SQUIRE SANDERS

EFFECTIVELY MANAGING THE SALE OF A PRIVATE COMPANY

About Frank M. Placenti

Frank Placenti serves as the chair of Squire Sanders' corporate finance and governance practice, and is nationally recognized for his work in corporate governance and mergers and acquisitions. Frank has more than 30 years' experience in mergers and acquisitions, private equity, corporate governance, securities law, antitakeover and shareholder relations issues. He has represented public companies, private equity firms, portfolio companies and brokers/dealers in capital formation, securities and corporate law, regulatory compliance, recapitalizations, and mergers and acquisitions.

Placenti is listed in the 2006 to 2012 editions of *Best Lawyers in America*, the 2003 to 2012 editions of *Chambers USA: America's Leading Lawyers for Business* and is a multi-year member of the *Lawdragon 500*, an acknowledgment given to the top 500 lawyers in America. He was recommended in Arizona for corporate matters and mergers and acquisitions by *PLC Which Lawyer? Yearbook* 2009 and is listed in the PLC Cross-Border Mergers and Acquisitions Handbook 2008/2009. Each year since 2007, Placenti has been selected by his peers to appear in *Southwest Super Lawyers*, a distinction awarded to the top five percent of lawyers in the region. Frank also serves as vice chair of the Corporate Governance Committee of the American Bar Association and as the chair of its Shareholder and Investor Relations Subcommittee.

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For owners of privately-held businesses, the decision to sell their Company is often the culmination of decades of hard work and may be one of the most important personal and financial events of their lifetime[1].

The desire to sell may be driven by the liquidity needs of the owners (for whom the business often represents their largest single asset); by succession needs (when subsequent generations in the family may opt out of the operational participation in the business); or by other business requirements (particularly when capital needs have increased or competitive pressures have intensified) or changes in the owner's health. In other cases, a savvy owner may simply sense that recent Company performance, trends in the capital markets, and other industry dynamics may mean that an optimal window for a sale has opened.

Regardless of the underlying motivations, it is important that the Company, its owners and any affected family members or other constituencies are properly prepared for what will often be a life-changing event. Careful advance planning on the part of the Company and its advisors can help to smooth the transaction process and ultimately lead to a better, more profitable and tax-efficient outcome.

Unlike decisions made in the context of a public or institutionally-held company, the choice to sell a private business is often an intensely personal one. Factors such as family participation in the Company, the intertwining of an owner's personal identity with that of the business, and the loyalty felt by owners toward employees, customers or the community can be just as important as financial or strategic considerations.

While there are several potential alternatives to selling a Company, the vast majority of family-dominated businesses not seeking to pass the business to the next generation will find that their only viable exit is to sell the business to a third party. There are financial and practical reasons why other alternatives, such as management-lead buyouts, face challenges to completion. In addition, selling the business to a third party creates an opportunity for the owner to diversify the wealth concentrated in the business into a broader portfolio. That said, some consideration of alternatives is appropriate.

Alternatives to an Outright Sale

Experienced financial advisors will help the owner evaluate alternatives to an outright sale (such as a recapitalization) as a means for addressing both the owner's liquidity objectives and any corporate funding needs. Other issues to be addressed may include structures to accommodate the owner's desire to maintain a financial interest or operational involvement in the Company after the sale. The advisory team should work with the owner to understand whether the owner's objectives are reasonable and achievable, and then help to implement strategies to pursue the agreed-upon goals.

Taking the First Steps – Assembling the Project Team

Most successful private companies routinely utilize accountants, tax advisors, attorneys and other advisors. Generally, these advisors are competent to handle the Company's ongoing business needs. When engaging in an exit transaction, however, a Seller should consider engaging an advisory team experienced in the specialized tasks associated with selling a business. Many experts suggest that owners engage these advisors six to 12 months prior to embarking on the actual sale process.

The advisory team will provide crucial assistance in helping the owners to articulate their objectives and identify areas where the additional effort may be needed to prepare the Company for sale.

Often, the planning process will lead to a realization that the Company's management team, while competent to operate the business, has no prior experience in preparing a Company for sale. In these cases, the advisors may suggest that the Company augment its senior staff, at least on a temporary basis, to assure that the sale process runs smoothly and the business can continue to run successfully without undue strain from the sale process.

Certain key planning issues (such as generational transfers or tax planning concerns) ideally would have been dealt with long before the decision to sell is made. If they have not been addressed, they should be dealt with immediately as, in certain cases, they may dictate the delay of a sales effort.

