MATT DICKSTEIN

Business Attorney

Making legal matters easy and economical for your business

39488 Stevenson Pl., Suite 100, Fremont, CA 94539
510-796-9144. mattdickstein@hotmail.com. mattdickstein.com

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Buying and Selling a Business, Part II – The Deal

In this article, I give Part II of my overview of buying and selling a private, closely held business. Part I discussed how buyers and sellers find one another, and how they evaluate the business to be bought or sold. This Part II discusses the deal itself, including its structure and the deal documents.

In general, a small deal takes a few months to close. Sellers usually want to speed up the process to lock in their payday. Buyers, especially first-time buyers, like to slow it down to get more time to evaluate the purchase.

The first deal document is the letter of intent, also called a term sheet. The parties use the letter of intent to confirm the basic deal terms. The letter of intent should not be binding on the parties, except for such matters as due diligence procedures and perhaps a lock-up or exclusive period within which the seller may not field other offers.

Clearly the most basic deal term is the purchase price. The purchase price should take taxes into account, because it is your after-tax (not pre-tax) purchase price that counts. After fixing a purchase price, the next question is how will the buyer pay it? The buyer must be sure that financing the acquisition will not dangerously reduce the buyer's liquidity.

Payment terms are just as important as the total purchase price. You have a multitude of choices in paying the purchase price: cash up-front, a promissory note, stock in the buyer, an earn-out (which is a purchase price that is paid over time based on the company's post-closing performance), a holdback for post-closing accounting or inventory adjustments, or some combination thereof. From the seller's perspective, cash is king. When a seller accepts a promissory note, stock in the buyer or an earn-out, the seller essentially becomes an investor in the buyer. Sellers hate this.

Now that you have settled on a purchase price, you have to choose a legal structure. The structure of the deal and the purchase agreement directly affect the bottom line risks and after-tax price of the deal. As a rule of thumb, buyers want to buy assets and sellers want to sell stock.

- *Stock Sales.* Here the buyer purchases the target company by taking all of its stock. When the buyer takes the entire company, it leaves all of the company's contracts, assets and liabilities in place. The buyer gets a carry-over basis in the company's assets (usually lower than a stepped-up basis). The seller / shareholders pay taxes on the appreciation in their shares (with no double-tax). For these reasons, sellers prefer stock sales.

- *Asset Sales.* Here the buyer purchases the target company's assets, and assumes only those liabilities that it agrees to assume. The seller keeps the shell company and all of its liabilities. The company dividends up to its shareholders the proceeds of the sale. This causes the double tax problem – the company pays taxes on the asset sale, then its shareholders pay taxes on the dividend to them (with an exception for pass-through entities). Buyer gets a stepped-up basis in the company's assets (consisting of the purchase price plus assumed liabilities plus transaction expenses). For these reasons, buyers prefer asset sales.

Once the parties have agreed to the basic deal terms, they can move on to the deal documents, including the purchase agreement. In the purchase agreement, the seller will make extensive and important representations about the target company. This allows the buyer to recover back some of the purchase price if any of the representations is materially misleading, for example, the seller did not disclose certain liabilities. Representations are not a substitute for due diligence, but they do provide additional security to the buyer.

The last important piece of the deal documents is the non-competition agreement. In most cases, the buyer should receive a non-competition agreement from the seller. Otherwise the buyer is at risk that, after collecting the purchase price, the seller will set up a competing shop across the street.

That's it for your whirlwind tour through mergers and acquisitions. Remember that buying or selling a business is a complex process. Legal, tax, accounting, valuation and psychology issues are all involved. As always, get help from professionals.

From the human quote machine, Mark Twain

- Always acknowledge a fault. This will throw those in authority off their guard and give you an opportunity to commit more.
- By trying we can easily learn to endure adversity -- another man's I mean.
- Clothes make the man. Naked people have little or no influence on society.
- Courage is resistance to fear, mastery of fear - not absence of fear.
- Get your facts first, and then you can distort them as much as you please.
- Honesty is the best policy - when there is money in it.
- I have been through some terrible things in my life, some of which actually happened.
- I thoroughly disapprove of duels. If a man should challenge me, I would take him kindly and forgivingly by the hand and lead him to a quiet place and kill him.