

PROBUS BUSINESS SALES

**THE SALE OF A
SMALL BUSINESS**



If you are considering selling your business, there will be many questions that you will want answered as you begin.

This booklet will give you some basic guidelines to help you answer these

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THE SALE OF THE SMALL BUSINESS

The sale of a business can be one of the most stressful yet rewarding activities engaged in by an entrepreneur. The successful sale of a business is the dream of every entrepreneur. By properly preparing the business for sale, assembling a team of qualified attorneys, accounts, financial planners and professional business brokers, and understanding the process, an entrepreneur can help ensure a successful and profitable sale.

This process can be very complicated. It is often the end result of years of hard work by an entrepreneur. Like any endeavor that has significant financial consequences, proper planning is crucial to the successful sale of a business. This guide is designed to help the owners of businesses navigate these waters.

PRE-SALE PLANNING

A business owner should start making preparations as soon as the decision is made to sell the business. Selling takes time. The process of selling a business can take from 18 months to three years from the first stage of determining a market value of the business, to attracting buyer interest and exploration, to the negotiations, and to the final contract that transfers possession. Even though about 50% of the businesses are sold within the first year, a business owner should not get discouraged if it takes longer.

In order to maximize the benefits of a sale, a seller must be thoroughly prepared. Two important aspects of planning are; **1) identifying the objectives of the parties and 2) preparing the business to be sold.**

IDENTIFYING THE OBJECTIVES OF THE PARTIES

It is important for the seller to determine not only his or her own objectives but also those of the buyer. All too often, either or both parties fail to properly analyze what they want to achieve in the purchase and sale. Even when a party's objectives are identified, they often are forgotten or put aside while the negotiations take place. This is a critical mistake and can lead to an unsuccessful transaction. Once these objectives have been identified, they should be the focus of each step in the negotiations. Otherwise, buyers and sellers engage in competitive warfare where winning points and arguments becomes the focus. In these circumstances, negotiations become adversarial, emotional and often collapse.

Generally, a seller is interested in some or all of the following:

- Obtaining the highest and best price for the business AND ensuring that the purchase price is fully paid,
- Transferring the business to a quality buyer whom the seller can trust to safeguard, maintain and even grow the business, and

- Minimizing the income taxes resulting from the transaction.

The seller also may have more specific objectives, such as using the proceeds of the sale to fund retirement or, perhaps, to establish a new and different business venture. These different objectives could result in completely different structures for the transaction. For example, a seller desiring to use the proceeds for retirement may wish to receive a lower down payment, a longer payment stream and more property to secure the payment of the note. This would result in the creation of an annuity, spreading the tax liability over time and potentially lowering the tax rate. A seller desiring to use the proceeds to fund another business venture might want an all-cash, or a substantially all-cash transaction. In that case, in order to minimize taxes, a seller should explore the possibility of a 1031 exchange and defer payment of taxes that would result from the sale.

The typical buyer, on the other hand, is usually interested in:

- Purchasing a quality business,
- Having the actual business purchased be consistent with what the buyer believes he or she is purchasing,
- Protecting his or her assets against potential failure of the business after completion of the purchase,
- Minimizing cash investment,
- Leveraging the skills of his or her prior employment or occupation.

CONTACT YOUR ACCOUNTANT

The tax codes are constantly being revised and changed. It is extremely important that anyone considering selling a business discuss the tax implications of the sale with a tax accountant who is thoroughly familiar with the latest changes in the tax code. In this way the seller can be prepared to structure a sale to obtain the greatest tax advantages. If the buyer is also willing to structure the sale in this way, the price of the business could be reduced and still net the seller more money after taxes. This should result in a win-win situation for both parties.

