CHOICE OF ENTITY AND STRUCTURE OF SALE

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Introduction

The purpose of forming an entity and setting in place an agreement between parties is to protect your client's business and family assets. There are many variables and many options available when forming an entity. However, to properly represent your client, it is necessary to fully understand the intentions of the parties involved and to ensure that the parties are aware of the rules and consequences set forth by the agreements. Remember that an agreement sets out terms for not only forming the business, but management of the business and its profits or losses, all the way to transferring or ending the business at some point.

This program addresses some of the options for formation and transfer of a business, but also cautions that one way may work for one party and not for another. There is no standard fit and the agreement should be tailored to the needs of the parties involved.

Laws vary from state to state, so when forming companies and setting forth agreements, it is imperative that you consult state laws while drafting the agreement to make sure that all issues comply. This applies to not only the state where the company is formed but the particular state where the company will operate.

As always, this information is not intended as legal advice but as a generic overview of the options available to all parties involved in the formation of a company or an agreement relating to that company.

Choice of Entity

Which entity should I form for my new business? There are several types of entity formations to choose from, including corporation, limited liability company, limited partnership, general partnership, joint venture, disregarded entity, and a professional entity such as a professional association or a professional corporation. The following will focus on advantages in forming an LLC, LP, or disregarded entity in the operation of a business.

Limited Liability Companies. Generally for most small businesses, a limited liability company ("LLC") provides the most flexibility along with protection from creditors. The flexibility and benefits of an LLC include, but are not limited to, the following:

- Ugly Asset. Interests in an LLC are considered an "ugly asset" by creditors. In a corporation, if a shareholder is sued or subject to bankruptcy or similar action, then that shareholder's stock in the corporation is at risk of being lost because a creditor can obtain direct ownership in the stock. In the event a member of an LLC is sued or subject to bankruptcy or similar action, a creditor is entitled to a charging order in the membership interests of the LLC, but not actual ownership of the membership interests in the LLC. A charging order gives the creditor rights to distributions when made, but the creditor has no right to vote the interests in the LLC, has no right to force distributions, and has no right to force liquidation. Further, all income the creditor receives is taxed as if it were the member of the LLC. Thus, the creditor could have a tax liability without the offsetting cash to pay that tax liability. An interest in an LLC is termed an "ugly asset" because the creditor does not want to necessarily foreclose upon it for the foregoing reasons.

- Flexibility on Management. As a general rule, manager-managed LLCs are preferred as it adds an extra layer of protection around the members, so long as a member who is a manager respects the title. However, the members can choose to be a member-managed LLC, which some clients may prefer for simplicity.

- Flexibility in Management's Control. Management by Managers can be very broad or can be limited based on the company agreement. An example of limiting the Managers' power is the requirement of a majority or supermajority consent of the members for the LLC to borrow more than a certain amount in any calendar year.

- Flexibility on Classes of Ownership. One or more classes of membership interests, including voting and non-voting, can be created in the Company Agreement. The use of voting and non-voting interests is useful as a wealth transfer mechanism. It is also useful in situations in which the initial owners want to provide ownership interest in the LLC in exchange for capital, but such initial owners do not want the investors to be involved in any decision making of the business.

- Choice in Federal Taxation. Unless another tax election is chosen, LLCs are taxed as a partnership by default. WARNINGS: Beware that if you form an LLC taxed as an S-corporation, mistakes can easily happen because third parties hear the term "LLC" but never ask how the entity is taxed. Instead, they automatically believe it is taxed as a partnership. Further, company agreements need to be drafted such that references to capital accounts, distributions, capital commitments, and allocations of profits and loss, etc. are not included in the company agreement. Another pitfall of taxing an LLC as an S-corporation and making the assumption the entity is taxed as a partnership is making a transfer of an interest to an owner who is not qualified to be a sub-S shareholder.

