K&L GATES

READY TO SELL GUIDEBOOK

A Manual for Owners and Executives Considering a Sale of Their Privately Held Business

CONTENTS

INTRODUCTION

As the owner of a business, you probably have considered selling some or all of your company at some point in time. The successful sale of a business can result in substantial economic gain for the owners and can provide new opportunities for the employees. While some entrepreneurs make a career out of building and selling businesses, many business owners sell a company only once in their lifetime. Thus, you may get just one chance to maximize the economic gain for a business that has been built over years of hard work.

The sale of businesses in the United States is itself a big business. During an active mergers and acquisitions (M&A) period, more than 10,000 US companies may be sold annually. While multibillion-dollar sales of public companies grab most of the headlines, the majority of domestic M&A activity is accounted for by sales of companies valued from US$1 million to US$100 million.

If you are considering selling some or all of your company, a number of questions may arise. Why should I sell? What will the terms of my sale be? Who are the prospective buyers? What is the process for selling my company? What assistance should I seek as I go through the sale process? How early on should I engage legal counsel? How long does it take? What can I do to help move the process along? When will I get the sale proceeds? What will my obligations be after the sale is completed? These are all good questions that we will address in this guidebook.

The goal of this guidebook is to provide an overview of the private company sale process, identify some of the key steps required, provide some general information about those key steps, and help direct you to other sources of information. Although it is intended for business owners, the information is similarly useful to other people involved in the sale process, including officers, directors, and employees of a company being sold; buyers; parties that may provide financing for a business sale; and advisors to sellers or buyers, such as investment bankers, accountants, lawyers, and others. Please note that the sale of a company whose shares of capital stock are publicly traded or otherwise subject to the US Securities and Exchange Commission rules involve further complexities and considerations that are not addressed in this guidebook. This guidebook also provides a general overview of a private sale in the context of a fairly normal sale process, but very attractive companies in certain auctions may be able to attract better terms, avoid granting exclusive dealing rights to a potential buyer, and generally move the sale process faster than some of the timeframes noted herein.

At K&L Gates, we have a skilled group of lawyers that focuses on helping people sell and buy businesses. Our Corporate practice group has over 450 lawyers that focus on structuring, negotiating, and documenting the sale of businesses. In addition, our lawyers in other industry groups are seasoned M&A practitioners who focus on particular regulated or specialty industries. Plus, our Corporate practice is supported by numerous other lawyers in areas involved in the sale process, such as tax, trusts and estates, employee benefits and executive compensation, real estate, environmental, intellectual property, and data privacy law.

In addition to representing business owners selling their privately held companies, we have significant experience representing public companies in their acquisition or sale strategies, including representing special committees of directors and advising public companies in takeover and proxy contest defense, as well as representing financial buyers (including private equity groups), strategic buyers, financing parties, management teams, investment bankers, and others involved in both public and private company M&A activity. We are here and ready to help you through the sale process.

CHAPTER 1

Deciding to Sell Your Company

Why do you want to sell?

Business owners sell their companies for many different reasons. Identifying the principal reasons for a proposed sale and the key objectives related to the sale will guide you and your advisors in structuring and negotiating the best possible deal. Some of the more common reasons for selling a business include:

- **Liquidity and Diversification**. A private company is, by its nature, an illiquid investment, and many business owners have an unusually large percentage of their net worth tied up in their businesses. Owners often seek to cash out their investment, including for the purpose of diversifying their assets.

- **Retirement and estate planning or lifestyle changes**. Many owners who have built a business over a period of years are seeking to retire or otherwise plan for their later years. Plus, running a business is hard work and some business owners just want to do something different.

- **Management or owner issues**. Positive or negative developments relating to the key individuals responsible for running a company may lead to a decision to sell. When a company has two or more owners and some of the owners have fundamental disagreements over how a company is run, selling some or all of the company may be a solution.

- **Timing of business cycle**. We all wish we had a crystal ball that could tell us when to time investments so we could buy low and sell high. Nonetheless, business owners and their advisors can often identify certain factors occurring in the general economy, the company's industry, or a particular company that would affect the best timing of a sale.

- **Need for financing for working capital or growth**. All companies need working capital to function, and many companies need additional capital to fund growth or expansion. Some private companies can have difficulty raising capital, whether it is debt or equity financing. Thus, the sale of the company to a buyer with greater access to capital can be a good result.

- **Sale of non-core assets or repayment of company debt**. A company with multiple lines of businesses may decide to sell one or more segments that are no longer key to the future growth of the larger enterprise. A company with substantial debt that has experienced a downturn in its cash flow may have difficulty in repaying its debt, so it may sell some or all businesses to pay off its debt.

What do you want to sell?

This may seem like an unnecessary question, but let's break it down.

First, you may want to sell an entire company. The sale of the entire company can be accomplished through an equity sale, an asset sale, a merger, or certain other structures, as discussed in Chapter 5.

Second, if your company has multiple owners, some owners may desire to sell their equity, while others opt to retain their equity. Structuring this type of sale depends largely on the size of the ownership percentage being sold. If the selling owners own more than 50% of the equity, the sale may be structured more similarly to a sale of the entire company.

Third, if the selling owners own less than 50% of the equity, they might best accomplish their objectives through either of the following options rather than selling their minority interest to a third party: (1) the company repurchasing or redeeming the minority owners' interests, or (2) the majority owners buying out their fellow owners. This type of sale often involves third-party financing to fund the buyout, or seller financing, in which the selling owners receive a promissory note to be paid over a period of years.

Finally, you may want to sell off part of your company while maintaining ownership of the rest. Dividing the company between what is sold and what is retained may be based on product lines, geographical territory, or other factors. Also, an owner may desire to retain ownership of certain real estate owned by the company.

What are the alternatives to a sale?

After you identify the principal reasons that a sale of the company appears desirable, you should consider whether the objectives might be accomplished through other means.

- **Recapitalizations**. If you are seeking liquidity, interested in buying out another owner, or want to diversify, you can sometimes accomplish these goals by instructing your company to sell equity or debt securities and distribute the proceeds to you (or the other owner to be bought out). For example, if your company has a small amount of debt in comparison to its cash flow or has significant assets, it may be able to obtain a secured debt financing, which could be used to provide liquidity to you or the other owner. In most cases, the financing source in such a transaction will require you to continue your role in management, if any.

- **New management**. If you are also the principal executive of the company and want to wind down your management responsibilities but do not want to sell your equity stake, you may be able to arrange for others to take over the day-to-day management of the company. These new managers may come from within or from outside the company. In either case, the management transition typically involves some equity stake for the new managers.

- **Strategic partnerships**. If a principal reason for considering a sale is that your business lacks certain resources that are critical for its growth or survival, it is possible that those needs could be met through a strategic partnership. Such partnerships or joint ventures can take many forms, from licensing arrangements to research, and development initiatives to independent contracting.

- **Do nothing**. If your situation is flexible, you may decide that this is not the best time to sell. Such a decision may be motivated by negative factors, such as poor market or industry conditions, lack of buyer interest, an operational downturn at the company, or financing challenges. On the other hand, a decision not to sell now may be based upon near-term growth opportunities that could result in the business being sold at a much higher price or on better terms in a year or two.

Do you want to be involved in the post-sale management of the company?

This is a critical question. It involves some serious analysis by both you and your buyer about how important your role may be to the future operation and growth of the business. In fact, the answer to this question may even limit the scope of the potential buyer pool. There are a number of potential scenarios:

- **No post-sale involvement**. This situation may arise because the owner was not recently involved in management of the company or because the owner wants to retire.

- **Consultant**. If the owner wants to stop managing the company but the buyer insists on some transition advice, the owner may enter a short-term consultant arrangement (usually less than full time) for a period of time, perhaps six months to two years.

- **Short-term employment**. This option is essentially an extension of the consultant role. Instead of a part-time consultant arrangement, the former owner works on a full-time basis for a certain period with the buyer's understanding that management will be transitioned.

- **Long-term employment**. Sometimes an owner realizes that the successful growth of his business requires his continued involvement even though a new, perhaps better-capitalized owner is brought in, or when that owner's business is combined with another larger company. In this situation, both the buyer and the seller may regard the owner's continuation with the business as extremely important.

Once you have some idea of what type of role you will have in the post-closing management of the business, your advisors can counsel you on different structuring and negotiating strategies, including tax considerations you should be aware of in considering a post-closing arrangement. Post-sale arrangements often involve equity or cash compensation tied to obtaining certain performance objectives. In any case, the parties will need to document their understanding of the owner's post-sale arrangements, which may involve an employment agreement, a consulting agreement, equity incentive agreements, or other documents.

If you are retaining any ownership, what type of rights will you have?

Regardless of the level of your post-sale management responsibilities, if you will have any equity ownership in the post-sale enterprise, you and your buyer will need to determine what equity rights you will have. These types of rights are often embodied in a shareholders' agreement or operating (or similar) agreement and fall into three general categories: control, capital structure, and equity transfers.

- **Control**. The question of control relates to who is entitled to make decisions about the post-sale company's future. Control can be determined based on corporate governance—who controls the board of directors or managers and how much autonomy various officers are given. Control can also be managed through contractual rights to approve or veto certain company actions, such as raising capital, acquisitions, budgets, personnel decisions, and a variety of other matters. Typically, if a buyer acquires a majority of the company, the buyer expects to control it. But even in that case, the buyer may have some contractual limits on its control as far as certain actions that would adversely impact a seller's minority interest in the post-closing enterprise.

