Merger & Acquisition Focus

August/September 2007

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Good deal or bad deal

AVOIDING COMMON MISTAKES WHEN SELLING A BUSINESS

If you're thinking of selling your business, it pays to plan ahead. Understanding common mistakes that sellers make can mean the difference between an acceptable deal and a lucrative one. So work hard now to address potential weaknesses that could otherwise cause deal-breaking surprises later.

Be an effective communicator

Before you begin the process of finding a buyer for your business or even assemble your deal team, inform your senior-level managers of your plans. Otherwise, poor communication can create uncertainty among your staff, negatively affecting your company's performance. It also can lead to the departure of key personnel, making your company less attractive to potential buyers. Offering these employees a percentage of the sale proceeds, additional compensation or a "stay" bonus can help motivate them during the sale process and encourage them to stay on board after the sale.

Disclose sensitive information such as changes in your product lineup last to prevent your competitors from finding out about the sale before it's necessary.

Be careful that you choose the best time to inform the rest of your staff about an impending sale. Prepare an internal memo, fact sheets and key talking points so that you have them on hand when your employees, customers and suppliers start asking questions. Once your deal is a go, arrange to meet with major customers or clients to introduce them to the buyer and clarify your role during the transition period.

Disclose sensitive information such as changes in your product lineup last — and only to a select group of insiders — to prevent your competitors from finding out about the sale before it's necessary. Competitors could try to taint your company's reputation or use other tactics to sabotage it.

Make the most of early stages

Get the upper hand early by discussing with your potential buyer important issues such as representations, warranties and indemnifications. This will help you understand the buyer's position at the onset of negotiations on key issues such as the allocation of financial responsibility. Be sure to enlist the help of an expert negotiator to facilitate even the earliest discussions so that you avoid disclosing too much information or making mistakes that could jeopardize the deal.

You may not even realize your company harbors such issues as product liability or employee claims when you sell your business. But if you agree to the normal representations, warranties and indemnifications, you could face postclosing exposure that exceeds the deal price. A liability that didn't exist at the time of closing — such as damage caused by a product you sold years before the acquisition — also can become a nightmare later on.

Your exposure for these types of claims depends on what you negotiate in your sale agreement. Try to direct the liability for these issues to your buyer or significantly limit your exposure. However, be diligent

in resolving any potential issues before you begin the sale, because a buyer will likely request indemnification from any possible liabilities.

Address other issues

Poor accounts receivable and slow-moving inventory are other liabilities that can contribute to a low sale price or termination of a deal. Buyers will be thorough in looking for these kinds of problems during the due diligence process. Any significant collection exposure or damaged or slow-moving merchandise should be addressed and negotiated as a deal price reduction early on. Once the deal is closed, you shouldn't be responsible for inventory or accept any liability for the acquirer's collection of receivables. Be prepared well in advance of the sale, knowing that performance improvement will greatly increase the valuation for your business.

Intellectual property such as patents, copyrights and trademarks also can determine the quality of the deal you get. Be sure that your company owns the rights to such property. If you don't, a potential buyer may have to purchase them from their owner or risk losing that portion of the business's profits in the future.

Depending on the type of business, there are myriad other hidden issues that might give a potential buyer pause. Some of them may include:

- Poorly kept financial and tax records,
- Contaminated property and other environmental hazards,
- Deteriorating sales,
- Unhappy employees,
- Inefficient processes,
- Contractual disputes, and
- Pending or threatened litigation.

Finally, your own emotional ties to the company may signal to buyers that you're not serious. Make sure you're secure in your decision before you put out the "for sale" sign.

