



Collecting the Right Data When It's Time to Sell the Family Business

By Barry Smith

Kee it. Sell it. Liquidate it. Those are the three alternatives available to the owners of a closely held business. Some businesses are kept and pass from one generation to the next. Many are liquidated or pass through the gates of bankruptcy. Some are sold, the ultimate exit plan for many an entrepreneur. This article will focus on some of the key issues that need to be addressed in the sale process and will highlight the need to collect accurate data.

Due Diligence

Due diligence usually comes after you have agreed on a sale and before closing occurs. It is the buyer's chance to send in the accountants and attorneys to comb through records. It is the ultimate exercise in data compilation, and it drives most sellers to the brink of exhaustion. It may

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be wise to sketch out what is involved in the due diligence process so that you will know what is in store at the end of the sale rainbow.

Most buyers use a due diligence request list that is several pages long and comprehensive. It can fit a public acquisition of a billion dollars or a closely held purchase of a million dollars. Out of an abundance of caution, most buyers are reluctant to pare down the list. (See the sidebar on page 38 for an overview of the principal categories of information required.)

The final work product is one or more boxes that are tabbed to match the due diligence list and sent to the buyer. That way, when the buyer's team descends on the seller's place of business, they already have had the chance to go through the boxes without causing disruption. They may have reduced their list of outstanding requirements down to one page and one day, versus an interminable upheaval for sellers.

Who assembles all this data? It may be the business owner who is selling or (ideally) the outside CPA or attorney who is used in discovery. The better the data looks at this stage, the smoother will be

Sample Due Diligence Request List

Category	Include
Corporate Structure	Articles, bylaws, minutes
Legal Proceedings	Any orders or judgments Pending or threatened litigation Correspondence with regulatory agencies (OSHA, EEOC, OIG)
Shareholders	Copies of shareholder agreements Shares outstanding Shareholder list SEC filings
Contracts	For sale or lease of capital assets Letters of intent Partnership or JV agreements Restrictive covenants Loan or credit agreements Supplier agreements
Regulatory	Licensing issues Coding, zoning compliance State, local, or federal
Financial	Balance sheets, income statements, cash flow statements for the last three years and year-to-date Correspondence from CPAs Detailed general ledger and trial balance Schedule of indebtedness Bank statements, last three years A/R aged A/P aged Current inventory Detailed listing of all property, plant, and equipment
Sales	Details on the sales force, territories, goals, and expenses
Marketing	Plans, brochures, budgets
Tax Matters	Tax returns Correspondence with agencies
Human Resources	Employee listing Union contracts Employee handbook Benefit summary and costs
Management Information Systems	Inventory of hardware and software
Insurance	Copies of all policies
Intellectual Property	Trademarks, copyrights, patents

the journey to the final destination.

It isn't always smooth sailing. I once sold a company that was originally incorporated in 1848, and the minute book had no entries save for the handwritten notes from the first meeting to elect officers.

Preparation

You get only one chance to make a first impression. Rarely does a business owner decide to sell the business today and close the deal tomorrow. To maximize value, the present owners need to prepare the business for the microscopic examination of a buyer, and that takes time. The books may need to be cleaned up, the inventory properly valued and managed, the receivables examined for bad debt, the roster of personnel reviewed to see if anyone is being carried who cannot be justified. Sometimes closely held businesses are managed in a way to avoid taxes, but the owners will need to show prospective buyers that the enterprise is capable of generating profits.

Preparation may include audited statements. Buyers like to see audits because they provide a degree of assurance and reliability. But not all deals require audits, and not all companies can afford them.

If there is a lot of radical surgery that everyone agrees needs to be done—closing that satellite branch, retooling the sales and marketing, or making major personnel changes or significant capital expenditures—these should all be considered by the seller. It may or may not be feasible to effect such changes, but if a buyer has to do so at its expense, the purchase price will reflect it.

When a homeowner sells a house, a fresh coat of paint and new landscaping can dramatically increase the chances of selling and impact the price. It is no different with a business. Be objective and look with a buyer's eyes.

Valuation

Inevitably, the discussions will focus on price and terms. All deals have the same common denominator, and they almost always turn on price.

