

ACQUISITIONS AND DISPOSITIONS OF CLOSELY-HELD COMPANIES

Presented to: Fort Worth Chapter
Texas Society of Certified Public Accountants
Continuing Education

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Date: June 25, 2002

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We appreciate the assistance of Michelle Eaton and Marcus Johnson, both of whom are associate attorneys of Bourland, Wall & Wenzel, P.C., in the preparation of this seminar outline.

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1. INTRODUCTION

[See Attachment 1]

One of the most critical times in a client's life is when he or she is selling the business they have spent years building. At the same time, the client who is in a growth and expansion mode also views clean, successful acquisitions as the key to his or her growth strategy. This article is intended to provide an outline to the practitioners of the basic steps in the acquisition or disposition of a privately-held business with references to key issues at each juncture of the process. While it is beyond the scope of this article to address all the tax issues related to merger and acquisition activities, a couple of tax planning tools are discussed which could be used to lower the overall tax burden to the Seller by reducing franchise taxes and converting a portion of the income from ordinary income rates to capital gain.

2. PREPARING TO SELL

Sometimes a client wants assistance in selling his business and hires a Broker to search out prospective Buyers, screen the Buyers and assist in the negotiation of the terms and conditions of the sale. While each Broker Agreement has its own special provisions and nuances, there are certain major issues the Seller should focus on prior to signing the Broker Agreement. The main issues which should be carefully studied prior to entering into a Broker Agreement are as follows:

- (A) Confidentiality – Most Sellers do not want public disclosures to third parties that their business is for sale because of the impact it could have on their business relationship with customers and their employees. There are varying levels of confidentiality in Broker Agreements starting from no requirement to maintain the confidentiality of the materials of the Target Company to a provision that the name of the Target Company cannot be disclosed to the prospective Buyer until the prospective Buyer signs a confidentiality agreement. Normally an agreed generic information package, approved by the Seller, can be prepared and provided to the prospective Buyer who, if it expresses an interest in more information, would then be required to sign a confidentiality agreement before receiving additional information.
- (B) Definition of Sales Price – Each Broker Agreement provides for a commission to be paid to the Broker based on the sales price of the business of the Target Company. The Seller needs to have a clear understanding of the calculation of the sales price, which in most agreements will include not just the cash or other property received by the Seller, but also include debt assumed, compensation agreements, covenant not to compete payments, lease write-ups, warrants or other options, and consulting fees. This is just an initial list of certain items. Some agreements will provide for a commission to be paid on the retained cash by the Target Company or any liquidation proceeds that are distributed by the Target Company to the Seller shareholders including cars, personal property, and other non-business assets.
- (C) When is the Fee Earned? – The Seller is normally of the belief that the fee is only earned by the Broker if the transaction closes and it receives payment of the sales price. The standard Broker Agreement will sometimes contain provisions in which the fee is earned prior to the closing, i.e. when the Acquisition Agreement is entered into or sometimes when the Seller rejects a prospective candidate who proposes a letter of intent at the price

and terms previously set by Seller. Each agreement has to be carefully analyzed on this point so that the Seller does not receive a surprise as to when the fee is earned.

- (D) Expenses – It is common for the Broker Agreement to provide that the Seller will pay all of the Broker’s expenses related to its work on behalf of the Seller in the sale of the business. This is sometimes accomplished by an up front fee based on their estimates of the expenses to be incurred, or an agreement to reimburse them for their out-of-pocket expenses in the preparation of marketing materials, travel costs and other matters in the promotion to sell the Target Company. This is usually addressed by putting a specific cap on the type of expenses and amounts of expenses and/or an agreement to only reimburse the broker for pre-approved expenses.
- (E) Termination of Agreement – The Broker Agreement will normally have a set term, but most Agreements will provide that the Agreement continues beyond the set term unless either party provides a written termination of the Agreement, an “evergreen” type clause. Additionally, even if the Agreement is terminated it often will provide that the Broker will be paid its commission if the Seller sells the Target Company within a certain period of time after the termination of the Agreement to a prospective Buyer provided by the Broker. While this type of provision is not unreasonable, the time period beyond the termination of the Agreement in which a sale is to occur for the Broker to receive commission and the definition of a prospective Buyer are both matters which should be carefully reviewed. Part of the Broker sales process is to send out mass mailings to prospective purchasers. This type of contact with prospective Buyer, i.e. a mass mailing, can give rise to a claim by the Broker that if the Seller ultimately sells the Target Company to that Buyer within the time period after the Broker Agreement is terminated that the Broker should receive a commission because it was the Broker’s “contact” of that prospective Buyer that triggered the sale. The preferable way to handle this is to define a higher standard of who a prospective Buyer would be for purposes of any sale after the termination of the Agreement and further to have the parties agree on a specific list of prospective Buyers upon termination of the Broker Agreement and attach the list to the Agreement.

The above is a general listing of major terms of a Broker Agreement which should be carefully reviewed prior to any Seller entering into the Agreement. In no event should a prospective Seller enter into a Broker Agreement without a careful review and understanding of all of its terms. There is no “standard” Broker Agreement as each Broker has developed its own format of terms and conditions. One thing is consistent with these Broker Agreements however, is that is the Broker is willing to negotiate and revise the terms of the Agreement in order to obtain the right to sell your client’s business.

3. ROLE OF THE ACCOUNTANT

In most acquisitions, the accountant for the Seller and Buyer will play a key role in the entire acquisition process. Accordingly, it is vital that the accountants for both the Seller and the Buyer be involved in the acquisition transaction early on and continue such involvement throughout the entire acquisition process. The Seller’s accountant is normally the first party with which a Seller will discuss the economics of the sale, prospective Buyers and other issues. In some situations, the Seller has used the accountant as the contact and screening party for prospective Buyers. The Seller’s accountant will need to advise the Seller on the economic terms of the acquisition transaction. This will include explaining the federal, state, and other tax consequences that will result from the sale of the Target Company and assisting the Seller in structuring the transaction in a manner that will provide the Seller with after-tax

benefits that are consistent with the financial goals of the Seller. If the Target Company is a C corporation for federal income tax purposes (or an S-corporation that recently converted from C corporation status), these issues can become very complicated and the Seller needs to be educated on the tax and other differences in a stock or asset sale involving the Target Company. Oftentimes, the purchase price is based upon certain formulas (i.e. EBITDA, Net Working Capital, etc.) The accountants for both the Buyer and the Seller will need to assist the parties in analyzing and understanding how these purchase price formulas will operate and making sure such formulas really work when applied to the particular circumstances of the Target Company. In the end, it will be the accountants and other financial personnel who actually “crunch the numbers” on these formulas. In addition, in an asset acquisition, the accountants for the Buyer and Seller need to be involved in the allocation of the purchase price among the assets of the Target Company being purchased by the Buyer. The manner in which the purchase price is allocated among the acquired assets may have significant tax consequences to both the Buyer and the Seller. In connection with the Buyer’s evaluation of the financial condition of the Target Company, the Seller’s accountant may need to assist the Seller in preparing financial statements of the Target Company. In addition, the Buyer’s accountant will need to assist the Buyer in its evaluation of the financial condition of the Target Company to make sure the acquisition makes good economic sense. This may require analysis of tax returns and financial statements of the Target Company, talking with the chief financial officer or other financial personnel of the Target Company, and reviewing and inspecting the books and records of the Target Company. Furthermore, if the Seller will be receiving promissory notes or stock of the Buyer as part of the acquisition transaction, the Seller’s accountant may need to assist the Seller in conducting a financial evaluation of the Buyer to confirm the financial position of the Buyer and assess potential risk. The Acquisition Agreement will certainly contain detailed representations and warranties of the Seller regarding the tax returns, financial statements, accounts receivable, employee benefits, and other financial matters of the Target Company. The Seller’s accountant, who usually has a good knowledge of the business of the Target Company (i.e. tax returns, financial statements, litigation, claims by employees, employee benefit issues) needs to review these representations and warranties to make sure that these statements are accurate, and if not, propose appropriate adjustments to make such statements accurate. After the closing of the acquisition of the Target Company, the accountants for the Buyer and the Seller may need to perform post-closing purchase price adjustments. Finally, the Seller’s accountant may need to need to assist the Seller in preparing final federal and state tax returns for the Target Company and also the personal tax returns of the Seller.

