

## ROBERT G. HUTCHINS – LEGAL ESSAYS

### Selling Private Companies – Part II - The Case for an Auction

---

---

#### Preliminary Note

The sale of a private company can be a hit-or-miss affair. Few people outside the company know much about it. When owners initiate the sale, prospective buyers must first be identified, often on the basis of sketchy data, then solicited aggressively. Those who respond must be permitted to investigate the company thoroughly before the owners can determine the optimum terms on which a sale might be feasible. The investigations can be both extraordinarily time consuming and ultimately fruitless. If serious buyers do emerge, they will invariably demand the right to negotiate the final price and terms of sale on an exclusive basis. Thus before a sale is assured, the owners must select one leading candidate and suspend or terminate discussions with all the others. The owners will thus relinquish bidding competition at the time when they most need it.

Certainly, the advantage to the owners of competition between buyers is both obvious and well recognized, at least as an abstract principle. Investment bankers, business brokers and law firms acting for private sellers routinely try to encourage competition by creating an auction-like atmosphere for the transaction. In my view, however, these efforts rarely pursue the auction concept to its logical and most effective conclusion.

In the typical model financial, technical, contractual and other sensitive information about the offered company is disclosed in confidence to selected prospects. The prospects are encouraged to submit responsive but non-binding indications of a preferred sale structure and a tentative price or price range. The owners and their advisers progressively discard the least attractive responses until the most promising candidate is identified. Final negotiations are then pursued exclusively with that candidate until the transaction either closes or is abandoned. While a closing is usually treated as proof of a successful transaction, it provides no assurance to the owners that the optimum price was obtained. All bidding competition was eliminated before *any* price became binding. An abandoned transaction is, of course, disastrous for all parties.

This Essay examines the utility for private companies of a formal contractual auction in which, after a period of fact-finding open to all interested parties, the company is sold to a buyer that has submitted the highest bid above a pre-set minimum. This strategy, though unusual, can often produce significantly better results than traditional sale methods.

## Commonplace Auctions – Tangible Property and Public Companies

A formal auction conducted under established procedures has familiar and reassuring characteristics. It reaches a wide audience because it is announced to the general public. Known buyers receive personal invitations. Licensed auction houses are bonded and their activities are regulated to insure fair dealing. Information permitting an assessment of the auctioned property is provided to all participants who may submit responsive bids under uniform rules. The sale will be closed on a specified day, at a specified time and place. Clear title will pass to the person submitting the highest qualified bid and effective remedies exist for abuse of the underlying process.

The integrity of formal auctions produces competitive bidding, an essential condition for the full realization of potential value. Whether the property to be sold is a work of art, a thoroughbred horse, or a rare coin, an auction provides assurance that the price paid will be the highest that reasonably could be anticipated in the relevant market on the day of closing, the optimum attainable price.<sup>1</sup>

When directors seek shareholder approval of a plan to sell the assets of a publicly held company, or when a tender offer is made to holders to acquire the company itself, a de facto auction results automatically. A trading market already exists for the securities of the company. Proxy solicitations and tender offers are disclosed in regulatory filings and announced in the business press. The public has access to the annual, quarterly and current reports of the company and these are comprehensive enough to permit an informed valuation. Until binding contracts are approved, any party may submit an acquisition proposal under notice and procedural rules adopted by the Securities and Exchange Commission. The party offering the highest price can expect to acquire the assets or the controlling securities of the company. Though ultimately it may find itself acting alone, the exposure to competing bids prompts a would-be acquirer to price its offer as though an auction actually were taking place.

### The Dilemma of the Private Company

Transactions in private companies are not reached by the custom and practice employed at Sotheby's, or by the proxy solicitation and tender offer rules imposed under the securities laws. Consensual sales of private companies occur in an environment too haphazard to constitute an *a priori* market. This does not matter to those owners who are not driven by the maximization of price or to owners confronted by an offer they wish to accept without further inquiry. Succession sales to family members, management buyouts, pre-arranged sales to affiliates, and sales

---

<sup>1</sup> Traditional auctions are conducted either with or without "reserve." In the first case, bids must exceed a minimum amount or the offered property will be withdrawn. In the second, the highest bid will be accepted without qualification. In either case, a sale will close at the optimum attainable price.

initiated by buyers are concluded regularly by such owners and I do not address them here.

