Chapter 4

Structuring the Deal

Sea Story
Structural Problems

I couldn't help but smile as I read the broker's response. He had countered my offer with a half million-dollar price hike, but was so artful in doing so that I almost didn't notice. *Well played, broker-man, well played!* It probably didn't matter anyway. The structure they required would cost me more than that in taxes. Frustration over deal loss is just part of EtA, but this one was hard to take. The business had such potential! I couldn't stand to lose it over corporate structure considerations…

Admiralty Plumbing was an unglamorous business that worked dirty jobs and made lots of money. *Exactly the type of business I was looking for!* Located in northern Delaware, the company specialized in sewer inspection and repair. The owner Janet had inherited the business from her father. She had grown the business impressively – starting with 4 trucks, she now had 12. But she was at retirement age and her children had chosen other career paths.

I had gotten us off to an uncomfortable start. Our initial meeting began with introductions. I launched into my standard spiel –*where I went to school, what I studied, professional history, etc.* I wasn't half way through when her eyes glazed over. Janet had spent twenty years running a successful family business in a blue-collar industry; I was pitching myself the same way I had to Ivy League admissions boards. That absurdity made my story difficult to get through. *Next time have an abbreviated version! Know your audience!* When I was finished, Janet paused for a moment and then kindly asked, "So what brings you here?"

I explained my affinity for tried-and-true businesses that could not be *digitized* out of existence. That eased the tension and got us back on track. For about an hour, we had a productive conversation about the customer base, production assets, and future opportunities. By the time we parted, I was sold!

The next step was drafting an LOI. My structure was basic – an asset purchase for $2M (4x EBITDA) with an appropriate amount of working capital included. For downside protection, I put $200k in a Seller Note that would be subject to revenue hurdles.

At first glance, the counter offer seemed to be in that ballpark. Upon further inspection, it became clear it changed everything of value.

First, the counter offer increased the stated purchase price by $200k to $2.2M. That seemed reasonable. An EBITDA multiple increase from 4x to 4.4x was something I could work with. If they'd split the difference, we would land on a 4.2x purchase price. I was confident I could have success under those terms.

Second, they stated that the working capital target was to include the $300k note that financed the most recently acquired truck. This was problematic for three reasons. (1) These transactions are typically done on a cash-free, debt-free basis; this demand violated that convention. (2) Working capital is defined as current assets minus current liabilities; including this 5-yr note would break that definition. (3) The purchase price was based on a multiple of cash flow; because the financed truck was necessary to produce cash, assuming the debt would amount to double paying for the truck. Ultimately, this so-called working capital adjustment was just a $300k price increase. Bluntly, the company wasn't worth the $2.5M price tag now attached.

Finally, they insisted on a stock purchase. This was the real killer. I did, however, understand their reasoning. Admiralty Plumbing was a C-Corp, which has tax disadvantages. My proposed asset purchase would cause Janet to be taxed twice – *first* she would pay capital gains tax on the sale of the assets; *then* she would pay income tax on the sale proceeds when she took them as a dividend. *Taxed twice for the same event?!* This change to deal structure was understandable, *but I couldn't accept it*.

There were three reasons why:

(1) I would inherit any and all liabilities from the previous ownership. If a former employee decided to sue the company, I would have to deal with it.

(2) An asset purchase requires the *allocation of purchase price*. If we settled on a $2.1M purchase price, that amount would be segmented into categories – *production assets, non-compete agreement, goodwill, etc.* Whatever portion is attributed to goodwill is amortized over 15 years. This amortization expense reduces the new owner's tax liability. *Stock purchases eliminate this advantage*.

(3) Most importantly, a stock purchase would eliminate the *step up* in depreciation basis. As previously mentioned, a portion of the purchase price would be allocated to *production assets*. Just as goodwill is amortized, production assets are depreciated. Under provisions of the recently passed Tax Cut and Jobs Acts (TCJA), that amount could be depreciated on an accelerated basis – most of it in the first year. This provides valuable tax advantages up front. Because Admiralty was an asset-heavy business (about $1.5M in sewer cleaning trucks), I would be shielded from taxes for the first few years of my ownership. *A stock purchase eliminates depreciation step up just as it does goodwill amortization*.

To properly understand the counter offer, I would need to determine the *stock purchase equivalent* of my $2M asset purchase offer. With access to Admiralty's financial records, my CPA could determine the value of depreciation step-up and goodwill amortization and adjust accordingly.

This, however, would lower my offer substantially. With the sell-side pushing price up and their required structure pushing my willingness to pay down, this deal wasn't going anywhere.

The Process

Structuring the Deal

Deal structure has significant financial implications for both buyer and seller. Stock and asset purchases are entirely different with respect to liabilities and taxes. Corporate structure (C-Corp, S-Corp, or LLC) determines strategy. Businesses must be approached differently based on the value of their assets. A successful deal depends on getting these details right.

Stock vs. Asset Purchase

Once you're ready to move on an acquisition target, you must decide if you want to buy the business' *assets* or its *stock*. This decision should be stated on the LOI.

In an asset purchase, the buyer sets up an entirely new business entity (usually an LLC), which acquires all the assets (both tangible and intangible) of the seller's business entity. Asset purchases are most common and have the following advantages:

- **Alleviation of (most) liabilities of the seller's business entity** – This generally protects the buyer against unpaid creditors and lawsuits from the seller's tenure. *But be careful!* Even in an asset purchase, some liabilities are *transferable* to the new owner. These are called *successor* liabilities and include unpaid payroll taxes and sexual harassment claims. S*uccessor* liabilities vary from state to state.

- **Goodwill amortization –** Asset purchases allocate the purchase price across a number of categories. Some portion of the purchase price will be allocated to goodwill. This amount is amortized over 15 years, providing a valuable tax benefit to the buyer.

- **Depreciation basis step-up –** In addition, some portion of the purchase price will be attributed to the business' physical assets. This amount can be depreciated by the buyer in accordance with the tax code, even if the assets had already been depreciated by the seller. Recent changes to the tax code have allowed accelerated depreciation, providing buyers with large tax advantages in the early years of their tenure.