4. TRANSACTION STRUCTURE

[See Attachment 2]

An acquisition transaction can be structured in multiple ways. The manner in which the acquisition transaction is structured will have significant tax and non-tax consequences to both the Buyer and the Seller. Accordingly, the acquisition structure should be addressed and agreed to at the outset of the acquisition transaction. The basic acquisition structures are: (1) asset purchase transaction, (2) stock purchase transaction, and 3) merger transaction. This presentation will focus on the first two types of acquisition structures.

A. Asset Purchase Structure.

Under an asset purchase structure, the Buyer purchases the operating assets and goodwill of the Target Company. Often, the Buyer will also purchase the accounts receivable and perhaps even the cash of the Target Company--but this will be a business point to be negotiated by the parties. The consideration for the purchased assets is paid directly to the Target Company. Furthermore, in an asset purchase, the Buyer only assumes those liabilities of the Target Company which the Buyer expressly agrees to assume as set forth in the Acquisition Agreement; all other liabilities of the Target Company remain the obligation of the Target Company. As a result, after the closing of an asset purchase

acquisition, the Target Company is still owned by the Seller, with the primary assets of the Target Company being the consideration received from the Buyer for the acquired assets (this assumes, of course, that the Target Company has only one line of business which was acquired by the Buyer). The Buyer will generally prefer the asset purchase structure because it allows the Buyer to limit its exposure for debts, obligations, and liabilities of the Target Company to only those debts, obligations, and liabilities which the Buyer expressly agrees to assume. In addition, an asset purchase structure allows the Buyer to obtain a “stepped up” tax basis in the acquired assets of the Target Company for federal income tax purposes. Such “stepped up” basis is equal to consideration paid for the assets (including assumed liabilities) plus acquisition expenses. As a result of such “stepped up” basis in the acquired assets, the Buyer may obtain significant tax benefits in the future in the form of depreciation and amortization deductions. The tax attributes of the Target Company, including net operating loss carryovers and built-in gains, do not carry over to the Buyer. (**Note:** In the absence of an express allocation agreement between the Buyer and the Seller, the purchase price for the acquired assets is allocated among such assets pursuant to Section 1060 of the Internal Revenue of Code. Final Regulations under Section 1060 have been issued and these Final Regulations apply to asset acquisitions occurring after March 15, 2001). On the other hand, the Seller will generally disfavor the asset purchase structure if the Target Company is a C corporation for federal income tax purposes, because such structure could lead to double taxation (i.e., at the corporate level on the sale of the assets and at the shareholder level on a distribution to the shareholders). In addition, an asset purchase structure could also give rise to additional Texas franchise tax liability for the Target Company.

Finally, the asset acquisition structure can also be cumbersome to both the Buyer and the Seller if the Target Company has many assets that need special documentation for transfer to the Buyer (i.e., real property deeds, motor vehicle titles, patents, trademarks and other intellectual property, etc.) and/or contracts that are to be transferred to the Buyer. Considerable time and expense may be involved in the preparation of the documentation necessary to transfer the special assets from the Target Company to the Buyer, including filing such documentation with the appropriate governmental authorities. Furthermore, with respect to the contracts of the Target Company to be transferred to the Buyer, the Buyer and Seller may need to obtain the consent of the other party to such contracts in order to effectively transfer such contracts to the Buyer. The failure to obtain such necessary consents could lead to a default under such contract if the contract contains an anti-assignment clause that prohibits the Target Company from transferring the contract to another person without the consent of the other party to the contract. The process of obtaining such third party consents on the contracts to be transferred from the Target Company to the Buyer can take a considerable period of time especially if the other party to the contract is being difficult, slow, or trying to obtain additional benefits for its trouble.

B. Stock Purchase Structure.

In a stock purchase structure, the Buyer purchases the shares of stock in the Target Company directly from the Seller (i.e., the shareholders of the Target Company). The consideration for the stock acquisition goes directly to the Seller (rather than to the Target Company as in the asset purchase structure). After the closing of a stock purchase, the Buyer is the new shareholder of the Target Company. Generally speaking, the Buyer disfavors the stock purchase structure because it will acquire all of the liabilities of the Target Company--both known and unknown. As a result, the Buyer faces unknown and potentially unlimited liability in a stock purchase transaction. In addition, for federal income tax purposes, the stock purchase structure results in a "carryover" tax basis for the assets of the Target Company--a less favorable result to the Buyer than the "stepped up" basis that arises under the asset purchase structure. On the other hand, the Seller prefers the stock purchase structure (especially if the Target Company is a C corporation for federal income tax purposes) because this structure results in a single level of tax at the lower capital gains tax rate for individuals. In addition, the stock purchase structure allows the Target Company to avoid any franchise tax consequences because the transaction does not involve the sale/transfer of the Target Company's assets.

Finally, because no transfer of assets or contracts occurs in a stock purchase acquisition (i.e., all of the assets and contracts remain inside the Target Company--only the shares of stock in the Target Company are transferred), the stock purchase structure allows the Buyer and Seller to avoid many of the problems associated with an asset purchase structure with respect to: (a) the need to prepare and file additional documentation to transfer special assets of the Target Company, and (b) the need to obtain third party consents on contracts of the Target to be transferred to the Buyer. Please note, however, that certain contracts, especially contracts with sophisticated parties, may require the consent of the other party to the contract in the event a "change of control" occurs with respect to the Target Company. A stock purchase transaction would result in a change of control of the Target Company (i.e., from the Seller to the Buyer) and therefore would require the consent of the other party to the contract.

5. THE CONFIDENTIALITY AGREEMENT

[See Attachment 3]

Unless a Broker Agreement is in place, the Confidentiality Agreement is usually the first document to be prepared and delivered in the acquisition transaction. It is extremely important for the Seller to require a Confidentiality Agreement because oftentimes the Buyer is already a direct competitor of the Target Company or is trying to establish a presence in the market served by the Target Company. The Seller should always require the Buyer to sign the Confidentiality Agreement before the Target Company provides any confidential material to the Buyer. Many times, it is in letter form addressed to the Target Company from the Buyer, especially if the Buyer is a larger business that has engaged in a number of acquisitions in prior years. However, the Confidentiality Agreement may be structured as a drafted agreement, executed by both parties to the transaction.