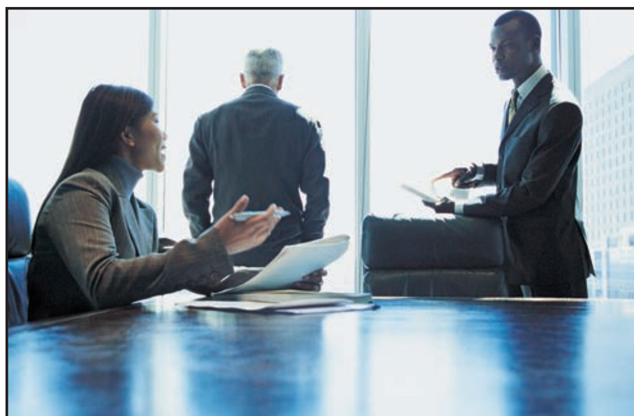
Scrutinize carefully

Many things can sabotage an M&A deal. Knowing what they are and having plans in place to address them provides you with the best chance of getting an offer you're glad to accept. ■

An earnout can break your price negotiation impasse

Price negotiations over a business sale can be contentious — occasionally ending in an impasse. To prevent your deal from falling apart, consider an earnout. An earnout provision sets a purchase price based on how well the acquired company performs after the deal closes. This allows buyers to pay less up front and sellers potentially to receive a higher amount than they otherwise might.

But earnouts can be complicated. Before you agree to structure your transaction this way, acquaint yourself with the risks.



Benefiting both parties

With an earnout, buyers pay only a portion of a company's total purchase price at the deal's closing. The balance is paid in installments as the acquired company achieves specific performance metrics and milestones that the seller and buyer have agreed on.

These milestones might involve performance in:

- ❖ Revenue,
- ❖ Net profits,
- ❖ Cash flow,
- ❖ Earnings per share, or
- ❖ Level of capacity utilization.

Or they could specify the successful launch of new products or the acquisition of new customers.

Appropriate earnout period

Deal participants must agree on an appropriate earnout period based on how long both parties project it will take to adequately measure the company's performance and reach a total satisfactory estimated transaction payout. An earnout period that's too short may encourage managers, in pursuit of short-term profitability, to neglect aspects crucial to the business's long-term success such as product quality and customer service. But an earnout period that's too long may drag out the process unnecessarily and delay payment to the seller.

Earnouts can be attractive to buyers who might not otherwise be able to finance a larger up-front payment.

Once performance metrics and milestones for the earnout have been set, deal participants should address potential issues that could impede the company's ability to reach these goals after the acquisition is complete. These include a changing competitive landscape or a large-scale economic downturn. To protect against these events affecting future payments, sellers might want to consider negotiating alternative methods of measuring the company's future performance in the earnout agreement.

When it makes sense

An earnout can be a good solution when sellers are confident that their company's future performance will meet or exceed projections. Sellers, however, likely will want the company to be operated as a stand-alone unit during the earnout period. If the buyer is planning to fully integrate the acquisition into existing operations, it may be difficult to separate various functions such as accounting and the allocation of expenditures and to isolate performance — which will be necessary if the company is to reach the earnout agreement's benchmarks.

While earnouts can net sellers a higher price in the long run, sellers need to consider the possibility that they will never receive more than the closing price. The buyer could default or the company's future performance could fail to meet the agreement's terms. Though protections such as money in escrow or a letter of credit are options, sellers should think twice about an earnout unless they're willing and able to accept only the initial amount.

Earnouts can be attractive to buyers who might not otherwise be able to finance a larger up-front payment. The buyer also may reap the benefits of a seller who's motivated to reach operational or financial milestones and increase the value of the company.

Potential power struggles

Significant power struggles between parties also are possible. Sellers generally want input into how the company is run to help ensure it will meet performance targets. They can do this by structuring the earnout to require their consent to any significant business decisions, such as the sale or acquisition

of major assets or the termination of key personnel. Buyers, on the other hand, desire the freedom to steer the business in the direction of their choosing and will want to ensure that the earnout provides them with the authority to do so.

The parties can head off another potential conflict by making sure the earnout agreement includes specific guidelines for the calculation of performance measures. A seller may choose to define control provisions in the purchase agreement to ensure buyer performance. The buyer, likewise, can implement control provisions to ensure contributions by the seller during the earnout period. The agreement also should address accounting matters that could cause discord down the line, such as allocation of the buyer's corporate overhead, depreciation and taxes, and extraordinary events.

