

ROBERT G. HUTGCHINS – LEGAL ESSAYS

Selling Private Companies – Part I - How to Prepare

Preliminary Note

Nothing in the history of a private company is more likely to provoke heated argument among its owners than a proposal to sell it. Wealth accumulated during a working lifetime is often at stake, family planning is impacted and jobs are on the line. Because of this, many companies cannot be put in play until extended discussion has produced a working consensus among the owners that selling out is timely and appropriate. Other companies are propelled into the marketplace without protracted debate by unforeseen events covering the spectrum of triumph and tragedy. On rare occasions owners sell their companies as the final phase of a carefully planned business career.

Regardless of the motivation for it, devising and implementing a sale strategy will be difficult and unprecedented for most owners. Uncertainty or disagreement among the owners about the strengths and weaknesses of their company can frustrate a cohesive sale presentation. Inconsistent owner objectives may emerge for tax treatment, the target price, the merits of a given purchase offer and the timing of a closing.

To avoid impasse, owners engaged in a sale effort must occasionally accept constraints they did not anticipate when they acquired their interests in the company. They also must recognize that gaining consensus for the proposition that a sale is appropriate is not enough. The skills necessary to sell a company for maximum profit and with a minimum of post-closing risk are not acquired merely by owning the company or managing it. Yet, many owners believe their general experience equips them for the sale process. That belief is invariably subjective. If it is also wrong, it will blind the owners to their need for help in determining the market value of the company, identifying and screening likely buyers, devising an appropriate sale structure, conducting the negotiations and concluding an acquisition contract that permits full realization of the negotiated price.

The primary requisite for developing an appropriate strategy is a clear appreciation of the fact that the sale process favored in the United States, Canada and most European countries follows a stylized and predictable course once initiated. A preliminary solicitation using a company brochure is followed, at varying

intervals, by a proposed Letter of Intent, one or more "due diligence" investigations, the negotiation and execution of a detailed acquisition contract and a closing.¹

This Essay summarizes measures I believe can create an effective sale strategy for larger private companies with multiple owners. Because of its focus upon meticulous preparation and marketplace dynamics, however, the summary should also be useful to proprietors and owners of smaller concerns.

Insuring Stability during the Sale Process

The first objective is to insure that company operations remain stable while a strategy is devised, buyers are solicited and the sale is negotiated and closed. From the beginning, the owners must be conscious of the time period and context in which these events will occur.

The Time Period: When the owners themselves initiate the process, it can require a full year to sell a private company for the optimum price and on the optimum terms reasonably available. By definition, the company's securities are not traded in any recognized market. The company does not file financial statements or narrative reports respecting its business with any agency. Promotional websites notwithstanding, there are no public sources of meaningful information about the company itself, even though information may be widely distributed about the company's products. Accordingly, any sale will be preceded by a potentially lengthy period devoted to the identification and education of buyers.

The Context: The initial planning will be shrouded in secrecy, but word of a possible sale will spread inevitably, no matter how carefully the owners attempt to control information. Rumors will begin to circulate that can cause unsettling side effects. Nothing can be done about this phenomenon other than to prepare for it and to agree in advance upon the company's response. When valid questions are raised, there should be a prompt and forthright admission that the owners are considering a sale. Simultaneously, persons with an interest in the company should be assured, whenever it is the case, that no sale will be consummated that would involve abandonment by the company of commitments to its customers, employees and community.

¹ The process is quite different in Islamic countries, Latin America and Asia where business transactions are concluded primarily on the basis of personal relationships. The phrase "due diligence" derives from the United States Securities Laws which provide a defense against certain investor lawsuits for persons who exhibit diligence when attempting to verify the accuracy of offering materials. The phrase has been expanded to include a comprehensive, pre-closing investigation undertaken by a buyer to confirm its expectations about a target company. Due diligence investigations or "reviews" have become a fixture of merger and acquisition practice in the United States. Preparing for them is a major part of the selling effort for private company owners.