Limited Partnerships. A close cousin to the LLC is the LP. An LP is an entity that has two kinds of interests, the limited partnership interests and the general partnership interests. The general partner manages the day-to-day operations of the LP and is responsible for all the liabilities of the partnership. It is advisable that the general partner be an entity and not an

individual. The limited partners are not responsible beyond their actual capital investment and, if applicable, of an agreed upon future investment generally referred to as a commitment (discussed below). A limited partner is a passive investor and the income allocated to it should not be subject to self-employment tax. However, if a limited partner is found to be acting in the business, then the income allocated to that partner will be taxed as self-employment income.

Forming an LP is appropriate in several situations:

- Active and Inactive Partners. If the LP will have multiple owners, some of which are active in the operations of the LP and other owners who are not active, it is easier to characterize the income earned by the non-active partners as passive income. Thus, avoiding self-employment tax.

- Securities Offerings. If the LP is to have investors in accordance with an Offering Memorandum and your client wants investors with limited voting rights, then the LP may be preferential. By their nature, limited partnership interests have very limited voting rights. Although two classes of voting rights may be created in an LLC, C-corporation, or an S-corporation, such classes of securities require stating the voting rights associated with the interests being offered, and offering "non-voting" securities may appear less attractive.

- Wealth Transfers. High net worth clients can use limited partnerships as a vehicle for wealth transfers by gifts or sales of limited partnership interests to their descendants, usually to one or more trusts for the benefit of such descendants. One advantage of using the LP in wealth transfers is that management and control of the LP is retained by the senior generation making the wealth transfers as the senior generation will be the owners and in the management positions of the general partner of the LP. Another advantage relates to gift tax and estate tax benefits which are beyond the scope of this article.

- Ugly Asset. Like LLC interests, LP interests are ugly assets to creditors.

The issue of choosing to tax an LP as an S-corporation carries the same warning provided above for LLCs.

Some other issues to consider when choosing to form an entity:

- Fraud on Creditors. It is important when recommending the formation of an LLC or LP, you ensure that such formation will not harm the existing third party creditors or potential known creditors of any assets to be contributed to the LLC/LP by one or more owners or by way of merger or conversion. The prime example of a potential known creditor – the threat of a lawsuit. If you form an entity when such issues exist, the formation could be deemed a fraud on creditors. Although this kind of fraud on creditors rarely rises to the level of criminal fraud, the person that recommends the LLC could be sued for conspiring to commit the fraud on creditors.

- Commitment. A commitment is an obligation to provide additional funding if requested to meet the cash flow needs of the LP and is generally, but not always, limited to a specific dollar amount. An LLC taxed as a partnership also may have the option to require a commitment. Generally, commitments are not recommended in my practice because if the business fails and has third party creditors, then the owners who have any remaining unused commitment could be required to fund that commitment to be used to pay those third party creditors. If the partnership agreement of the LP or the company agreement of the LLC requires a commitment or the owner agrees to make a specific commitment amount, the owner should be aware that if the owner changes its mind later, the owner would be in breach of its obligation and could be sued.

Disregarded Entities. The final situation to be discussed is the formation of an entity disregarded for federal income tax purposes. In the case of a sole proprietorship or a relatively small business that is owned by a husband and wife that has a true risk of liability, the formation of this kind of entity is appropriate to protect the owners from that liability. Under state law, this is an entity and should protect the owners from the liability of the business, no different than a corporation, an LLC with multiple owners, or limited partners of a limited partnership.

A few final thoughts on choice of entity:

- No matter what type of entity is used, for the owners to receive the asset protection provided by an entity, the owners must respect the entity and follow proper procedures. Many times the owners fail to follow proper procedures or comingle personal assets with business assets and such actions lose the protection of the entity. This is known as "piercing the corporate veil." If a creditor is owed money and the entity does not have the assets to pay, then piercing the veil will be threatened and the owners will be personally liable for such debts of the entity if it is determined that the entity has been treated as an alter ego of the owners.

- The owner will not be protected from the creditors of the business to the extent the owner is personally obligated to pay that debt, i.e., the guarantee of a lease or loan. For any obligation of the entity in which the owners have made a personal guaranty, the owners need to understand that they are liable to pay such guaranteed obligations even though the business failed.

