10 KEY COMPONENTS OF SUCCESSFULLY SELLING YOUR BUSINESS

LAW FOR BUSINESS

Introduction

Undertaking a M&A transaction can achieve a variety of goals for the businesses involved, such as facilitating growth by expanding current markets or customer bases, increasing operational efficiencies, diversifying products or services, or even eliminating competition. Alternatively, the seller may be seeking to retire or to exit the business to cash out the founders and investors. Whatever the end goal for the parties involved, M&A transactions require significant focus and expenditure of time and resources.

The process of a M&A transaction often requires continued focus by and contact with executives, key employees, access to facilities, the negotiation of deal terms, assembling, organizing, and responding to many financial, tax and legal requests, attendance at meetings and calls, and finalizing definitive agreements. These activities, for both the buyer and the seller, can divert significant resources from the day-to-day businesses of the participants. A M&A transaction is driven by process and can be overwhelming to even to the most sophisticated business operations. There are generally multiple stages for the deal and components of strategic business considerations, from evaluating and developing the transaction structure, through negotiations and closing, to ultimate integration and transition of the businesses involved.

This resource is a guide to provide a summary of considerations and an overview of the typical M&A transaction process for sellers.

Business Reasons to Consider a M&A Deal

Common business reasons to consider a M&A deal include:

- ***Market Base.*** Expansion into a new or underrepresented market or customer base, typically in a similar business or in a different region or territory where the seller has a moderate to significant presence.

- ***Operational Efficiency.*** Operational synergies, such as to combine facilities, enhance capabilities of the work force and other resources, increase the revenue base to offset costs, or negotiate more favorable terms with suppliers or vendors.

- ***Diversification.*** Diversification and enhancement of the portfolio of products, services or intellectual property offerings or capabilities of the parties.

- ***Competition.*** Elimination of a competitor by acquisition or other combination.

- ***Owning an Established Business.*** Buying an established business to own, operate and grow as opposed to starting a business from inception.

- ***Cashing Out.*** Selling a business to cash out the founders and investors.

- ***Access to Growth Capital.*** Combining with a strategic or financial buyer that can provide the seller with greater access to growth capital (such as private equity recapitalizations where the seller or its owners continue to maintain a minority stake in the business).

10 Key Components of Successfully Selling Your Business

1. Getting Educated on the Value of Your Company.

Understanding customary factors that drive enterprise values and sale prices based on your specific business or industry is critical in reasonably assessing potential fair market value. EBITDA or other earnings-based multiples are used for some industries and technologies whereas others may be driven more by top-line revenue figures with less emphasis on profitability, or by other intangible assets, including goodwill. Goodwill assets include brand recognition and reputation, a strong customer base, good relations with employees, customers and vendors, or patents or other proprietary intellectual property. An independent third-party valuation, such as from an experienced investment banker, can provide a realistic estimate of what qualified buyers may be willing to pay for the business. It is best to evaluate opportunities to increase the value of the business before going to market. To enhance value, management may want to identify and implement opportunities for revenue and profitability growth, cost reductions and improved operational efficiencies. A seller should also identify and support key employees for retention to help demonstrate to potential buyers that the business will continue to thrive post-sale.

2. Taking the Letter of Intent Seriously.

The parties to a M&A deal will typically negotiate and enter into a letter of intent (LOI) before conducting full due diligence and before starting to negotiate definitive agreements. The LOI is a key component to any successful M&A transaction and many sellers treat it as boilerplate, which inevitably is a costly mistake in the end. Click ***here*** to review our discussion and analysis of LOIs in M&A transactions ("*Letter of Intent Considerations in Mergers & Acquisitions*").

3. Structuring the Deal Advantageously (Especially Tax).

There are typically 3 transaction structures in M&A deals:

