

Top Three Legal Considerations for Family Business Owners Preparing for a Sale

The Great Wealth Transfer: Strategies for Succession, Legacy and Wealth Generation

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As the "Great Wealth Transfer" unfolds, family business owners face critical legal decisions in connection with a sale transaction that can determine whether a deal closes smoothly or is derailed as a result of preventable issues. This piece outlines three critical legal considerations for family business owners preparing for a sale, from understanding purchase price mechanics and the closing process to navigating due diligence. Grasping these concepts, processes and risks will streamline a transaction, maximize the enterprise value of the business and minimize closing risk.

This is the fourth part in a series examining the impact of the "Great Wealth Transfer" on business and succession planning for family business owners, including [strategies for business succession planning](#), recommendations to [prepare for a third-party sale](#), key principles from the [private equity playbook](#) and how wealth transfer and other estate planning techniques can further optimize the business strategies set forth in this series. For more, [subscribe](#) to our series and receive our extensive guide, *The Great Wealth Transfer: Strategies for Succession, Legacy and Wealth Generation*, coming later this year. The guide will expand on the topics covered in the series and provide additional context, explanations and cost-benefit analyses for each topic.

1. What You Need to Know About Purchase Price Mechanics in M&A Deals

The top-line purchase price for your family business is likely the most exciting detail when reviewing letters of intent (LOI) or speaking with potential buyers or bankers. However, this number may be a bit misleading without a full understanding of how the purchase price works. As a seller, you need to understand and focus on the components, timing and risk allocation issues embedded in the proposed purchase price, as well as the surrounding mechanics that govern how and when you get paid.

Most deals are priced on a cash-free, debt-free basis, with a normalized level of working capital to be delivered at closing. This means a seller keeps the business's cash at closing, but also needs to use

sale proceeds to pay off all company indebtedness and sell-side transaction expenses and must deliver the business with the agreed-upon level of working capital on the books. In addition, buyers typically require a seller to escrow funds at closing, both for purposes of working capital and indebtedness true-ups, and for purposes of satisfying buyer indemnity claims. Any funds placed into escrow are not paid to the seller at closing; instead, they are held (typically by a third-party escrow agent) for a defined period and only released according to the terms of the definitive agreements. If such adjustments are not in the seller's favor, or if the buyer prevails on its indemnity claim(s) (for example, a claim for seller's breach of its representations and warranties), such escrows may never be released to the seller.

Additionally, a buyer may offer a variety of purchase price forms beyond a cash payment at closing, including deferred cash payments, seller notes, earnouts and rollover equity, each of which involves certainty and time-value trade-offs. Seller notes and earnouts can bridge valuation gaps, but also introduce credit and performance risk, and may constrain post-closing operations. Rollover equity can align interests and enhance seller upside, but reduce seller liquidity at closing and add post-closing governance complexity. Moreover, payment on earnouts and the ultimate valuation of rollover equity are subject to the businesses' post-closing success and growth, which are often out of a seller's control and depend significantly on the buyer's efforts.

Don't forget about taxes! Deal structure and your unique tax situation will impact your total take-home pay from the transaction. Depending on your risk profile and tolerance, an offer for your family business with a slightly lower purchase price but more certain payment terms and limited indemnity obligations may be the most appealing option. Leverage your experienced advisors to fully understand a potential offer, identify payment and risk levers that matter most to you, and negotiate an offer that most closely aligns with your objectives.

2. How Selling a Business Works: Key Steps From LOI to Closing

In analyzing a sale process, it is helpful to consider a timeline of steps to guide the transaction from initial interest to closing. Selling a business takes time and effort, but being proactive and organized will make the entire process run more smoothly.

The first step is to engage sophisticated legal, tax and investment banking advisors to advise on the sale process and other issues. Leverage your advisors' experience and relationships to attract robust buyers and offers and reduce and allocate risk. Be sure to utilize your advisors in negotiations regarding the non-disclosure agreement (NDA) and LOI.

Second, use a sell-side NDA tailored to the sale of a business. While you may have examples of confidentiality language from commercial contracts or other matters, these provisions do not necessarily protect you in the sale context. Ensure that your NDA addresses use and destruction requirements, standstill or no-hire concepts for your employees, a defined duration, and restrictions

on a buyer's access to your employees without your advance approval. If a potential buyer is a competitor, additional safeguards are required. Do not progress to due diligence review or LOI negotiations until an NDA is signed with a potential buyer. Once signed, a buyer will begin its due diligence process by asking questions about the business and its structure. Typically, a buyer will circulate a robust due diligence request list that you will need to complete. Proactive risk mitigation and due diligence is discussed in more detail below.

Next, review and negotiate the LOI. Treat the LOI as a blueprint. Although largely non-binding on the sale transaction itself, a detailed LOI can lock in economics and allocate key risks that are difficult for a buyer (and for the seller) to revisit later in the process. The LOI should address the purchase price form and mechanics, the working capital methodology, the indemnity package, closing conditions, restrictive covenants, rollover terms, exclusivity and governing law. Getting the LOI right will have a material impact on the outcome of the sale process. The LOI stage can also serve as a signaling device, previewing, through a buyer's tone, approach and responsiveness, how it is likely to conduct itself during the negotiation of definitive agreements.