- For a long time, failure of an entity to do annual minutes was a significant factor to be considered to hold the owner liable for the debts of a business. Several years ago, the law was changed to make this merely a factor and failure to do the annual minutes alone was not a reason to pierce the corporate veil.

- If the entity is a flow-through entity for income tax purposes, consider including a tax distribution provision. In other words, to the extent the entity has cash (less cash funds used to pay current operating expenses and to pay or establish reasonable reserves for future expenses, debt payments, capital improvements, and replacements), the entity is required to make a distribution to the owners to cover their income tax liability associated with their allocable share of income.

- It is very rare when a general partnership or joint venture makes sense.

- In a few cases, forming an entity that is taxed as a C-corporation is the better choice, but is beyond the scope of this article.

Who Will Manage the Entity?

Owner is One Person or Husband and Wife. The answer is simple if there is only one owner or if the owners are husband and wife. The owners will hold the board/manager/officer positions and will determine their distributions and salaries. However, there is one issue to be considered, if the business is formed during the marriage – how the ownership of the securities is titled can matter. Although an entity formed during marriage is characterized as community property under Texas law, it does not mean the voting rights will transfer to the non-owning spouse. In other words, if the entity is an LLC (as opposed to a corporation) and the LLC interests are in the name of John Doe, the non-owning spouse, Jane Doe, would receive half the entity in a divorce, but such ownership would be as an assignee and not as a member of the LLC. An assignee of an LLC does not have the right to vote or be involved in the management of the LLC.

Multiple Owners. In all other cases, where you have unrelated owners or multiple related parties, you need to consider the following to be included in the company agreement of an LLC, a partnership agreement, or under a buy-sell agreement of the owners:

- Is each owner entitled to management rights as a manager of an LLC or as a director of a corporation? If there are to be officers, who will fill those roles?

- Do certain actions require the consent of certain persons? For example, does a loan require more than a simple majority in a member-managed LLC?

- Are all owners involved in the business? If so, what is each person's role and/or responsibilities? What is their compensation, if any? Employment agreements make sense even in these situations.

- If the business has investors, how will they be paid back? Do they receive a preferential payment and/or a preferred return on their investment?

- Does an investor have the right to "put" his interest to the company? If so, how is the purchase price determined?

- If the entity has two equal owners, how is a deadlock handled? Is the deadlock broken by an arbitrator or is a push/pull mechanism used? A push/pull is where Owner A offers to

buy Owner B's interest, however, that triggers the right of Owner B to buy Owner A's interest on the same terms. I do not traditionally use a push/pull provision.

- If one owner sells their interest, does it give all other owners the right to participate on a pro rata basis? This is known as a tag along right.

- The reciprocal of the tag along right is the drag along right. If a certain percentage of owners vote to sell the business, then the other owners could be forced to sell on the same terms and conditions.

- Are ownership interests subject to a right of first refusal? If an owner wants to sell, then that owner must give the other owners the right to purchase his or her interest on the same terms and conditions as a third-party offer.

- Other restrictions on transfers include death of an owner, incapacity of an owner, total disability of an owner, divorce of an owner, or bankruptcy of an owner. All of these situations could give rise to the option to purchase the interest of that transferring owner regardless of reason. However, if the spouse of an owner is not also a direct owner, then it is very important that the spouse consent to the agreement in writing. Also, if you are asking the spouse to sign the agreement, I strongly recommend a consent that explains the spouse's legal rights, including the right to hire his or her own lawyer.

- If you have an entity taxed as an S-corporation, it is imperative that you restrict transfers to qualified shareholders.

- In the event of a sale of an owner's interest, other than in the case of the right of first refusal, what is the purchase price? Is it a formula as agreed upon? Most often this is not a preferred method because the formula today may not accurately reflect the value of the business in the future. Is it as agreed between the owners from time to time? Again, this is not recommended because owners forget to update the values. If the owners cannot agree at the time of the event triggering the purchase, then the use of an appraised value is suggested. If the owners cannot agree on one appraiser, then it is suggested that the agreement provide a provision that the purchase price will be the average of three appraisers. You also need to determine whether or not to apply any discounts to the valuation, such as a discount for lack of control (because it is a minority interest) or a discount for lack of marketability (because the entity is not publically traded). Or, in the alternative, should a premium be applied because the interest being sold is a majority interest?