PREPARING THE BUSINESS FOR SALE

Sellers often fail to take steps that could increase the value of their businesses, help it to be more attractive to potential buyers and, therefore, sell more easily. Even before a buyer is found, a seller should “clean up” the business. Cleaning up the business includes:

- Removing assets on the balance sheet which the seller wishes to retain such as vacation homes, automobiles or other company-owned items for which the seller wishes to retain personal ownership;
- Ensuring that the financial records are in good order. Accounting adjustments which would normally be made at year-end should be

made prior to the sale, including writing down inventory and writing-off uncollectible accounts receivable;

- Thoroughly cleaning and organizing the premises. A buyer's initial reaction to the look and feel of the business premises will often make the difference between whether the buyer wishes to proceed with the purchase or not. The appearance of a company's premises reveals much about the company itself;
- Documenting all loans to or from shareholders and employees;
- Developing a comprehensive list of all of the seller's assets, including a detailed list of furniture, fixtures and equipment;
- Creating a list of all necessary governmental permits;
- Creating a list of all equipment leases, including details of monthly payments, number of payments remaining, and buy-out costs at the end of the lease terms;
- Compiling a list of the company's key employees, their job descriptions and their compensation packages.
- Compiling a list of the company's patents, trademarks and copyrights;
- Compiling information regarding the company's product and/or service warranties and warranty claims, and
- Compiling information regarding the use, storage and disposal of hazardous materials.

THE ASSET SALE

The sale of a small business that is either a sole proprietorship, partnership or LLC, is always considered an asset sale. A corporation may be structured as either a stock sale or an asset sale. **The definition of assets includes “hard assets” such as inventory, equipment and leasehold improvements, as well as “soft assets” such as goodwill, business name, reputation, etc.**

In an asset sale, the buyer will purchase specific assets of the business, either from the owner or from the corporation, and may negotiate to assume certain liabilities. The buyer usually purchases substantially all of the fixed assets and some current assets, including the furniture, fixtures and equipment, inventory, and the premises lease. Generally, the assets purchased do **not** include current assets such as accounts receivable, deposits, or cash, and the purchase does not include any of the liabilities. Whereas current assets such as accounts payable are usually **not** part of the sale, these and others may be considered during negotiations. The same is true for liabilities, such as equipment leases and other debts of the company. Keep in mind that anything may be negotiated to be part of the transaction.

In an asset sale, the cash in the bank accounts is usually kept by the seller. In addition, certain assets that are owned by the company but primarily acquired for the personal use of the owners - such as vacation homes, club memberships,

and automobiles - are not part of the sale. A buyer usually will **not** assume any liabilities for taxes, employees back wages, or employee benefits.

An asset sale permits the buyer some degree of latitude regarding the assets purchased and the liabilities assumed. It also reduces the likelihood that the buyer would be liable for the unknown liabilities of the seller.

THE STOCK SALE

A sale of 100% of the stock of a company is another method of structuring a purchase or sale of a business. When the stock is sold, a buyer will deal directly with the owners of the corporation as opposed to the corporation itself. In this type of transaction, the buyer acquires all of the shares of the corporate stock. This permits the buyer to effectively control the corporation by electing the board of directors and, thereby, controlling the management of the company. If there are multiple shareholders, they should all agree in advance to sell all their shares of stock so the buyer will acquire 100% of the corporation.

A stock sale has several advantages for the seller. Most notably, the seller's tax liability may be less. The favorable tax treatment results from the fact that, in most cases, the sale of stock will be taxed at long-term capital gains rate. In addition, the purchase price is paid directly to the seller. It is usually more difficult to minimize taxes for the seller in an asset sale since the proceeds are paid to the corporation which then distributes cash to the shareholders. When the sale is an asset sale, the buyer may be required to pay sales tax on the value of the equipment. If the sale is a sale of stock, there will be no sales tax due on the equipment, which can result in a substantial savings to the buyer.

However, a stock sale has several disadvantages for the buyer. The buyer of the corporate shares purchases the company and all its attributes, both good and bad as is. Certain items that can lead to substantial liability are cause for concern. These include liabilities for toxic wastes or hazardous materials, unpaid taxes, penalties and interest. There are ways to protect the buyer from many of these potential problems including indemnification, a thorough due diligence investigation and requiring the seller to make certain representations and warranties regarding the business. In addition, the buyer must assume the depreciation and amortization schedules as they currently exist on the corporate balance sheet. If the assets have already been substantially depreciated, the buyer loses the tax advantage of future tax deductions. In an asset sale, the buyer starts entirely new depreciation and amortization schedules based on the purchase price, and, therefore, gains a substantial tax savings.