- **Capital structure**. If the company will have no debt and only one class of equity after closing, the capital structure should not be a significant concern. On the other hand, if the company will have multiple types of debt or equity securities, you will want to know the exact amounts, relative payment priorities, and other key terms of each type of security. For example, a class of preferred equity issued to other equity holders could contain special rights (e.g., liquidation preferences, participation features) that could result in your equity representing an economic stake that is significantly less than the percentage of the outstanding equity represented by your interest.

- **Equity transfers**. This topic deals with situations when the company or an owner desires to buy or sell equity securities in the company. If an owner wants to sell its interest in the company, should it be required to first offer to sell its interest back to the company or the other owners before selling its interest to an independent third party? Also, if you are continuing in a management role, the buyer may want the right to buy out your stake if your management role terminates or is materially diminished. These are the types of issues that you and your buyer will have to answer and document with the help of your advisors.

CHAPTER 2

Choosing Your Advisory Team

The sale of a company is often a once-in-a-lifetime event. It is your opportunity to cash in on all of those years of hard work. You will want to be involved in the sale process, but you will need a qualified advisory team to assist you. Some of the functions performed by those team members are outlined below. In addition to these functions, you should rely on your team to help achieve the following:

- **Level the playing field**. Buyers generally have more experience in the M&A field than sellers, and the knowledge and experience of a qualified advisory team should help offset this advantage of the buyer.

- **Free management to remain focused on business operations**. Marketing and negotiating the sale of a business can be a full-time job. Preparing your company for sale, locating a buyer, negotiating the purchase price and other terms, due diligence, documentation, and closing processes take a considerable amount of time and effort from you and your key employees. Although you and your employees will need to devote substantial time and effort to this process, the successful operation of the business during this period is critical, not only to its economic viability, but also to the sale process.

The mix of advisory team members needed for a transaction varies from deal to deal, but you will always want to consult with law and accounting firms with substantial M&A and tax experience. Because of the importance of this experience, you may need to consider bringing in accounting and law firms in addition to your regular lawyer and accountant. However, your lawyer and accountant will usually continue to play a role due to their knowledge of your company. You may also want to involve an investment banker with experience in valuing businesses. Most investment bankers also have experience in developing a pool of qualified potential buyers and in serving as a disinterested intermediary for you.

Lastly, you should assemble your advisory team as early as possible (preferably before you contact potential buyers or entertain discussions about the sale of your company), so you get the full benefit of their advice and assistance at each stage in the process.

Law firm

Your law firm may serve the following functions on your advisory team:

- Assisting you and your other advisors in planning the sale of your company.

- Drafting and negotiating the letter of intent (if you choose to use one), as well as the engagement letter for any investment banker you retain.

- Drafting and negotiating the purchase agreement and other necessary contracts and documents to ensure that you receive your bargained-for purchase price and that your post-closing liability is as limited as possible.

- Evaluating transaction structures and related tax issues, including proposing a structure that will provide you with optimum tax treatment.

- Assisting with due diligence requirements, including responding to concerns raised by the buyer and its advisors.

- Identifying contractual, regulatory, and other legal issues that may be hurdles for you as you move through the sale process.

- Advising you regarding disclosure and fiduciary duties, including fiduciary duties owed to the shareholders of the company being sold.

- Advising you as to various estate planning considerations regarding your receipt of the sale proceeds.

Investment banker

An investment banker can provide valuable assistance to a prospective seller. Many firms offer M&A advisory services, and they range from large bulge bracket investment banks to boutique investment banking firms specializing in middle-market transactions to more local or regional firms. In considering an investment banker, you will want to take into account transaction experience (including transactions in the expected price range for your company), industry knowledge, and the amount of the engagement fee. Your lawyers and accountants may serve as referral sources in helping you identify qualified M&A advisors. In some transactions, an investment banker may not be as essential. This may be the case in a smaller transaction or due to the nature of the business being sold. For example, in a fragmented industry that is undergoing substantial consolidation, the only realistic buyers may be known players in the industry, and perhaps an intermediary is not needed. The functions an investment banker may serve on your advisory team include the following:

- Assisting you and your other advisors in planning the sale of your company.

- Advising you on actions you could take to increase the value of your company as you move toward sale.

- Performing a business valuation to help you determine the appropriate price range for your company, taking into consideration industry and macroeconomic dynamics.

- Performing a market analysis focused on trends in transaction types and purchase prices of other company sales in your industry.

- Creating a marketing package that will best position your business to qualified potential buyers.

- Leading your search for potential buyers. A qualified investment banker will have many contacts in various industries and will be experienced in screening potential buyers to ensure that only qualified buyers with the financial ability to purchase your company are solicited. In addition, an investment banker can market your business under its name or solicit potential buyers while maintaining confidentiality.

- Managing the due diligence process, including identifying potential issues that could impede closing and positioning the issues appropriately to potential buyers.

- Creating and managing a customized sale process that will put your company in the best position to optimize value and the terms of the transaction.

- Leading or assisting in deal term and contract negotiations and rendering financial advice and assistance as those negotiations proceed.

Accounting firm

Your accounting firm may serve the following functions on your advisory team:

- Auditing your financial statements if you and your advisory team—or the buyer and its advisors—have determined that this will be necessary.
- Assisting you in preparing financial projections and in recasting historical financial statements, if necessary, including preparation of a sell side quality of earnings report.
- Evaluating tax issues, including proposing transaction structures that will provide you with optimum tax treatment.
- Evaluating the economic impact of structural proposals or other deal terms proposed by the buyer.
- Assisting you in determining and projecting your company's working capital early in the sale process in anticipation of often detailed negotiations with the buyer regarding working capital adjustments (see Chapter 5).
- Responding to accounting due diligence concerns from the buyer and its advisors.

CHAPTER 3

Preparing Your Company for Sale

After you have decided to sell your company, you and your advisory team should consider how to prepare your company for sale. Preparing your company for sale generally consists of determining an expected value range for your business, preparing the package of information (including a financial overview, summary of the business, and description of the market) for the potential buyers to review, considering the means by which you will keep the sale process confidential, and cleaning up business records and addressing corporate housekeeping issues in preparation for due diligence review by the potential buyers and their advisors. In addition, you will want to work with your investment banker, if you have engaged one, to customize a sale process that will best position your company, which is discussed in Chapter 4.

How much is my business worth?

Obviously, most sellers want to sell their businesses at the highest price possible. Prior to any sale negotiations, you should understand how much your business is worth and at what price you expect to sell your business. Valuing your business is a key step in preparing your business for sale. While a formal appraisal of your business may not be necessary, you should complete some form of business valuation to determine an appropriate selling price or range of prices for your business.

The Valuation Process

If you have engaged an investment banking firm to assist you with the sale, one of its core competencies is determining market sale price ranges. If you have not hired an investment banker, your other options are to seek valuation advice from the company's accounting firm or to engage a firm that specializes in valuation services.

Valuation Methodologies

There are many ways to value a business, and generally multiple valuation methodologies are considered in arriving at the final range of values. Some of the more common valuation methodologies are based on (1) the company's historical revenues, earnings, or cash flow, (2) the discounted cash flow approach, (3) a valuation of the company's assets, (4) comparisons to similar companies or similar transactions in the company's industry, and (5) the value that a financial buyer is able to pay and still obtain its required level of return of capital.

- **Historical performance**. In a valuation based on revenues, earnings, or cash flow, historical figures are used to extrapolate a future value. For example, a company may be valued by using a multiple of its cash flow as measured by earnings before interest, taxes, depreciation, and amortization (EBITDA). Obviously the most recent financial performance, the last 12 months for example, is most relevant. This most recent EBITDA figure then will usually be adjusted to account for extraordinary items (e.g., asset sales outside the ordinary course of business), one-time events (e.g., corporate relocation), and ongoing expenses or revenues that will necessarily change as a result of the sale (e.g., if the seller is the president, his salary may be significantly above or below current market rates). This adjusted or pro forma EBITDA will then be multiplied by an appropriate multiplier to determine a rough estimate of a potential purchase price. The multiplier is usually based on numerous factors, including general market conditions and the company's industry, size and growth prospects. For example, a company with adjusted annual EBITDA of US$8 million and for which a 6.0x multiplier is appropriate would be valued at US$48 million on a cash-free, debt-free basis. In this case, US$48 million represents the enterprise value for the company. The value of the owners' equity would be reduced by the amount of debt and increased by the amount of cash on the books of the company (hence the term cash-free, debt-free basis) (see Chapter 5).

- **Discounted cash flows**. This approach arrives at a valuation through an estimation of the present value of projected future cash flows generated by a company, usually without considering any synergies or cost savings that may be generated by a combination with the buyer. These cash flows are discounted at a rate that reflects the risk associated with their achievement. A terminal value is often calculated by assuming a subsequent sale of the company at some point in the future and that value is also discounted to the present.

- **Asset valuation**. As the name implies, this methodology assigns a value to a company based on valuations of assets like real property, equipment, inventory, accounts receivable, and certain intangible assets such as customer lists or intellectual property rights such as patents and trademarks.

- **Industry comparables**. This approach compares various measures of financial performance for a company to those of other companies in the same industry that have been recently sold or to trading histories of public companies in the same industry.

- **Private equity or leveraged buyout**. This method determines the amount that a financial buyer could pay for your company and still achieve its targeted return of capital.