In a stock purchase, the buyer acquires the corporation stock (or LLC membership interest). This structure is most common when the target is a C-Corp. Acquiring a C-Corp via stock purchase saves the seller from double-taxation – *capital gains on the sale of assets and then income tax on the proceeds* – but has serious financial disadvantages for the buyer. A stock purchase does now allow for goodwill amortization or depreciation basis step-up and leaves the buyer exposed to all liabilities created before the sale.

Stock purchases can, however, offer the buyer operational efficiencies. A stock purchase may be preferable when contracts are the main business asset. So long as those contracts do not have *change of control* provisions, a stock purchase allows the contracts to pass to the buyer without voiding the contracts or requiring additional administration.

Sea Story

Have Your Cake and Eat It Too

I was driving down a winding country road when my CPA Stephen returned my call.

Stephen had been working accounting due diligence on my current target. While he conducted a proof of cash and a financial statement review, my legal team had studied every customer contract and professional license held by the business.

The lawyers' determination was that these contracts and licenses accounted for nearly all of the business' assets. Because most of these contracts were not *assignable*, this had the potential to complicate the asset purchase stated in the LOI.

To make an asset purchase work, we would need to approach each customer with an active contract and seek permission to transfer the contract to my new business entity. If that permission could not be obtained, the customer would have to consent to an entirely new contract. If they refused, the contract would have no value to me.

My lawyers' recommendation was simple – *change the deal from an asset to a stock purchase*.

Because these contracts lacked *change of control* provisions, a stock sale would keep the contracts intact. But this administrative advantage came with a price. The target was a service business with few physical assets. Consequently, most of the purchase price would be attributable to goodwill. A stock sale eliminated the ability to amortize goodwill over a 15-year period, eliminating a valuable tax write off.

Stephen listened closely as I explained my dilemma. "You know," he said, "you can have your cake and eat it too…"

"What do you mean?" I asked, confused as to how the saying applied.

"It's called a 338 election," Steven replied, "you can do a stock deal, but treat it as an asset sale for tax purposes."

"That sounds great," I said a bit incredulously, "how do we do that…?"

"There are a few things we'll need to coordinate. The buyer must be a corporate entity and the seller has to agree, but, all-in-all, it shouldn't be too difficult. I'll email you later today to get things started."

Section 338 Election

Section 338 refers to a section of the tax code passed in 1982. The purpose was to allow qualified stock purchases to be treated as asset purchases for federal tax purposes. There are two possible elections under this section – the "regular Section 338 election" under Section 338(g) and another under Section 338(h)(10).

The regular 338 election does nothing to eliminate the double taxation problem associated with buying corporate stock. As a result, the 338(h)(10) option is much more common. 338(h)(10) taxes the acquisition as though it were an asset sale, ignoring the stock purchase for tax purposes. However, this election is only available when buying the stock of an S-Corp.[i]

Corporate Structure of the Target

The implications of the target's corporate structure have been explored above. Let us now consider corporate structure implications from a buyer's point of view.

There are numerous legal structures for a corporate entity. These include C-Corporations, S-Corporations, LLCs, Sole Proprietorships, LLPs, and JVs between GPs and LPs. Virtually all EtA deals result in an operating company that is an LLC, S-Corp, or C-Corp. Even so, we will briefly explore each structure below, starting with the most seldomly utilized:

JVs between GPs and LPs – A joint venture (JV) is a legal structure in which participants combine their resources for a specific business objective. While the JV is its own legal structure, it is often composed of general partners (GPs) and limited partners (LPs). GPs concern themselves with the day-to-day business operations, while LPs typically contribute capital or other resources.[ii] GPs have unlimited liability to the business' debt, while the LP's risk is limited to the amount of their investment.[iii]

LLPs – A limited liability partnership (LLP) is a legal structure that offers the partners some level of protection from the partnership's liabilities.[iv] This structure is popular with professional services firms, such as medical practices and law firms, in which partners would desire legal protection from each other's negligence.

Sole Proprietorships – The simplest form for a business entity, a sole proprietorship is owned directly by the individual operating it. While a sole proprietorship is simple to setup, subject to few regulations, and has tax advantages, it does not form a separate legal entity, thus exposing its owner to unlimited liability.[v]

LLCs – A limited liability company (LLC) is a legal structure that protects an individual from business liabilities.[vi] An LLC is a *pass-through* entity with respect to taxes. While the business itself pays no tax, LLC members incur a tax liability on their share of the profits. A member's share of the profits is taxed as normal income. Most LLC operating agreements have provisions requiring the business to distribute enough cash to cover that tax liability.

S-Corporations – A corporation is a business entity that is formed in a given state. An S-Corp is a corporation that has selected to be taxed in accordance with subchapter "S" of the Internal Revenue Code.[vii] This selection makes the corporation a pass-through entity for tax purposes. An S-Corp is also eligible for a 338 election when sold.

C-Corporations – A C-Corp is a business entity in which the business and its shareholders are taxed separately.[viii] The corporation pays taxes on its net income at the corporate tax rate. The corporation's shareholders are taxed only when the C-Corp distributes cash to them. These distributions are taxed as normal income.[ix]

Because the corporate tax rate is lower than income tax rates, a C-Corp is the optimal entity for building working capital inside a business.

The problems arise when trying to get money out of the business and into the hands of its shareholders. Cash that is distributed to shareholders has already been taxed at the corporate tax rate and is then taxed again as income to the shareholder. This double taxation has made LLCs and S-Corps preferable to most business owners.

Sea Story

A Personal Touch

"So, what worries you about this one?" asked Tom as he placed his coffee mug on the table.

Tom was the broker representing a trucking company that hauled hazardous materials. I had met him and the seller Mark at a diner just south of Wilmington, Delaware to discuss the business. Mark's eyes widened, eager to hear my critiques of the company he'd built.

But I was smarter than that. I wasn't going to risk offending him at our first meeting with operational concerns. Instead, I used the opening to bring up the potentially deal crushing elephant in the room.

