2. Tradeoff between cash and terms.
3. Relative tax consequences for the buyer and seller, which depend on how the transaction is structured.

The definition of fair market value is the price at which property would change hands between a willing buyer and a willing seller, both being adequately informed of all material facts and neither being compelled to buy or to sell. In the market place, buyer and seller are nearly always acting under different levels of compulsion.

Rule-of-Thumb Formulas

The rule for using rule-of-thumb formulas for pricing a business is don't use them. The problem with rule-of-thumb formulas is that they address few of the factors that impact a business's value. They rely on a 'one size fits all' approach when, in fact, no two businesses are identical.

Rule-of-thumb formulas do, however, provide a quick means of establishing whether a price for a certain business is "in the ballpark." Formulas exist for many businesses. They are normally calculated as a percentage of either sales or asset values, or a combination of both.

Comparables

Using comparable sales as a means of valuing a business has the same inherent flaw as rule-of-thumb formulas. Rarely if ever are two businesses truly comparable. However, businesses in the same industry do have some characteristics in common, and a careful contrasting may allow a conclusion to be drawn about a range of value.

Balance Sheet Methods of Valuation

This approach calls for the assets of the business to be valued. It is most often used when the business being valued generates earnings primarily from its assets rather than the contributions of its employees or when the cost of starting a business and getting revenues past the break-even point doesn't greatly exceed the value of the business's assets.

There are a number of balance sheet methods of valuation including book value, adjusted book value, and liquidation value. Each has its proper application. The most useful balance sheet method is the adjusted book value method. This method calls for the adjustment of each asset's book value to equal the cost of replacing that asset in its current condition. The total of the adjusted asset values is then offset against the sum of the liabilities to arrive at the adjusted book value.

Adjustments are frequently made to the book values of the following items:

Accounts Receivable—often adjusted down to reflect the lack of collectability of some receivables.

Inventory—usually adjusted down since it may be difficult to sell off all of the inventory at cost.

* Shannon Pratt, *Valuing Small Businesses and Professional Practices* (Homewood, Illinois, Dow-Jones Irwin 1986.)

Real Estate—frequently adjusted up since it has often appreciated in value since it was placed in service.

Furniture, Fixtures, and Equipment—adjusted up if those items in service (probably more than a few years) have been depreciated below their market value, or adjusted down if the items have become obsolete.

Income Statement Methods of Valuation

Although a balance sheet formula is sometimes the most accurate means to value a business, it is more common to use an income statement method. Income statement methods are most concerned with the profits or cash flow produced by the business's assets. One of the more frequently used methods is the discounted future cash flow method. This method calls for the future cash flows (before taxes and before debt service) of the business to be calculated using the 4-step formula below.

Step #1

The historical cash flows are a good basis from which to project future cash flows. Cash flows are computed to include the following:

1. The net profit or loss of the business.
2. The owner's salary (in excess of an equivalent manager's compensation).
3. Discretionary Benefits paid the owner (such as automobile allowance, travel expenses, personal insurance and entertainment).
4. Interest (unless the buyer will be assuming the interest payment).
5. Non-Recurring Expenses (such as non-recurring legal fees).
6. Non-Cash Expenses (such as depreciation and amortization).
7. Equipment Replacements or Additions. (This figure should be deducted from the other numbers since it represents an expense the buyer will incur in generating future cash flows).

While the future cash flows may be projected out for a number of years, for many small businesses it is not possible to project very far into the future before the projections become meaningless. Even with somewhat larger and more substantial businesses, it is difficult to project cash flows for more than 5 years.

Step #2

Once the future cash flows have been projected, they must be discounted back to their present value. This is done by selecting a reasonable rate of return or capitalization rate for the buyer's investment. The selected rate of return varies substantially from one business to the next and is largely a function of risk. The lower the risk associated with an investment in a business, the lower the rate of return that is required. The rate of return required is usually in the 20–50% range and, for most businesses, it is in the 30–40% range. The present value of the future cash flows can then be determined by using a financial calculator or a set of present value tables that are available in most book stores. The following example demonstrates how the conversion is made with a 40% rate of return.

Year	Projected Cash Flow	Discount Factor *	Present Value	
Year 1	$360	.714	$257	
Year 2	$383	.510	$195	
Year 3	$397	.364	$145	
Year 4	$413	.260	$107	
Year 5	$438	.186	$ 81	
			$785	Total**

* — Based on 40% rate of return. The discount factor declines in each succeeding year.

