

Buying or Selling a Business:

Introduction to Asset and Stock Purchase Agreements

SC Bar Corporate CLE June 9, 2017

Nelson Mullins®

Jay Rogers



Jay Rogers is a partner in Nelson Mullins Riley & Scarborough LLP's Greenville office, where he provides corporate counsel to businesses, including assistance with mergers and acquisitions, corporate structure, commercial relationships, and economic development incentives. From 2006 to 2009, Mr. Rogers served as Chairman of the Board of Directors of the Greenville Area Development Corporation, the economic development agency of Greenville County. Mr. Rogers has practiced law in Mexico and Brazil and speaks both Spanish and Portuguese. In addition to being a U.S. citizen, Mr. Rogers is also a Brazilian "Permanent Resident" (or "Greencard" holder).

Typical Legal Milestones in the Purchase or Sale of a Business:

- 1) Parties sign a Non-Disclosure Agreement and begin negotiations**
- 2) Sign Letter of Intent (typically non-binding)**
- 3) Due Diligence**
- 4) Parties Execute an Asset or Stock (Equity) Purchase Agreement**
- 5) Closing**

What is the primary purpose of either a Stock Purchase Agreement (SPA) or an Asset Purchase Agreement (APA)?

To insure that each party, when buying or selling a business, gets what it bargained for. As a practical matter, due to knowledge asymmetry between Buyer and Seller as to Seller's business, the APA/SPA functions primarily as a tool to ensure that the Buyer receives what he or she bargains for (and is not just buying a "pig in a poke").

The Seller mostly just wants to get paid and minimize any "open issues."

- What is the primary purpose of the delay between signing of Stock or Asset Purchase Agreement and Closing?

To sort things out with third parties; i.e. obtain government approvals, assignment of third party contracts, working through issues with employees, permit Buyer to finalize financing, etc.

Issues Common to the Drafting of both Stock Purchase Agreements (SPAs) and Asset Purchases Agreements (APAs).

Drafting Pre-Closing Covenants

- **Covenants are agreements to do/not do certain things, such as....**
- **Stop flirting ("no shop" covenant)**
- **Make no unusual expenditures or asset transfers outside the ordinary course of business**
- **Not to take on new debt**
- **Maintain confidentiality of the deal**
- **Maintain existing business relationships with customers, employees, vendors, etc.**

Common "Conditions to Closing"

- **No "Material Adverse Change" in Seller's business between signing of the APA/SPA and closing. What if the economy generally, or the Seller's entire industry, takes a nosedive? Is this an MAC?**
- **Seller has received all necessary consents to closing**
- **All Reps/Warranties continue to be true as of closing date**
- **Drafting tip: if you're the Seller, avoid Conditions to Closing which are wholly within the control of Buyer, e.g., closing occurs only if Buyer is "satisfied with its due diligence" or closing occurs only if Buyer can obtain financing**

Representations and Warranties

- Typically the most highly negotiated portion of the SPA or APA concerns the Reps and Warranties section.
- Purpose of Reps/Warranties: to continue due diligence, ie. uncover problem areas, create "walk rights," lay groundwork for indemnity claims.
- More detailed Reps and Warranties in an SPA than APA?

Typical Reps and Warranties concern...

- **Organization and Authority of Buyer and Seller**
- **Consent by Governing Body to do the deal (Board, Members, etc.)**
- **Financial Statements are accurate**
- **Title to the stock or assets being transferred is clear**
- **Assigned contracts are valid**
- **Permits/Licenses needed to operate the business are valid**
- **Seller in compliance with "all laws"**

Typical Reps/Warranties (cont'd)

- **No litigation except as scheduled**
- **All taxes have been paid**
- **Seller's intellectual property does not infringe anyone else's IP**
- **No Broker fees/commissions due unless scheduled**
- **No environmental issues**
- **No employee disputes**

Reps/Warranties (International)

- **No violations of Foreign Corrupt Practices Act**
- **No violations of sanctions promulgated by Office of Foreign Assets Control (trading with Cuba, Iran, etc.)**
- **All employees have proper I-9 documentation and, especially if in SC, have been E-verified to confirm right to work. If employees have temporary work visas, critical to investigate rules for transferring visa sponsorship to Buyer prior to closing**

Buyer's Reps/Warranties

- **Necessary financing to consummate the deal has been arranged (bank commitment letter, etc.)**
- **"Break up fee" if financing does not come through?**

Many Reps/Warranties are Subject to “Materiality” and “Knowledge” Qualifiers.

- **Popular areas of contention:**
- **What is material? Try to quantify, but not always possible.**
- **Precisely who must know something in order for that knowledge to be imputed to the company (the CEO and CFO only? Any employee?)**
- **Survival of Reps/Warranties**

Indemnity

- Popular areas of contention: types of claims covered and time period for notice of claims, which may vary depending on type of claim; eg. Breach of Reps/Warranties (1-2 years?), products, tax or environmental claims (open-ended?).
- Seller typically wants indemnity to be Buyer's sole remedy, unless Seller commits fraud or intentional misrepresentation
- Seller wants to limit damages, exclude "remote" damages (incidental, consequential, punitive, etc.)

