All Dressed Up with Somewhere To Go:

How To Succeed in Selling Your Business without Really Trying (Too Hard)

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In the current economic climate, a merger or sale can be an attractive exit strategy for many businesses. Although the deal can take almost any form, there's more to it than due diligence and structuring the sale.

AN ENTREPRENEUR WHO has worked a lifetime (whether an actual lifetime or an "Internet lifetime" which may be considerably less) may have one or more reasons for selling his or her business. No heir apparent or pool of talented management may be at hand to lead the business after the entrepreneur's retirement. The capital required for the business to expand or be competitive may be excessive. The market timing for sale may be ripe. The industry in which the business competes may be consolidating. No public offering may be possible or desired.

Whatever the businessperson's reasons for sale, he or she typically has only one real chance to do it right. A sale process which is not conducted thoughtfully and efficiently may diminish the ultimate ability to maximize the sale price, not to mention disrupt employee morale, customer and supplier relations, and the owner's and the owner's family's peace of mind.

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This article discusses the legal and strategic issues that an entrepreneur should address in preparing for the sale of his or her company. We will provide a special emphasis on pre-sale team formation, preparation for due diligence, retaining employees, corporate risk assessment and housekeeping, and avoiding common mistakes. We will discuss but only briefly touch upon valuation, pricing and structuring, letters of intent and definitive documentation, since those topics have been well documented and defy the constraints of concise discussion.

Although the article offers a seller's perspective in preparing for the sale of his or her company, a buyer who is considering purchasing a growing business will find these materials helpful in providing insight into the seller's strategies and areas of concern.

PREPARATION FOR SALE • To paraphrase Thomas Edison, selling a business is five percent inspiration and 95 percent perspiration. The main preparatory steps are:

- Forming a team of trained and experienced advisors expert in selling businesses;
- Preparing for prospective buyers' due diligence;
- Formulating a package of materials to assist potential buyers in evaluating the business;
- Considering employee retention programs;
- Recasting the seller's previous financial results in a normalized way; and
- Avoiding common but avoidable mistakes.

Selecting the Seller's Team

The need to form a team of expert advisors should be obvious. Very few businessmen, however, form a team of professional advisors in a systematic and organized way early in the sale process. Often-cited reasons are:

- The entrepreneur's own self-confidence in his or her ability to sell the business;
- Lack of awareness of the benefits of dong so; and
- Minimization of expenses.

A team of three indispensable types of advisors, however, can facilitate the process and maximize potential value by assisting the entrepreneur in minimizing typical mistakes and in preparing the business for sale in a professional way. The three types of advisors that should be a part of any team for all but the smallest transactions are:

- Investment bankers/advisors;
- Accountants; and
- Attorneys

Investment Banker/Advisor

Depending on the size of the transaction, this professional will perform several functions for the seller.

First, the investment professional will give the seller a reasonable range of likely values for the business. These values and ranges will be based on the investment professional's access to and experience in comparable transactions in the same industry. The entrepreneur may have a visceral sense of what he would like for the business. The investment professional may be able to educate the entrepreneur regarding valuation methods for different industries (e.g. appropriate multiples of revenues for Internet companies, operating cash flow for wireless telephone companies) and give the executive a reasonable expectation of value.

Second, the investment professional can prepare a confidential information memorandum ("CIM"). This process will be described in more detail below.

Third, the investment professional will formulate a list of potential buyers and advise on a strategy and timetable for contacting those buyers in a way to maximize value. For example,

given the nature of the business and the industry, the sale process may be a controlled auction, a direct contact of one or more likely buyers with exclusive or partial exclusive opportunities to negotiate, or a pre-emptive right granted to one buyer to short circuit the more formal auction process. Part of this formulation of a list of buyers is to "pre-qualify" the financial wherewithal of a prospective purchaser.

Finally, the investment advisor, working in tandem with the other members of the team, may assist in developing the legal and tax structure of the transaction to address the unique structure of the seller.

Fee structures for investment advisors vary with the size of the transaction. While they are negotiable, there is often a stated norm based on the range of the deal.

Accountant

A certified public accountant ("CPA") will assist the seller in preparing the tax returns, financial statements and related reports that the potential buyers will need to review. The CPA will be able to explain whether the seller's accounting practices conformed with or deviated from generally accepted accounting principles and what deviations, if any, were made. The CPA, as with the attorney, will also advise the seller on the tax implications of the proposed transaction. Finally, the CPA may assist in estate planning and structuring a compensation package for the seller to maximize the benefits associated with the proposed transaction.

Attorney

The business lawyer is crucial in performing several functions to assist the seller in maximizing value for its business. First, the lawyer will assist the seller in pre-sale corporate housekeeping which involves the clean-up of corporate records, developing strategies for dealing with dissident shareholders, and shoring up third-party contracts.

Second, the attorney will review the CIM to avoid misrepresentations and minimize any other legal exposure and assure compliance with the securities laws.

Third, the attorney will advise the seller on how to evaluate competing offers. Two identical proposed purchase prices may have radically different implications from a tax standpoint, or from the standpoint of certainty of closing, or minimization of post-closing potential liability to the seller. For example, a proposed $10 million purchase price for assets may or may not be different than the same price for stock. Conditions to closing such as satisfaction with due diligence or obtaining financing or a renegotiation of key contracts with customers or suppliers certainly reduces the chance of a successful and prompt closing. Broad representations, warranties, and indemnities also increase post-closing liability to the seller. These are all areas which trained counsel should give expert advice.

Related to evaluation of competing offers is counsel's services in drafting and negotiating confidentiality agreements, risk assessment, letters of intent and purchase agreements, as well as organizing the data room and other due diligence functions.

Further, an attorney can advise the entrepreneur regarding employee retention programs that will be described below.

Finally, experienced attorneys should assist in structuring the transaction within seller's existing organizational framework to minimize income and estate tax liability. Hopefully, the entrepreneur has worked with counsel from the inception of the business to structure the business in a way which will provide flexibility for, and minimize the impact of, an ultimate sale. Moreover, a well-attuned executive will discuss estate planning opportunities with

counsel at an early stage of the company's existence to try to shift future appreciation to junior generations (which may be done at minimal tax cost and at the same time retain control in the entrepreneur).

Preparing for Due Diligence

The attorney plays at least three vital roles during this stage:

- Data room preparation;
- Confidentiality Agreements; and
- Legal evaluations and clean up.

Data Room Preparation

As trivial and mundane as this may sound, a well-organized and neat data room redounds very favorably to the benefit of the seller. Having all relevant contracts, leases, financial statements, employment agreements, human resources materials, litigation summaries in a tidy, easy-to-read, easy-to-catalogue and orderly area gives a buyer several favorable impressions of the seller. The seller appears accommodating, well organized, and prone to full and complete disclosure.

