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Buy/Sells - Part III:
Stock Purchase Agreements

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This is Part III in a five-part series on buy/sell basics. Part I examined the three different types of buy/sell agreements. Part II discussed the basics of one of those: Asset Purchase and Sale Agreements. This article discusses Stock Sale and Purchase Agreements.

What's the Difference?

A Stock Sale and Purchase Agreement is different from an Asset Sale and Purchase Agreement in that it transfers an entire business, lock, stock and barrel, rather than just assets. When buying stock of a business, the buyer buys all of the cash, all of the receivables, all of the payables, as well as all of the assets that would be purchased if you purchased just assets – and all the liabilities too.

Liabilities purchased include many things that could be very expensive, so it is important to really know what the liabilities are before buying capital stock. A buyer will typically have an opportunity after signing a purchase agreement to examine all the liabilities, but only if the purchase agreement is drafted to allow it. The purchase agreement also typically protects the buyer from things that should be disclosed but aren't and from things that cannot be discovered through due diligence.

Tax Liabilities To Consider

The most expensive areas of possible exposure when buying stock will vary depending on the circumstances. For example, when buying the stock of a C corporation, the entity purchased remains responsible for all corporate taxes, whether past due or current, as well as penalties and interest. This includes income taxes, sales taxes, employment taxes, franchise taxes, and if the corporation owns real estate (which is never a good idea) real property taxes. When buying the stock of an S corporation, on the other hand, no income taxes are paid by S Corporations; rather, S corporations are pass-through entities so the shareholders owe and pay the tax on corporate income, so income tax liability for any period prior to closing can be easily avoided when buying an S Corporation, with limited exceptions.

But tax issues aren't limited to just taxes that were not paid or that will be due from conducting business. A buyer also has to think about the tax consequences of the transaction itself. For example, a seller could end up paying unnecessary capital gains tax without proper planning. Here's why: Because an S corporation is a pass through entity, its shareholders pay taxes on income even if it is not distributed to them. This income on which tax has already been paid is recorded in an account called an AAA account. When income is later distributed, it can be distributed tax-free, as long as there is a balance in the AAA account. Each distribution reduces the AAA account. When an owner sells capital stock, the owner will want to make sure the purchase agreement allows them to take a distribution of AAA earnings before the sale so they can distribute the cash equal to the AAA account balance tax-free rather than receiving payment for the same cash through the stock purchase agreement and having to pay capital gains tax on it as profit on the sale.

What's Important For The Buyer And Seller

Some of the most important parts of a stock purchase agreement will be the warranties, representations and conditions to the obligations of the buyer. These are the provisions that will dictate the rights and liabilities of the parties. For example, a condition to Seller's obligations could be that the Seller shall have withdrawn all AAA earnings. Conditions typically provide for due diligence. The due diligence in a stock purchase agreement will need to be much more extensive than the due diligence for an asset purchase agreement. For example, in addition to just doing a Phase I and building inspection, the buyer is going to want to really understand how assets were accounted for on the financial statements.

The way assets were accounted for could significantly affect the purchase price. Adjustments may be required to the purchase price under certain circumstances. For example, if the seller has an aged inventory of used vehicles and has not written them down each year, the value may be overstated on the financial statements. Likewise, if year-end journal entries have not been made, then adjustments for depreciation on fixed assets may not be showing up on the financial statements. Whether adjustments are made may also depend on accounts in which payments are being kept. Looking at the detail behind the accounts will tell a buyer a lot about whether the dealership's finances have been well managed, and the real value of its assets.

These things won't matter as much in an asset purchase because the buyer will set up its own set of books and records (although they may be important in determining purchase price of the assets if appraisals are not done). In a stock purchase, on the other hand, it is very important to look at these details because the buyer is taking over the seller's books and accounts and could be held accountable later on by taxing authorities or the vehicle manufacturer if they were handled improperly. Warranties, representations and indemnity agreements are designed to provide a buyer with protection, but knowing what is going on up front is a much better approach than seeking damages or indemnification in a lawsuit later.

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