Acquiring a Business:
Ins-and-Outs

By Kyla A. Parrino

DURING THE ACQUISITION of a business, either the assets of a company or the stock of a company are purchased. In an asset acquisition, the tangible and intangible property of the business are purchased and could include assets such as inventory, intellectual property, goodwill of the business, vehicles, and the business facilities. The particular assets being purchased and the assets which are being excluded from the sale are outlined in an asset purchase agreement, along with the particular liabilities the buyer will assume as a result of the purchase.

The asset purchase agreement also contains the representations and warranties of the seller. The representations and warranties are statements of fact by the seller—as of the date when the statements are made—the buyer may rely on those statements to be true.

Accompanying the seller's representations and warranties are the disclosure schedules, the legal documents which provide specific disclosures or exceptions to specific disclosures about those representations and warranties to the buyer. For example, one schedule may disclose a seller's pending litigation while another may disclose the seller's material contracts.

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If a seller misrepresents representations and warranties to the buyer, the buyer will have an opportunity for recourse against the seller. In California, the asset purchase agreement, representations and warranties and disclosure schedules serve as unique legal documents which, if not negotiated and completed correctly, could well result in a variety of noisome legal consequences.

Survival Clause

The representations and warranties by the seller to the buyer in an asset deal provide a unique opportunity for the seller to disclose to the buyer both the positive and negative aspects of the business. The representations and warranties "serve as a safety net for the seller and buyer," and if discovered prior to closing, give the parties involved grounds to back out of the asset deal.[1]

Further, if a survival clause is included in the agreement, the representations and warranties contained in the asset purchase agreement can survive post-closing as well.[2] A survival clause exerts additional pressure on the seller to ensure that their representations and warranties are in fact truthful because it gives the buyer additional time to discover if there has been a breach.

If no survival clause is included in the asset purchase agreement, or if the clause is not properly drafted to conform to California law,

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the representations and warranties expire at closing.[3] In *Western Filter v. Argan, Inc.*, the court established the importance of properly drafting a survival clause to ensure that it is enforceable post-closing.[4] In that case, the court ruled that for a survival clause to be enforceable in California, the clause must explicitly state that the intent of the survival clause is to contractually reduce the statute of limitations period.[5]

If the survival clause does not state such intent, the survival clause is void and the buyer only has until closing to bring action for breach of the representations and warranties.[6] The survival clause helps the buyer by giving them more time to discover a breach of the representations and warranties post-closing, while it may also help the seller because it can shorten a statute of limitations period. Given that the representations and warranties are of such value to the buyer and seller in an asset deal and given that the courts have decided that a survival clause must be precisely drafted to conform with specific requirements in order to be enforceable, it is imperative to ensure that a well-drafted survival clause is included in an asset purchase agreement.

Non-Compete Agreements

In the context of an asset sale, another critical legal tool the buyer and seller may utilize is entering into a non-compete agreement—a contract between the buyer and employee, where the employee agrees not to compete with the business of the buyer for a period of time post-sale and upon termination of employment with the buyer, or if the employee quits.

Although in a majority of states reasonable non-compete agreements are enforceable, in California—subject to several narrow exceptions—non-compete agreements are generally unenforceable. California Business and Professions Code §16600 codifies that a contract which restrains an individual from “engaging in a lawful profession, trade, or business of any kind is to that extent void.”[7]

One of the exceptions to this general unenforceability of a non-compete agreement is codified in Bus. & Prof. Code §16601, which refers to the sale of the goodwill of the business. It provides that a non-compete agreement is enforceable in the connection to the sale of a business if it is “limited to the area where the sold company carried on business” and if it is “to prevent the seller from depriving the buyer of the full value of its acquisition, including the sold company’s goodwill.”[8]

Often what makes a contribution to the profitability of a business are its key employees. If a business is sold and previous employees of that business

leave and begin competing with the seller, the seller loses part of the initial bargain.