The purpose of the Confidentiality Agreement is to preserve the Target Company's confidential information that will be disclosed to the Buyer during the acquisition process. It does not bind either of the parties to complete the contemplated acquisition, but merely serves as a starting point for the exchange of information vital to the Buyer's determination of the desirability of the acquisition. While the Seller may desire to sell the Target Company, the Seller does not want important confidential information of the Target Company, such as trade secrets, financial statements, gross margin ratios, inventions, formulas, research and development, customer lists, supplier lists, and other important information to be unprotected should the acquisition not occur. The Confidentiality Agreement limits the

Buyer's use of the Target Company's confidential information solely to evaluating the desirability of the acquisition transaction.

Probably the most important provision of the Confidentiality Agreement is the definition assigned to "confidential information." Obviously, the Buyer wants to make this definition as narrow as possible, since the less information that is protected, the less risk of being held liable for its use or disclosure of the Target Company's business information. The Seller, however, desires a broader definition of "confidential information" to have increased protection from use and disclosure. Generally, most Confidentiality Agreements will define the term to include all information (whether or not marked "confidential") in whatever form (i.e. documents, computer files, etc.), provided by the Target Company to the Buyer. Additionally, the term may include any information, in whatever form, prepared by the Buyer based upon information provided by the Target Company. The definition of confidential information usually excludes information that becomes publicly available other than as a result of acts or omissions of the Buyer in violation of the Confidentiality Agreement. Sometimes, in a more "Buyer-friendly" Confidentiality Agreement, the definition of confidential information will exclude any information that becomes available to the Buyer from a source that is not bound by a confidentiality agreement or other obligation of secrecy to the Target Company.

Another key provision of the Confidentiality Agreement from the Seller's point of view is the provision that limits the use of confidential information by the Buyer solely to the evaluation of the desirability of the acquisition. Once "confidential information" is defined, this provision prohibits the parties from using any of such information for any purpose other than evaluating the acquisition transaction. Disclosure of confidential information by the Buyer, however, should be permitted where the Buyer needs to consult with those people who reasonably need to know such information to assist the Buyer in evaluating the acquisition transaction, such as advisors, accountants and legal counsel. In such event, the Seller would want an agreement of the Buyer to inform the Buyer's representatives and advisors of the confidential nature of the information being provided and to obtain the agreement of such representatives and advisors to keep such information confidential.

Generally, most Confidentiality Agreements will call for the return or destruction of the confidential information upon written request by the Target Company. The option of destruction or return is usually delegated to the Target Company, and, if destruction is used, written certification by the Buyer that such destruction occurred should be provided for.

Finally, the length of the survival period of the terms and obligations of the Confidentiality Agreement is also a very important provision. The provision is extremely important if the proposed acquisition transaction is terminated. The Buyer will want a short survival period in order to limit the time period it is bound by the terms and conditions of the Confidentiality Agreement. Many times, the Buyer will seek a one year survival period for the Confidentiality Agreement. On the other hand, the Seller will want a long survival period for the Confidentiality Agreement—and will often seek to have the survival period be perpetual.

6. LETTER OF INTENT

[See Attachment 4]

The Letter of Intent is often entered into between the Buyer and the Seller as a result of successful preliminary negotiations regarding the acquisition transaction. The Letter of Intent is not the final Acquisition Agreement between the parties, but instead sets forth the key terms and conditions regarding the transaction which will be included in the final Acquisition Agreement. The Letter of Intent really symbolizes the mutual desire of the Buyer and Seller to earnestly move forward with the acquisition transaction on the basic terms and conditions already agreed to. The Letter of Intent is usually nonbinding--meaning that either the Buyer or the Seller may terminate the acquisition at any time prior to signing the final Acquisition Agreement without any liability whatsoever.

The level of detail covered by the Letter of Intent will vary significantly depending upon the personal preferences of the Seller. Some Sellers are content to limit the scope of the Letter of Intent to the basic economic terms of the transaction and address other significant non-economic items later down the road in the Acquisition Agreement. On the other hand, some Sellers prefer to address most of the significant economic and non-economic items at the Letter of Intent stage before proceeding any further with the acquisition transaction. From the Seller's perspective, the advantage of a detailed Letter of Intent is that, early on in the acquisition process, the Seller knows that he/she has struck a deal with which he/she is comfortable. Also, it has been our experience that, in many cases, the Seller has more bargaining power early on in the acquisition process and may be able to obtain concessions from the Buyer at the Letter of Intent stage that would not be possible later on. The disadvantage of the detailed Letter of Intent, however, is that it is more time consuming, more costly, and more contentious than a Letter of Intent that covers primarily the economic terms of the transaction. In any event, the letter of intent will usually address the following items: (1) acquisition structure (i.e. asset purchase, stock purchase, merger, etc.), (2) the purchase price (including any related formulas to determine the purchase price), (3) the type of consideration to be paid (i.e. cash, promissory notes, stock, or a combination of the foregoing), (4) the holdback/escrow amount, (5) the fundamental terms of any employment agreements to be entered into, (6) the fundamental terms of any non-competition restrictions (what, where, and how long), and (7) the closing date.

In addition to setting forth the basic terms and conditions of the acquisition transaction, the Letter of Intent addresses certain other important matters. First, the Letter of Intent contains the agreement of the Seller to allow the Buyer to conduct a formal and comprehensive due diligence review of the business and affairs of the Target Company. Second, if the parties have not previously entered into a Confidentiality Agreement, the Letter of Intent will contain confidentiality provisions to ensure the secrecy of information exchanged between the Buyer and the Seller. Third, the Letter of Intent usually contains a "no-shop" provision which prohibits the Seller from negotiating for the sale of the Target Company with any other potential buyers while the Letter of Intent is in effect (and frequently for an extended period of time after the termination of the Letter of Intent). Fourth, the Letter of Intent addresses how the costs and expenses related to the acquisition transaction are to be allocated, including costs and expenses related to brokers, attorneys, accountants and other professional advisors. Finally, many times the Letter of Intent requires the parties to refrain from disclosing the proposed acquisition transaction until a final definitive Acquisition Agreement is signed and delivered by the parties.

7. DUE DILIGENCE

[See Attachment 5]

Due diligence is the process by which the Buyer obtains information about the Target Company and investigates the Target Company in order to evaluate the desirability of the acquisition transaction. Usually, the Buyer's formal due diligence begins with the submission of a Due Diligence List to the Target Company. The Due Diligence List is a comprehensive list of various information to be provided by the Target Company regarding its business and affairs. Examples of the type of information to be provided by the Target Company include: 1) copies of financial statements, 2) copies of tax returns, 3) copies of audit letters, 4) copies of major contracts (including a description of any defaults relating to such contracts), 5) descriptions of pending or threatened litigation, 6) descriptions of governmental audits, investigations, or inquiries, 6) major customers and suppliers, including associated revenues and expenses, 7) special permit and licensing requirements, 8) states in which the Target Company's business is conducted, 9) intellectual property rights and 10) environmental issues.

After the information requested in the Due Diligence List is provided by the Target Company to the Buyer, the Buyer (along with its professional advisors such as the lawyer and accountant) should carefully review such information to assess the overall condition, prospects, and risks of the Target Company. Often, the Buyer's review of the information provided by the Target Company will trigger additional questions and additional requests for information.

