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Buy-Sell Agreements: The Good, The Bad, The Ugly

When negotiating the acquisition or sale of a business, attorneys need to understand the dynamics of the deal from both sides of the table.

BY ERIN K. TENNER

Buying or selling a business seems simple to clients who are buyers or sellers, but to those of us who frequently handle buy/sells, it is anything but simple. There are many things to consider: the type of transfer that best suits the situation; the circumstances that are dictating the transfer; whether the business will be moved; or whether the land on which the business is operated will be purchased or leased. And that's just for openers.

TYPES OF TRANSFERS

Fundamentally, there are three different types of buy/sell agreements: an asset purchase; a stock transfer; and a so-called "owner's agreement." Which one of these fits best for your client will depend on the circumstances of the particular transfer.

THE GOOD: ASSET PURCHASES

The good news for buyers is that they do not have to buy the seller's liabilities just because they are acquiring the business. That's where an asset purchase agreement comes in handy. Indeed, asset transfers are the most common way small businesses are bought and sold. Why? Because the buyer can pick and choose which liabilities to assume. See generally *Ray v. Alad Corp.,* 19 Cal 3d 22 (1977). In an asset transfer situation, the buyer typically forms a new entity and that new entity enters into an agreement to buy "substantially all of the assets" of the entity that owns the business being purchased.

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However, just as forming a corporation is not enough, without following corporate formalities to provide limited liability to a business, buying assets does not in and of itself provide protection from a seller's liabilities. See *Ray, supra*, 19 Cal.3d at 28. Some liabilities can be avoided only if certain steps are taken. For example, to avoid employment, sales and franchise taxes a buyer must obtain tax clearance certificates or releases. Cal. Unemp. Ins. Code §1733; Cal. Rev. & Tax Code §6811, et seq. and §19226). Complying with bulk sales laws will protect a buyer from the aggravation of a lawsuit over a seller's unsecured creditor claims. Cal. Com. Code §6107. Secured creditor claims that would otherwise become the buyer's problem after purchase can be terminated prior to closing with the agreement of the secured party by filing UCC termination statements.

Other liabilities can only be avoided by making clear that there is no implied assumption. See *Ray, supra,* 19 Cal.3d at 28. To minimize the risk of employment-related liability after closing, for example, a purchase agreement should require the seller to terminate employment of all its employees at the closing and give the buyer the right, but not the obligation, to hire any of them. The buyer also needs to be counseled to interview all employees it desires to hire and treat them just like any other potential employee rather than relying on information the seller may provide. This protects the buyer from most of the seller's employment obligations, but not all. The buyer can pick and choose the employees it wants to hire and the liabilities it wants to assume. However, if the purchase agreement implies liability or if the buyer does not know the

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things that can cause trouble and acts inappropriately, the buyer can become liable for all of the seller's obligations, including employment obligations, as a successor in interest.

The good news is that with proper planning an asset purchase agreement can be utilized to avoid successor liability.

THE BAD: POTENTIAL LIABILITY WITH A STOCK TRANSFER

An alternative to an asset purchase is a stock transfer. Technically, under that scenario, the buyer, purchases stock and does not acquire successor liability; however, the purchaser does acquire the entity which retains all the liabilities. See *Potlatch-Corp v. Superior Court,* 154 Cal App. 3d 1144, 1150-51 (1984).

The bad news is that although a buyer may prefer to buy assets, a stock transfer is preferable for a seller. Although sellers are often willing to sell assets, sometimes the cost of selling them can be too high. For example, deferred taxes like depreciation or LIFO, or contingent liability that vests upon sale of assets (such as unfunded pension plan liability that must be paid if the assets are sold) may cost the seller a small fortune. A stock transfer, on the other hand, will transfer only the capital stock of the entity. The business continues without itself changing hands, so the seller will not have to pay off the liabilities, since the entity is not winding down.

Now let's look at the deal from the buyer's perspective. Why would a buyer agree to buy stock when pension plan liability and/or other major liabilities exist? Because the purchase price will be lower, reducing the need for an immediate cash outlay, and often the liability can be reduced or even eliminated over time.

In other situations, a seller and buyer may have agreed to transfer just a percentage of the business. This often happens when cash is needed or when an employee or child is given an opportunity to buy into the business.

