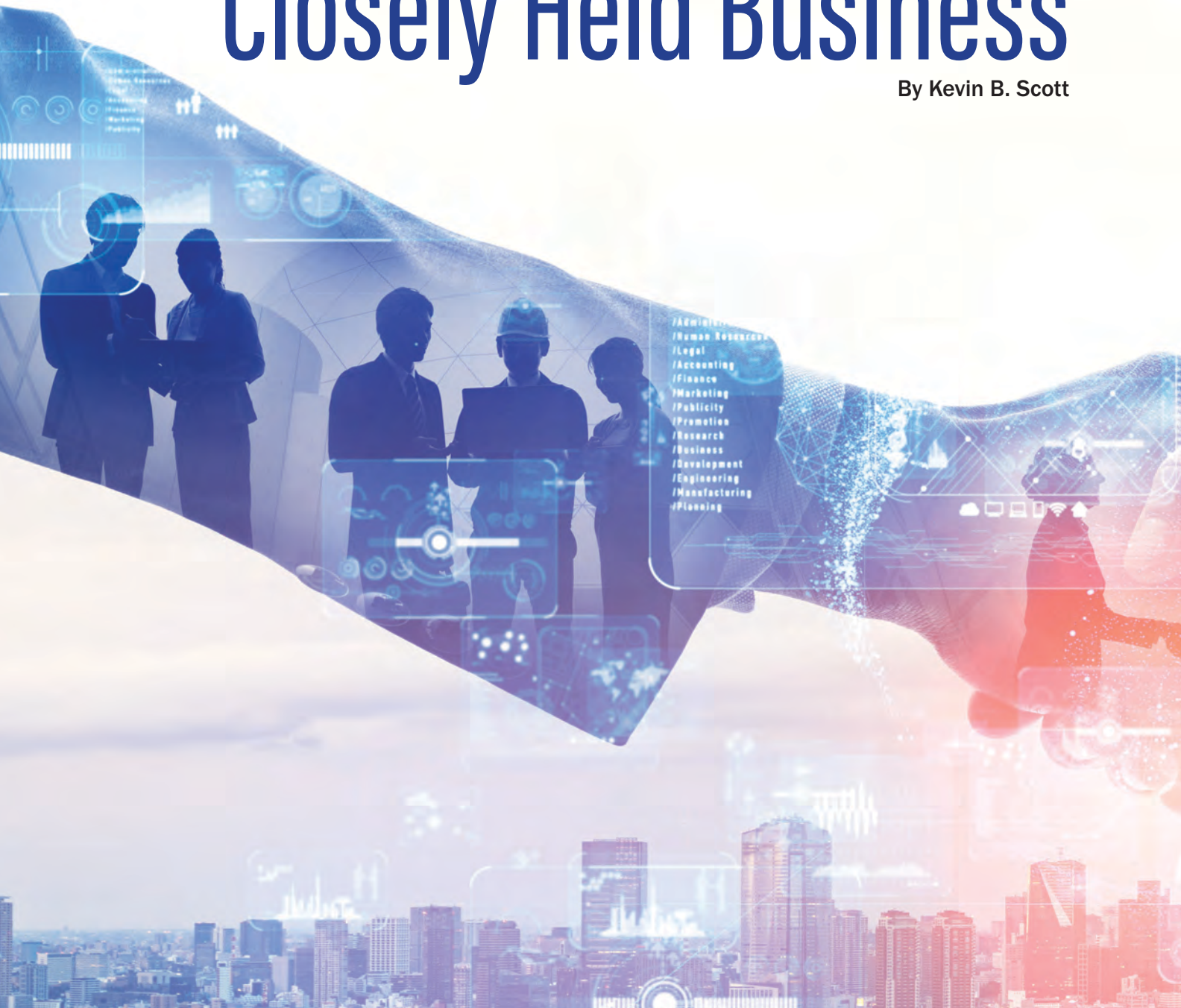


Nine Ways You Can Help Your Clients Sell Their Closely Held Business

By Kevin B. Scott



In my 40-year career as a business lawyer, I had a front-row seat to numerous entrepreneurs selling their businesses. While larger businesses have alternatives, such as an initial public offering to realize value, owners of smaller businesses generally rely on a sale for their ultimate payday. Of course, selling the business is not the only exit strategy, but it is a frequent one.