This analysis is highly dependent on the amount of financing (or leverage) the buyer desires to use in the purchase (hence, the term leveraged buyout or LBO). Ultimately, the valuation of the company under this method will be highly sensitive to the current market rates and terms, or structures for the various layers of potential financing (debt and equity). In summary, the more favorable the financing rates and terms, or structures for a potential acquisition of your company, the higher the implied value.

In practice, several or all of the valuation methodologies discussed above may be used to determine the range of values of a company. In addition, the determination of value often depends in large part on a company's long-term prospects as well as a judgment as to industry performance and general business, market, and financial conditions.

While a business valuation generates a range of values for your company based on comparisons to certain objective criteria, that does not mean that this is the right price for your company. Certain external factors influence value but may not be reflected in a business valuation. For example, a strategic buyer may be willing to pay more for your company than a financial buyer because of potential synergies with its own products or operations. In addition, certain decisions by you, like your willingness to stay active in the business or your willingness to accept a promissory note or rollover equity for part of the sale consideration, may be of value to a potential buyer and thus increase value.

What financial statements are needed?

Another critical step in preparing your company for sale is assembling financial information for potential buyers to review. While a buyer often reviews a large amount of financial data, some of the most important financial information will be the company's historical financial statements and future projections. Generally, a buyer will expect to review company financial statements for at least the last three years.

If your company's financial statements have been prepared in accordance with generally accepted accounting principles (GAAP) and have been audited by an independent accounting firm, then the buyer's financial due diligence can be more efficient. Although it has a number of subjective components, GAAP provides a detailed set of accounting standards so that financial statements can be interpreted on a more consistent basis. When a company's financial statements have been audited to further ensure GAAP compliance, a potential buyer will have more confidence in the company's financial statements thereby potentially simplifying the financial due diligence process. Even if your company does not have audited financial statements, it can still be a good candidate for sale, but the lack of audited financial statements may complicate the financial due diligence process and, in some cases, a buyer will require that an audit be performed before closing. If you are considering a sale in the near future and your company does not have audited financial statements, you should talk to an accountant about the benefits and the cost of an audit.

Potential buyers will also expect you to provide financial projections for the company that extend for anywhere from one to five years. These projections will provide a buyer with some basic information about your anticipated cash flow and future performance. They also may provide a starting point for valuations based on future performance, like the discounted cash flow method. If a potential buyer is intending to finance the acquisition, the projections can take on added importance because that buyer will need to justify future cash flows to its financing parties.

Depending on the nature of your business, you may want to recast historical financial statements. Financial statements can be recast to (1) remove or account for certain expenses or practices specific to your operation of the business that may not continue post-closing, (2) remove certain assets that will not be sold (e.g., real property), or (3) reflect current values of assets rather than their current book value. Examples of recasting would include removing excessive salary or perks to yourself or your family members and removing debt service for debts that will be retired in the transaction or assets that will not be sold to the buyer. These recast financial statements may provide a more reasonable basis for preparing financial projections and valuing your company. In addition, historical financial statements may be recast in different ways for different potential buyers. For example, they may be recast to remove the distribution component for a potential strategic buyer that intends to use its own distribution network for your business. Your accountant or investment banker will be able to assist you with preparing recasts and other financial information.

How do I keep sale information confidential?

You will need to consider carefully who should be informed of the potential sale and the processes that should be put in place to protect the confidentiality of the sale process. In most (but not all) cases, the senior management team and key financial personnel will need to know about the sale to assist in the sale process. Furthermore, if a potential buyer expects the senior management to continue with the business after closing, the buyer will probably want to interview the management team and discuss future employment arrangements.

Beyond the company's senior management team, you should be extremely cautious about talking about a potential sale with employees, customers, suppliers, or others. The principal concerns are twofold. First, employees, customers, and suppliers may feel uneasy about their post-closing role with the company. You will want to disclose information about a sale to these different constituencies, but at the right time and armed with more facts and answers to potential questions. Second, if a sale is pursued but is not ultimately consummated, the company wants to avoid any appearance that it is damaged goods. This can best be avoided by limiting disclosure until a sale is close to completion.

You should instruct anyone that you tell about the potential sale process to keep all sale information confidential. People in the know should be specifically instructed as to whom they are permitted to discuss sale-related matters. You should also consider (1) what forms of communication are safe and what forms are not (e.g., who has access to emails, voicemails, and other company messaging platforms) and (2) what to tell administrative assistants and others who support senior management. In some cases, senior management may attempt to disguise the sale process as a debt financing or internal audit. Confidentiality agreements will be needed with potential buyers, and these are discussed in Chapter 4.

How do I handle the clean up of business records?

A final step in preparing your company for sale is to clean up the business records and address any corporate housekeeping issues. Proper recordkeeping and corporate formalities are often overlooked in privately owned businesses, but a potential buyer will want to minimize any risks associated with such matters. These matters therefore should be cleaned up as much as possible in preparation for a potential buyer's due diligence review.

Good corporate housekeeping will require attention to organizational formalities like proper approval for certain company actions, maintenance of certain required records, and filing all paperwork relating to a company's continued legal existence. Company actions that were not properly approved should be ratified. A company's organizational records, including its minutes, resolutions, and equity transfer records, should be reviewed by your law firm and completed to the extent appropriate. You should confirm that the company has paid any franchise taxes or similar fees and made all required filings in its state of formation and other states in which it conducts substantial business. Other relevant business records (including contracts) should be reviewed and cleaned up as necessary to be able to provide the information a potential buyer will want to review in connection with its decision to bid on the company (see Chapter 7).

In addition to the items mentioned above, you may need to address the legal structure of the business, certain business relationships between the company and you, and any potential liabilities that might concern a buyer. If the business is operated in multiple entities or in partially owned subsidiaries, you may want to consolidate these entities or buy out the minority owners. Certain options, warrants, or other special classes of securities may need to be eliminated or consolidated. Finally, certain arrangements in which business assets are leased by the company from you or an entity you own may need to be addressed.

If significant real estate is involved, you may want to hire an environmental consultant to perform a Phase I study so that early in the process you are aware of and can address environmental issues that may concern a potential buyer. If other potential liabilities exist that may concern a potential buyer, such as a pending lawsuit, you may want to consider resolving these liabilities.

CHAPTER 4

Finding the Right Buyer

Selling your business is similar in many ways to selling a product, so certain marketing principles will apply. The salesperson needs to know the market—who the potential buyers are, the limitations of the market, and how to target that market to best present the product. The salesperson also needs to know the product—in this case, your business. The better your business is presented to potential buyers, and the greater their demand, the better your economic results are likely to be. Whether the salesperson is you or an investment banker, focus on the market and the product to attract the right buyer, and customize the sale process to reflect this focus.

Identifying your target market

The first step in identifying your target market is to brainstorm, with your investment banker if you have one, to develop a list of potential buyers. Potential buyers for your business can be anyone—customers, suppliers, competitors, individuals or firms with money to invest, or even current management or employees. You will want to narrow your list, however, to financially qualified buyers with a serious interest in your company. Otherwise, valuable time and effort will be wasted and the potential for confidentiality leaks will increase. Potential buyers generally tend to fall into three categories: financial buyers, strategic buyers, and insiders.

Financial buyers

These are firms, such as private equity groups, venture capital funds, or family offices, who purchase businesses primarily to generate financial returns by growing the business or improving its revenues or operations before ultimately selling the business to another buyer or taking the company public. Financial buyers are typically looking for this liquidity within three to seven years, although family offices may take a longer-term investment horizon. Attractive buyout candidates for financial buyers usually have several (but not all) of the following characteristics:

- Stable cash flow.
- Fixed assets to be used as collateral (financial buyers will often borrow a substantial portion of the purchase price).
- Low or moderate ongoing capital expenditures.
- Experienced management with a proven track record.
- Opportunity for cost reduction or margin improvement.
- Growth opportunities (both organic and by acquisition).

Private equity groups, venture capital funds, or family offices also may be strategic buyers if they own a portfolio company that is in the same industry as your company or is in a related industry.

Strategic buyers

Strategic buyers purchase businesses primarily because the business is a good fit with, or complement to, an existing line of business they already operate. Strategic buyers are generally in the same industry (like competitors, suppliers, and customers) that may be looking to grow their business, but they also include synergistic buyers who tend to be in a related industry that can benefit from the strength of the seller's business. An interested strategic buyer with financial resources sometimes will pay a higher purchase price due to the strategic buyer's relatively low cost of capital, cost synergies, the long-term benefit it expects to achieve from the acquisition, or the value it sees in your management team.

Insiders

A third group of potential buyers includes members of existing management, key employees, and your family members. These people already know your business, and their inside knowledge may facilitate their ability to purchase the company. Insiders frequently lack financing, however, and this may require you to agree to some form of seller financing. An investment banker can often assist inside buyers in raising the capital needed to fund the buyout.

Reaching your target market

Methods for reaching your target buyer market range from approaching only one party (who may have previously expressed an interest), to contacting a limited pool of potential buyers (perhaps only insiders, known strategic buyers with whom you have contacts or financial buyers you or your advisors are familiar with), to using a broad-based, professionally managed sale process. In addition, your investment banker can advise you about the timing in approaching various types of buyers. For example, you may want to approach a potential strategic buyer that competes with you only after you are relatively certain that you have a viable offer from another potential buyer. The approach should be tailored to your needs, your business, and the target market.

