

On Your Marks, Get Set... and Get Set Some More Preparing a Private Company for Sale

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Lawyerly articles on mergers and acquisitions (M&A) abound. Many of these are directed at covering changes in what is “market” for deal terms or new twists to be aware of as a result of recently reported litigation. And many are worthwhile reading for company owners or senior executives who are considering selling a company as they offer detailed insights into the nomenclature, legal intricacies and mechanics commonly associated with the sale of a company or business. However, because these articles tend to focus on the nuts and bolts of the deal, usually limited to one or two specific points of discussion, they fail to shed light on some of the more holistic issues that typically arise in company or business sale transactions, especially for first-time sellers.

Over the past many years of representing clients in private company sale transactions, both on the seller and purchase side, I have identified 10 key areas to which sellers often fail to give sufficient consideration when planning a sale. In most of these cases when one or more of these issues has come into play, the resulting concerns weren't fatal to getting the deal done, but they did result in added time, cost and extra stress that could have been avoided or at least greatly reduced with a little better planning and organization. If you are considering a sale of your company, whether in the near future or as part of a longer term exit strategy, giving due consideration to each of these subject areas should be on your agenda.

1. Determine your objectives. A key first step in any exit planning is to figure out what you want out of the deal up front. Sometimes this is simple. Sell the company, collect your purchase price, plan the trip around the world that you have always dreamt of taking and leave it to the purchaser to take over. Sometimes, though, there is more to selling your company than just turning over the keys to the plant in exchange for an agreed-upon purchase price. Perhaps you have key employees that you want to ensure are retained for at least some reasonable period after the sale closes. Perhaps you want the ability to stick around for a period of time in a management or consulting capacity to ensure a smooth transition of ownership and continued success of the business. Or perhaps the reverse – you want to make a clean break, even if the purchaser may want you stick around for a period of time to assist with the transition of ownership. Perhaps you would like to retain a small ownership interest in the company to share in its future growth. Alternatively, you may want a full cash-out and good riddance.

Take the time to consider your options and set your goals; and prioritize those goals. When you ultimately negotiate your sale transaction, you may find that you don't get everything you were hoping for, but you will at least be in a position to measure the deal that has been struck against what you originally set out to achieve. You can then decide as to whether you want to proceed with the deal or walk away and wait for a better opportunity.

2. Establish a realistic time frame. On average, a typical private company or business sale transaction takes three to five months to complete from the starting point of negotiating a letter of intent or term sheet through closing. A variety of factors, including the structure of the deal, the number of parties involved, the number and complexity of deal terms to negotiate, the scope of purchaser due diligence activities, and external issues such as the need to obtain regulatory or other third party consents, will dictate the pace of the deal. Timetables can also be affected by unanticipated issues arising in the middle of the deal that are difficult to plan for, whether as a result of problems being turned up in the purchaser's due diligence process, negotiation hang-ups over deal terms or the occurrence of unexpected external events such as new litigation or regulatory problems.

On more than one occasion, during planning discussions with first-time sellers, I have provided a reasonable estimate of timing for a sale transaction, with the added caveat that such estimate assumes that the parties will work cooperatively and that no unforeseen issues will arise, only to be told by the sellers that I'm way off base and that the deal will be done in 30 days or less. With expectations blurred by optimism, the excitement of the sale and a lack of understanding of what goes into negotiating, documenting and effectuating a sale transaction (and sometimes by unrealistic timing forecasts made by the buyer) such sellers are looking to what they want rather than what is reasonable. Then, when the realities of the deal prove out my timing estimations (or worse), these sellers end up frustrated.

So be realistic with timing plans and expectations, be prepared for delays and take steps well in advance to expedite the sale process. Get your corporate and business records organized (as discussed in further detail below). Be proactive about tackling

business issues that may cause concern for a prospective purchaser (e.g., resolving outstanding contract disputes with customers or suppliers). Also, be mindful of calendar year issues. If you absolutely, positively must have your deal done by a fixed date, such as calendar year-end, allow yourself plenty of time to meet that deadline. Otherwise, you may find yourself in a tough position where the purchaser, aware of your timing needs, is able to threaten a delay in closing unless you agree to certain concessions. If closing of your deal is contingent on completion of a financial audit of your company, be mindful of the full agendas and tight schedules that audit firms are invariably working under during the first four months of the calendar year.