** — Present value of the sum of discounted projected cash flows. This figure is added to the residual value of the business to arrive at the total value of the business.

Step #3

One more calculation must now be done—the residual value of the business. The residual value is the present value of the business's estimated net worth at the end of the period of projected cash flows (in this example, at the end of five years). This is calculated by adding the current net worth of the business and future annual additions to the net worth. The annual additions are defined as the sum of each year's after-tax earnings, assuming no dividends are paid to stockholders. These additions are added to the current net worth, and that total is discounted to its present value to yield the residual value.

Step #4

The residual value is added to the present value sum of the projected future cash flows previously computed to arrive at a price for the business. An example follows.

	After Tax Income		
Year 1	$125		
Year 2	$131		
Year 3	$138		
Year 4	$144		
Year 5	$152		
Total Additions to net worth		$690	
Current net worth		$910	
Total net worth		$1600	
Residual Value (1600 × .186)			$298***

*** — Multiplying the total net worth by the discount factor used in the final year of projected cash flows yields the residual value. Adding the residual value of $298 to the present value sum of projected cash flows of $785 yields a value for the business of $1,083.

Although this formula is widely used, it cannot be applied in this simplistic form to arrive at a definitive value conclusion. It fails to address issues such as the buyer's working capital investment, the terms of the transaction, or the valuing of assets like real estate which may not be needed to produce the projected cash flows. However, it is useful in establishing a price range for negotiation purposes.

7. The Role of Advisors

A variety of resources are available for those buyers and sellers wanting to obtain professional advice. These resources include business owners in the industry, Small Business Administration counselors, industry consultants, professional intermediaries, business valuation experts, accountants and attorneys. Each of these resources can be of assistance and each has its limitations.

Business owners, SBA counselors, consultants, and intermediaries are the best source of industry information and operating suggestions. SBA, SCORE (Service Corp of Retired Executives) or ACE (Active Corp of Executives) counselors provide their services free of charge and can be reached through local SBA offices. Business owners may be able to give free advice, and they are often the best source of information. No one knows more about an industry than someone who is successfully running a business in that industry.

Business valuation experts can independently appraise a business's value. Bear in mind, however, that they rely on the representations of the seller. They render a conditional opinion based on the assumption that the financial statements are accurate and complete. They will attempt to independently verify only certain information.

Accountants are best used to perform an audit (if one is needed), help interpret financial statements, or provide advice in structuring the transaction to minimize tax consequences for the buyer and seller.

Probably the most often consulted advisor in the purchase or sale of a business is an attorney. Attorneys are asked to do everything from assessing the viability of a business and appraising its value to negotiating the purchase price and preparing the necessary documents. Attorneys, however, cannot assess the viability of a business undertaking. That is something only the buyer and seller can do. Attorneys also generally cannot value a business, but they can occasionally help negotiate a price between buyer and seller. The involvement of an attorney (or any individual other than the principals) can, however, strain the lines of communication between buyer and seller, so they should be allowed into the negotiation process only after careful consideration.

The primary function of an attorney is to prepare the purchase and sale documents as negotiated by the parties. It should include reasonable and balanced protections for both parties. Experience and reputation are important criteria when selecting an attorney. The attorney chosen should have experience handling similar transactions. It may make sense to choose one attorney to represent both buyer and seller. This avoids the adversarial relationship that opposing attorneys often adopt and improves the odds of successfully completing the transaction. It also eliminates some of the emotion in the negotiation process, improves the lines of communication between the parties, expedites completion of the deal and is less expensive.

8. Structuring The Transaction

Tax and other consequences of the structure of a transaction have an important effect on the overall value of the transaction to the principals. Each type of structure carries with it different tax consequences for the buyer and seller. The type of corporation owned by the seller (regular corporation or S corporation), the size and date of the transaction, and the type of consideration paid may all have a bearing on the tax consequences. Since tax law is constantly changing, it is important to seek legal and tax advice in determining the best way to structure the purchase or sale.

Asset Versus Stock Transactions

The purchase and sale of a business can be structured in either of two basic formats: (1) the purchase of the stock of the seller's corporation, or (2) the purchase of the assets of the seller's business.

—Asset Transactions—

In an asset transaction, the assets to be acquired are specified in the contract. Practices vary from industry to industry but, in general, all the assets of the business except cash and accounts receivable and none of the liabilities of the business convey to the buyer. The seller uses the proceeds from the sale to liquidate all short term and long term liabilities.This means that the buyer purchases all of the business's equipment, furniture, fixtures, inventory, trademarks, tradenames, goodwill and other intangible assets.