- Are there certain events where the purchase price will be less than fair market value? Certain situations give rise to a discounted purchase price, such as an owner who is to be active in the business quits before a certain date or some other important issues. Further, sometimes an owner is expelled for no consideration, such as for embezzlement from the company or formation of or activity in a competing business.

- Are the owners subject to a non-compete or any other obligations? Investors traditionally are unwilling to sign a non-compete. On the other hand, owners active in a business should be required to sign a non-compete and have a duty of loyalty to the business.

- There are many other issues to consider when forming a business that are beyond the scope of this article.

You Now Have a Successful Business but Want to Exit

An owner may want to sell for many reasons, health, age, no family member to take over the business, or it is time to sell because the market conditions are right. Or, they just want to do something else.

Regardless of the reason, the transition from the business is dictated by the method of transition. Although many issues are the same, there are differences regarding family transition of the business that will be addressed below.

Family Member Acquiring the Business

- <u>By Gift During Life</u>. Some clients require or desire that the business remain in the family. For estate tax reasons, it is advisable to make gifts of the securities of the business entity during the owner's life. Some issues to consider when using this method are:

    - The senior generation should retain control during their lives or until their desired retirement. To accomplish this, the entity will be capitalized (or recapitalized, as the case may be) into voting and non-voting securities. The senior generation will keep all voting securities but will transfer, in one or more events, their nonvoting interests to one or more children's trust. Traditionally, those transfers will be made to a trust to offer protection from creditors and divorce, and if done correctly, the trust will not be subject to estate tax at the recipient's death. The benefits of a trust are beyond the scope of this article, however, before making a gift to a trust, you need to verify the trust is a qualified owner of an S-corporation, if applicable, and consider the tax for the Affordable Health Care Act.

    - Although the transfer of securities in the business entity is a gift, the phrase "No good deed goes unpunished" applies. Before making a gift of the securities in the business entity, you should require the recipient to sign certain agreements. If it is a partnership or an LLC, the recipient needs to agree to be bound by the terms of the applicable LP or LLC agreement. If the interest being transferred is stock in a corporation, or interest in an LLC or LP that does not have transfer restrictions as part of their company or partnership agreement, it is recommended that the recipient and other owners sign a buy-sell agreement restricting the selling or

transferring of the interest. Just because they are family does not mean they will not disagree.

- Other agreements to consider include the senior generation's compensation and how disagreements are to be settled.

- If the desire of the senior generation is to transfer the business to all of their children, one thing to consider is if all of the children will be involved in the business? If not, then the children that are involved in the business will have different goals from children not involved in the business. This conflict can be avoided by transferring different assets of equal value to those children not involved in the business, rather than interests in the business entity.

- Assuming the transfers will be made to all children of the senior generation, then it is important to provide management transition. Mechanisms to consider are employment agreements and succession management planning. Succession management planning can include naming successors to fill officer positions and to provide that an officer can only be removed for "cause." This is to avoid the potential of other family members aggregating their votes to remove the "child" most active in the business from the business.

- Another management transition option is to require a Board of Directors/Managers that must approve certain actions. This Board is put in place by the senior generation naming successors in the event a current Board member is unable or unwilling to serve. A Board can provide stability during a transition period.

- **Death of an Owner**. Many of the issues considered under the gift scenario above are applicable at death. However, there are a couple of options to consider.

  - By way of an option agreement or under the terms of the Will, at death, one child has the right to purchase the business. The option agreement or terms of the Will provide the terms and conditions of the purchase price. This avoids the conflict between the heirs associated with the negotiation of the purchase price. It also avoids the inherent conflict associated with the ongoing operations of the family business.

  - Sometimes the owner of the business desires to provide one or more key employees an opportunity to purchase the business in a similar fashion as described above for a child.

In either case, it is important that all necessary business documents be signed. Further, if there is seller financing, which is most likely the case, the parties must understand those terms and the lending party must be willing to foreclose on the note in the event of default.

