PREPARING THE SALE OF YOUR COMPANY

FOR PRIVATELY HELD BUSINESSES

LOEB & LOEB LLP

Taking steps to prepare your company for sale before you put it on the market can significantly help to enhance its attractiveness to prospective buyers, improve pricing and reduce the time and stress required to complete a transaction. The following outline details key tactics to consider, mistakes to avoid and important questions to ask and address along the way. It is critical to lay the groundwork early and to recognize that selling your business is not an event, but a process that requires time, teamwork and preparation. The investment you make in identifying the right advisors and properly planning will pay off with the best deal scenario.

1. Form a **trusted team of senior management and outside advisors**, and stress the need for confidentiality.

2. Establish **a timeline** and **a checklist**.

3. Look at your business **through the eyes of the buyer.** If you don't like what you see, **fix it**.

4. Develop **a detailed business plan**.

5. Take steps to **avoid key management disruption**.

6. Get books and records in shape and bring in **legal and tax advisors** early.

7. Anticipate the **tax and estate consequences of the sale**.

8. Make sure your **existing team of accountants and lawyers** is up to the task of selling your company.

INITIAL PREPARATION

Start Early

One of the greatest challenges in selling your company can be balancing the demands of the sales process while also running your business and remaining attentive to your day-to-day operations. Start early with the initial preparation to make things easier on you and your team. Here are some of the key action items and considerations at the early stage.

- Form a team of trusted senior management and outside advisors, and establish responsibilities. Keep the team small and stress the need for confidentiality.
- Establish a timeline. It will always take longer than you think, but a timeline and checklist can be very helpful.
- Look at your business through the eyes of a buyer. Would you as a buyer be happy with your management team? Would you buy your company as currently positioned? If so, for how much? How would you defend your expectation of the valuation of your company?
- Develop a detailed business plan. How would you as a buyer evaluate that plan?
- Are your facilities presentable to a potential buyer? Would you be impressed or distressed if you were a potential buyer doing a walk-through of your premises? If you're not impressed, clean up your act. Visual first impressions count.
- Start early with your legal and tax advisors to explore estate planning considerations. Generally, the earlier you start the better are your chances for a lower valuation for estate planning purposes.
- Is the timing of the sale right, given your industry and sector and the economy in general? Have a convincing explanation for any potential buyer as to why you are selling now.

Management

- Do you have a succession plan in case you or any C-level executive are no longer going to be in place?
- Are you satisfied with the performance of your key employees? If not, it's best to address the issue as early as possible.
- Are C-level and other key managers properly motivated to enhance the value of the company upon sale? Do you have restricted stock plans, option plans, profits interests plans and the like in place? Do you have employment agreements with those managers that are transferable to a buyer?

- Sale/stay bonus plans can keep key management in place and significantly enhance the value of your company and the amount you take home. Do you have such a plan in place?
    - Sale Bonuses: Sale bonuses with key employees are bonuses that are payable in full by the company upon the closing of the sale of your company.
    - Stay Bonuses: Stay bonuses with key employees are typically bonuses that are payable in part at the closing of the sale with the balance payable after some stated period (e.g., 12 months, 24 months) if the employee has not terminated his or her employment with the buyer prior to the expiration of the stated period.

Books and Records

- Clean up your books and records by neatly compiling all contracts and amendments, leases, employee records, benefit plans, and governance documents (minute books, stock ledgers and the like). Pay particular attention to the immigration status of employees. Your lawyers and accountants can help you with this. Do not feel alone.
- Review your intellectual property, including trademarks, copyrights, patents and applications to be certain that the filings were properly made and maintained and are not infringing on the intellectual property of others, and that others are not infringing on your IP assets. Make sure that consultants (software developers, website developers and the like) have no ownership interests in your intellectual property. Do you have the proper confidentiality and other arrangements in place with your employees? Reach out to your IP lawyers.
- Do you have a current business plan with reasonable assumptions for your projections? If not, you and your management team should develop a plan going out at least three years, preferably five. The more comprehensive the better.
- Review your insurance policies and related coverage with your insurance broker. Make sure you have the right types of coverage in the right amounts comparable to others in your sector.

Governance

- Are there minority owners of the business? Review the governing charter documents, as well as any shareholders' agreements, to determine whether there are particular rights that can be exercised or obligations that must be met in connection with the sale of your company.
- Be aware of the fiduciary duties owed by majority shareholder(s) to the minority with respect to loyalty and fairness of the transaction. Your lawyers can help you meet your fiduciary obligations.

Financial Statements

- Do you have the right systems and controls in place? Consult your accountants to be sure.
- Are your CFO and controller up to the task of the business now and going forward?
- Do you have audited/reviewed financial statements? Financial statements that are audited by a reputable regional accounting firm can add significant value to your company. Smaller companies frequently forgo the costs of preparing audited annual financial statements. Your financial statements should go back three full years. They should be GAAP compliant, or you should be prepared to explain any exceptions to GAAP.
- Review and manage working capital. Make sure all accounts payable are paid in the ordinary course and are well documented. Collect or write off accounts receivable so that they are accounted for in compliance with GAAP consistently applied. Clean up or otherwise devise a plan with respect to any obsolete, damaged or slow-moving inventory.
- Obtain a quality of earnings analysis. An analysis prepared by an independent accounting or consulting firm can increase the valuation of your business.