Both SPAs and APAs Frequently Contain "Purchase Price Adjustments."

- **These adjustments may move the purchase price up or down between the time of signing the APA/SPA and the date of Closing.**
- **Adjustments are frequently based upon changes in inventory, accounts receivable, accounts payable and/or working capital and the like. Adjustments may be pre- or post-closing.**

Post-Closing Adjustments to the Purchase Price May Occur As:

- **Earnouts:** upward adjustments in the purchase price based upon the business meeting certain financial projections; or
- **Clawbacks:** decreases in the purchase price based upon the failure to meet financial projections.

Escrow and Set Off Rights

- **Buyer typically wants part of purchase price escrowed and/or...**
- **Wants set off rights, in order to make Purchase Price Adjustments or Indemnity Obligations easier to enforce**

Key Post Closing Covenants

- **Non-Competition Clause preventing Seller's key employees/shareholders from competing with the acquired company for (typically) 2-5 years**
- **Non-Solicitation Clause preventing recruitment of key employees of the acquired company for a similar time period**

Key Boilerplate

- **Ability to Assign the Asset or Stock Purchase Agreement**
- **Assignability is important as Buyer may want to create a new entity prior to closing to consummate the deal**
- **Allocation of Expenses**

Common Differences Between Asset and Stock/Equity Purchase Agreements

Warts and All

- **In a Stock or Equity purchase, the Buyer typically purchases the entire business, "warts and all," ie. including all of the liabilities, although there may be specific liability carve-outs.**
- **Generally speaking, for all outward appearances, the business continues on as before (with regard to third parties). Only the internal ownership structure changes.**

Who Owns the Target?

- Risk when purchasing stock or equity; who owns the company (if privately held)? Have you purchased all of the issued stock? How do you know? No public registration of ownership in U.S. corporate scheme.
- Compare with civil law countries, e.g., Brazil, Mexico, Western Europe, with notarial registration of private company ownership.
- In the U.S., contractual indemnity is typical solution.

"Substantially All" Assets

- An asset deal typically involves the sale of "substantially all" of the assets needed to operate the business. These specific assets are then "scheduled."
- "Substantially all" assets typically excludes cash, marketable securities, 401(k) assets and related liabilities.
- Thus, Buyer can be more selective about the assets he buys, and, perhaps more importantly, the liabilities he or she assumes.

SC Tax Lien May Follow Assets

- Although Buyer in an asset deal is typically able to exclude unwanted liabilities, this not always the case:
- For example, S.C. Code Ann. 12-54-124 (1976) provides that if the business selling its assets has not paid all taxes due to the state of South Carolina, then Buyer may have to pay these taxes.
- Buyer's protection: Buyer should require, no more than thirty (30) days before closing, a "Certificate of Compliance" from the South Carolina Department of Revenue stating that Seller has paid all taxes.

Other Liabilities May Follow Assets

- **Thus, certain tax, environmental, product or other liabilities may follow the assets in spite of Buyer's contractual attempt to exclude them in the Asset Purchase Agreement.**

Liabilities Normally Assumed in an Asset Deal

- **In addition, Buyer typically will voluntarily assume liabilities such as those related to contracts assumed by the Buyer and accounts payable generated in the normal course of business.**

Differences in Stock and Asset Transactions from a Tax Perspective:

- **Asset Purchase:** possibility of double taxation of share or equity owners if Seller is a C corporation. Thus, if Seller is a C-corp, Seller may prefer a stock sale. But where Seller is a flow-through entity, ie. an LLC or S-corp, double taxation not such a concern.
- **Buyer in asset purchase** generally gets to record asset values based upon Fair Market Value paid. If Buyer buys stock, Seller's basis generally carried over.

- **So... for tax and liability reasons,
Buyers frequently push for an Asset
deal; Sellers for Stock/Equity
transaction.**

Caution:

If Seller is an S-corp...

- **There are limitations on who may be an S-corporation Shareholder; generally Shareholder must be an individual (a real, live human being), or certain trusts and estates.**
- **No Partnerships, Corporations or Non-Resident Aliens may be S-corp Shareholders.**
- **A person qualifies as a “resident alien” if the person is “a lawful permanent resident of the United States,” fulfills the “substantial presence test,” or fulfills the “first-year election” requirements. IRC 7701(b)(1)(A).**

Conversion of S-corp?

- **If the Seller is an S-corp, it may be possible to convert it to another legal form prior to sale if the Buyer is not eligible to own shares in an S-corp.**

Conclusion: Remember the Emotional Side of Buying/Selling a Business

- **For Seller, the sale is frequently a very emotional, life-changing event, particularly if the Seller is also the Founder of the business.**
- **For Buyer, the purchase is typically a high stakes gamble.**
- **So, lots of adrenaline on both sides.**