The purchase price for your business is likely to increase as the number of seriously interested buyers increases. However, as the number of potential buyers solicited increases, other concerns may increase, such as time frame and confidentiality. The more potential buyers you contact, the longer it will likely take your transaction to close. Any premature leaks to customers, suppliers, or employees that you are considering the sale of your company may be troublesome or, in some cases, devastating—customers might start to look for other sources, suppliers might start to look for other customers, and employees might quit or stop performing. You should weigh these concerns and discuss them with your investment banker when determining the method to reach your target market.

Circumstances that would suggest a limited solicitation include:

- Limiting the solicitation to insiders when no strategic buyer seems likely and the company does not seem to satisfy the parameters important for financial buyers or when there is a family, personal, or personnel reason to limit the solicitation, at least initially, to insiders.

- Limiting the solicitation to select strategic buyers when the company generally does not satisfy the parameters important to financial buyers (for example, debt financing is unlikely due to lack of steady cash flow or assets to serve as collateral).

- Limiting the solicitation to a few financial buyers when strategic buyers seem unlikely or if establishing a strong working relationship with the buyer after closing is important (perhaps you or other key members of management will continue with the business).

If a wider solicitation is envisioned, an investment banker's services will almost invariably be needed. An investment banker's experience and contacts will be essential to running such a solicitation in a timely, efficient, and effective manner.

Generally, this process, even when well managed and run under optimum conditions, will require four to six months or longer.

Your product

Before you approach a potential buyer, you should carefully consider the qualities and characteristics that will make your company an attractive product to a potential buyer. Obviously, each industry is different and each business in an industry is distinctive. Your investment banker can assist you in analyzing your business from the perspective of each category of potential buyers and articulate why your company would be an attractive purchase.

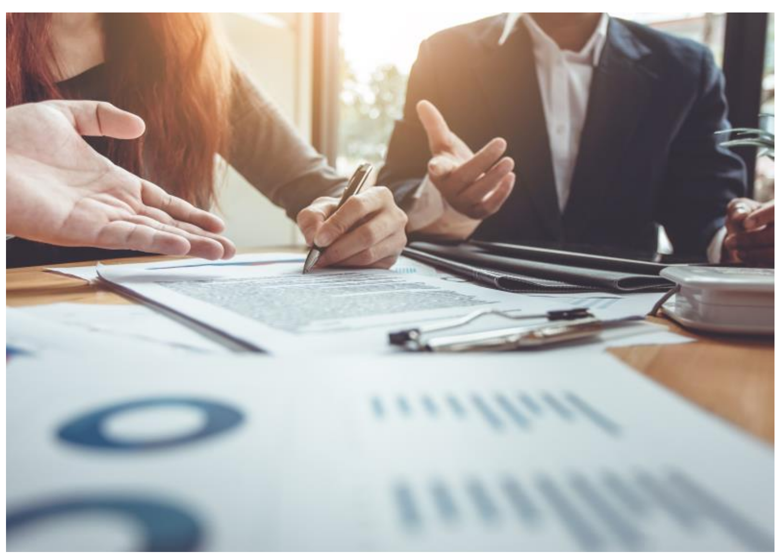
If you have retained an investment banker to approach multiple potential buyers, your investment banker will likely prepare a Confidential Information Memorandum (CIM) to describe your business, tell its story, and portray your company as an attractive investment. The CIM should include a statement of your reasons for selling the company and will typically include financial statements (historical, projections, and recasted, if necessary), descriptions of the industry outlook and market conditions, products and technology, management and organizational structure, history, potential new business areas, and market position and strengths. Your CIM should be reviewed by your lawyers and accountants prior to its distribution to any potential buyer.

Confidentiality

Prior to disclosing any significant information about your business to a potential buyer, you should require that the potential buyer execute a confidentiality agreement that has been prepared by one of your advisors. Confidentiality agreements are very important because, as discussed above, breaches of confidentiality can affect employee morale, relationships with customers and suppliers, proprietary technology and know-how, and your competitive position in the marketplace. A potential buyer should be amenable to signing a confidentiality agreement because a confidentiality agreement will give the potential buyer greater confidence that it is getting all pertinent information and that the use of the information being shared with other potential buyers and competitors is being restricted.

A confidentiality agreement should:

- Prohibit the disclosure or use of confidential information except to evaluate and negotiate the transaction.
- Apply to the potential buyer, its agents, and advisors.
- Prohibit the recipient from trying to hire away your employees.
- Require the return or destruction of all materials provided to the potential buyer if the acquisition does not occur.



CHAPTER 5

Initial Negotiating Dynamics and Key Business Terms

In formulating your sale strategy, you will want to focus first on fundamental items, such as the initial negotiating dynamics, transaction structure, the amount and form of purchase price and timing of payment, any purchase price adjustments, and key management and employee matters.

Initial negotiating dynamics

Seller's objectives

One of the seller's primary goals will be to get the money (the purchase price proceeds) and keep it. In order to get the money, greater certainty in the transaction helps a seller, and a seller therefore should give special consideration to a buyer who is committed to closing the deal and who has the financial resources to do so. To get or keep the money, a seller is usually best off with payment of a fixed amount in cash at closing, rather than getting notes, an earnout, or some other deferred or contingent payment. To keep the money after closing, a seller must limit its post-closing indemnification obligations (See Chapter 8). Also, the seller typically wants to minimize the amount of time between signing the letter of intent and closing the deal.

Buyer's objectives

A buyer's objectives vary significantly from those of a seller. A buyer may desire to make an acquisition, but it may have a number of different opportunities to do so over a period of time, and the timing of a specific transaction may not be critical. A buyer may not have in-depth knowledge of your business but will make certain basic assumptions when formulating the price to pay. The buyer will conduct due diligence in part to determine the accuracy of these assumptions. Furthermore, the buyer will expect certain representations from you—generally backed up by an indemnification obligation—that the business meets these assumptions. These assumptions will be based primarily on the operations (including financial results) and liabilities of your business.

Intersection of objectives

You and any buyer must keep in mind the essence of the transaction. By way of comparison, if you are seeking to be paid for a new Cadillac with a five-year warranty, that is what the buyer expects to get. On the other hand, if the buyer is only paying for a used Ford with no warranty, that is all the buyer should get, and the deal documents should reflect this distinction. Similarly, if your hard assets are not critical to what the buyer is paying for, but the customer base is, then the parties and their advisors should take that focus into account.

Early leverage

Your leverage probably will be the greatest when a letter of intent is first discussed or negotiated. The purchase price, for example, is not likely to increase afterwards and often will be subject to some downward pressure. This downward pressure could result from subsequent circumstances, such as an economic or industry downturn or from matters discovered by the buyer in doing its due diligence. A seller sometimes loses leverage if it becomes—or appears to become—too committed to or too invested in a particular deal. A seller may also lose leverage if suppliers, customers, or employees learn about the transaction during the due diligence process. Even though your leverage may be greatest at the outset, you may not want to be the first to propose a purchase price at this early stage. This is to avoid opening with a price that a potential buyer views as unreasonably high or, worse, one that is lower than the upper range of a potential buyer's thinking, thus setting a cap for subsequent price negotiations.

Transaction structure

Introduction

The most common structures used for an acquisition are described below. For acquisitions of smaller private companies, an asset purchase structure is often used, primarily because of the buyer's desire to avoid unwanted liabilities. Even when an asset purchase is used, however, the alternatives of an equity purchase or merger are often considered or at least compared. An acquisition of a public company is almost always by way of merger. Variations or combinations of these transactions are also used.

Income tax considerations should be a significant factor in selecting a transaction structure. For example, your tax consequences can vary substantially depending on whether your business is held in a C corporation, an S corporation, or a partnership or limited liability company (LLC), and can vary substantially when comparing an equity purchase to an asset purchase structure. In the case of an asset sale, your tax accounting methods and your company's tax basis in the assets being sold will determine some of the income tax consequences of the transaction. Tax consequences obviously have a real monetary impact, so the parties often will discuss whether the purchase price should be adjusted to reflect the tax benefits or detriments to a party.

Purchase of assets

In an asset purchase, the buyer would buy the business's assets directly from your company and would likely assume specified liabilities of the company. This acquisition structure has two main advantages, both of which favor the buyer:

- The buyer can limit the liabilities that it is assuming in the transaction to those expressly set out in the purchase agreement. The buyer thereby avoids unwanted liabilities, subject to any transferee liability. These unwanted liabilities may include known liabilities, perhaps discovered during the due diligence process, as well as unknown liabilities—those presently unknown and perhaps unknowable but which may materialize and be significant in the future. These unwanted liabilities would remain the responsibility of you or your company after the closing.

- The buyer will obtain a step up in the basis of the assets being acquired, the depreciation or amortization of which will reduce the buyer's ongoing income tax liability after the closing.

The primary disadvantage to you from an asset purchase is when your company is a C corporation, in which case the transaction is likely to result in a second level of income tax. The first level of income tax will be borne by your company from any gain realized by the company on the sale of its assets. The second level of tax will be borne by owners if any distribution is made to them of the sale proceeds (either as dividends or, more often, as distributions from the company's liquidation). An asset purchase also raises other issues, although they are generally manageable in most cases, such as:

- If the company is selling all or most of its assets, the owners must approve the transaction.

- In addition to any double level of taxes discussed above, transfer taxes may be payable on the sale of any real estate (which in some cases could be substantial) and some transfer taxes, such as sales taxes, may apply to the sale of some or all of the company's personal property.