If the family owns real estate in a separate entity that is necessary for the business, it is important a long-term lease is involved between the two entities. The child that owns the business has an interest to get the lowest rent possible. On the other hand, if other children own the real estate entity, then they have an interest in getting the highest rent possible. To avoid that conflict, a long term lease will provide the rules for many years. Also, such a lease could provide the tenant a right of first refusal to purchase the real estate. The long-term lease also makes sense in the gift situation, even though the parents are alive, because it protects against the same potential conflict.

What if none of the children are involved in the business and the owner dies? The owner's children may have no interest or be unable to take over the business. If no key employee is scheduled to purchase the business, then we strive to avoid a "fire" sale. Upon the death of an owner, employees will many times begin looking for another job because they are concerned about the future of the company. In this case, it is imperative to name a successor President while the owner is alive. Further, it may even make sense to name a Board to vote on certain key issues. Finally, it probably makes sense to authorize retention bonuses for certain key employees. The retention bonuses would provide that "upon the earlier of two years or the sale of the business, employee will receive X amount." The goal is to provide continuity and avoid a misstep.

Sale of Business. Assuming the transition is not by gift or due to death, then it will be a sale. If it is a sale to a family member, key employee or unrelated third party, they should all be approached in the same manner. Some of the things to do in preparation of a sale are:

- Before a sale is negotiated, the business should be analyzed to determine what expenses the business currently has that a new owner will not be required to pay. Thus, we want to get to normalized EBITDA.
- Are financials done in accordance with GAAP?
- What assets in the business does the owner not want to sell?
- Determine if the business is minority-owned and what ownership is integral to its success.
- What liens are on file with the state?
- Are there any special license or regulatory requirements?
- Educate the seller about the process. It is important that the seller understand the due diligence requirements. The process can be lengthy and frustrating.
- The seller needs to understand a capital lease is most likely a lease the buyer will not assume. Instead, it will be treated like debt and need to be paid at closing.
- Finally, determine if the seller is realistic about the purchase price.

Non-disclosure Agreement

Before providing information to anyone, the recipient of the seller's information should sign a non-disclosure agreement ("NDA"). The NDA requires the recipient of the seller's information to keep such information confidential and not to use it in a way to harm the company being sold.

Brokers

If hiring a broker, make sure they are reputable and knowledgeable in the particular industry. It is important that the owner have the lawyer review the broker agreement before the seller signs it. The lawyer will review for how the transaction amount is determined and how the commission is paid on contingent payments. For example, does the seller need to pay a commission on assets retained or does the seller pay commission on future potential earn out, even if not paid by the buyer.

A Buyer is Found

Letter of Intent

- The buyer will issue a term sheet or letter of intent (LOI). Again, it is important the lawyer review the LOI because this is where negotiations begin and deals break down. Even though the LOI is not binding, it will be relied upon in negotiating the final agreement.

- Also, the LOI will many times contemplate an asset purchase. However, that may not be the best way to structure the deal. If the business has certain licenses or other assets that cannot be transferred, the buyer may need to buy interests in the entity. Or, if the business is a C-corporation, then the double tax system will be overly burdensome. Although buyers prefer to purchase assets, we can provide protection from creditor claims through escrow accounts or holdback accounts. However, if the buyer cannot purchase assets, the buyer will not be able to deduct (depreciate) the purchase price against future income from the business.

- Once the LOI is signed, the due diligence process begins. The due diligence process is exhaustive. I always stress to the seller – disclosure, disclosure, disclosure. This is now the time to tell us everything because if something shows up after closing, it is much harder to address or negotiate. The attorney needs to know about every contract (including yellow page ads, copier lease or postage machine), any threat of lawsuits, any notice that a customer is leaving, any issue with equipment. Have the client ask himself, "What would you want to know if YOU were buying the business?" It will need to be determined what contracts require consent or if any notice needs to be provided to regulatory agencies.

- Once due diligence process is complete and the parties desire to proceed, the formal agreements are drafted. In reality, the documents are drafted simultaneously with the due diligence process.

