

**BUYING AND SELLING A BUSINESS IN COLORADO -
MASTERING THE BASICS
SEMINAR 8/7/03**

**IV. DRAFTING ANCILLARY DOCUMENTS -
Presented by Robert L. Allman, Esq.**

BUYING AND SELLING A BUSINESS IN COLORADO -
MASTERING THE BASICS
SEMINAR 8/7/03

IV. DRAFTING ANCILLARY DOCUMENTS -
Presented by Robert L. Allman, Esq.

Robert L. Allman, Esq.
Allman & Mitzner, LLC
535 16th Street, Suite 727
Denver, Colorado 80202
rallman@allman-mitzner.com

Copyright © 2003 by Robert L. Allman

I. INTRODUCTION AND SUMMARY

Drafting ancillary documents requires organization, attention to detail, and coordination with the primary purchase agreement. The topics addressed are: promissory notes, pledge and security agreements, escrow agreements, non-compete agreements, employment and consulting agreement, and other ancillary documents.

There is a tendency to prepare these ancillary documents only after the primary purchase agreement has been negotiated. It is suggested here that the ancillary document issues be addressed, at least in general terms, within the primary purchase agreement and that, to the extent reasonably practicable, the ancillary documents be presented with the purchase agreements.

The ancillary documents are often those which guide the parties' conduct after the sale is consummated, and they are often those documents which become

the focus of the parties' interests should conditions change or some other unforeseeable event occur.

One of the virtues of ancillary documents is that they are susceptible to being utilized as working forms and, accordingly, they can be relatively rapidly prepared and can help to expedite the transaction, particularly with early preparation.

A. Promissory Notes

The key issue in drafting promissory notes is making certain that the note reflects the purchase term set forth within the purchase contract. If there are to be additional terms, such as default interest rates, change in condition clauses, prepayment penalties, or other terms which make the terms more onerous than might be expected by the purchaser, it is always helpful to have addressed these at least within the outline of the business deal.

A realistic approach to promissory notes, as with all of the ancillary documents, is to outline the major transaction points. It is suggested that these transaction points be reflective of the reasonable expectations of the parties. It is disconcerting, to say the least, to find significantly onerous terms within a note within the context, for example, of a relatively simple transaction. It would seem apparent that the more complex the transaction, the longer the promissory note.

From the standpoint of drafting, there are obviously numerous forms and examples that one can use. The key concerns revolve around whether one is on the purchaser's or seller's side.

From a seller's perspective, security and holding as many legal rights as possible is usually the order of the day. The seller will want, and the purchaser usually has the opportunity to negotiate default interest rates, acceleration terms, events of default for matters other than non-payment - such as failure to meet a condition, cure periods, choice of law, prepayment rights, venue clauses, jury waivers, arbitration, attorney's fees, and other protective terms. If the note is secured, the security ought to be referenced within the note.

From the purchaser's perspective, one would like to seek the lowest interest rates, no or minimal penalties and certainly no increase in interest rates, longer default cure terms, the requirement of written notice of default and opportunity to cure, and reasonable limitations on venue so that it is at least convenient, the retention of jury trial rights, and the incorporation of the agreements by reference within the note. A comfort clause, allowing the seller to accelerate or default the note in the event of reasonable fear of non-payment, should be avoided by the purchaser if possible.

The incorporation clause could be important in a complicated transaction should there be an obligation that the purchaser has not met, such as matters such as the quality of products or the nature of the business that was purchased. It is

preferable from the purchaser's standpoint for any such change of condition or unexpected issue to be at least incorporated as a potential defense for payment on the note. This can be a source of considerable negotiation if the seller allows it and/or the purchaser insists.

More onerous terms such as confession of judgment clauses are typically not acceptable in the ordinary transaction, and are not commonly seen. In addition, in the note there is also a place where, for purposes of non-monetary breach which could lead to a default of the note, the rights to cure should be the subject of some significant negotiation. For example, the agreement of a purchaser to maintain a certain status of the business or its equipment should, if monetary obligations are being met, not ordinarily trigger default without purchaser's reasonable opportunity to cure. If cure cannot be effected within, for example, a 15 day period, then diligent pursuit of such cure would not be a default.

Obviously, this can be a recipe for further disputes, but the common thinking would be that, as long as the monetary obligations are being paid and the assets to be purchased are not being wasted so as to jeopardize security, the purchaser should not be put into default. However, depending upon the negotiation, the seller could insist that it have the right, within its own discretion, to seize or take over property for purposes of preserving it and, depending upon the nature of the business, that could be appropriate.