The attorney should prepare an index of all relevant materials that will be copied, bound, and placed in a data room for prospective buyers to peruse. Some sellers will even go the extra mile and suggest that the attorney summarize each contract and lease and place the summary in the data room as well.

Confidentiality Agreements

The confidentiality agreement prohibits the prospective buyer and its agents from disclosing or using any non-public information concerning the seller discovered during the due diligence process. While these agreements are fairly straightforward, the seller and her team should evaluate certain complexities and nuances. For example, is the prospective buyer merely using the due diligence process as a "fishing expedition" to extract a competitive information to be used against the seller? If this sort of voyeurism is a concern, the seller has several options:

- First, the seller could "stage" the release of data until it became absolutely certain that the potential buyer was seriously interested in making a responsible bid for the business. The seller could provide certain redacts of financial information and other data, but not disclose sensitive data such as pricing, gross margins, or customer and supplier lists;
- Second, the confidentiality agreement could also contain a clause prohibiting the prospective buyer from soliciting seller's employees for a certain period of time. Buyers will resist such a provision and argue that the restriction is too burdensome.

In managing the due diligence process, the seller should maintain careful records concerning what information was given to whom and at what time. These records will help rebut a buyer's claim that it obtained the confidential information from an unrelated source. While confidentiality agreements often also relate to oral information, a seller should consider following up oral communication with written confirmation of such disclosure, especially in sensitive cases with buyers who are competitors.

Finally, the seller should be aware that the practicality of enforcing the confidentiality agreement is limited by the integrity and ingenuity of the unscrupulous buyer. Clever buyers can find many ways around all but the best-crafted agreements. Even if an agreement were clearly breached, and proof of the breach could be clearly demonstrated, the practicalities of the proof might outweigh the associated costs. For example, a seller may be understandably hesitant to call a customer or supplier as a witness,

or potentially expose well-guarded trade secrets in open court.

Related to the dissemination of information to third parties is the disclosure of the potential sale to employees. The uncertainty involved in any sale, and the impact that uncertainty has on job security, tends to have an impact on morale of seller's employees. We discussed retention programs earlier in the article.

Legal Evaluations and Clean-Up

The attorney should begin considering possible legal obstacles to a smooth sale. These impediments may include: obtaining consents from landlords or government agencies, assessing the likely cost of resolving litigation or other claims, environmental clean-up responsibility, the existence of unfavorable material contracts, and anti-trust or other regulatory concerns. The team should also evaluate whether obtaining any critical consents may be problematic.

For example, in the broadcasting industry, the consent of the network to the transfer of its affiliate is key to any transaction involving the affiliate. In the recent purchase of LIN Television by Hicks Muse, LIN was able to thwart an unwanted bid from Raycom when LIN's network, NBC, announced that it would not consent to Raycom as a successor to LIN. Smoking out these problems early on will save everyone time and aggravation, and also avoid diluting seller's negotiating position.

Proper recordkeeping is extremely helpful to enhance the appearance of the seller for a possible sale. While prospective buyers may not be impressed with meticulous minute books, company documentation and other records, they will undoubtedly be unimpressed by sloppy and haphazard recordkeeping. Additionally, counsel should try to assure that all other "housekeeping" items are in good order. These items include removing liens if the underlying debt has been discharged, having proper non-compete and confidentiality agreements in place with key employees, and perfecting registration and assignments of patents and trademarks.

Preparing the CIM

The investment advisor, together with the other members of the team, should prepare some form of CIM. The CIM is like a business plan, serving as an informational tool and roadmap to the prospective buyer. The CIM provides an executive summary of the seller's business, its history, its management, competitors, marketplace, financial history and business plan, and financial prospects. The CIM will serve as a marketing tool for the business and answer many obvious questions about the seller.

Employee Morale and Retention

To employees of a seller, a sale can be both the best and worst of times. If the buyer is a large company with generous benefits and better opportunities for growth, the prospects can be exciting and fulfilling for employees. However, the unknown is always frightening. Moreover, diverting employees' energies from conducting their business toward a sale can adversely affect normal operations.

Keep a Low Profile

Therefore, the seller needs to devise ways both to limit the number of employees with knowledge of the impending sale and to motivate and retain employees through the closing. Devising programs to limit the disclosure of the impending sale to only those employees of seller who "need to know" will minimize the anxieties of seller's employees as well as keep them focused on conducting the business in the normal and ordinary course. Key executive and supervisory personnel should be briefed first, and all of their questions should be answered so that they can inform their subordinates. Immediately before the closing, top management of the ac-

quiring company needs to assure the employees of the seller that the beneficial policies of seller will be continued (if true) and that such employee will be welcome into a larger and better organization if that is their intent. Employees who do not feel they are part of a team will have poor morale and poorer productivity. Alternatively, if employees are not to be retained, stay bonuses and other retention programs will at least keep them motivated through the closing. It is essential that lines of communication be kept open at the time of the acquisition.

Maintaining Stability

In addition, the entrepreneur and her team should consider means to retain employees between signing and closing, to assure that seller's financial performance does not deteriorate and that seller can deliver to buyer an intact organization without mass defections. Common retention programs include "stay bonuses," rolling over of stock options, revisions to employment agreements, revised equity participation plans and acceleration of vesting if the employee remains through the closing (or stays for a finite period after closing at the request of the buyer). Stay bonuses may vary based on the size of the transaction, the generosity of the seller, the trepidation of the seller of losing key people, and the age of the work force. Bonuses may be determined based on a percentage of the person's salary, a percentage of the price, or a figure dependent on the employee's longevity with the company.

Recasting Prior Financial Results

Since privately owned companies often tend to keep reported profits and thus taxes as low as possible, financial recasting is a crucial element in understanding the real earnings history and future profit potential of the entrepreneur's business. Buyers are interested in real earnings and recasting shows how the business would look if its financial management practices were normalized or matched that of a public corporation in which earnings and profits are maximized. In presenting the complete earnings history of an entrepreneur's company, financial statements should be recast for the preceding three years. There is nothing wrong or untoward about this process. This is merely an attempt to enable a prospective buyer to compare apples to apples in assessing the raw earnings potential of a business. Recasted items to consider include:

• *Salaries and benefits.* Many successful entrepreneurs are fortunate enough to have been rewarded with salary and bonuses far in excess of their comparable worth. Additionally and conversely, many family members who may not be making as great a contribution may have been excessively compensated. Perversely, some owners of pass-through businesses may take a low salary (to minimize payments to Social Security and Medicare) and pay the rest in dividends. Therefore, actual salaries of family business participants should be adjusted to prevailing market levels;

• *Expense records.* Examine the expenses of key personnel. Country club dues, fancy dinners, car leases, first-class travel and other "perks" may be items which could be reduced or eliminated;