On the other hand, rampant speculation about the price, the terms of sale, the closing date, the identity of the buyer and the fate of specific employees can be fatal to a transaction. Unauthorized disclosure of information about those subjects should be suppressed ruthlessly. When all underlying issues have been resolved, the owners and the buyer can usually agree upon an appropriate announcement to employees, the trade and the public that a sale will be consummated.²

Consider a Voting Control Agreement: Charter documents and internal buy-sell agreements rarely provide effectively for a sale of the entire business enterprise conducted by a private company. Instead, they are confined to sales or testamentary transfers of securities representing fractional interests in the company itself. They preserve, by default, the unwieldy approval mechanisms for a merger or sale of substantially all the assets of the company that are contained in the governing statutes. Owners confronted by this situation can benefit from an anticipatory Voting Control Agreement if they have determined that a present sale is appropriate in principle, subject to the fairness of the price and terms. When executed in an early atmosphere of relative calm, Voting Control Agreements can put to rest basic issues that could prove divisive with a closing at hand.

These agreements typically expire on the earlier of a fixed date (such as the first anniversary of their execution) or the closing. They obligate participating owners to vote their company securities *in favor* of sale proposals meeting elementary criteria (e.g. a minimum net price) and to vote them *against* eleventh hour attempts by unhappy or disillusioned minority owners to negate the criteria by indirect means (such as transfers of company securities to persons not party to the agreement, or the issuance of new securities with superior voting rights). Courts give these agreements wide latitude. If used, the agreements should be executed before buyers are solicited.³

Review Executive Employment Contracts: The sale of a company occasionally depends upon commitments from key personnel to remain with the company for a protracted period after the closing. That introduces a special dynamic and a management constituency, to the sale process.

² See this Website, Publications, Essays, *Letters of Intent In Business Acquisitions. Problems, Risks and a Mechanical Solution.*

³ Majority owners of a private company must provide full disclosure and accord fair dealing to minority interests. In addition, a statutory "dissenter's right" to force a judicial determination of the value of their interests may be asserted by corporate shareholders who object to a sale price as inadequate. These subjects may be addressed in a future Essay. This one is confined to recurring issues raised by consensual sales. It assumes, in keeping with the vast majority of actual transactions, that all owners will be fully informed and that the inevitable policy differences between them will be resolved by candid discussion. Voting Control Agreements provide a framework for such discussions.

Formal employment contracts with key managers should be signed (or amended) in light of the pending sale effort. The contracts should have a long enough term to align them with the special business plan discussed below. Early retirement benefits or severance compensation should be provided for managers who will not be retained. (In the absence of compelling circumstances, this is no time to discourage or terminate them.) The rest should be offered immediate incentives tied to improvements in the company's income statement (e.g. salary increases and cash bonuses), or mid-term incentives tied to improvements in the company's balance sheet (e.g. redeemable equity appreciation units). Managers should *not* be offered incentives tied to the sale itself unless the arrangements are reviewed by counsel for compliance with statutes governing the offer and sale of securities and the registration of selling agents, business brokers or "finders."

Adopt a Special Business Plan: When the sale process begins, the company will usually be committed to strategic business objectives requiring substantial investments of time and money. These objectives should be reviewed methodically to identify possible conflicts with the sale effort and in recognition of the fact that the buyer may revise or even abandon them. The owners should create a one or two-year provisional business plan that ignores the possibility of a sale and assumes the company will operate with only its existing sources of capital (e.g. unexpired credit lines, committed equity contributions and internally generated cash). The plan should contain specific responses to catastrophe. It should assume, literally, that a plane has just crashed with all owners and senior managers on board. What exactly should be done by heirs and replacement managers for the first week, the first six months, etc?

Formal stabilization plans free the owners from distractions. They also marshal resources and create a blueprint for conservative, relatively risk-free operations that can survive the tumultuous aftermath of an aggressive marketing of the company that fails to produce a closing. Offering a company for sale can weaken relationships between owners and with customers and suppliers. The sale process can panic employees, energize competitors and acquire a momentum that imposes enormous pressure on unprepared owners to accept a bad bargain. A well-conceived stabilization plan builds confidence, strengthens resolve and places the marketing effort on a sound footing. The greatest negotiating strength of all owners is the inner conviction that they need not sell.

