McCLAIN & ELLIS LLC

ATTORNEYS AT LAW

1512 LARIMER ST.
SUITE 600
DENVER, COLORADO 80202
TELEPHONE: (303) 860-8400
www.mcclainellis.com

≈≈≈≈≈≈≈≈≈≈≈≈≈

WHAT TO EXPECT WHEN BUYING OR SELLING A BUSINESS: THE LEGAL PROCESS

≈≈≈≈≈≈≈≈≈≈≈≈≈

The sale or purchase of a business is typically an important, and sometimes a life changing, transaction for both the buyer and the seller. While the experience can be exciting and rewarding, it can also be stressful.

Knowing what is involved in the process of negotiating the legal documents may help you form realistic expectations about the time and effort this type of transaction requires. It may also help you to manage the range of emotions that buyers and sellers typically experience as the closing approaches.

The Letter of Intent

One of the first documents the parties will execute is often a "letter of intent," sometimes referred to simply as a term sheet. The purpose of a letter of intent is not to create a contract, but simply to ascertain whether the parties see "eye to eye" on enough points to justify moving forward.

It is important to understand that the letter of intent does not set forth *all* of the terms the parties must agree upon in order to close the deal. Instead, a letter of intent is just a brief summary of several key terms that will be incorporated into a comprehensive purchase agreement. Whereas a typical letter of intent might be two to three pages long and in bullet-point form, a typical purchase agreement for the same transaction might be twenty to thirty pages long.

Although letters of intent are usually *non-binding* (except as to certain terms such as confidentiality and "no shop" clauses), it is nevertheless very important to consult your attorney before signing a letter of intent. Once you accept a particular term in the letter of intent, you should be prepared to stick to it, or the other party may think you are acting in bad faith. If any terms in the letter of intent subsequently turn out to have a downside you did not foresee, you could find yourself having to backtrack, which is never a good negotiating position.

It is also important to be aware that letters of intent can (sometimes unintentionally) become *binding* contracts, depending on how they are worded. If, as in most cases, you do not want a binding letter of intent, be sure to have your attorney review it before you sign it.

Due Diligence

Once the parties are ready to move forward, and after the buyer has executed a suitable

© 2013-2018 McClain & Ellis LLC. All rights reserved.

confidentiality agreement, the "due diligence" process begins. Usually, the buyer sends the seller a list of materials the buyer would like to review before committing to purchase the business. If the seller is extending credit to the buyer, the seller may likewise request some financial due diligence materials from the buyer.

Responding to a buyer's due diligence requests can be a time consuming project, as it generally requires finding and copying (or scanning) a good deal of documents and records spanning several years. Typically this must be done by a trusted employee of the seller who is familiar with the intricacies of the business. It is also important that the exchange of these materials be done in an organized fashion, to ensure there is a clear record of exactly what was produced. Without a clear record, a buyer could potentially claim that the seller failed to produce material information. In transactions involving a large volume of documents, the due diligence process can be greatly facilitated by the use of virtual data rooms.

Sometimes, during due diligence, a buyer discovers information that might warrant a price reduction or other alteration of the original deal terms. At the start of the negotiations a savvy seller should be aware that due diligence might open the door for the buyer to try to re-negotiate some of the terms.

The Purchase Agreement

Once due diligence is complete, the parties must negotiate a written purchase and sale agreement. If there is a letter of intent, the terms of the letter of intent can simply be restated, with more precision and detail, in the purchase agreement.

However, as noted above, a letter of intent only contains some of the essential terms of the deal, and its brevity and simplicity can be deceptive. Often (if not always), the terms in the letter of intent implicate many other business and legal issues that must be identified and addressed in the purchase agreement.

For example, in an asset sale transaction, the purchase agreement must specifically identify each and every asset and liability to be transferred from the buyer to the seller. Sometimes this requires detailed schedules, so that there can be no confusion or disagreement about who gets what. Depending on the nature of the business being sold, the schedules to an asset purchase agreement may consist of lists of equipment, inventory, accounts receivables, accounts payable, etc. As with due diligence, the preparation of schedules to the asset purchase agreement can be time consuming and must be done by a trusted employee of the seller.