• *Inventory numbers.* A lower ending inventory level increases the cost of goods sold, which in turn reduces net income. More accurately counting inventory will also increase profits to more actual levels and, at the same time, increase the book value of the business;

• *Affiliated transactions.* Leasing or licensing real estate, equipment, or patents from the entrepreneur or her family to the business (or vice versa) is a typical way to inflate or deflate earnings. These rentals should be reviewed for their fairness and recast if appropriate;

• *Writeoffs.* If a division or line of business or facility had been sold, or there was an extraordinary writeoff of an item such as a large bad debt from a bankrupt customer, consider removing these items since they are not normal or recurring;

• *Expensed capital items.* Some capital items may be expensed, instead of depreciated, by private businesses, further deflating profits. For example, in some cases customer acquisition costs should be amortized (such as in the case of an Internet service provider attempting to gain a customer) instead of deducted in the year in which the expense is incurred;

• *Depreciated capital items.* The entrepreneur may have depreciated capital items on an accelerated depreciation method. If the seller had used a straight-line method of depreciation, which may be more appropriate for a public company buyer, net income would have been increased; and

• *Removal of corporate overhead expenses.* If a seller is likely to be purchased by a consolidator, then the seller's home office and top management team are likely to be redundant. The seller may therefore suggest that it is appropriate to recast its earnings to reflect the elimination of this overhead. The buyer may respond that it should not have to pay a higher price due to the fact that it is incurring these overhead expenses.

Avoiding Common Preparation Mistakes Made by Sellers

Even if the entrepreneur has meticulously followed the steps suggested above, he or she needs to try to avoid stepping in any of several minefields of common human mistakes:

• *Impatience and Indecision.* Timing is everything. If the seller seems too anxious to sell, buyers recognize desperation and take advantage of impatience! If the seller ponders on the sidelines too long, the window or market cycle to obtain a top selling price may pass by;

• *Telling others too early or too late.* Again, timing is critical. If you tell key employees, vendors or customers that you are considering a sale too early in the process, then they may abandon your relationship in anticipation of potentially losing their jobs or fear of the unknown. Key employees, fearful of their jobs, may not want to take the chance of relying on the unknown buyer to honor their salary or benefits. Yet these key employees and strategic relationships may be items of value that the buyer is counting on being around after closing. If you wait too long and disclose at the last minute, then employees may feel resentment for being kept out of the loop or key customers/vendors may not have the time to react and evaluate the impact of the transaction on their businesses or, where applicable, provide their approvals. This is another reason why consideration of retention bonus programs is critical;

• *Eliminate third-party transactions with relatives.* This especially applies when these relationships will be of no strategic interest to the buyer. Shed ghost employees and family members on the payroll who will follow you out the door;

• *Purchase Minority Shareholder Interests.* So the new owner won't have to contend with their demands after the sale or be concerned that they will delay the sale process. However, be careful not to underpay since a selling minority shareholder could claim that you did not disclose the material fact about the impending sale;

• *Positioning the proforma.* The price that a buyer may be willing to pay depends on the quality and reasonableness of your overall presentation of the future potential of the business, including profit projections which you are able to demonstrate and substantiate;

• *Pre-qualify your buyer.* It is critical to pre-qualify your buyers, especially if the transaction will

contemplate a continuing business relationship after closing. Needless to say, you do not want to be left alone at the altar by a bridegroom who cannot afford the tuxedo for the wedding! The buyer must demonstrate its ability to meet one or more of a series of pre-closing conditions, such as availability of financing. The seller should take the time to understand the buyer's post-closing business plan, especially in a roll-up or consolidation where the seller's "upside" will depend on the ability of the buyer to meet its business and growth plans.

THE PRELIMINARY AGREEMENT/LETTER OF INTENT • Why have a letter of intent? Some question the need for the letter at all. Instead of getting bogged down in the mire and details of a letter of intent, some suggest going full tilt for a definitive agreement. Sellers prefer this approach when they are discussing terms with multiple buyers and do not wish to grant exclusivity to any buyer, and want to retain maximum flexibility. Sellers desire letters of intent, however, when they want to see if a buyer is committed to memorializing its thoughts, albeit in a non-binding way, on a piece of paper and enable the seller to assess the buyer's seriousness. Buyers will prefer a letter of intent to obtain an exclusive right to evaluate the company and to see if the seller is really serious about selling.

Timing of the Letter of Intent

On rare occasions, a buyer will provide a letter of intent to a seller before the conduct of the buyer's due diligence. This letter will be subject to a wide range of conditions, not the least of which is due diligence. The letter is furnished at this early stage to show a seller a price range (or a valuation methodology such as a certain multiple of operating cash flow) that the buyer would be willing to pay if the due diligence analysis is satisfactory. These letters are often furnished during early stages of controlled auctions. This allows a buyer to winnow out other potential buyers, pre-empt a seller's discussion with those other buyers, or to see if a seller is interested in discussing a transaction before the buyer spends time and money on a due diligence. Letters of intent furnished before the conduct of due diligence, however, may be exceedingly dangerous since they may emotionally lock a seller into a price range which will be difficult to change even if the due diligence uncovers facts which warrant a change.

Key Items in a Letter of Intent

Following are several key terms to set forth in a Letter of Intent:

• *Binding nature.* Letters of intent are frequently considered as mere agreements "in principle" and not binding. Some courts have nonetheless imposed a duty of good faith negotiation on the parties and awarded damages for breach of that duty (usually "reliance" damages limited to the harmed party's out-of-pocket expenses, but in some cases, the most notable of which was Pennzoil-Texaco-Getty, punitive damages). The binding or non-binding nature of the letter of intent should be carefully stated. Regardless of the legal implications involved, however, execution of a Letter of Intent typically fosters an emotional and psychological commitment of the parties;

• *Purchase price.* As stated above, the willingness, and advisability, of a buyer to formulate a price in a Letter of Intent is a function of the stage of its due diligence. In any event, Buyers should be cautioned against stating a firm price or making it clear that the price is clearly predicated on the consummation and conclusion of the due diligence. Too often a buyer unwittingly traps itself into a price commitment based on a set of unarticulated assumptions and then appears to be renegotiating when, in reality, the due diligence contradicted the un-

derlying assumptions and therefore justified a price reduction;

• *Assets and liabilities.* The letter often spells out, in general, the key assets and liabilities included and excluded in the transaction. This is often difficult to state before the completion of the due diligence and therefore is often discussed generally. For example, are all contracts going to be assumed? As seller may desire this position since it desires to sell its entire business, but a buyer may want to pick and choose which contracts it will assume and does not know enough at this point to make an informed judgment. Are there any assets to be excluded and retained by the seller? Due diligence will also provide better responses to these and related questions;

