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FIVE THINGS BUSINESS OWNERS SHOULD DO TO PREPARE FOR THE SALE OF THEIR BUSINESS

By: Eric C. Perkins, Esq.

1. Assemble the "Sale" Team. Depending upon a variety of factors (e.g., the size and type of business), your team might include: legal counsel, an accounting firm, a business broker or investment banker, an insurance broker or agent, an environmental consultant, your banker, and potentially other specialists. The key is to assemble a team of professionals with experience closing business transactions that you are confident can provide effective and efficient service. It is also important to clearly define everyone's role at an early stage of the process (i.e., you do not need or want a team with ten quarterbacks).

2. Set Reasonable Expectations. The process of selling a business is complicated by the fact that unique and unexpected issues arise in every transaction. Advance planning can minimize many of these problems, but expect some hiccups along the way. For many business owners, selling their business is a very emotional experience. When raw emotion interacts with the rational, mechanical process of negotiating and closing a business transaction, strange things can and will happen. Finally, never lose sight of the fact that, under certain circumstances, the best deal for you could be no deal at all.

3. Get Your Due Diligence Ready. Most business sellers (and buyers) grossly underestimate the time, energy, and expense necessary to conduct proper due diligence on a business. A business owner can benefit greatly from undertaking a due diligence review of its business structure and operations before formally putting the business on the market for sale. This process should enable a company to proactively identify and address problems, and it is always better to catch and fix your own problems than have a potential buyer point them out for you during the course of a negotiation. In addition to helping maximize the value of your business, having due diligence materials reviewed and organized for potential buyers will save considerable time during a bidding process or negotiation period.

A due diligence checklist will vary depending upon the nature of the business and other deal-specific factors, but generally it will include the following:

(a) Corporate Documents (for a stock corporation)

- Articles of Incorporation
- Bylaws
- Copies of any shareholder agreements
- List of owners, officers, and directors
- Corporate minute books and records
- Employee and independent contractor lists (including compensation summaries)
- Copies of any stock pledge agreements

(b) Financial and Tax Records

- Financial statements and tax returns for the company for the last 3-5 years and current year to date
- Monthly internal financial statements for the last six months
- Bank statements
- Aged accounts receivable and payable lists

(c) Real Estate

- List and description of all real estate owned or leased by the company
- Copies of all deeds, leases, purchase agreements, title insurance policies, appraisals, environmental reports, and related agreements

(d) Intellectual Property

- List of all intellectual property, including copies of all patents, copyrights, trademarks, service marks, trade names, and logos
- List and copy of all license agreements of the company, either as licensor or licensee, relating to intellectual property rights

(e) Contracts

- List and copies of all material agreements to which the company is a party
- Form agreements used by the company with customers and vendors
- Copies of all insurance policies held by the company and a schedule of outstanding claims
- Copies of all employment agreements
- Copies of all loan or other financing agreements (including guarantees)

(f) Litigation

- Summary and documentation concerning all litigation, judicial, administrative, and other dispute resolution proceedings pending or threatened against the company
- Orders and judgments of courts, government agencies, or other tribunals to which the company is subject

(g) Regulatory

- Copies of all governmental permits, licenses, and authorizations issued to the company
- Copies of all applications filed by the company for required permits, licenses, and authorizations

(h) Miscellaneous

- List of all current customers of the company
- List of all current suppliers of the company

4. Understand the Differences Between an Asset Sale and a Stock Sale. There are different ways to structure a business transaction. The two most common ways are for the owner(s) to sell either the assets of the company (i.e., an asset sale) or 100% of the stock in the corporation itself (i.e., a stock sale). Tax considerations, financing relationships, pending litigation, and other business factors might contribute to the final determination, but generally speaking, buyers prefer to purchase assets rather than stock for several reasons, including: (i) to minimize the risk of successor liabilities, (ii) to enjoy the tax benefits of a step-up in basis of the assets purchased.

On the other hand, a stock sale can be advantageous if the buyer is more concerned about realizing the value of net operating losses of the company than the risk of inheriting liabilities from the seller, or if the company is a party to material licenses, leases, or other contracts that would be difficult or costly to transfer in an asset sale (but are not triggered by an ownership transfer under a stock sale).

Sellers will prefer to sell stock, particularly when dealing with a “C” corporation because the owners will be taxed twice on proceeds from an asset sale—once at the corporate level and once more at the individual level when net proceeds are distributed to owners. In addition, if the seller has used accelerated depreciation for company assets such as machinery and equipment, the seller may face a potential depreciation recapture tax at closing. All else equal, buyers will be willing to pay less for stock than for assets, and sellers will ask for more if they are selling assets than if they are selling stock.

5. Understand the Issues Likely to be Most Heavily Negotiated. Provisions of a purchase agreement that typically receive the most attention leading up to closing include:

(a) Representations and Warranties. Virtually all purchase agreements include representations and warranties running from the buyer to the seller and vice

versa. The issues addressed by these provisions, the applicable standard or level of knowledge, the identity of those individuals whose knowledge counts, the survivability of these provisions, and a variety of other details will be analyzed and negotiated in great detail by the lawyers, sometimes to the chagrin of their respective clients who mistakenly thought they had a "done deal" and were ready to close.

(b) Indemnification. Indemnification provisions go hand-in-hand with the representations and warranties because they can be rendered meaningless without carefully drafted indemnity provisions. By agreeing to indemnify another party, an indemnitor is promising to reimburse the other party for losses, damages, and costs arising from a breach or default by the indemnitor. This often includes an obligation to pay for legal fees and costs to defend the other party against such claims and damages arising from the breach or default. Defining indemnitors, indemnitees, the types of claims to which the indemnity provisions apply, and other substantive and logistic issues are critical components of the purchase agreement and often take considerable time to flesh out.

(c) Remedies. Most purchase agreements will set forth one or more remedies available to the parties in the event of a default. Different types of defaults might give rise to different types of remedies. Again, these issues are often vigorously negotiated by the parties and their respective attorneys.

(d) Earnouts. An earnout is a portion of the purchase price that is contingent on the company's post-closing performance over a defined period of time. Earnout provisions are often incorporated into purchase agreements as a final compromise when a buyer and seller are unable to mutually agree on a purchase price. From a seller's perspective, earnout provisions create risk and can be the source of post-closing controversy and litigation.