

The

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WHAT'S INSIDE

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AVOIDING DISASTER

In the December 1998 issue of *The Exit Planner*, we discussed how business owners could increase the value of their businesses in the eyes of a buyer. This was a popular topic because it described what business owners could do *now* to positively affect a future event — the sale of their businesses. With that in mind, I've asked one of my law partners, Tony King, and Steve Dyke, an investment banker, to pen this issue on another aspect of selling a business over which you, the business owner, have some control. Namely, the due diligence investigation. Rather than bore you with a long-winded description of the ins and outs of the due diligence investigation, the authors will describe how you can control the process through planning and avoiding the most common pitfalls.

Exactly what is a buyer's due diligence investigation? Simply stated, it is the investigation of your business to confirm that it is:

- what you say it is;
- worth what the buyer is paying;
- free from contingent or unknown liabilities; and
- capable of continuing as represented.

The due diligence investigation varies in scope and detail depending on:

- the type of business;
- the amount of the purchase price to be paid;
- the buyer's knowledge of the business and its industry; and
- the risk tolerance of the buyer.

Typically, the due diligence investigation is conducted by the buyer's personnel, the buyer's CPA, attorney and investment banker, if one is involved. Depending on the type of transaction, other professional advisors or consultants of the buyer may become involved. They may include an environmental consultant, an ERISA consultant (employee benefit specialist), and a regulatory compliance specialist (if the company is in a highly regulated industry).

The buyer's due diligence investigation is a key component (or necessary evil) to any transaction. Negative issues that surface during the due diligence investigation can result in adjustments to the transaction's purchase price. Their revelation can also cause the buyer to withdraw the offer to buy the business or result in post-closing liability to you, the seller. The best way to avoid these problems is to involve your professional transaction advisors (CPA, attorney, investment banker and other advisors as appropriate) at the outset of the sale process. Wise owners (those who subscribe to *The Exit Planner*) have their professional advisors conduct a due diligence audit of the business. The purpose of this audit is to identify and fix potential due diligence problems that may arise in a sale, thus preserving the sale and its full value in order to allow you to leave your business in style.



Editor's Note: *All of the names and facts used in this issue's case studies are fictional.*

DUE DILIGENCE PITFALLS – CAN THEY BE AVOIDED?

by Anthony A. King and Stephen P. Dyke

In this article, we identify some of the most common due diligence problems that we encounter in our respective practices. We've chosen these items because they are commonplace and are almost always correctable prior to offering a business for sale. If not correctable, we are often able to formulate a plan to present the issues to a potential buyer in a proactive manner, thus avoiding or minimizing any negative impact on the acquisition.

EP STOCK RECORDS UNCERTAIN STOCK OWNERSHIP

A shareholder's stock certificate is his "title" to a piece of a corporation. If the stock certificates are lost, improperly documented or improperly accounted for, it is difficult, if not impossible, to determine who owns or has rights to ownership in a corporation.

"Too insignificant," you say, "for a mogul like me to worry about." Really? Several years ago we represented a corporation (with two current shareholders and multiple former shareholders) in its sale as a stock (rather an asset) acquisition. The buyer, in its due diligence investigation, was unable to confirm the status of each of the former shareholders. Most of the former shareholders' stock certificates were lost and thus not properly canceled in the corporation's records. Also, there was insufficient documentation to show that the corporation had bought out all of the shareholders. Because of this uncertainty, the buyer insisted on restructuring the transaction as a purchase of assets. Purchasing only assets, the buyer could rest assured that the former shareholders would not appear after the transaction to claim an interest in the corporation. Fortunately, the corporation was an "S" corporation so the tax impact of restructuring the deal to an asset purchase was not as great as it would have been had the corporation been a "C" corporation.

The moral of the story is to keep your stock records up-to-date, keep track of all the stock certificates and properly document issuances and surrenders of stock certificates. Also, use agreements to properly document all purchases and sales of stock. With some advance notice, the seller's attorneys could have avoided these problems entirely.

