SELLING A BUSINESS – UNDERSTANDING THE PROCESS AND AVOIDING COMMON MISTAKES

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PART ONE
THE DEAL PROCESS TAKES LONGER THAN BUSINESS OWNERS IMAGINE

It's not this linear, and it does not always go this smoothly, but here are the steps in a typical sale of a business[2]:

1. Seller gets referrals to a good **business broker** or **investment banker**.[3]

This outline should be viewed only as a summary of the law and not as a substitute for legal or tax consultation in a particular case. Your comments would be appreciated and are invited.

[2] These steps are typical with an investment banker involved or, after step 0, with an attorney but no intermediary. With a business broker, the process would be somewhat different. See "Mistake No. 5 – Rushing to the closing *or* spending the sale proceeds before the closing" at page 7.

[3] See "Mistake No. 4 – 'For sale by owner'" at page 8.

IN THE FOLLOWING STEPS, THE BUISNESS OWNER WORKS PRIMARILY WITH THE INVESTMENT BANKER.

2. Seller gets a sense of the **current enterprise value** and the **possible value after "grooming"**.

   2.1. Often adjusted 12-month EBITDA × a "multiple."

   2.2. "EBITDA" = Earnings Before Interest, Taxes, Depreciation and Amortization expenses = cash flow.

3. Seller considers growing the business by acquisitions or expansion to achieve a higher **multiple** of EBITDA.

4. **Groom** the business and get ready for the sale process.[4] This includes:

   4.1. Estate and charitable gift planning;[5]

   4.2. Protecting brands and intellectual property;[6] and

   4.3. Binding key employees to the business until a sale closes.[7]

5. Intermediary does his or her due diligence on the "target" company and compiles the information that a prospective buyer will want.

6. Intermediary identifies prospective buyers, without proving much info about the target company.

   6.1. "Strategic buyers" are already in the same industry and are looking to enhance their existing business.

[4] See "Mistake No. 9 – Viewing the business from the perspective ofr an owner and not as a seller" at page 5.

[5] See "Mistake no. 6 – Waiting until after the sale to think about estate planning and charitable gifts" at page 7.

[6] See "Mistake No. 8 – Leaving brands, trade secrets and secret processes unprotected" at page 6.

[7] See "Mistake No. 7 – Assuming that key employees will stay until the closing" at page 7.

6.2. "Financial buyers" (private equity groups) are looking for businesses that they can but, increase the "mutiple" and sell at a profit.

6.3. There are variations and hybrids, such as a private equity group that already owns several companies in related industries, and is looking to add to its portfolio so that it can sell all of the companies at one time – and at a higher multiple.

7. Intermediary provides "blind" data to interested buyers (business in not identified by name or location).

8. Intermediary gets a Nondisclosure Agreement ("NDA") from the most promising prospective buyers, and only then identifies the target business.

9. Intermediary provides prospect with more specific info about target.

9.1. A prospective buyer can't make an offer without some info about the target.

IN THE FOLLOWING STEPS, THE BUSIENSS OWNER DEALS WITH BUYER NO. 1, THE INVESTMENT BANKER AND THE BUSINESS OWNER'S TAX ADVISOR

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10. **Intermediary introduces buyer No. 1 to seller**, keeps buyers No. 2 and No. 3 "warm."

10.1. Note: **This is where a seller without an intermediary typically starts, but *without* buyers No. 2 and 3**.

11. Intermediary, buyer and seller discuss sale terms, deal structure.

12. Buyer and seller each get separate **tax advice** about possible deal structures.[8]

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[88] See "Mistake No. 10 - Waiting too long to get tax advice" at page 5. See *Selling the Business: Practical, Tax and Legal Issues* at http://www.staleylaw.com/images/Sale_of_Business_-_15380.pdf.

IF THE MERGERS AND ACQUISITIONS ("M&A") ATTORNEY HAS NOT BEEN CONSULTED ALREADY, NOW IS THE TIME TO GET THE M&A ATTORNEY INVOLVED.

13. Intermediary, buyer and seller agree on deal structure and principal terms, and **shake hands** on general sale terms.

14. Buyer drafts – and gets tax and legal advice about – the **letter of intent**.

15. Buyer provides letter of intent to seller.

16. Seller gets tax and legal advice about the letter of intent.[9]

17. Seller gets buy-in from co-owners.

18. Buyer and seller negotiate and then **sign letter of intent**.

THE SELLER'S M&A ATTORNEY STANDS BY WHILE THE BUYER, THE SELLER AND THE INVESTMENT BANKER CONDUCT THE DUE DILIGENCE PROCESS.