Finally, negotiate a purchase agreement with clear closing mechanics, appropriately tailored representations and warranties and thoughtfully drafted covenants calibrated to your business. Invest time upfront in preparing disclosure schedules (i.e., disclosures made by seller in response to, and to qualify and limit, seller's representations and warranties, thereby limiting a seller's indemnification exposure). Detailed and complete disclosure schedules earlier in the process help shift post-closing risk away from the seller and reduce last-minute buyer concerns. Negotiate ancillary documents, such as employment or bonus agreements, equity rollover documents, transition services agreements, escrow agreements, real property leases, intellectual property assignments and third-party consents, and be sure that all are ready for execution by the expected closing date.

3. Best Practices for Mitigating Legal Risks and Managing Due Diligence

Identifying and addressing legal risk is one of the most important aspects of any pre-sale process and should not be underestimated. Well before taking a business to market, evaluate and scrutinize your repository of written records. This will highlight issues likely to arise during a buyer's due diligence review. Unresolved legal risks can slow a transaction, weaken negotiating leverage, or lead to price reductions or unfavorable changes to deal terms. Addressing matters early, outside the pressure of an active sale, lets you control whether to remediate, disclose or manage the potential risk through deal structure.

Based on a plethora of experience, pay close attention to the following potential issues. Confirm the accuracy of the company's capitalization table, ensure documentation validates each entry, and take stock of any convertible securities or phantom equity, rights of first refusal or negative consent rights, and any investor or family-level arrangements that could affect approvals or economics. Remedy missing documentation and signatures where possible. Identify any change-in-control and/or

assignment provisions, expiration dates and termination rights, and most-favored-nation provisions across customers, vendors, landlords, lenders and licensors. Assess revenue-critical agreements and analyze the path for obtaining any required approvals. Catalog and attempt to resolve any pending lawsuits or other disputes. Inventory your employment, confidentiality, non-compete/non-solicit, and bonus and incentive agreements. Reconcile employment agreements, offer letters, and handbooks to actual practices. Assess employee/independent contractor classifications, accrued paid time off and sick leave, bonus policies and practices, Form I-9 compliance and Rule 409A compliance. Verify chain-of-title for all owned company intellectual property, ensure employee and contractor intellectual property assignment agreements are sufficient and properly executed, and confirm intellectual property registrations are current and in the correct entity name. Review regulatory licenses, filings, and any investigations or consent decrees. For regulated industries, preview the regulatory path required for closing the sale transaction and plan a course forward for obtaining such approval in a timely manner. Addressing these items in advance and on your own terms will be quicker, less expensive, and, in the end, will minimize the number of buyer red flags.

Thereafter, you will be ready to tackle a buyer's due diligence process. Any owner who has sold a business can attest to the challenges of the due diligence process. Potential buyers circulate extensive due diligence request lists to analyze the business and its risks. They will ask follow-up questions, request additional documents and schedule numerous calls to fully understand the enterprise. Organization is key here for a seller. If you have already identified and mitigated legal risk and maintain a centralized, well-indexed repository of all financial, legal and commercial documents and records, you will be able to timely respond to a buyer's due diligence requests by sharing the relevant records through the seller's data room. The diligence process moves most efficiently when the seller controls the narrative with a comprehensive data room that is populated in advance of a buyer being chosen or an auction process started.

Ensure that the data room contains all corporate records, board and shareholder consents, the capitalization table, stock certificates and minute books. Include fully executed contracts with all amendments, schedules and exhibits, and remediate any unsigned or "working" versions. Stage sensitive materials, such as detailed customer pricing, trade secrets, or key customer or vendor names, for release only upon completion of buyer milestones or under a clean-team protocol. Additionally, establish confidentiality protocols so that only a small, trained group handles buyer Q&A and document distribution.

When you begin seriously considering the sale of a business, put the right legal team in place early. This is especially true for owners of family-owned businesses who may be navigating a sale while balancing legacy considerations, family expectations and their own leadership goals. Look for a transactional attorney who regularly handles middle-market mergers and acquisitions and genuinely understands closely held and family businesses. With respect to the due diligence process, the right

legal team will help you identify and proactively solve legal issues before they become concerns or red flags for a buyer.

The Importance of Planning Ahead

Although the sale process may feel daunting, utilizing experienced advisors at the outset will enhance your understanding, approach and transparency. Understanding purchase price, sale mechanics and legal risks (hopefully proactively by completing a legal due diligence "audit" before launching a sale process) will ultimately save you time and money. The upcoming "Great Wealth Transfer" presents both challenges and opportunities for family business owners. Careful evaluation of succession and transition options, supported by sound legal and strategic advice, is essential to achieving long-term goals and preserving family and business legacy. Following these recommendations protects your legacy and maximizes exit value while keeping the closing process streamlined and on your timeline. Preparation creates leverage, and leverage drives results.

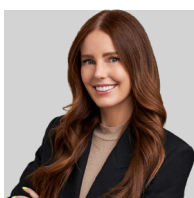
Katten is here to help you plan in the near term and execute for the long term when it comes to navigating important commercial and legal considerations for your family business, including wealth transfer and business succession. [Click here](#) to subscribe and receive the rest of our series and our extensive guide, The Great Wealth Transfer: Strategies for Succession, Legacy and Wealth Generation, coming later this year. This article was written by Michael L. Sherlock, a corporate and family office lawyer in Katten's Chicago office. Julia Brook and Emily Kay Watson, M&A and private equity lawyers in Katten's Chicago office, also contributed to this article.

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