"I noticed that the company is a C-Corp, but the offering memorandum indicates you intend to sell in an asset purchase. This is an asset-heavy business; have you considered the tax implications of that?" I asked.

The bewildered expression on Mark's face as he turned to look at Tom made it clear the matter hadn't been previously discussed.

Tom nodded, "Well… we'll have to play some tax games. Is your accountant comfortable with *personal goodwill*?"

I wouldn't get the answer to that question until Pete, my tax CPA, returned my call the next day. I was unfamiliar with *personal goodwill* and was anxious to hear what he had to say.

"Personal goodwill asserts that the customer relationships are with the individual rather than the business," Pete explained, "Any amount of the purchase price allocated to *personal goodwill* avoids double-taxation."

"Are there any risks?" I asked.

"Not for you as the buyer," Pete said, "but the seller could be challenged by the IRS. If they determine the personal goodwill to be bogus, the seller would be on the hook for the additional taxes. But, if he's willing to take that risk, the asset purchase would work."

The Process

Personal Goodwill

The IRS defines goodwill as "the value of a trade or business based on expected continued customer patronage due to its name, reputation, or any other factor." For tax purposes, a distinction is made between the goodwill of the business (corporate or enterprise goodwill) and the goodwill arising from the personal services of the business owners and professionals (personal or professional goodwill).[x]

Should a C-Corp be acquired via asset purchase, (corporate) goodwill is subject to double taxation because it is an asset of the company. However, if the purchase price allocation recognizes goodwill as *personal*, it is taxed as a personal asset - only once, when the proceeds are distributed to the seller.

Personal goodwill is derived from the attributes of the seller. Goodwill can reasonably be considered *personal* when it is derived from their experience, credentials, specific industry skills, standing within the industry, or relationships with customers and suppliers. These characteristics might be described as *nontransferable* to the buyer.[xi]

By eliminating some double taxation, personal goodwill can facilitate the asset purchase of a C-Corp. There is, however, some risk to the sell-side. Should an IRS audit determine that goodwill should have been classified as corporate, the seller will be on the hook for taxes not paid.

Sea Story

What did Dela wear, boys? What did Delaware?

"… so why did you incorporate in Delaware in the first place?" my father asked incredulously. He is a lawyer and was helping me change the legal name of my fashion accessory business to *Squared Away Pocket Squares*.

The change was rejected because my LLC was not in *good standing*. I was unaware that Delaware levies an annual tax on LLCs and was thus delinquent. What would have been a $300 fee had accumulated penalties and was now nearly $500.

I didn't answer the question. I was embarrassed to admit that I incorporated in Delaware because that's what they do in the movies.

"Thanks for letting me know," I said, "I'll settle up with Delaware online and get this tax on my compliance tracker."

"Better yet," he responded, "Let's redomicile the business in Pennsylvania. There is no state LLC tax and my firm can serve as your registered agent."

I agreed, thanked him for the help, and signed off the call. I only had a few seconds to ponder my mistake when my phone lit up with a call from my business partner Matt.

"Just got off the phone with Jack," Matt said, "he doesn't care about the operating companies, but he's requiring the holding company be a Delaware LLC."

Jack was a wealthy investor from Kentucky. We were pursuing him for an equity investment in support of our next strategic acquisition. He liked the opportunity and we were now negotiating terms.

"Why's that?" I asked.

"Well," Matt replied, "he owns businesses all over the country. He has lawyers and accountants on his corporate staff. They can't be experts in the laws of all fifty states, but they do know Delaware. For his people to work effectively, Delaware is their default."

"Makes sense to me," I said, "and it makes no difference to us. I just have to make sure I remember to pay the state LLC tax."

"What's that?" Matt asked.

The Process

Forming Your Legal Entities

Businesses exist as legal entities to create a liability shield for their owners. In the course of doing business, a company may be sued. A customer may slip and fall on company property; an employee may claim wrongful termination; a supplier may claim breach of contract. If business owners were personally liable, no one would risk owning a business.

So business owners form a corporation to distinguish the business from themselves. Aggrieved parties can still sue, but their potential award is limited to the assets of the business, the owner's personal belongings are safe.

Operating and Holding Companies

When discussing the legal entities associated with a business, we will distinguish between an *operating company* (OpCo) and a *holding company* (HoldCo).

An operating company is the legal entity that does business. It is the business itself. In previous chapters, we considered the example of *Paula's Print Shop*. The legal entity for that business was *Paula's Operating LLC*. That is the name registered with the state in which Paula incorporated. That is the name attached to the IRS issued tax ID number. Paula's Print Shop is just a *doing business as* (DBA) name filed by Paula's Operating LLC after its legal formation. A DBA name is a registration that connects the business' marketing name to its legal name.

When a business has only one owner, an operating company may be the only legal entity needed. However, when a business has multiple owners, it may be advantageous to form a *holding company*.

From 2019 through 2021, I was one of six owners of three printing companies operating in the Midwest. Each owner held a stake in HoldCo (a Delaware LLC) and HoldCo owned 100% of each operating company (two Illinois LLCs and one Michigan LLC).

Because the six owners held stakes in HoldCo, one operating agreement served as the primary document for corporate governance. This streamlined the delineation of duties placed on company management and the relationship between owners. The HoldCo operating agreement was the document that codified carefully negotiated issues, such as: (a) the pro rata distribution of profits, (b) special veto rights for certain owners, and (c) the conditions under which the companies could take on additional debt.

The OpCos also had operating agreements; but they used standard boiler plate language, included no sensitive issues, and were of no practical consequence.

State of Formation

Delaware

Corporate entities need not be formed in the state in which they reside. This being the case, many businesses incorporate in Delaware. So many, in fact, that Delaware incorporation is expected in the popular culture. Few, however, stop to ask why Delaware incorporation is so popular.

There are advantages to incorporating in Delaware. Some of these reasons are summarized below[xii]:

1. One person can hold the title of all officers of the business.
2. While some states require a balance of at least $1,000 in the corporate bank account, Delaware has no minimum balance.
3. Delaware does not require business owners to list their names on incorporation documents, allowing ownership to remain private.
4. Delaware does not impose state income tax on businesses that operate outside the state.
5. Incorporating in Delaware places your business under the jurisdiction of the Delaware Court of Chancery, which has a reputation for being business friendly in matters of corporate law and case law.
6. Delaware does not regulate price on shares of stock.
7. Delaware has streamlined the incorporation process, making it simple and affordable.