• *Representations, warranties, indemnities.* Some letters of intent attempt to state the specific or most important representations and warranties to be sought by a buyer. Sellers may resist this on the grounds that the letter of intent will be too lengthy and protracted. The parties may therefore agree that the representations and warranties may be of a nature and type appropriate for the type of transaction. Sellers will often use this language from the letter of intent to argue during the definitive documentation that many transactions in this white-hot acquisition market are analogous to "public market deals" and therefore the representations and warranties should be narrow. Further, sellers will sometimes try to negotiate "cushions," "caps," and "survivals" of representations and warranties at the letter of intent stage. This tactic is often advantageous since the buyer is not as focused on the issue at that point, and is more likely to concede these issues at this stage before it has any exclusive or other leverage with the seller;

• *Deposit/earnest money.* The entrepreneur will sometimes request a deposit or option fee to evince the buyer's sincerity. The parties must determine to what extent, if at all, this deposit will be refundable and under what conditions. There are often timing problems with this provision that can be difficult to resolve. For example, the buyer will want the deposit to remain 100 per cent refundable if the seller is being uncooperative, or at least until the buyer and its team complete and are satisfied with its due diligence. The seller will want to set a limit on the due diligence and review period at which point the buyer forfeits all or a part of its deposit. The end result is often a progressive downward scale of refundability as the due diligence and the deal overall reach various checkpoints towards closing. To the extent that the buyer forfeits some or all of the deposit, and the deal never closes, the buyer may want to negotiate an eventual full or partial refundability if the seller finds an alternative buyer within a certain period of time;

• *Protection of confidential information.* The Letter of Intent should make clear that it is in no way negating the effectiveness of the Confidentiality Agreement. The letter should also be kept confidential unless either party has a legal disclosure obligation. Consistent with the discussion regarding the impact of this information on the seller's employees, suppliers and customers, great care needs to be taken to maintain the confidentiality of this letter of intent or manage the disclosure of its existence to preserve intact the seller's business;

• *Key post-closing agreements.* Letters of Intent often set forth the key post-closing agreements that a buyer feels are necessary. These may include certain employment, non-compete, and lease arrangements;

• *Exclusivity/no-shop/standstill provisions.* A major benefit of a Letter of Intent to a buyer is the seller's binding commitment to (a) give it access to conduct a due diligence and (b) agree not to solicit, negotiate with, or entertain or accept offers from other buyers. The prospective buyer will typically want a period of exclusivity where it has the confidence of knowing that the

seller is fully engaged and committed to buyer and is not considering other alternatives. The seller will want to place a limit or "outside date" to this provision to allow it to begin entertaining other offers after buyer has had a reasonable period of time to evaluate the business. Some sellers will seek to limit this exclusivity further if the buyer is not proceeding with all deliberate speed or if it is not negotiating in good faith. This latter point is obviously very subjective and may only serve as a practical matter to keep the buyer from unnecessary delays or dramatically excessive bad faith;

- *Conditions to closing.* Sellers will want to limit the types of conditions to a buyer's obligations to proceed to closing, beyond those that are "normal and customary." Sellers will want to assure that the closing may not be delayed or upset for any reason except for an event caused by the seller (such as the significant change in its operations) or a third party (such as the withholding of a key consent). For example, the seller will want to assure that the buyer cannot "walk" from the closing as a result of its inability to obtain financing, or its inability to obtain board and/or shareholder approvals.

BUYER'S DUE DILIGENCE • Once a Letter of Intent has been executed, the seller should anticipate that a buyer and its acquisition team will want to immediately embark on the complex and extensive legal and business due diligence. As a result, the seller and the seller's team of advisors should be prepared to accommodate all reasonable requests made by the buyer. Seller should always try to promptly accommodate these requests. This cooperation and patience connotes the appearance that the seller has nothing to hide (which hopefully it does not) and that the seller is accommodating and easy to work with.

Focus of the Inquiry

The buyer's financial and legal due diligence will focus on the potential financial and legal issues and problems that may serve as impediments to the transaction as well as shed light on how the documents should be structured. Business due diligence will focus on:

- The strategic issues surrounding the transaction such as integration of the human and financial resources of the two companies;
- Confirmation of the operating, production and distribution synergies and economies of scale to be achieved by the acquisition; and
- The gathering of information necessary for financing the transaction.

Overall, the due diligence process can be tedious, frustrating, time-consuming, and expensive. Although a seller is well advised to be as patient and accommodating as possible, it should not condone a buyer's "due diligence overkill." Buyers should be admonished that due diligence is not a perfect process and that some information may not be available or may simply slip through the cracks.

VALUATION • The seller typically may have three basic approaches to valuation: comparable prices for which competitors have been purchased, prices he or she would like, or the visceral "I know it when I see it" price. Valuation of a business is as much an art as a science, and is far beyond the scope of this article. At the risk of oversimplifying three university courses on finance, the seller's investment advisor will typically adopt one or more of the following basic approaches. Many assumptions and value judgments are implicit in all of these methods.

Comparable Business

A first method may find the seller (and certainly the buyer) looking at what comparable businesses have sold for in the jargon of the par-

ticular industry. This could be a price based on any of the following formulas:

- A multiple of earnings;
- Cash flow (i.e., earnings after adding back interest, taxes and depreciation expense and amortization charges ("EBITDA"));
- Modified EBITDA (by providing for changes in working capital, capital spending, taking out or adding back extraordinary items or costs which should be normalized);
- Multiple of book value or revenues; or
- Some other standard formula.

Replacement Cost

Buyers and sellers sometimes judge what it would cost to replace the assets and going concern value of the seller's business. This replacement cost method addresses the perennial issue of "buy versus build." The prospective buyer or seller adds up the sum of all of the parts—the buildings, distribution channels, reserves, brand name recognition, and so on—to gauge what it would actually cost to duplicate the business. This method is also helpful in acting as a sanity check on the buyer overpaying, since it knows that its worst case is just to reconstruct the business itself. The obvious fallacy with the approach is that putting a value on intangibles such as brand recognition, employee talent, distribution channels and goodwill is difficult if not impossible to gauge accurately.

Discounted Cash Flow/ Internal Rate of Return

The most sophisticated parties will use the following two approaches. They judge the anticipated future cash flow streams of the business (unlike the comparable business approach, which looks at the past) and the replacement value approach which looks at the present. This method attempts to estimate the future cash flow streams of the business, and discount those cash flow streams to the present by using a reasonable discount or "hurdle" rate. The discount rate will be higher based upon perceived risk and uncertainty that the projected results will be achieved. If the discounted present value of that cash flow stream exceeds zero, the purchase price makes sense.

Early Stage Valuation

Valuation of mature businesses is difficult enough. In the case of early stage companies (such as e-commerce start-ups and biotechnology research and development companies) valuation becomes even trickier. The early stage company has no products, no cash flow, high research and development expenses, negligible assets, few if any patents and its future is predicated on hope and dreams. Valuation at this stage is perhaps the true province of the artist. However, a few approaches are common to valuing early stage enterprises. The revenue multiplier approach simply values the early stage business based on a multiple of revenues. This method is most common when the early stage business obviously has some level of revenues, but is draining cash due to high ongoing research and development expenses.