In addition, as part of the due diligence process, the Buyer often talks with key management personnel, customers, key suppliers and other business relations in order to obtain additional first hand information about the Target Company. Furthermore, the Buyer will visit the facilities of the Target Company for review and inspection of the buildings, equipment, machinery, inventory, and overall operations of the Target Company. If the Target Company is involved in an environmentally sensitive line of business, the Buyer may have an environmental study performed on the real property used by the Target Company. The Buyer will also conduct formal computerized searches of the state and county databases to determine whether there are any security interests, tax liens, or judgments affecting the Target Company and its assets.

The due diligence process continues until the closing with Buyer's review of the Seller's final Disclosure Schedules (discuss below). A solid due diligence review by the Buyer reduces the risk to the Buyer and provides some assurance for the Buyer that the Target Company really is operated in a manner consistent with the Buyer's analysis and belief.

8. ACQUISITION AGREEMENT

A. OVERVIEW

The Acquisition Agreement is the centerpiece agreement in an acquisition transaction. The Acquisition Agreement contains all of the material terms and conditions of the transaction. As a result, substantially all of the negotiation process involves "hammering out" the terms and conditions of the Acquisition Agreement.

No two Acquisition Agreements are identical, but they all possess a similar structure and common elements. In any Acquisition Agreement, the following subjects will likely be addressed (each of which is discussed in more detail below):

1. Purchase Price/Consideration;

2. Hold Back/Escrow;
3. Representations and Warranties;
4. Covenants;
5. Indemnity; and
6. Competition Restrictions.

B. PURCHASE PRICE/CONSIDERATION

The Purchase Price/Consideration section sets forth the purchase price and type of consideration to be paid by the Buyer to the Seller. Generally, the consideration paid by the Buyer consists of cash, promissory note, stock of the Buyer, or a combination of the above. Oftentimes, the purchase price is based, in part, upon the working capital position or balance sheet of the Target Company at the time of closing. Because the working capital position or balance sheet of the Target Company at the time of closing will not be known with certainty at that time, the parties will need to make adjustments after the closing and adjust the purchase price accordingly. Consequently, after the closing, the Buyer will need to make additional payments to the Seller if the purchase price has increased as a result of the post-closing adjustments OR the Seller will need to make reimbursement payments to the Buyer if the purchase price has decreased as a result of the post-closing adjustments. In the event a dispute arises between the parties as to the proper amount of the post-closing adjustments, the Acquisition Agreement usually requires that such dispute be submitted to an independent accounting firm for resolution, with the determination of the accounting firm to be final and binding on the parties.

C. HOLDBACK/ESCROW

The Holdback/Escrow section requires that a portion of the purchase price be withheld at the closing rather than paid by the Buyer to the Seller. This withheld portion of the purchase price can serve as a reserve to be used by the Buyer to compensate itself for any post closing purchase price adjustments, uncollected accounts receivable, or any losses it incurs as a result of breaches of the representations, warranties, and covenants of the Seller. This withheld portion may either be held by the Buyer itself or by a neutral third party escrow agent--such as a bank. The Buyer will prefer to retain the withheld portion so that it can exercise absolute control over such funds. On the other hand, the Seller will prefer the withheld funds to be held by a neutral third party escrow agent because ordinarily such escrowed funds cannot be disbursed to the Buyer without the approval of the Seller. The withholding period will vary from transaction to transaction but may range from a period of a few months to one or two years. In the event the Buyer has one or more claims against the Seller at the time the withheld funds are to be disbursed, any funds in excess of the amount reasonably necessary to cover the Buyer's claims should be disbursed to the Seller, with the remaining amount retained until the Buyer's claims are finally resolved. If part of the consideration paid by the Buyer to the Seller is Seller's promissory note, then in lieu of a holdback or escrow fund, the Buyer will retain an offset right against the promissory note payments to satisfy any obligations the Seller owes to the Buyer. (**Note:** If the Seller is required to reimburse/indemnify the Buyer for uncollected accounts receivable of the Target Company purchased by the Buyer, then the Seller should require the Buyer to reassign the uncollected accounts receivable back to the Seller so that the Seller can attempt collection.)

D. REPRESENTATIONS AND WARRANTIES

[See Attachment 6]

(1) Representations and Warranties of Seller.

This section sets forth a series of representations and warranties made by the Seller regarding the business and affairs of the Target Company. A comprehensive series of representations and warranties provides the Buyer with some assurance that the business of the Target Company is a good, clean business. It is not uncommon for this section to comprise 25% to 50% of the entire Acquisition Agreement. In the event the Seller's representations and warranties prove to be inaccurate, the Buyer will be able to obtain reimbursement for its losses from the Seller under the indemnity section of the Acquisition Agreement (as discussed below). Typical representations and warranties made by the Seller include representations and warranties regarding: (a) authority to enter into the transaction, (b) title to the assets, (c) condition of the assets, (d) collectability of accounts receivable, (e) accuracy of financial statements, (f) litigation, (g) compliance with laws, (h) payment of taxes, (i) employment issues, (j) real and leased property, (k) existing contracts and agreements, and (l) environmental matters. Furthermore, in a stock acquisition transaction, the Seller will make comprehensive representations and warranties regarding their stock ownership in the Target Company (i.e. number of shares owned, good title, etc.). Although there are standard representations and warranties in every Acquisition Agreement, it will be necessary to customize many of the representations and warranties to fit the particular business situation. For example, the acquisition of a gas station business will require extensive environmental representations and warranties by the Seller because of the significant environmental risks involved in that line of business, while the acquisition of an insurance business would not require extensive environmental representations and warranties.

(2) Representations and Warranties of Buyer.

This section contains representations and warranties made by the Buyer to the Seller regarding the business and affairs of the Buyer. The extent of the representations and warranties of the Buyer will depend on the type of consideration being paid to the Seller. If the consideration being paid to the Seller consists only of cash, the Buyer will generally provide very limited representations and warranties (i.e. representations and warranties to the effect that the Buyer has the authority to enter into the transaction) because the Seller will be taking the cash and "walking away" from the transaction without having any ongoing relationship with the Buyer. However, if the Seller will be receiving a promissory note issued by the Buyer or stock in the Buyer, the Seller will also require relatively extensive representations and warranties of the Buyer in order to make sure that the Buyer's note or stock is validly issued and authorized and that Buyer is a sound and financially stable company.

(3) Limitation on Representations and Warranties.

The Seller and the Buyer may attempt to "water down" or soften their respective representations and warranties by adding certain qualifications to their representations and warranties. The two most common qualifications are the "Knowledge" qualifier and the "Materiality" qualifier. The "Knowledge" qualifier insulates the maker of a representation or a warranty from liability unless the maker "knows" the representation or warranty being made is inaccurate. Frequently, considerable negotiation is involved in defining the meaning of "Knowledge." For example, with respect to the representations and warranties made by the Seller, the Buyer will want to define "Knowledge" to mean the knowledge the Seller would possess after conducting a reasonable investigation into the matters represented and warranted; on the other hand, the Seller will want to define "Knowledge" to mean actual knowledge of the Seller without

any investigation at all. Likewise, the “Materiality” qualifier insulates the maker of a representation or warranty from liability unless the representation or warranty proves to be inaccurate in any material respect. The “Materiality” qualifier is often used to prevent the parties from arguing over minor or technical breaches. Only when the breach has a material adverse effect will the maker have liability to the other party. Of course, the point at which a breach is material is subject to debate between the Buyer and the Seller. For example, if the Seller makes a representation that the operating assets of the Target Company are in good working condition in all material respects, then the fact that one vehicle is in need of minor repairs would probably not constitute a breach of this representation; however, if several vehicles require major repairs, then the Seller would probably be in breach of such representation.