Sellers also should insist on protections in the event the buyer attempts to undermine the company's performance to avoid payments. Accurate accounting and auditing methods can be tricky during an earnout, and the seller should define a process and schedule for reviewing and assessing performance as part of the purchase agreement.

Buyers, for their part, should negotiate provisions that preserve their economic interest in the business. If the seller maintains management control after the acquisition, the buyer may, for example, want to request the right to mandate the reduction of expenses if the business isn't meeting its targets. Buyers also should be careful when agreeing to protective provisions that could force a barrier between the acquired business and other business units. This could lead to greater expenses that potentially diminish the benefits of the acquisition.

Heading off trouble

Earnouts can be a useful tool in getting a deal accomplished — but they aren't without risk. Careful negotiation, attention to detail and comprehensive documentation can go a long way in eliminating risk and help achieve terms that lessen the odds for legal disputes in the future. ■

Lurking dangers

DON'T FAIL TO PLAN FOR YOUR M&A DEAL'S TAX CONSEQUENCES

Unforeseen taxes can turn a good M&A transaction bad — and even result in the loss of thousands of dollars for buyers and sellers alike. Before you green-light a deal, consider how you'll structure it to offset such risks and maximize tax savings.

Buyers and sellers be aware

With most acquisitions, either stock or assets are purchased. Buyers typically prefer asset transactions because they allow for a step-up in the target's basis for tax purposes and help avoid undisclosed tax and other liabilities.

Asset sales also are flexible, allowing buyers to purchase only the parts of the target company they want. And they can provide buyers with a bigger tax write-off. Buyers of depreciable assets can begin reducing their taxes right away by taking the depreciation expense. If, for example, a company pays $10 million to purchase assets with 10 years of remaining life, its taxable income can be reduced by $1 million each year for the next 10, using a straight line depreciation schedule.

Sellers, on the other hand, often prefer stock transactions, because they're subject to taxation at a relatively low capital gains rate. For sellers structured as C corporations, asset sales can be particularly unfavorable. C corporations are required to pay ordinary income tax on the amount by which the sale price of the assets exceeds their tax basis. What's more, when money from the sale is distributed as dividends, or the corporation is dissolved, the corporation's shareholders pay capital gains tax on the distributed money. C corporation sellers, therefore, typically try to negotiate for a stock sale. This

way, gains are taxed once at the relatively low long-term capital gains rate of 20%.

Structure the deal carefully

The structure of an M&A deal can significantly affect the tax consequences for buyers and sellers. Typically, deals are structured as one of the following types of transactions:

Taxable. In this type, the buyer purchases a company's stock or assets and the company realizes a taxable gain or loss on the transaction.

Tax-deferred. Here, the buyer generally acquires stock or assets in exchange for stock in its own company. There's no immediate gain or loss to the seller or shareholders. Instead, the shareholders "carry over" their basis in their old stock to the new stock and realize a taxable gain or loss only on a taxable disposition of the new shares.

Hybrid. This reorganization also involves a certain degree of nonqualified deal consideration at the time of the transaction. As such, the transaction may be taxable to some parties but not to others. It may offer flexibility if some of the participants are willing to realize taxes when the deal closes, and others need to defer the taxable event until a later time.

Find common ground

Although buyers and sellers have different needs — which often are at odds — financial advisors can help structure a transaction so that it's amenable to both. Even, for example, when the seller exchanges stock with the buyer, the deal can be structured as a more tax-advantaged asset acquisition by making a Section 338 election.

In this case, the buyer benefits from the step-up in basis on the acquired assets and is able to claim the acquired company's financial and tax liabilities resulting from the transaction. Although the seller treats any asset sale gains above the tax basis as ordinary income, the bulk of the transaction is likely to be taxed as capital gains. Adjustments in the purchase price can offset the ordinary income amount.

Beware of tax traps

Determining the tax implications of a potential deal should occur early — preferably during the due diligence phase. But even if you plan ahead, tax pitfalls lurk. State and local governments assess a varying range of income, sales and transfer taxes, particularly if one or both parties to the transaction do business in multiple states or internationally.