- ***Merger.*** A transaction where a surviving company (the buyer) merges and combines with the selling company (the seller) with the seller ceasing to exist post-closing. The buyer also generally assumes by operation of law all the assets and liabilities of the seller, making the indemnification considerations critical for the surviving company.
    - ***Positives of a merger.*** Larger companies with economies of scale; diversification of products and services; operational efficiencies; possible reduction in competition for the merger participants.
    - ***Drawbacks of a merger.*** Possible long integration process; cultural clashes; internal competition; possible loss of key personnel and management; cost of retraining of employees; need to identify and eliminate duplication of resources.
- ***Purchase and Sale of Assets.*** A transaction where the buyer purchases most or all the assets and customarily assumes limited specified liabilities of the seller. The buyer can better limit its risk of exposure to unwanted and unknown liabilities of the seller through an asset transaction.
    - ***Positives of asset deal.*** Step up in tax basis for the buyer; specifically determined assumed liabilities; no corporate liability for the seller's pre- closing operations; amortization of goodwill; deal approval sometimes permitted through just a simple majority of the seller's owners; ability to pre-determine specified employees of the seller to be retained by the buyer post-closing.
    - ***Drawbacks of asset deal.*** Can be more complex; rehire of employees of the seller required; potential for more transfer restrictions on permits or government approvals; potential for needing more third-party contract consents to assign the seller's contracts; potential for higher tax to the seller.
- ***Purchase and Sale of Equity.*** A transaction where the buyer purchases the equity of the seller from its owners (i.e., stockholders, members, partners, etc.). Like in a merger, the buyer is purchasing the seller in its entirety and effectively absorbing and assuming all the seller's liabilities (and like a merger, making the indemnification considerations critical for the buyer in an equity transaction). Unlike a merger, the seller typically continues to exist and operate in some capacity post-closing in an equity transaction as a subsidiary of the buyer.

- ***Positives of equity deal.*** Potentially less complex; possible retention of operating capital; potential for fewer third-party contract consents; employees often remain without change; potential for lower tax to the seller.

- ***Drawbacks of equity deal.*** Inherit by operation of law known and unknown liabilities, contractual and otherwise; no step-up in tax basis for the buyer; goodwill not tax deductible; likelihood of minority owner approval requirement is higher, thereby in creasing potential for divergent owner views on deal benefits and delaying approval.

4. Being Ready Early for Due Diligence.

The buyer will circulate requests for due diligence materials from the seller on most or all aspects of its business and operations. The type of documentation and categories of request generally include the following:

- ***Corporate.*** Incorporation and organizational documents, ownership records, subsidiary information, and equity issuances.

- ***Financial.*** Financial statements, budgets and strategic plans, bank statements, ledgers, accounting records, payroll information, and financing instruments.

- ***Tax.*** Tax returns, tax receipts, filings and other tax records, and any audit documentation.

- ***Customers and Suppliers.*** Lists of material customers and material suppliers, information on sales and costs, and copies of related agreements.

- ***Material Contracts.*** Lists of manufacturers, resellers, distributors, joint ventures, professional services, sales representatives, leases, and government contracts with copies of the related agreements.

- ***Intellectual Property and Information Technology.*** List of all used or owned intellectual property and information technology, all IP-related filings, licenses and permits, licensing agreements, and list of software and hardware components.

- ***Human Resources.*** Human resource records with schedule of compensation and benefits paid to employees and independent contractors, benefit plans offered, employee handbooks, and employment and contractor agreements.

- ***Marketing and Sales.*** Sales and product literature, price lists, catalogs, purchase orders, business plans, marketing research, press releases, and list of competitors.

- ***Legal and Regulatory.*** Permits, governmental filings, litigation, regulatory and/or environmental proceedings, actions, investigation and related documents and information as to any non-compliance with laws.

- ***Operations.*** Insurance policies, operations manuals and processes, research and development information, and real property and facilities documentation.

It is advisable that you proactively get your "business house in order" before going to market, which will assist you and your personnel to be better prepared for (and less burdened by) the rigorous due diligence process that buyers thrust on sellers. Among other things, the buyer's comprehensive due diligence investigation on your business and its records will be utilized by the buyer to evaluate your company's strengths and weaknesses. Do your best to assess your business through the lens of a potential buyer with a reverse due diligence process. Then take steps to position the business in the best light possible and to minimize issues that might negatively affect valuation. Transparency and a clean business will provide a buyer with more confidence about paying a higher purchase price than for a business that has clean-up issues.

A few examples include:

- Ensuring that books and records – especially accounting and financial records – are up to date, accurate, complete and use sound accounting principles. There is no faster way to scare off a buyer than to have sloppy, incomplete, or questionable accounting and financial records or practices.

- Making sure your arrangements with key customers and vendors are memorialized in signed written contracts.

- Documenting and clarifying ownership and licensing of intellectual property that is important to the business.

- Buttoning up your capitalization table and owner or founder agreements, such as operating agreements, shareholder agreements, voting agreements, buy-sell or similar agreements among owners and investors.