EP FINANCIAL MANAGEMENT PRACTICES

Getting your financial house in order long before the sale process begins is an important step you can take to ensure a smooth transaction, to minimize the risk of back-end purchase price adjustments and to increase your company's worth. In every due diligence process, buyers scrutinize a seller's financial reporting system, internal controls and financial statements in an attempt to validate the financial condition of the company. Moreover, buyers perform post-closing audits to

ensure that financial representations contained in the definitive purchase agreement have been satisfied. Because companies are generally priced as a multiple of earnings or book value, material adverse changes to a seller's financial statements lead to adjustments to purchase price, deal structure and consideration or, in extreme cases, the demise of a deal.

The three areas to emphasize when reviewing your financial management practices are:

- professionally prepared financial statements,
- adherence to Generally Accepted Accounting Principles ("GAAP"); and
- the thorough examination of tax minimizing practices.

Having a well-respected CPA firm audit or review your financial statements is an investment that will reap dividends when you sell your business. We recently represented an owner who did not appreciate the value of strong financial management. When approached by a prospective buyer (unbeknownst to us), our client provided his company's internal financial statements. Based upon these financial statements, the buyer prepared a draft letter of intent containing very specific purchase price adjustment parameters. Unfortunately, the seller's financial statements proved to be virtually worthless because they omitted important items such as long-term debt and incorrectly classified others such as shareholder notes receivable. When properly accounted for, these two items alone could reduce net worth of the company by 80 percent and result in a post-closing purchase price adjustment equivalent to 25 percent of the original price!

When apprised of the situation, we recommended that our client retain a CPA firm to prepare reviewed financial statements for his company. Once completed, the GAAP-based reviewed financials helped us to identify potential pitfalls in the buyer's letter of intent. With accurate financial statements we renegotiated the deal so that the purchase price adjustments parameters better fit our client's needs. The client would have avoided delay and increased the ultimate purchase price had he invested in the services of a good CPA firm in the years preceding the sale.

In addition to having professionally-prepared financial statements, owners must incorporate adjustments into internal financial statements and heed their CPAs' advice on how to enhance financial management practices. Throughout the sale process, buyers depend on internal financial statements; failing to bring your internal financial statements up to GAAP standards can lead to significant and unnecessary delays.

Although GAAP can seem confusing, intimidating and sometimes even counter-intuitive, remember that adhering to GAAP lends integrity to your financial statements and affords a buyer a certain level of comfort in relying upon the financial

information you provide. Consider the owner of a construction company who thought she was recognizing revenue properly but whose approach led to significant fluctuations in earnings making it virtually impossible to analyze the company's financial condition. Recognizing that this owner would incur unreasonable financial due diligence risk, we recommended that she have her financial statements audited before marketing her company. Because the CPA firm applied the proper revenue recognition method she was able to show prospective buyers a much more accurate and credible picture of her company's earnings capability.

The final financial management practice area to clean up is the common practice of running personal expenses through your company in an attempt to minimize taxes. Although most deals involve recasting expenses to more accurately reflect a company's earnings, excessive "add-backs" taint the company's image and increase the amount of due diligence a buyer performs. To generate positive momentum toward closing, it is best to focus a buyer's attention on positive issues (growth opportunities, market leadership, strength of the management team, internal controls, systems and other factors) that demonstrate how the company can quickly meet the prospective buyer's growth objectives. When a company has to add back substantial expenses to achieve a certain earnings level, conversations with buyers move in an entirely different direction.

Rather than focusing on positive selling points that help increase value, buyers delve into the validity of the add-backs and the prudence of operating a business in that manner. Furthermore, excessive add-backs can make a buyer wonder, "What else don't I know about?" In order to substantiate add-backs during the due diligence process, a buyer must scrutinize cash disbursements, credit card statements, purchase orders and accounts payable records. If personal expenses are not defensible, the recast earnings will be lower and the purchase price will likely be reduced. Be prudent in the magnitude of personal expenses your company incurs on your behalf. Clean, well-run organizations command higher prices.

EP ENVIRONMENTAL ISSUES

Buyers place a great deal of emphasis on a company's environmental history during the due diligence process. This is not surprising given the increase in environmental regulations, litigation and remediation costs. Prospective buyers often run from deals when "surprise" environmental issues rear their ugly heads—or in the case of Reek Enterprises, extract a heavy price.

