Manufacturers' Agents Association for the Foodservice Industry

LEGAL ASPECTS

BUYING OR SELLING A REP FIRM

Published as a service by:
Manufacturers' Agents Association for the Foodservice Industry (MAFSI)
1199 Euclid Ave, Atlanta, GA 30307
Phone: 404-214-9474 – Fax: 404-522-0132
Email: info@mafsi.org – Web: www.mafsi.org

Manufacturers' Agents Association for the Foodservice Industry

Introduction

This article is intended to provide a brief road map of the issues and mechanics involved in the purchase and sale of a sales representative agency. Its purpose is to help the reader recognize and address the issues which arise in almost every transaction.

1. 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 are not typically 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.

> Letters of intent are typically "non-binding."

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.

2. 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."

3. 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.

> 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.

4. 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 which 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 liabilities "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.

> The chief advantage to the seller in a stock sale or merger is that there is *no tax* liability at the corporate level

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 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.

5. 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.

6. 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 tum 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.

> A prudent seller will also do his own due diligence about the buyer

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.

7. 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.

8. 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.

9. 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.

10. 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.