This inquiry concerns owners who are intent on selling their private company for the optimum attainable price and who must therefore cope directly with the absence of a ready market. These owners must *identify* prospective buyers before a *potential* market can be defined, then *solicit* them to determine whether an *effective* market actually exists. The structural framework for any ensuing transaction is rudimentary, shaped only by the general laws of property and of contract formation.

I believe that the element of competitive bidding inherent in a formal auction can be obtained *by contract* to help owners realize the optimum attainable price in voluntary sales of their private companies. I also believe that contractual auctions can be structured to encourage buyer participation, preserve negotiating flexibility and reduce transaction costs. This discussion begins with a review of current practice.

### **Typical Private Company Sale Strategies – Open-Ended Negotiations**

The sale strategies adopted most often when price is the dominant factor reflect the tenuous nature of the market for private companies. They vary to some extent with the attributes of the company, the views of the owners and the talents of their advisers. They evolve from internal preparations that identify strengths and weaknesses, analyze alternatives and position the company for the sale effort.

All of these strategies, however, share a common strategic theme, a negotiating tactic in which the owners try to withhold any indication of an asking price that is both realistic and firm until they have received the best preliminary offers likely to be made. The negotiations produced by that tactic are called "Open-Ended."

By definition, business owners pursuing Open-Ended negotiations have rejected an auction. Perhaps they are uncertain about the value bidders would place on their company. They fear that if their auction is "without reserve" the highest bid will be too low to produce a satisfactory price, but if it is "with reserve" the minimum bid level will be too high to attract the largest possible group of buyers. Perhaps a formal auction is simply too alien for them. Whatever may be their motivation, however, these owners believe they must contact prospective buyers individually and coax from them somehow reliable indications of a firm price. They take pains to avoid linear negotiations with one uncommitted buyer at a time because they realize that process is apt to be prohibitively expensive. They engage instead in simultaneous Open-Ended negotiations with all prospects divided into three roughly sequential phases.

During phase one, the owners try to stimulate broad interest with eye-catching highlight sheets, brochures or "tout books." These materials describe the company's product and geographic markets, summarize recent financial results and extol the benefits of a purchase. They are submitted in confidence, but make no

attempt to set forth all material facts for fear of disclosing too much, too soon. They are designed to encourage buyers, not to inform them.

When affirmative responses are received, the owners enter phase two and seek firm acquisition proposals at an acceptable price. They answer questions, provide limited additional information and try to stimulate bidding competition by letting it be known whenever it is the case (and sometimes when it is not) that more than one prospect is interested. They match each prospect against the others, tolerate the withdrawal of those who lose interest and eliminate those clearly not suitable. They anticipate a closing as a result of phase three, detailed negotiations for the highest price with those who remain.

### **The Problem**

Open-Ended negotiations do not produce reliable indications of price or meaningful bidding competition because no responsive proposal is firm. No one will be committed to *purchase* before signing a binding contract with an owner committed to *sell*. Owners cannot contract simultaneously with multiple buyers and they cannot contract at all without quoting a price.

Further, no contract at *any* price will be signed by a buyer unless it follows or is subject to a detailed investigation of the company completed to the buyer's satisfaction. An adverse investigation can prompt the reduction or outright withdrawal of the buyer's initial proposal and the abandonment without liability of any conditional promise to pay. Even if there are a number of prospects initially, a point is reached prior to the emergence of a reliable "deal" when, to continue at all, the owners must abandon their Open-Ended stance, indicate a firm price, and chose one prospect with whom to negotiate in earnest. That, as a practical matter, involves the deferment, and risks the ultimate termination, of negotiations with all other prospects.

Once the most promising candidate is identified, the ensuing documentation confirms the abandonment of bidding competition. Formal acquisition proposals are evidenced by an "Agreement in Principle," "Memorandum of Understanding" or "Letter of Intent." While these documents purport expressly to be non-binding as to their financial terms, they contain (or are delivered in a context that clearly imposes) "lock-up" provisions. The lock-up gives the prospective buyer the right to negotiate on an exclusive basis pending the completion of its investigation and the mutual approval of a final contract.<sup>2</sup>

The owners thus find themselves dealing exclusively with the single most promising suitor even though no one is bound. The owners have been propelled by events into the very circumstance they tried originally to avoid; one-on-one negotiations with an uncommitted buyer. Now, however, that buyer must be

---

<sup>2</sup> I have addressed the perils associated with letters of intent elsewhere. See, this Website, Publications, Essays, *Letters of Intent in Business Acquisitions - Problems, Risks and a Mechanical Solution*.

accommodated or the owners must resurrect discussions previously terminated with others, if they can, or launch the entire process again with their company decidedly shopworn.

