# Business Transition Checklist

## Key legal (and some business) considerations for a smooth and profitable business transition

**by James J. Scheinkman, Brian L. Blaylock and Brian D. Manning**

If you remember anything after reviewing this checklist, remember this: If you are a business owner looking to exit your business successfully, the four most important tasks for you and your team to accomplish in advance of the sale are:

1. ***Prepare*** to Execute (Get the deal done).
2. ***Prepare*** to Demonstrate the Sustainability of Future Increasing Cash Flows.
3. ***Prepare*** to Demonstrate Mitigation of Risk to the Buyer.
4. ***Prepare*** to Maximize Net Proceeds from the Sale.

Here is why these four steps are so important:

- *Most buyers evaluate a business based on the risks associated with the ability to generate sustainable and increasing cash flows*

  In order to convince a buyer to pay more, the successful seller will have evaluated the ongoing risks to the business in the same manner as the buyer and will have proactively reduced those risks. The successful seller will also have established that the company has the infrastructure and programs in place to sustain future increasing cash flows. This needs to be done before the buyer engages in its evaluation of the business, and can't be done overnight – some actions often take years in the making.

- *Time is the seller's enemy once a letter of intent has been signed (Part One).*

  To evaluate the risks to, and confirm the likelihood of, future sustainable and increasing cash flows associated with the business, many buyers will send an army – ok a little hyperbole here, but it will feel like an army to many sellers – of financial and tax accountants, lawyers, internal diligence and integration teams, insurance experts, environmental consultants, and others, to evaluate all aspects of the business.

  It's called "due diligence," but it will feel to many sellers like the primary job of these folks is to find out what is wrong with their business so the buyer can take advantage of or decide to walk away from the deal. To the extent a seller 1) has not performed diligence on his or her own business, 2) is not prepared to answer questions and provide information and documents satisfactorily and on a timely basis, or 3) does not understand his or her business better than the buyer does, the more risk there is of the deal not closing at the purchase price originally negotiated or closing at all.

- *Time is the seller's enemy once a letter of intent has been signed (Part Deux).*

  Ok, we are being a little redundant but it bears repeating. Once a letter of intent is signed, it's not uncommon for the purchase price to go down and very rare for it to go up. Apart from surviving the gauntlet of the buyer's due diligence, a seller needs to be prepared to execute the transaction quickly. If there are delays because a seller can't execute on a timely basis – say due to disagreements or issues among the multiple owners of the business, incomplete corporate organizational documents, pending employee issues or litigation, unidentified approvals from third parties to sell the business, or a host of other reasons – the risk of an unsuccessful sale outcome dramatically increases.

- *The medium is the message.*

  To borrow from Marshall McLuhan, prospective buyers will evaluate a business and its management team based on not only the substance of the responses to due diligence, but also the timeliness and manner of the response. If the response is not timely or is disjointed or not credible, it is human nature for the buyer to begin to question the quality of the seller's management and wonder what other problems may be lurking, about which the seller's team is not aware and which the buyer has not yet discovered. This is particularly the case with financial buyers, such as private equity firms, who are often counting on that same management team to successfully operate the business post-closing.

- *It is the net purchase price proceeds, not the gross purchase price proceeds, which matter the most.*

  The lesson that many of us learned when receiving our very first paycheck also applies to the sale of a business: It is not just about how much you make; it is also about how much you get to keep. Take for example the organizational form and tax status of your business. If the business is organized as a corporation and taxed as a "C corporation," a deal structured as an asset sale may be problematic on account of the application of a double tax at the corporate and shareholder level. Yet, many buyers will insist on a purchase of assets or, assuming they will agree to a stock sale, will insist on paying less on account of the perceived risk of a stock deal and less favorable tax treatment to the buyer.

## KEY QUESTIONS FOR THE BUSINESS OWNER

Ok, first the bad news. If you are a seller who just signed a letter of intent to sell your business, that buyer due diligence army referenced above will likely send you multiple, redundant, and mind-numbing lists of document requests and questions.