(4) Disclosure Schedules.

The Disclosure Schedules set forth specific information which is required to be disclosed under the various representations and warranties. Because most of the representations and warranties are made by the Seller, the Disclosure Schedules ordinarily contain information regarding the business and affairs of the Target Company. Accordingly, this section will focus upon the Disclosure Schedules to be provided by the Seller.

The Seller’s Disclosure Schedules serve two main purposes. First, the Seller’s Disclosure Schedules allow the Buyer to obtain key information regarding the business and affairs of the Target Company. For example, under the representations and warranties section, the Seller may be required to list on the Disclosure Schedules all of the states in which the Target Company conducts its business. The Buyer will then review this list and make sure that is consistent with their prior due diligence investigation, and the Buyer can then verify that the Target Company is properly filed to do business in those states (if the Buyer has not already done so as part of its prior due diligence). Thus, the Disclosure Schedules serve as a concise information gathering mechanism for the Buyer and help the Buyer evaluate the Target Company before signing the Acquisition Agreement. Second, the Seller’s Disclosure Schedules allow the Seller to avoid being in breach of their representations and warranties by disclosing relevant information. For example, the Seller may be required to represent and warrant to the Buyer that there is no litigation affecting the Target Company. If, however, there was a lawsuit affecting the Target Company and the Seller did not disclose such lawsuit to the Buyer, the Seller would have breached their representation and warranty and risk liability to the extent the Buyer incurred losses as a result of such undisclosed litigation. The Seller can avoid breaching such representation by disclosing the particular lawsuit on the Seller’s Disclosure Schedules. In this respect, the Seller’s Disclosure Schedules are really “exceptions” or “exclusions” from their representations and warranties. Once the matter is disclosed on the Seller’s Disclosure Schedules, the Buyer has three options: 1) proceed with the transaction and accept the risk relating to the matters disclosed, 2) proceed with the transaction but shift the risk back to the Seller by requiring the Seller to indemnify the Buyer for any losses incurred in such matter, or 3) walk away from the deal (if the contract allows).

The Disclosure Schedules are prepared and agreed to by the parties prior to entering into the Acquisition Agreement. This is important because the Buyer needs time to evaluate the exceptions to the representations and warranties to insure that it does not impact the future profitability of the Target Company or did impact profitability in any material manner. Additionally, in most asset acquisitions, the Buyer will be assuming certain contracts and obligations of the Target Company as part of the overall acquisition transaction. The Buyer has to evaluate these contracts and obligations prior to agreeing, pursuant to the Acquisition Agreement, to assume these contracts and obligations at the closing. The manner of preparing the Disclosure Schedules can become a matter of dispute between the parties as the Seller wants a general disclosure to be all that is required while the Buyer wants specific disclosures so that it can more easily pinpoint problems (i.e. specific descriptions as to the nature of pending or threatened litigation, contract breaches, etc.).

E. COVENANTS

(1) Pre-Closing Covenants.

The Pre-Closing Covenants section is included in the Acquisition Agreement only if the Buyer and Seller are signing the Acquisition Agreement on one date and actually closing the acquisition transaction on a later date. One reason the transaction may have to be structured in this manner is to allow the parties time to obtain any required third party consents, including government approvals, prior to consummating the transaction. Most of the pre-closing covenants are designed to make sure the Seller continues to operate the business of the Target Company prudently until the closing. In other words, the Buyer wants to obtain assurances from the Seller that they will not let the business of the Target Company “fall-to-pieces” between the date the Acquisition Agreement is signed up by the parties and the date of the closing. Common pre-closing covenants of the Seller include promises to: (a) conduct the business in the ordinary and customary manner, (b) maintain the operating assets in good condition, (c) maintain relationships with customers, suppliers, employees, and other business contacts, and (d) give the Buyer access to the books, records and facilities of the Target Company so that the Buyer can continue any due diligence review until closing. In addition, the Buyer and Seller often jointly covenant (or promise) to cooperate with one another in moving forward to close the transaction. This would include working together to obtain any necessary third party consents and government approvals for the transaction.

(2) Post-Closing Covenants.

The Post-Closing Covenants section sets forth duties and obligations of the Buyer and Seller after the closing of the acquisition transaction. A common covenant of the Seller is to maintain the confidentiality of all non-public information relating to the Target Company’s business being sold to the Buyer. The Buyer often covenants (or promises) to give the Seller access to any books and records of the acquired business to enable the Seller to prepare their tax returns for the periods prior to the closing. In addition, frequently there are loose ends that need to be tied up after the closing, so the parties ordinarily covenant that they will cooperate in good faith to finalize any outstanding matters relating to the acquisition transaction after closing.

F. INDEMNITY

(1) Indemnity by the Seller.

This section describes the obligations of the Seller to indemnify (i.e. reimburse) the Buyer in the event the Seller breaches any of their representations, warranties or covenants contained in the Acquisition Agreement. Generally speaking, this section requires the Seller to fully indemnify (or reimburse) the Buyer from any losses that the Buyer incurs as a result of the Seller’s breach of representations, warranties, and covenants. However, the Seller will often try to limit their indemnity obligations as discussed below. Other than the purchase price, indemnification can be one of the most heavily negotiated sections of the Acquisition Agreement. The end result of this section will determine the amount of risk and liability the Seller and the Buyer have after the closing for breaches of the Seller’s representations or warranties. Is the Seller liable for damages from the first dollar of damages the Buyer suffers (see subsection 1 below--Indemnity Basket)? Is there any limit on the liability of the Seller, i.e. the purchase price, beyond the purchase price (see subsection 2 below--Indemnity Caps)? How long does the Seller have this liability, i.e. one year, four years, lifetime (see subsection 3 below--Survival of Representations and Warranties)? For the non-sophisticated Seller, it is not uncommon for them to believe that once a transaction is closed they walk away from the sales transaction without any risk in the

future. This will almost never be the case and the Seller has to understand exactly what its risks are so there are no surprises in the future.

(a) Indemnity Basket

The indemnity basket is like an insurance deductible to be borne by the Buyer. Under a basket provision, the Buyer may not make any claim for indemnity against the Seller until the Buyer has incurred losses in excess of a specified threshold amount—and then, usually, the Buyer can only recover its losses in excess of such specified threshold amount. For example, if the Acquisition Agreement contains a basket provision in the threshold amount of \$100,000, then the Buyer will not be able to make any claims for indemnity against the Seller until the Buyer has suffered losses in excess of \$100,000—and then only to the extent of such excess (so if the Buyer has aggregate losses of \$150,000, the Buyer’s indemnity claim against the Seller would be limited to \$50,000). Sometimes, however, the basket is structured as a “trap door” basket, meaning that once the specified threshold amount is exceeded, the Seller must reimburse the Buyer for all of its losses starting with the first dollar of loss. Finally, the Buyer will not want the basket to apply to certain breaches of the Seller’s representations and warranties, i.e. title to assets, taxes, accounts receivable, etc. which the Buyer believes are the very basis of the bargain and should be compensated for by Seller from dollar one.