For example, within the software business, if software is escrowed, as will be discussed below, there could be grounds for the seller to take the source code out of escrow if it feared a bankruptcy or other threat of insolvency. The threat of insolvency issue is one which is commonly addressed, but ordinarily does require some identifiable indicator of such insolvency.

From the purchaser's perspective, the note should also provide for a procedure for its cancellation and the release of any security instruments upon payment in full. Any recorded security should be formally released by recorded instrument.

The promissory note is often the key document, yet it is also often the simplest and one which might not be closely scrutinized. There is opportunity to include within a promissory note various other promises that have been made by the parties. Depending upon the nature of the circumstances, this is a negotiating tip worth remembering.

B. Pledge and Security Agreements

There are relatively standard pledge and security agreements available to all. The issue with both is that of perfecting one's secured interest. The perfection issues have been simplified somewhat by the new UCC provisions which went into effect _____, 2002. The pledge instrument is ordinarily utilized for purposes of protecting stock ownership or other indicia of ownership in other entities, such as a limited liability company. The pledge rules must be strictly followed. The security

agreement is intended to provide the rights of the secured holder and it supplements the UCC filing with which it is ordinarily associated.

Key conditions for the pledge agreement are as follows:

1. File the UCC-1 in the state of the seller's location;
2. Hold the pledged securities.

Key conditions for a security agreement are as follows:

1. Adequately describe the collateral.
2. Record the UCC-1 in the state of the Seller's location.

With regard to the pledge agreement, the secured party must maintain physical possession of the securities. The pledge agreement must be very specific about the relinquishment of those securities once the obligations are met. The pledge agreement should provide for the default provisions and including any cure provisions contained within the agreements, because this is such a powerful document. The pledge itself allows for the pledge holder to succeed to that shareholder's interest within the entity in the event of default. It does not require court action or other formal action unless the agreement so provides.

To reiterate, the UCC-1 form may reference securities and, in order to perfect the pledge agreement, the UCC-1 needs to be filed in the state which is the location of the debtor. In addition, the secured party must have possession of the securities. It is also suggested that any existing securities include a legend referencing the existence of a stock pledge agreement, that any subsequently issued

securities reference the existence of the stock pledge. Obviously, this would be more suitable for the closely held company.

Accordingly, extra care must be given by the party giving the security to ensure that the valuable ownership interest is not lost as a result of technicalities or minor breaches. Always, from the debtor's standpoint, try to provide for generous cure periods.

The security agreement provides for the parties' rights as the secured party. It may also cover security interests in stocks, but it is not quite as powerful as the pledge, since the pledge essentially allows for the pledgeholder to succeed to that shareholder's interest with a minimum of formality.

The security agreement, like the promissory note discussed above, should not ordinarily add significantly onerous terms which were not included in the primary purchase agreement. However, the security agreement will commonly provide for a form of preemptive taking in the event of uncured default, insolvency, lack of confidence in the borrower's ability to pay, and other somewhat vague conditions. The risk of utilizing the security agreement in this fashion, from the standpoint of the security holder, is that it can lead to significant litigation if the security agreement, under those more vague standards, is unreasonably exercised. Obviously, it is intended as a "hammer" but must be utilized under carefully controlled conditions.

In the old days, the UCC-1 form had basic terms of a security agreement included on its back page. The current form of UCC-1 is simply intended to give notice that there is a security interest. It is not intended to explain in full detail the extent of that security. The role of the security agreement is to define those rights with particularity.

There are two keys to Article 9 of the UCC. The first is that the UCC-1 is to be filed in the location of the residence or domicile of the debtor. This may be counter-intuitive - if the property is located in Colorado and the debtor is a Delaware corporation, the UCC-1 must be filed in Delaware to be perfected. Second, the collateral descriptions must be specific and, while there can be certain generic descriptions, descriptions such as “all of debtor’s property or assets” will or may not be sufficient. Accordingly, be specific with the collateral descriptions.

Of utmost importance with the UCC-1 is to protect that interest by properly filing it in order to have a perfected security interest. This may provide additional protection in the event of a bankruptcy and for priority in the event of disputes with other subsequently-secured creditors.

The rules have become simpler in allowing for a central filing with the Colorado Secretary of State. Their website can be accessed at www.sos.state.co.us, and their forms may be completed online and downloaded for manual filing.