Establishing the Market Value of the Company

Consider a Formal Valuation Opinion: Prior to engaging brokers and starting the marketing effort, owners usually test their perception of the value of the whole company and any independent value associated with a major division or subsidiary, by discussing the subject informally with business and professional acquaintances. The results will be inconclusive. Private companies are sold infrequently in transactions that are not widely reported. Estimating the value of a given private company involves difficult comparisons with other companies both public and private. All owners can identify an asking price and support it with a

rationale gleaned from friends, other business sellers, a publication or a seminar. In my experience, that does not prepare the owners for the marketplace. I recommend that, unless their company is very small, owners obtain formal valuation opinions from qualified experts. If controversy exists between owners about an acceptable price, such opinions are essential.

Business brokers compile case summaries of their own transactions. Through networks they receive anecdotal but relevant information about a variety of other transactions both completed and aborted. Experienced brokers can make practical valuation assessments useful to owners when they are engaged as consultants. It should be remembered, however, that when brokers are engaged to produce buyers, their commissions depend upon closings, not maximum price levels or accurate valuation opinions.

Accountants, registered investment advisers and other financial experts develop a comprehensive grasp of the technical side of the valuation process. Their measurements of balance sheet risks and future cash flows discipline the effort to place the company in its industry and compare it with its peers. Their analysis of the pricing mechanism proposed by a buyer and their recommendations for the owner's response will be extremely valuable during negotiations. Virtually all financial experts offer valuation opinions.

In my view, however, the most reliable valuation advice will be provided by an investment banking firm familiar with the company's industry. Investment bankers make their living in the trenches. Time and again they subject their own capital, and the capital of their investors, to the risk that their valuations are wrong. They survive by avoiding catastrophic or repeated error and they flourish only when they are consistently accurate. When acting as consultants, successful investment bankers bring to bear a combination of technical competence and marketplace realism that I have been unable to find anywhere else.

Calculate the existing "investment" in the company: As part of the valuation process, the owners should commission a baseline calculation of their existing "investment" in the company. A return on that investment, measured by net profits of the company (restated to eliminate distortions created by owner compensation) can then be compared with the probable return on marketable securities purchased with net sale proceeds at hypothetical price levels. The comparison will help quantify the financial advisability of putting the company on the market.

The baseline calculation will not be derived from cost figures, market data or books of account. Owners of private companies have often paid little for their interests, or have acquired them by inheritance. Relatively few have an "investment" measurable entirely in money and in any case their interests have not been traded in an active market. The book value of a private company is a meaningless accounting construction in the sale context, having no correlation with market value. I believe the assumed value of the aggregate owners' investment should be equal to the

liquidation value of the company. Significant company real estate should be appraised by experts qualified in that field after a "Phase I" study respecting hazardous substances has been completed. Separate appraisals should also be obtained from auction houses or industry specialists for the company's production equipment and other *tangible* assets. Intangible assets such as goodwill should be valued at \$1 unless the company has established a brand identity that is likely to be attractive to buyers as a discrete asset. In that event, valuation experts should be engaged specifically to estimate the market value of the brand.

An informed and appropriately conservative assessment can then be made of the money that could be raised if the company were liquidated, its assets sold, its debts paid and its cash receivables collected. I am not suggesting here that the resulting number would reflect a desirable sale price for the company as a going concern. I mean merely that the liquidation value of the company's assets is an appropriate benchmark for establishing the "investment" of the owners in the company itself. The company can always be liquidated. For owners developing a sale strategy, the relevant question is whether they would achieve any greater return by retaining it or selling it as a going concern.

Anticipate the Buyer's Natural Obsession with Risk: All business activity is associated with inherent risk. Buyers, however, do not accept that concept with stoicism. During negotiations, they will exhibit an extraordinary preoccupation with the specific financial and business risks associated with the company. Unusual customer or credit concentration, undercapitalization, excessive leverage, dependence upon key personnel, the lack of a proprietary technology and the presence or threat of intense competition are all risks common to private enterprises. Buyers' apprehensions about them in the context of a given sale will be heightened by their lack of familiarity with the company.