(b) Indemnity Caps

An indemnity cap establishes an absolute maximum amount of the liability of the Seller to the Buyer for the Seller’s breach of representations, warranties, and covenants. In the event the Buyer incurs losses in excess of such indemnity cap, the Buyer would have no recourse against the Seller. Many times, the indemnity cap is fixed at the purchase price for the acquisition.

(c) Survival of Representations and Warranties

This section sets forth the time period the Seller’s representations, warranties, and covenants will survive the closing. In other words, the survival period constitutes an expiration date with regard to the Seller’s representations, warranties, and covenants. Once the survival period has expired, the Seller will have no further liability to the Buyer for any breaches of the Seller’s representations, warranties, and covenants. Naturally, the Seller will want the survival period to be as short as possible (one year is very desirable). On the other hand, the Buyer will want the survival period to have no limitation at all—subject only the applicable statute of limitations. Often a compromise is reached such that the survival period for the representations, warranties, and covenants of the Seller survive the closing for a period of two or three years. Moreover, it is not uncommon to have different survival periods for different representations and warranties, with a longer survival period for matters that may arise several years after the closing (i.e. environmental and tax matters) and a shorter survival period for matters that will “pop-up” shortly after the closing (i.e. collection problems on accounts receivable).

(2) **Indemnity by the Buyer.**

This section describes the obligations of the Buyer to reimburse the Seller in the event that the Buyer breaches any of its representations, warranties, or covenants. The same indemnity limitations discussed above with respect to the Seller also apply to the Buyer; however, because the degree of risk associated with the Buyer's representations and warranties is considerably less than the Seller's representations and warranties (especially if the Seller is receiving all cash consideration), there is not as much negotiation on baskets, caps and survival periods for the benefit of the Buyer.

G. COMPETITION RESTRICTIONS

The Competition Restrictions section sets forth restrictions on the ability of the Seller to compete with the Buyer after the closing in the line(s) of business being sold by the Seller to the Buyer. The last thing the Buyer wants to see happen is to pay the Seller a large sum of money for their business, only to have the Seller set up a competing business next door and steal away customers with the goodwill that the Seller has established with their customers over the years. There are three basic competitive restrictions that are often contained in the Acquisition Agreement. Such restrictions are discussed in more detail below.

(1) **Noncompetition Restriction.**

Generally speaking, the noncompetition restriction prohibits the Seller from engaging in the line(s) of business of the Target Company being sold by the Seller to the Buyer. In order for this restriction to be enforceable, the restriction must be reasonable as to: (1) the scope of the business being restricted (i.e. the Seller should only be prohibited from engaging in the line(s) of business being conducted by the Target Company as of the closing), (2) the geographic area to be restricted (i.e. if the Target Company only operates the business in a particular geographic area, the noncompetition restriction should be restricted to such geographic area), and (3) the time period of noncompetition (i.e. ordinarily a time period of up to five years has been held to be valid).

(2) **Nonsolicitation of Customers.**

This restriction prohibits the Seller from soliciting any customers of the Target Company (regardless of their location) for the purpose of providing any service or product competitive with the business of the Target Company.

(3) **Nonsolicitation of Employees.**

This restriction prohibits the Seller from soliciting and/or hiring any of the employees of the line(s) of business of the Target Company being sold by the Seller to the Buyer. The purpose of this restriction is to prevent the Seller from "stealing" key employees who will be important to the continued success of the business being acquired by the Buyer.

9. ANCILLARY DOCUMENTS

While the Acquisition Agreement is the key document in any acquisition or sale of a business, there are numerous ancillary documents that are a part of the Acquisition Agreement or complimentary to the Acquisition Agreement. These documents include, but are not limited to, the Disclosure Schedules to the Acquisition Agreement, employment agreements, noncompete agreements, lease agreements,

consulting agreements, assumption agreements, license transfer agreements, and bills of sale. The normal process in any acquisition is that the parties will focus on the Acquisition Agreement and its issues first to determine if there is a general meeting of the minds regarding the terms and provisions of this Agreement (see discussion on main components of Acquisition Agreement below for a review of these issues). As the parties are proceeding on the negotiations of the Acquisition Agreement, the Seller should be preparing the Disclosure Schedules to the Acquisition Agreement as these schedules will need to be carefully reviewed and analyzed by the Buyer prior to the Buyer entering into the Acquisition Agreement with the Seller. As discussed below, the Disclosure Schedules provide listings of key contracts, assets, and other obligations of the Target Company, as well as a listing of exceptions to the representations and warranties made by the Seller. What is disclosed and how items are disclosed in the Disclosure Schedules can be negotiated as hard between the parties as the Acquisition Agreement itself.

As the Acquisition Agreement is in its second or third draft of negotiations, the parties are then normally drafting and exchanging the ancillary documents mentioned above, which, in many cases, are normally exhibits to the Acquisition Agreement. It is recommended that these documents be exhibits to the Acquisition Agreement so that these documents are negotiated and agreed to prior to the time the Acquisition Agreement is executed by all parties and the Seller is bound to sell the Target Company. In this fashion, both the Seller and Buyer are aware of all the key terms and provisions of their “deal” thereby reducing the risk of future disagreement among the parties on the terms after the Acquisition Agreement has been entered into by all the parties.

10. THIRD PARTY MATTERS

While the Buyer and Seller are proceeding on negotiating the Acquisition Agreement and the ancillary documents, there is a line of information that the Seller and Buyer are pursuing in order to insure a smooth and orderly transition of the business with no surprises. In any asset sale, there will be contracts, agreements, and other rights to be transferred and assigned by the Target Company to the Buyer. Normally, these type of agreements require the consent of the unrelated contracting party prior to the assignments or transfer of the rights under the contract or other agreement. Early on in the acquisition process, the Seller should be reviewing the contracts of the Target Company in order to determine what third party consents are going to be required in order to start this process early on in the negotiations. It is not unusual for a transaction to be delayed because third party consents for the transfer of a contract are not obtained. At the same time, the Buyer normally requires its purchase of the assets of the Target Company to be free and clear of any bank liens or other liens. In most situations this is important to the Buyer because the Buyer will have its own financing which will require a first lien on all the acquired assets. To accomplish this at closing, the Seller needs to have contacted the Target Company’s lenders, equipment lessors and other third parties who have liens or other rights against the assets of the Target Company prior to closing so that payoff amounts can be determined and appropriate lien releases obtained at the closing. Also, if the Seller has any personal guarantees outstanding with banks, suppliers, or other creditors of the Target Company, the Seller needs to make sure that these guarantees are terminated at the closing of the acquisition transaction.

On the Buyer’s side, it will need to pursue its bank or other financing in a diligent manner to insure that it has satisfied the due diligence requirements of the bank regarding the prospective acquisition of the Target Company. If there is real estate or substantial leasehold interests involved in the acquisition, it is not unusual for the bank to require an environmental study and a title policy on each piece of property. Certain title policy issues will require a survey to be obtained on the real or leased property. These matters need to be addressed with the bank or lending institution early on in the negotiation process to determine the requirements of the bank that must be satisfied prior to the closing.

