

Protecting a Business Owner Who Sells the Business

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The sale of a business can often result in significant financial gain for the owner, but there are also new inherent risks for the owner. This article will discuss some of the ways to protect the seller:

Taking Back Paper. The more the purchase is in cash at closing, the less risk the seller has that the buyer will refuse to pay the full purchase price (e.g., the business is run into the ground by the buyer who blames the seller). In many cases, the seller is in the worst possible position. Control of the business has been given up, but he or she must wait to see whether the buyer can properly manage the business and pay the remaining purchase price. If the business is run into the ground, the buyer may throw up his hands and say, "Here, take it back." Unfortunately, there may be little of value to take back.

The seller should take back as little paper as possible and require the buyer to provide the seller periodic financial statements for the business. Because a faltering buyer may be reluctant to provide evidence of problems, the failure to provide the financial statements should be a default under the promissory note. If a promissory note is a part of the sale, try and minimize the payment period (e.g., 3 to 5 years, instead of 10 years) and use an interest rate higher than commercial rates because the risk to the seller is generally greater than a commercial loan.

The note should be secured by not only the equity of the buyer in the business, but also by a broad form UCC filing on all of the assets of the business. The agreement may also allow the seller to foreclose if the business incurs a downturn (e.g., a 20% drop in gross revenue). However, many sellers are reluctant to take their businesses back and the buyer may also have the possibility of using bankruptcy to forestall any foreclosure.

The seller should also obtain personal guaranties, not only from the buyer, but also deeper pockets that may be in the family (e.g. the buyer's father). Additional collateral security may also be important (e.g., security in the buyer's home).

Warranties and Representations. Most transactions (particularly stock transactions) require the seller to provide broad warranties and representations with regard to the business and its operations. Before such a sale, the owner's corporate shield (or L.L.C. shield) provided a measure of protection from the liabilities the seller is now effectively assuming as a result of the warranties and representations. To protect the seller, the sales agreement should fully disclose any and all exceptions to the warranties and representations. Even if the seller believes there is very little likelihood that an issue will cause problems (e.g. a sexual harassment claim from three years before), is it safer to disclose, because the failure to disclose can result in future liability. Even if the exception has been disclosed to the buyer, the agreement should document the disclosure.

The seller should also try to minimize the nature of the warranties and representations to

include using best knowledge and belief in place of absolute truth as a standard. If it was the seller's belief that there was no issue, but there later turns out to be a liability issue, the use of this limitation will limit the claim to what the seller believed to be true, not what was actually true (e.g., the seller believed the financial statements were true, accurate and complete, but the bookkeeper made significant errors). Moreover, such a standard shifts some of the burden of proof back to the buyer to prove that the seller knew the representation was false.

Finally, if the sale is to an "insider" such as a partner or a long term employee, it would appear that the seller should not have to provide as broad a set of warranties and representations. The insider should have an intimate knowledge of the business operations and in many cases may have a better knowledge than the seller (e.g., the buyer was the business's president for 10 years).

Indemnities. Most of these transactions require indemnities by the seller with the indemnities generally being based upon the warranties and representations. There are a number of ways to limit such claims, including:

- ! by time - such as providing that any indemnity ceases one year after the closing;
- ! by amount - providing that the buyer cannot make claim against the seller until the indemnity "pot" has reached a certain floor, such as \$30,000; or
- ! by the nature of any claims - restricting indemnities to only certain claims, such as tax and environmental issues. Such a limitation can also occur by limiting the warranties and representations made by the seller.

Finally, to avoid having the buyer arbitrarily make indemnity claims (which may be used to reduce the note payments), the sales agreement should provide for an even handed process for making claims under the indemnity. It may also provide that the seller has a right to takeover the defense of any third party claims to assure that the buyer does not quickly agree to an unreasonable settlement of an indemnified claim. If agreement cannot be made between the seller and the buyer, the sales agreement may provide for binding arbitration by the parties.

Insurance Coverage. In many cases, the warranties, representations and indemnities results in the seller effectively dropping the protection the seller had from the business's entity shield. But a significant portion of the liabilities that the seller may be taking on may have been covered by the insurance of the business. One major way to protect the seller is to provide that the buyer is required to maintain comparable insurance coverages to those maintained by the seller's business and that any claims under the sales agreement must first be made against the insurance. The agreement should also provide that the insurance carrier has no claim against the seller if the carrier is required to make such payment.

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