Of these advantages, the business-friendly disposition of the Delaware Court of Chancery is the focus for most businesses. Delaware incorporation is favored by businesses worried about being sued.

Furthermore, Delaware's popularity causes its corporate laws to be understood by many attorneys and CPAs. This is convenient when ownership and professional service providers reside in multiple states.

Despite these advantages, Delaware does levy an annual business entity tax for the privilege of being a Delaware corporation. The amount varies by business entity type. This tax is $300 for LLCs at the time of this writing.[xiii]

Nevada

Nevada is another popular choice for business entity formation. There are three primary reasons why this is so[xiv]:

1. *Business courts* – Nevada has special courts for disputes between corporations and for conflicts among stakeholders within a corporation. This focused approach to corporate law provides clear precedents and efficient processes that businesses can rely on.

2. *Asset protection* – Nevada provides *charging order protection.*

   Most business owners incorporate to create a liability shield that protects them personally from the business' liabilities. If customers are injured by the company's product or service, business owners want to ensure their personal assets are protected.

   Charging order protections work the other way around – protecting the business' assets from the owner's personal creditors. Let's say someone is injured in a business owner's home and subsequently wins a $1M judgement. As a result, the business owner is required to divulge his assets, including his 100% interest in his company LLC.

Charging order protection prevents the creditor from seizing this interest. Furthermore, the creditor cannot dictate how the business is run, including when cash distributions are made. The only thing the creditor is entitled to is any cash that is distributed by the company to the owner.[xv]

3. *Tax free for businesses* – Nevada is one of only four states with no corporate tax and no personal income tax.

Wyoming

While Wyoming has no corporate tax, most businesses incorporate there for privacy. Wyoming does not require the names of business owners or managers be listed on incorporation documents. This keeps stakeholders' identities out of the public record.

Furthermore, in its attempt to create a favorable business environment, Wyoming grants favorable tax exemptions. These include the *manufacturing sales tax exemption*, which exempts manufacturing equipment from sales and use tax, and the *sales tax exemption on electricity consumption in manufacturing*, which lowers utility costs for manufacturers.

Wyoming also has minimal corporate formalities. The lack of bureaucracy streamlines the incorporation process and reduces costs. Incorporation can be done online, which makes the process flexible and accessible.

Wyoming has the advantage of *no minimum capitalization*. Some states require a certain amount of capital be deposited in the business bank account to incorporate and start business operations. Wyoming has no such requirement, meaning you can form your company with as little as $1.

Wyoming also offers low startup costs. The annual fee is based on the value of the company's assets and can be as low as $50. The incorporation fee is only $100.[xvi]

Summary

As helpful as these overviews are, comparing incorporation in Delaware, Nevada, and Wyoming is best done with the help of a chart. See below[xvii]:

	Delaware	Nevada	Wyoming
One-person corporation is allowed	X	X	X
No minimum capital requirements	X	X	X
No Initial List of Officer/Members is filed with the state	X		X
No state corporate income tax		X	X
No state corporate income tax for entities operating outside the state	X	X	X
No tax on corporate shares	X	X	X
No franchise tax		X	X
Minimal annual fees			X
Minimal initial filing fees			X
Stockholders are not revealed to the State	X	X	X
No annual report required until the anniversery of the incorporation date			X
No general Business License required	X		X
Unlimited stock is allowed, of any par value	X		X
Nominee shareholders are allowed		X	X
Share certificates are not requred			X
Meetings may be held anywhere	X	X	X
Officers, directors, employees and agents are statutorily indemnified		X	X
Continuance procedure (allows adoption of a corporation formed in another state)			X
Doesn't collect corporate income tax information to share with the IRS		X	X

Ultimately, most businesses incorporate in Delaware if they are worried about being sued and in Wyoming if they value privacy. To some extent, Nevada offers both these benefits, but tends to cost more in incorporation and annual fees. If these concerns don't apply to your business, it may simplest to incorporate in the state in which your business resides.

Law Firm vs. Legal Zoom

Regardless of where you incorporate, someone will have to do the paperwork. While it is possible to complete the incorporation documents yourself, I recommend using a professional.

If due diligence efforts have caused you to establish a relationship with a law firm, that may be a good place to start. Many law firms provide free registered agent services for corporate entities they created. There is also an advantage to working directly with a lawyer who will a) keep detailed records of your corporate formation, b) explain to you your compliance responsibilities, and c) be available to answer questions.

However, lawyers can be expensive. Legal Zoom is an online service that can form a corporate entity more cheaply. Because creating entities is straight forward, Legal Zoom incorporation may be a good way to save money.

Just make sure you understand your compliance responsibilities. As mentioned in the previous *Sea Story*, I used Legal Zoom to form a Delaware LLC and then lost track of the business entity tax. The result was my LLC's loss of *good standing* with the state, which could not be restored until I'd paid the tax and hundreds of dollars of late fees. In fairness, Legal Zoom does offer services to help its clients keep up with compliance. Even so, it's not the same as having a seasoned attorney ensuring success.