SELLER FINANCING

The sale of a business usually requires the seller to finance part of the purchase. Sellers provide financing for several reasons. First, few individual buyers have liquid assets to pay the purchase price in full. Secondly, many sellers wish to defer and minimize the tax consequences of the transaction by spreading

the receipt of the sale proceeds over time and taking advantage of lower tax rates. Thirdly, as buyers explore businesses for possible acquisition, they will want to leverage their cash as much as possible. This means that buyers will give stronger consideration to those businesses that are sold with seller financing.

Seller financing is accomplished by the buyer executing a promissory note in favor of the seller. The promissory note is paid in periodic installments, usually monthly. **In negotiating the sale, the terms of the financing can be more important than the price of the business.** These terms include interest rate, late fees, duration of payments, the nature of the collateral, events of default and remedies. Since a major objective of the seller is to receive full payment of the purchase price, the collateral provided by the buyer and the events of default and remedies are some of the most important legal issues in the sale.

SECURITY

The **security, or collateral**, for the note is the property offered by the buyer to secure the payment of the note. The terms governing the security are set forth in one or more security instruments.

The issue of security may bring together the conflicting objectives of the buyer and seller and may be one of the most intensely negotiated issues. The seller's objective to obtain assurance that the full purchase price will be paid may be inconsistent with the buyer's desire to avoid committing personal assets and assuming personal liability if the business fails. As a result, the parties usually compromise on this issue. However, the issue of security is very technical and it is very important to understand the consequences of all options. (See addendum for discussion of real property collateral).

Collateral can consist of the assets of the purchased business, the shares of stock in the buying corporation, real estate including personal residences or income property, bank and investment accounts and personal guarantees. The collateral received by the seller is usually a combination of these.

It is very common for the buyer to provide the seller with a lien on the assets of the newly acquired business as security for the note. However, if the business fails, the security may have little, if any, value. Consequently, sellers will require the buyers to personally guarantee payment of the note. Under such circumstances, if the buyer defaults, the seller may pursue all of the buyer's assets to recover the amount owed. Since a personal guarantee puts all of a buyer's personal assets at risk, buyers often resist personally guaranteeing the purchase price. A common compromise is for the buyer to personally guarantee part of the debt or guarantee the debt for a period of time until the buyer demonstrates the ability to operate the business. This time period is shorter than the term of the promissory note.

SUBORDINATION

Another issue commonly arising in sales financed by sellers is the circumstances under which the seller will **subordinate its security interest** to the

security interest of another lender, usually a bank or the SBA lender, which will provide a portion of the purchase price as well as working capital to finance the business after the closing. Often buyers have used substantially all of their liquid assets for the down payment. The business may need working capital or other financing. If the seller has been granted a lien on the assets of the business being sold, and on substantially all of buyer's assets, the buyer will be unable to obtain the financing necessary to operate the business successfully.

It is common for a seller to agree to subordinate its interest under certain circumstances and usually only to banks and financial institutions, not private lenders. In addition, a seller may only subordinate to liens on certain assets such as accounts receivable or to loans for certain amounts where there is a sufficient cushion between the value of the secured assets and the amount owed. In the event of default, the party with a first lien on the assets must be paid in full before the party in the second position, the seller, can be paid.

EVENTS OF DEFAULT AND REMEDIES

In the situation where the buyer has failed to pay the amount due to the seller, the buyer often has defaulted on obligations to other creditors as well. The business may be suffering from a temporary cash shortage or the situation may be more critical. When the buyer's situation is critical, the buyer probably is not maintaining the equipment and other assets purchased, and not paying sales and payroll taxes and other important obligations. As a result, it is important for the seller to have the right to take action quickly in order to recover the unpaid portion of the purchase price.

The seller's right to take action to foreclose upon the security is governed by seller's right to **declare the buyer in default**. The circumstances under which a seller can declare the buyer in default on the buyer's obligations to the seller are referred to as "events of default." Since the seller is interested in receiving payment, the seller will want the events of default to be numerous and broad. The buyer, however, will want the events of default to be limited, and will want notice and sufficient time to cure the default.

To be adequately protected, the seller should insist upon events of default that permit the seller to take action early when trouble with the business is in its early stage. Having such rights may permit the seller to avoid a race among the creditors to obtain judgments against the buyer.

