

Protecting the Buyer of a Business

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In the previous article we discussed ways to protect the seller of a business. In many cases, protections for the buyer are directly opposed to the protections for the seller. The result is usually a negotiated arrangement by which each party get some (but not all) of what it wants. Among the protections the buyer should consider are:

Give Paper. Obviously, one of the best protections for a buyer is to put as little initial cash into the deal as possible. If the buyer determines that there are inaccuracies in the seller's warranties and representations, the buyer may reduce the amount of the promissory note - rather than having to demand that the seller return some of the purchase price. Direct recovery from the seller may only come after expensive litigation. The more cash paid up front, the harder it is to recover funds (e.g., the seller spent the down payment in Las Vegas).

The buyer should make sure that any promissory note provides for a "right of set-off" by the buyer. The set-off right allows the buyer to reduce the note by the amount of any future claims against the seller. The note should specifically state how the set-off is computed. There are three methods. First, the offset can reduce the next note payments due to the seller. This is generally the most advantageous approach for the buyer because the claimed amounts are often unanticipated out-of-pocket costs to the buyer. Second, the payments can be made at the back-end of the note. However, from a cash flow standpoint, this often hurts a buyer who must expend current cash to fix the problems incurred by the inaccuracies. Third, the entire principal amount could be readjusted as of the Closing date and re-amortized based upon the change in payment due. This is helpful if there are concerns that large claims may be uncovered by the buyer (e.g., where there is sloppiness in the financial statements). It is also too complex when the claims are relatively small.

The buyer should also make sure that any promissory note contains language that denies an assignee of the note the right to be a "holder in due course." Thus, any person who acquires the note, (e.g., someone who obtains the note as security for a loan) takes subject to the set-off rights of the buyer. In the absence of such language, the buyer might have to seek recovery directly from the seller, instead of reducing the note - not always a comfortable approach (i.e., remember Las Vegas).

Warranties and Representations. Normally the buyer has not operated the business and does not have an intimate knowledge of its operations. Therefore, the buyer requires a statement of "truth." This statement of truth is, in effect, a baseline giving certain assurances to the buyer of what he can expect and is accomplished by the use of broad warranties and representations about the business, its finances and operations. Most warranties and representations should be absolute and not subject to what the seller believed to be true - otherwise the buyer, in effect, may be assuming the seller's errors in judgement.

To the degree that a warranty or representation is in error and an exception is not noted

in the documents, the buyer may have a right to recovery from the seller. This recovery may be by demand for repayment of funds, or by exercising the set-off rights against any promissory note.

The warranties and representations, in effect, serve as the baseline for the indemnification of the buyer. The buyer has to make sure that the indemnity language is sufficient to provide for recovery for those claims. The less restrictions on the indemnity rights the better. For example, if the seller has a right to defend any third party claims, the agreement may provide (as a pre-condition to such defense) that the seller escrow sufficient funds to protect the buyer from the claim.

Liabilities. The agreement should provide that the buyer is only assuming those liabilities explicitly and specifically listed in the agreement. The buyer should also obtain a UCC, judgement, lien, and FIFA search on the business and the seller prior to closing. These searches will reduce the possibility that the assets or the seller's equity is encumbered by an unknown security interest - which the buyer may be inadvertently assuming if the search was not conducted (i.e., the buyer may have to pay the lien off to sell an asset).

Continued Employment. Any business survives because of the relationship of the owner with his customer and vendor base. Because of this, the post-closing retention of the seller should be a paramount concern to the buyer. The buyer needs the seller to help manage (for 3-18 months) the process of moving the customer and vendor relationships to the buyer.

The buyer is well advised to have a incentive provision in the agreement that provides for a penalty if the seller leaves the business earlier than agreed or fails to help in the transition. The penalty may reduce the note balance. The set-off rights might also be extended to any employment related payments due the seller (e.g., a deferred non-compete payment).

Negative Covenants. The buyer should make sure the seller will not begin operating a competitive business using the customer and vendor relations, employees, knowledge and trade secrets of the acquired business. Therefore, the agreement should provide for one or more of the following "negative covenants" to protect the buyer: non-competition, non-solicitation of customers, non-solicitation of employees, non-solicitation of vendors and protection of trade secrets and confidential information. These negative covenants must be carefully drafted to comply with applicable state law. The agreement should allocate a significant part of the purchase price to these covenants and allow the buyer to seek injunctive relief if violations of the covenants occur.

It is also advisable to obtain similar negative covenants from key employees of the business. Very often, their loss can be more damaging than the loss of the seller. This might be a requirement placed on the seller as a part of the pre-closing requirements for the sale of the business.

Cash Flow Projections. It is amazing how few buyers run calculations to determine whether the business (or other sources) can fund the future payments due to the seller. Many a buyer has had to renegotiate the agreement or lost a purchased business because of the inability

of the business to fund the payments to the seller.

Selling or buying a business is never easy. It can be disastrous if the parties fail to adequately protect themselves.

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