In some circumstances it may be necessary to uncouple certain operations or assets from the core business of the Company to assure that a potential new owner is presented with a "clean" operation following the closing. This is often best done in advance.

Setting Objectives for Sale

As is any other business endeavor, clear objectives tend to produce better outcomes. When selling a business, an owner's personal values will play a significant role in helping to set their goals. The owner's objectives could include a simple maximization of the total value received for his business. In other cases, maximization of cash on closing can be a primary consideration. An owner may be seeking financial security, an opportunity to diversify his or her net worth or other financial goals. In some cases, the owner would like to continue actively participating in the business, while in others they want to completely exit and pursue other interests.

[1] This article will address primarily the issues and concerns of individual or family-owned businesses as opposed to institutionally-owned private companies.

In some instances, the owner can be focused on other constituencies such as employees, customers or suppliers who have helped the owner to create a successful business, engendering feelings of loyalty and obligation.

The advisory team needs to understand the owner's motivations in order to assist in executing them.

Be Flexible in Evaluating the "Right" Time to Sell

In determining when to sell a business, owners must balance personal and business objectives with existing market conditions. The right time to sell from a business and personal perspective may not align with market factors. For example, a tight credit market may make it difficult to obtain an optimal sales price. Thus, owners must be flexible and opportunistic in order to maximize the valuation to be received upon sale.

These and other factors (such as the possible need for the owner to continue to participate in the business for some time following the sale to a financial buyer) suggest that sales preparations should begin two to three years before the owner's targeted retirement objectives.

Tax Considerations

The initial choice facing most corporate Sellers, from the standpoint of federal income tax, is between a taxable or a tax-free (tax deferred) transaction. Taxable transactions may involve two levels of tax – one at the corporate level and one at the shareholder level – while strategies to avoid two tiers of taxation can be pursued. While a detailed discussion of tax planning and tax considerations is beyond the scope of this brief outline, the Sellers should ensure that they have on the project team individuals capable of providing sophisticated tax advice with respect to alternative structures, particularly since many Buyers have significant experience in this area and can be expected to shift the transaction structure in their favor.

Preparing the Company – Seller Due Diligence

Once a decision to sell has been made, it is advisable for Sellers and their advisors to conduct an in-depth examination of key corporate operations prior to designing or embarking on a transaction process. The Company should evaluate areas such as:

Financial Statements and Operations: It has become increasingly common for Buyers, particularly those that are public, to view unaudited financial statements (or those prepared by obscure auditing firms), with skepticism. Sellers are almost always advantaged by having audited financial statements prepared in advance by auditors retained by the Seller, rather than by an acquiror's auditing firm as part of the due diligence process. Sellers should also consider shifting to a high-quality audit firm several years in advance of the sales process in order to produce audited financial statements that will be readily accepted by a Buyer. This process can also help to uncover problems of which the owner may not even have been aware, thereby mitigating the likelihood of significant adjustments made after financial information is presented to Buyers.

Pro Forma Financials: It is often the case that some expenses incurred in operating a private company would not be passed on to Buyers, such as certain aspects of the owner's salary or expenses. The Seller's advisors can help to identify and eliminate those expenses in preparing pro forma financial statements so that extraordinary items will not affect the Buyer's valuation process.

Financial Forecasts and Business Plans

A key element of creating Buyer interest and realizing potential high valuation is the ability to articulate the Company's future growth, strategy and prospects. Owners and management should devote significant time to developing both a near-term budget and longer term financial forecasts, derived from and based upon a credible business plan. They should also anticipate that Buyers will expect to receive regular and detailed financial updates during the transaction process. The Company should put in place the systems that will allow it to meet those expectations.

Management Team

Owners should evaluate whether the existing management team will be viewed as complete and competent by Buyers, particularly if the owners will not be involved going forward. The Company should consider filling any potential gaps prior to the sale process, particularly if it is likely that it will be sold to a financial rather than a strategic Buyer. Additionally, if the owner is depending upon the assistance of key employees throughout the sale process, consideration should be given to implementing incentives to assure their cooperation, such as stay bonuses, equity incentives or management contracts to quell any concerns that managers may have about their future prospects.

Key Contracts

Buyers will certainly review key customer and supplier contracts, and, not uncommonly, will request access to those parties during the diligence process. The Seller should ensure that its contracts with key parties are legally reviewed, well-drafted and current. In evaluating the sale strategy, the owner must determine his willingness to allow access to customers and suppliers, and at what point during the process he would agree to do so. Timing can be particularly important when dealing with a potential Buyer who is a competitor.