- Since leases, license agreements, and other contracts will be transferred, the consent of the other parties to these contracts generally may be necessary, especially for significant agreements.

- Because of the need to actually transfer assets, and the need to properly identify or describe them, closing an asset sale can be more complicated than other closings.

Asset sale transactions may be disadvantageous even when your company is an S corporation or taxed as a partnership. Sales of cash-basis accounts receivable are generally treated as if the receivables were collected, and sales of previously depreciated assets can cause depreciation recapture, in each case resulting in ordinary income rather than capital gains, which characterization will generally result in a higher tax burden. As a result, advanced tax planning and consideration of tax results are critical in any asset transaction.

Equity purchase

An equity purchase is usually the easiest transaction to consummate. In its simplest form, you would simply transfer your equity interest—which, in the case of a corporation, could be done by endorsing the back of your stock certificate, or in the case of an LLC, by executing an assignment of membership interests—in exchange for the purchase price to be paid by the buyer. An equity purchase is generally a good tax result for a seller in a cash transaction over a corporation because any gain recognized in the transaction would be capital gain for federal income tax purposes. The buyer, on the other hand, loses out on two of the advantages it would have had in an asset purchase—the buyer now will be responsible for all of the acquired company's liabilities, including unknown and unwanted liabilities, and it will not receive any step up in basis in the assets of the acquired company.

Although an equity purchase is usually simpler than an asset purchase, equity purchases may have some complicating structural factors such as:

- All of the owners must transfer their equity for the buyer to acquire 100% of the equity. In essence, an equity sale therefore requires unanimous approval for the buyer to acquire 100% of the business.

- Even though contracts are not actually transferred or assigned in an equity sale, the company's contracts may include "change of control" provisions requiring approval of the other party if all or a specified percentage of the outstanding equity is sold. Similarly, the equity sale may result in the acquired company having to obtain new licenses or governmental approvals.

- Certain equity transactions—including S corporation acquisitions in connection with certain elections, reorganizations, or partnership acquisitions—can have materially different tax consequences than a simple corporate equity transaction generating capital gain, and those approaches are prevalent in the market (particularly the financial sponsor market). Careful consideration of any such proposals is necessary to ensure your tax result is optimized.

Merger

In a merger, your company will be combined with another company or entity owned by the buyer. The surviving entity in the merger (i.e., the identity of the combined company after the merger) could be either your company or the buyer's entity.

A merger has many of the attributes of an equity sale. In fact, if your company is merged with the buyer's newly formed subsidiary and your company is the surviving company, the resulting structure will look exactly like an equity sale. Regardless of the type of merger, the buyer directly or indirectly will be responsible for all of the liabilities of your company. Your company's owners will receive the proceeds from the sale directly from the buyer or an entity owned by it, and any gains recognized by the owners would generally be capital gains.

Mergers are used in lieu of equity sales mainly in two contexts:

- When the buyer's equity is being offered as a material part of a consideration of the purchase price for another company, a merger may be more advantageous from a tax standpoint to a seller who desires to receive tax-deferred treatment for the buyer's equity it receives.

- It may be impractical to have all or the requisite number of owners transfer their equity to the buyer. This is obviously the case with a public company and may be the case with a private company when one or more owners are balking at selling their interests. Approval of a merger usually requires approval by less than all owners (and in fact only a majority in many states). The dissenters' rights statutes, however, may give owners who dissent from the transaction the right to obtain the appraised value of their equity in cash rather than receiving the amount and type of consideration offered in the merger.

Types of purchase price

Cash

A cash payment at closing often will be at least part of the purchase price. Obviously, cash at closing is generally a seller's preference unless the seller is seeking deferred tax treatment.

Deferred payments

Part of the purchase price may be paid a significant time after closing. A buyer often prefers for a seller to agree to such deferred payments, usually in the form of a promissory note, as a means of providing the buyer with seller financing. Alternatively, to defer part of the income tax recognized from the transaction, a seller may desire to receive cash at a significant time after the closing to obtain installment sale tax treatment.

The timing of any deferred payments, as well as the interest thereon, will be items to be negotiated. The more difficult negotiations, however, may be regarding what right the buyer has to set off against these deferred payments any amounts owing to the buyer that arise from the seller's post-closing obligations, including for breach of a representation in the purchase agreement. If you also agree to set off rights against these deferred payments, you should take the position that these set off rights are in lieu of putting any of your sale proceeds in escrow (or being held back by buyer) for post-closing indemnification purposes.

You, as the seller, on the other hand, may desire that the deferred payments be secured with some collateral. You should also ensure that you are reasonably comfortable with the buyer's financial capability to make the future payments when due. Finally, you should be aware that any deferred payments may be subordinated to the lender's loan, if there is one, and therefore might not be paid until after the lender is paid in full.

Earnout payment

An earnout is a contingent payment to be made if the acquired business achieves some future financial performance goal specified in the purchase agreement. In this way, the payment is to be earned by the acquired business meeting its goal. An earnout is most often raised as a possible means to bridge a gap in valuation between the buyer and the seller, especially regarding the future prospects of the business being acquired. An earnout may also be proposed to address a narrow valuation issue. For example, the seller may have a new product without any proven financial record and an earnout may be used to place a future value on this new product based on the product's future performance.

Although the concept of an earnout is fairly easy to understand, earnouts are fraught with potential problems, require detailed thought and drafting, and sometimes can bog down the overall process because of the separate negotiations necessary to address the many details in a well-drafted earnout. Earnouts also can often lead to post-closing disputes.

The first question in addressing an earnout is determining the valuation formula to be applied in the earnout, although this valuation formula may simply mirror the one used in setting the initial purchase price. For example, if a multiple of EBITDA was used to set the initial purchase price, an EBITDA formula may be used for pricing the earnout although usually several adjustments will be needed for the EBITDA formula to account for certain post-closing items.

The parties must address several other basic terms regarding the earnout, including the following: the threshold to be satisfied before payments are due; the amount of the payments (including whether it is a specified amount or based on some percentage); the time period over which the future performance will be measured (usually in the one- to five-year range); whether annual payments are to be made and, if so, whether there will be an overall cap; and whether the payments bear interest. As with any deferred payment, a seller entitled to an earnout also must be concerned about the buyer's financial ability to make the payment and any rights of set off in favor of the buyer as well as whether the buyer's lender will try to subordinate the payment.

Buyer's equity

All or part of the purchase price may be in the form of equity of the buyer. The buyer may offer equity to minimize its own cash needs, or the seller may desire equity in order to receive certain tax-deferred treatment or to continue to participate in the growth of the business. In addition, the equity may have a contingent nature if it includes a put right exercisable within a negotiated time frame in favor of the seller or a call right pursuant to which the buyer could repurchase the equity. The put and call rights would each specify a pricing formula, which may be the same or at least similar. In the case of the put, the seller would be able to collect its contingent payment by exercising its put at the formula price and selling the equity to the buyer. Several other issues arise if equity is used as part of the consideration, including the following:

- How is the equity of the buyer to be valued? If the buyer is a private company, no reliable indicator may be available. If the buyer is a public company, value will be based on the equity's trading price, in which case the question will be fixing the date for when the buyer's equity is valued. If it is to be fixed at closing, the seller runs the risk that it will receive far fewer shares than expected if there is a run-up in the trading price before closing, with the added concern that, after the closing, the trading price will fall closer to its historical level. The buyer runs a similar risk from any substantial decline in the equity's trading price before closing. Fixing the equity's value when the letter of intent is signed also results in market risks for each party. As a result, a purchase agreement will often place caps or floors, above or below which the trading price is not expected to rise or fall. When combined, a cap and a floor are referred to as a collar. The purchase agreement will also specify the consequences from the equity trading above or below the cap or the floor. For example, if it exceeds the cap, then the value may be pegged at this cap or, alternatively, the party adversely affected may be entitled to walk from the transaction.

- The buyer’s issuance of equity will require that the equity issuance be either registered, or be exempt from registration, under the federal securities laws and any applicable state securities laws.

- If a seller is to receive equity as part of the purchase price, the seller and its advisors should generally conduct their own due diligence of the buyer since the seller will have an economic stake in the buyer after the closing. Similarly, the seller should consider whether the buyer should make certain representations in the purchase agreement about the buyer’s business and its equity.

Purchase price adjustments

Many transactions involve one or more purchase price adjustments. The most common purchase price adjustment is for working capital.

Working capital adjustment

A buyer typically wants to ensure that the company’s working capital at closing is sufficient to support the company’s earnings projections in the months immediately following the closing. Viewed simplistically, the buyer can agree to pay a certain amount for the enterprise value of the business plus a separate amount equal to the seller’s working capital (or receiving a credit for any working capital deficit). The calculations and mechanics surrounding working capital adjustments can be fairly intricate. Working capital adjustments generally serve two purposes:

- To ensure that the seller does not manipulate the working capital to the buyer’s disadvantage since the seller generally controls the business and its working capital until closing.

- To measure the company’s actual working capital at closing against some agreed-upon target specified in the purchase agreement. This target could be based on the actual working capital when the letter of intent is signed, the average working capital for the prior 12 months, or the projected working capital as of the time of closing.

Since the actual working capital at closing will not be known until sometime after the closing, the final working capital adjustment (and payment thereon) will not be determined until usually several months after the closing. As a result, the parties often will include an estimated working capital payment at closing, with this estimate subsequently trued up based on the actual working capital at closing.

