Chapter 16: Selling a Business: Finishing Steps

This section presents an overview of the steps needed to complete a sale. The letter of intent and purchase/sale agreements are some of the most important documents which one will draft and sign in his life.

Letter of Intent

The letter of intent is generally a one to two page letter which establishes a buyer's interest in purchasing the business. This letter is generally not legally binding. If the seller signs the letter, the seller is still not legally obligated to sell the business. A sample of a letter of intent can be seen in Figure 12-2 on page 274.

This letter performs a number of functions:

- it establishes the form of the sale.
- it indicates the basic terms of the sale.
- it establishes whether the transaction will be a stock or asset sale.
- it allows the buyer to contact the seller's bankers, accountants and attorneys in order to begin due diligence once the seller accepts the letter.
- it establishes all of the things which need to be accomplished before signing a purchase/sale agreement (see "Making an Offer/Letter of Intent" on page 273 for more discussion).

In addition, the letter should obligate the buyer not to disclose to anyone that negotiations are taking place. Also, the letter should restrict the seller from shopping the deal (e.g., going around and trying to get a better deal after he has signed the letter).

The letter is useful for the buyer to present to bankers, landlords and others during due diligence. This is generally a low key document and should be one to two pages long, so as not to scare the seller. Also, it should *not* have a lot of legal jargon. The document should state that it is nonbinding and that neither party is liable. After drafting the letter and reviewing it, the letter should be

hand delivered and explained to the seller. While the letter should be self explanatory, some issues may not be understood by the seller.

Due Diligence

Due diligence has already been discussed in Chapter 13. Accountants begin cash flow projections and checking financial statements while attorneys begin to check title or UCC-1 filings and potential lawsuits. Proformas (hypothetical financial projections) and a business plan should also be prepared.

Purchase/Sale Agreement

Of all of the contracts which you will ever sign in your life, the purchase/sale agreement is the most important. The purchase/sale agreement states all of the representations, warranties, and conditions for the close of the sale, and it is drafted by the buyer's attorney. Whatever is drafted in this contract is what may end up holding up or not doing so in court. In addition, if it has not been drafted correctly, then the buyer may have no recourse against the seller. In summary, the seller will have to live with whatever is or is not in this agreement.

Different Provisions

Robert F. Klueger, in his book *Buying and Selling a Business*[1] indicates that the following major provisions should be included:

Table 16-1: Purchase Agreement Provisions and Clauses

Provision	Clauses
• **Purchase and Sale of Business and Assets**	Include the seller's name in addition to the corporation. If the warranties and representations made to the buyer are not completed, then the buyer wants to be able to sue the individual; Itemize all items being sold so that there is no misunderstanding as to what is to be sold with the business and what is being leased, or not owned by the business. Sellers often want to take certain assets with them; Check to itemize the liabilities, if any, which the buyer will take on;
• **Purchase Price**	Any promissory note should be a separate document prepared as an addendum or exhibit; The seller wants to have the promissory note secured by an agreement. A UCC-1 financing statement which will be filed with the secretary of state or county clerk after the closing;

1. Klueger, Robert F. *Buying and Selling a Business: A Step-by-Step Guide,* John Wiley & Sons, 1988, pp.170-176.

Table 16-1: Purchase Agreement Provisions and Clauses

Provision	Description
• **Assumption of Liabilities**	Include a holdback provision since a buyer may end up paying debts which the seller did not disclose;
• **Allocation of Assets**	See that an allocation of the purchase price is made. This will clarify what is being sold as well as aid in later filing the respective tax returns;
• **Closing**	After signing the purchase agreement a buyer is obligated to go through with the deal. If the seller refuses to turnover the business on the scheduled date of closing, then the seller can be sued. A buyer can be sued if he or she fails to deliver the required funds on the closing date. If an obligation which a buyer or seller was required to complete did not happen, then the closing can be terminated or postponed.
• **Seller's Obligations at Closing**	Make sure that all officers and directors deliver their resignations at the closing, if they need to be re-hired.
• **Representations & Warranties**	The seller may have exaggerated on a number of items when negotiating the sale with you. But if he or she exaggerates on the representations and warranties, then it is a breach of contract; if any items turn out not to be true and thereby lowers the value of the business, then the buyer can hold back part of the money that has not yet been paid or sue to recover.
Organization, Standing and Qualification	Make sure that the corporate standing is still in existence with the state, and that it has not been dissolved.
Subsidiaries	Check that the seller did not conduct part of his business through a business entity that you did not buy.
Transactions with Certain Persons	This clause is stated so as to find out whether all business transactions are third party (arm's length) and that a large customer or vendor is not controlled by the seller. You do not want 50% of the sales to evaporate if the existing seller relationship (say with his brother in law) evaporates after the sale; Definitely see that there are no deferred compensation agreements with any employees or other persons; Follow through that any assets used in the business are only used by the selling company, and not part of a subsidiary. For example, you do not want to have to replace any assets just to maintain a business.
Execution, Delivery and Performance of Agreement	Check that the transfer of assets is allowed in the loan documents. The seller may not be aware of any clauses in his loan documents. Do not rely upon this representation - read all documents.
Financial Statements	Does the seller promise that the financial statements are true and that interim statements are provided up to the time of transfer. Minimum or maximum values may need to be stated for certain assets or liabilities.
Taxes	Check if the taxes have been paid, and/or there are no taxes outstanding; any audits or interest payments due as a result of a tax penalty need to be known.
Litigation	You do not want to purchase any lawsuits.