- Reviewing your contracts and applicable regulations to identify approvals that might be required from customers, vendors, regulators or other third parties in connection with a sale of the business.

5. Strategically Negotiating and Preparing the Definitive Agreements.

- ***Purchase Price Consideration.*** The purchase price consideration can be cash, promissory note, **earnout,** equity in the buyer [including **rollover equity** in many instances, particularly in sales to private equity buyers], or a combination of the foregoing. Read our discussion and analysis on purchase price considerations in M&A: (1) **here** ("*Letter of Intent Considerations in Mergers & Acquisitions*"); (2) **here** ("*Earnouts in M&A Transactions*"); and (3) **here** ("*Rollover Structures in M&A Transactions*").

- ***Working Capital Adjustments.*** A part of the purchase price consideration typically includes an adjustment for working capital (current assets minus current liabilities), which will be definitively calculated in the weeks or months following the closing. Drafting working capital adjustments can be complicated in M&A transactions due to the various negotiations to determine what constitutes current assets and current liabilities and what mechanisms will be used for calculating the adjustment.

- ***Escrow Holdbacks.*** Escrow holdbacks are often used for working capital adjustments and for indemnification. Based on M&A deal studies, the typical holdback amount ranges from 10% to 20% of the total consideration with the escrow period ranging from 12 to 24 months after the closing.

- ***More on Earn-outs.*** Some M&A deals have negotiated earn-out payments that are used to provide the possibility of obtaining additional consideration for the seller or its owners based on the achievement of certain post-closing financial objectives by the acquired business. Because the seller often does not maintain control over the business post-closing and because the buyer will normally have financial and accounting control post-closing, negotiating and drafting the criteria required to achieve and determine earn-out metrics is crucial.

- ***More on Rollover Equity.*** Almost any sale to a private equity (PE) buyer will involve a requirement by the PE buyer that the selling owners "rollover" a portion of the sale price, which means either maintaining a level of minority equity in the acquired company post-closing or in one of the private equity funds of the PE buyer. Understanding and negotiating the particulars of rollover equity, the conditions imposed upon it, and the |risks associated with it, is crucial. Click ***here*** to learn more on the particulars of rollover equity. Speaking of private equity, PE buyers have their advantages and disadvantages. PE buyers can be great financial partners and provide sellers with the opportunity to participate in "second bite at the apple" sales down the road. However, understand that PE always negotiates hard, the deal will likely be more challenging than with strategic acquirers, and selecting the right PE partner is critical. Click ***here*** to learn more on how to choose ***the best PE partner*** for your business.

6. Understanding and Negotiating the Representations and Warranties.

A critical and time-consuming aspect of any M&A transaction involves negotiating and drafting the representations and warranties (affectionately known as "reps"). A rep is a statement to the other party of a prior or current fact relating to the operations, finances, assets, liabilities, operations, properties, employees, customers, suppliers, etc. of the seller and its business. Almost universally, after purchase price and structure, the primary focus and attention of the parties in the transaction is on the reps to be given by the seller. A well-advised seller will use and point to market deal studies around customary categories of reps that are readily available to M&A professionals. For example, these studies generally show limited use of draconian and open-ended "catch-all" reps that were historically more prevalent in M&A deals than is the case today. On the other hand, a buyer may have identified areas of concern or known liability potential, such as ongoing litigation or product issues. In these instances, the corresponding reps are often negotiated to specifically address the buyer's concerns on the specific issues. If the transaction size warrants it, obtaining a ***representations and warranties (R&W) insurance policy*** is typically well worth the cost of the premium and can dramatically reduce the typical extensive negotiations over the scope of representations, warranties, holdbacks, and indemnification liability. R&W insurance, once reserved for public company and higher-market M&A deals, is becoming more prevalent in lower middle-market private company M&A transactions. Recent trends show that R&W insurance, which provides liability coverage for breaches of representations and warranties made by a seller in an M&A deal, is now being used in an estimated 25% of private deals. Click ***here*** to learn more on representations and warranties insurance.