Other purchase price adjustments

The parties often consider other purchase price adjustments so that the final purchase price will reflect the economic expectations on each side. Circumstances in which these adjustments may arise include the following:

- Unless the seller’s debt is being repaid by the seller at closing, the seller’s indebtedness may be a reduction of the purchase price on a dollar-for-dollar basis. Although this concept is relatively straightforward, questions often arise about what is included in indebtedness, such as whether a capital lease should be treated as indebtedness.

- Similar to the working capital adjustment discussed above, an adjustment based on the company's net worth may be used in some circumstances.

- If the seller guarantees the collectability of its accounts receivable, this may be an indirect yet significant purchase price adjustment. In such a case, the seller will be obligated to reimburse the buyer for all accounts receivable which remain unpaid at some specified post-closing date, subject to any uncollectible reserve.

Management and employee matters

In approaching a possible sale of its company, a seller will frequently need to consider a number of issues regarding its management and other current employees, including the following:

- Depending on the terms of various employment agreements and employee benefit plans, the sale of the company may trigger the vesting of benefits or other obligations, for which the seller and not the buyer is usually responsible.

- A seller will want to consider whether it is appropriate to offer any special incentives to its management in connection with the potential sale. These incentives, typically in the form of bonuses, may be premised in part on the management's past loyalty, but more importantly, they would serve as recognition of the significant effort expected from management in the sale effort, as well as to give some financial assurances in light of the insecurity typically felt when one's employer is being sold.

- The seller also will need to consider to what extent the buyer should be contractually obligated to retain the sellers' current employees and, if so, on what terms. In some cases, the seller will want to require a transfer of its employee benefit plans to the buyer, and in other cases, the seller will ask that the buyer have a comparable employee benefit plan to which the employees can roll over their existing benefits.

- The buyer may have a keen interest in trying to ensure that key employees are subject to binding non-competition (or similar) agreements that extend for some duration after the closing.

- The buyer, particularly a financial buyer, also may have an interest in retaining the seller's work force, especially its key employees. In that case, the buyer may be willing to offer, or insist upon, employment agreements with key employees, and offer comparable employment and benefits to the seller's employees.

CHAPTER 6

Letters of Intent

After you and the buyer have agreed upon the purchase price and other key business terms of the deal, you will want to consider signing a letter of intent. A letter of intent is really just that—a letter between a seller and a buyer which sets out the purchase price and some other fundamental terms of the proposed transaction. It indicates the parties' willingness to negotiate and document the more specific terms and provisions of the deal needed to consummate the transaction.

The letter of intent is rarely intended to be a binding commitment, either regarding the fundamental terms of the deal or as a promise to agree on more specific or detailed terms. Instead, it typically contemplates a subsequent purchase agreement that would contain the binding terms and provisions. Even though a particular letter of intent may be presented as nonbinding, every letter of intent should receive full review and comment by a seller, its counsel, and perhaps its other advisors.

A letter of intent has two primary functions:

- To ensure that the parties have a common understanding of the fundamental business terms before more time and expense are devoted to the negotiations, documentation, and due diligence necessary to complete the deal.

- To specify certain covenants (such as a no-shop provision described below) that are binding between the time the letter of intent is signed and the time a purchase agreement is signed.

If no binding provisions are to be included in the letter of intent, the parties could use instead an unsigned term sheet or memorandum of understanding to ensure they have a common understanding of the fundamental terms.

Typical non-binding terms

Below are some of the items that almost always are included in a letter of intent (keeping in mind that each deal is different and therefore each document, such as a letter of intent, ought to be individualized):

- The amount of the purchase price. Sometimes purchase price adjustments will also be included (see Chapter 5).

- The form of the purchase price (cash, notes, or equity).

- The form of the transaction (for example, equity or asset sale—see Chapter 5).

- Certain procedural steps, including the date by which the purchase agreement is expected to be signed.

Other nonbinding terms

Examples of other nonbinding terms that may be included in the letter of intent include:

- The specifics of non-competition or non-solicitation agreements that the buyer may require of you, other sellers, or perhaps your management.

- The terms on which your management and employees will be employed by the buyer after the closing (including any understandings of how employee benefit plans are to be transferred).

- Aspects of your indemnification obligation after the closing, including whether the parties have agreed that at the closing you will pay part of your purchase price proceeds into escrow (or be held back by buyer) as a fund to reimburse the buyer for any indemnification claims it may have against you. Indemnity thresholds, caps, and survival periods may also be addressed. In addition, the parties may address at the letter of intent stage whether the buyer intends to obtain representations and warranties insurance (RWI) for the transaction, which can significantly affect the scope of the seller's indemnification exposure. See Chapter 8 for a discussion of indemnity issues and RWI.

Examples of binding terms

Although a letter of intent does not need to include any binding provisions, it often will. The provisions below, for example, might be included as binding provisions in a letter of intent:

- Any no-shop provision, which would require that you deal exclusively with the buyer (i.e., not discuss or negotiate a deal with any other potential buyer for a specified time period and terminate any current discussions with other potential buyers).

- Any break-up fee you would be required to pay to the buyer if you decide to proceed with another buyer, or any earnest money deposit the buyer would be required to pay into escrow at the time the letter of intent is signed.

- Any special sharing of expenses (such as a governmental filing under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (HSR Act) or for a special audit of your financial statements), especially if the expenses are to be incurred before the purchase agreement is signed.

- Confidentiality and non-solicitation provisions if a confidentiality agreement was not signed earlier (see Chapter 4).

- Certain boilerplate terms, including the date on which the letter of intent terminates (assuming no purchase agreement has been signed by that date), and a statement that the letter of intent is nonbinding except for those provisions expressly stated to be binding.

Advantages and disadvantages

Letters of intent are fairly common in acquisitions. Although they are not absolutely necessary, some writing (for example, an unsigned term sheet) is almost always advisable. In deciding whether a letter of intent is appropriate in your transaction—as well as the type and timing—you should consider the advantages and disadvantages of a letter of intent, including the following:

Advantages

- A letter of intent puts in writing those key terms that have been agreed upon (at least tentatively) and thereby provides better assurance that the parties have a common understanding of what has been agreed upon. Parties can point to a written document rather than rely on their collective memory of key terms (which may result in a misremembering of what was agreed to by the parties).

- Because a seller's negotiating leverage is typically higher at the letter of intent stage, you may be able to negotiate more favorable terms (at least tentatively) on certain provisions, such as meaningful limits on your post-closing indemnification obligations.

- A letter of intent can help to identify issues before they cause the deal to fall apart, thereby allowing the parties to deal with these issues earlier in the process, saving the parties time and expense if they cannot resolve the issues.

- Even though typically nonbinding, letters of intent often have symbolic importance and can help generate momentum in a transaction.

- Certain binding provisions to be included in the letter of intent may be of special importance to you (for example, sharing of certain costs).

- A letter of intent may assist the buyer in arranging its financing by showing potential lenders a deal is imminent.

Disadvantages

- If the parties attempt to provide too much detail in the letter of intent, the negotiation can raise difficult issues too early, which can slow the momentum and bog down negotiations at a critical point in the process. Occasionally, parties are concerned that negotiation of a letter of intent may delay entering into a purchase agreement or result in extra expense, especially in the case of a smaller transaction.

- A letter of intent typically would be the document in a private transaction in which the buyer would insert a no-shop provision. This may seem inappropriate in your deal, especially if you feel that critical terms need to be set out more definitively or the buyer's ability to close the deal is in question, perhaps because of the need for financing.

- If the buyer is a public company, the buyer or its counsel may have concerns that the letter of intent could trigger public disclosure under securities laws.

In our experience, a written letter of intent or term sheet usually benefits all parties, and the disadvantages mentioned above can be addressed in an appropriate manner.

CHAPTER 7

Moving Toward Closing

After a letter of intent is signed or the key business terms of the sale are otherwise agreed upon, you and the buyer will begin taking the steps necessary to move toward the closing of the sale. During this busy period, the buyer will complete its due diligence review and seek financing for the transaction (if necessary), and the parties will negotiate the transaction documents and pursue any approvals or consents required for the transaction.

Timing

The timing of the sale of a business is often very important to at least one of the parties. The amount of time between the letter of intent (or agreement on key business terms) and the closing can range from a few weeks to many months but is typically between 30 and 90 days outside of certain auctions. Key factors that affect the time to close include the size and complexity of the transaction; the level of sophistication of the parties and their advisors; the extensiveness of due diligence; the amount of negotiation and documentation involved; whether third-party financing is required; and whether there are regulatory or other third-party approvals or consents.

You and the buyer will need to make the timing-related decision as to whether the parties will sign the binding purchase agreement at some point prior to the closing or at the actual time of closing. For a sale of a private company in an industry that is not highly regulated, signing the purchase agreement at the time of closing is usually the easiest route (often referred to as a simultaneous sign and close deal). However, in some cases, the parties can reach agreement on all or most aspects of the deal but must wait for a specific event (e.g., third-party financing, regulatory approval, or owner vote) before they can close. In those situations, the parties may want to sign the purchase agreement in advance of closing and have an interim period to accomplish the remaining items (often referred to as a staggered or bifurcated sign and close deal). Signing a purchase agreement early, even though it will contain conditions to closing, also has a certain feeling of finality or closure. This route, however, will result in extra negotiation and potential disputes regarding matters that could arise between signing and closing. Some of these may be hypothetical while others are real, such as how the business is to be run during the interim period. Signing before closing will also require the parties to negotiate and agree on the circumstances under which one or the other party may terminate the agreement and walk away from the deal.