Sale Agreement. The following are certain key points of the sale agreement to keep in mind:

- Representations and Warranties. What representation and warranties are being provided? Make sure you go through them with your client. When representing the seller, always strive to get a knowledge qualifier. For example, "to the knowledge of the seller, there are no environmental issues." On the other hand, a buyer wants less limitation, therefore, we will agree on "To the best of seller's knowledge." This means the seller had some duty to inquire.

- Purchase Price. The other important issue to negotiate is the purchase price. The determination of purchase price is not that easy. The purchase price includes the amount to be paid at closing. It is very rare to get all cash at closing. Inevitably, there are future payments, whether it is in the form of seller financing, earn-out, escrow accounts, or stock/securities in the buyer.

  The buyer wants deferred money for various reasons. First, the buyer wants contingent money because if something goes wrong and the buyer is owed money, the buyer has an asset to offset the claim against. In other words, if after closing, a creditor makes a claim for payment, the buyer can offset that payment by reducing the Seller financing or receiving payment from an escrow account. Second, if there is contingent money, the seller is motivated for the buyer to succeed and will remain involved for a period of time. Third, if the buyer borrows money from a bank, the lender prefers for the seller to remain involved because it helps protect their loan.

  Any time contingent or deferred proceeds are involved in the sales price, the seller should be told there is no guarantee they will receive those payments. Therefore, in determining their desire to sell, assume they only receive the cash at closing. If the seller then receives the contingent or deferred payments, it is a bonus.

  There is a difference in deferred payments. If the deferred payment is in the form of a promissory note, earn-out or escrow account, the seller is not taxed on such amounts until received.

On the other hand, if the consideration is stock/securities in the buyer, then that consideration is taxed at the time of the closing. Thus, the seller is obligated to pay income tax on assets they cannot connect to cash. It is important for the seller to understand that obligation.

Further, it is important that the seller understands that stock in another closely-held business is risky. The company may never sell, go to public, or worse, it could fail. If the closely-held business fails, then the seller has a capital loss but traditionally has no other recourse. The seller must feel comfortable with the buyer's company and should conduct its own due diligence of the buyer.

- Allocation of Purchase Price. After the purchase price is negotiated, it will be allocated to the assets purchased. Again, sellers and buyers have different goals. Sellers desire to allocate as much as possible to goodwill because it is taxed at capital gains tax rates. However, this asset is depreciated over 15 years.

  On the other hand, buyers desire for the purchase price to be allocated to furniture, fixtures, and equipment because the depreciation schedule is much faster, thus, providing much better cash flow in the early years of purchase. However, such an allocation is, most likely, subject to depreciation recapture, which is taxed at higher rates than current long term capital gains to the seller.

  The other asset that involves negotiation is the amount allocated to the non-compete. This is an ordinary income tax item to the seller, so the seller will want very little of the purchase price allocated to that item.

- Post Closing Obligations. The next issue to be negotiated is the obligations of the seller post-closing. In other words, after closing, what is the seller liable to pay for actions or unknown claims that occurred prior to closing? Of course, Seller does not want to be obligated to pay anything and the buyer wants Seller to pay for everything. Thus, a period of time for which the seller is obligated to pay is negotiated and known as the indemnification period. The period of time will generally range between one year (seller wants shortest time frame) to two years or more (buyer wants longer time frame), with the negotiations usually settling for 18 months. If an issue presents itself after the expiration of that period, the seller is not liable and the buyer pays. Notwithstanding a limited period to make claims, such limitation does not apply to "fundamental items." The seller will be liable for the applicable statute of limitations if the seller did not pay its taxes, misrepresented itself, or committed fraud.

  In conjunction with negotiating the limitations period, a "basket" and a "ceiling" are negotiated. Before a seller is liable to pay any claim, the aggregate amount of the claim needs to exceed a certain amount (the "basket"). There are two ways this is handled, either as a true "deductible," where the seller is obligated to pay all amounts above that threshold amount. Or, it is treated as a threshold, where if the aggregate amounts owed exceed that threshold, the seller is obligated to pay all amounts from the first dollar. On

the flip side, the seller does not want to be obligated to pay for claims beyond a certain amount. Therefore, maximum liability (the "ceiling") can be negotiated so that once paid, the seller is no longer liable for any amounts beyond the ceiling amount. The "basket" and "ceiling" do not apply to select key points such as taxes, fraud and misrepresentation.