STRUCTURING THE DEAL • Analysis of the valuation and structure of the transaction vastly exceeds the focus and scope of this article. However, sellers should keep in mind that there are virtually an infinite number of ways in which the transaction may be structured, and a wide variety of corporate, tax, and securities laws and issues to consider in light of both legal and accounting principles. These issues and considerations are a function of several items unique to each seller and buyer, each deal, and its unique set of facts and circumstances. Additional variables include varied the goals of seller, the business form of seller, and the goals of buyer.

Main Points

At the heart and soul of the structure of each transaction are the following items. (We will simply list these considerations since the considerations and nuances merit much lengthier analysis and discussion.)

- Is the transaction structured as a sale of assets of the seller, the selling shareholders' stock, or a merger of seller and buyer?
- What is the form of consideration (e.g. cash, notes, securities, etc.)?
- Is the purchase price fixed or is it contingent on the achievement of financial results before or after the closing?
- Is the purchase price payable in cash, stock in the buyer, or is it payable over time on an installment basis?
- What are the tax consequences of the proposed structure for the acquisition?

Stock vs. Asset Purchases

Perhaps the most fundamental issue in structuring an acquisition is whether the transaction will take the form of an asset or stock purchase or a merger. Each form has advantages and disadvantages that depend heavily on the circumstances surrounding any given transaction. Typically, the following factors should be considered.

Stock Purchase

The following are beneficial attributes of a stock transaction:

- The business identity, licenses, and permits can usually be preserved, and consents to third-party agreements may sometimes be avoided;
- Continuity of the corporate identity, contracts, and structure;
- From a seller's standpoint, the entire business, including all liabilities are transferred to the buyer. However, seller's retention of certain assets not "part of the deal" may have tax consequences to seller.

Conversely, the following are some negatives to a stock sale:

- Buyer has less flexibility to "cherry pick" key assets;
- The buyer may remain liable for certain unknown or contingent liabilities;
- The buyer may not obtain a step up in basis of the seller's assets and as a result will not be able to write off the purchase price as quickly. The impact will likely be a lower offer by buyer;
- The offer and sale of the securities may need to be registered under federal or state securities laws

Asset Purchase

The following are beneficial attributes of an asset transaction:

- The buyer may be more selective regarding which of the seller's assets it will purchase. At the same time, the seller may more easily retain certain assets it desires to keep;
- The buyer is generally not liable for seller's liabilities unless specifically assumed under contract; and
- The buyer will obtain a step up in basis of the seller's assets and as a result may justify a higher purchase price.

Conversely, the following are some negative aspect- to an asset sale:

- Although the buyer may be able to insulate itself from unknown liabilities by simply not assuming them, some states have adopted successor liability theories and held an unwitting buyer responsible for the sins of the seller. This risk is heightened in cases involving product liability for manufacturing or design defects, environmental contamination, and where the seller has distributed its assets to its owners and ceases to exist;

- Obtaining third-party consents to leases and other agreements may render the parties susceptible to being held for ransom by an unscrupulous landlord.

DEFINITIVE PURCHASE AND SALE AGREEMENT • Negotiating and drafting the definitive purchase and sale agreement (the "PSA") is the culmination of the multi-step process discussed above. The PSA will often take on a life of its own. This article will only tangentially highlight major areas of conflict in the PSA. The issues themselves warrant a much more comprehensive discussion, and are only inserted here to apprise the seller about areas that it might expect to confront.

Major battlegrounds in the PSA frequently revolve around six items. These areas frequently were not negotiated, or vaguely addressed, at the Letter of Intent stage. These major contest areas include:

- Price;
- The nature and scope of representations and warranties made by the seller (and selling owners);
- The terms of the seller's indemnification of the buyer;
- The conditions precedent to closing, including the absence of a material adverse change in the seller's business;
- The responsibilities of the parties during the time period between execution of the PSA and closing; and
- The scope of post-closing non-compete covenants and any predetermined remedies for breach of such covenants.

The Purchase Price

Nothing superficially appears as simple and self-evident as documenting the purchase price. The reverse has been true, however, on many occasions. An entrepreneur client may call and say that she is selling her Internet service provider business for $50 million. Easy, right?

Consequences of Structure

Is the client selling the assets of the business or the stock? Frequently, the buyer and seller do not even address this issue when they agree on a "sale" and agree on the "purchase price." Significant price differences arise from the failure to address this fundamental point. If the basis in the seller's assets is less than the basis in its stock, or even if the basis of both stock and assets are comparable, but the seller is a "C" corporation, the difference in income tax to the seller could be huge. If you also include possible recapture of depreciation, the seller's income tax liability in an asset deal increases even more.

For example, if the basis in seller's stock is $20 million, the basis in its assets is $10 million, the net after tax proceeds to seller in a stock transaction would be $43.1 million (assuming long term capital gain rate and a federal and state income tax rate of 23 percent). In an asset sale assuming seller is a pass-through entity, and assuming no recapture tax, the net after-tax proceeds would be $2.3 million less than a stock sale. If seller were a "C" corporation, the net after-tax proceeds would be approximately $13.1 million less than a stock sale. Conversely, buyer's purchase of stock deprives it of the tax benefits from a faster write-off of the purchase price and also straddles it with all of seller's liabilities. Introducing the allocation of some of the price to consulting, employment, or non-compete agreements further complicates this discussion. In some deals, the parties either accept paying more money (in buyer's case if it buys stock), receiving less money (in seller's case depending on the circumstance), adjusting the price to share some of the unintended tax burden, or terminating the transaction. In some rare occasions, a consolidated seller, with tax losses from its other subsidiaries or the target itself,

may have the opportunity to sell stock but enable the buyer to treat it as an asset purchase and gain the benefits of that treatment.

Has the client decided to merge with the other party? Hopefully, the two parties are capable of merging on a tax-deferred basis. It is never fun to burst the bubble of a client asking you to document the merger of her target, a corporation, into his business, a limited liability company. This type of transaction generally cannot be accomplished on a tax-deferred basis.