19. Buyer begins **due diligence process**.

20. Seller responds to buyer's due diligence requests.

IN THE FOLLOWING STEPS, THE SELLER DEALS PRIMARILY WITH THE M&A ATTORNEY, AND WITH THE INVESTMENT BANKER OCCASIONALLY.

21. Buyer prepares **purchase agreement**, employment agreement, consulting agreement, covenant not to compete, escrow agreement.

    21.1. Good references are the ABA's MODEL ASSET PURCHASE AGREEMENT and MODEL STOCK PURCHASE AGREEMENT.

    21.2. See also the ABA's THE M&A PROCESS and MANUAL ON ACQUISITION REVIEW and *Deal Points*, a journal of the Business Law Section of the ABA that publishes surveys of deal terms.

[9] See "Mistake No. 1 – Asking the family doctor to do heart surgery – without an anesthesiologist" at page 9.

22. Seller reviews buyer's agreements and prepares **promissory note** and security agreement, guarantees, leases, licensing agreement; terminates agreements buyer does not want to continue.[10]

23. Seller assembles the information and **schedules** (to the purchase agreement) necessary to make the representations true (much of which was **already provided** in the due diligence process, but this time the seller is promising that it is true and providing indemnification if a rep is not true).[11]

24. Buyer organizes **acquisition entity**, if necessary.

25. Parties identify any conditions (other than payment) that must be satisfied before closing.

26. If asset sale, seller shareholders and directors approve sale.

27. At "**pre-closing**," parties sign all docs, but don't close.

    27.1. Doing a "pre-closing" (or "two-step" closing) requires a more complicated purchase agreeement.

    27.2. A "single-step" closing is best, if there are no conditions that must be satisfied, but can't be satisfied until a binding agreement is in place.

28. Conditions to closing are all satisfied or waived.

29. **Deal closes**, transfer documents and payment exchanged.

    29.1. Intermediary paid from sale proceeds.

    29.2. Incentive payments to key employees paid by target.

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[10] See "Mistake No. 2 – Becoming married to the deal" at page 8.

[11] See "Mistake No. 3 – Letting the business suffer as the sale process drags on" at page 8.

29.3. In an asset sale, employees cease to be employed by seller and are hired by buyer.

THE ROLE OF THE INVESTMENT BANKER ENDS AT THIS POINT. THE SELLER DEALS WITH THE SELLER'S M&A ATTORNEY AND CPA OCCASIONALLY.

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30. Buyer and seller issue joint press release and announcement to customers and vendors.

31. Parties carry out **post-closing obligations**, such as removing seller from bank and lease guarantees (although these might be conditions to closing) or changing the seller's corporate name.

32. Seller facilitates transfer to buyer.

33. The parties's attorneys separately prepare **closing volumes** containing a table of contents and copies of all of the preliminary, closing and post-closing documents involved in the transaction . These ar very helpful for answering questions about the deal later.

34. Seller and buyer file **tax returns** reporting the deal.

35. Buyer determines whether to make any indemnification claims.

36. Buyer and seller resolve any **indemnification claims.**

37. Buyer (or escrow agent) **disburses remaining holdback.**

38. Seller collects remaining sale proceeds on **promissory note.**

39. On full payment, seller **releases security interest.**

40. **Statute of limitations runs** for buyer bringing claims against seller.

THIS IS GENERALLY THE END OF THE PROCESS OF SELLING THE BUSINESS, UNLESS THE SELLER RETAINS AN EQUITY INTEREST IN THE BUSINESS OR CONTINUES AS AN EMPLOYEE OF OR CONSULTANT TO THE BUSINESS. THE SELLER'S PROMISE NOT TO COMPETE WITH THE BUSINESS MIGHT REMAIN IN EFFECT.

PART TWO
COMMON MISTAKES

Mistake No 10.	Waiting too long to get **tax advice**

- After the handshake and before the letter of intent is a good time to get tax advice about the proposed deal; before the handshake is better.[12]

- After the letter of intent is too late.

- The night before the closing is way, way too late.

Mistake No. 9.	Viewing the business from the perspective of an **owner**, and not as a **seller**

- At this point, the game is no longer about saving taxes.

