* PART ONE OF A TWO-PART SERIES *

## LEGAL ASPECTS OF BUYING OR SELLING A REP FIRM

# A ROADMAP TO SUCCESS

EDITORIAL | GERALD M. NEWMAN, ESQ.

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This article, presented in a two-part series, is intended to provide a summary roadmap of the issues, steps and mechanics involved in the purchase or sale of a sales representative agency. Its purpose is to assist the reader in recognizing and addressing the areas of concern which arise in almost every transaction.

## Letter of Intent

Most transactions begin with a so-called "letter of intent." The purpose of the letter of intent is to set out the basic business terms of the deal, such as whether it will be a sale of stock or assets, the purchase price, and how and when the purchase price will be paid. Letters of intent are typically "non-binding." In other words, they typically are not enforceable in court. Most buyers, even after they sign a letter of intent, are not willing to sign a binding agreement until they have been able to learn more about the target company through the "due diligence" process. While a letter of intent may not have any legal effect, it does have a psychological value. Buyers and sellers should not expect to easily renegotiate the purchase price (or any other significant term) once set forth in a letter of intent.

Caution is warranted when signing a letter of intent. On one hand, to ensure that a letter of intent is not legally binding, it must clearly say so. Otherwise, a court may find that the buyer and seller intended to be bound by their letter of intent. On the other hand, the parties often want certain provisions in a letter of intent — such as the seller's agreement not to solicit other buyers — to be legally binding. Thus, the letter of intent must clearly state which provisions are intended to be binding and which are not.

## Confidentiality

In most cases, buyers and sellers want to keep a potential transaction confidential. Buyers don't want to invite other bidders, and sellers don't want employees, customers, principals, or competitors to know the business is for sale (particularly since the transaction could fall through). Further, as part of the due diligence process, a seller will often have to disclose trade secrets or other sensitive information to the buyer. From the seller's point of view, it is imperative that confidential information be protected from disclosure or improper use by the buyer — particularly if the buyer is a competitor. The need for confidentiality is often covered in a letter of intent. If handled this way, the letter of intent must make clear that the parties intend to be legally bound by its confidentiality provisions. However, where confidentiality is a major issue, it is best handled in a separate written agreement, typically referred to as a "Confidentiality Agreement."

## Due Diligence

Due diligence is the investigative process associated with purchasing a business. Some buyers even "camp out" at the seller to complete the investigation. For the buyer, due diligence is often crucial, as it is the only way to "look under the hood" of the business and make sure it really works, is worth the price agreed upon by the parties, and that the business the buyer actually ends up owning is the business the buyer thought he was purchasing.

In fact, buyers who fail to adequately conduct due diligence may be barred by a court from claiming after the sale that something about the sale was improper.

On the other hand, due diligence can be quite burdensome for the seller. Sellers will often spend weeks digging materials out of files for the buyer to review, and making its offices, staff and records available to the buyer. At the end of the process, each party should know everything about the business. For the well-organized seller, the process is not too painful. For less sophisticated sellers, the due diligence process often involves getting the company into the shape it should have been in the first place.

## Structuring the Transaction

There are two common ways to structure the sale of a business. The first is to buy assets. The second is to buy stock. Often, some due diligence is required in order to determine which structure is the appropriate one.

From the buyer's point of view, purchasing the assets of a business is often preferable. In an asset deal, the buyer can acquire only those assets that it wants to own. Moreover, by purchasing assets, the buyer gets a stepped-up basis in those assets (equal to the acquisition cost of the assets). This allows the buyer to recover its acquisition cost through depreciation and amortization. Finally, by purchasing assets, a buyer can generally avoid acquiring unknown or unwanted liabilities, unless there is an express agreement to acquire them. Buyers, however, should beware of some important exceptions to this rule. First, the buyer of a going concern may not be able to avoid liability for the seller's unpaid taxes. Second, many environmental liabili-

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ties "run with the land," so if one of the assets purchased is real estate, particular care is warranted in ensuring that no environmental liabilities exist.

From the seller's point of view, the chief drawback to an asset sale is that it can result in additional tax liability at the corporate level that would not exist in a stock sale or a merger. This will occur only if the seller is a so-called C corporation, because "C corps" are taxed at the corporate level. However, if the corporation is a so-called S corporation, the gain realized by the corporation on the sale of its assets passes through to the shareholders, rather than being taxed at the corporate level. Thus, only the shareholders in an "S corp" pay tax on any gains resulting from the sale.

The other common way to sell a going concern is to sell the stock (or other equity interest), or for the selling corporation to merge into the buyer. Either way the effect is the same — the buyer winds up owning all of the assets and liabilities of the seller. The chief advantage to the seller in a stock sale or merger is that there is no tax liability at the corporate level. The only tax liability is at the stockholder level.

There are, however, several drawbacks to the buyer in a stock sale or merger. First, because the purchaser is buying stock, and not the underlying business assets, the buyer gets a "stepped-up" basis in the stock it acquires, but no stepped-up basis in the company's assets. That is, the buyer gets a basis in the stock acquired equal to the purchase price, which presumably reflects the value of the assets purchased. Thus, a buyer cannot obtain the benefit of increased depreciation and amortization deductions because stock is not depreciable. Second, a transfer of stock (whether by sale or merger) always results in the buyer acquiring all of the seller's liabilities. Thus, despite the best due diligence, the buyer always runs the risk of assuming unknown liabilities. As such, a buyer's only protection from the risk of unexpected liabilities is to seek indemnification from the seller — which is nothing more than a promise that the seller will pay for any undisclosed liabilities that surface after the sale. To secure the seller's ability to indemnify the buyer, a prudent buyer in a stock sale or merger will insist that a portion of the purchase price is set aside in an escrow for a period of time.

## Valuing the Business

A common rule of thumb in valuing a rep firm is that it is worth approximately 100% of the previous year's gross commission income. This may be varied, however, from as little as 75% to 125% based upon several factors. Factors which tend to increase the price are stable relationships with principals and customers, products that have a future in the market, a rising trend in the firm's commission income, and the period of time over which the seller will be paid.

One way for a seller to potentially maximize the purchase price is to share some of the risk with the buyer. For example, the price could be 15% of gross commission income for the eight years following the sale. Thus, if business is good, the seller's price goes up. If business is bad, of course, the seller will get less, but the fact is that any time business is really bad, the seller is going to wind up taking less whether he wants to or not.

Look for the second segment of this series in the next issue of **Agency Sales Magazine**.

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