Once the buyer is declared to be in default, the seller then may resort to the remedies provided in the security instrument and California law. **The first remedy the seller must secure is the right to accelerate the amount owed.** The failure to secure this right in the security instrument severely limits the steps the seller can take to collect the amount owed.

The seller should contact his or her attorney to draft the promissory note to ensure that the rights of the seller are protected in case of default. The seller should not rely on the boilerplate promissory note language.

ALLOCATION OF THE PURCHASE PRICE

In an asset sale, the buyer and seller must **place a value on the items purchased**. These include all assets of the business; equipment, inventory, goodwill, covenant-not-to-compete, etc. Since the value of the items purchased must equal the purchase price, this process is referred to as “the allocation of the purchase price.” The tax consequences of the transaction flow from the allocation of the purchase price. Both the buyer and seller attempt to obtain the best tax advantages through the allocation.

With respect to the tax consequences, the seller usually strives to obtain capital gains treatment. The buyer desires an allocation that allows substantial tax deductions as early as possible. These objectives may be conflicting. The purchase price usually is allocated among inventory, furniture, fixtures and equipment, a covenant-not-to-compete, goodwill, leasehold improvements, real property interest (lease), patents, and consulting agreements with the former owner/operators. The amount of the purchase price allocated to these various items must be reasonably equivalent to their fair market value. Since “fair market value” is a vague concept, the parties have a great deal of flexibility in this area.

If the form of the sale is a stock sale, there is no allocation of purchase price. Technically, the buyer is just purchasing shares of stock in the company.

FURNITURE, FIXTURES AND EQUIPMENT

The portion of the purchase price that is allocated to furniture, fixtures and equipment will result in a scheduled deduction for depreciation for the buyer. That schedule will be pursuant to the appropriate depreciation schedule set forth in the Internal Revenue Code, which can vary for different types of property. The seller would pay taxes at the ordinary income rates for the gain realized on the furniture, fixtures and equipment (the amount received over the depreciated value as shown on the company’s balance sheet). In addition, state sales tax may be levied on the declared value of the furniture, fixtures and equipment, depending on the type of business sold. This is usually paid by the buyer.

COVENANT NOT TO COMPETE AND GENERAL INTANGIBLES

In almost every sale of a business there is a covenant-not-to-compete whereby the former owner of the business is prevented from engaging in a competing business. Often, this is a very valuable part of the transaction and, therefore, part of the purchase price may be allocated to this item. The buyer may amortize the declared value of the covenant-not-to-compete over a fifteen-year period. The recipients of the consideration for the covenant (the sellers) are taxed on such proceeds at ordinary income rates. This income is not subject to payroll or self-employment taxes.

CONSULTING AGREEMENT AND TRANSITION PERIOD

Generally, when there is a transfer of a business from seller to buyer, there is a transition period during which the seller assists the new buyer or its management in the operation of the business. The seller's obligations to assist in the transition of ownership usually are set forth in The Purchase Agreement. Likewise, depending on the nature of the obligations and time period for the transition, it is common for the parties to allocate a part of the purchase price to this item.

Since payment of consulting fees results in a tax deduction for the buyer for the year in which the consulting fees are paid, allocation of this part of the purchase price is favored by the buyer. Sellers must remember that they must pay self-employment taxes on the portion allocated for training and transition. If the business being sold is a corporation, the payment of this fee can go directly to the owner of the selling corporation, as opposed to the corporation itself. However, the seller may be subject to self-employment taxes on the consulting fee, which is usually offset by the reduction in the corporate taxes.

GOODWILL

The last amount calculated in the process of allocating the purchase price is the amount attributed to **goodwill**. This generally is the excess amount paid for a business above the values attributed to specific areas. The buyer may amortize the value of the goodwill over 15 years. Consequently, buyers tend to minimize its value in order to gain a faster write-off. Sellers, however, favor a larger amount for goodwill since the gain in that area is taxed at capital gains rates.

The allocation of the purchase price can result in saving or losing thousands of dollars. Sellers and their advisors must analyze the seller's tax situation and be prepared to negotiate for the best results.