The good news? We want you to keep reading this article, so we are not going to do the same; rather the following is a good starting point in non-legal terms of some of the questions to ask yourself in advance of initiating an exit based on the same four preparation tasks listed above.

| **1. Are you prepared to execute?** | |
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| i. *Can you quickly locate all of your key records that are necessary to produce in due diligence?* These would include corporate records, key contracts and leases, insurance policies, records of prior acquisitions and divestures, financial information, tax returns, employment records (i.e., payroll head count, vacation accruals and workplace eligibility compliance), lists of patent, trademarks, and other intellectual property, warranty and product return information, key customer and vendor lists, governmental permits, real estate documentation, environmental reports, etc. | Y N |
| ii. *Can you quickly locate these materials without tipping off all of your employees that you are considering selling the company?* | Y N |
| iii. *Can you do so without it becoming such a distraction from your ability to focus on running your business and avoiding the number one mistake sellers make when selling their business – missing the anticipated financial targets they communicated to the buyer prior to sale?* | Y N |
| iv. *How much remedial work needs to be done on the key corporate records in order to ensure they are complete?* To take one example, if the company has issued stock options or restricted stock to any employees, have those issuances and stock option agreements and shareholder agreements been properly documented?<br>Notes: | Y N |

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| v. *If the business has multiple owners, are the owners aligned as to how, when, and to whom the business should be sold?* Are there existing shareholder agreements to resolve disputes among the owners, such as a shareholder agreement providing for so-called "drag-along" rights in which majority owners can force a transaction in certain instances without minority shareholders triggering appraisal rights or filing litigation? | Y N |
| vi. *Have you identified what consents or approvals you will need from third parties under the company's contracts, leases, permits, and government authorizations in order to sell the business? Will any of them be problematic or difficult to acquire or affect the structure of the transaction?* | Y N |
| vii. *Are all the business assets and contracts held by the company?* Buyers expect to acquire all necessary and appropriate rights to operate the business. If key assets or contracts are held in the name of the individual owners or affiliated entities, a buyer will likely expect these to be transferred to the buyer or the company at the time of sale. | Y N |
| viii. *Will there be ongoing relationships between the business and its owners or affiliated entities after the closing?* Examples would include the lease of the company's headquarters if the real estate is owned by the sellers outside of the company, provision of services by an affiliate, and license of intellectual property from an affiliate. If a buyer is not going to insist these assets be transferred to the business, they will expect the arrangements to have been appropriately documented and provide for customary, arm's length terms. | Y N |
| ix. *Will any non-business assets held inside the company need to be transferred or distributed to the owners in advance of a sale if the transaction is structured as a stock sale or a merger?* If so, it may take time and planning to ensure those assets can be transferred in a tax-efficient manner, in accordance with applicable corporate governance procedures, and designed to avoid having adverse consequences to the business the buyer is acquiring. | Y N |
| x. *Have you identified your internal team (e.g., CFO and other key management members and advisory board members) and outside advisors (M&A attorneys, accountants, investment bankers, etc.) to help you prepare and execute a sale strategy?* It will take time both to educate the team as to your goals and objectives and to find the right outside advisors. You do not want to be doing this while you are negotiating your deal with the buyer. The failure to have a team ready to engage will wind up causing more distractions from your proper focus on continuing to operate the business while the transaction is pending. | Y N |

**2. Have you established the infrastructure and programs for sustaining future increasing cash flows?**

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| i. *First and foremost, what are the special qualities of your company which will ensure continuing and reoccurring revenue?* A buyer will expect the seller to be able to articulate those qualities and demonstrate that those qualities will remain in place and will differentiate the company from its competition.<br>Notes: | Y N |

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| ii. *Do those special qualities involve intellectual property?* If so, the buyer will expect the business to own or have a valid right to use that intellectual property to the exclusion of competitors and to have taken appropriate action to ensure patent, trademark, copyright, and trade secret protection. This goes beyond what patents have been issued to the company or what trademarks have been registered. A buyer will want to know that the business has confidentiality and invention assignment agreements in place with its employees as well as contractors involved in creating the intellectual property and appropriate nondisclosure agreements with customers and vendors who have access to the company's intellectual property. | Y N |
| iii. *How strong is the management team and will they stay after the sale or look for new jobs?* It is often said that a buyer would rather acquire a good business with a superior management team than a superior business with a good management team. It may take years to find and train that superior management team capable of continuing to operate the business successfully without the involvement of the sellers. Once that team has been retained and mentored, the business should put into place appropriate incentives and agreements to ensure that team will remain post-closing. Notes: | Y N |
| iv. *Does the business have the right customer mix and arrangements in place with customers?* To begin with, customer concentration issues will frequently quash a buyer's appetite for a business opportunity so the mix of customers and level of revenue and profitability concentration is important to evaluate. Beyond customer concentration, sellers need to be able to demonstrate the likelihood of reoccurring revenue from current customers – this could be based on strong relationships with the customers, long-term supply agreements, maintenance contracts, or other means. | Y N |
| v. *Does the business have the right arrangements in place with key suppliers?* Sellers must also demonstrate that they have a supply chain in place which will facilitate future growth and avoid disruption to the business. Doing so means taking efforts to verify that key suppliers have the necessary capacity to support the business, seeking second source alternatives if and when needed, and verifying that the suppliers own the rights to the goods supplied and are themselves compliant with all legal requirements. One means of doing this may be to have long-term supply contracts in place with key vendors. | Y N |
| vi. *Is expansion of the company's business dependent upon long-term use of its existing facilities (at stable rent and occupancy costs) or will the company require new facilities?* This question will significantly impact the buyer's assessment of existing leases, including as to the remaining term, occupancy costs, ability to make leasehold improvements, and other issues. | Y N |