- It's about a beautiful set of books, a couple of beautiful, reviewed or audited financial statements, a well-functioning organization, great products, dependable vendors, and predictable earnings growth.

- The business should be able to run well without the founder's involvement in every decision.

- **Grooming** the business involves:

  ⇒ Reviewing the stock records.

  ⇒ Review the S corporation status.

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[12] See *Selling the Business: Practical, Tax and Legal Issues* at http://www.staleylaw.com/images/Sale_of_Business_-_15380.pdf.

⇒ Have buy-sell agreements or buy-back agreements with other shareholders – with right of first refusal provisions.

⇒ To have a prayer of selling stock, get the **non-business assets** (the condo, airplane, RV, art) off the balance sheet, possibly by creating a holding company and separating those assets in a separate subsidiary from the subsidiary that operates business and will be the target.

⇒ Do **labor law** and **pension plan** "self-audits" to assure the seller can make "clean reps" about these areas.

⇒ Organize the **business records** for a smooth due diligence process.

⇒ **Paint**, make the interior offices pleasant, and consider updating old signage or logos.

Mistake No. 8. Leaving valuable **brands**, **trade secrets** and **secret processes** unprotected

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- ♦ Make it necessary for a prospective buyer to pay for the business in order to use the brands, knowhow and trade secrets.

- ♦ Don't leave them "in the driveway" to be taken by anyone who wants them.

Mistake No. 7. Assuming that **key employees** will stay until the closing

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- ♦ The sale process takes a long time and is stressful for employees.

- The only way the seller can reduce the stress is to say "The company will pay a bonus to you if and only if you are employed on the closing date."

- It's up to the buyer to keep the employees happy after that.

Mistake No. 6.	Waiting until after the sale to think about **estate planning** and **charitable gifts**

- This planning for the sale proceeds should start as soon as the seller has a sense of the value of the business.

- It's not going to be the first thing on the seller's mind at this point, so advisors need to be proactive.

- Several great techniques cannot be used after the letter of intent is signed.

Mistake No. 5.	**Rushing** to the closing *or* **spending the sales proceeds** before the closing

- The process has its own speed. Trying to hurry it up means losing negotiating leverage.

Mistake No. 4.	"**For sale by owner**"

- It is not likely that the first buyer who comes along is the best.

- It's a great market for a seller with a quality company and strong earnings.

- A seller who rushes in without an NDA or a "buyer No. 2" in the wings will eventually exude desperation. The buyer is likely to whittle at the purchase price and to drag out the process. The employees are likely to bond with the "new boss" before the closing. The business can slip out of the seller's fingers before the seller knows what's happened.

- The intermediary can provide perspective about the market that other advisors don't have.

- The intermediary can save the deal when the parties and their attorneys get locked into positions and won't budge.

Mistake No. 3. **Letting the business suffer** as the sale process drags on

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- The seller needs either a temporary CFO to allow the real CFO to spend almost full time on the sale process, or a temporary CFO to handle the sale process and to leave the real CFO to mind the business.

- The seller will not be able to spend much time on the business. The intermediary, lawyers and CFO will demand the seller's attention. (This is one reason why part of the grooming process is getting the business to run without the seller's attention.)

Mistake No. 2. Becoming **married to the deal**

- The seller must be ready at all times to walk away from the deal. If there is no buyer No. 2 in the wings, the seller must be ready to spend another 18-20 months strengthening the business before taking it back to market.

- Otherwise the buyer – and the seller's employees – will smell the desperation.

Mistake No. 1.	Asking the **family doctor** to do heart surgery – without an anesthesiologist

- Use an expert in selling and buying businesses. An inexperienced attorney on either side will substantially slow the process and increase the transaction costs for both sides (example: leaving substantive issues to be resolved after the letter of intent, so that the parties are rewriting – and re-reading -- the purchase agreement more than necessary).

- If the client wants an attorney without experience to be involved, the attorney should hire an experienced attorney as a sounding board, and to review documents and to refer experts as necessary to keep the deal moving.

- Get expert tax advice on the transaction – both initially and as the deal morphs. What's the good of only knowing the pre-tax price for the business?

- Bring in labor, employee benefit, real estate and intellectual property counsel as needed. Trying to avoid bringing in an expert will either slow the process (and threaten the closing) or result in bad surprises after the closing..

[End of outline.]