The Process

Develop Your Capitalization Table

A capitalization table (or *cap table*) tracks each business owner's capital contribution, shares held, and percentage owned. See below for an example.[xviii]

	Company Valuation			
	Total Value (S)	**Per Share (S)**	**# of Shares**	**% of Total**
Series A				
Pre-Investment Valuation	$ 1,000,000	$ 5.00	200,000	22.2%
Investment Capital Raised	3,500,000	5.00	700,000	77.8%
Post-Investment Valuation	**$ 4,500,000**	**$ 5.00**	**900,000**	**100.0%**

	Company Ownership Cap Table				
	Capital (S)	**Common Shares**	**Pref. Shares**	**Total Shares**	**% Ownership**
Shareholders					
Founders	$ -	200,000		200,000	22.2%
Investor A	$ 100,000		20,000	20,000	2.2%
Investor B	$ 250,000		50,000	50,000	5.6%
Investor C	$ 100,000		20,000	20,000	2.2%
Investor D	$ 1,200,000		240,000	240,000	26.7%
Investor E	$ 250,000		50,000	50,000	5.6%
Investor F	$ 100,000		20,000	20,000	2.2%
Investor G	$ 500,000		100,000	100,000	11.1%
Investor H	$ 400,000		80,000	80,000	8.9%
Investor I	$ 250,000		50,000	50,000	5.6%
Investor J	$ 350,000		70,000	70,000	7.8%
Total	**$ 3,500,000**	**200,000**	**700,000**	**900,000**	**100.0%**

This example centers around a company's $3.5M raise of outside equity capital. Prior to the raise, the company was owned by its founders and had a valuation of $1M. This valuation was undoubtedly negotiated with the incoming investors as it provides the baseline for equity allocation. The founders apparently made a decision to split their $1M in value into 200k shares, setting a share price of $5.

At this $5 share price, the $3.5M investment is worth 700k shares, which are allocated to the investors. Individual business ownership percent is thus established – the shares owned by the individual divided by the 900k outstanding shares.

This example also distinguishes between *common shares*, owned by the founders, and *preferred shares*, awarded to the investors. Some of the key differences between preferred and common shares are:

1. Common shares confer voting rights. Preferred shares do not.
2. Preferred shares pay a set dividend on a schedule. If the company cannot pay the dividend, it becomes a liability and must be paid in arears.
3. In the case of liquidation, preferred share holders are senior to common share holders with respect to claims on company assets.

Sea Story

For Richer or Poorer

“Jeff, I think you just got the Holy Grail!” exclaimed my attorney over the phone.

I knew what he meant – we’d been using “Holy Grail” as a euphemism for weeks. It referred to the aspect of the debt term sheet that was most important to me.

While deep in due diligence of a computer training company, I was working with lenders to secure SBA 7a financing. From my previous experience, I assumed that a *spousal guarantee* was just a fact of life for those partaking in the 7a program.

My attorney was not so sure. He urged me to pitch the deal to multiple lenders. He hoped I could negotiate a term sheet that would require my personal guarantee, but not that of my wife. My father thought that was good advice; he even offered some financial support to help entice the bank.

I jammed the phone between my ear and shoulder, freeing my hands to open my email. When my inbox finally loaded, I saw the email at the top the list. It was from 44 Business Capital, a division of Berkshire Bank. To the loan officer’s surprise, the bank’s credit department had accepted my proposal.

I had asked them to modify their originally proposed term sheet. The change was simple – remove my wife’s personal guarantee and accept the following as measures to de-risk the loan:

1. $100k placed in a CD at Berkshire Bank. The bank would have first lien on the CD, securing it as collateral.
2. A commitment to sell my condominium in Florida, which would create about $125k in cash to be used to fund the business acquisition.
3. Acceptance of a $100k loan from my parents for the purpose of post-acquisition working capital. That loan would be subordinate to all bank debt.

This change was extremely valuable to my family. Should the business fail, I would find myself in personal bankruptcy, but my wife would be unaffected. Any assts I owned would become property of the bank, but my wife's property and assets we owned jointly would be off limits. *Holy Grail* indeed!

The Process

Personal Guarantees

Personal guarantees are of concern whenever debt financing is used. Investopedia defines a *personal guarantee* as follows:

> *The term personal guarantee refers to an individual's legal promise to repay credit issued to a business for which they serve as an executive or partner. Providing a personal guarantee means that if the business becomes unable to repay the debt, the individual assumes personal responsibility for the balance. Personal guarantees provide an extra level of protection to credit issuers who want to make sure they will be repaid.*

Essentially, if the business cannot repay a debt, the creditor is coming after the personal guarantors.

Required at the Discretion of the Creditor

Whether a personal guarantee is required is at the discretion of the creditor. Expect lenders to seek a personal guarantee in most cases. After all, they need some recourse should the business be unable to pay.

Think of the personal guarantee as the bank's last line of defense. When an acquisition is well planned and executed, cash flow from the business pays the debt service. Should the business underperform, the bank is protected by its claim on the business' tangible assets. If the value of these assets is insufficient to cover the balance of the loan, the bank can reduce its losses by pursuing the guarantor's personal assets.

The SBA 7a loan program has a standard personal guarantee policy. Any individual owning 20% or more of the business must guarantee the loan.

Most SBA lenders will also pursue a *spousal guarantee*. Spousal guarantee is the personal guarantee of the primary guarantor's spouse, regardless of whether the spouse owns any portion of the business. The purpose of a spousal guarantee is to provide the lender with a claim on any assets the primary guarantor and their spouse own jointly. It is rare, but in some cases, an SBA lender will waive the spousal guarantee. *This is worth negotiating for!*

Personal Financial Statement

Lenders will assess your creditworthiness by having you complete a *personal financial statement*. While each bank's form will be different, all have you provide your personal balance sheet (personal assets less liabilities) in order to ascertain your net worth.

Having obtained your personal balance sheet, the bank will first seek to understand how *liquid* you are. *Liquidity* is a finance term indicating the ability of assets to transact. Cash is perfectly liquid; you can immediately exchange it for goods and services. A house is much less liquid; it takes time and effort to sell a home before the cash obtained can be used to buy anything. Liquid personal assets typically consist of cash, cash equivalents, and non-retirement investment accounts. Banks view liquidity favorably because it is an indication that a buyer can fund an acquisition's equity and working capital requirements.

The bank will also have interest in your real estate equity value. This is the value of your real estate assets less the remaining mortgage balances. Lenders often place a lien on a personal guarantor's real estate to secure the equity value as loan collateral.