You may still also record your financing statement with the clerk and recorder of each county in the event that the financing statement relates to real

property. While the security agreement is ordinarily not recorded with the clerk and recorder, there is no prohibition against such recording, and it might be appropriate. Ordinarily some reference to the security agreement should be included on the UCC form.

The security agreement should also include the following: (1) identity of debtors and guarantors, and (2) location and identity of the assets secured. The list should be both specific and reasonably broad, i.e., identify specific equipment of which you are aware, particularly that of significant value, and also include broader phrases such as “all fixtures, furniture, equipment, accounts receivable” et cetera. “All property” is not specific enough.

The security agreement should be signed by the debtor and guarantor, and most people prefer a notarized signature.

The security agreement should provide for remedies in the event of default, and may include those such as self-help, injunctive relief, attorney’s fees, and interest consistent with default interest.

The debtor will likely want the security agreement to at least reflect by reference the other documents to the transaction, with the view that in the event of default, which has a reasonable explanation due to the creditor’s conduct, that those issues can more easily be brought to bear in the event of litigation.

There is a tendency with the UCC-1 form and with the security agreement to treat them as boilerplate documents, with a few blanks filled in. There is

significant opportunity within these documents to protect the parties' interests, regardless of the side you represent.

For example, in a situation where the purchaser is not personally guaranteeing the promissory note, it may be appropriate for the purchaser to guarantee the debtor's obligations under the security agreement, such as those of not wasting the property, paying property or sales taxes as appropriate, or other protective measures.

C. Escrow Agreements

Issues with escrow agreements arise, most often, when something has gone wrong. Accordingly, the escrow agreement should be written to accommodate the event of something going wrong. The length and complexity of the escrow agreement will vary depending upon the amount held in escrow, the length of the escrow and the level of routine.

Ordinarily, a professional escrow holder will have its own forms. A financial institution will often have forms that essentially state that once the institution receives written agreement from both parties that the escrowed funds or other property may be paid out, it will simply hold those funds and tie it to a deadline. If the deadline is then not met, the escrow holder is allowed to interplead the funds at the parties' expense.

A key to escrow agreements is to be very clear in defining those circumstances under which the escrowed funds are paid out or returned to the

provider of the funds. If those issues can be made as simple as possible, there is much less likelihood of harm.

There are, however, other types of escrow, such as software escrow, or where the escrow is intended to protect against subsequent bankruptcy, insolvency, or failure to provide adequate updates or services. This type of escrow agreement must be specifically tailored to the nature of the property held.

The escrow can be a very useful device in that it does give the seller an indication of the purchaser's intentions. The earlier that the seller can get the purchaser to place funds into escrow for purposes of being applied towards closing, then the more real the transaction would appear to be. Conversely, a purchaser may not wish to prematurely be forced to place funds into escrow until such time as due diligence has been completed and ample opportunity has been provided to verify the transaction and also to consider the fairness of the purchase price.

The use of early escrow, as on an earnest money basis, can be effective in the purchase acquisition, regardless of the size of the transaction. Although there is a tendency in larger transactions to forego earnest money escrow until certain fairly lengthy conditions have been met, it is always an encouraging sign. Where earnest money escrows are commonly utilized in smaller business acquisitions, they have a tendency to solidify that the purchaser is able to do what it says it will do, and to give the parties a milestone to accomplish in terms of disclosures to make the escrow non-refundable.

The escrow agreement itself will, from the purchaser's standpoint, want to allow for the purchaser's refund of escrowed funds, and to ensure that the escrow is not paid out until closing. The seller will wish to see that there is no premature refunding of escrow without seller's agreement and, under some circumstances, to see that the escrow is maintained for the benefit of the seller in the event that the transaction does not close. The escrow holder has to be taken into account, because it does not want to be embroiled in unnecessary disputes, particularly where it might potentially hold the escrow holder to have to engage in litigation or retention of counsel. The escrow holder may actually require some sort of deposit in that eventuality. It may also require that the funds will first be applied towards its expenses and this is a common solution for the escrow holder, but not often a happy one for the party contributing the escrow.