Buyers may demand a substantial "discount" from the asking price to compensate them for accepting risk. To hedge further, the buyers may try to impose onerous representations, warranties, indemnification provisions and post-closing price reduction, offset or earn-out mechanisms upon the owners. The cumulative effect of these demands can convert the owners from sellers to insurers. To respond effectively, the owners must avoid any suggestion that they are complacent about risk. They should identify specific practical responses to manageable risk which could be implemented by the buyer with the resources of the company, then articulate them during the negotiations. The best opportunity to prepare those responses arises while the owners are completing their internal assessment of the value of their company.

The importance of establishing the probable enterprise value of the company by objective means before commencing the sale effort *cannot* be overstated. Uninformed owners are no match for the sophisticated buyers they will encounter. They must arm themselves before entering the arena.

Planning and implementing The Sale Effort:

Establish a Budget: Selecting potential buyers and presenting the company to them can require extraordinary time and effort. Owners may spend significant sums investigating whether a sale is feasible without any assurance of a closing. The company will assign key executives to the project thus diverting them from their normal activities and subjecting the owners to the risk of lost business opportunities and reduced operating efficiency. Owners sometimes have wildly inaccurate notions about the fees of advisers and little understanding of how fees can be controlled through careful planning. A formal project budget should be established after consultation with outside advisers about their anticipated fees. Most advisers welcome the opportunity to define responsibilities, identify time requirements and establish a working budget in advance.⁴

Delegate Authority: The sale process requires strict management of people and information. The owners should form a committee of no more than three to oversee it. The committee should have authority to engage finders or brokers, outside attorneys, financial advisors and other experts. It should be directed to report to the owners regularly in writing. While the committee cannot commit the owners to any transaction without separate approval, it should be delegated *exclusive* authority to control the sale effort.

Identify Non-Price Considerations: The owners should identify at the beginning all non-price considerations potentially impacting the sale:

- What are the owners' attitudes about employees, the community and the environment? How, if at all, should these attitudes impact the selection of appropriate buyers for the company?
- What are the major *post-closing* issues that will confront the owners? What commitments, for example, have the owners made to executives or employees of the company that are not reflected in formal contracts or benefit plans? A buyer is not likely to assume or even to know about such arrangements in the ordinary course of events.
- Is the timing of the sale consistent with realization of the company's immediate strategic objectives? Should a sale effort be launched that might frustrate those objectives?

⁴ Commission payments due brokers are contingent and thus funded by the sale price. Their impact can be taken into account when the adequacy of the price is considered. The company's internal budget, on the other hand, is a relatively fixed investment that will be lost entirely if no sale closes. An adequate budget is essential if the owners are serious about selling at an optimum price.

Non-price considerations can loom large as a closing approaches. The common perception that if the price is high enough owners are interested in little else is not unfailingly accurate.

Identify a Buyer Profile: The owners should identify possible buyers in light of the unique attributes of the company:

- What is the strategic fit associated with suppliers, customers and competitors, the buyers most likely to grasp the potential of the company? Is there an inherent acquisition bonus for any of these buyers that might overcome their natural reluctance to pay a full price?
- Are the potential buyers publicly or privately held? What are their financial, technological, productive and management talents and resources?
- Should the sale be conducted as an auction or on a negotiated basis?⁵

Analyze Structural Alternatives Promptly: With the assistance of accountants and counsel, the owners should identify tax and structural alternatives and their financial consequences *before* engaging brokers or commencing negotiations. For example:

- Should stock be sold or only assets?
- Should the price be paid all in cash or in installments?
- What are the quantifiable financial advantages of transactions involving an exchange of marketable securities of the buyer for the securities or assets of the company? Could the owners accept "restricted" securities of a buyer that cannot be traded in public markets for as long as two years after the closing?
- What are the tax implications associated with potentially excluded or unwanted assets? Can such assets (e.g., company real estate) be held for later disposition after they are "split-off," or "spun-off" from the company to the present owners?