Unusual or Contingent Liabilities

Difficult issues can arise in the presence of unusual liabilities such as those relating to environmental exposure, litigation, contract disputes, employee lawsuits or the like. Whenever possible, it is advisable to resolve these issues prior to presenting the Company for sale.

Intellectual Property

In certain businesses, the Company's most valuable assets are its intellectual property. Uncertainty around any intellectual property ownership, sloppy record keeping or inadequate efforts to establish and protect intellectual property rights can cause significant transactional delays, derail transactions entirely or result in dramatically-diminished valuations. Whenever the Company has a portion of its value tied up in intellectual property rights, an intellectual property review by the Seller's own counsel should take place, with appropriate measures taken to shore up any weaknesses.

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Communications with Constituents

Sometime during the course of the initial preparations, it will become necessary to discuss the process with key members of the family, key employees, any existing investors in the Company, commercial lenders and, in some cases, customers. The nature and timing of these communications should be well thought-out to assure they are not premature, nor that they come so late that key constituencies have heard about the process as a result of rumors.

Setting Your Expectations and Those of Your Team

The sale process can seem unduly complicated and drawn out to business people accustomed to making and implementing their decisions quickly and pragmatically, with a minimum of complication. There will be dozens of documents prepared and reviewed, extensive information gathering and long discussions over legal and financial points. At times, the process will be preoccupied with difficult tax issues that seem to have no bearing on the business as it is really conducted. For many owners, the process of selling their Company is unfamiliar and not particularly pleasant.

Moreover, much of anyone’s sense of self-worth is tied to their work. This is particularly true for a founder who has established a successful business over time. Mixed emotions, and the stress that comes with them, must be managed.

The most important aspect of presenting a Company to a market is to establish its effective “positioning” in the eyes of potential buyers. Effectively positioning the Company entails identifying its key attributes and often involves an iterative process between the Company and its financial advisors.

Various ways to position a Company can include:

- Industry leader
- Industry innovator
- High growth
- Stable performer
- Proprietary technologies/information
- Marquee client information

When positioning the Company it is also important to give careful consideration to how the Company’s weaknesses will be described and explained.

An important part of positioning involves differentiating the Company’s service offerings. Efforts should be made to establish the uniqueness of the Company’s offerings. Scarcity adds to value and buyers will not generally pay a premium price for commodity product or service offerings. If there are any key barriers to entry, those should be identified. Proprietary technology and valuable customer supplier relationships should also be well-described. Financial advisors (investment bankers or business brokers) will play a key role in the transaction process. Among other things, they will:

- Assist in positioning the buyer in preparing sales and marketing materials
- Identify a list of potential buyers
- Contact potential buyers, negotiate confidentiality agreements and distribute marketing materials to potential buyers
- Manage due diligence, bidding and negotiations process
- Assist in the negotiation and the terms of the transaction
- Evaluate the attractiveness of offers relative to alternative strategies

The Seller’s financial advisors should work closely with its legal counsel. In addition to preparing the necessary documentation, experienced legal counsel will be able to offer advice on negotiation strategies, deal structures, tax structures and the like. Legal counsel will also play a key role in managing the Seller’s risks associated with the transaction.

Often, transactional advisors can interface with the Company’s regular legal, accounting and tax advisors to assure access to important historical information.

Identifying Your Theoretical “Best” Buyer

Buyers can be identified in a number of ways. A long-time employee, a competitor or a customer may make an overture. The Company may be approached by an investment banker or business broker acting for parties seeking to make an acquisition. The effort is initiated by the Seller itself, believing that it is time to move on for various reasons.

Potential buyers for any business will look for quantitative and qualitative indications of the strong, successful business that has a sustainable competitive advantage in the market place, a diverse customer base and a solid business strategy. Even when an investor may intend to bring in its own senior management team, the strength and depth of the overall management group will be a key area of focus.

Individual buyers will weigh each of these components differently. By taking time to understand each individual Buyer’s needs and what drives their perception of value, the Seller and its team can understand how its business is being evaluated, and which Buyer is likely to find it most valuable.

Categories of Buyers

Owners not familiar with the process of selling a Company may wish to take some time to understand the three broad categories of Buyers:

Strategic Buyers: Can include existing competitors, or a company looking to get a foot hold in a particular industry. These can include vertical integrators looking to collapse elements of the supply chain.

Financial Buyers: These are often more opportunistic Buyers who may or may not have expertise in the Seller's industry, but who may be interested in investing capital and leveraging operations with debt, or combining with other portfolio companies they may already own.