Reek Enterprises was a company that used small amounts of hazardous materials in a secondary production process. In the 1970s, it contracted with a hazardous materials disposal firm that, unbeknownst to Reek, illegally dumped the waste. Although informed by the Environmental Protection Agency

of the problem, the owner of Reek took no action to correct the problem. When the issue came to light during the buyer's due diligence, Reek had no negotiating leverage. The buyer demanded and received a larger indemnity holdback and tripled the holdback period. Had Reek addressed this issue up front, it could have avoided the delay in payments of the sale price.

EP BUY-SELL AGREEMENTS

The buy-sell agreement is not only a key component of Exit Planning for the closely held company with multiple owners but it is a key component in the transfer of that company as well.

In a buy-sell agreement, the owners of a business agree to certain restrictions on their rights to transfer their ownership interests in that business. Typically, the buy-sell agreement addresses and restricts how an owner's business interest is transferred upon an owner's death, disability or involuntary transfer (such as bankruptcy or divorce). The buy-sell agreement also defines each owner's rights with respect to his or her ownership interest in the business when faced with an offer to buy the company or an offer from a third party to purchase his or her ownership interest. Thus, the buy-sell agreement becomes crucial to the sale transaction.

As an incentive, some companies grant stock to a key employee, thus allowing that key employee to become a minority shareholder. A buy-sell agreement is the flip-side of any grant of stock to an employee. It is the buy-sell agreement that requires the key employee to sell his ownership interest in the corporation to a third party when the majority owners of the corporation have decided to sell their ownership interests in the corporation to that third party.

Transactions in which selling companies and the owners of selling companies either do not have buy-sell agreements or have buy-sell agreements which do not thoroughly address the sale to a third party can become nightmares. Witness Susan Banbury's "nightmare." She once awarded a valued key employee and close friend a 25 percent ownership interest in her corporation, but failed to require that employee to enter into a buy-sell agreement. Some years later a buyer approached Susan about the possible purchase of all the stock of the corporation. Susan's employee had different thoughts about the value of his stock and refused to agree to the sale unless he got more money for his shares; in essence he wanted 50 percent of the proposed purchase price. As a consequence, Susan could not promise to sell all of the outstanding stock of the corporation nor, because the company was a "C" corporation, did it make economic sense to sell all of the assets of the corporation. A properly drafted and signed buy-sell agreement (i.e., one that required the employee to sell his shares when the controlling shareholder desired to sell her shares) would have handled this problem.

EP PROMISES TO EMPLOYEES

Business owners often make verbal or handshake promises to key personnel. These agreements run the gamut from stock ownership to cash bonuses to personal vehicles. The event that often triggers these promises is an upcoming change in ownership of the business. Don't underestimate the havoc verbal commitments can wreak on a potential transaction, particularly if they are not disclosed to your advisors at the front-end of the sale process. At a minimum, undisclosed verbal agreements add unnecessary tension and complexity to a transaction.

Sumo Distributing was a rapidly growing uniform distributor that had hired Elizabeth Cowan and Scott Stevens as managers about two years prior to its sale. Elizabeth was told if her division achieved certain financial goals in its first year, she would receive 15 percent of the company's stock. Scott was told that if the company was sold within five years of his hiring, he would receive a "substantial" bonus. Neither commitment was disclosed to the company's advisors until three days before closing at which point the buyer demanded additional indemnity clauses in the definitive agreement and clearly stated that it would not close with these issues outstanding.

Agreements with key employees are inevitable. Documenting these commitments at the time they are made is an important business practice that can help your transaction proceed smoothly.

EP FACILITIES

Most buyers are looking for well-run companies that are poised for growth. The appearance of the company's facility is an indicator of internal controls, systems and the overall "cleanliness" of the organization. If a business operates a well-lit, well-organized clean facility in an industry known for dark, cramped, dirty facilities, it shows to potential purchasers a high-quality company with excellent operating systems and employees who take pride in their work environment. Businesses like this receive (well-deserved) premium valuations. Clean up your facility! Make it a place a buyer would want to spend 40 hours a week.