3. Determine a realistic valuation. What your company or business will actually sell for may be well below what you believe it is worth. (This works the other way too, although in my experience, sellers rarely under-value their companies). This is especially the case in a weak economy. While valuation methods vary somewhat based on the condition of companies and the industries in which they operate, a common ballpark approach (at least as a starting point) is to measure a company's revenues, earnings or EBITDA (earnings before interest, taxes, depreciation and amortization) and apply an applicable multiple. Larger, healthy companies with good prospects and consistent growth command higher multiples (e.g., 6 to 10 times EBITDA) than smaller, struggling or slow growth companies (e.g., 1 to 5 times EBITDA). Other factors will be used to determine valuation, including the condition of the company's balance sheet (especially with respect to debt), the current market and near-term horizon for the company's products or services, attributes that may either give the company a unique edge over its competitors (e.g., a newly-issued patent) or serve as a drag on its revenues (e.g., environmental cleanup obligations), the seasonality of the company's revenues and the concentration of its customers.

The bottom line - get your valuation expectations in line with what the market will bear. Engage an M&A intermediary (as discussed in further detail below) or other qualified business valuator to analyze your company or business – warts and all – and provide you with a realistic price range within which you can expect to sell. If you don't like what you hear, you then have the ability to delay a sale until you can get your company or business into sufficient shape to command the price that you want. Or you can simply adjust your expectations based on the valuation that you receive and proceed with a sale under existing conditions. Either way, you will at least be aligning your expectations with the likely financial outcome of the deal.

And be honest with yourself and with prospective purchasers from the start about what your company is worth. As part of the due diligence process, a purchaser will examine your company in fine detail and from many different angles. If the purchaser discovers accounting tricks aimed at puffing asset values or revenues, manipulating earnings or hiding liabilities, or other efforts to unreasonably inflate the company's attributes, you will at best end up back at something closer to where your true valuation should have been and at worst have a purchaser that no longer trusts you and that may walk from the deal.

4. Get your house in order. As touched on above, in almost all company or business sale transactions, the purchaser will undertake an extensive due diligence review of the target company. A key part of that due diligence will be a thorough review of the target's financial, corporate and business records. A company's failure to maintain accurate, complete and up to date records is one of the primary hindrances to completing a sale transaction in a timely and efficient manner. Incomplete stock ownership or LLC membership records, delinquent corporate filings, irregular or sloppy accounting records, incomplete documentation of intellectual property rights, missing copies of material contracts or permits, and poor (or no) documentation of special compensation arrangements for key employees are common examples of company records issues that can slow a deal down or kill it altogether.

Even if a sale of your company or business is not on the immediate horizon, take the time now to start getting your house in order. Establish a documented chain of ownership of your company's stock or other equity, including properly documenting equity issuances, transfers and repurchases. Identify and document any outstanding options, warrants or other rights to acquire company equity. Ensure that your regulatory filings in all applicable jurisdictions are up to date. Compile and maintain a centralized source for all contracts, permits and other material documents, and for documenting your company's ownership of intellectual property rights and other assets. If you are not already producing audited financial statements, consider an audit, or at least a review, of your most recent year-end financial statements by a qualified accounting firm. To the extent your company is not using GAAP accounting, be prepared to identify where, how and why your accounting practices differ from GAAP.

To the extent you have employees working under other than "at-will" employment terms, ensure that such terms are accurately documented. Arrange for applicable employees to execute agreements under which they agree not to misuse or disclose confidential company information to third parties. Consider additional invention disclosure and assignment, non-competition and non-solicitation agreements for key employees. These agreements are often of real interest to prospective purchasers as they serve as valuable tools for protecting a company's intellectual property, customers and employees. If appropriate in the

circumstances, undertake an internal audit of your employees' legal (i.e. immigration) status via social security number check, E-Verify or other means.

However daunting a task corporate housekeeping may seem, it will be even more so if you only have a limited time period to get it done while you are negotiating a sale transaction. And just as a poorly organized and sloppily documented company will slow down the deal process and potentially give a prospective purchaser second thoughts about proceeding with a deal, a well-organized, cleanly documented company will make for a more efficient deal process and give a prospective purchaser confidence in the company and its management.