Sellers need to get an objective opinion from a broker, investment banker, or other industry expert as to valuation. It may be

that there are other comparable reported sales. What a seller wants, viscerally, is nice to know, but irrelevant. Sellers, almost always, have rose-colored glasses.

If there is a multiplicity of interested buyers, then the marketplace will furnish the seller with the range of values. Remember, fair market value is that which a willing buyer is prepared to give a willing seller, both being aware of all material facts and neither acting under duress. If the seller's expectations do not comport with reality, then you really don't have a seller at all.

Disclosure

To avoid litigation and a deal going bad, sellers need to disclose all relevant information to a buyer. If a major customer has indicated that next year he or she will be buying from the competition, a buyer needs to know that. Your place of business used to be a chemical plant? Disclose it. Your patent has only two years remaining? Disclose it. Your product seems to break down after three years and litigation is looming? You got the message.

Sunlight really is the best antiseptic.

Taxation

The best investment an owner can make is to have a tax professional advise him or her on the consequences of a sale. Each deal has its own twists and turns, but here is a generic analysis:

- The sale of a capital asset is eligible for capital gains tax treatment. Thus, if a corporation (or modernly, an LLC, which is taxed like a partnership) is sold and the buyer buys the stock, favorable capital gains tax treatment should result.
- Buyers are reluctant to buy stock in a family business because of liabilities that may be undisclosed or unknown. So, a buyer would rather buy assets leaving the seller holding the stock, a shell with the sales proceeds contained therein. That produces taxation at two levels—the corporate level as assets are sold and the personal level if the corporation makes a distribution to shareholders.
- Usually, even if a Subchapter S corporation sells assets, the flow-through nature of the entity results in

taxation once at the shareholder level. The S election must have been made at inception or at least ten years prior to sale to so qualify.

- Section 338 election allows the buyer who buys stock to treat the purchase as an asset purchase for tax purposes and may provide the best of both worlds to buyer and seller. But the seller may need to ask the buyer to indemnify it for any adverse tax consequences that the election produces.

Terms

Terms can be varied—anything from cash to debt, secured or unsecured. Public buyers may use their stock, which could be freely traded or restricted. Cash is king, and everything else is usually seen as a poor substitute. The concept of present value is the key to evaluating competing offers using different terms. (See the sidebar on page 40 for a table illustrating the point.)

Which is the best offer? Debt may or may not be paid. Stock in two years may be worth zero or a great deal. Each non-cash component needs to be risk-adjusted and valued in cash equivalent terms today, so that a comparison can be made.

Non-Competition Agreements

Most buyers want a seller to execute a non-compete agreement to prevent competition from the seller for a period of time after the sale. Courts enforce such covenants if they are reasonable as to time and scope.

The California Business and Professions Code provides that non-compete agreements will not be enforced unless they are part and parcel of the sales transaction.

Buyer and seller need to agree on an allocation of a portion of the purchase price to the non-compete—the buyer gets to deduct such amount, and the seller receives it as ordinary income, not capital gain, so buyer and seller are at odds usually over this key item.

OINC and EBITDA

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If the seller's expectations of fair market value do not comport with reality, then you really don't have a seller at all.

OINC is the "operating income" of the target company, and it is second in importance to the EBITDA of the target, the "earnings before interest, taxes, depreciation, and amortization." EBITDA is the driver of most closely held deals because the cash flow of the target company dictates price and terms.

EBITDA may not be readily apparent in the family business that is now being sold. Capital assets may have been expensed to avoid tax. I recall one company where the real estate acquired was expensed under cost of goods sold. Even more astonishing, it also showed up on the balance sheet and was being depreciated.

There are many expenses that the seller has on the profit and loss statement that may not be continued on a go-forward basis. These include club memberships, personal autos, life insurance premiums, unlimited expense account/credit card usage, and above-market rents paid to the seller as landlord.

Thus the task at hand for the seller is to recast the historical financials to allow a buyer to readily see the real bottom line. Buyer and seller will arm-wrestle over the adjustments, and it is usually here where the deal lives or dies.

What Dictates Price

A host of issues, not all of them financial, dictate price. Here is the usual list of issues, but this list will vary from deal to deal:

- **Balance sheet.** The buyer gets the seller's balance sheet, so it's helpful if

that is clean, with no debt. Often the balance sheet is a push: The assets match the liabilities, and there is really no tangible equity.