In addition to appearance, buyers look for a facility that can accommodate future growth. Are you out of space? Are machines and desks packed in next to each other, are hallways used for storage? Cramped, cluttered facilities reflect poorly on a business and can lead to discounted valuations because a buyer must factor a new facility (capital expenditure) into the price he is willing to pay for the business. Of course, you don't need a facility with wasted space. If you expect to

require a larger facility in the near future, begin planning for it now. Pick out sites; estimate the requisite costs and capital expenditures associated with the move. Looking to the future demonstrates confidence in your company's prospects and reflects positively on your company.

EP PROPER ADMINISTRATION OF EMPLOYEE PLANS

Most companies today have one or more employee benefit plans intended to be qualified plans under the Internal Revenue Code. Employee benefit plans can be a major source of off-balance sheet liabilities, as well as unknown liabilities. Consequently, these plans represent a due diligence pitfall that can injure or potentially derail a transaction. In some cases the off-balance sheet liabilities or undisclosed liabilities associated with employee benefit plans can cause the sale of a company's business to be restructured as an asset sale rather than a sale of its stock. (Refer back to the "C" vs. "S" discussion.)

The first pitfall has to do with the plan that has been treated as "qualified" but turns out not so "qualified" according to the Internal Revenue Code. This failure can have significant adverse tax consequences with corresponding negative financial impact on the business being sold. Lacking "qualified" treatment can mean contributions losing tax deductible status, investment income becoming subject to income tax, or employee benefits becoming subject to taxation (that employee/participants would have to pay!).

Employee benefit plans generally lose their status as "qualified" plans under the Internal Revenue Code for one of three reasons:

- the plan discriminates in favor of its officers, shareholders, or highly compensated employees;
- the plan is not properly administered in accordance with the Internal Revenue Code and the plan document; or
- the plan does not comply with the requirements of the Internal Revenue Code (usually due to the failure to timely update the plan to comply with changes in the tax law).

Ned Simms entered the sale of his business assuming that the 401(k) and profit sharing plan it had adopted was a qualified plan and was, in all respects, compliant with the Internal Revenue Code. During the due diligence investigation, the buyer discovered that the plan had not been updated to comply with changes in the law leaving its "qualified" status in jeopardy. This uncertainty meant the buyer demanded that the transaction be restructured to provide for a three year escrow

of a significant amount of the purchase price to cover any liabilities that might result from the loss of the plan's "qualified" status. Ultimately, the plan document was amended to bring the plan up-to-date and then the plan was terminated. Paying to correct the deficiencies in the plan and to file for determination and termination was a small price to pay. In the worst case scenario, Ned's failure to maintain the plan as a "qualified plan" and administer the plan properly could have cost him the transaction.

As a matter of good business practice, as well as in anticipation of any transaction, consult regularly with your company's plan administrators or ERISA advisors to ensure that all your employee plans comply with the requirements of law and are being administered properly. Many employee plan administration errors or deficiencies can be corrected without adverse consequences if discovered early enough and corrected in a timely manner.

EP YEAR 2000 COMPLIANCE

More commonly referred to as the "Y2K" problem, companies are protecting themselves against the effects that may result from the programming of a computer with respect to the date and applications based thereon, which in the past, consisted of two-digit recognition (i.e., MM/DD/YY). Commentators warn that when a computer's internal clock reaches the year 2000, the computer program will be unable to process the digits "00." The effect on any type of software, hardware, or computer chip that relies on two digit dating, (such as computer programs—including accounting software, inventory software, operations software—or any other programs that run systems—such as inventory control systems, security systems, telephone systems, voice mail systems, or any other date dependent software) is unknown.

Buyers have become increasingly aware and sensitive to the Y2K problem in their due diligence and in structuring their transactions. In conducting its due diligence, a buyer will look at all computer software and hardware to ensure Y2K compliance. The buyer will review contracts that are being assigned or transferred to investigate the extent to which third parties to those contracts are Y2K compliant and whether or not a non-Y2K-compliant contract will have a material affect on the business or the transaction. If the seller of a business has computer software, hardware, or systems that are non-Y2K-compliant, and if the buyer's cost is substantial to bring that software, hardware or systems into Y2K compliance, expect adjustments to the purchase price. If the seller's non-Y2K-compliant software, hardware or systems could result in potential liability to a third party, (or for that matter, if the seller is party to

any contracts affected by any non-Y2K-compliant software that could result in potential liability) the seller should, at a minimum, expect adjustments to the purchase price, the possibility of the restructuring of the transaction, post-closing liability, or, in the worse case scenario, the demise of the deal.