11. TEXAS STATE TAX ISSUES

The Texas Tax Code imposes liability on the Buyer who fails to withhold an amount of the purchase price in order to satisfy the Target Company's outstanding state tax liability. Texas Tax Code, Section 111.020. If the Buyer does not inquire into the state taxes of the Target Company, and withhold amounts for any state taxes due and owing to the State from the purchase price, then the Buyer is liable to the State for any taxes, penalties and interest owed by the Target Company up to the purchase price paid for the business. The purchase price of a business includes, but is not limited to, monetary consideration, assumption of debt, transfer of property, forgiveness of debt or issuance of debt instruments. Texas State Comptroller Rule 3.7. The determination of whether a business has been sold is a very fact specific determination dependent upon the type of business involved. The Comptroller has set forth the following sale transactions which might constitute a sale of a business and thereby invoke potential successor liability for the Buyer:

- ◆ Sale of a building, land, furniture, fixtures, inventory and the right to use a seller's trade name;
- ◆ Sale of all of the capital assets of a business;
- ◆ Sale of the name and goodwill of a business;
- ◆ Sale of all the inventory of a business; or
- ◆ Sale of the fixed assets and realty necessary to operate a similar business in the same location.

In order to avoid potential liability for the state taxes of a Target Company, the Buyer can request a tax clearance certificate from the Texas State Comptroller's office. A tax clearance certificate must be requested prior to the closing of the sale and the Comptroller's office has a maximum of ninety (90) days from the date of the request to audit the Target Company's books and issue the certificate. Texas State Comptroller Rule 3.7. In the event that the Texas State Comptroller's office determines that the Target Company owes any tax, then the certificate will not be issued until the tax is paid. If the Comptroller fails to issue the certificate within the time frame set forth above, the Buyer is released from the obligation to withhold or pay the state tax due to the Comptroller's office. Texas Tax Code, Section 111.020; Texas State Comptroller Rule 3.7. This will not release the Buyer, however, from successor liability for state taxes when the Buyer acquires the Target Company's business or assets through a fraudulent or sham transaction. One method commonly used by the Buyer of a business to avoid any exposure to state tax liabilities of the Target Company is to include an indemnification provision in the Acquisition Agreement. Although the Buyer has recourse against the Seller in the event a state tax liability arises, provided the claim is brought within the survival period of any representations made by the Seller, an indemnification provision in a sales contract does not prevent the Texas State Comptroller's office from pursuing an enforcement action against the Buyer.

12. FRANCHISE TAX PLANNING

One franchise tax planning technique that could be used when substantially all of the assets of a Target Company are being sold (i.e. asset purchase structure) and the Target Company is taxed as an S corporation for federal income tax purposes, is to structure the sale so that a substantial portion of the purchase price is paid through a short term promissory note. In order to implement this planning technique, the Target Company would, prior to the closing of the sale, adopt a plan of liquidation to liquidate the Target Company within twelve (12) months. Thereafter, the sale transaction would close with the Target Company receiving a short term promissory note for all or a substantial portion of the purchase price secured by a Standby Irrevocable Letter of Credit issued by the Target Company's bank. The Standby Irrevocable Letter of Credit would be secured by the purchase price funds that would be deposited in an account with Target Company's bank. As long as the bank's Irrevocable Standby Letter of

Credit is structured pursuant to the terms and conditions of Treas. Reg. §15A.453-1(b), the Target Company is not in constructive receipt of the funds securing the promissory note, thereby allowing the Target Company to receive installment treatment. The promissory note would be structured such that a substantial portion of the principal of the note is due within sixty (60) to ninety (90) days of the closing in order to allow the Target Company time to liquidate and distribute all of its assets to its shareholders (including the promissory note). Within twelve (12) months of the adoption of the plan of liquidation and following the closing of the sale, the Target Company would liquidate pursuant to the plan of liquidation adopted by the Target Company and the installment note would be distributed to the shareholder(s) of the Target Company. Upon payment in full of the note, any gain to be recognized as a result of the payment would be subject to tax at the shareholder level.

Section 453(b) of the Code provides that an installment sale is “a disposition of property where at least one (1) payment is to be received after the close of the taxable year in which the disposition occurs.” Thus, if a payment is received on the installment note (which is distributed in liquidation) after the complete liquidation of the corporation, such installment sales transaction should be treated as an installment sale for purposes of Section 453. In some situations, out of an abundance of caution, we would recommend that a small portion of the note be paid in the succeeding calendar year in order to clearly receive a payment after the close of the taxable year in which the sale occurs.

Normally, if an installment note is distributed or otherwise disposed of, any gain inherent in the note is accelerated and reported in income at that time. IRC Section 453; Treas. Reg. 1.453-11. This would normally require a corporation to accelerate any gain inherent in an installment note and recognize the gain on the corporation’s tax return when the corporation distributes the note to its shareholders in liquidation. However, except as set forth with respect to depreciation recapture below, an S corporation will not recognize any gain from the distribution of an installment note if the distribution is made pursuant to a complete liquidation and the shareholder(s) is treated as receiving the note as payment for his or her stock under Section 453(h)(1). Section 453(h)(1) provides that payments on an installment note distributed in liquidation will be treated in the hands of the shareholders as payments for stock if:

- A. the distribution is a complete, taxable liquidation under the liquidation rules of Section 331 of the Code;
- B. the installment note was received from the sale of corporate assets within twelve (12) months after the adoption of a plan of complete liquidation; and
- C. the liquidation and distribution of the corporation assets occurs within twelve (12) months after the adoption of the plan of liquidation.

If these rules are met, the shareholder receiving the installment note would not have to recognize gain on the receipt of the obligation but rather, would recognize the gain as payments on the installment note are received. The character of the gain would be determined under the S corporation income characterization rules, i.e., the character of the gain to the shareholder will be determined on the basis of the character of the gain at the corporate level. The deferral of recognition of income to the shareholder of a Target Company through the use of this planning technique does not defer recognition of income attributable to depreciation recapture. If property on which depreciation has been taken is sold by a Target Company, the Target Company must report all recapture income in the year of sale. IRC 453(i)(1)(A). The installment method of reporting would apply only to the gain on the sale of the property in excess of the recapture income. IRC 453(i)(1)(B).

For a short period of time, the use of this franchise tax planning technique was not available to accrual basis taxpayers. In the 1999 Tax Relief Extension Act, Code Section 453(a)(2) was amended to provide that the installment method of accounting was not available for dispositions of property by an accrual basis taxpayer. This change caused major concern among taxpayers and a backlash of bad publicity to Congress. For once, the criticism was heard and in the Installment Tax Correction Act of 2000, the changes made by the 1999 Tax Relief Extension Act were repealed retroactive to its date of enactment. Because of the repeal, this planning technique for S corporations is available whether the S corporation is a cash or accrual method of taxpayer.