I have found it convenient to update a personal balance sheet every month. I've made this update part of my routine personal financial tracking. Keeping this record up to date allows me to respond quickly to lenders. Prompt responses are essential in moving deals forward. See below for an example:

Personal Financial Statement	**4/30/2022**	**5/31/2022**	**6/30/2022**	**7/31/2022**	**8/31/2022**	**9/30/2022**
Assets						
Cash in Bank Accounts	$ 146,608	$ 112,258	$ 83,920	$ 94,779	$ 77,259	$ 80,278
Investment Accounts	300,350	286,946	277,274	301,152	281,539	253,333
Liquid Assets	**$ 446,957**	**$ 399,205**	**$ 361,195**	**$ 395,932**	**$ 358,798**	**$ 333,611**
Retirement Accounts	$ 311,649	$ 310,018	$ 308,104	$ 327,478	$ 322,367	$ 308,858
Real Estate	1,501,900	1,551,300	1,549,300	1,547,700	1,541,200	1,543,900
Automobiles	48,605	48,605	48,605	48,605	48,605	48,605
Total Assets	**$ 2,309,111**	**$ 2,309,127**	**$ 2,267,204**	**$ 2,319,715**	**$ 2,270,970**	**$ 2,234,974**
Liabilities						
Mortgages	$ 1,236,859	$ 1,232,480	$ 1,230,116	$ 1,229,782	$ 1,225,368	$ 1,225,030
School Debt	31,487	28,672	25,848	23,014	20,171	17,318
Credit Cards	16,379	21,040	18,067	18,055	22,339	12,386
Total Liabilities	**$ 1,284,726**	**$ 1,282,192**	**$ 1,274,031**	**$ 1,270,851**	**$ 1,267,877**	**$ 1,254,733**
Net Worth	**$ 1,024,386**	**$ 1,026,935**	**$ 993,173**	**$ 1,048,863**	**$ 1,003,092**	**$ 980,241**
Equity in Real Estate	*$ 265,041*	*$ 318,820*	*$ 319,184*	*$ 317,918*	*$ 315,832*	*$ 318,870*

Borrowing against illiquid assets is a strategy for obtaining additional capital. A home equity line of credit (HLOC) is a debt product that uses home equity as collateral. However, because a 7a loan typically requires a lien on the borrower's home, HLOC capital is not an option for many small business acquirers.

Another strategy to unlock capital from illiquid assets is to borrow against your retirement accounts. Because protecting retirement savings is in the public interest, such borrowing is tightly regulated. Even so, there are opportunities to obtain capital if needed. See below for some examples:

- **401k** – Most 401k retirement plans allow its owner to borrow against its balance. You can borrow 50% of the 401k balance *or* $50k, whichever is lower. There is no interest on a 401k loan because you are loaning money to yourself. However, the loan must be repaid within 5 years; failure to do so results in harsh penalties.[xix]

- **IRA** – While it is difficult to generate cash from a traditional IRA without incurring penalties, IRAs can support an acquisition through the rollover for business startups (ROBS) program. The ROBS opportunity is described in detail in Chapter 3 of this book.

- **Roth IRA** – With a Roth IRA, you can always withdraw your basis without penalty. Basis is the dollar amount that you have contributed to the Roth IRA account. It excludes gains made from the account's investment activities.

However, before acting on any of these strategies, it would be wise to consult a professional financial advisor. Financial advisors can provide specific guidance regarding the benefits and pitfalls of each. They can also recommend other liquidity strategies applicable to you.

In addition to understanding your personal balance sheet, a bank may request high-level information pertaining to your personal cash flow. This is the net of your income and your living expenses. If in a month you have $10k in income, pay $2k for your home mortgage, and have a fully paid off car, banks will be satisfied that you live within your means. If you have $10k in income, pay $6k for your mortgage, $2k in student loans, and $1k in car payments, banks will be concerned that your personal needs may become a cash drain on the business you are acquiring.

The Process

Personal Asset Protection

Internal vs. External Claims on Assets

Internal claims are limited to assets of a particular legal entity. External claims extend beyond the legal entity to the personal assets of its owners.

For instance, if a customer falls down steps on a property owned by a corporation, the injured customer can only pursue the assets owned by the corporation. This would be an *internal claim* because the assets at risk are internal to the corporation and do not extend to the personal assets of its owners.

Conversely, if an owner or employee of the corporation were to maliciously push the customer down the steps, the injured customer would also have an *external claim*. In this scenario, the customer could pursue both the corporate assets and the personal assets of the individual who pushed them.[xx]

<u>Dangerous vs. Safe Assets</u>

Dangerous assets are those that create substantial risk of liability. Commercial property, production equipment, and business vehicles fall into this category.[xxi] To protect the business owners, dangerous assets should always be owned by the corporate entity.

Safe assets do not typically create significant risk and are often owned by individuals. Stocks and bonds are examples of safe assets.[xxii]

<u>Asset Protection Strategies</u>

Because businesses are dangerous assets, business owners have long formed legal entities to protect their personal assets. Since their origination in the 1970s, limited liability companies (LLCs) have become the incorporation vehicle of choice for most businesses. Their flexibility, efficiency, and low-cost have caused LLCs to be formed instead of C-Corps in most cases.

Even so, corporate business entities cannot protect personal assets in certain professions. For instance, a corporate liability shield cannot protect doctors and lawyers from malpractice claims. Business owners in this predicament should consider protecting their personal assets in other legal entities, such as a family limited partnership (FLP).[xxiii]

Sea Story

Where's the Rescue Capital?

I sat down at my parent's kitchen table and opened my laptop. My father settled in next to me as it booted up. "So, you're excited about this one?" he said with a note of skepticism.

But I was excited. My prospect was a business that trained the unemployed to renter the workforce. It had strong cash flows and a semi-absentee owner. I had run the financials and they supported a highly levered acquisition using SBA debt.

Once the financial model was open, I walked my father through it. Revenue was stronger during the summer months, so closing date would affect cash flow. Gross margins averaged about 65%. Overhead was reasonable with most SG&A expenses coming from employee salaries. Net profitability was reliably greater than 30%. Cash flow was strong, even after accounting for debt principal payments. As I finished my explanation, I leaned back in my chair, expecting my father's approval.

"Looks pretty good," he said, "but, you'll need about $200k for the equity piece."

"I've got it," I replied, "I've got just that much in savings. I won't even have to raise equity capital on this one."