It probably is not necessary to add that the final contract does not produce the optimum attainable price. It produces a price negotiated in depth with only one buyer that has emerged as an informal finalist from a group of original prospects. It reflects the highest offer made by that buyer, nothing more.<sup>3</sup>

We turn, then, from Open-Ended negotiations to an alternative resting upon a diametrically opposed bargaining tactic; a contractual auction in which owners agree, *prior to the time any bidder will be committed*, to accept the highest offered price that exceeds a minimum amount.

### **The Rationale for a Contractual Auction**

The rationale for the contractual auction of a private company can be stated simply:

To *maximize* the sale price, the owners must induce prospective buyers to compete for their company. Open-Ended negotiations produce Open-Ended results, not competition. Competition requires an auction. The New York Stock Exchange is an auction house for public companies. Private companies do not have an institutional equivalent and must provide a surrogate by contract.

To *validate* any amount received as the optimum attainable price, owners need a representative number of supporting bids, each reflecting independent investment discretion exercised on the basis of common ground rules and uniform data.

### **Implementing Documents**

The documents signed by auction participants must establish by contract the conditions associated with regulated auctions in the markets for art, antiques, precious metals, livestock and other commodities. The conditions are: (a) uniform rules for participation backed by effective remedies for abuse, (b) early disclosure to all interested parties of information permitting an informed valuation of the object of sale and (c) reasonable assurance that the highest qualified bid will be accepted. In a

---

<sup>3</sup> Nevertheless, owners who manage to close a sale at a price within range of their original expectations will claim success. When the expectations are consistent with valuation guidelines established within the relevant industry, or are based upon widely used analytical techniques, the claim has a surface plausibility. The thought seems not to occur, however, that the buyer merely followed the guidelines, or applied the techniques, and offered a conforming price. The real question is whether, confronted by bidding competition, the buyer would have paid more. My experience persuades me that in many instances the buyer would have paid much more.

contractual auction these conditions are introduced by the Invitation to Bid. They are made binding by Instructions to Bidders and responsive Bid Forms.<sup>4</sup>

The remaining documents consist of "Due Diligence" Investigation and Acquisition Contracts, a Disclosure Memorandum setting forth material facts and risks related to the company and its business and personalized letters of transmittal.

The Invitation to Bid is distributed to all desired prospects. It summarizes the information to be contained in the Disclosure Memorandum and identifies the basic terms, other than price, upon which the owners are prepared to consummate a sale. In that respect the Invitation resembles a short form "tout book" of the type commonly used to launch Open-Ended negotiations.

The Invitation also contains Instructions that describe the procedure to be followed. Acceptance and an agreement to participate are evidenced by a signed request to obtain the Disclosure Memorandum. The request form imposes an obligation on the bidder to follow the Instructions, and to hold all information received in confidence. The Disclosure Memorandum is accompanied by the text of the proposed contracts and the necessary Bid Forms.

The bidding is conducted in two phases. In phase one, non-binding preliminary bids are submitted against the Disclosure Memorandum but without an on-site investigation of the company. Any or all preliminary bids may be rejected arbitrarily by the owners. If all are rejected, the auction is terminated without further liability. If the auction continues, binding final bids are submitted after an investigation by those preliminary bidders invited to participate in phase two. To qualify, final bids must exceed a minimum amount established by the owners at the conclusion of phase one. For their part, the owners *must accept* the highest qualified final bid.