Due diligence

Although the buyer probably will have received some basic information about your company early in the process, the buyer usually will want to review thoroughly the operations and risks relating to the company and its business before closing on the transaction. This review process, called due diligence, involves specific financial, business, and legal reviews.

Financial due diligence includes a review of the company’s financial information, including financial statements and tax returns, by the buyer and its financial and accounting team. Other business due diligence will normally include interviews with management, facility tours, review of sales and marketing programs, contacts with major suppliers and customers, and background checks on the company’s principals. Legal due diligence normally includes a review of the company’s organizational documents (including its charter, bylaws, operating agreement, or comparable governing documents), debt and equity documentation, other material contracts, employment arrangements, employee benefit plans, real estate and environmental matters, intellectual property, litigation, data privacy, regulatory compliance, and files relating to other legal and regulatory matters.

In some cases, limited due diligence occurs prior to signing a letter of intent, while the bulk of the buyer's due diligence starts after a letter of intent is signed and often continues until the closing date. In other cases, especially if an investment banker is actively engaged in the sale process, a potential buyer is required to conduct the bulk of its due diligence before entering into a letter of intent (if one is signed). In any case, you should be prepared for the overall due diligence process to be extensive, burdensome, time-consuming, and distracting for you and your management team. First-time sellers are often surprised and aggravated by the buyer's diligence demands, which may seem unreasonable but usually are relatively standard. The due diligence process is integral to getting the sale done, and you should rely on your advisory team to assist you in the process.

While the buyer's review may seem burdensome, surfacing issues early in the due diligence process can be beneficial. Generally, negative information can best be dealt with early on when the terms of the transaction are still fluid and at a time when your leverage may be the greatest. Identifying issues early will also diminish any surprises on the disclosure schedule (see Chapter 8).

Documentation

The documentation for the sale of your company will usually consist of one major acquisition or purchase agreement which, depending on the structure of the transaction, may be an asset purchase agreement, an equity purchase agreement, a merger agreement, or a recapitalization agreement. This agreement will contain the business and legal terms of the sale and reference the other major documents, which might include an employment agreement, consulting or non-competition agreement, and possibly an equity incentive agreement or rollover agreement if you continue with the business.

Buyer financing

If the buyer intends to finance part of the purchase price by obtaining debt financing, the buyer will need to negotiate and document that financing prior to the acquisition closing. This financing may affect you in several ways. First and foremost, if the buyer is unable to obtain the financing, then the sale may not occur. Second, if the buyer has overestimated the amount of financing it can obtain, then the buyer may seek to either reduce the purchase price or have you provide a portion of the financing. Third, you will need to respond to requests for information from the buyer's potential investors or creditors, as these parties conduct their own diligence on the company. Finally, the time associated with negotiating and documenting the financing may lengthen the time necessary to close the sale.

Approvals and consents

During the due diligence phase, the parties and their advisors will seek to identify and obtain consents from all governmental entities, third parties, and company security holders that must approve or consent to the transaction.

Three major types of governmental consents may be involved. First, the HSR Act requires premerger notification of transactions meeting certain monetary thresholds (adjusted annually for inflation) to the Federal Trade Commission and the US Department of Justice Antitrust Division, unless an exemption applies. Outside of the United States, over 100 jurisdictions around the world have merger control regimes that may be implicated by a transaction, depending on where the target company operates. Depending on the nature of the buyer and its operations, other governmental transaction review regimes (like CFIUS in the United States or foreign direct investment reviews in foreign countries) may apply. Second, regulated industries like telecommunications, utilities, healthcare, defense, and insurance may require change of control filings or clearances with relevant federal or state regulators. Finally, governmental consent may be required to assign specific governmental permits or licenses in the sale. Your advisory team will be able to assist you with identifying and attempting to obtain these governmental consents and approvals.

You may also need to obtain consent from various parties that have contracts with your company. If the sale is structured as a sale of assets, then every contract that is to be transferred to the buyer may technically require the consent of the other party to the contract if that contract contains anti-assignment language. If the sale is structured as a sale of stock or a merger, there are usually fewer issues regarding contractual consents. However, consent may be needed if any of the company's contracts have change-of-control or similar provisions, which is often the case with real estate leases.

Finally, the transaction must be approved under applicable entity law. Applicable laws typically require that the seller's board of directors or managers, as well as a majority of the owners of the seller, approve a merger of the company or a sale of substantially all of its assets. The company's organizational or other investment documents may also impose more stringent or additional approval requirements.

CHAPTER 8

The Purchase Agreement

As mentioned in Chapter 7, the documentation for the sale of your company will usually consist of one major acquisition or purchase agreement. This agreement will set out the structure of the transaction, the purchase price, and any purchase price adjustments—all of which are discussed in Chapter 5—as well as numerous other aspects of the overall transaction.

In almost all transactions, the seller will be required to provide significant representations and warranties in the purchase agreement regarding the business being sold. In addition, in an equity purchase agreement, each selling owner will make representations regarding the ownership of the equity owned by such selling owner. Although these representations serve several functions, a primary one is that they form the basis for any post-closing indemnification claims made by the buyer against the seller. The seller representations and the post-closing indemnification obligations often will be the provisions in the purchase agreement on which you should focus most.

Seller's representations

Most sellers are surprised by the breadth of the representations in a purchase agreement. These representations have three overlapping functions:

- They elicit disclosure from the seller about its company at the time the purchase agreement is signed. In some cases, this disclosure will be a representation that the matter in question does not exist (for example, no material lawsuits), and in other cases the representation will require a listing and detailed description in a disclosure schedule (for example, if material lawsuits exist, a listing and description of them).

- In a non-simultaneous sign and close transaction, they give the buyer the right to terminate the agreement prior to closing if the representations prove incorrect. The representations must be correct (or correct in all material respects; or correct except as they might have a material adverse effect, with these materiality qualifiers often being heavily negotiated) at the closing, as well as at the time the agreement is signed.

- They survive the closing and, subject to whatever limitations are included in the purchase agreement, they give the buyer the right to be indemnified for any losses incurred from a breach of representations. The representations thus serve to allocate the economic risks between the buyer and the seller.

The representations generally will include representations about the operation of the business, the financial statements and financial condition of the business, the physical condition of tangible assets, and a number of other business and legal matters. The scope and extent of the seller's representations will depend, in part, upon the relative bargaining power of the parties, as well as their understanding of the essence of the transaction.

Qualifying the seller's representations

A seller may limit the effect of its representations in the following two ways:

- In the text of a particular representation, the seller can request certain qualifiers. For example, matters may be represented only to the extent they are material or to the knowledge of the seller or limited to being correct for only a certain specified time period. In each deal, the parties will often negotiate about the exact meaning of these qualifications, and the buyer will generally resist including these qualifiers.

- Because the text of the representations is generally also qualified by "except as otherwise disclosed," matters appropriately disclosed in the seller's disclosure schedule that accompanies the purchase agreement may be excepted from the representations. This disclosure schedule is prepared by the seller and delivered concurrently with signing the purchase agreement. After the seller delivers the disclosure schedule, the buyer and the seller often have significant negotiations regarding the matters disclosed and the allocation of the risks of such matters.

Post-closing indemnification

As discussed above, one of the functions of the seller's representations is to provide the basis for which a buyer may seek indemnification (or reimbursement) from a seller if the seller's representations prove to be incorrect after the closing. Unless the representation is expressly limited to the seller's knowledge, a seller will generally be liable whether or not it knew of the facts or circumstances resulting in the breach of the representation. In this sense, a seller has strict liability for its representations, subject to the qualifications in the representations, identified items in the disclosure schedule, and the limitations included in the indemnification section. This strict liability reflects that the seller's representations and indemnification serve to allocate the economic risks between the parties. As discussed below, representations and warranties insurance (RWI) has become an increasingly common mechanism for transferring some or all of these economic risks to a third-party insurer, which can significantly benefit both buyers and sellers in negotiating the representations and warranties, scope, and other terms of the seller's corresponding indemnification obligations.

In addition to indemnification for a breach of a representation, in some instances a buyer may seek an indemnification provision that reimburses it for losses in certain specified circumstances, whether or not the circumstances are covered by a representation. A known environmental problem, for example, may be the subject of such a straight indemnification provision. Assuming the parties are aware of the environmental problem (so there's no need for disclosure) and are intending to close regardless (so no walk right for the buyer is appropriate), a straight indemnification accomplishes the remaining function of allocating the risks between the buyer and the seller for the costs of the environmental problem.

Indemnification limitations

Some of the general indemnification limitations included in purchase agreements are as follows:

- **Time limit**. A time limit is specified for how long the representations survive the closing. This time limit is usually between one and two years after the closing, although it may not apply to all of the representations, some of which may have their own specified time limit while others may extend in perpetuity.

- **Deductible**. Generally, some specified minimum amount of losses by the buyer must be exceeded before the seller's indemnification obligation arises, again subject to certain representations being excluded from this limitation. In some cases, there are per claim minimums or per claim deductibles as well.

- **Cap**. Oftentimes, a maximum amount for which the seller is responsible is specified (as either a dollar amount or a percentage of the purchase price), with this cap likely being inapplicable to certain claims.

As noted below, the indemnification provisions related to breaches of representations and warranties will be impacted (or in some cases eliminated) if RWI is used.