Management Buyout or ESOP: It may be possible to sell the Company to its management in a "management buyout" or to an ESOP formed for the benefit of employees that will buy the Company over time.

Understanding the Strategic Buyer

The strategic Buyer seeks to enhance its own business by acquiring the Seller's Company. This type of Buyer is frequently in the same, or a related, business and is trying to access new markets, increase market share, or acquire expertise, patents or proprietary know-how. A strategic Buyer sees the target as a way to acquire products, operations or expertise that it does not already own, or key customer or supplier relationships. In what is often called a "build or buy" decision, strategic Buyers will "buy" rather than "build" when they determine that it is cheaper and faster to acquire an existing company, than it is to develop their own resources from scratch or when the target company has something difficult to replicate.

Strategic Buyers in a similar business often have their own sense of the Seller's industry and market dynamics. If it sees significant synergies in combining two businesses, a strategic Buyer is often willing to pay more, especially when those anticipated benefits are specific to that Buyer compared to those achievable with other potential transaction parties.

Thus, in dealing with the strategic Buyer, owners must thoughtfully consider ramifications for employees and stakeholders. In obtaining its "synergies," a strategic Buyer is likely to eliminate a portion of the existing management team after the transaction, and may undertake other actions such as eliminating or combining of facilities. If this is important to the Seller, it will need to be weighed against the higher sales price that is likely to be obtained from the strategic Buyer focused on identified cost synergies. The Seller may seek to negotiate some protections for the management team or make other financial arrangements for them.

The following lists some of the advantages and disadvantages of selling to a strategic Buyer:

Advantages:

- May provide a higher valuation
- May enable the entrepreneur to completely "walk away" and to obtain complete liquidity, rather than maintaining ongoing involvement
- Strategic Buyers may be more knowledgeable from an operational and business perspective, facilitating due diligence and closing; often closing will be much faster than with a financial Buyer
- Qualified Buyers may not be constrained by financing contingencies or be at the mercy of credit markets

Disadvantages:

- Continuing management may lose their autonomy, lose their jobs, or have their roles diminished
- Possible negative impact on culture and morale
- Many affect customer loyalty
- Long-term upside valuation potential is terminated unless there is a significant earnout or other long-term component
- Certain large strategic Buyers have bureaucratic delays built into their processes
- If the Buyer is a competitor, special efforts to protect competitive information must be undertaken.

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Understanding the Financial Buyer

A financial Buyer is not usually focused on immediate synergistic opportunities from the transaction, unless it already owns a business in the industry and is seeking to combine it with the target (in which case it really is a hybrid strategic/financial Buyer). By nature, the financial Buyer searches for opportunities to invest in under-valued companies, provides financial support, provides other management upgrades and potential expertise, and then plans to exit their investment for a profit in the shorter media term.

Financial Buyers (often private equity, venture capital or investment funds) may focus on particular industries. Many financial Buyers are "agnostic" as to the industries in which they participate. Financial Buyers tend to look for businesses with solid cash flows, defendable market position, lower capital expenditure requirements, higher barriers to entry, and products and services in markets that are growing.

Typically, financial Buyers are extremely sophisticated in terms of deal structures and in conducting due diligence. In order to achieve their targeted investment returns, they will generally finance the transaction with leverage. As a result, not only they, but their financing parties will need to be satisfied with the investment. There are much more sensitive issues such as management depth and quality, and sustainable EBITA that can find the leverage used by the Company.

The following lists some advantages and disadvantages of selling to a financial Buyer:

Advantages:

- Current management shareholders may retain upside potential
- Current management shareholders may maintain significant involvement in the direction and operations of the business
- Provides access to "deep pockets" for other acquisitions and growth initiatives
- May provide owner with the ability to realize additional returns in the future
- Can provide management expertise and assistance
- Can often offer alternative transaction structures that can create and flexibility

Disadvantages:

- Likely requires ongoing involvement by the owner of the business going forward, at least in the short term
- Heavy debt requirements may limit capital availability for growth
- Heavy debt load limits margin for error, placing the Seller's continuing investment at risk
- May involve a financing contingency condition
- Upside potential is dependent upon strong management direction and growth
- Significant financial reporting requirements post-closing
- Extended and more extensive due diligence because of reliance on lender participation

Management Buyout

Often, an owner can achieve an exit from the Company by selling it to its existing management team. Usually (but not always), the management team will need external financing for the transaction. If the transaction financing cannot be accomplished with standard bank debt financing, (which is often), the management team will need a financial sponsor. In those cases, the transaction takes on many of the characteristics of a sale to a financial Buyer, as the outside financing sources will be driving the transaction structure and negotiations.