An asset transaction generally favors the buyer. The buyer acquires a new cost basis in the assets which may allow a larger depreciation deduction to be taken. The seller must pay taxes on the difference between his basis in the assets and the price paid by the buyer for the business.

The buyer may also prefer an asset transaction for liability reasons. By purchasing assets, the buyer may avoid the possibility of becoming liable for any of the seller's corporation's undisclosed or unknown liabilities. The most common liabilities of this type are federal and state income taxes, payroll withholding taxes and legal actions.

—Stock Transactions—

Stock transactions generally call for all of the assets and liabilities of the seller's corporation and the stock of the corporation to be transferred to the buyer. In some cases, the buyer and seller may choose to exclude certain assets or liabilities from being conveyed. The seller must pay taxes on the difference between the seller's basis in the stock and the price paid by the buyer for the stock.

Sometimes stock deals are more expedient for both parties. Stock transactions provide for continuity in relationships with suppliers. They also preclude the necessity of obtaining a lease assignment when the lease is held only in the name of the corporation and when there is no provision in the lease calling for an assignment in the event of a change in the controlling interest of the corporation.The risk of inheriting undisclosed debts of the seller in a stock transaction can be minimized by providing for the right of offset to future payments due the seller.

In choosing to structure a deal as a stock transaction, the seller should be aware that the U.S. Supreme Court has ruled that the sale of the stock of a closely held corporation falls under the umbrella of federal securities laws. This places a greater burden on the seller in a stock transaction to fully disclose all material information about the business. Failure to do so opens the seller up to the risk of securities fraud litigation.

Installment Sales

It is rare for a privately-held business to change hands for an all-cash price. Almost all transactions are structured as installment contracts which provide for the seller to receive some cash, but for the bulk of the purchase price to be owner financed. For smaller privately-held businesses, the down payment often ranges from 10% to 40% of the selling price and the buyer executes a promissory note (secured by the assets of the business only) for the balance. Such notes are typically for a period of 3–15 years at an interest rate that varies with the prime rate but is most often 9–12%. The payments required to retire the debt service should not exceed 25–50% of the discretionary cash flow as calculated in the section on "Pricing the Business."

Leveraged Buyouts

Just as in an installment sale, a leveraged buyout uses the assets of the business to collateralize a loan to buy the business. The difference is that the buyer in a leveraged buyout typically invests little or no money, and the loan is obtained from a lending institution.

This type of purchase is best suited to asset rich businesses. A business that lacks the assets needed for a completely leveraged buyout may be able to put together a partially leveraged buyout. In this structure, the seller finances part of the transaction and is secured by a second lien security interest in the assets. Because leveraged buyouts place a greater debt burden on the company than do other types of financing, buyer and seller must take a close look at the business's ability to service the debt.

Earn-Outs

An earn-out is a method of paying for a business that helps bridge the gap between the positions of the buyer and seller with respect to price. An earn-out can be calculated as a percentage of sales, gross profit, net profit or other figure. It is not uncommon to establish a floor or ceiling for the earn-out.

Earn-outs do not preclude the payment of a portion of the purchase price in cash or installment notes. Rather, they are normally paid in addition to other forms of payment. Because the payment of money to the seller under the provisions of the earn-out is predicated on the performance of the business, it is important that the seller continue to operate the business through the period of the earn-out.

Stock Exchanges

In some instances a business owner may want to accept the stock of a purchasing corporation in payment for the business. Typically, the stock he receives (if it is the stock of a publicly-held company) may not be resold for two years. If the stock may not be freely traded, it is not as valuable as freely traded stock, and its value should be discounted to allow for this lack of marketability.

There is an advantage to the seller in this kind of transaction. Taxes incurred by the seller on the gain from the sale of the business are deferred until the acquired stock is eventually sold. This kind of transaction is termed a tax-free exchange by the IRS. There are several tests that must be met to qualify for this tax treatment.Check with a competent accountant or tax attorney or request a ruling from the IRS Reorganization Branch in Washington, D.C.

9. Negotiation

The art of negotiation plays an important role in buying or selling a business. Differences of opinion are inherent in the negotiation process and only realistic negotiators can find creative solutions to such differences. Businesses change hands most easily when the parties assume a non-adversarial posture. It is imperative that the parties know the issues that are important to one another. Each should understand the other's position on these issues.

