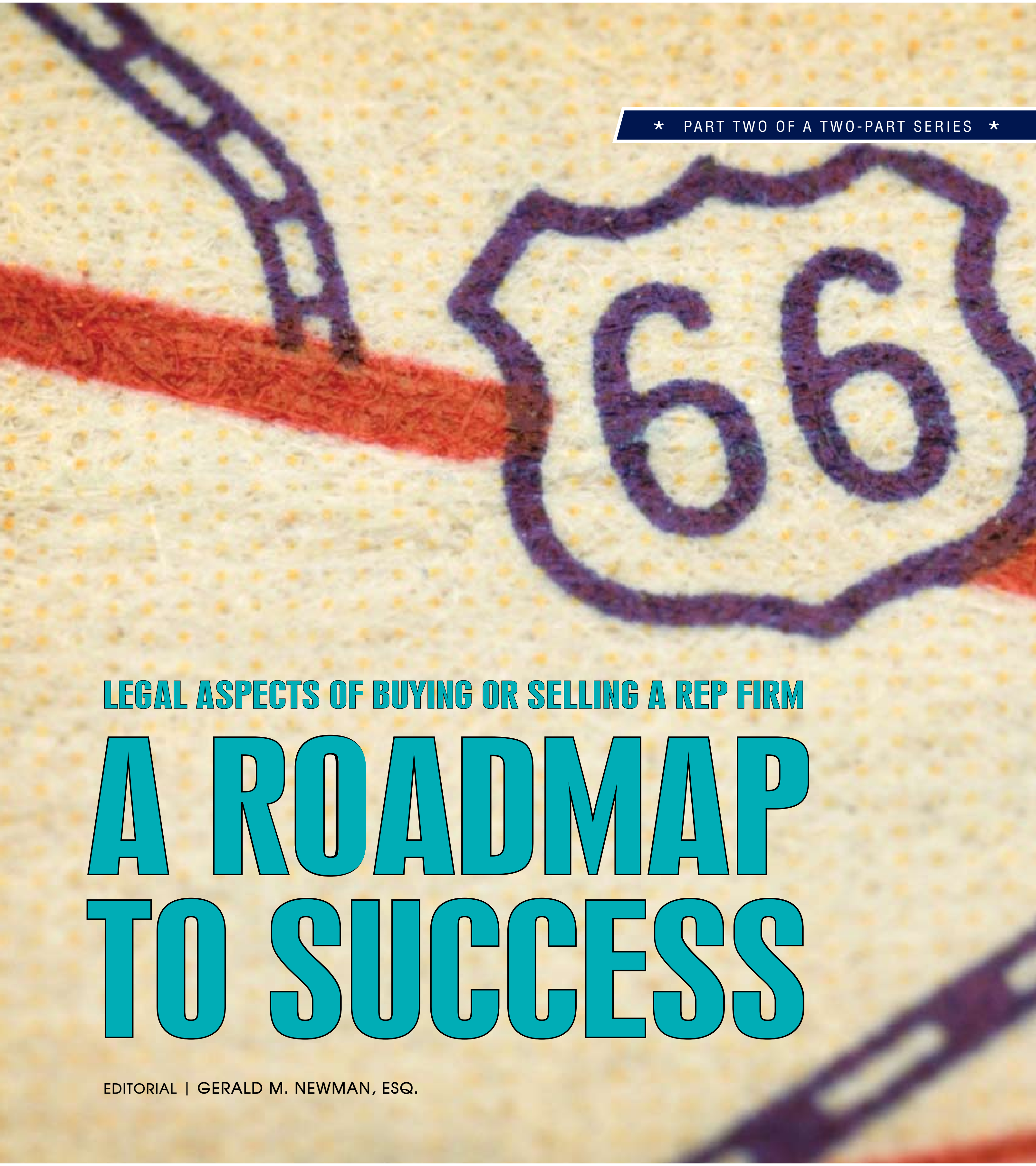

PART TWO OF A TWO-PART SERIES

LEGAL ASPECTS OF BUYING OR SELLING A REP FIRM

A ROADMAP TO SUCCESS

EDITORIAL | GERALD M. NEWMAN, ESQ.