Taxes

- What is the form of your business? Is it a C-corporation? An S-corporation? A limited liability company? Understand how tax approaches vary with the form of business and the implications for your company's sale.
- If your company is a C-corporation, you will have little choice but to sell the shares of the corporation. A sale of assets would result in double taxation to you on the gain, once at the corporate level and then at the shareholder level. A sale of the shares by you and other shareholders would result in taxation at your level only.
- If your company is an S-corporation or a limited liability company, the company may sell its assets to the buyer without double taxation, meaning that the company will not pay taxes and the equity holders of the company will be taxed on the gain at their level. The buyer will be able to obtain a "step up" in the tax basis of the purchased assets. With the stepped up basis, the buyer will be able to depreciate and amortize certain of the purchased assets at the higher valuation and thus obtain greater deductions going forward. That tax advantage going forward often is of such value to the buyer that the buyer is willing to pay a higher purchase price than if it were to purchase the shares of a C-corporation.
- Make sure all the company's tax returns that are due have been filed. Unfiled tax returns serve as a significant red flag to buyers. It tells them that you have not paid careful enough attention to tax matters and will set off alarm bells as to tax exposure. It may also do damage to your and your management team's reputation in the eyes of the buyer.
- In addition to income and franchise tax returns at the federal and state levels, there are several other types of tax returns that companies often neglect to file. This can include sales and use tax returns, or the various types of property tax returns for real property and business personal property.

- Make sure your payroll taxes have been paid and all requisite withholdings have been properly made.
- You should have your accountants review all your company's tax returns, first to ensure that all required filings have been made and then to identify issues where there could be some tax exposure.

Estate Planning

- When contemplating the sale of a business (and, preferably, well in advance of the sale), you should consult with an estate planning attorney to explore the steps that can be taken to minimize estate taxes that will be imposed on your estate with respect to the company or the sale proceeds.
- A common strategy is to transfer the company in a tax advantaged manner to a family trust in advance of the sale. A technique used in tandem with the family trust is to recapitalize the company into voting and nonvoting interests in order to produce an optimal discounted value for gift and estate tax purposes.

Human Resources

- Maintain employee records and policy manuals
- Conduct required training sessions (e.g., safety courses, sexual harassment/discrimination and so on).

Accountants/Lawyers

- Are your accountants and lawyers up to the task of helping you sell your company? Your existing professionals may have been just fine for the day-to-day needs of your business operations but may have little or no experience in the sale of a business of your size. Your management team should think independently, as your personal relationship with your existing professionals may get in the way of an objective determination. Going into the sale of your company, you must have accountants and lawyers who are experienced mergers and acquisitions professionals. Feel free to interview new candidates and to seek recommendations from their clients. In the end, much will be determined by how comfortable you are with them and by their experience and service approach.

NEXT STEPS

Hiring a Banker

- A banker can help you receive the best price for your company by helping you position your company in the best light, find the best buyer and obtain the best price.
- A banker, along with you and your lawyers, will prepare a Confidential Information Memorandum, or CIM, that will describe all the relevant information about your company.
- Just as it is generally a mistake to get only one quote from a contractor when renovating your home, for example, it is generally a mistake to engage the first banker you meet. Several should be interviewed. Your lawyers can help you. Does the banker know your industry? Is your company the right size for the banker? Is the banker conflicted by being currently in the market to sell one of your competitors? Will the banker's team be focused on your company? The bank that offers the lowest fee is not necessarily the right bank for you.
- Experienced M&A lawyers can help you with the pricing formula to be negotiated with your banker and other terms of your engagement letter with the banker you select.
- The banker you select will advise you about who are your potential buyers. The banker should know which financial investors, for example, private equity or home office investors, are interested in your industry and the size and other features of your company. The banker must also know which strategic investors, such as, your competitors, might be interested in purchasing your business.
- You should have a discussion regarding which potential buyers the banker may approach; you may not what them to disclose to certain competitors that your company is for sale. This discussion may result in the banker conducting a limited auction to financial investors only or other limitations.

Whom do you want as your buyer?

- Discuss with your lawyers and bankers the difference between "strategic" and "financial" buyers. "Strategic" buyers are operating companies that may be already engaged in your business and are thus your current competitors. "Financial" buyers are private equity funds, hedge funds, family offices and the like. Each presents multiple issues.

- Strategic investors may pay a much higher price than financial buyers will for a variety of industry-related reasons. They may also not need or even want existing management of your company to stay on. Holding together your management team until closing could be much more difficult if your team senses that their jobs are at risk, in which case you may need stronger sale bonus arrangements. Strategic investors may or may not leverage the purchase price. Your lawyers and bankers can walk you through these issues.

- Family offices may have a long-term approach to the purchase of your company. They may keep your management team pretty much intact and expect your management team to buy into that plan with a long-term incentive arrangement. Private equity and hedge funds will typically want to own your company for four to seven years and then sell it. Financial investors can be expected to be more dependent on existing management and thus more willing than a strategic investor to motivate management with incentive plans.

- Whether you team up with a strategic or financial firm, some key questions are:

  (A) How does your company "fit" within the buyer's plans? For example, if the buyer is a "strategic" based outside the United States and has an international focus, how do you, your business and management team blend with an international plan? If your buyer is a financial investor, what is the amount of leverage, the plan for growth and the "exit" strategy?

  (B) Does the buyer want you to stay on as an investor/manager? If so, on what terms?

  (C) How does the buyer's "culture" mesh with your company's? How does this affect you or your team going forward? If you are not staying on, how important a consideration is this for you and your family?

We at Loeb & Loeb have deliberately not made the foregoing a strictly legal questionnaire because we handle the sale of companies as a daily matter from both perspectives – the seller and the buyer. Thus we see and understand the whole process – the big picture – instead of looking at it through the narrow telescope of many lawyers. We can, and would be happy to, walk you through the whole process.

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