"That's great," my father nodded as he took it all in, "It's always easier to do a transaction with your own capital. Keeps all the equity in your hands too, which is worth its weight in gold if the business is successful. That just leaves one question…"

"What's that?" I asked.

"Where's the rescue capital?"

"What does that mean?" frustration permeated my voice. He was driving at something specific – something he knew I hadn't thought of.

"Well, my experience is on the legal side. I've helped clients buy businesses since the 70s. The ones who are successful have *staying power*. That means they have cash reserves sufficient to survive the inevitable hiccups. You know, customer attrition after change in ownership, misrepresentations in the financial statements, due diligence failures – all that stuff."

His point was well taken. I could fund the equity piece from my personal savings, but at that point I would be tapped out. I'd have to use debt for the initial working capital, so where would I get additional cash if things didn't go as planned?

As I shut down my computer, I realized I had work to do on the risk mitigation aspects of the deal.

The Process

Rescue Capital and Staying Power

There are no easy solutions to the challenges presented in the sea story above. Nevertheless, cash reserves to supplement the business are key to risk mitigation. The following are considerations that will help you assess your post-close staying power:

- How much of your personal savings will be left after the deal closes?
    - How much of that are you prepared to inject into the business if needed?

- Are your equity investors willing to contribute additional capital?
    - If so, are the terms clearly stated in the operating agreement and other governing documents?
    - If not, will your investors allow you (personally) to lend the business money?

- What are your post-close debt sources?
    - Which, if any, of your assets (personal or business) remain without a lien?
        - How much can you borrow against those *free and clear* assets?
    - How much unsecured debt can you borrow?
        - What is the interest rate on that unsecured debt?

The Process

Working Capital Target

To keep a business properly capitalized, you must understand the business' required working capital.

Working capital is defined as current assets less current liabilities.

$$Working\ Capital = Current\ Assets - Current\ Liabilities$$

Current assets are company assets that can be turned to cash within one year.[xxiv] Current liabilities are all financial obligations that must be settled within one year.[xxv]

Working capital target refers to the amount of working capital that the seller will leave in the business after close. From the buyer's perspective, this amount should be enough to continue normal operations without injecting outside capital. The idea is that the purchase price should include all assets the business needs to operate normally, including working capital.

While this position is logical, sellers typically object.

Sellers often believe they should keep the cash in the business bank accounts, accounts receivable (A/R) recognized before close, and accounts payable (A/P) incurred before close. They will argue that these represent the spoils of their labor. Needless to say, parting with these current assets and liabilities makes it very difficult to be properly capitalized after close. This will result in the buyer immediately injecting working capital, which essentially equates to an increase in the purchase price. Further complicating matters, in businesses that carry physical inventory, sellers often want to be paid for inventory value on top of the purchase price for the business itself.

With respect to cash in the business bank accounts, industry precedents favor the seller. The seller always keeps the cash. Don't fight on that front. Rather, insist that the business remain properly capitalized by retaining sufficient net A/R to continue normal operations. Also, insist that the inventory required to operate normally be included in the purchase price. After all, you are paying a multiple on the business' cash flow – *and, without proper inventory, there is no cash flow!*

12-Month Average Less Cash Methodology

One methodology of determining working capital target subtracts cash balances from monthly working capital and averages the results over 12 months.

$$Working\ Capital\ Target = \frac{\sum_{month=1}^{12}(Current\ Assets_{month} - Current\ Liabilities_{month} - Cash_{month})}{12}$$

This method, however, requires you to replace the cash you eliminated from the calculation. This is typically done by borrowing against the A/R included in the working capital target, so having an A/R line of credit is essential to successful implementation.

It is also important to remember that you are averaging working capital less cash over a entire year, so the target may be lower than the working capital requirement at the specific time of close. Any such shortfall should be a point of negotiation. The seller should either agree to increase the working capital target or lower the purchase price to bridge the gap.

Self-Sustaining Methodology

Another methodology determines working capital target based on the amount needed to ensure 12 months of positive free cash flow (FCF). Consider the example of Paula's Print Shop examined in previous chapters.

	Year 5											
	January	February	March	April	May	June	July	August	September	October	November	December
Income	$ 165,891	$ 90,744	$ 189,751	$ 66,270	$ 75,225	$ 163,774	$ 208,195	$ 167,196	$ 125,315	$ 164,686	$ 203,294	$ 219,659
COGS	89,278	32,142	87,499	34,170	23,355	59,961	72,800	50,796	39,177	58,983	79,604	56,197
Gross Profit	**$ 76,614**	**$ 58,602**	**$ 102,252**	**$ 32,100**	**$ 51,870**	**$ 103,813**	**$ 135,395**	**$ 116,400**	**$ 86,138**	**$ 105,703**	**$ 123,690**	**$ 163,462**
SG&A	82,642	85,916	95,933	70,532	70,138	95,549	88,870	97,221	77,348	78,125	83,084	82,246
Net Operating Income	**$ (6,028)**	**$ (27,314)**	**$ 6,319**	**$ (38,432)**	**$ (18,268)**	**$ 8,264**	**$ 46,525**	**$ 19,179**	**$ 8,790**	**$ 27,577**	**$ 40,607**	**$ 81,217**
Principle Payments	3,051	3,066	3,082	3,097	3,113	3,128	3,144	3,159	3,175	3,191	3,207	3,223
Depreciation & Amortization	(833)	(833)	(833)	(833)	(833)	(833)	(833)	(833)	(833)	(833)	(833)	(833)
Taxes Burden / (Benefit)												82,286
Free Cash	**$ (8,246)**	**$ (29,547)**	**$ 4,071**	**$ (40,696)**	**$ (20,547)**	**$ 5,970**	**$ 44,214**	**$ 16,853**	**$ 6,448**	**$ 25,219**	**$ 38,233**	**$ (3,458)**
Buyer Contribued WCAP $ -												
WCAP Acquired in Deal $ 100,000												
Running Cash Balance	**$ 91,754**	**$ 62,207**	**$ 66,278**	**$ 25,582**	**$ 5,035**	**$ 11,005**	**$ 55,219**	**$ 72,072**	**$ 78,520**	**$ 103,739**	**$ 141,972**	**$ 138,513**

This example assumes that the first year of your ownership will produce the same financial results as Paula's fifth and final year of provided financials. Net Operating Income is then adjusted to FCF by considering the new ownership's principle payments, depreciation / amortization, and tax burden. Working capital (WCAP) acquired in the deal is then adjusted to ensure that running cash balance remains positive.