Buyers also should assess the target company's property tax situation. This includes searching for any liens and requesting proof of payment for the most recent property tax cycle. If the target company isn't in compliance, buyers risk failing future audits, potentially subjecting themselves to unnecessary tax liabilities. They also should be mindful of a potential property value reassessment — which typically results in a tax increase — after the deal closes.

Maximize tax savings now

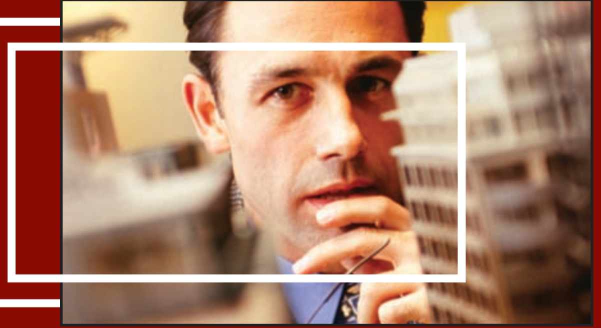
Even an advantageous M&A transaction can sour if you fail to plan for taxes. But with thorough preparation, buyers can minimize net costs and sellers can maximize after-tax proceeds, resulting in a win-win situation. ■

Executive pay agreements: Another potential pitfall

Business buyers should be careful not to overlook one potential tax pitfall: executive pay agreements. With many of these agreements, a change in control can accelerate vesting of deferred compensation or require the payout of a severance package — resulting in a large tax liability for the new owner. Buyers, therefore, should look into reworking existing compensation packages for key executives well before the deal closes.

Ask the Advisor

Q. How should my company prepare for the buyer visit?



A. This visit is an opportunity for a qualified buyer to meet with your management team and tour the company's offices and other facilities. Not to be mistaken for a meet-and-greet or quick once-over, the buyer visit can be a rigorous exchange of information to determine the viability of a sale or acquisition.

Give and take

During the visit, the buyer is likely to ask probing questions about your business to determine the benefits and risks of making the acquisition. Acquirers will want to know if your company shows signs of financial distress or harbors other potential deal-killers such as legal liabilities. Experienced buyers will study how closely the physical space and operations parallel your reported numbers and description of the business, so be careful to communicate pros and cons clearly before they visit.

Buyers may be concerned about other issues, such as the likelihood that key staff and customers will remain after the deal is complete or how easily historical knowledge can be transferred to new management. Buyers further look for potential synergies and opportunities to turn weaknesses around for greater profits. If, for example, your company's relatively understaffed marketing department has resulted in a weak market position, your business could be a great growth opportunity for a buyer with a strong marketing team.

You, too, should use this visit as a learning opportunity. Ask questions that will help you ascertain if the buyer has the financial resources to make the acquisition. Also learn more about your buyer's motivations. If you know what it perceives as valuable and how your business fits into the buyer's strategic plans, you may have better pricing leverage. Finally, ask questions that will help set your mind at ease that the business you've spent years building — perhaps at great personal sacrifice — will be in capable hands.

Get organized

To prepare for the buyer visit, assemble financial statements and other important data pertaining to accounts receivable, working capital, cost of goods sold, inventory turns and earnings. Ensure that data is current and presented in a manner that helps potential buyers understand your business's total financial picture. Also have ready documentation of important information such as vendor payment terms, employee benefits, marketing strategies, training techniques, and billing and collection procedures.

Show buyers that you've solidified relationships with key customers and suppliers, successfully renegotiated leases for facilities and equipment, and documented and safeguarded any proprietary processes or patents. To make your business visually appealing, clean up, organize and paint facilities, and, if necessary, repair or replace equipment. Keep in mind that the culture and operational consistency of your business will be apparent once the buyer assumes ownership and that any misrepresentations could adversely affect your reputation.

In the best light

A buyer visit is an important opportunity to share information that will confirm for a potential buyer the viability of an acquisition. As long as you protect your company's proprietary information, this is your chance to put your company in the best possible light. ■

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