This article is aimed mainly at general practitioners, many of whom, even if they do not consider themselves business lawyers, find themselves as legal counsel to one or more private businesses. The relationship often dates back many years, over which time the lawyer has developed a strong relationship of trust with the owner.

Even if you do not directly handle the transaction, your position of trust and knowledge of the business allows you to bring significant value to the owner in finalizing this important milestone.

Stay involved and keep these nine suggestions in mind as you help your client with this unique process.

1. Avoid foot-dragging.

There is no perfect time to sell a business. If, based on your client's age, life situation or other factors, he or she has come to the decision to sell, proceeding expeditiously to the sale is probably in the client's best interest. Based on my experience, once owners reach the point where they are ready to sell, the value of the business tends to erode the longer they wait.

I am not suggesting rushing into the decision or cutting corners. There may be legitimate reasons (lack of fair offers, for one) to decide not to sell. But once your client has made up his or her mind, equivocating and hand-wringing are to be avoided. I have never heard business owners say they sold too quickly. I have heard many express regrets about waiting too long.





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Encourage your client to prepare the business for sale, invest in the process and choose the best offer based on the results.

2. Suggest early help.

It may be that your client already has a good idea of who is the most logical potential buyer for the business, such as a longtime supplier, competitor or customer. The client may have even had unsolicited offers in the past. If the client is not in that category, he or she may benefit by retaining a business adviser who is experienced in buying/selling businesses of similar size in the same industry. These folks will help line up potential buyers, organize and simplify the process and lessen your client's burden. You or your client's accountant may have suggestions on where to start finding the appropriate business adviser. Urge your client to interview a few with experience and choose the one with whom he or she feels most comfortable.

3. Understand the tax/structuring alternatives.

One of the threshold questions in selling a business is how to structure the sale for tax and other considerations. While a detailed discussion of this topic is beyond the scope of this article, a brief summary follows.

Most sellers want to structure the sale as a sale of the capital stock of the business (stock sale). This has two advantages for the seller. First, it transfers the liabilities of the business to the buyer as a matter of law (subject to the risk allocation in the sale agreement). Second, gains realized from the sale are generally taxed at the lower capital gains rate available to non-corporate taxpayers. Under current law, corporations selling stock are subject to essentially the same rate on capital gains. The buyer, on the other hand, generally



wants the business transferred by a sale of assets (asset sale). In an asset sale, the buyer (subject to certain exceptions) only assumes the liabilities it agrees to assume. In addition, the buyer can depreciate the acquired assets, including goodwill and going-concern value, which are amortizable over a 15-year period at the higher sale value versus the book value in a stock sale.

Sometimes, however, a buyer wants a stock sale. This is often the case where the business owns numerous licenses or other rights that would have to be assigned, preclosing, absent a stock sale. If this is the case and the seller is an S corporation, the buyer may suggest a Section 338(h)(10) election, to which the seller must agree. At the risk of oversimplification, if such an election is made, the stock sale is treated as a deemed asset sale and generally results in an increased basis in the assets of the target corporation assets sale for federal income tax purposes. The seller, if he or she agrees, will normally demand an adjustment to the purchase price to

compensate for the loss of the capital gains treatment of a stock sale for the conversion of long-term capital gain to ordinary income.

From a planning perspective, you should work through the structural details with your client's accountant and any other relevant professionals before approaching potential buyers so you can present the most advantageous option for your client right from the start.

4. Perform due diligence before the buyer does.

Part of making the sale process smooth means anticipating a buyer's concerns. This goes beyond the skeletons discussed later in this article. Assemble a list of the items buyers will want to review ahead of time. These items include employee compensation, employment contracts, pension plans, health plans, licenses, customer and

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supplier contracts, warranty claims, leases, historic financial statements, accounts receivable collectability, sales tax records, customer concentration, etc. Helping your client collect, arrange and present these items in a user-friendly format and ultimately make the client responsive to the buyer's due diligence list will go a long way toward making an overall positive impression of the business in the buyer's eyes. Sellers who dribble out due diligence materials and let the buyer put the puzzle together usually pay a price. The messier these materials, the less likely the buyer is to give your client the benefit of the doubt as questions arise.

It also helps to review these materials as you are collecting them so you can anticipate questions from the buyer. In asset sales, the buyer will be particularly interested in assignment and change of control provisions (especially for licenses and real estate leases). Put yourself in the buyer's shoes to try to see what questions you would have and then have the answers ready.

