Key Conversations

Selling Your Company: Anatomy of a Deal

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"A rose is a rose is a rose." A line from a poem by Gertrude Stein, an influential American writer of the 20th century, means that things are what they are. But if you are a business owner considering the sale of your business, it's important to keep in mind that not all deals are simple or the same. In fact, there are a number of variables that must be considered and evaluated to determine if a proposed deal helps achieve your personal and financial objectives.

This would be an easy exercise if everyone selling his or her business received all cash at closing from the buyer. Unfortunately, this is rarely the case. Instead, three basic variables usually come into play:

- What's being sold
- The sales price
- Payment structure

Let's take a look at each of these variables and how they could impact the sale of your business.

What's being sold?

When a buyer has trouble financing the purchase of the entire business, he or she may settle for a purchase of a majority interest in the company,assuming control but leaving the seller with a minority ownership position. The seller will typically receive a "second bite of the apple" in a couple of years when the buyer purchases the remaining interests from the seller under an option agreement. Similarly, as part of the payment, the seller may choose to receive stock in the new buyer's company, effectively reducing the seller's ownership to a minority position. There may also be similar options to purchase related property, such as real estate used or anticipated to be used by the business.

The sales price

The discussion above shows how the "sales price" variable is dependent upon the "what's being sold" variable. But what else do you need to consider about the sales price? The seller usually accepts a potential buyer's offer by signing a "letter of intent" proffered by the buyer. The letter of intent sets a proposed sales price, and that price can shift up or down before closing. The more common occurrence is for the price to adjust downward, as the buyer during due diligence discovers some chinks in the armor of the company and uses those findings as negotiating leverage.

Key Takeaways

When selling a business, very few business owners receive a single, lump-sum cash payment.

Instead, payment of the purchase price is often structured as a down-payment combined with deferred payments.

Careful consideration of the timing and tax impacts of payments on the net sales proceeds of your business is required regardless of how your deal is structured.

Payment structure

Another major variable in most deals is the payment structure. Very few sellers receive a lump-sum, all-cash payment for their business. One of the disadvantages of an all-cash deal is the spike in income and the seller's inability to spread the tax liability over two or more tax years.

Naturally, the payment structure is interrelated with sale price. If the seller requires a relatively large down payment, the buyers will negotiate for a lower overall price. If a seller is willing to receive payments over time or work under a consulting agreement, he will typically limit requests to reduce or tamp down the total price. A seller willing to take a seller's note or work under an earn-out demonstrates confidence in the future earning power of the business and helps with the buyer's psychological comfort in paying a higher overall price.

Much more common than an all-cash deal is a payment structure consisting of a down payment combined with various forms of deferred payments, such as seller-financed loan payments, employment or consulting contracts, and/or "earn out" payments. With a "seller's note," the seller is "carrying paper" by providing a loan to the buyer for a portion of the purchase price. A promissory note is signed by both seller and buyer and incorporates a negotiated term, payment schedule, and interest rate.

With a seller-financed loan, the buyer avoids some of the paperwork burdens associated with SBA-guaranteed loans and the loan origination fees a bank might charge. For the seller, a seller's note may help avoid a spike in income and defer income. The installment sale treatment offered by a seller's note may also help buyers avoid paying Alternative Minimum Taxes. The buyer is often asked to secure the note by pledging personal or business assets, and/or company stock as collateral.

Another form of deferred payment is a management or consulting agreement entered into between seller and buyer. The consulting agreement will help the new owners sustain and grow the profitability of the business because the seller stays on to assist with the transition of key customers and vendors. Under the consulting agreement, the seller can also help train new owners and managers on best practices and insider know-how.

The buyer and seller can also consider another form of deferred payment—an earn-out—that can be used with or without a seller's note. With an earn-out, the seller agrees that part of the sales price will be determined by how the business performs after the sale. For a seller optimistic about his or her company's future growth, an earn-out is a great opportunity to participate in that growth and get a couple more bites of the apple without incurring the high income tax rates of a consulting agreement. For a buyer, there is comfort in knowing the seller is willing to "put his money where his mouth is" by tying a portion of the purchase price to those bold earning projections.

Earn-out payments are calculated based on a formula set forth in the purchase agreement. Typically lasting one or two years, earn-outs can be tied to increases in sales revenue or increases in gross profits. The formula may establish a minimum amount – a floor – as well as a maximum amount—a ceiling. It usually benefits the seller to link an earn-out to a top-line number like revenue, rather than a bottom line figure like profits, because the new owner could manipulate the latter numbers by artificially increasing discretionary expenses.

As you consider the sale of your business, these are the key variables you need to understand and evaluate when looking at a deal to ensure you achieve your financial goals. For more information about business succession issues, talk to your Key Private Bank Relationship Manager who can introduce you to our Business Advisory Services team.

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