If this planning technique is not available, a more extreme planning technique for a C or S corporation would be to reorganize the business operations of the corporation (whether through out-of-state reorganization techniques or other plans) into a limited partnership structure so that the income and sales proceeds are reported at the partnership level for Texas state franchise tax purposes. **[See Attachments 7 and 8 for information concerning one method of reorganization into a limited partnership.]**

13. PERSONAL GOODWILL

The concept that goodwill could be attributable to the personal efforts of a shareholder of a corporation rather than to the corporation itself is a concept that has been accepted by the courts since the mid 1940's. Prior to 1998, the cases that dealt with the issue of personal goodwill primarily involved the valuation of assets in the liquidation of a corporation that provided professional services to the public. However, in 1998, the United States Tax Court in Martin Ice Cream Co. v. Commissioner, 110 T.C. 189 (1998), broadened the concept of personal goodwill outside the context of a liquidation of a professional services corporation and applied the personal goodwill concept to the sale of a business providing other than professional services.

In determining if a shareholder of a corporation has personal goodwill separate and apart from that of the business, there are several factors which the Courts have taken into consideration. These factors, which are consistent throughout the existing case law irrespective of whether the services that were provided were professional or otherwise, are as follows:

1. There is no existing contract (employment or noncompete) between the corporation and its key shareholder/employee prior to the sale or liquidation. Because there are no contract rights held by the corporation, the intangible rights tied to the shareholder/employee are not assets of the corporation.
2. The value paid for the ongoing business of the corporation exceeded the fair market value that could be attributed to the gross sales and net income of the corporation.
3. The relationship between the shareholder/employee and the customer of the corporation was such that the customer looked to the shareholder/employee as the provider of the services not the corporation. In other words, the customer would do business with the entity chosen by the shareholder/employee (i.e. personal relationship and goodwill).

In Martin Ice Cream Co. v. Commissioner, Arnold Strassberg ("Arnold") entered into the business of selling ice cream products shortly after WWII. In the early 1960s, he incorporated his own

business and began to develop relationships with the owners and managers of several supermarkets where he developed an innovative packaging and sales campaign for the resale of ice cream products to consumers under each supermarket's private label. In the late 1960s, Arnold's business was forced into bankruptcy. In the early 1970s, Arnold and his son, Martin, incorporated under the name of Martin Ice Cream Co. ("MIC") and entered into the ice cream distribution business. Neither Arnold nor Martin entered into an employment agreement with MIC. In 1974, Arnold was approached by the founder of Haagen-Dazs to facilitate the introduction of its ice cream products into supermarkets. Utilizing his expertise and relationships with supermarket owners and managers prior to this time, Arnold was able to obtain shelf space for Haagen-Dazs. Prior to its relationship with Arnold, Haagen-Dazs had made little headway into the supermarket sector as a result of its own marketing efforts. Neither Arnold nor MIC ever entered into a written distribution agreement with Haagen-Dazs or Mr. Mattus, the President of Haagen-Dazs. In 1985, the Borden Co. retained Arnold to use his contacts with the supermarkets to put Borden's ice cream products into supermarket freezers. Arnold was successful in doing so and personally earned commissions on the sales of Borden's ice cream; MIC did not participate in Arnold's work for Borden. Additionally, during the 1980s, Ben & Jerry's contacted Arnold seeking help in introducing its ice cream into the supermarket arena. As Ben & Jerry's was a competitor of Haagen-Dazs, Arnold declined the request for assistance.

In 1983, the Pillsbury Co. purchased Haagen-Dazs and sought to restructure the distribution of the ice cream products into its own distribution centers. As a result of the consolidation, Pillsbury approached Arnold and MIC in efforts to acquire the distribution business conducted on behalf of Haagen-Dazs to the major supermarket chains. During the course of negotiations with Pillsbury, Martin and Arnold entered into an agreement whereby the distribution rights to the major supermarket chains were transferred to SIC, a subsidiary of MIC, and Arnold, in exchange for the stock of the subsidiary, terminated any interest that he had in MIC. SIC and Arnold then entered into negotiations with respect to the sale of the rights to distribute the Haagen-Dazs products to the supermarket chains and an agreement was reached for the sale of the business. The purchase price for the distribution rights included a base price of \$1.5 Million, \$350,000 in additional contingent payments payable over 3 years, and annual payments of \$150,000 to Arnold for 3 years and \$50,000 to Martin for 5 years in return for consulting services and covenants not to compete in the retail super premium ice cream distribution business to supermarket chains. The total purchase price had been determined by Haagen-Dazs based upon MIC's annual sales of Haagen-Dazs products to the supermarkets. Haagen-Dazs allocated \$1,200,000 of the purchase price to the distribution rights and \$300,000 to the business records relating to same. There was no evidence of any negotiations between the parties regarding the allocation or evidence as to why Haagen-Dazs allocated it in this manner. Additionally, there was no allocation of the total consideration received in the sale between Arnold and SIC in the sale documents, however, Arnold and SIC reported that \$286,068 of the sales proceeds were attributable to the business records and goodwill of SIC and the remaining \$1,144,272.00 was attributable to Arnold's personal goodwill, i.e. the distribution rights.

In determining whether the distribution rights for Haagen-Dazs ice cream products, valued at \$1,144,272.00, were attributable to the personal goodwill of Arnold, the Court looked at two factors. First, the court found that the more valuable assets in connection with the sale were Arnold's rights under his oral distribution agreement with Mr. Mattus and his relationships with the owners and managers of the supermarkets as these assets formed the basis of his ability to direct the wholesale distribution of ice cream to supermarkets. The court, in outlining the personal nature of such relationships, pointed out that the development of such relationships preceded the creation of MIC and SIC by some years. Additionally, the court recognized that since Arnold never entered into a covenant not to compete or any other agreement with MIC or SIC, the personal relationships developed by Arnold were not corporate assets. The second factor considered by the Court was the financial records of MIC. Based upon MIC's sales and net income for the prior years, the Court concluded that the purchase price far exceeded any possible fair market value that MIC might have had prior to the sale and that Haagen-Dazs attributed the portion of the purchase price above the fair market value to the distribution rights.

Although not every sale transaction will qualify, by structuring the consideration received in a sale of a Target Company that is taxed as a C corporation for federal income tax purposes in the manner outlined above, the Target Company can avoid the payment of a corporate level tax on that portion of the sales proceeds attributable to a shareholder's personal goodwill. Another manner in which to structure the payment of the purchase price in a sales transaction to avoid a corporate level tax on a portion of the sales proceeds is to have the shareholder execute a non-compete agreement and allocate a portion of the purchase price to the non-compete. However, this structure may not work in each case as the shareholder may not be willing to execute a non-compete agreement. Additionally, the allocation of a portion of the purchase price to personal goodwill of the shareholder is more favorable from a tax standpoint as the purchase price would be taxable to the shareholder at capital gains tax rates while any allocation of the purchase price to a covenant not to compete would be taxed as ordinary income to the shareholder.

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ATTACHMENT 1

PRIMARY PARTICIPANTS IN ACQUISITION TRANSACTION

ATTACHMENT 2

ASSET PURCHASE V. STOCK PURCHASE DIAGRAM

ATTACHMENT 3
CONFIDENTIALITY AGREEMENT

ATTACHMENT 4

LETTER OF INTENT

ATTACHMENT 5
DUE DILIGENCE LIST

ATTACHMENT 6

SAMPLE REPRESENTATIONS AND WARRANTIES

ATTACHMENT 7

IRS PRIVATE LETTER RULING 200221035

ATTACHMENT 8
FRANCHISE TAX PLANNING DIAGRAM