Another important issue that must be addressed in the purchase agreement –and which is almost never addressed in the letter of intent– is the scope of the seller's "representations and warranties" regarding the business. Typically the buyer requires the seller to make certain promises, such as promises regarding the condition of the assets, the correctness of financial records, the absence of undisclosed liabilities, etc.

Unfortunately, representations and warranties can be a minefield of potential liability for the seller if not drafted properly. Overly aggressive representations and warranties can put an unsuspecting seller in the dangerous position of making unreasonable guarantees to the buyer, essentially turning the seller into an insurance company for the buyer. Likewise, poor drafting can leave an innocent buyer without adequate recourse if the seller's promises later prove to be untrue.

In general, properly drafted representations and warranties enable the parties to allocate certain risks between them. Appropriate allocations of risk depend on many factors, including the nature of the business, the price being paid, and many other terms of the deal. If one party is willing to assume more risk than the other, the purchase price and other terms of the deal should reflect that.

© 2013-2018 McClain & Ellis LLC. All rights reserved.

Related Documents

In addition to the purchase agreement, the following are some related documents that may also be needed, depending on the transaction:

- Promissory note from buyer to seller, along with a security agreement (for collateral) and personal guaranty
- Employment or consulting agreements between buyer and key employees of seller
- Real estate documents relating to seller's business facility, such as a deed, lease, or sublease
- Bills of sale (for personal property)
- Certificates of title (for vehicles)
- Assignment agreements for transferring specific contracts between seller and its customers or vendors. *Note that the consent of the seller's customers and vendors may be required for the transfer of these contracts to the buyer.*

Bank Documents

If the buyer is obtaining loans from both the seller and a bank, the bank will likely require the seller's loan to be subordinated. It is customary for the bank to provide its own forms of subordination documents, but the documents must be carefully reviewed before signing them. Unfortunately, bank forms typically contain one-sided "boilerplate" language that favors the bank – sometimes, to an unreasonable extent. In our experience most banks are willing to make a few brief changes to their subordination documents upon request, but otherwise they tend to be largely non-negotiable.

Sometimes, the bank does not make its documents available until just before the closing – at a point when the parties have invested a lot of effort into the transaction and are most anxious to complete it. This type of "eleventh-hour" disclosure by the bank can put the seller in the uncomfortable position of having to make last minute decisions about bank documents that may contain unreasonable terms. It is not always possible to avoid this, but ideally the bank's subordination documents should be requested as early as possible.

The Closing

Once all of the transaction documents are finalized, including any bank loan commitments, the closing may take place. These days, many closings occur by electronic exchange of documents and funds, rather than in person.

Keep in mind that the closing date depends on how quickly the parties are able to work through the terms of the various agreements – it is usually *not* just a matter of picking a date on the calendar. In our experience, buyers and sellers frequently underestimate the amount of time it takes to work through the issues of transferring a business. The amount of time required to close usually depends not on the number of documents to be drafted, but on the extent to which the parties are able to reach agreement. It is a relatively simple matter to draft documents that reflect what the parties have agreed upon; but the process of reaching agreement takes some time. To keep things moving along, it is a good idea to set a target date for the closing, but each party should be prepared for the possibility that the closing might not necessarily happen on the selected date.

Tips for Successful Negotiations

To facilitate the process of working through the issues with the other party, and to ensure that the resulting written agreements protect your interests to the fullest extent possible, here are a few thoughts to keep in mind.

Understand the Other Party's Legitimate Concerns

For both a buyer and a seller, a transaction of this nature can be daunting. Each party probably worries to some extent about things that might go wrong.

© 2013-2018 McClain & Ellis LLC. All rights reserved.