Table 16-1: Purchase Agreement Provisions and Clauses

Provision	Description
Compliance with Laws and Instruments	Know whether the seller has violated any laws and that the seller is not aware of any violations of existing laws.
Schedules	Spell out all the important items which the seller is obligated to provide you with, such as contracts, leases, licenses, agreements with unions, profit sharing agreements, etc. If any of these items are not delivered, then it is a breach of contract.
Absence of Certain Business Practices	Have the seller warrant that he does not have any illegal arrangements made or kickbacks in the works.
• **Conduct of Business Prior to Closing**	During the beginning and closing of the transaction (say over three months), the seller may allow the business to flop. You want to make sure that you motivate the seller to keep things as they are. This keeps the seller from doing anything non-recurring, such as giving bonuses, or allowing sales to fall, etc.
• **Access to Information and Documents**	After the purchase agreement is signed, the buyer wants to keep in close daily contact with the seller and the business. This provision would allow such access.
• **Conditions Precedent to Purchaser's Obligations**	This provision allows an escape clause for the buyer. If any conditions which you mention in this clause occur, then the buyer does not have to go through with the sale.
• **Bulk Sales**	This is only for an asset sale. You want to have the sale comply with the Bulk Sales Act.
• **Indemnification**	In this clause, you want to have the seller pay any additional damages over and above the holdback for anything which is not correct and true in the agreement.

Klueger, Robert F. *Buying and Selling a Business: A Step-by-Step Guide.* New York: John Wiley & Sons, 1988, pp.170-176.

Related Documents

The purchase/sale agreement typically has related documents such as:

- promissory notes
- closing or settlement statement
- an assignment of patents, tradenames or copyrights
- covenants not to compete
- consultation agreements
- employment contracts
- deeds and bills of sale
- financing statements or security agreements

These documents are separately drafted but are related to the purchase/sale agreement.

Pre-Closing

Pre-closing is a busy time. Many items need to be completed. If you are purchasing the assets and forming another entity, then you will have to have your attorney form it. You will need to visit the seller's vendors and customers, meet with key employees, and review problems with the business. Preparation to comply with the Bulk Sales Act must be made, and a new lease will need to be signed or assigned. In addition, an audit of the assets listed in the purchase/sale agreement should be made a day or two prior to closing. Make sure that the assets all work. If assets are broken or missing, then there is a breach of contract, or an adjustment to the sale price needs to be made.

Some people choose to use an escrow company, while others avoid them. Escrow companies are expensive, but can help in prorating funds and are sometimes less expensive than attorneys for checking the title of assets. Either way, adjustments need to be made for issues such as vacation accruals, personal or real property taxes, assumptions of liabilities, inventory valuations, receivable values, deposits, etc.

Covenant Not to Compete/ Consulting Agreements

There are two reasons for obtaining covenants not to compete and consulting agreements:

(1) you need to secure that the seller will not go into business or consult a competitor and compete against you; and

(2) if an asset sale is done, then an allocation of the value of the covenant not to compete, and/or consulting agreement as part of the overall purchase price is helpful.

Covenants not to compete (Noncompetition Agreements) should always be obtained. These agreements protect the buyer from the seller starting up a business next door, or anywhere in proximity to the business. These are generally described in the purchase/sale agreement, and a separate document is also drafted.

The agreement is not just for protecting the buyer against future competition. It also protects the buyer from having the seller disclose anything about the company, its processes, know how, technology, and so on. In addition, the agreement protects the buyer from having another corporation, (say owned by the seller's wife, brother or best friend), compete with you and then use the seller and his contacts as a consultant.

An attorney is a must at drafting this agreement since it has to hold up in court. Every state has different rules, so the agreement must be watertight. Generally, three to five years is usually seen as an acceptable time limitation in court, depending upon the state and local jurisdiction.