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Seller Beware? 4 Key Features of Business Sale Transactions that Sellers Should be Familiar with Before Negotiating

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You have prepared your business for sale and have determined an enterprise value with which you are comfortable. Perhaps you have already found a buyer and signed a letter of intent, or at least agreed in principle on the overall purchase price for the business.

While determining the overall value of your company is an important step, negotiating the final terms of the business sale is just as important and oftentimes is far more arduous. Some business owners, especially first-time sellers, are surprised by the complexity of the sale process and are unprepared for negotiating through the many common provisions that affect how, when, and even if the full purchase price is ultimately disbursed to the seller.

This article analyzes key deal terms of a business sale and provisions that affect the timing and ultimate payment of the purchase price. This article also reviews the responsibilities of the parties after the deal closes, so that sellers can anticipate what the buyer is likely to demand and how to negotiate from a position of strength. It is important for sellers to keep in mind that nearly all of the items described here are designed to allocate risk. Buyers want to receive the value they expected from purchasing the business and allocate risk to the seller if there is an unexpected obstacle in the transition to new ownership. Sellers want to avoid business-related risks after closing and retain as much of the full purchase price as possible.

Understanding these key provisions allow sellers to identify early in the process which provisions may be more or less risky based on their understanding of the business, which provisions to prioritize, and how to build a negotiating platform that fits their expectations and goals. Sellers should consult with financial and legal consultants for the most recent market trends and figures related to the topics in this article.

Feature #1: Economic Terms.

Generally, buyers want to avoid going after a seller post-closing to recover funds already disbursed because the funds may no longer be available; to accomplish this, buyers want to maintain control over some portion of the purchase price funds until their window for making claims against the seller has expired. This section outlines common economic terms in purchase agreements that affect the timing of payments to the seller and portion of the overall price ultimately paid by the buyer.

Escrow Holdback. A certain portion of the purchase price will be placed in escrow at closing and held for a period of time in order to fund post-closing claims against the seller without requiring the buyer to go directly after the seller for proceeds already disbursed. The escrow holdback is usually a key provision of the deal and heavily negotiated by both parties given the funds in escrow are at risk and not available to the seller until the escrow holding period expires. The amount of funds held in escrow will vary depending on deal size, industry, business risk, negotiating leverage and other factors.

Escrow Holding Period. In connection with the amount of funds held in escrow, sellers should consider the amount of time that is acceptable to the seller for the escrow funds to be unavailable to the seller at risk for buyer claims. A longer holding period can often be a trade-off on the part of the seller to get a better position on a different priority during negotiations, but the seller must balance their short-term cash needs against the longer holding period. The escrow holding period can range from months to a few years after the closing date.

Target Working Capital. The seller is generally expected to provide working capital to fund the operations of the business immediately after closing, and the seller and buyer should work together to come to a realistic working capital number. At closing, the buyer will calculate the actual working capital in the business using an agreed-upon formula, at which time the parties will “true up” the working capital to match their agreed-upon target number. If the actual working capital at closing is deficient compared to the agreed-upon target working capital, the seller must pay the difference to the buyer. If the actual net working capital is in excess of the targeted amount at closing, the buyer will pay the excess amount to the seller, increasing the seller’s proceeds from the business. Keep in mind that working capital adjustments, unless otherwise agreed to, are generally considered separate from indemnity claims and are usually paid within 90 to 120 days after closing.

Set-off Rights. A purchase agreement may contain broad set-off rights in favor of the buyer, allowing the buyer to set-off funds owed to the seller but still in the buyer’s possession (such as working capital excess, or earned but unpaid earn-outs) against claims the buyer has against the seller. Setoffs are another way for buyers to mitigate risk by controlling funds. Sellers should be careful that set-off provisions are consistent with indemnity provisions to avoid having more funds at risk than anticipated.

Earn-outs. The parties may agree to pay a portion of the purchase price in future year earn-outs, such as annual bonuses to the seller for meeting certain financial metrics in post-closing business operations. Buyers may favor earn-out provisions if the seller is going to remain an employee of the ongoing business, as it aligns interests in working toward the continued success of the business. For sellers, earn-outs can be a great way to negotiate a better purchase price and push a portion of the seller’s tax liability into future years; however, the benefits must be balanced against the likelihood of meeting the earn-out metrics and the seller’s short-term financial needs. An earn-out can also bridge the gap if the parties disagree about the value of the business.

Feature #2: Indemnification.

Indemnification provisions provide the buyer recourse against the seller for post-closing expenses and liabilities resulting from the seller’s misrepresentations or inaccuracies when providing the buyer with information (or withholding material information) during due diligence. As discussed further below, buyers will often try to expand their indemnity coverage through various legal provisions.