5. Take the skeletons out of the closet.

All businesses have situations or circumstances, both prospective and in the past, that may affect the value of the business and may not be discernible from a review of the financial statements or other documents. As counselor to the business, you are probably aware of these. It could be an environmental issue that the client hopes never comes to the surface, so to speak, or it could be a dispute with a big customer. While the buyer may undertake extensive due diligence, there is a chance it might not discover these facts. What do you do? Your client only has two choices: disclose and explain to the buyer or don't disclose and hope for the best.

Putting aside ethical considerations for the moment, if the client does not disclose and the feared situation occurs, there are very few agreements that will protect them. That is because the matter will probably breach a representation or warranty in the sale agreement and, even if it doesn't, the buyer is going to allege fraud because your client knew about it. At that point, the client no longer controls the situation — a court does. Your client's life and retirement will be interrupted, he or she will incur significant legal fees and the ultimate cost to the client may be many times what it would have been had the client disclosed the situation in the first place.

Let's say you convince your client to voluntarily elect to disclose the issue early in the process. The client is still in control. The client can explain to the buyer why the client does not think the matter is likely or material and how the buyer can protect against it going forward. The buyer may exact a cost, but it will never be in a better mood to discount that cost to get on with the deal.

6. Don't rely on the buyer to take care of employees.

Most small business owners have one or several longtime, loyal employees they want to make sure are "taken care of" after the sale. This is an honorable thought. But the client should not expect the buyer to do it. To the buyer, any post-closing commitment to any employee (beyond future salary/compensation) is purely a liability, for which the buyer will require a dollar-for-dollar decrease in the purchase price.

Better that you sit down with the client and accountant and devise a tax-friendly plan to compensate these special employees out of the sale proceeds and keep the buyer out of it.



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7. Be wary of earn-outs.

An earn-out is a device sometimes suggested by buyers that purports to give the seller additional consideration if certain performance-based thresholds are achieved post-closing. From your client's perspective, it is essential to determine whether the buyer is proposing additional consideration (i.e., is paying fair value at closing, plus more if the targets are met), which is fine, or whether the buyer is simply paying less up front and making your client earn the rest via the earn-out, which is not.

There could be situations where an earn-out is appropriate, such as if the client wants credit for a product or service the client thinks enhances the business value but is yet untested or unrealized. In that case, a narrowly tailored earn-out could be appropriate. If the earn-out relates to the operation of the business generally, however, it could be just cheap financing for the buyer and should be avoided. Even the best drafted earn-out provision provides significant discretion to the buyer and can easily lead to disputes.

The question I always asked clients who were considering an earn-out was whether they would be happy if all they received was the money delivered at closing, because that was the only consideration I could comfortably foresee that they would actually receive.

8. It may be in your client's interest to work with the buyer post-closing.

Many buyers want the seller and certain executives to work for the business post-closing as a way of ensuring a smooth transition with customers, suppliers, etc. That may be a good idea for your client as well. Your client has an interest in making sure the buyer is happy even if there are no post-sale payments. If the client is still running the business (albeit for the buyer's account), he or she will be in an excellent position to make sure the transition is smooth, as well as heading off any glitches, which, if not properly handled, could result in a claim by the buyer. So long as it is a finite period (no longer than a year) and the client is properly compensated, it adds

another level of insurance for the client to feel confident once he or she walks away.

9. Don't overanalyze the noncompete.

In my experience, nothing makes a buyer more nervous than when a seller spends an inordinate amount of time trying to chip away at the noncompete provision of the sale agreement. While courts and legislators have been chipping away at the reach of noncompetition agreements, enforceability is not often questioned in the sale-of-business context. The buyer wants to be assured that your client has no intention of entering back into the business in any way.

The buyer's patience will soon run thin if your client keeps coming up with scenarios (e.g., "What if I want to do X?" or "What if I help my son or daughter do Y?") that he or she wants excepted from the noncompete. Most sellers have no intention of doing anything in the field, so why complicate the sale by trying to negotiate exceptions that will never be used?

Conclusion

If you urge your client to rely on advisers for help, anticipate a buyer's concerns and organize the process as discussed above, the client will be in a position to obtain a fair price and a worry-free, expeditious sale. ☞



Kevin Scott has been practicing corporate and transactional law in Pennsylvania for over 40 years. In addition to speaking and writing on issues of corporate law, he provides expert witness services for attorney liability cases involving transactional issues. The author would like to thank Jerald D. August, Esq., for his assistance in crafting Section 3 of the article.

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