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This second part of a two-part series is intended to provide a summary roadmap of the issues, steps, and mechanics involved in the purchase and sale of a sales representative agency. Last month, in the first segment, we discussed the letter of intent, confidentiality, due diligence, structuring a transaction and valuing the business. This second segment deals with the preparation of written agreements, covenants not to compete, consulting arrangements, third-party consents, the closing, and some final tips.

Preparing Written Agreements

Once the business deal has been made, someone has to put it in writing. The sophisticated buyer will usually insist that his lawyer do this, since the larger part of the agreement is for the buyer's benefit. The seller's lawyer, of course, will then have his turn to comment on whatever the buyer's lawyer has prepared. Two issues which the lawyers will typically negotiate heavily are the seller's representations and warranties about the business and the scope of the seller's indemnification of the buyer for the breach of those representations and warranties. Here again, due diligence plays a major role in how these negotiations proceed.

In some cases, a prudent seller will also do his own due diligence about the buyer. For example, if all or a part of the purchase price is to be paid in the form of the buyer's stock, the seller should conduct substantial due diligence — after all, by agreeing to take some of the buyer's stock, the seller is purchasing a piece of the buyer's business. Similarly, if the buyer is giving the seller a promissory note as part of the purchase price, the seller should assure himself of the buyer's creditworthiness and may also seek personal guarantees or other security.

Covenants Not to Compete

Every buyer who buys or sells a business should expect that the owners of the business will give the buyer a covenant not to compete. The purpose is to protect the good will being acquired by the buyer by preventing the owners from competing against their old company. Although covenants not to compete are often difficult to enforce, particularly in the employment context, restrictive covenants signed in conjunction with the purchase and sale of a business are routinely upheld by courts.

Unfortunately, the tax treatment of these covenants is still not very favorable. Any amounts paid to a selling individual in exchange for his covenant not to compete is ordinary income rather than a capital gain, while a buyer cannot deduct such payments for tax purposes, but must amortize them over 15 years, even though the covenant not to compete will always have a much shorter life.

Consulting Arrangements

In order for a buyer to get the benefit of the goodwill for which it is paying, it is often crucial for one or more of the seller's key people to remain after the sale. This is especially true in a personal service business such as a rep firm, where so much of the goodwill lies in relationships with principals and customers.

Sometimes, a substantial portion of the overall price being paid for a business will be allocated to one or more consulting agreements. Amounts paid for consulting services are ordinary income to the recipient and deductible by the buyer. The tax advantages and disadvantages to each party to the transaction, however, will depend upon whether the deal is structured as an asset sale or stock sale, and whether the seller is a "C" corp. or "S" corp. Consequently, structuring the transaction, including whether to do an asset or a stock transaction, and how much to allocate to a consulting agreement, requires the input of skilled legal and tax advisors, who should be consulted by a seller before negotiations get underway with a potential buyer.

Third-Party Consents

Often there is a period of several weeks to a few months separating the time when the final agreement is signed and the time it is actually closed. In the case of the purchase and sale of a rep firm, it is during this period that the seller will obtain his principals' consent to the transaction. Other third parties that typically will have a right to consent to the transaction are the seller's landlord and equipment lessors.

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The prudent seller, however, will not wait until after an agreement is signed with the buyer to prepare his principals for the sale. Needless to say, this can sometimes be a rather delicate matter, but there is little point in the buyer and the seller spending time and money negotiating a deal that the seller's principals are unwilling to go along with.

The Closing

The parties have successfully negotiated and entered into a letter of intent (and perhaps a separate confidentiality agreement), have completed their due diligence, and have negotiated, drafted and are ready to sign a definitive agreement for the purchase and sale of the business.

But it is only at the closing that the business will finally be transferred to the buyer and the purchase price will be paid to the seller. The complexity of the closing will vary. If the transaction has been structured as an asset sale, each of the assets being sold must be conveyed at the closing. For a larger business, with many different types of assets, this can become quite a task. On the other hand, if a stock sale is contemplated, then the complexity may depend on the number of shareholders. Nonetheless, despite all the differences the parties may have had during their negotiations and due diligence, closings usually go smoothly.

Some Final Tips

Buying or selling a business can be a stressful event. It is definitely not something that business owners should attempt without professional help from well-qualified advisors. The key to making any transaction a success on both sides of the table is to involve skilled legal and financial advisors early in the process. Finally, buying and selling a business takes time. Don't expect to have it done in a week or two. The typical transaction will usually take anywhere from two to six months from beginning to end. asm