The power to shape the representations, warranties, closing conditions and post-closing remedies of the parties thus resides in the owners, an important advantage. On the other hand the Acquisition Contract, which in most cases will be largely non-negotiable, must be fair (and perceived as such) before meaningful bids will be submitted in response. This factor, however, is not threatening to the owners. Unless the other party is deprived of all bargaining power (in which case an exploitive contract might be voidable anyway), attempts to impose one sided contract terms tend to produce a loss of credibility and cause more harm than good. Such contracts rarely survive negotiations between well advised parties. The Disclosure Memorandum should include a forthright discussion of the known risks facing the company. The Acquisition Contract should warrant the truth of the owners' *factual* representations about the company while making it clear that the owners are not insurers of the buyer's post-closing success. If that is done, the documentary

---

<sup>4</sup> Duress sales managed as "auctions" by bankruptcy courts, levying government agencies, or judgment creditors establish these conditions, but their coercive nature stifles the realization of optimum prices and they are irrelevant for us.

package will lend credibility to the entire auction process without weakening the owners bargaining position.

In an unusually complex transaction, phase one bidders can be given an opportunity to comment upon the Acquisition Contract and to condition their advisory bids upon the owners' acceptance of revisions. The owners can take account of this when determining whether, at what minimum price and on what contractual terms to proceed to phase two. The final Acquisition Contract would contain those revisions acceptable to the owners. It would be distributed with the phase two invitations, but would not open to further modification. The salient point is that, even in this situation, the owners can control the sale process and maintain bidding competition.

### **Potential Detriments**

Despite its inherent advantages for owners intent on maximizing price, a contractual auction is rarely used and it must overcome several obstacles. These are identified below in underlined text. My response to them is set forth in Italics.

The auction must be "sold" as a concept to owners who are afraid they will lose negotiating flexibility if they commit in advance to accept the highest bid and who are also concerned that an auction may increase transaction costs. *For several reasons these fears are groundless: First, in any negotiation owners will lose flexibility as soon as they indicate a fixed price. That will occur prior to any closing regardless of the selling method. In an Open-Ended negotiation it occurs after bidding competition has already been eliminated as we have seen. Second, a contractual auction "with reserve" featuring a minimum bid level will protect owners against valuation discrepancies and unacceptably low prices. Third, for all but the most egotistical or naive, the competition between bidders inherent in an auction will compensate for the loss of any extraordinary negotiating skills possessed or claimed by the owners or their advisers.*

*Transaction costs will be substantially lower for an auction than for Open-Ended negotiations pursued to completion with the same number of initial prospects. The scale economies resulting from a single set of documents and a controlled disclosure and investigation process are very significant. Open-Ended negotiations can begin innocuously and inexpensively, but if a "deal" does not emerge quickly, they become a quagmire of duplicated effort, shifting positions, multiple investigations and numerous contract drafts, revised piecemeal. Satisfactory transactions require hard work. Auctions concentrate and organize the work effort avoiding makeshift strategies and expensive delays.*

The auction must be "sold" as a concept to buyers who fear competitive bidding, who are accustomed to direct negotiations and whose initial reaction to an auction is apt to be negative. *That merely shifts the focus of the owners from their negotiating prowess, real or imagined, to the clarity and substantive quality of their documentary package. A well-prepared set of documents will gain the confidence of buyers because the auction will be perceived as both fair and efficient. Sophisticated buyers will forego any theoretic advantage attributable to their own negotiating skills in exchange for a contract providing the means and*

*allowing the time for them to analyze an acquisition dispassionately and close it, if at all, at a price they are prepared to pay.*

The auction must strike an effective balance between the necessity of providing information to bidders and the imperative of controlling the unauthorized exploitation of proprietary data. The auction must also protect sensitive relationships with employees, lenders, customers and suppliers. This, of course, is a dilemma in any acquisition. In a contractual auction, each counterpart of the Disclosure Memorandum is numbered and dated. A receipt for it is signed by an agent of the recipient. The Memorandum becomes a permanent record of what has been revealed, when and to whom. Before receiving it, bidders must agree not to disclose or exploit confidential information without additional prior authority.

*The Memorandum can be reviewed by bidders in their own offices, thereby shielding employees of the company from an unsettling exposure to the sale process at least during phase one. Though final round bidders will have the right to conduct a hands-on investigation of the company, such investigations are indispensable and must be addressed by any sale strategy. In a contractual auction, the investigations will be conducted by a relatively small group of final prospects. Each of them will have submitted a preliminary bid at an acceptable level after taking the time to review the Memorandum in detail. The Memorandum will focus the investigations and the Due Diligence Agreement will control the time frame and procedure for completing them. Well-prepared owners will have available supporting documentation for the representations contained in the Memorandum and requests for additional documents can be screened in advance. All documents can be housed in a "data room" and examined off-premises. Facilities inspections and employee interviews can be cleared through authorized personnel.*