An owner's agreement—which is the third type of buy-sell agreement mentioned above—is always a good idea as part of a partial transfer. Oddly, counsel often avoid using it. An owners' agreement is another form of buy/sell arrangement that protects a buyer and seller from ending up being partners with an ex-spouse who acquires an interest in the business via divorce, a creditor who forecloses on an interest in the business, or an heir who inherits an interest. Parties often want to do only one agreement at a time and opt to address the need for documentation of the transfer at the expense of protecting against future events. When parties avoid doing what they should do, like owners' agreements, or even hiring competent counsel, things can get ugly.

THE UGLY: LOOSE ENDS

An asset purchase agreement without a statement that the buyer is not assuming any obligations of the seller, except as specifically set forth in the purchase agreement, exposes a buyer to all kinds of unnecessary liability. By the same token, a buyer's failure to act consistently with the statement that it is not assuming liabilities can result in successor liability in an asset transfer. A buyer typically pays more for assets than for stock because liabilities are retained by the seller. The last thing a buyer wants is to end up with unanticipated successor liability when buying only assets.

Successor liability can arise when the buyer acts like the successor of the seller's business. Buyers often think of themselves as buying a going concern even when they are purchasing "only assets." In reality, if only assets are purchased, the buyer will need to change enough so that the business does not appear to be a mere continuation of the seller's operation and can succeed in avoiding that liability if the buyer is careful in hewing to that approach. See *Ray, supra,* 19 Cal.3d at 28.

For example, in an attempt to smooth the transition, a buyer will often decide to provide some benefit to employees that they received from the seller, such as seniority or vacation pay. This can be a very costly mistake. Agreeing to continue even one of the seller's employment obligations can open a buyer up to successor liability because it implies an agreement to assume the liability. See *Fisher v. Allis-Chalmers Corp. Prod. Liab. Trust,* 95 Cal App. 4th 1182, 1188 (2002).

A better approach is to terminate all employment relationships, and proceed to interview former employees and make decision about whom to hire and what the terms will be. As part of this process, the purchaser's representatives can ask the persons being considered for employment what terms they would accept and then make a decision that is consistent with *the buyer's* employment policies about how to treat all employees being hired. If the policy happens to be the same as the seller's, that should still insulate the buyer from assuming the seller's employment liability as long as the buyer does not agree to assume the seller's obligations with respect to any established policy of the seller.

Buyers often get salary history from sellers for all employees. However, under new California legislation effective January 1, 2017, asking for individual salary history on employees could lead to a claim of wage discrimination against the buyer by one or more of seller's employees. SB 1063, 2015-2016 Leg. Sess., Chapter 866; Cal. Labor Code §§1197.5, 1199.5. A better approach is to ask a prospective employee what they are looking for in compensation. You can also ask them why they think they are worth that amount of pay. If they tell you their prior salary without you having asked, it is ok as long as you don't base their pay on the history. Keep record of the reason for the salary decision and make sure it is not based on salary history.

INADVERTENT ASSUMPTION OF LIABILITY

It is also possible to inadvertently step into successor liability. In *Golden State Bottling Company v. NLRB*, 414 U.S. 168 (1973), the Supreme Court ruled that the buyer of a business who knew about an unpaid wage claim that was not resolved prior to closing was nevertheless required to reinstate the employee (who had not been hired by the buyer) and in addition, the court held that the buyer and seller were jointly responsible for back pay. The fact that the buyer had not been told about the lawsuit by the seller did not matter because the buyer had hired the seller's manager and required that he work for the buyer for at least a year as a condition of the transfer. The court stated that an inference that the manager told the buyer about the lawsuit was not unreasonable even if strict agency principals would not impute the knowledge of the manager to the buyer prior to the transfer. See *Golden State Bottling Co. v. NLRB, supra,* 414 U.S. at 174-175.

INDEMNITY & TAX ISSUES

A buyer can protect itself from a seller's liability with indemnity agreements, but they are only as good as the indemnitor's bank account. Some potential liability can only be handled by indemnity agreements, like the liability for unpaid wages such as arose in the *Golden State* case. Indemnity agreements typically include liability arising out of a seller's business operations prior to closing, environmental liability, and breach of warranties and representations. The seller's indemnification is a mirror image: A seller is typically indemnified from liability arising out of operation of the buyer's business *after* closing, breach of warranties and representations and environmental liability caused by the buyer.

A seller selling stock, however, should never agree to personally indemnify for corporate liabilities, and often won't. For instance, corporate rents are a liability of the corporation, not the shareholder, unless the shareholder has given a personal guaranty.