- Non-compete. Although the seller knows there will be a non-compete, there is always the fear that something will go wrong and they will need to be employed. Thus, the seller will strive to narrow the scope of the non-compete. Of course, the buyer is paying for the business and wants it to be successful and the last thing the buyer wants is to compete with the seller. The non-compete is usually 3-5 years, though negotiating longer periods when seller financing is involved is advised. If the seller financing is for seven years, then the non-compete period should be no less than seven years.

  If the buyer defaults on the seller financing and seller forecloses on its security interests, then the purchase agreement should provide for the termination of the seller's non-compete. However, if third-party financing is involved in conjunction with seller financing, the third-party lender may not agree to this provision because it affects the lender's interest because if the seller's non-compete terminates with the foreclosure, it affects the value of the business in foreclosure. A buyer in foreclosure would pay less if the protection of the non-compete is no longer available.

  In negotiating the non-compete, consider specifically including not only the sellers, but also the seller's immediate family.

- Right of Offset. One final issue that can be contentious in negotiations is the right of offset. If the buyer is owed money pursuant to the indemnification provisions, the buyer does not want to pursue collections, but would rather reduce the amount under any seller financing. If this happens and the seller does not agree, then it shifts the burden to the seller to sue for the monies.

  If a right of offset is not included, then the burden is on the buyer to pursue the claim and seek collection. Traditionally, a right of offset is included if there is no escrow accounts or holdback amounts.

After the Business is Sold

Seller. You sold the business. What are your obligations? Once the business is sold, people like to relax and forget about important issues. However, that is a mistake.

- If there is seller financing, the seller needs to stay diligent about the buyer meeting the terms of the financing. If the loan has covenants such as providing monthly financials or annual tax returns, then the seller needs to make sure to get those items. They can provide

information on how the business is doing and whether future payments are at risk. Also, if a seller remains diligent, it is less likely the buyer will try to get away with anything.

- The diligence discussed in regard to promissory notes should be applied to any other post-closing payments, such as working capital adjustments, earnouts, or inventory calculations. The seller needs to make sure that any adjustments are reviewed by their CPA and lawyer.

- Further, if the seller received stock/securities in the buyer, then the seller should review financials and attend shareholder/members/partner meetings.

- If the buyer was family, the same rules apply. If the buyer is not meeting their obligations, then the seller (most likely parents) needs to send a default notice and be willing to foreclose on the promissory note. The parent seller is often reluctant to pursue foreclosure, but they may not have a choice. If the seller does not foreclose, it will affect the lifestyle of the seller, as they have lost their income stream.

- In many cases, the family home is the most significant asset. However, in the case of the business owner, the closely- held business is the most important asset. Also, many times profits are reinvested in the business; therefore, sellers do not have any other significant retirement or investment accounts to rely upon if they do not receive the sales price. After they sell their business, where they receive all cash or significant portion of the purchase price is paid in cash, they believe they are wealthy because they now have cash, though their net worth has not changed. It is imperative that the sellers are counseled on investments and a budget. In some ways, it is no different than hitting the lottery. The seller needs guidance.

Buyer. You purchased a business. What are your obligations?

- First, the obvious, operate the business and make your payments on all promissory notes and other company obligations.

- Next, make sure the seller is not violating the non-compete. Although most sellers are ethical, there are some that look to take advantage by starting a competing business. If that happens, the buyer must enforce its rights under the non-compete.

This article does not attempt to comprehensively address all issues of a business sale or transaction. Instead, it strives to address the key points and make you aware of the many issues that must be considered. There are many other issues that are involved, such as employment agreements, assignment of contracts, and lease terms. The sale of a closely-held business is complex and emotional. A good transition not only addresses the business terms, but also considers the emotions of the client and their life after the sale.