Working Capital

Another economic item that the parties frequently fail to address during the stage at which the price is agreed upon is the seller's working capital (i.e. current assets such as cash, accounts receivable, deposits and inventory minus current liabilities such as accrued expenses, customer deposits, deferred billings and accounts payable). This oversight occurs regardless of the form of transaction. Sellers will insist on either retaining, or requiring buyer to pay for, all net working capital (assuming this number is anticipated to grow between signing and closing) since this represents the profits of the business from a particular point in time. Buyers will retort that working capital is just part of a business and was subsumed within the purchase price. You cannot operate a business without working capital, just as you cannot run a business without the computers and software. Buyers may also contend that paying a seller for its working capital falsely incentivizes a seller to refrain from making capital investments (notwithstanding any covenant to conduct its business in the ordinary course) since it would not be paid for the capital investments but would be paid to sit on its working capital. A buyer may further attempt to restrict the growth in working capital as a percentage of total assets on the basis that this relationships indicates customers may be given additional incentives to sign on, inventories may be too high, investment in capital assets may be too low, and the business's capital is not being allocated consistent with past practices.

Classification of Items

Parties often dispute the proper classification of items comprising working capital. While generally accepted accounting principles may classify, for example, cellular telephones as inventory and therefore current assets, buyers have persuaded sellers that cellular telephones are likely to be held by customers for a long period and therefore are fixed assets. Although accounts receivable may be simple to measure for accounting purposes, the actual amount ultimately collected will not be known until 90 to 120 days after closing. To avoid post-closing adjustments in businesses with thousands of customers, these provisions in telecommunications industry transactions frequently value receivables based on a sliding scale. For example, receivables less than 30 days old may be valued at 100 per cent of face value, those 31 to 60 days may be assessed at 90 percent, and so on, to fix a firm value at closing and avoid the accounting and administrative nightmare of revisiting the payment practices of thousands of accounts.

A variety of compromises resolve differences over payment for working capital items. Frequent approaches include having a buyer pay for (if a positive number) or receive a credit for (if a negative number) all changes in working capital from a certain date (such as from the balance sheet date which formed the basis for determining the price or from the signing date) to the closing, all changes in excess of a certain amount or all working capital period.

Hidden Assets and Liabilities

A final purchase price item which the buyers and sellers seldom discuss in arriving at the purchase price is the off balance sheet or hidden

asset or liability. In a sale of an Internet service provider business, for example, the seller may also design websites as an ancillary service. The buyer may view the assets related to the design business as ancillary to the business and potential sources for service line extensions. The seller may retort that these assets have generated no appreciable revenue, are merely ancillary to the main business and should not be given away gratuitously. Likewise, shareholders or partners of a seller sometimes own office or tower space that is leased to the seller at bargain or above market rates. Buyers frequently prefer conveyance of the property and merging the lease with the deed at closing. Not surprisingly, buyers are not averse to retaining the bargain lease approach (provided it is a long-term lease). Sellers will attempt to extricate itself from a bargain lease and buyers will point out how the bargain lease has artificially inflated the seller's cash flow and thus valuation.

A hidden liability includes an off balance sheet (or off footnote) contingent liability to a potential litigant (such as potential liability for a garden variety of contract disputes or torts). A different type of hidden liability has been surfacing more recently in highly leveraged transactions in the software and telecommunications industries—liabilities for the unwinding of interest rate swaps. Many lenders to sellers have required the seller to "hedge" or swap out part of the enormous debt incurred by seller to finance its acquisition or working capital. An interest rate swap, in theory, provides protection against dramatic swings in interest rates. The value of the swap varies with fluctuations in interest rates and the amount of time elapsing until the swap expires. When a seller sells its business, the buyer may agree to assume seller's "debt" as part of the purchase price. Surprisingly, sophisticated businesspeople rarely discuss and frequently overlook whether the value of the swaps is included in this debt assumption. In many deals, this value could be significant and resolution of the proper allocation between the parties has been a prominent last minute obstacle.

Scope of Representations and Warranties

A major battleground in the PSA is the scope and breadth of seller's representations and warranties ("reps"). The buyer will desire the seller to make a wide range of written and binding representations and warranties in the PSA. Among the assurances which a seller will be expected to provide a buyer are the following:

- The sale is not a breach of any other agreement or obligation;
- Its assets are free and clear of all liens and encumbrances and in good operating condition; and
- All material facts have been disclosed.

The buyer will want the scope of these representations and warranties to be as broad and comprehensive as possible, primarily because these clauses serve three purposes:

- They assist in due diligence;
- They form the basis for "kicking out" of the deal between signing and closing if the reps turn out not to be true; and
- They serve as the basis for indemnification if they are breached.

In essence, buyers look to reps as a form of an insurance policy. As a result, seller will zealously strive to negotiate limitations on the scope of these provisions where necessary. Particularly, sellers will suggest qualifications of the reps by their knowledge or by a materiality standard. Additionally, sellers will try to eliminate reps and suggest that the buyer is welcome to conduct its own due diligence and find out all facts of the business for itself. In the final analysis, the reps simply shift the risk of the accuracy thereof between the parties.

The Comfort Factor

The reps should seek to give some comfort to the buyer that the seller's financial information is true and the business is sustainable in the future if managed properly and consistently. The typical financial statement rep usually confirms (with or without a materiality qualifier) that the financial records fairly reflect the results of operations. This rep, standing alone, will not provide sufficient comfort regarding reliability of a seller's cash flow. Significant liabilities relating to past periods, as well as future periods, could loom and need to be analyzed. For example:

- Has the software developer infringed on other software?
- Does the seller have legal access to its code?
- Are salesmen or technicians being treated as independent contractors, and thus no withholding tax provisions have been made?
- What barter obligations are owed to advertisers? Are there any "make good" time spots owed to advertisers on a portal site?
- While environmental liabilities are typically absent in technology or communications transactions, the potential liability cannot be ignored and may surface based on the prior use of the business' property and the manner in which the property is held. (For example, does the business use back-up generators with underground fuel tanks? How does it dispose of its batteries?) The issue of liability for radiofrequency exposure, moreover, is unresolved, but few sellers will ever represent anything except that they have complied with all existing laws with regard to that issue;
- In an asset transaction, buyers usually exclude liabilities that are not expressly assumed. A stock or merger transaction requires far more due diligence, or indemnification protections, to assure that the buyer is not taking any risk which has not been factored into its OCF pro forma model. The practical world, however, may dictate that these liabilities may either need to be shouldered by the buyer, if not for prior periods, certainly for periods after the closing.

While reps may provide some assurance of the reliability of trailing revenues or operating cash flow, reps will rarely give any comfort that the figure is sustainable. Certainly a seller is well advised to expressly disclaim any guarantee of future results or performance. Sustainability beyond closing is typically a function of both macroeconomic conditions as well as the operating talent of the buyer. However, reps addressing the following may provide an early warning signal to a buyer:

- Whether contracts are in default;
- Notice of dissatisfaction or termination from major customers or advertisers;
- Renegotiation of major contracts;
- Notice of termination of key personnel and similar items;
- Notice of complaints from customers, employees, suppliers, or the government.