Representations and warranties insurance

As stated above, negotiating the seller's representations and limitations on indemnification thereto is about the allocation of economic risks between buyer and seller. Representations and warranties insurance (RWI) transfers some or all of those economic risks to a third party. RWI has become a widely used tool in private company M&A transactions and is a popular product for both buyers and sellers. For buyers, RWI provides a means to shift certain unknown risks to a third-party insurer and, if any sellers have rolled over equity in the transaction, reduce the chance of a dispute with their ongoing partners (and, in some cases, ongoing management team). For sellers, RWI can result in reduced or even eliminated post-closing indemnification exposure for breaches of representations and warranties, as well as for pre-closing taxes owed by the company, thus potentially allowing the seller to achieve a clean exit at closing with minimal or no escrow or holdback requirements. In turn, the insurer will typically require that a detailed diligence process is undertaken and known risks identified during due diligence will generally be excluded from coverage under the RWI policy.

Items that are generally excluded from a RWI policy include purchase price adjustments, fines and penalties, asbestos or PCBs, and PPP loan matters. Since the cost of a RWI policy involves certain underwriting fees and a premium usually around 2.5-3.5% of the insured amount with retention (which is like a deductible) roughly around 0.5-1.0% of the deal value, obtaining a RWI policy generally makes sense economically for a deal value that is higher than US$25 million - although in certain circumstances it may be used in smaller deals. In terms of survival periods under the RWI policy, general representations in the purchase agreement are usually for around three years and fundamental representations, as well as coverage for pre-closing taxes owed by the company, are usually around six years.

Certain buyers are very comfortable using RWI while other buyers are not. Generally, the proposition for buyers is that they don’t practically lose any significant protection (as compared to a standard indemnity from the sellers for representation and warranty breaches) as a result of using RWI, and some buyers may require the sellers to pay for some or all of the premiums and other fees, costs, and expenses associated with the RWI policy. Because RWI will not cover known risks identified in diligence, even if the buyer intends to obtain RWI for the transaction, the seller should still address those issues early in the transaction when they may have more negotiating leverage. Doing so will help to avoid a scenario where an issue is uncovered late in the transaction causing the buyer to require indemnification (and new or increased escrow or holdback) for that issue on a dollar-for-dollar basis that will not be covered by the RWI policy. Practically, RWI tends to provide a good solution for both parties in situations where the target business has good accounting, finance, and compliance functions. In situations where that isn’t the case, the chances of a cleaner exit for the seller are lower and, to the extent the seller is paying for some or all of the premiums and other costs of the RWI policy, the potential cost to the seller may exceed the practical value the seller receives in the deal from the buyer having such coverage.

Escrow or holdback

In many sales of private companies, the buyer will seek to have a portion of the seller’s cash proceeds held in escrow after the closing, unless the buyer has obtained a representations and warranties insurance (RWI) policy, in which case the escrow may be reduced or eliminated entirely or limited to an escrow for certain purchase price adjustment payments. Where an escrow is required, it acts as a fund to secure the seller's indemnification and payment obligations. Absent RWI, the amount of this escrow often will be in the range of 5%–15% of the total purchase price, although larger escrows are not uncommon. The size of an escrow is often heavily negotiated and will depend on numerous factors including the size of the deal, the buyer's comfort with its due diligence, the availability of RWI, and the magnitude of potential liabilities. The escrow sometimes will be held for the time period for which most of the representations survive, although it sometimes expires at an earlier time.

Sellers often worry that an escrow may permit the buyer access to the escrow funds when it would not otherwise be entitled to indemnification. That should not be the case, however, if the escrow agreement is prepared correctly. Instead, the escrow would merely serve as security to the buyer that the money would be available if it has an indemnification claim. An escrow account also limits the need for a buyer to track down a seller after closing to secure an indemnification claim. The seller does, however, lose use of its funds while they are in escrow, and the seller is therefore usually entitled to the interest on the escrowed funds.

In some transactions (perhaps to avoid any complications from an escrow), the parties will agree to a holdback where part of the purchase price is retained by the buyer for a specified period of time, during which the buyer is entitled to set off its indemnification claims against the funds being held back. In the case of a holdback, a seller should be assured that the buyer has the financial ability to pay the holdback when due and that the holdback payment will not be subordinated to repayment of the buyer's lender. Also, as discussed in Chapter 5, if the seller is receiving deferred payments (for example, in the form of a promissory note for part of the purchase price), these deferred payments can serve the function of an escrow or holdback if the buyer has the right to set off against the deferred payments.

CHAPTER 9

The Closing and Beyond

The Closing

You and your advisory team will have worked very hard to reach this stage. The closing of the sale of your company will be the culmination of the entire sale process. Like other aspects of the transaction, each deal is unique and so is every closing. In every case, however, there should be a closing checklist, normally prepared by the buyer's counsel, which will set out the various steps and documents required for closing.

Historically, all parties—the seller, the buyer, and their respective lawyers—gathered in a conference room at the offices of either the buyer's or the seller's law firm. Which law firm would host the closing tended to be a negotiated issue, as the hosting party was often viewed as having a home court advantage. Although face-to-face closings still occur, they are significantly less common. Virtual closings now are very frequently conducted via video conferencing, telephone, and email.

In a perfect world, every transaction document would be fully negotiated and final before the closing, and the closing—whether face-to-face or virtual—would simply involve the parties executing the various documents, with the buyer paying the purchase price to the seller and the seller handing over the business to the buyer. Closings do not take place in a perfect world, of course, so last-minute items, expected or unexpected, almost always occur. It may be a third-party consent that has not yet come in, additional due diligence questions from the buyer's investors or lenders, or deal points that are introduced late in the game. Such issues will have to be addressed and negotiated at or right before the closing, and although this can sometimes be very frustrating and taxing, especially at the end of a long sale process, you and your advisory team should be prepared to handle them in a productive manner while continuing to protect your interests.

Beyond the closing

After your company is sold, you probably will want to take a vacation and start enjoying your sale proceeds. Aside from that, though, you will continue to have a connection with the company for several reasons. First, of course, will be your historical ties to the company and its employees. You also may have decided to continue your investment in or your employment with the company. Second will be your obligation, as described in Chapter 8, to indemnify the buyer after the closing for any breach of the seller's representations or similar indemnification obligations. Even in the absence of express representations or indemnification rights, a buyer may have recourse against a seller under various federal and state laws.

In addition, most transactions have one or more purchase price adjustments that occur after the closing. A working capital adjustment, discussed in Chapter 5, generally happens within several months after the closing. Other purchase price adjustments, such as an earnout, may not be determined for many months or even years after the closing.

Related to your indemnification obligation (and perhaps related to the working capital adjustment), part of your sale proceeds may be placed in escrow as described in Chapter 8. The administration of this escrow account, which may include receiving periodic payments of interest or earnings on the escrow account, will be another item to address after the closing. The most critical aspect about the escrow, of course, will be the distribution of the escrow funds, ideally to you in the full amount or near full amount of the funds placed in the escrow account. The distribution of the escrow funds will depend on what indemnification claims the buyer makes during the escrow period and how these claims are resolved. Also, although indemnification claims are more likely to be made during the escrow period, as a seller you likely will continue to have indemnification obligations for claims after this time, at least with respect to certain representations.

In each of the post-closing situations above, you should seek legal counsel and perhaps advice from other members of your advisory team as soon as a claim or issue arises or in some cases in anticipation of a claim.

Subject to navigating these post-closing issues and complying with any non-compete agreement, we hope you are now in a position to enjoy your well-earned sale proceeds in a way that is the most satisfying and rewarding to you. Even if you have a clear view of how you intend to use them, we suggest that you rely on your advisory team to assist you in considering some of the various issues that may arise in connection with your receipt of the proceeds. For example, your advisory team can advise on various alternatives for trust and estate, tax, and investment planning that may be advantageous. Most importantly, enjoy the rewards from your sale—you earned them!

APPENDIX

Sample Transaction Timeline

The following is a simplified timeline, which generally summarizes the timing of the major milestones you will encounter in the sale of your business. To illustrate the timing, the decision to consider a sale is assumed to be made on January 1 with the other milestones occurring during that calendar year. Of course, the timing of a particular transaction will be highly dependent on the facts and circumstances of that particular transaction and may move faster or slower than the sample below. For example, completion of audited financial statements may be critical, especially for a transaction either beginning or ending near year end, and the schedule may need to be adjusted to allow time for completion of the audited financial statements.

January 1	Decide to sell your company.
January 15	Assemble an advisory team.
January 16–February 28	Prepare your company for sale (determine a range of values for your business, prepare package of information for potential buyers to review, determine the means by which to keep the sale confidential, clean up business records, address corporate housekeeping issues in preparation for due diligence review, and begin assembling a data room).
March 1–April 15	Determine customized sale process and approach potential qualified buyers. Data room available for due diligence.
April 16–May 15	Select qualified buyer, negotiate preliminary business terms and sign the negotiated letter of intent.
April 16–Signing	Continue due diligence.
May 15–June 30	Draft and negotiate purchase agreement (including disclosure schedules) and other necessary contracts (e.g., employment or consulting agreements).
June 30	Signing of purchase agreement.
Closing	Closing may occur simultaneously with signing of the purchase agreement (often referred to as a simultaneous sign and close deal) or at a later time if, for example, necessary financing, regulatory approvals or third-party consents cannot be obtained prior to execution (often referred to as a staggered or bifurcated sign and close deal).