Think of it like this: In January and February, the business operates at a loss and has negative FCF. Then, despite a small March profit, resumes losses in April and May. The first five months of the year are tough! You will need to start with a large amount of working capital to remain solvent until profits from June through November build your cash reserves. Consequently, a working capital target of at least $100k is needed. This target keeps the cash balance just above $5k at its low point at the end of May.

It is also important to understand that the model above assumes a December 31 close date and that operations under new ownership start January 1. The 12-month model would be adjusted for a different start date.

Cash on Day 1 of new ownership would also be an issue. Even if you succeed in convincing the seller to leave $100k of working capital in the business, that amount would not include cash. *Remember, the seller always takes the cash*. Rather, it would be some combination of A/R, A/P, and inventory. You would still need to borrow against company assets to get cash in the bank account until A/R started converting to cash.

Chapter Summary

The Essential Process

1. Asset purchases have the advantages of reduced buyer liability, goodwill amortization, and depreciation basis step-up.

2. Stock purchases save sellers from double-taxation but eliminate the buyer benefits associated with an asset sale. Stock purchases can offer buyers operational efficiencies. This is the case when there is value in preserving company contracts through the sale.

3. A Section 338 election allows a stock purchase to be treated as an asset purchase for tax purposes.

4. Most business acquisitions result in an LLC, S-Corp, or C-Corp corporate structure.

5. Personal goodwill is goodwill intrinsic to the seller and is distinguished from corporate goodwill. Personal goodwill is considered to be nontransferable to the buyer and is thus not subject to double taxation. This can facilitate the asset purchase of a C-Corp. However, a seller claiming personal goodwill should be prepared to defend this classification to the IRS.

6. Corporate entities (usually LLCs, S-Corps, or C-Corps) create liability shields for their owners. This protects the owners' personal assets from claims against the business.

7. Ultimately, most businesses incorporate in Delaware if they are worried about being sued and in Wyoming if they value privacy. To some extent, Nevada offers both these benefits, but tends to cost more in incorporation and annual fees. If these concerns don't apply to your business, it may simplest to incorporate in the state in which your business resides.

8. Cap tables track ownership percentages by owner.

9. Personal guarantees protect creditors by collateralizing the guarantor's personal assets. When guaranteeing a loan, it is worthwhile to avoid a spousal guarantee.

10. Keeping your personal balance sheet (personal assets and liabilities) up to date makes it easy to complete Personal Financial Statement when needed.

11. Be sure to think through where you will get *rescue capital* should your acquired business experience financial difficulties. Successful business owners have *staying power* to make it through the hard times.

12. Working capital target is often a key point of contention between buyers and sellers. While the seller always takes the cash, the buyer must insist that the business remain properly capitalized through a combination of net A/R and inventory.

The Essential Partners

- BizBuySell.com – find businesses for sale
- Axial.net – aggregates businesses for sale and tracks deal progress
- Tri-Merit Specialty Tax Professionals – cost segregation study that can accelerate depreciation tax benefits on purchased real estate
- Guidant Financial – leading ROBS provider
- Legal Zoom is cost effective way to create a corporate entity.

The Essential Library

- HBR Guide to Buying a Small Business by Richard S. Ruback and Royce Yudkoff
- The E Myth Revisited: Why Most Small Businesses Don’t Work and What to Do About It by Michael E. Gerber
- Buy Then Build by Walker Deibel

[i] https://corporatefinanceinstitute.com/resources/knowledge/accounting/section-338/
[ii] https://www.investopedia.com/terms/j/jointventure.asp
[iii] https://www.investopedia.com/terms/l/limitedpartnership.asp
[iv] https://www.forbes.com/advisor/business/llp-vs-llc/
[v] https://corporatefinanceinstitute.com/resources/knowledge/strategy/sole-proprietorship/
[vi] https://www.investopedia.com/terms/l/llc.asp
[vii] https://www.forbes.com/advisor/business/s-corporation/
[viii] https://www.investopedia.com/terms/c/c-corporation.asp
[ix] https://www.rocketlawyer.com/business-and-contracts/business-operations/small-business-taxes/legal-guide/c-corp-taxation
[x] https://mercercapital.com/article/an-overview-of-personal-goodwill/
[xi] https://assets.gordonbrothers.com/insights/article/2020/tax-benefits-of-personal-goodwill-in-ma-transactions
[xii] https://www.delawareinc.com/blog/why-do-businesses-incorporate-in-delaware/
[xiii] https://corp.delaware.gov/paytaxes/
[xiv] https://corporatenevada.com/blog/why-incorporate-in-nevada/
[xv] https://www.youtube.com/watch?v=QaYcQz_NO4g
[xvi] https://incparadise.net/wyoming/reasons-incorporate-business-wyoming/
[xvii] https://www.myusacorporation.com/articles/delaware-vs-nevada-vs-wyoming
[xviii] https://www.investopedia.com/terms/c/capitalization-table.asp
[xix] https://www.lsfcu.org/borrowing-against-your-401k-is-it-ever-a-good-idea/
[xx] https://www.investopedia.com/articles/pf/08/asset-protection-business.asp#toc-asset-types
[xxi] https://www.investopedia.com/articles/pf/08/asset-protection-business.asp#toc-asset-types
[xxii] https://www.investopedia.com/articles/pf/08/asset-protection-business.asp#toc-asset-types
[xxiii] https://www.investopedia.com/articles/pf/08/asset-protection-business.asp#toc-asset-types
[xxiv] https://www.investopedia.com/terms/c/currentassets.asp
[xxv] https://www.investopedia.com/terms/c/currentliabilities.asp