The auction must eliminate at an early stage irresponsible or frivolous bids submitted merely to "test the waters," to obtain and exploit confidential information about the company or to manipulate the general bid level. On the other hand, the auction must also protect serious bidders against the "shopping" of bids by sellers while protecting the ultimate buyer against the risk of overbidding. Invitations will be sent only to prospects that survive a preliminary evaluation similar to the one that would precede Open-Ended negotiations. Unresponsive or inadequate bids will be eliminated in phase one. (Recall that phase one bids are non-binding and may be rejected arbitrarily by the owners.) On the other hand, though phase one bids may be disquietingly low from the owners' perspective, they are not likely to be frivolous. A careful review of the Disclosure Memorandum will require a significant expenditure of time and effort. Any serious buyer will realize that its phase one bid should be realistic. If it is too low, the buyer may be excluded from phase two. If it is too high, it will be self-defeating since its only possible effect will be to raise the minimum level for final bids. Assuming a quality Disclosure Memorandum, the phase one bids will constitute an effective test of the owner's initial assumptions about the value of their company. If the assumptions appear valid, the owners can proceed to phase two. If not, they can abandon the auction without liability and with a relatively limited investment of time and money.

*Final bids constitute binding offers to purchase the company at the bid price on the terms set out in the Acquisition Contract. Phase two bidders are protected against "shopping" by the owner's commitment to accept the highest final bid above the minimum. The ultimate buyer is protected against overbidding because final bids may be hedged; e.g. "\$100,000 above the highest competing bid to a maximum of X."*

*Additional opportunities for distinguishing between bids are presented in an asset purchase because bidders can increase the after-tax value of their final offers without increasing their gross acquisition cost through tax allocations favorable to the seller. A well-designed final bid form will permit wide flexibility in the structuring of such allocations. In a stock purchase the same result can be achieved by affording the owners flexibility in pre-closing tax planning. Financial terms, such as the level of working capital permitted the company at closing, and collateral terms, such as the size and duration of the buyer's purchase price hold-back or indemnification fund, are also useful sources of bidding flexibility and heightened competition.*

## **Conclusions**

Owners who have satisfactory transactions at hand or within reach are well advised to pursue them before subjecting themselves to the market at large. Owners without such transactions whose firm goal is the maximization of price should consider the auction carefully before embarking on an Open-Ended sale strategy. If an auction is attempted, success will depend upon the quality of the communications with bidders. The Invitation to Bid and the related Instructions must be fully informative and clearly written. They must establish the integrity of the auction from the beginning. The Disclosure Memorandum must be comprehensive to permit an informed valuation of the company. It must also be painstakingly accurate to eliminate the risk that later investigation by phase two bidders will expose it as misleading.

For prospective buyers, the spectre of bidding competition is initially daunting, but if the bid package demonstrates the owners are informed, and under no compulsion to close, the prospects will realize they would gain nothing by negotiating alone. The Disclosure Memorandum requires less time to evaluate than information obtained during protracted personal meetings and staged exchanges of documents. That, on balance, should be an acceptable trade off.

Owners can gain an efficient sale process, an objective verification of their assumptions about company value and substantially reduced transaction costs.

## **Recommendations**

A contractual auction may be particularly appropriate when any of the following conditions predominate:

- The owners have made a firm decision to sell subject to a minimum price that fairly takes account of the negative attributes of the company.

- The owners cannot readily identify a bona fide purchaser willing to acquire the company at an acceptable price.
- The owners can identify or have been approached by more than one or two prospective buyers.
- The owners have not commenced serious Open-Ended negotiations with responsible purchasers that would be threatened by a switch to an auction format.
- The company has a strategic or franchise value substantially exceeding its net asset value.
- The owners are in a relatively weak negotiating position.

\*\*\*\*\*

These Essays are published periodically by the Law Offices of Robert G. Hutchins, PS on subjects potentially of interest to clients and others with whom the firm maintains business or professional relationships. The Essays do not address a specific situation, are necessarily general in scope and should not be construed as legal advice. For more information, please contact Robert G. Hutchins at 1201 Pacific Avenue, Suite 1702, Tacoma, WA 98402-4322, 253-272-5480, [rghutchins@msn.com](mailto:rghutchins@msn.com).