Compare Several Brokers/Finders before Engaging One: The owners should interview several brokerage or merchant banking firms. They should ask for references and summaries of completed transactions. Like all of us, brokers possess a wide range of experiences, interests, networks and talents. In the absence of extraordinary circumstances, the engagement of a competent business broker will be

⁵ See this Website, Publications, Essays, *Selling Private Companies - The Case For An Auction*.

essential to a successful sale. The investigation should be thorough, however, because the owners will not have a realistic chance of correcting a mistake after an engagement has been entered. The owners should designate a lead broker if more than one is to be used. The brokers themselves may be unable to agree upon a leader.

The engagement should specify the extent of the negotiating authority, if any, granted to the broker, the representations that the broker can make (or is precluded from making) about the company and the buyers or class of buyers the broker is authorized to contact. Controlling written and verbal communications during the sale process is an extremely difficult but important task. The subject should be addressed prominently in the broker's contract.⁶

The commission structure should be negotiated in detail. If the sale contract requires that the owners be paid in installments, the broker should be paid in like installments. If the broker will engage third parties, the means by which those parties will be compensated should be understood in advance. If the owners are to receive consideration other than money, the impact of that fact upon the compensation of the broker should be addressed specifically. If the terms of the sale agreement involve an escrow of part of the purchase price as an indemnification fund, proportionate broker's compensation should be escrowed as well. If there are post-closing earn-out, purchase price reduction, or other formulas requiring a lapse of time before their impact is felt, the broker's compensation should be proportionately and commensurately delayed and adjusted.

Prepare Thoroughly for Due Diligence Investigations: Ideally, the company should conduct an internal audit and corporate clean up before drafting its brochure. In any case the clean up should be completed before negotiations with buyers prompt due diligence investigations. These investigations are not cursory and their disruptive impact can be serious. The owners should insist that a due diligence agreement be signed that will set out the permitted areas of buyer inquiry. The agreement can identify the personnel of the company and of the buyer to be assigned to the investigation, the times and places at which the investigation will be conducted and the employees the buyer will be permitted to interview during working hours.

Relatively few negotiations lead to final sales. The due diligence agreement should obligate the buyer to hold acquired proprietary information in confidence. Sales brochures and other written materials should be packaged, marked "Confidential" where appropriate and numbered. A log should be prepared of the

⁶ The broker will want to prepare a company brochure for distribution to potential buyers. Unless restrained contractually, buyers may exploit or disseminate all financial and other information contained in that brochure. Buyers will usually expect the owners to warrant the accuracy of the brochure in any purchase agreement. Accordingly, a brochure should never be used until it has been reviewed by the owners' accountants and counsel.

persons to whom those materials will be shown. Dated and signed receipts should be obtained from them. The agreement should obligate each recipient to return all materials to the company after they have served their purpose.

Anticipate Regulatory Issues and Third-Party Consents: The owners should identify regulatory, lender, landlord and other approvals that will be necessary to consummate a sale. The approval process will affect the timing of the closing. Among the regulatory approvals that may be necessary are those associated with the Hart-Scott-Rodino Antitrust Improvements Act. The Act covers companies above a threshold size (\$100 million or more in assets or gross sales) that acquire operating assets, business divisions or other companies for a price of \$15 million or more. The underlying transaction must be reported to the antitrust division of the Justice Department and to the Federal Trade Commission at least 30 days in advance of closing. If the transaction is reviewed for its competitive impact, the waiting period will be extended. Authorities can block anti-competitive transactions.

The company's loan agreements will inevitably contain covenants requiring the lender's consent to the closing of any significant financial transaction with third parties, to say nothing of a sale of the entire company. Real estate and personal property leases uniformly require landlord or lessor consent, even if the transaction is structured as a sale of securities.

Plan for Excluded Assets and Retained Liabilities: In most significant acquisitions, there will be miscellaneous assets and liabilities of the company that the buyer will not be willing to acquire or assume. After the company sells its business assets to the buyer, it will cease operations, pay its debts, conclude its other affairs and liquidate as a corporation, partnership or other statutory entity. Final tax returns will then be filed for it and unsold assets will be distributed ratably to its owners for ultimate disposition by them. If the transaction is structured as a sale of securities the same result will be achieved, but the distribution to owners will precede rather than follow the closing. In either case, there will be a number of post-closing issues and their resolution can consume an extraordinary amount of time.