For this very reason, California courts have upheld that non-compete agreements between the buyer and an employee were part of the asset sale that included purchase of the business' goodwill when it limits the employee to a specific geographic area.[9]

Real Property Lease Restrictions

Often, a business does not own all of the real property that it needs to operate, but instead rents its property and space from a third party. For this reason, the parties to an asset deal must review the seller's lease agreements to determine the restrictions, if any, of the contract.

If the buyer desires to assume the rental contract, it must examine and analyze the terms to determine if it can even be assigned to the buyer. Generally, the courts desire free alienability of property.[10] For this reason, California has codified many of the rules relating to the assignment of commercial leases. California Civil Code §1995.250 provides that a tenant's interest in a lease may be restricted by requiring the landlord's consent, so long as the landlord's consent is not unreasonably withheld and subject to express standards or conditions.[11]

One commercially reasonable restriction on a California commercial lease agreement is the inclusion of a rent recapture clause.[12] The purpose of a rent recapture clause is often utilized by the landlord in the context of an asset deal to reclaim the fair market value of a rental property when it is being rented to the seller for under fair market value. In an asset deal, the buyer desires to purchase the assets of the seller, often including an assumption of the seller's rental agreements. Without a rent recapture clause, the seller would be able to assign the lease to the buyer with the same rental terms, including the same under fair market value rental price.

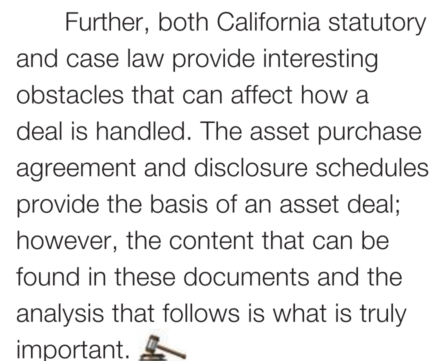
The rent recapture clause effectively acts as an anti-assignment clause where, if the tenant assigns the initial lease to a third party, the landlord has the right to terminate and recapture the lease.[13] Although the landlord may choose to rent the property to the buyer, the rent recapture clause gives the landlord the ability to prevent the assignment if they so choose.

When analyzing the rental terms in an acquisition, it is critical to look for a valid rent recapture clause to determine if the seller will even be able to assign the lease.

Additional Considerations

Conducting an asset sale in California has many unique legal considerations. The concerns listed above have not even begun to scratch the surface of the issue. For example, regulatory matters related to Internal Revenue Service audits and a plethora of employment law matters predominate negotiations and affect many aspects of an asset deal. Pending litigation and Uniform Commercial Code liens may affect how an asset deal is negotiated.

Further, both California statutory and case law provide interesting obstacles that can affect how a deal is handled. The asset purchase agreement and disclosure schedules provide the basis of an asset deal; however, the content that can be found in these documents and the analysis that follows is what is truly important.



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[1] *W. Filter Corp. v. Argan, Inc.*, 540 F.3d 947 (9th Cir. 2008).
[2] *Id.*
[3] *Id.*
[4] *Id.*
[5] *Id.* at 949.
[6] *Id.* at 952.
[7] CAL. BUS. & PROF. CODE §16600.
[8] *NewLife Scis. v. Weinstock*, 197 Cal. App. 4th 676, 689, 128 Cal. Rptr. 3d 538, 549 (2011).
[9] *Fillpoint, LLC v. Maas*, 208 Cal. App. 4th 1170, 1177, 146 Cal. Rptr. 3d 194, 199 (2012).
[10] *Kendall v. Ernest Pestana, Inc.*, 40 Cal. 3d 488, 494, 709 P.2d 837, 840 (1985).
[11] CAL. CIV. CODE §1995.250.
[12] *Carma Developers (Cal.), Inc. v. Marathon Dev. California, Inc.*, 2 Cal. 4th 342, 376 (1992).
[13] *Id.*