COMPLETING THE TRANSACTION

NEGOTIATING THE OFFER

The Purchase Agreement will include many factors, all of which must be negotiated between the buyer and seller. Business owners should decide which factors are most important and which he or she is willing to concede. These determinations should be made well ahead of receiving an offer. Remember, generally speaking, to gain on one point, the party must be willing to concede on another point. Among the factors that will be negotiated in The Purchase Agreement for Business Assets are:

1. the purchase price,
2. the terms on which the purchase price is to be paid,
3. the security for the seller financing,
4. which current assets are to be transferred and which liabilities are to be assumed,

5. the method of handling accounts receivable,
6. the value of inventory to be included in the sales price, and how to handle excess inventory,
7. how to calculate work in progress and how much is to be included in the sales price
8. the length of the transition period,
9. the allocation of the purchase price,

PREPARATION AND NEGOTIATION OF THE DOCUMENTATION

Once the buyer has presented an Offer to Purchase, the real negotiations begin. **The buyer and seller should not be discouraged if there are several counter-offers presented**, since there are many issues to be resolved. Some of these will be monetary issues and other will not.

When using a Business Broker, the Purchase Agreement usually will include provisions to meet all the legal requirements necessary to complete the transaction. The Purchase Agreement includes not only the negotiated terms such as price, down payment, seller financing and terms, but also includes a substantial number of representations and warranties by the seller through which the seller certifies to the buyer certain facts regarding the condition of the business.

In addition, the Purchase Agreement contains certain conditions which must be satisfied in order for the buyer and seller to complete the transaction. The usual conditions to closing for the buyer include satisfaction with the due diligence review, obtaining a lease assignment or a new lease if necessary, obtaining necessary licenses and permits, obtaining financing if necessary and completion of the legal documentation necessary to consummate the sale.

Depending upon the size and complexity of the transaction, there normally are several additional documents that become part of the final purchase agreement, including promissory notes, security agreements, deeds of trust, lists of assets being transferred, consulting agreements, employment agreements, and the bill of sale. Some of these documents will be prepared by the escrow holder. Others, such as employment agreements or consulting agreements, should be prepared by an attorney and reviewed by the attorneys for all parties.

THE DUE DILIGENCE INVESTIGATION

In every sale of a company, the buyer conducts an investigation into the business, a process known as **due diligence**. This investigation not only is helpful to the buyer, but also serves to protect the seller as well. The goal of the due diligence investigation, from the buyer's perspective, is to fully understand the business, its markets, customers, legal position, and other risks inherent in the transaction. From the seller's perspective, the due diligence investigation is an opportunity to disclose all facts and circumstances regarding the business to the buyer.

The key to having a smooth due diligence process is for the seller to be organized **prior** to the commencement of the transaction, to anticipate all the items that the buyer will request, and to have them ready for delivery immediately upon request. In addition, there should be no surprises for the buyer. Each surprise uncovered by the buyer not only causes the buyer to be concerned about what is found, but also with what has not been found. With each new negative discovery, the buyer loses substantial confidence in the seller and the seller's business. The seller should take the initiative and disclose any negative aspects of the business to the buyers. In this manner, the seller can control the disclosure.

CLOSING

The date on which the title to the assets transfers is referred to as the **closing date**. The actual meeting where the transfer takes place is referred to as the **closing**. Many sellers tend to have mixed feelings at the closing. These include elation over the removal of the tremendous responsibility of ownership including making payroll, handling and supervising employees, collecting accounts receivable, etc. On the other hand, the seller no longer owns the business. Most sellers have spent years building and developing the business and are often depressed that they are "losing their baby."

POST-CLOSING MATTERS

TRANSITION OF OWNERSHIP

A critical period in the sale process is the transition of the ownership from the seller to the buyer. A poor transition can lead to decline and failure of the business. The difficulty in the transition results from a number of causes, namely, the difficulty a seller encounters in relinquishing the authority and responsibility he or she once possessed, the desire of the seller to focus on retirement or other business opportunities or on matters other than the operation of the business, and the discomfort that a buyer often experiences in dealing with the former owner. As a result, the closing of the transaction does not signify the end of the seller's responsibilities. The seller must focus on the transition period and ensure that the business under the new ownership has a good start and a smooth transition.