vii. *Are the business' financial results reliable?* Buyers and sellers often calculate business profitability very differently. It is important for a seller to be able to identify whether its financial results are determined in accordance with general accepted accounting principles (GAAP) and, if not, how the seller's practices depart from GAAP. Many buyers will insist that the last several years of financial performance be audited by an independent accounting firm. Even if a buyer is willing to accept reviewed statements as an alternative, a buyer, particularly one that is publicly traded or a private equity buyer, will require that the business' financials be "auditable" – meaning that an accounting firm would be able to provide an audit opinion after the closing for pre-closing results. Such a buyer will also want to know that proper accounting procedures and controls exist. Y N

**3. Have you taken appropriate steps to mitigate the buyer's risks in operating the business?**

i. *Are there other material tax risks affecting the business?* For instance, an issue we frequently see arise in transactions is sales tax exposure for sales to customers in states in which the company does not believe it is presently doing business, but there is enough of a nexus for the states legally to impose sales or use tax. Another common sales tax issue occurs when sellers believe that certain transactions or activities are not subject to sales tax, but a state takes a contrary view. Y N

ii. *Is there any existing material litigation or basis for potential litigation involving difficult-to-quantify loss estimates or potentially affecting future operations?* Some examples we have encountered are large-scale employee wage and hour claims, intellectual property infringement claims, and environmental claims. To the extent these exist, a seller may need to delay a sale to resolve them (or at least to better quantify the level of risk). Y N

iii. *Does the company have adequate and the right type of insurance to mitigate its risks of operations? Casualty? Property? Employment practices liability? Product liability? Discontinued operations? Data security?* Has management had a recent meeting with the company's insurance brokers to review the adequacy of the insurance and to ensure the brokers understand the real business risks when placing the insurance? Y N

iv. *Does the company comply with all human resources policies?* For example, as referenced above, wage and hour litigation is becoming more and more frequent and may interfere with the sales process. Other frequent employment risks relate to classification of independent contractors and workplace eligibility. Reviewing your company's compliance with employment laws in advance and implementing the appropriate policies and recordkeeping procedures is important as these will be topics for the buyer's due diligence. Y N

v. *Are there known or potentially significant environmental or worker safety and health risks?* If so, are there programs in place to address these risks? Y N

vi. *Are all permits, licenses and registrations that are required in connection with the company's operations current and in the name of the correct entity?* Y N

vii. *Is your company in compliance with all applicable laws relating to data privacy and protection? What about cybersecurity?* A buyer will want to know that the company has adopted appropriate privacy policies and taken steps to protect personally identifiable information against loss, unauthorized access, or misuse. Also, as demonstrated by the recent "Wannacry" ransomware outbreak affecting businesses and other organizations in an estimated 150 countries, cybersecurity is not just an issue for large international companies (or presidential elections) but also poses significant risks to midmarket companies. Y N

**4. Have you taken steps to maximize the net proceeds from the sale?**

i. *Is the current corporate structure tax efficient to facilitate a sale of the business?* Timing is critical on this question since it may take many years to properly implement an efficient tax structure. Y N

ii. *Have the business owners engaged in estate planning and considered appropriate estate planning structures and vehicles to reduce the impact of estate taxes?* The time to do effective estate planning is well before the sales process begins and the agreed upon purchase price with the buyer influences the determination of the value of the owner's shares. Y N

## CONCLUSION

The above is a summary of some of the key issues a business owner will face in order to successfully exit his or her business. Selling a business is one of the most stressful life events a business owner can go through. To the extent that a seller prepares for this significant life event, the level of stress will be mitigated and the odds of achieving a successful outcome significantly increased.

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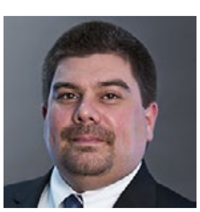

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