For example, a buyer may be wondering:

- Is this business really worth what the seller says it is worth? How can I be sure of that?
- Are there liabilities I don't know about, such as undisclosed debts, environmental contamination, lawsuits, etc.?
- Will I be able to run this business successfully? What if the key employees don't stick around to help me? What if the seller's customers don't want to do business with me?

A seller may be wondering:

- Is the buyer able to fund this transaction?
- If the buyer is paying a portion of the purchase price by a promissory note, can I trust the buyer to make the payments after the closing?
- If a portion of the purchase price is being paid as an "earnout," is the buyer capable of running the business successfully so that the earnout targets will be achieved?
- If the buyer is borrowing from a bank, to what extent will I be subordinated to the bank? If the buyer defaults, will the bank take all of the buyer's assets, leaving the buyer's debt to me unsecured?
- If a key employee of the seller has agreed to work for the buyer for some period of time after the closing, will the buyer be a good employer? What will it be like to work for an employer who may not know how to run the business yet?

These types of issues are likely to come up, directly or indirectly, during the negotiations. Sometimes, one party may believe its concerns can be addressed only in one way, when in fact there may be other ways to achieve the same result. Understanding the other party's concerns can make it easier to find alternative, mutually acceptable solutions.

Choose Your Battles

Of course, there are times when a party makes demands simply for the purpose of getting a better deal, rather than to resolve a genuine concern. In our experience, some people believe successful negotiation means driving a hard bargain right up to the closing date. Unfortunately, that approach usually only works when one party is in a stronger bargaining position and has leverage. Otherwise, the other party may simply call off the deal. To reach a successful closing, both parties should choose their battles wisely.

"The Devil is in the Details"

Although we all like to keep things simple, the fact is that most successful business ventures involve a lot of "details." If not addressed properly, seemingly minor matters can unexpectedly turn into major problems later on. To avoid loose ends and unpleasant post-closing surprises, it is important that the written agreements address the fine points of the transaction, in addition to the obvious bigger issues. Unfortunately, thoroughness sometimes requires a lot of paperwork.

Careful attention to the details of the drafting process is also necessary, such as the use of correct terminology and phrasing. Although the parties may completely agree on a general concept that is briefly identified in the letter of intent, there is often more than one way to express the same concept in the formal agreements. Different ways of expressing a concept may result in different nuances in meaning, which could affect the interpretation of the document later on.

Keep in mind that, in the event of a dispute after the closing, your rights will be governed by the written agreements, so it is worth taking the time to ensure they are written correctly. Bad

© 2013-2018 McClain & Ellis LLC. All rights reserved.

drafting can be very costly, because ambiguous or imprecise words and phrasing leave the door open for arguments and lawsuits later on. The fact is, even if both parties enter into a transaction with good intentions, disputes sometimes arise, whether due to unexpected changes in circumstances, or for a multitude of other reasons. While it may seem tedious, the process of drafting and re-drafting documents to achieve mutually acceptable wording is a necessary one, as it is the only way to ensure the documents reflect the actual agreement of both parties.

Despite everyone's best efforts, it is not uncommon for transaction "fatigue" to set in at some point, especially if the closing does not happen as quickly as expected. When it seems like the closing is within reach, but there are still a few final issues to work though, it can be tempting to simply concede or ignore them for the sake of getting the deal done. This is a judgment call, but if you begin the transaction with realistic expectations about the closing, you may be less tempted to make concessions out of impatience.

Remember – You Have The Final Word!

As your attorneys, our sole objective is to help you achieve your goals in the transaction, *based on informed decisions*. It is our job to identify and explain the legal issues and risks to you – even if this sometimes means giving you bad news when you would rather not hear it.

In almost every transaction, both parties must accept some degree of risk and make some concessions in order to close the deal. Ultimately, you must decide which risks you are willing to take and which concessions you are willing to make. Understanding the legal issues involved in these decisions will enable you to act based on informed judgment.

© 2013-2018 McClain & Ellis LLC. All rights reserved.