Sometimes, but not always, an owner will permit the management team to compete to buy the Company while bids from other external parties are solicited and considered. This procedure requires great care in order to assure that the Company's best foot is put forward to all bidders. The owner must be watchful that the management team does not "shade" presentations to other bidders in a way that is intended to discourage their participation or reduce their valuations.

In cases where the management buyout is being considered side-by-side with other alternatives, the financial advisor plays a particularly important role in assuring that the bidders are presented with a fair, accurate and positive image of the Company.

The following lists some advantages and disadvantages of a management buyout:

Advantages:

- Allows the owner to sell the Company to the management team that has helped to grow the business
- Can permit the owner to have some ongoing role in the operation of the business on a reduced basis
- Can allow the owner to continue to have some equity ownership in the Company, while diversifying the owner's portfolio
- Minimum of disruption to key customer and employee relationships

Disadvantages:

- Does not always produce the highest value
- Can have many of the disadvantages of selling to a financial buyer
- Can create challenging conflicts of interest for the management team when competing against other bidders

Sale to an ESOP

An Employee Stock Ownership Plan (or ESOP) is often considered a hybrid exit strategy because the owner is selling to a trust owned by his employees over time and not to a strategic or financial Buyer. During the period of time in which the ownership is gradually transitioned to the trust, the owner usually actively manages and participates in the business. This can be an effective strategy to generate liquidity and address key succession in employee issues envisioned by an owner or a group of shareholders.

ESOP transactions are inherently complicated and present significant fiduciary, valuation, ownership and tax restrictions. ESOPs are sometimes found to be too complex to live with for a modestly-sized Company. However, in the right circumstances, it can be an excellent vehicle.

The following lists some advantages and disadvantages of selling to an ESOP:

Advantages:

- Allows owners to pass ownership all on to employees and management in a tax-efficient manner
- A corporation can make tax-deductible contributions to the ESOP
- Structure tax benefit upon the repayment of loan principal
- Tax-deferred rollover of the price paid for the Seller's stock

Disadvantages:

- Possible impact on cash flow and the need for financing due to the requirement to cash out employees when they leave the Company's employ
- Increase administrative burden, including Department of Labor and IRS requirements, as well as fiduciary duties to the ESOP
- Transaction valuation is predictably not as high as with other exit options
- No new equity or capital is provided for business use, possibly limiting future capital growth

Marketing the Company

There is no one "right" way to present a Company to the market. In broad terms, financial advisors generally will assist the owner in considering three alternative paths:

- An extensive "auction" in which materials regarding the Company are made available to a relatively large number of potential purchasers (often 30 to 50 or more)
- A narrow auction in which the Company is presented to a smaller group (five to eight) of the most likely purchasers
- A highly-targeted sales approach in which the Company is first presented to one or two parties that are most likely to pay a high price for ascertainable reasons

Making the right choice among these alternatives is highly situational. However, the owner should be aware that many financial advisors have a bias toward a "broad auction" because it affords them the opportunity to trumpet to the market their participation in the transaction. Care should be taken to assure that if a financial advisor is recommending a broad auction, it is doing so for the right reasons.

In many instances, the Company's advisors will prepare a set of confidential offering materials to be presented to potential Buyers. When the right information is properly presented strategically, succinctly and thoughtfully, the documents can help entice Buyers and unlock the basis for value and build confidence in projected performance. The Seller should strive to create a sense of scarcity in the mind of Buyers, convincing suitors that the investment opportunity for the business being sold is unique in some regard. All in all, the objective will be to build value, while avoiding creating expectations that cannot be met. The materials should identify key value drivers in the business.

Materials presented in the early portion of the process must be coordinated with the information that will be provided by the Seller's team – both internal managers and external advisors – later in the process. Conflicting signals can compromise credibility and effectiveness by creating confusion and doubt. Trust is critical throughout a sale process and, if Buyers sense that the information they are being provided is not reliable, their concerns can derail what would otherwise be a successful process at a high valuation.

As stated above, value can depend on a great degree on who is the purchaser. In some cases, it will make sense to craft specific presentation materials for targeted individual purchasers where the effort to do so can unlock greater value.

A Company's historical and projected financial results will generally be included within these materials.

“Various federal and state tax considerations will influence the form of the transaction, as well as issues relating to the desire to allocate liabilities, including contingent liabilities.”