THE SUCCESSFUL SALE OF A BUSINESS

The sale of a business can be one of the most stressful yet rewarding activities engaged in by an entrepreneur. The sale of a business is the dream of every entrepreneur. By properly preparing the business for sale, assembling a team of qualified attorneys, accounts, financial advisors and professional business brokers, and understanding the process, an entrepreneur can help ensure a successful and profitable sale.

ADDENDUM

SECURITY FOR SELLER FINANCING

A note taken back by a business seller for part of the purchase price will customarily be secured by a lien on the assets of the business. The real value of an on-going business is its ability to generate income, not the potential proceeds from a foreclosure sale of its assets. By the time a foreclosure becomes necessary, the income may be substantially reduced and the value of the business assets insufficient to cover the balance owed on the note. Therefore, the seller may seek additional security from the buyer, such as a second deed of trust on a piece of real property. Brokers tend to discourage such requests, knowing that the average buyer will strongly resist. The request suggests to the buyer that the business is not worth the purchase price. Assuming the buyer can be persuaded to give a deed of trust as additional security, the seller must assess the pluses and minuses of such security.

If the lien securing the note is secured both by the business assets and real estate of the buyer, the seller has a security interest in “mixed security,” both personal property and real property. As long as an obligation is secured in part by real estate, the California anti-deficiency statutes apply. A deficiency judgment is a judgment for any amount of the obligation that is not satisfied by the proceeds of the foreclosure sale.

California Code of Civil Procedure (CCP) 580d provides that there can be no deficiency judgment after a trustee’s private sale foreclosure. CCP 726 provides that there can be only one action (lawsuit) on an obligation secured by real estate, which must be a suit to foreclose. CCP 726 has two aspects, the affirmative defense aspect, by which the buyer can compel that the seller’s one action be a judicial foreclosure, and the sanction aspect, by which the buyer can prevent the seller from taking any subsequent action against any security not included in the one permitted action. In addition, CCP 726 states that the buyer must be given credit for the fair market value of the real property, **whether or not that price is obtained in the foreclosure sale**.

The California Commercial Code (ComC) foreclosure procedure contained in ComC 9504 applies to liens on personal property (i.e., the business as collateral). There are no anti-deficiency protections for the buyer, except that the foreclosure must be done in a “commercially reasonable manner.”

There has been much discussion and uncertainty as to how the foreclosure approaches interact in a mixed collateral situation. The underlying purpose of the real estate anti-deficiency rules is to protect the debtor. The underlying purpose of the Commercial Code is to facilitate commercial transactions and protect the reasonable expectations of the parties including the seller/secured party. To help resolve the conflicts between these two approaches, the legislature has enacted ComC 9501(4), which lays the ground rules for foreclosure of mixed collateral. It provides that the secured party may proceed in any sequence, acting in accordance with the secured party’s rights and remedies contained in real property law as to real estate security, and acting in accordance with the Commercial Code as to security interest in personal property. The general rule is difficult to apply.

There is one overriding principal to keep in mind. **The real estate anti-deficiency rules will prevail to the extent applicable.** Therefore, any time there is a trustee's foreclosure on a deed of trust, there can be no subsequent deficiency judgment. If a lawsuit on the debt is brought, the debtor can compel that the lawsuit be one to foreclose on the real estate security.

As noted above, a deficiency judgment may be obtained as part of a judicial foreclosure suit on real estate. Such a suit is quite complicated and may require years to complete. Among other problems, the buyer will have one year to redeem the property after the sale and may continue to occupy the property during that period. A trustee's foreclosure sale will require a minimum of 4 months to complete and the debtor can reinstate the loan by paying the arrearage as late as 5 days before the sale. On the other hand, ComC 9504 foreclosure against the business assets can be completed in as little as 5 days, it is final, and it permits a deficiency judgment.

The foregoing is an overview rather than an in-depth analysis of the problems and choices presented in enforcing a lien on mixed collateral. Before the seller accepts mixed collateral, the legal ramifications should be discussed with an attorney. The seller may be better off to not taking any real estate security and rely only on the business assets as security and on the general creditworthiness of the buyer, or the seller may be better off in taking only real estate and not a lien on the business assets. Each case is unique and should be reviewed with the seller's attorney.