7. Limiting Indemnification Exposure.

Like the negotiation of the reps, negotiating and preparing the indemnification provisions of the definitive agreement is a crucial and time-consuming aspect of a M&A deal. The buyer will want broad protection, higher liability, longer time limits to make indemnification claims, and the right to set-off any indemnification amounts it may owe against other payment obligations it may have to the seller (such as promissory note or earnout payment obligations). The seller will want to reduce indemnification exposure through the negotiation of caps and baskets, dollar limitations, and shorter time frames for the buyer to assert claims post- closing. Indemnification caps are generally based on a percentage of the purchase price (e.g., 10% is customarily the median indemnification cap but which can fluctuate depending on the size or complexity of any one deal). However, general indemnification limits often will not apply with respect to certain categories of "fundamental" or "carveout" reps, which have higher indemnification limits (or no limits in some instances) and survive for a longer period than the general categories of reps. Examples of customary fundamental or carveout reps include, among others, proper organization and good standing, capitalization, power and authority, title to assets, and taxes. Like fundamental reps, fraud is often specifically carved out from any indemnification cap or basket. For example, a definitive agreement might permit for a fraud claim before the lapse of the statute of limitations as opposed to a contractually limited indemnification claims period. Like analyzing appropriateness for categories of reps and the associated indemnification standard, a well-advised seller will point to market deal studies around indemnification trends that are readily available to M&A professionals.

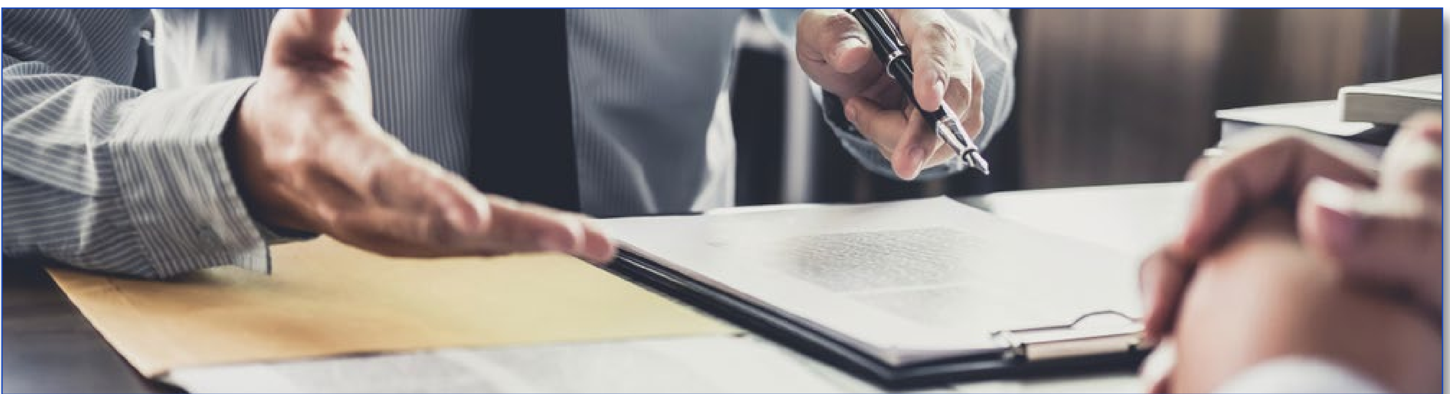
8. Knowing and Negotiating Post-Closing Rights and Benefits.

Rarely do private company owners sell their companies, pocket all the cash at closing, and ride off into the sunset to never worry about their business again. Selling owners and key employees of acquired private companies almost always both play a crucial post-closing role in the 2-to-5-year period after the initial sale. The buyer (particularly any private equity buyer) will lean heavily on selling owners and existing management to continue operating the business day-to-day post-closing. This helps the buyer to learn and acclimate to the purchased business. The continued involvement of the selling owners and key management after the closing is usually a condition imposed by buyers to proceed with the transaction. Given this reality, there are some fundamental post-closing management considerations that are pivotal for selling owners to prepare for before the transaction closes. Click ***here*** to read more on the particulars of these important ***post-closing management considerations for sellers***, which include negotiating airtight employment agreements and establishing the right ***equity incentive plan*** for key post-closing personnel (and likely including the selling owners as part of this pool) to incentivize them to stay on-board after the sale and to do what is necessary to help achieve a lucrative "second bite at the apple" sale [particularly in the instances of PE buyers, who will look to resell the acquired business 2-5 years post-acquisition]. Often, the equity incentive plans established for key personnel and employees post-closing are ***profits interest plans***, especially in instances of sales to PE buyers.