Taxes can also be an area of potential liability. Taxes are sometimes a corporate obligation and sometimes a personal liability. A buyer also has to think about the tax consequences of the transaction itself. For example, 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 a triple A (AAA) account. When the income is later distributed, it can be distributed tax free, as long as there is a corresponding balance in the AAA account. Each distribution reduces the AAA account, while retained earnings increase it.

An owner selling capital stock will want to make sure the purchase agreement allows distribution of AAA retained earnings before the sale closes. If it doesn't, the seller can't withdraw the cash on which taxes were already paid equal to the AAA account balance. Instead, the cash increases the purchase price resulting in a higher capital gains tax bill for the seller.

WARRANTIES, REPRESENTATIONS, DUE DILIGENCE

Warranties and representations and due diligence are important in any business transfer, but play a larger role in a stock transfer, for they will dictate the rights and liabilities of the parties. For example, if the seller has given a warranty and representation that financial statements accurately reflect the financial condition of the business but has not given the owner a right to withdraw AAA earnings, the warranty and representation could prove very costly to a seller for the reasons stated above.

Not surprisingly, the due diligence obligations in a stock purchase situation will need to be much more extensive than the for an asset purchase transaction. To illustrate, in addition to just doing a Phase I environmental review, a building inspection, and financial due diligence to make sure the business is what the buyer thinks it is, the buyer is going to want to understand how assets were accounted for on the financial statements. The way assets were accounted for could significantly affect the purchase price of the stock and even create corporate liability for fraud. Adjustments may be required to the purchase price under certain circumstances. One such circumstance calling for an adjustment is when the seller has an aged inventory, the value of which 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.

The same concerns exist even if only a minority interest is being purchased. However, a buyer buying a minority interest in a business in which he or she has worked will often take risks that an outsider, unfamiliar with the particular business operation, would be unwilling to assume. Even a buyer who is familiar with the business in general may not have any idea about whether corporate formalities have been followed or whether the S election was made properly. These are important considerations. If the S election is lost—which can happen for any number of reasons including transfer to an unqualified buyer or a failure to properly make or authorize the S election in the first place—the corporation is treated as if it were a C corporation. If that occurs, the entity could end up owing C corporation income taxes and penalties for failure to pay. See 26 U.S.C. §1371. This could be an issue even in an asset purchase situation because tax liens attach to assets of the taxpayer. 26 U.S.C. §6321.

Failure to follow corporate formalities can result in alter ego liability. See *Mid Century Ins. Co. v Gardner*, 9 Cal. App. 4th 1205, 1213-1214 (1992).

The buyer will need to know that the corporate formalities were properly maintained so that, as a new shareholder, the buyer does walk into alter ego liability for corporate obligations. Buyer's often fail to understand the importance of corporate formalities when they are buying a minority interest. Minority owners have certain statutory rights that can provide some protection, but it is best to know the risks going in so that indemnity provisions can be written into the agreement for risks a buyer never intended to assume.

Finally, the consequences of not entering into an owner's agreement as part of a transfer of less than all the ownership interest in a business can result in costly litigation over what will happen if a shareholder becomes unhappy and wants out, or over what rights a spouse, heir or creditor has with respect to the business once they become an owner.

Simple as they may seem, buy-sell situations pose many traps for the unwary. The good news is that those "traps" can be avoided if addressed in timely fashion by experienced counsel who can lead the client to a safe transactional conclusion through careful planning and due diligence.

MCLE – Buy-Sell Agreements

True/False Test & Answer Key

1. Of the three ways to buy an interest in a business, a stock issuance is the best way to avoid buying unnecessary liability.

   Answer: False. The best way for a buyer to avoid unnecessary liability is to buy assets since buying stock, either from a corporation or from a third party, is a way of buying an interest in an entire business which effectively transfers the entire business, including its assets and liabilities.

2. In an asset transfer the liabilities of the seller are never assumed, unless the buyer specifically agrees to assume them.

   Answer: False. While generally the buyer will not be buying liabilities unless the buyer agrees to assume them, many liabilities are automatically assumed unless specific steps are taken to make sure the buyer is not assuming the liabilities, and others can be assumed by implication.

3. A stock transfer requires more warranties and representations and more due diligence by a buyer than an asset transfer.

   Answer: True. Because the buyer is buying the entire business, it is important for a buyer to understand what all the liabilities are before closing the purchase.

4. Complying with bulk sales laws protects a buyer from claims by secured creditors.

   Answer: False. Complying with bulk sales laws protects a buyer against a seller's unsecured creditor claims.