Scope of Indemnification

Indemnification clauses provide the ultimate protection to a buyer for a seller's breach of a rep or non-fulfillment of a covenant or for liabilities that arose before the closing. Selling entrepreneurs attempt to limit a buyer's indemnification rights in several ways and these are frequently the most fiercely contested donnybrooks in the agreement. Battles are typically waged over:

- Limiting the time period when the buyer may assert claims;
- The dollars which must be suffered before claims may be asserted (and then whether all damages may be recovered or just those in excess of the agreed amount);
- The total amount of damages for which a seller may be liable, the types of damages (i.e.

whether consequential or punitive damages are excluded or modified in some ways);

- Whether damages are calculated before or after the tax effect thereof, and the procedure for controlling third-party claims and handling the disputes between the parties.

Further, buyers will also attempt to hold the owners of the seller, and not just the seller, liable on a joint and several basis. Surprisingly, very few buyers attempt to insert indemnification clauses which specifically recite that the purchase price was based on a certain multiple of revenue (such as in the software industry) or of operating cash flow (such as in the telecommunications industry) and therefore any dollar amount of damages suffered should be multiplied by that factor. Sellers intensely resist that type of provision and a humbled buyer will usually resign itself to deferring that battle to another day when proof of damages is submitted to a trier of fact. The amount of creativity and nuance in devising acceptable peace treaties ending these battles is virtually limitless.

Conditions Precedent to Closing

Sellers try to limit the conditions to closing to all but the most crucial few—items such as obtaining major third-party or governmental consents and the absence of an injunction. Buyers, on the other hand, will try to finagle wiggle room and seek to impose conditions to closing such as:

- Satisfaction with its due diligence;
- Obtaining financing;
- Receiving board and/or shareholder approval;
- Obtaining all, not just material, consents; and
- The absence of any actual or threatened litigation challenging the transaction.

"Mach Out"

One condition to closing which is frequently the subject of fierce negotiation is the right of the buyer not to close as a result of a material adverse change in the seller's business, financial condition, assets or properties, and sometimes "prospects" (a "mach out"). A mach out takes many forms. Most clauses tend to be purely subjective in nature. A mach out will occur, for example, if there has been a mach in seller's business, financial condition, properties, or prospects. These are all value-laden concepts and reasonable people can honestly differ on whether any or all of these machs have occurred. Further, while a mach in seller's "business, financial condition and properties" has actually occurred and may be analyzed based on the facts as known, sellers should resist a mach out based on a change in "prospects" since this calls for pure prophecy about future events. Sellers should also qualify a mach out based on changes in "properties" if such changes are covered by insurance or relate to intangible and conjectural properties such as goodwill or franchise value.

Qualification of Mach Outs

Sellers frequently attempt to qualify mach out clauses to exclude events affecting the economy in general or the industry in particular. They justify this qualifier on the grounds that the mach out should only apply to conditions to the business caused by seller. To the extent that factors outside of seller's control propagated the mach, seller should not be penalized. Buyers try to resist these caveats on several grounds. Allocating blame between a seller's management fault or general economic conditions takes Solomonic wisdom and, in reality, immeasurable precision. Regardless of the source of the mach, moreover, the seller's business has suffered, and it is not the same business that was the subject of the original bargain between the parties.

The parties less frequently attempt to devise an objective mach out clause. For example, the agreement may specify that a mach out will

only be triggered if trailing cash flow or revenues decline by 10 percent or more over the prior measuring period. If this concept is agreed to, buyers try to tie the figure to a less manipulable item such as revenues. While the buyer may fixate on revenues in other respects, tying a mach out clause to revenues is dangerous since many expense items may be deferred or revenue items accelerated to manage the revenues number. While contractual clause may admonish against such devises, they are often subtle and subjective and furthermore typically avoid detection until after the closing.

Finally, the parties should reconcile the mach out provisions with the casualty section. A telephone outage incapacitating Internet access and therefore loss of e-retailing orders is certainly a mach in the literal sense. However, since repair of the telephone lines can be expected in a brief period of time, and no lasting impact on the business would likely be felt, it would be unfair for buyer to avail itself of the mach out. Instead, the buyer should delay closing until the casualty is fixed (or close and receive an assignment of the insurance proceeds).

Conduct of the Business Between Signing and Closing

Axiomatically, buyers expect to own the same or better business at closing as existed when the PSA was signed. Contractual provisions governing the conduct of the operations ("conduct provisions") of the seller's business between signing and closing attempt to assure the normal continuation of the business during this period. The importance of conduct provisions is magnified in transactions when a significant delay, perhaps due to regulatory filings or shareholder solicitations, is expected between signing and closing.

Subjective Conduct Provisions

Conduct provisions in most transactions are drafted subjectively or objectively or both. The most subjective provisions require the seller to continue to conduct its business during this period in the ordinary and usual course consistent with its past practices. The subjectivity of this obligation satisfies many parties, particularly when the seller does not want to incur specific obligations and the buyer is confident that the seller is well managed or has nothing to gain by mischief. The practicality that the seller's employees will begin dividing their loyalties between the parties is also a fact of life which provides comfort to buyers that employees' self-preservation instincts will prevail over any last minute gamesmanship by a seller.

Objective Conduct Provisions

Objective provisions are carefully negotiated. A buyer may insist on approval rights over the change in billing rates or license fee schedules, entry or termination of leases or site acquisitions, acquisitions or dispositions of software or fixed assets, termination of personnel, or paying bonuses or raises. Sellers attempt to fine-tune these provisions to make sure that they do not unduly interfere with their management. Sellers should require that the subjective revenue or cash flow requirement is satisfied to the extent that it is modified by the objective components.

Non-Compete Agreements

PSAs frequently require the selling entity and certain key shareholders to agree not to compete against that entity, solicit its employees and customers, or disclose confidential information after the closing. While sellers and owners naturally desire these clauses to be as limited as possible, buyers need to be cognizant as well that a narrower covenant has a better chance of enforceability and a broad and overreaching provision may be stricken as an undue restraint of trade. Several key issues arise in negotiating these agreements.

Product or Service Prohibitions

First, the parties will discuss the products or services in which the seller or its owners is precluded from competing. A buyer will desire the clause to encompass any product or service from which the seller derived revenues, or had taken steps to develop (such as formulated a business plan to enter into a new product or service). The seller will rebut that it should not be precluded from competing, since this deprives her livelihood, but rather from soliciting existing or past (within the past six to 12 months) customers and employees. In the context of the sale of a business, the buyer will usually prevail since it is paying a considerable sum to keep seller from upsetting the marketplace for a period of time. A seller may succeed, however, in carving out certain product or service lines that have not generated significant revenues or profits.

Related to the seller's agreement not to compete is the not too infrequent problem of overlapping purchasers. A manufacturer of telephone switches and cables may sell the cable business and agree not to compete in the cable business. The seller then may sell the switching business to a manufacturer (such as Lucent), who is also in the cable business. Appropriate carve-outs for subsequent acquisitions need to be addressed.