Price is just one aspect of the transaction to be negotiated. Terms are just as important, particularly the period of time over which the debt is to be repaid and the allocation for tax purposes of the purchase price.

Sellers naturally have the upper hand in negotiations since they best know the business. A seller should make full use of that advantage. A buyer should minimize the seller's advantage by learning as much as possible about the business. The section in this booklet entitled "*Evaluating the Business*" identifies the key areas to be studied.

It is important to do more than study the business to prepare for negotiations. The parties must both understand each other's motivation for wanting to buy or sell the business, and each other's plans after transition takes place. They must also understand why the other party has taken a certain position on an issue.

Developing a working strategy means each party must not only know the other's position, they must develop their own position as well. They should prepare in writing a list of reasons that validate their position. They should also think through possible weaknesses in their reasoning. In this way, each can anticipate and respond to the objections the other party may raise.

Buyers should request that the seller not negotiate with other buyers while the specifics of the offer are being negotiated. Sellers, on the other hand, are advantaged when they can negotiate with more than one buyer at a time. The most important thing in negotiations is to be able to see things from the other party's perspective. This eliminates much of the difficulty of reaching agreement and keeps the parties from wasting time.

10. Making And Evaluating Offers

Making the Offer

Before making an offer, a buyer will typically investigate a number of businesses. At some point in the investigation process, it may be necessary to sign a confidentiality agreement and show the seller a personal financial statement. A confidentiality agreement pledges that the buyer will not divulge any information about the business to anyone other than immediate advisors.

A buyer should determine a range of value for the business. An appraisal of the business as is can be used to establish a pricing floor. A pricing ceiling can be established by using an appraisal that capitalizes projected future cash flows under new management.

A buyer should have access to all records needed to prepare an offer. If some information is lacking, the buyer must make a decision to either discontinue the transaction or make an offer contingent on receiving and approving the withheld information. The nature and amount of withheld information determines which course of action to take.

An offer may take the form of a purchase and sale agreement or a letter of intent. Purchase and sale agreements are usually binding on the parties while a letter of intent is often non-binding. The latter is more often used with larger businesses.

Regardless of which form of the agreement is used, it should contain the following:

1. Total price to be offered.
2. Components of the price (amount of security deposit and down payment, amount of bank debt, amount of seller financed debt).
3. A list of all liabilities and assets that are being purchased. The minimum amount of accounts receivable to be collected and the maximum amount of accounts payable to be assumed may be specified.
4. The operating condition of equipment at settlement.
5. The right to offset the purchase price in the amount of any undisclosed liabilities that come due after settlement and in the amount of any variance in inventory from that stated in the agreement.
6. A provision that the business will be able to pass all necessary inspections.

7. A provision calling for compliance with the Bulk Transfer provisions of the Uniform Commercial Code. (This does not apply to sales of the stock of the corporation.)
8. Warranties of clear and marketable title, validity and assumability of existing contracts if any, tax liability limitations, legal liability limitations and other appropriate warranties.
9. A provision (where appropriate) to make the sale conditional on lease assignment, verification of financial statements, transfer of licenses, obtaining financing or other provisions.
10. A provision for any appropriate prorations such as rent, utilities, wages and prepaid expenses.
11. A non-competition convenant. This document is sometimes part of the purchase and sale agreement and is sometimes a separate exhibit to the purchase and sale agreement.
12. Allocation of the purchase price.
13. Restrictions on how the business is to be operated until settlement.
14. A date for settlement.

The purchase and sale agreement is a complex document and it is a good idea to get professional help in its drafting.

Evaluating the Offer

The seller should look for all the same provisions in an offer that were enumerated in the section on making the offer. The types of offers a seller is likely to receive depend in some measure on the size of the business. A seller should ask for a resume and financial statement from an individual buyer and an annual report if the buyer is another company. Find out what attributes the buyer brings. Sometimes, a buyer with a commitment to the work ethic is all that is needed. In other cases, successful related work experience may be important. If the acquiror is another company, look for the logic behind the acquisition. Perhaps some kind of synergy or an economy of scale is created. A buyer should prepare and show the seller a post-acquisition business plan.

One final note—carefully study offers to determine what assets and liabilities are being purchased. An offer for the assets of a business may be worth considerably less than an offer for its stock even though the price offered for the assets is higher.