5. Get your shareholders on board. Closely-held companies, especially family-owned companies, often have differences of opinion among their shareholders (or, in the case of LLCs, members) with regard to strategic decisions, including sale transactions. This can be a major obstacle in the process of selling a company, and one that you want to face sooner rather than later. Consider the frustration of expending a significant amount of time, effort and money on negotiating and documenting a sale transaction only to have a dissident shareholder or member refuse to play along and bring the transaction to a screeching halt.

If you believe that you may have shareholder or member disagreement with the decision to sell your company or business, or the proposed terms of that sale, try to get a mandate from your shareholders or members to authorize a sale of the company before going too far down the path of negotiating the transaction. This may include obtaining formal shareholder/member approval for a sale of the company at a minimum price or within some specified price range. For a merger or asset sale, be sure to adhere to the necessary corporate formalities for obtaining shareholder/member approval for the transaction so you don't have to go back to the shareholders/members later for further approval. If some of your shareholders or members are not prepared to authorize a sale until the material terms of the sale are finalized, try at least to get a commitment in principle from them that they will support a sale if the terms are fair and reasonable.

If you have one or more shareholders or members who are opposed to a proposed sale transaction, consider what options you have to work around that opposition. For instance, if the company sale transaction that you are considering is in jeopardy because a 20% shareholder or member refuses to sell her shares, consider a merger structure or a sale of the company's assets and business – both of which normally only require the approval of a majority of a company's shareholders or members entitled to vote on the transaction. If you have a shareholder or operating agreement that contains "drag-along" provisions, you may be able to contractually require a hold-out shareholder or member to sell his shares or membership interest on the same terms as are applicable to the other shareholders/members. In the end, though, you will be in a better place if you can convince your shareholders or members to support the sale transaction rather than forcing a deal through based on corporate machinations or the enforcement of contractual rights.

6. Form and control your internal deal team. Give serious thought to which members of your management you will want to have on your deal team. The stronger and more focused your transaction team, the easier the sale process will be. Do your best to strike the right balance between having sufficient bench strength to get the deal done in an efficient and timely manner with the need to restrict the flow of information about the deal to those who have a need to know. Keep the team as small as possible, limiting it to those whose participation will be necessary, such as your CEO, COO, CFO and human resources director.

Ensure each team member is on board with the mission and understands his/her role. Team members may have their own concerns about job security or how transaction-related work will add to their already busy workloads. Be prepared to deal with this. Since their personal interests will often not be the same as those of the company's owners, you may need to consider financial or other incentives such as retention bonuses or job protection arrangements to ensure that your management team stays intact and properly motivated throughout the deal process.

Admonish each team member about the need for strict confidentiality about the deal until such time as you determine that the deal can be disclosed. Rumors about plant closings, job losses or other anticipated changes resulting from a pending sale can have a negative effect on employee morale, leading to reduced productivity, unexpected (and unwanted) employee departures and even employee attempts to sabotage the deal. As well, leaks to the public about a pending sale can spook customers and vendors. Leaks can also cause real consternation for the purchaser if there is an expectation that the deal is to be kept confidential until an agreed-upon announcement is made.

7. Get good professional advice. If you are not already working with a good CPA or tax attorney, get one. This isn't something to put off until you are ready to pull the trigger on a sale transaction. Since the best tax strategy for the sale of your company may

require months or possibly even years to implement, this is not something to leave to the last minute. With that said, last minute tax advice is better than no tax advice at all. Selling your company without understanding the tax effects of the sale is extremely risky, and failing to explore opportunities to limit the tax bite on sale proceeds is a disservice that you do to yourself and your company's other shareholders or members.

As for the sale transaction itself, make sure you are represented by qualified legal counsel with plenty of M&A experience. As with many professions, lawyers come with all sorts of skill sets and specialties. And just as you wouldn't go to your general internist for cardiac bypass surgery, you shouldn't go to your general practice attorney to represent you in the sale of your company (unless, of course, he or she is also an experienced M&A attorney).

A good deal attorney will expedite the negotiation process, knowing what deal terms are standard and usually not worth spending much time haggling over and what terms make up the core of the deal and deserve the most attention. A good deal attorney will reduce your risk by recognizing what representations, covenants and other obligations required of the seller are reasonable and which ones merit push-back. A good deal attorney will either know or have the resources within his or her firm to recognize, advise on and deal with the many legal facets of selling a company or business – contractual, corporate, securities, employment, employee benefits, intellectual property, environmental, real estate and tax, among others. Above all, a good deal attorney will understand the nature and consequences of the deal terms that are negotiated by the parties and will be able to communicate that knowledge to you in manner that allows you to make informed decisions.