Another use of escrow may be that of the purchaser who wishes to be certain that the business purchased is what it was intended to be. Accordingly, a portion of the purchase price may be held in escrow to cover instances such as unexpected creditors' claims, unanticipated loss of revenue, or other protective measures. This creative use of escrow can be the type of detail that helps a deal along where due diligence is hurried, or the business is such that there could be unanticipated risk that it would be unfair for the purchaser to assume. This type of escrow would ordinarily have a time frame put upon it, and it would be unusual for such time frame to be longer than six months.

D. Non-Compete Agreements

Colorado recognizes the validity of non-compete agreements in limited circumstances. Those circumstances are: in association with the sale of a business, for purposes of protection of trade secrets, or those signed by managerial personnel. All non-compete agreements must be reasonable in scope, duration and geography. They are not to extend beyond the reasonable necessity of the non-compete so as to be considered unconscionable. A non-compete agreement, otherwise valid because it is associated with the sale of a business, may still become invalid if it is deemed unconscionable or otherwise violates reasonable terms.

In modern times, the trade secret exception has been utilized to expand the scope of non-compete agreements well beyond business sales, and this can be very useful in protecting against key employees, including those who are not managerial. Within the context of the business purchase, it is ordinary and expected for there to be a non-compete given by the selling owner. The issue then also becomes which other employees or agents of seller should also be bound by non-competes. If the person to be bound is an equity owner, the issues of legality are relatively straightforward. If the non-compete is to be imposed on all employees, then management personnel are more easily covered, and employment personnel will likely only be covered for the purposes of protection of trade secrets.

In a technology-based transaction, the protection of technical staff by way of non-competes can be quite effective. In less technical businesses or where the work

is of a more common variety and without access to trade secrets, the non-competes become less effective for mere employees.

As to the scope of the non-compete, the agreement should define the competitive activity that is to be restricted. The seller would prefer to have that definition of competitive activity to be drawn narrowly, and the purchaser would prefer that it be drawn more broadly. For purposes of effectiveness, it is better to have the competitive activity be specifically defined, even if it actually covers a broad area. For example, the activity might be “enterprise accounting software, including, but not limited to, “Add It Up,” the company’s chief competitive product.” If there is concern about employees going to particular competitors, then examples of such competitors can be included within the agreement.

Under the duration of the agreement, it was a commonly held belief that those longer than two years would be viewed with great suspicion. It would seem now that those longer than five years would be cast that suspicious eye. It appears the courts have simply gotten more used to non-compete agreements and the fact that they have often been upheld. When the economy was on “internet time,” a one-year non-compete could often be considered to be too long if the restricted activity was too broad. Now that internet time has passed, and the business transactions are of a more traditional variety, the most common time period is a two-year period, and it can be stretched into a five-year period, assuming there is a reasonable basis for same.

A seller will frequently insist upon a non-compete that continues for the period of any payment term, plus an additional two-year period. In effect, that could extend an agreement to over a decade but, if the price is right, it would appear that such restrictions are reasonable. Obviously, the more equal the bargaining power, the more likely the competitive restriction will be upheld.

The non-compete agreement should also define activities not simply in the form of starting a new competitive business, but also as agent, employee, representative, consultant, investor, lender, and direct or indirect participant in any such competitive activity. One could also include involvement in affiliates of those in a competitive activity. In other words, if the need is large to protect against the seller coming back as a competitor, then trying to cover the bases of all aspects of involvement with a competitor becomes important.

It is also appropriate to scale the non-competes to the level of the participant. A minor shareholder ought to be seen to have a lesser requirement of non-compete than a majority shareholder. A limited form of non-compete could also include advisement by the individual signing the non-compete. That signer must give notice to the purchaser of his or her employment over the next two or three years, in order that the purchaser can verify that, for example, trade secrets of the entity are not being utilized.

The non-compete, in modern times, constantly comes back to trade secrets. When in doubt, make certain that the agreement covers trade secrets in an

intelligible manner. There are numerous forms which include broad definitions of trade secrets that are so broad as to be relatively not useful. Those definitions should be preceded by a listing of those items which are indeed deemed the trade secrets of the company. What I mean by this are those categories (not the trade secrets themselves, obviously) and matters which are intended to be protected be defined with some particularity. Some examples are customer prospects gathered by a particular marketing campaign, or a particular business method, or new plan of business campaign that the purchaser most dearly wishes to protect. The more specific, the better.

