

# Buying or Selling a Small Business... from a Legal Perspective



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Whether you are a business owner looking to sell, or a would-be owner looking to buy, asking the right legal questions up front can spare you from many problems later.

The information below generally applies to the arms-length sale between a Seller and a third-party Buyer. If one partner is buying out another partner in a business that they co-operate, things change dramatically.

## **Do I Need a Lawyer?**

Yes, regardless of the size of the transaction, you need an attorney to represent your interests, and to ensure the purchase agreement (and related documents) are consistent with your objectives. Some will say: "*I don't need a lawyer, I have a business broker*". Great, but you need both. While there are a handful of really good business brokers out there who pay close attention to fine details, most simply use boilerplate forms to get the deal closed quickly (so they can earn their commission). If you need a referral to a really good business broker, call us.

What kind of a lawyer should you look for? Most importantly, one who specializes in law for small businesses. Too many otherwise talented consumer attorneys (family law, personal injury, etc.) try to dabble in business law to their client's detriment. Also, remember, we said small businesses. Selling a business with 30 employees is not the same as selling one with 300 employees. Hiring a big firm's lawyer that also does Fortune 500 mergers and acquisitions can easily run up a five-figure legal bill that you weren't expecting.

## **What Happens, and in What Order?**

In a typical small business sale, things tend to work like this:

- 1) Letter of Intent. Once a seller and buyer show mutual interest, they should immediately execute a Letter of Intent ("LOI") that achieves two important

objectives: a) Protects the confidentiality of the Seller's information provided during the due diligence period, and b) Establishes a timeline as to when future events will occur, such as the drafting of the purchase agreement and the proposed closing date. Some LOIs go further, establishing the sale price without further negotiation, and a "no shop" period, where the Seller may not offer the business to other Buyers, except in a back up position to the one in the LOI.

- 2) Purchase Agreement. Most transactions are an "Asset Purchase", meaning the Buyer will purchase most of the Seller's assets and transfer them to the Buyer's new or existing entity. Occasionally, the Seller's entity has extensive licenses that are difficult to transfer, and the Buyer will take over the Seller's entity. The latter is rare, due to the Buyer's automatic assumption of nearly all Seller liabilities.
- 3) Closing. Except for very small transactions, Closing should be handled by an escrow company that focuses on small business sales. Do not use a garden variety real estate escrow service, where the escrow agent will fumble their way around the process. Again, if you need a good referral, we're got the sources.

### **What are the Big Legal "Landmines" for a Seller?**

Sellers of a business are usually focused on one thing: getting their money. In doing so, they often overlook details in the purchase contract that come back to bite them. Top five examples:

- 1) Indemnification. Naturally, the Buyer will want the Seller (and its principal) to assume responsibility for any claims and/or damages incurred prior to the Closing Date. That's fine, but for how much? In no case should the Seller ever agree to an unlimited indemnification. At most, it should be capped at the purchase price, and preferably a much lower amount.
- 2) Warranties. The Buyer will require the Seller to warranty certain aspects of the transaction, such as the condition of the assets being sold, and the lack of any pending claims. Whenever possible, these warranties should contain a "knowledge qualifier" so that the Seller is only representing what they actually know, and not what they have yet to learn about.

- 3) Failure Warning. You are able to sell your business for only one reason: you ran it profitably for many years. Will the Buyer? Many don't, and then cry foul when the profits don't materialize after the sale. Every Purchase Agreement should contain harsh warnings about the risks of running the business and the lack of guarantees of future profitability.
- 4) Remedies in the Event of Breach. So, the Buyer is running your former business into the ground, they aren't making the payments as scheduled, and you need to take the business back so you can sell it to someone else. Can you? Absent specific language in a security agreement, you can't. Since getting a money judgment against a defaulting Buyer is usually worthless, this is a huge consideration.
- 5) Continued "Employment". Most Buyers will ask the Seller to stay on for a few months (sometimes longer) to help with the transition. Fine, but in what capacity? For the protection of the Seller, it is best to be a W-2 employee of the Buyer, rather than an independent contractor. The general rule is that employees are not liable for their own negligence in the course and scope of their employment. As an independent contractor, liability is unlimited.

### **What are the Big Legal "Landmines" for a Buyer?**

Buyers are laying out the cash, and need to be sure they are buying what they think they are. Top five examples:

- 1) Indemnification. Here, the situation is reversed: a Buyer wants to keep the Seller on the hook for all claims and/or damages incurred prior to the Closing Date... without limitation. Further, if the Seller will be asked to indemnify the Buyer for liabilities post-Closing, the Buyer should insist on mounting a joint defense so the Seller doesn't get his own attorney and run up the meter twice.
- 2) Warranties. The Seller must warrant that all Seller financials are accurate without exception. Under no circumstances should a Buyer allow the Seller to add a "knowledge qualifier" to them. If a Seller won't stand behind their own financials, the Buyer should walk from the deal.
- 3) Definition of "Assets". A Buyer is only purchasing the assets listed in the Purchase Agreement. If not listed, they remain with the Seller. To be all encompassing, the Purchase Agreement should specify that "all assets used

in the (*business*) are being sold to the Buyer, except for \_\_\_\_\_." Basically, the Buyer should put the burden on the Seller to list out any assets that are excluded from the sale.

- 4) Lease Assumption. Unless specified in the Purchase Agreement, the Buyer is on their own to obtain a new lease from the landlord (or get an assignment from the Seller's lease). Any agreement must make the Buyer's new lease a "condition precedent" to the deal closing. If the landlord won't approve the Buyer on terms the Buyer can live with, the Buyer needs to be able to walk.
- 5) Due Diligence on Steroids. It's one thing to have your CPA go over the Seller's financials, and to physically inspect the premises. In the end, follow Ronald Reagan's solid advice: "*Trust, but verify*". Compare bank statements to financial statements: does the cash flow match? If the Seller claims intellectual property rights, are they registered with the USPTO or USCO? This is where your attorney needs to get involved.

### **New Entities for Buyers**

Regardless of how small the business or transaction price, a Buyer should never purchase an operational business in his or her own name (or worse, in a general partnership). A corporation is usually best, although in rare cases an LLC may be required. For more information, ask The Small Business Law Firm, P.C. for a copy of our "*Small Business Entity Guide*".

### **Franchises**

There are enough complexities in buying or selling a business, but involving a franchisor makes things exponentially complex. First, the franchisor has an unconditional right to reject a Buyer for almost any reason, so Sellers, be prepared for delays. As a Buyer, you can expect the equivalent of a proctology exam, so get your paperwork organized. Also, most franchisors will not negotiate any term or condition in their franchise agreements, so have your attorney look them over carefully and be prepared to walk if needed.

### **In Closing...**

Whether you are selling or buying a business, you need a small business attorney on your side who will look out for your specific interests. Please feel free to call us for a free, no-obligation consultation on these matters.