Representations and Warranties (RWs). RWs are assurances that the seller makes and on which the buyer relies when purchasing the business and are the basis for the buyer's indemnification claims after taking over operations. A seller's breach of RWs resulting in costs to the buyer triggers indemnification claims to recover the damage caused by the seller's breach. RWs are generally divided into two types: fundamental and non-fundamental.

- Fundamental. RWs are critical to the buyer's willingness to consummate the transaction, and which, if breached, usually call into question the legitimacy or enforcement of the entire business sale. Breaches of fundamental RWs carry higher indemnification liability for the seller in order to place the buyer in a position as if the transaction never occurred. Fundamental RWs commonly include representations regarding ownership of the business equity, authority to enter into the transaction, and non-existence of other ownership claims against the business. They may also include other key issues or risks that the buyer feels are especially important to the deal.

- Non-fundamental. RWs are statements and disclosures made by the seller that the buyer relies on for a smooth transition of ownership and operations of the business immediately after the closing date; generally, this includes all RWs made by the seller in the purchase agreement that are *not* fundamental RWs.

Ideally, sellers will want to make as few fundamental RWs as possible; the goal is to (i) limit the seller's top-end exposure to a handful of statements that the seller is generally comfortable making, and (ii) cap the remainder of its aggregate liability to the indemnity cap amount. Sellers can be creative in reducing the number of fundamental representations they need to make by working with buyers to find alternative ways to mitigate buyer risk and seller liability; for example, exploring insurance options can be a sound strategy.

Indemnity Threshold. The indemnity threshold sets the *minimum* amount of aggregate damages a buyer must accrue against a seller before the buyer can recover *any* damages for indemnity claims. There are two main types of indemnity threshold:

- Deductible. The "deductible" method of indemnity operates much like consumer insurance. The buyer must absorb all aggregate damages up to the "deductible" (indemnity threshold) amount, and the seller indemnifies the buyer for all claims in excess of the indemnity threshold.

- First Dollar. The first dollar method of indemnity requires the seller to pay *all* damages once the buyer's aggregate damages reach the threshold amount. Illustratively, this can be thought of as a tipping bucket. The buyer must "fill" the bucket with damages against the seller. Once the amount of damages fills the bucket (reaches the indemnity threshold amount), the bucket "tips" and all damages down to the "first dollar" become the liability of the seller.

Ideally, sellers want the deductible type of indemnity threshold because it reduces their overall risk. However, sellers may be able to leverage a concession on first dollar indemnity in exchange for a higher threshold amount, which can ultimately produce a better outcome because the likelihood of any liability is reduced as the threshold amount increases. Additionally, sellers should try to negotiate indemnity threshold provisions in tandem with other indemnity provisions.

Indemnity Cap. Whereas the indemnity threshold sets the minimum amount of damages a buyer must accrue before the seller is liable, the indemnity cap limits the *maximum* amount the buyer can recover due to the seller's breach of RWs. The indemnity cap is often a heavily negotiated provision, as it caps the risk for the seller, and conversely, raises the cost to the buyer for the most expensive seller breaches. For fundamental representations, the indemnity cap usually equals the full purchase price of the business. For non-fundamental representations, the indemnity cap is commonly a fraction of the deal value. Matching the indemnity cap to the escrow holdback amount can provide benefits to both parties: the buyer does not need to recover any funds directly from the seller; and, barring breach of a fundamental representation, the funds disbursed to the seller at closing are not at risk.

Indemnity Period. The indemnity period is the amount of time that the buyer has to make a claim against the seller for breach of the seller's RWs. Generally, fundamental representations survive until, at minimum, the statute of limitations expires on the underlying claim. For example, if one of the seller's fundamental representations is that all taxes have been timely paid, the indemnity period for the seller's tax representations might be the time limit that the IRS could audit or bring a claim for unpaid tax liability accrued through the closing dates.

Non-fundamental representations often have a much shorter indemnity period, which may match the escrow holding period or expire according to some other defined schedule, usually not longer than a couple of years after closing. Sellers want the shortest possible indemnity period; however, defining which RWs are fundamental versus non-fundamental may be more productive than spending negotiating capital on shortening the indemnity period, where there is often less room to maneuver.

Feature # 3: Legal Provisions.

This section covers terms only a lawyer could love—obscurely worded and buried deep in the bowels of the purchase agreement far removed from the exciting topics like financial terms; however, these legal provisions affect the overall application of the economics and liabilities of the deal, which can have sweeping consequences for the seller if not properly understood and negotiated.