5. The buyer of a business is well advised to find out salaries of all the seller's employees to use for determining what the buyer will pay the same employees.

   Answer: False. Basing pay on salaries paid by the seller to the same employees could result in a claim of discrimination against the buyer and violation of privacy laws against seller.

6. A buyer will always have successor liability when buying stock, but may or may not have successor liability when buying assets.

   Answer: False. Successor liability can be largely avoided by buying assets, but only if certain steps are taken and certain provisions are written into the purchase agreement. There is no successor liability when buying stock, because the shareholder is the buyer and is immune from corporate liability provided the corporation is properly set up and maintained.

7. An owner's agreement protects owners of a business from having unintended partners.

   Answer: True. One of the primary purposes of an owner's agreement is to protect the owners from becoming partners with someone with whom they did not agree to partner.

8. An asset purchase agreement does not need to specifically state that no liabilities are being purchased.

   Answer: False. If an asset purchase agreement describes assets being purchased but does not specify that no liabilities are being purchased, transfer of liabilities can be implied, such as employee obligations if the seller's employees are hired by the buyer.

9. If an asset purchase agreement clearly states that the buyer is not assuming any of the seller's obligations, then there can be no successor liability.

   Answer: False. Successor liability can arise in an asset purchase from a buyer acting in a manner that is inconsistent with the terms of the purchase agreement, for example, by giving all of seller's employees who were hired by the buyer the same accrued vacation they had with the seller.

10. A buyer who buys assets can have successor liability even if the buyer does everything right.

    Answer: True. A buyer can become liable for the seller's obligations under certain circumstances that might be unanticipated, such as by hiring the seller's manager who knew about liability that is not disclosed to the buyer. This is why indemnity agreements are important.

11. A buyer can always protect itself from successor liability with an indemnity agreement.

    Answer: False. A buyer can only protect itself with an indemnity agreement if the seller agrees, and if the seller has the assets to back up the indemnity agreement.

12. An S corporation owner without the right to withdraw retained earnings prior to the closing of a stock transfer may pay unnecessary taxes.

    Answer: True. S corporation retained earnings are called triple A (AAA) earnings. The shareholder pays tax on AAA earnings whether or not they are distributed. If they are not distributed, they will increase the value of the corporation and therefore the purchase price on which the seller must pay tax.

13. Violation of S Corporation rules can have adverse tax consequences for both a buyer and seller.

    Answer: True. In an asset purchase a tax lien can attach to assets being purchased if an S election was not made properly or lost. In a stock purchase agreement the buyer could end up with a C corporation, and C corporation tax liability, when it thought it was buying an S corporation. In either case the seller can be held liable under indemnity provisions.

14. A risk of not having an owner's agreement is protracted litigation over the rights of an unhappy owner, or spouse, heir or creditor.

    Answer: True. Because an owner can lose their interest to a spouse in divorce, an heir upon death or a creditor in litigation or bankruptcy, and because sometimes even intended owners become unhappy, the risk of not having an owner's agreement is protracted litigation over issues that could have been easily addressed in an owner's agreement to avoid litigation.

15. Successor liability can arise out of a buyer acting like a successor in interest although the buyer only purchased assets.

    Answer: True. If a buyer of assets uses them to merely continue the seller's business, practices and procedures, the buyer can have liability as a successor in interest.

16. It is a good idea for a buyer who purchases assets to offer a seller's employees the same benefits they had with the seller to keep them happy.

    Answer: False. Offering employees the same benefits the seller gave them could expose the buyer to successor liability.

17. A buyer who is buying stock in an S corporation must qualify so the corporation does not become a C corporation.

    Answer: True. A buyer of an S corporation must be a person qualified to own an interest in an S corporation or the corporation will lose its S election and become a C corporation.

18. The partners in a business cannot become partners with third parties unless all existing partners agree.

    False. Unless the partners have an owner's agreement that prevents other partners from being added, a partner can involuntarily lose their interest to a third party, or sell their interest to a third party, who will then be a partner.

19. Maintenance of corporate formalities is irrelevant to the transfer of a business.

    Answer: False. A buyer who buys the stock of a corporation that has not been properly maintained could have personal liability for the corporation's obligations.

20. Transferring a business is simply a matter of drafting a contract and anyone who has taken a contracts class in law school has the experience necessary to handle the transaction competently.

    Answer: False. Many issues can come up that require knowledge of secured transactions, corporate law, tax law and accounting in addition to contract law.