- **Profitability.** The amount of profit in absolute terms, and its sustainability, is a primary driver.
- **Trends.** One year does not a trend make. Five or ten years of steady growth in key financial ratios is much more impressive than overnight success.
- **Personnel.** The existing personnel may be key to maintaining a business because of relationships. Sometimes the inability to retain certain people can cause a buyer to back away.
- **Intellectual property.** This includes copyrights, trademarks, and patents—if the seller is well protected and the buyer can step into his shoes and enjoy years of protection, that bodes well. A buyer needs to have an IP expert review the assets and comment.
- **Competition.** The target company may have a monopoly, but nowadays there are few left, and competition needs to be studied and evaluated. Sometimes a seller will sell because the best days are behind her and the future looks questionable.

Buyers will usually do a SWOT analysis (strengths, weaknesses, opportunities, and threats) for a target company. Sellers should anticipate this and do their own.

The Team

Getting a transaction done is a team effort. Buyers will usually have a seasoned group

Evaluating the Present Value of Competing Offers

	OFFER A	OFFER B	OFFER C
CASH	\$5,000,000	\$2,000,000	\$1,000,000
DEBT		\$2,000,000	\$3,000,000
PUBLIC STOCK (restricted for 2 years)		\$2,000,000	\$3,000,000
	\$5,000,000	\$6,000,000	\$7,000,000

of experts, depending on the deal size. Sellers need to assemble an equivalent team. Some will get paid by the hour, some based on a successful transaction. Transaction costs will vary from, say, 10 percent for a small deal (under \$1 million) to 1 percent for a large deal (\$50 million), and there is no one formula that fits all.

At a minimum, the seller will need a CPA to produce financial statements (that may or may not be audited) and compute the seller's tax liability under a variety of scenarios, an attorney to document the transaction (oftentimes the seller's attorney reviews and edits documentation provided by the buyer), and a point person to negotiate the deal.

As the size increases, the team gets bigger. There may be an IP attorney to handle the intangible property transfer, an SEC attorney to comment on securities details, an antitrust attorney if the buyer and seller combined trigger scrutiny, etc. One law firm with all these skill sets in-house is ideal.

The buyer usually will require the seller's counsel to provide a legal opinion that, among other things, assures a buyer that the target company is in good standing, that there are no lawsuits pending or threatened, and that the sellers actually own that which is being sold. Depending on how much detail the buyer wants, the legal opinion can be a major impasse. Seller's counsel will be reluctant to be cast in the role of guarantor or insurer, and legal opinions can take time and become costly.

Finally, sellers need to follow the adage that too many cooks spoil the broth. Someone (a point person) needs to be in charge, and everything must funnel through that person. Because everyone wants to be a dealmaker, it is critical to have an understanding with the team ab initio about roles and responsibilities.

Confidentiality

How do you ensure that a deal in process remains confidential until the parties are

ready to make an announcement? You do two things. First, the parties sign a confidentiality agreement at the onset of discussions. Second, the parties agree that no one party can make any announcement without the other's approval.

Employees are psychic. There are no secrets, and parties should assume that, notwithstanding their best-laid plans, word will leak out. I think it is best to anticipate this and take the key people to one side early on in the discussions and inform them. They will appreciate hearing it from the owners rather than through the grapevine.

Stumbling Blocks

There is an infinite number of ways for a deal to fall apart, and here is a list of the usual culprits. Note that attention to detail in the beginning can obviate months of work being to no avail.

- The attorneys forget that their job is to get the deal closed and instead they let their egos get in the way.
- The due diligence goes badly—it turns out that the business the buyer thought he was buying is not quite what it was represented to be.
- Real estate leases are often a drag, and sometimes the landlord(s) end up controlling a transaction. Solution: Get the leases early on and develop a game plan.
- Employees who are not shareholders usually have everything to lose and little to gain from a sale. They will be nervous. They may need to be paid to stay and perform. Don't overlook the hired help.
- The deal changes—usually it will be because a buyer realizes she has overbid or her due diligence reveals weaknesses not previously unearthed. Genuine issues that surface can usually be dealt with; it's the bogus issues that can torpedo the ship. **GPSOLO**

Sellers need to disclose all relevant information—even the unpleasant—to a buyer. Sunlight really is the best antiseptic.