Among the most vexing post-closing liabilities are those arising from informal promises to employees for such things as "life-time" medical benefits and special retirement enhancements. These inducements, often provided haphazardly, create enforceable obligations that cannot be extinguished for years after a closing. Environmental regulations often impose post-closing liability for contaminated real estate that can extend, literally, forever. The cost of special insurance is high.

Preparing For Negotiations

Many people who have engineered a closing once or twice think of themselves as consummate negotiators. Ego plays a large role here, fed by the notion that successful negotiating requires extraordinary insight and nerves of steel. Whatever may be said for those attributes, I think success depends primarily upon a methodical identification and clear understanding of objectives:

Appoint a Negotiating Team: Assemble a negotiating team headed by a majority owner or senior executive of the company. Often the team is simply a continuation or extension of the original sale committee. Other teams are comprised of persons assembled formally only after a specific transaction is at hand. A typical team will include the chief financial officer for the company, a lawyer, an outside accountant and an investment advisor. There should be no more than one spokesperson. Procedures should be established through which that person will report to the buyer, to the team and to all owners. The means by which the final acquisition contract is to be approved will be governed by the organic documents of the company, or by the special Voting Control Agreement recommended above. In any case, the negotiating strategy should not be devised at a town meeting or implemented by a committee of the whole.

Identify Negotiating Goals In Advance: Identify, *before negotiations begin*, the minimum acceptable financial and structural terms for the sale. Adhere to those terms in the absence of new facts virtually mandating a revision of them. Emotions run rampant in the negotiation process. Initial disagreements over relatively minor points can escalate into destructive contests of will. A clear understanding of fundamental objectives will keep the negotiations on course.

Engage Legal Counsel and Other Experts First: Engage counsel, accountants and other needed experts *before* engaging brokers, or starting negotiations with potential buyers. The role of the experts is to identify, organize and resolve technical issues, shepherd the transaction through the regulatory process, keep it out of trouble and get it closed. Few things are more frustrating for them, or costly for their clients, than being engaged for a pending sale only after the clients have committed themselves to an untenable tax position, to representations or warranties they cannot satisfy, or to an acquisition contract denying them the capacity to manage risk. I acknowledge the self-serving element in that statement, but the tax, regulatory, structural and contractual analyses associated with a significant business acquisition are too formidable and too critical to be deferred.

Investigate the Buyer: Even if the transaction involves a cash price, the background, financial resources and sophistication of the buyer are important and must be investigated thoroughly. It is astonishing to me how often this common sense precaution is ignored. Owners should be particularly wary of accepting at face value the assertion by a well-known buyer that "of course" the cash price will be paid at closing and there is no need for contractual protection on that score. The owners will invest substantial time and money and will forego other sale opportunities, to pursue a closing. If the closing payment is not made, the owners will retain their company, but that will not console them if their investment in the transaction is lost. Many large buyers close acquisitions as a matter of course through undercapitalized and newly formed subsidiaries. They do not guarantee the obligations of those subsidiaries voluntarily.

In an installment transaction, the owners will extend credit to the buyer equal to the deferred portion of the purchase price (including assumed pre-closing

debt), plus operating capital. The scope of the owner's investigation of the buyer, the buyer's contract warranties to the owner, the guaranties to be provided by the buyer's corporate group and the owner's collateral, all should be commensurate with the owner's risk.

In an earn-out transaction, the owners are making an equity investment in the company as constituted after the closing. To the extent of the earn-out portion of the purchase price, the owners assume the full spectrum of investment risk. They should insist upon full disclosure by the buyer of all material facts known to it that will affect post-closing operations of the company, including the buyer's strategic plan for the company during the earn-out period.

Understand the Impact of Momentum: As negotiations progress, the real possibilities of a final deal will become apparent. Pressures upon owners to close can be very great. Experienced buyers are aware of this phenomenon and will often delay making demands they know to be unreasonable until the last minute. In their anxiety to close, the owners may make concessions they will regret profoundly.

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