Initiating the Sale Process – Non- Disclosure Agreements

When the sales process begins in earnest, investment bankers and legal counsel will work with the Seller to develop a standard form Non-Disclosure Agreement to be executed by all parties receiving confidential information regarding the Company. This Agreement requires the Buyer to keep any information that it is provided regarding the Company or its finances confidential. It also normally requires the Buyer to keep confidential even the fact that a transaction is being discussed, something particularly important in order to avoid disruption with the Sellers, customers and employees.

A properly prepared Non-Disclosure Agreement should also prohibit Buyers and potential Buyers from hiring away employees (if there is no deal) and from utilizing information learned in the process to attempt to shift customer relationships. Non-Disclosure Agreements should require the Buyer to return or destroy documents if the deal does not progress, and eradicate the Seller’s data from the Buyer’s electronic records. Often, negotiations regarding a Non-Disclosure Agreement can become attenuated. That may, or may not, signal that dealing with a particular Buyer may involve more friction than in the case of other Buyers.

When the Company has certain highly-sensitive information (such as customer relationships), they are often segregated for separate treatment under Non-Disclosure Agreements, particularly in dealing with competitors.

Letter of Intent

While not always used, advisors will sometimes suggest the use of a Letter of Intent to more clearly define the terms proposed by a particular Buyer. A Letter of Intent sets out the fundamental agreed-upon business terms in writing. When properly prepared, it will provide a good framework for the Company’s alternative proposals and for drafting definitive documentation. Some basic elements covered in Letters of Intent often include:

- Price
- Transaction structure (merger, stock purchase, asset purchase)
- Any particular tax or specialized tax treatments being sought
- The identification of any excluded assets
- Commitments expected from the owner for any ongoing service
- Identification of key employees who may be required to sign employment agreements
- Timeline for the transaction, including a “outside” date for its completion
- Confidentiality and non-solicitation of Seller’s employees
- Exclusion provisions in which the Seller agrees to deal with the Buyer only for a fixed period of time, often 30 to 60 days
- Provisions for a deposit, if any
- Provisions for the payment of expenses, if any

Certain provisions in the Letter of Intent will be non-binding until the definitive agreements are signed (i.e., the price), while others, such as the exclusivity and confidentiality provisions, may be binding for a period of time.

The Form of Transaction

Sale transactions can take a number of forms. Various federal and state tax considerations will influence the form of the transaction, as well as issues relating to the desire to allocate liabilities, including contingent liabilities. The basic forms of transaction include:

Asset Sale: In this form of transaction, the Company sells its assets and operations to a Buyer, and conveys certain identified liabilities to the Buyer, as well. Because an asset sale involves the outright transfer of assets and the assumption of liabilities, key contracts will need to be reviewed to determine whether they are transferable or whether consent will be needed from third parties such as lenders, customers or suppliers. Many bank loans, licenses, leases and other key agreements contain some form of restriction on transfer or prohibition of assumption of debt by third parties without prior consent.

Share Sale: Here, none of the Company’s assets or liabilities are essentially transferred or assumed, they instead remain within the Company. However, the shareholders sell all of their shares to the Buyer, shifting control of the business. Even though the assets are not technically transferred, some company contracts may consider this type of transaction to be a change of control, requiring party consent. Once again, contracts should be carefully reviewed in advance to determine whether this will be an issue that must be dealt with. If the Company has more than one shareholder, usually all of the shareholders must participate in the sale and all must agree. This can present logistical or other more serious problems if there is an unwilling or recalcitrant shareholder.

Merger Transactions: A merger is a process by which two or more companies are combined, with only one of them remaining in existence after the process is completed. The surviving company acquires all of the assets, liabilities and operations that were owned by the two original companies before the merger.

Once again, key agreements will need to be reviewed to determine if this type of change of control transaction will require any third party approvals.

A merger transaction can be an excellent structure for dealing with a situation in which there are some shareholders that are unwilling to sell, or a relatively large number of shareholders with small positions.

- Mixed consideration (cash and stock)
- Asset exchange
- Earnout and contingent payments
  - Post-closing payment based on post-closing performance typically used when:
    - Buyer and Seller have valuation gap
    - Business values hooked to a major future event
    - Buyer needs the Seller after closing to assure value transition
  - Enables some deferral of tax lien until earnout payments are received

The Definitive Agreement

The sale of the Company will be accomplished by one or more definitive agreements that will take various shapes depending upon the nature of the transaction (or an asset sale, merger or share sale) and other factors.