Good professional advice is not cheap. But as with other products and services, you get what you pay for. Saving tens of thousands of dollars in fees by going with a solo accountant and a longtime family attorney with no M&A experience to speak of may seem like a smart move in the short term. But it could cost you far more down the road in missed tax savings, poorly negotiated deal terms and improperly drafted deal documentation, among other things.

8. Consider using a market intermediary. You may think you know the best way to market your company to prospective purchasers and you may have a good idea of what you can get for your company. You may be right. You also may be wrong, and that could cost you in terms of missing out on the best deal possible. There are times when using a market intermediary probably doesn't make sense. For instance, you may know that the well of prospective purchasers is shallow and already tapped; or you have received an offer from a prospective purchaser that even your existing advisors tell you is a screaming good deal. In many other cases, though, you may not know what opportunities are available to you in terms of prospective purchasers and deal terms.

Generally, market intermediaries are split into three groups – investment bankers at the top, M&A advisors in the middle and business brokers at the bottom. There is no specific range of deal sizes that one group handles, although generally speaking, the larger the deal size, the higher you move up the ladder. And the higher you move up the ladder, the more you will see in terms of sophistication, resources and market reach.

A market intermediary can prepare a reasonable valuation of your company, advise you on sale strategies, identify appropriate purchaser prospects, market your company (including preparing detailed marketing materials) and help you negotiate the terms of your deal. In most cases, the added value that a market intermediary brings in terms of getting a higher sale price or better financial terms than you might get on your own more than covers the intermediary's fees. Also keep in mind that the market intermediary will often take a good chunk of transaction-related work off your plate (e.g., meeting with prospective purchasers, preparing marketing materials, screening purchase offers), leaving you more time to focus on running your company.

A word of caution – as with any profession (lawyers included), you have the great, the good and the just plain bad. Before engaging a market intermediary, figure out a good fit for the size of your deal (you don't need Goldman Sachs to sell a \$10 million company, but you probably don't want a freshly minted business broker who was selling used cars six months ago). Interview at least a few intermediaries before settling on one. Ask for detailed, relevant transaction experience and references from past clients. Determine whether your prospective intermediary understands and has experience with your particular industry or business. Also, don't be afraid to negotiate the terms of the intermediary's contract – especially with respect to fees and provisions that seek to lock you into an exclusive engagement for an extended period of time.

9. Get emotionally prepared. Selling a company can be a major undertaking. Unless you have gone through it before, you probably won't be prepared for the amount of time, work and expense that goes into the process. I have worked with many company owners who are very smart, sophisticated and successful in running their businesses but are confounded by the depth of detailed agreement terms, paperwork and steps involved in selling a company or business. This is not to say that a sale

transaction is rocket science. But there is a process to go through that at times can be demanding of your time and energies. Given that this process must go on while you are already up to your ears in the day to day running of your business, you can imagine the stress that can result.

One other comment about emotions. A number of years ago, I attended the closing of a transaction in which my client was purchasing a company from its founder and sole shareholder. When my client, handed the seller the purchase price in the form of a rather healthy cashier's check, the look on the seller's face wasn't one of joy or even muted satisfaction. Rather, he looked as if someone had just shot his dog. You may not be thinking of it now, but if your company is your baby, if you have nursed it through tough times, enjoyed the sweet smell of success, watched your son or daughter step into a management position, or built close personal relationships with your employees, you may discover during the sale process that you are wistful about selling. You may even have second thoughts. This is not abnormal. So be prepared for some emotional wrangling.

10. Have a financial plan. Before getting too far down the path of selling your company or business, give some serious thought to what you are going to do with the proceeds of the sale. Make a plan. Speak with a qualified wealth management professional and an attorney specializing in estate planning. To the extent there are investment, tax or estate planning strategies that you can use to better preserve your sale proceeds or pass a portion of the proceeds along to your employees, spouse or heirs in a tax-efficient manner, you will want to know about these and have a plan for putting them into effect before the sale closes and the money arrives in your bank account.

Take the lead now. In the end, lawyers, accountants and your management team can guide you through the myriad details of selling your company or business. But if you take the time in advance to prepare yourself in terms of the bigger picture aspects of what goes into getting a deal done, you will almost certainly find the sale process less puzzling, not to mention faster, cheaper and less stressful.

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