9. Preparing Yourself Psychologically.

"Selling my business will be easy." Said no successful seller, ever, because it is simply untrue. M&A sale deals are hard, competitive, messy, exhausting, often contentious, and take a long time to complete. Buyer and seller are pitted against each other. Statistics time and time again indicate that the best deals come out of a competitive auction process, where numerous buyers are approached, screened, and given a chance to put forward their best offer for your company; in other words, you may receive several offers to evaluate and have multiple potential buyers to meet. Are you prepared to rework financial statements, objectively value your company, populate and monitor a data room, screen buyers, conduct tours, negotiate a deal, and handle frequent bouts of pre-deal jitters .... all the while continuing to run your business profitably? Selling your company will be an exhausting and emotional experience. Do not fall prey to the numerous ***deal myths*** about what it does or does not take to successfully sell a business.

Sellers are frequently surprised by the typical timeline and process of selling a business. Unlike selling the average house, for example, which sells in weeks, the average time to sell a business is 9 to 12 months. A successful sale of a business requires a great deal of planning and a year or more to control expenses, drive sales, document the operation, and develop key staff. Potential buyers need to be pre-qualified and then, as they perform due diligence on your company, you need to perform due diligence on the buyers. Unlike a house sale, the sale of a business involves confidentiality and intricate "base case" and "upside" financial models. The nuances of the letter of intent and definitive purchase agreement demand extraordinary attention to detail and in-depth discussions, as numerous variables can impact the amount and timing of proceeds paid to you. Even after you close the deal, if part of your payment is in the form of delayed or speculative compensation you continue to be on the hook helping the new owner run the business successfully. The process of selling a company takes far longer and is infinitely more complex than selling, well, just about anything. This is not to say you cannot and will not get a great outcome but know going in it will be one of the toughest professional challenges you will ever undertake. Also know that a successful M&A sale deal is more marathon than sprint. Understanding these elements from the get-go will prepare you to come into the fray ready for what is coming and will ultimately be integral to your ability to get the life-changing event every seller desires.



10. Assembling a First-Rate Deal Team.

Many selling owners believe they do not need the help of deal professionals to sell their business. Yes, you may already have skilled accountants and attorneys who do fine work for you, but are they experienced in working on complex M&A deals? You get one real shot at selling your company, and the outcome will impact the rest of your life. A seasoned deal professional will provide value beyond merely executing a closing, and each type of professional serves a specific purpose. An experienced deal professional is driven to get you the best possible deal and has a deep understanding of the market, the multiples, the financing options, and the documentation. You need to understand that most buyers for your business – whether strategic or financial – have completed numerous M&A deals and are adept in using various financing tools and strategies specifically intended to get them [not you] the best deal possible for themselves (and can you really blame them?). They will have scores of deal experienced M&A attorneys, accountants, investment bankers, and other seasoned deal professionals. You need to bring the appropriate arsenal on your side if you expect to get through the process and end on the 50-yard line, as opposed to say the 10-yard line, which is where you will start (and you likely may not realize that if you don't know what you should be looking at or asking for), which is part of what many buyers are counting on to stack the odds in "their" favor. Do not lose sight of this fact.

The worth of having advisors, including attorneys, with proven experience in M&A cannot be overstated. It may be tired, but it is true: you would not hire a general practitioner to perform your heart surgery. It is not surprising that the financial outlay for this level of expertise may not be insignificant. Cost savings in the short-term can seem attractive, and cost is important – to a degree. However, what seem like big fees are often dwarfed by the value of finding more money in the deal, enhancing terms, and seeing things that people who do not do M&A every day will not see and capture for you. Put simply, a great M&A advisor is no commodity. The overall value you should realize from their services and counsel will outweigh any relatively immaterial cost-cutting measures in the end. Key advisors to consider engaging for advice and assistance before you begin a sale process include:

- Experienced M&A legal counsel with specialization in business sale transactions.
- Investment banker or business broker to help value and market the business.
- Qualified tax or audit professional(s).
- Financial planner to develop a seller's post-sale wealth management plan.
- Human resource professional(s).
- Industry expert(s) versed and experienced in the opportunities and challenges of the business.

Conclusion

While each deal has its own goals and challenges, there are consistencies and commonalities around the process for all well managed M&A transactions. The ability to understand and distinguish between what is customary and what is nuance is critical to successfully navigating the rigors of the M&A process and closing the transaction with an optimal outcome. ***Linden Law Partners*** has extensive specialized experience on all types and aspects of M&A transactions across a broad spectrum of industries and participants. Feel free to contact us **here**.

© 2021 Linden Law Partners, LLC. All rights reserved.

LAW FOR BUSINESS