In some cases, consulting agreements, real property leases, employment agreements and other ancillary contracts must be prepared.

The nature of these agreements is highly variable and will depend on the specific transaction and the needs of the parties.

Indemnity Obligations

One of the key areas that any Seller must understand is the operation of representations, warranties and indemnities in the agreement. These provisions essentially represent a long series of multiple promises by the Seller to the Buyer that the business is in a particular condition, owns certain assets or contracts existing, and the like. If those representations should prove to be false, the Buyer often has detailed indemnification rights in which a portion of the purchase price can be "clawed back" and repaid to the Buyer.

For Sellers that are unfamiliar with the workings of representations, warranties and indemnities, time and care should be taken to understand them so that they provide the input necessary to assure that transaction documents are well prepared. Failure to do so will often mean that a portion of the purchase price will be vulnerable to claims by the Buyer.

In certain circumstances, special indemnifications will be negotiated to deal with conditions such as environmental problems, pending litigation, or the like.

A well-prepared agreement will specifically address how long the Seller's exposure on indemnity claims will remain in existence (often 12 to 24 months) and whether there are any caps or limits on the Seller's indemnification obligations. Such caps or limits are usually set at a portion of the purchase price such as 10% or 15%, but can be subject to exceptions for specific indemnifications. Liability for breach of fundamental representations such as the ownership of stock or environmental or tax claims can be uncapped.

Transaction agreements will also often provide for "baskets" or deductibles, i.e, exempting small amounts for immaterial problems from any indemnification payment.

Moving Toward Closing

The definitive agreement will set forth procedures related to how the transaction will move toward closing. Some documents are structured as "sign and close" agreements. In this case, the documents are signed, the transaction is closed and the funds are conveyed simultaneously.

More often, there is a delay between signing and closing for one or more reasons – the Buyer may need to retain financing, regulatory approvals may be required, third party consents under contracts may be needed, lender consents may be required. In this case, this document will set forth the specific time frames for closing and the conditions that must be met before each party is obligated to close.

One of the key conditions to the Buyer's obligations at close will be that Seller's representations and warranties, as described above, must remain true at the time of closing, at least in all material respects. If this is not the case, closing could be delayed, the price may be renegotiated or, in extreme cases, the transaction could be terminated.

The closing conditions and termination rights of the parties should be carefully thought out and specifically defined in the agreements. Ambiguity in this portion of the transaction document can be fatal and can frustrate months of careful, thoughtful and deliberate preparation.

Experienced legal counsel will often involve colleagues in litigation and other areas of their firm to help structure provisions that are "as airtight as possible" when it comes to enforcing the Buyer's obligation to close. Remedies for failure to close should be considered, such as termination fees as well as preservation of damage claims and specific performance, i.e., the right to force the Buyer to close the transaction. Dispute resolution mechanisms such as the use of independent accounting firms and arbitration should be considered.

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Life After Closing

The impact upon Seller’s life after closing will vary significantly, depending upon the nature of the transaction. In a sale to a strategic Buyer, the Seller will often be asked to provide short-term consulting and transitional services that may or may not require an extensive expenditure of time.

In most sales to financial Buyers, the owner may be asked to remain involved in the business for several years to assure an effective transition of value. Often, the owner is asked to “roll” a portion of his equity investment into the Company following closing to assure that he still has “skin in the game.”

Whether the owner obtains a complete exit relatively quickly after the sale, or whether he remains involved to work with a financial Buyer, life will clearly change. An owner who finds himself coming to work every day in a company now controlled by a financial Buyer will find that having a “boss” who demands accountability and frequent financial reports, is a new and different experience. One who is no longer coming to work at all faces a different set of challenges.

A sale can bring about a new and exciting sense of freedom to explore interests and spend time with family that has not been previously available. For some owners, this new-found freedom is a “return to life,” or an opportunity to explore long-neglected hobbies or interests. For others who have been “workaholics” or single-mindedly devoted to work, however, the transition period can be difficult. Regardless of the nature of the individual owner, time spent at the inception of the process to understand these personal issues is very important.

Many owners of substantial businesses have had much of their net worth tied up with the business. A liquidity event will bring about the need to appropriately invest the sales proceeds in a planned and thoughtful manner.

The sale of privately-held businesses often represents the end of one chapter and the beginning of another. The quality of the new chapter can depend significantly upon whether thoughtful preparation was undertaken well before the sale process began.