The last issue on validity of non-competes is that of geography. This is an older concept and one which was easier to understand when people travelled less, there was no email, the internet was not involved, and long distance was expensive. There is no Colorado case which has dispensed with the geographic restriction but, in practice, it would appear that the geographic restriction is often not stated. The restriction is more often in terms of nature of the competitive activity, interaction with specific competitors, and other types of specific restrictions. These types of restrictions do not realistically depend upon geography. However, it is always best to include some definition of geography and, if it is worldwide, within the continental United States, or in North America, explain the basis for same. You may also include a savings clause which indicates that if that geographic area is too

large, then provide at least one alternative, rather than simply state that it would be up to the Court to revise it.

The non-compete should have an attorney's fees clause, it may have a general damages clause, and it should provide for the person giving the covenant agreeing to injunctive relief without the necessity of bond. The bond issue is one which can come up and should always be included as being not necessary when such a written agreement is in place. Matters as to the enforcement of non-competes as to managerial personnel can produce disputes because of a lack of clear legal definition of what constitutes a managerial employee. While this can be addressed within the agreement, it does again point out the need for such agreements to also have as their purpose the protection of trade secrets. Since trade secrets may include customer prospects, price lists, and other customer-related information, such restrictions are logical. If specific payment is being given to an individual employee for purposes of signing the non-compete, then that should be reflected within that agreement.

As a matter of due diligence, it is always appropriate to have employees and/or owners identify any patents, copyrights, or other intellectual property rights which they may claim either individually or on the selling company's behalf, and the non-compete agreement may also be an appropriate place to do so.

E. Employment and Consulting Agreements

Employment agreements can take many forms. There is no standard employment agreement. The key considerations are as follows:

1. Length of employment;
2. Standards of performance;
3. Termination issues;
4. Payment in the event of termination for cause or not for cause;
5. Description of job duties;
6. Authority and decision making;
7. Status as consultant or employee.

The key here is to be clear about the expectations of the purchaser with regard to the seller's activity. It is difficult to make arrangements for a happy long-term marriage under the typical purchase scenario. The issues need to be provided for up front. Where job descriptions are relatively vague and "good faith" or "best efforts" standards are employed, this can be grounds for subsequent dispute. It is suggested with employment agreements that there be a period providing for notice and cure of any default in performance in order that any misperceptions of another party's performance have an opportunity for cure or, at least, discussion. A simple form of alternative dispute resolution is recommended.

F. Other Documents

A variety of other documents can be included within the purchase agreement. These include bill of sale, verification of due diligence documents,

representation and warranties as to particular portions of the business or assets, personal guaranties, and entity resolutions approving the transaction. Estoppel certificates from landlords or lenders may be appropriate. Verification from suppliers or customers may also be appropriate. The additional documents may also address issues regarding the involvement of third parties who may not be a party to the transaction.

G. Conclusion

The key to ancillary documents is anticipation and preparation. A good outline of the issues to cover, the appropriate method of providing reasonable assurance to both sides that their deal will be written as they expect, will help provide for an orderly transition.

II. HELPFUL AUTHORITIES

1. Colorado's Article 9 is found at C.R.S. §4-9-101, et seq.
2. Colorado's Uniform Trade Secrets Act is found at C.R.S. §7-74-101, et seq.
3. Colorado's Non-Compete Law is found at C.R.S. §8-2-113.
4. Articles regarding Colorado's Trade Secret and Non-Compete Law: 30 Colo. Lawyer 7 (April 2001); 30 Colo. Lawyer 5 (May 2001), a two-part survey of Colorado's trade secret and non-compete laws); and 28 Colo. Lawyer 73 (Sept. 1999) (inevitable disclosure doctrine).
5. Colorado Lawyer, September 2001, Volume 30, Number 9, at page 9, "Introducing Revised Article 9 of the Uniform Commercial Code," by McCabe and Travers.
6. Colorado Lawyer, April 2003, Volume 32, Number 4, at page 85, "Perfecting Security Interests in Intellectual Property," by Chatham.
7. Colorado Business Organization Forms with Practice Commentary, 3rd Edition, by John E. Moye, Lexis-Nexis, Matthew Bender (2002).
8. Colorado Bar Association, Business Law Section Newsletter, June 2003, at page 5, "UCC-9, Insurance for the Secured Lender," by Bulow and Sprink. (The Uniform Standards for recording have apparently produced an insurance policy to cover situations where the secured lender may have misfiled or made an error with its

financing statement or security agreement. The article references certain insurers offering such insurance products.)

9. Trade Secret Case Digest, by Haligan, James Publishing, 1999.

108E2P