Geographic Scope of Restriction

Geographic scope of the non-competition agreement is also a frequent area of discussion. An Internet retailer with sales in a few states will be hard pressed to accept a buyer's demand that the clause encompass the entire planet, since that is the potential reach of the Internet sales. However, the buyer's position is much more logical and sustainable in this context since, in reality, the seller has the possibility of making sales throughout the globe. In contrast, if the seller were a cellular telephone company with a defined territory licensed by the Federal Communication Commission, the non-compete clause would not likely be enforceable far beyond the extent of that territory.

Time Period

The time period of the non-compete and non-solicitation periods is frequently scrutinized. Sellers of computer and other high technology entities will rationalize a one-year term due to the lightning-paced changes in the industry. Although buyers may agree with this analysis in the context of the non-compete agreement, they will insist on a longer period for a non-solicitation covenant. This longer period for a non-solicitation clause may be justified on the grounds that soliciting the customers and employees of seller's business would undermine erode the asset which was the basis of the bargain between the parties.

Solicitation

Sellers will often seek to solicit their former employees in two circumstances: through means of general solicitation and if the employee was terminated without cause. A fair-minded buyer should not be too troubled by these carve outs, although care should be taken to prevent a clever seller from manipulating the spirit of these exceptions.

Parties to the Non-Compete

A further area of conflict is the persons agreeing to the non-compete. Buyers will sometimes ask that all shareholders agree not to compete, and also include their spouses and affiliates. Sellers will try to narrow the signers to those who are active in the business and exclude passive owners and investors.

Automatic Void Clauses

Finally, some sellers will attempt to void the non-compete and other restrictive covenants if the buyer is in default of any of its post-closing obligations, such as payments under a note. While this approach may be tempting and sound

symmetrical, sellers should remain skeptical of its practicality. If the seller were allowed to compete due to a breach by buyer under a note, and then the breach were cured, should seller then have to stop competing, and, if so, forego the costs it incurred in setting up a competitor?

AVOIDING POST-CLOSING LITIGATION WITH THE BUYER • The worst nightmare for a seller is to receive a phone call from the buyer after closing that something is wrong. After countless hours agonizing over the sale, selecting the team, organizing the due diligence, retaining the employees, and hammering out complex agreements, the only list of the buyer's on which seller wants to be included is the Christmas card list. As a result, here are some basic and obvious suggestions to assist the seller to minimize the risk of post-closing confrontation with the buyer:

- Disclose everything. Many post-closing disputes involve arguments over undisclosed liabilities or inaccurate representations. When in doubt, disclose. It is better to tell too much than too little;
- Make sure the buyer is clear about its post-closing obligations and liabilities. All liabilities to be assumed by the buyer should be expressly disclosed and all contractual obligations to be assumed or assigned should be included in the Schedule. Avoid surprises;
- Try to promptly obtain all required third-party consents. Post-closing litigation will occur if a third party comes out of the woodwork after closing and makes claims against the buyer (as successor). For example, make sure that all applicable Uniform Commercial Code "bulk sales" notice requirements are met;
- Make sure you are clear about your post-closing obligations in areas such as consulting services you will be required to provide to buyer, non-competition covenants, and other important post-closing conditions;
- Have a system in place for monitoring your "earn-out" compensation. Try to have the earn-out based on financial factors that would be difficult for a buyer to manipulate. For example, try to have the earn-out based on revenues or gross profit. Avoid tying the earn-out to net profit or cash flow since increasing expenses can easily deflate these figures;
- Carefully review all representations and warranties you have made in the definitive documents. If unclear, then prepare a disclosure accordingly or negotiate for a diluted standard;
- Try to limit the post-closing exposure with appropriate cushions, caps, and survival periods.

CONCLUSION • The right business, sold in the right way, should be able to take advantage of the current feeding frenzy for merger and acquisition activity. The demand for businesses spurred by a consolidation in virtually every industry, the creation of new industries due to the explosion of e-commerce and Internet-related activities and services, and an abundance of capital should create opportunities to enhance a seller's leverage in a sale negotiation. The National Venture Capital Association estimates that over $50 billion in venture capital was raised in 1999, an increase from $20 billion in 1998! *Mergers and Acquisitions* magazine reports that nearly 6,000 transactions worth almost $500 billion took place in 1997 alone and approximately $2 trillion in 1998. Most likely, these figures do not account for the additional thousands of smaller transactions that remain unreported each year. While the pace of initial public offering activity has been frenetic as well, a merger or sale is the likely exit strategy for most businesses. With proper attention to pre-sale team formation, preparation of the due diligence, retaining employees, corporate assessment and housekeeping—and avoiding some common mistakes—the sale of the business can meet the parties' expectations, both in terms of its efficiency and its profitability.

PRACTICE CHECKLIST FOR

All Dressed Up with Somewhere to Go: How to Succeed in Selling Your Business without Really Trying (Too Hard)

A business owner only has one chance to sell a business. With proper attention to the most important factors, the sale has a much better chance of fulfilling the expectations of both the buyer and the seller.

- In preparing for the sale:

☐ Select the seller's team. This will include an investment banker/advisor who should provide the seller with a reasonable range of likely values for the business, prepare a confidential informational memorandum, and formulate a list of qualified buyers. An accountant will assist in preparing tax returns, financial statements and related reports. An attorney will review existing corporate records, develop strategies for dealing with dissident stockholders, and review the banker/business advisor's confidential business memorandum, as well as drafting all related documents;

☐ Prepare for the due diligence. The attorney will set up a data room as a central repository of all relevant documents, organize these documents, and create relevant summaries. The attorney will also draft confidentiality agreements as necessary, and evaluate outstanding legal issues; and

☐ Recast prior financial results for the last three years to understand real earnings history and future profit potential. Examine salary, expenses, and bonuses of key personnel, inventory numbers, affiliated transactions, expensed and depreciated items, and overhead expenses.

- Draft a letter of intent. Include information about binding nature of letter, purchase price, assets and liabilities, representations, warranties, and indemnities, deposit/earnest money, protection of confidential information, key post-closing agreements, exclusivity/standstill provisions, and conditions precedent to closing.

- Perform due diligence.

- Establish a value for the business based on comparable businesses, replacement cost, discounted cash flow/internal rate of return, or early stage valuation.

- Determine the best structure for the deal. Should it be a stock or asset purchase, or some other arrangement? Be sure to address the form of consideration, whether the purchase price is fixed or consistent, whether the purchase price is payable in stock or cash or is payable over time on an installment basis.

- Draft the purchase and sale agreement. Address purchase price, scope of representations and warranties, scope of indemnification, conditions precedent to closing, the right of buyer not to close based on a material adverse change in the seller's business (a "mach out"), conduct of the sale between signing and closing, and non-compete agreements.