For sellers, ideally both of the terms discussed below – knowledge disclaimers and materiality scrapes – would be removed from any purchase agreement; however, transaction trends show that about half of all purchase agreements contain at least one of these legal provisions, if not both. Depending on the seller's negotiating leverage, they may have to decide whether to walk away from the deal or get comfortable with these provisions and try to use them as leverage for a better position on other negotiating points.

Knowledge Disclaimers/Sandbagging Provisions. Knowledge disclaimer provisions (commonly referred to as "sandbagging" provisions) generally prescribe that a buyer's right to recover from a seller is not affected by the buyer's knowledge, whether by the seller's disclosure or the buyer's own due diligence, of the inaccuracy or noncompliance by the seller of a representation or warranty. Stated more simply, the buyer is saying to the seller, "Even though we knew about the inaccuracy of your representations before we closed the deal, we can still sue you for any damages resulting from those misrepresentations after closing." From the buyer's point of view, this encourages proper due diligence and may be added protection. From the seller's perspective, this makes due diligence an expensive but largely meaningless exercise, wherein buyers can identify deal flaws but consummate the transaction anyway and then sue the seller post-closing.

From a practical standpoint, sellers can mitigate this risk by properly disclosing exceptions to their RWs in disclosure schedules, which are incorporated into the purchase agreement and make the seller's RWs accurate with the incorporated disclosures.

Materiality Scrape. A materiality scrape is a stand-alone provision that purports to eliminate materiality qualifiers from some or all other provisions of the agreement when: determining a breach of a seller representation or warranty; assessing damages for a breach; or both.

Because this concept is a legal art form, the following example will illustrate how this provision operates: *The seller represents to the buyer that the company is in material compliance with all required permits at the date of closing. The company requires a permit to store a barrel of industrial cleaning chemicals that the business uses infrequently in its operations. Right before closing the seller files a renewal application for the chemical permit, but the application is filed three days late which results in the buyer being assessed a $20 late application fee after closing when the permit is finally processed and renewed.*

Generally, this breach would not be considered material, as the permit is likely not material to operations and the permit is not adversely affected by a late renewal application. Additionally, the damages ($20) would also not be material, as it is a very small amount relative to the business' day-to-day expenses and operations. Therefore, the seller would not have breached its representation regarding permit compliance. However, if the purchase agreement contains a materiality scrape, then for purposes of determining a breach of the permit compliance representation, we would ignore the word "material" and in theory the buyer would have a claim against the seller for each technical breach of the seller's RWs, including permit compliance. Additionally, if the materiality scrape also affects the determination of damages, the buyer would include every damage claim, no matter how small (including the $20 late fee in our example above), to its aggregate claims against the seller, potentially filling the indemnity threshold bucket much faster than if only material claims were considered.

In fact, materiality scrapes can have the effect of filling the indemnity threshold quickly, so a seller may want to try to mitigate this risk by pushing for a higher indemnity threshold as a tradeoff.

Feature #4: Ancillary Documents.

Depending on how the business sale is structured, there may be substantial ancillary documentation in connection with the transaction, such as transition agreements, consulting agreements, employment agreements, shareholder agreements, and non-competition/non-solicitation agreements, to name a few. Although an in-depth review of these agreements is outside the scope of this article, it is important for sellers to analyze how the ancillary documentation operates in connection with the purchase agreement and how it affects the financial goals of the seller, such as illiquidity of assets, inability to re-enter the market, ongoing obligations or liabilities, and liquidation event triggers that are out of the seller's control, among others.

For example, if the seller receives the buyer company's stock as partial consideration for the sale of the business, the seller will likely be required to execute a shareholders agreement which may contain "black out" periods or call options where a buyer can force the seller to sell their shares. Sellers should *not* wait until just before closing to review and negotiate the terms of ancillary documentation; instead, sellers should request drafts of and review any other ancillary documentation concurrently with the purchase agreement so that all terms of the deal can be analyzed together in connection with the seller's overall strategy.

Conclusion

When preparing to sell a business, the big issues, such as finding the right buyer and company valuation, are key considerations; however, the terms of the sale can be just as important for the seller, especially as it relates to ongoing risk and short-term financial planning. Buyers want the benefit of their purchase and prefer to hold back some portion of the purchase price until their window for bringing claims against the seller expires. Sellers want to ultimately receive the full purchase price and feel secure in moving on after closing without the threat of claims against their proceeds.

By preparing for key purchase agreement terms ahead of time, sellers can identify which terms to prioritize, which terms to sacrifice for negotiating leverage, and areas where creative solutions may be appropriate. And perhaps more importantly, sellers can plan the terms of the deal around their financial needs and expectations.

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