11. Closing The Transaction

Meeting Conditions of Sale

After buyer and seller have entered into a binding contract, there may be several conditions to be met before the sale may be closed. Such conditions often address issues like assignment of the lease, verification of financial statements, transfer of licenses, or obtaining financing. There is usually a date set for meeting the conditions of sale. If a condition is not met within the specified time frame, the agreement is invalidated.

Types of Settlements

Business settlements or closings, as they are also called, are usually done in one of two ways.

1. An attorney performs settlement. In this procedure, the attorney for the buyer, or an independent attorney acting on behalf of both buyer and seller, draws up the necessary documents for settlement. Buyer and seller meet with the settlement attorney at a predetermined time (after all conditions of sale have been met). Documents are signed at the meeting by buyer and seller.

A good settlement attorney is also a good problem solver. He can help find creative ways to resolve differences of opinion. The settlement attorney holds money in escrow and disburses it when all the appropriate documents are signed.

2. Escrow. In an escrow settlement, the money to be deposited, bill of sale and other documents are placed in the hands of a neutral third party or escrow agent. The escrow agent is usually an escrow company or the escrow department of a financial institution. Buyer and seller sign escrow instructions that name the conditions to be met before completion of the sale. Once all conditions are met, the escrow agent disburses previously executed documents and disburses funds. There usually is no formal final meeting at which the signing of the documents takes place. Buyer and seller usually sign them independently of one another.

Regardless of whether escrow or a settlement attorney is used, requirements of the bulk sales act must be met if the assets (not the stock of the corporation) of the business are being sold. This law calls for the business's suppliers to be notified of the impending sale. The supplier must respond within the allowed time frame if money is owed by the seller. A lien search is also performed by the attorney or escrow agent. This determines if any liens against the business's assets have been filed in the records of the local courthouse.

Documents

A number of documents are required to close a transaction. The purchase and sale agreement is the basic document from which all the documents used to close the transaction are created. The documents most often used in closing a transaction are described below. Other documents not described below may also be needed depending on the particulars of the transaction.

Settlement Sheet: Shows, as of the date of settlement, the various costs and adjustments to be paid by or credited to each party. It is signed by buyer and seller.

Escrow Agreement: Is used only for escrow settlements. It is a set of instructions signed by buyer and seller in advance of settlement that sets forth the conditions of escrow, the responsibilities of the escrow agent, and the requirements to be met for the release of escrowed funds and documents.

Bill of Sale: Describes the physical assets being transferred and identifies the amount of consideration paid for those assets. It must always be signed by the seller and is often also signed by the buyer.

Promissory Note: Used only in an installment sale, it shows the principal amount and terms of repayment of the debt by the buyer to the seller. It specifies remedies for the seller in the event of default by the buyer. It is signed by the buyer and the buyer often must personally guarantee the debt.

Security Agreement: Creates the security interest in the assets pledged by the buyer to secure the promissory note and underlying debt. It also sets forth the terms under which the buyer agrees to operate those assets which constitute collateral. It is used only in an installment sale. It is signed by both parties.

Financing Statement: Creates a public record of the security interest in the collateral and therefore notifies third parties that certain assets are encumbered by a lien to secure the existing debt. The cost to record the financing statement varies by jurisdiction. It is used only in installment sales. It is signed by buyer and seller.

Covenant not to compete: Protects the buyer and his investment from immediate competition by the seller in his market area for a limited amount of time. The scope of this document must be reasonable in order for it to be legally enforceable. The covenant not to compete is sometimes included as a part of the purchase and sale agreement and is sometimes written as a separate document. It is signed by both parties. It is not required in every transaction.

Employment Agreement: Specifies the nature of services to be performed by the seller, the amount of compensation, the amount of time per week or per month the services are to be performed, the duration of the agreement and often a method for discontinuing the agreement before its completion. Employment agreements are not required in all transactions, but they are used with great frequency. It is not uncommon that the seller remain involved with the business for periods of as little as a week or as much as several years. The length of time depends on the complexity of the business and the experience of the buyer. For periods of more than 2–4 weeks, the seller is often compensated for his services. It is signed by both the buyer and the seller.

Contingent Liabilities

Contingent liabilities must be taken into account and provided for when a business is sold. They most often occur because of pending tax payments, unresolved lawsuits or anticipated but uncertain costs of meeting regulatory requirements. Contingent liabilities can be handled by escrowing a portion of the funds earmarked for disbursement to the seller. The sum escrowed then can be used to pay off the liability as it comes due. Any remaining money can then be disbursed to the seller.