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Items to Consider in Determining Whether to Sell Your Business in 2010 - Part 3 of 4

This is the third client alert in a series of four alerts generally describing (i) the tax changes that will occur on January 1, 2011 and in later tax years as a result of the recently enacted federal legislation, (ii) some of the steps a business owner should take in order to prepare his or her business for sale, (iii) the sale process, and (iv) several key factors to consider to maximize the net after-tax benefits to the owners and to help ensure a smooth sales process.

INITIATING THE SALE PROCESS – THE LOI

When a business has located a potential buyer and is presented with a purchase offer (sometimes referred to as a letter of intent or “LOI”), many issues arise from that offer, including (i) the necessity of entering into a confidentiality agreement, (ii) the evaluation of the purchase offer, and (iii) the navigation of the due diligence process.

When presented with an offer for the purchase of your company, it is critical to consider both the overall financial terms, as well as the other terms of the offer (e.g., indemnification obligations, financing contingencies, conditions to closing, and non-competition issues). These other “non-financial” terms, if not properly drafted, can severely reduce what might otherwise appear to be an acceptable financial arrangement. An offer to purchase your business should be in writing. There are many benefits to having an LOI. First, an LOI memorializes what the potential buyer has told you and/or what you have discussed. By memorializing these initial discussions, it can help minimize misunderstandings (as we have all experienced, people sometimes hear things differently from how the speaker intended to convey them). Second, an LOI should outline many aspects of the transaction, such as details about the financial aspects of the offer (e.g., an all cash offer, partial payment with a note or stock, an “earn-out,” etc.). It is also important to consider which aspects of an LOI are “binding” and which are “non-binding.” An LOI often outlines the indemnity terms a buyer will require from the seller, the representations and warranties concerning the business to be sold that the seller will give to the buyer, financing contingencies, and other terms of the transaction. Memorializing an offer into an LOI also helps a business owner compare one offer to purchase against another. For example, one offer may provide more money overall with an earn-out contingency payment, while another offer may provide less money overall, but because the up-front cash is more certain (e.g., initial cash payment), the second offer may actually be more favorable. Finally, an added benefit of an LOI is that it may also create momentum if a prospective buyer is waffling on a potential transaction.

Many buyers find it strategically useful to address certain negotiations up-front in an LOI as opposed to waiting to negotiate them later (and potentially come to an impasse) in the documentation stage. A well drafted, detailed LOI can save a great deal of time, transaction expense, and exasperation at the “definitive agreement” stage. On the other hand, an ambiguous LOI may lead to litigation and can make it difficult to sell your business to a different buyer (e.g., Was that previous LOI non-binding? Did it terminate completely?). It is important for the seller to find out early in the transaction whether the potential buyer and seller have an understanding about the essential aspects of the transaction.

As noted earlier, in order to sell your business you will undoubtedly need to disclose sensitive business information. This information is an asset and needs to be protected. Insisting upon a well-crafted confidentiality agreement before sharing any sensitive information will help protect this information in case the transaction is not ultimately consummated. Your legal professionals can help you evaluate and/or draft a confidentiality agreement tailored to your particular transaction.

THE DUE DILIGENCE PROCESS

Once a buyer and seller have executed an LOI and confidentiality agreement, the due diligence process will begin. In our previous alert, we discussed digitizing your minute book, vendor and customer contracts, employment records, business licenses, financial and tax records, and other important items particular to your business. A buyer will want to see these items, and may present you with a due diligence list requesting other items. You may want to consider discussing these requests with your legal professional as you may not want to turn over certain items until the transaction has progressed to a certain point (e.g., information can be released in stages as the transaction progresses in a manner satisfactory to you). Your legal professional can discuss the pros and cons of disclosure with you and ways to protect the business if the transaction does not close or the potential buyer misuses the confidential information.

During the due diligence process, other items relating to the sale process are often proceeding on a “parallel basis.” The buyer and seller often begin honing the details of the structure of a transaction and preparing the sale documents, both of which will be addressed in greater detail in our last alert. Additionally, the last client alert will outline some of the issues that are often negotiated in order to “close” a transaction.

For more information, please contact:

[Kenneth K. Bezozo](#)

212.659.4999

kenneth.bezozo@haynesboone.com

[Jeff S. Dinerstein](#)

713.547.2065

jeff.dinerstein@haynesboone.com

[Brandon S. Jones](#)

817.347.6626

brandon.jones@haynesboone.com

[Thomas J. McCaffrey](#)

713.547.2107

thomas.mccaffrey@haynesboone.com

[Arthur M. Nathan](#)

713.547.2009

arthur.nathan@haynesboone.com

[Robert E. Reetz Jr.](#)

512.867.8423

robert.reetz@haynesboone.com

[Chris Wolfe](#)

713.547.2024

chris.wolfe@haynesboone.com