Appendix 1

Ten Threshold Questions on Selling a Business

- When is a good time to sell my business? If not now, when?
- How much is my business worth and how would I determine it?
- How long will it take to sell my particular business and when should I start? Are there any seasonal considerations?
- Have I completed all preparatory steps?
- What is the best way to run the process, auction or limited auction or to approach specific parties?
- Are there any family or other constituencies that I should involve in or inform of the process?
- Have I adequately managed my tax position?
- Do I want a continuing role after the sale?
- What will I do with my time following the transaction?
- Do I have a plan for investment of any of the sale proceeds in an appropriately diversified manner?

Appendix 2

Presale Checkup

Preparation for sale should begin with a presale check-up – sometimes referred to as "sell-side due diligence." This process is most effective when undertaken well in advance of the sale as it often pinpoints areas that may take some time for corrective action.

Issues of focus may include:

- Are information and financial systems sufficiently robust?
- How strong is the management team and how capable of running the business without the Seller?
- What is the status of the Company's assets?
- What is the condition status of customer relationships?
- What improvements can be made that a Buyer will appreciate and pay a premium for?
- What are the key value drivers in the business, such as customer relationships, that should be documented (or better documented)?
- Does the business have an up-to-date business plan, including three-year projections?
- Does the Seller have a clear understanding of the strengths, weaknesses, opportunities and threats facing the business and how they should be addressed in preparation for a sale?
- Is there a plan for management succession?
- What efforts for employee retention would be necessary before initiating the sale process?
- Which third party relationships would be at risk in the event of a sale process, and is there anything that can be done to mitigate or manage that risk?
- What intellectual property does the Company own, and is it properly protected with appropriate documentation, including trade secret agreements with employees?
- Are the Company's premises and operating facilities clean, neat and well-organized; are there any asset dispositions or obsolete inventory that should be removed?
- Are the Company's corporate records and business documentation in appropriate condition?
- Are the Company's accountants, legal advisors and other financial advisors up to the task of managing a complex sale process?
- What is the Company's reputation and are there any steps that can be taken to improve it in anticipation of the sale process?

Appendix 3

Seeing the Business from the Buyer's Perspective

- Is the Company scalable?
- Does the Company have a diversified customer base?
- Is the founder the sole (or primary) reason the customers are doing business with the Company?
- Does the Company have a repeatable income stream or is it too reliant upon individual and isolated transactions?
- Does the Company have multiple products that it can sell or develop, or is it too heavily reliant upon a single product line?
- Are the Company's gross margins increasing or decreasing?
- Does the Company have standardized processes and procedures that can be easily followed?
- Is the business a "turnkey" operation or will there need to be a strategic capital investment, including investment for "deferred" maintenance?
- Are the financial and business records presentable? What does their condition say about the manner in which the business has been operated?
- Does the Company have a management succession plan or managers who can step up?
- Does the Company have a roadmap for growth?
- Is there any litigation against the Company, including employee litigation that speaks to the way in which the Company has been managed, or represents a significant ongoing risk that it will survive the closing?
- What type of growth has the Company been experiencing?
- What does the quality of the Company's offering memorandum or sale process tell us about the sophistication of the Company and its managers?
- Does the Company have a diversified supplier base?
- Are the Company's salaries above or below market level and how will they change the Company's operating margins going forward?
- Does the Company have written job descriptions for all of its employees and what does the absence of those descriptions tell us about the way in which the Company has been operated?
- Does the Company measure customer satisfaction? If so, how?
- Does the Company use management metrics and, if not, what does that tell us about the manner in which the business has been operated?
- Has the Company taken appropriate efforts to protect its intellectual property?
- Are there any significant barriers to entry?
- How does the owner's treatment of his own compensation and expenses affect the Company's operating metrics going forward?
- Does the Company have a research and development or other product development process?
- Does the Company have geographic diversification or is it overly concentrated?
- How does the Company market and advertise its services?
- What is the Company's record for quality?
- Has the Company recently increased prices or done anything else to "dress the Company up" for sale that may reflect upon future operating metrics?
- How current are the Company's accounts receivable and what do any large outstanding accounts receivable tell us about key customer relationships?
- How believable are the Company's projections?

Appendix 4

Preparing for Life After the Sale

Preparing for a successful life following the transaction involves a number of considerations, including:

- Income tax planning around the sale
- Assembling the right advisory team for effective wealth management and transfer
- An appropriate estate plan, including trust formation
- Wealth transfer planning
- Insurance planning
- Asset, cash flow and debt management
- Family educational funding
- Plans for charitable giving, including charitable trusts, if applicable
- Special family needs
- Assembling an appropriate wealth management team