Fortunately, Y2K problems can and should be corrected well in advance of December 31, 1999. If your company developed the software, you will likely bear the responsibility for correcting the Y2K problem (if any exists). If you purchased the software from a particular vendor, contact that vendor to determine if the software is Y2K compliant and, if not, who will bring the software into Y2K compliance. Refer to your software license agreement to determine whether or not the vendor is responsible for the software fix and has responsibility to bring it up to Y2K standards. Your system or software may be covered by a maintenance agreement that will require the vendor to bring the system or software into Y2K compliance.

EP CONCLUSION

Preparing for a buyer's due diligence is something you can and should do well before you receive an offer to purchase. Knowing the common due diligence pitfalls gives you the insight you need to spot these problems in your company or prevent them from occurring. We hope we've given you some insight as well into potential "fixes."

As a due diligence "rule of thumb," see with the eye of the buyer. If you perceive a problem in your business, so will the buyer. Fix it, if possible, but don't ignore it. Problems that surface during the due diligence investigation result in adjustments to the purchase price. They may cause a post-closing liability charged to you after the transaction has closed—if the buyer does not withdraw his offer altogether. Identify and fix due diligence problems in advance and you may be able to avoid or mitigate these results.

Involving your advisors, sooner rather than later, in any acquisition allows them to showcase all of the information you provide in the best possible light. They will confirm, refute or handle any due diligence issues that surface as part of a transaction. Using your advisors—before any effort to sell the business—to conduct a legal audit of your business and identify and fix potential problems is the wise owner's best due diligence strategy.

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MARCH, 1997 *Saving Millions While Giving it Away*

This issue of *The Exit Planner* addresses the part of the Exit Planning process designed to help you hang on to as much of the proceeds from the sale of your business as possible. Specifically, we look at the design, pros and cons of a Charitable Remainder Trust (CRT).

MAY, 1997 *Girding Your Loins and More/The Top Three Questions Business Owners Ask Before Selling Their Businesses*

In this issue transaction attorney, Ned A. Minor, answers the three questions most frequently asked by business owners who are contemplating selling their businesses.

JULY, 1997 *Beauty Is In The Eye Of The Beholder/The Eye of the Buyer*

To understand the value of a business and its cash flow from the buyer's perspective, several factors need to be examined that are generally not considered by CPAs and other business appraisers when they value a business.

NOVEMBER, 1997 *Where the Rubber Meets the Road/C or S Corporation: What Difference Does it Make?*

The best form of business entity (C or S) for tax purposes during a business's start up and operational years may not be the best when it comes time to sell the business. Find out why and what you can do about it.

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At some point, every owner leaves his or her business—voluntarily or otherwise. This issue discusses a proven seven-step Exit Planning process designed to maximize the business owner's financial and other goals.

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JULY, 1998 *Godzilla the Consolidator/What to do When the Consolidator Calls*

Read this vital issue to learn "the rules" that put you—not the consolidator—in control of the sale process.

OCTOBER, 1998 *Preserve and Increase Business Value Through Business Planning*

Attorney Barbara J. Wells discusses several business planning strategies designed to protect and to increase business value including: examining form of business entity, identifying possible problem areas, motivating and rewarding key employees, ensuring continuity and estate planning for the business owner.

DECEMBER, 1998 *Value Drivers/Why Buyers Pay Premium Prices*

In our most popular issue yet, investment banker, Joseph Durnford, and John H. Brown describe seven key Value Drivers—characteristics of a business that either reduce ownership risk or enhance prospects for future growth. Implementing these Value Driver techniques improves your chances of receiving a premium price for your business.

FEBRUARY, 1999 *Selling A Business to Key Employees*

John H. Brown describes the four possible methods of selling a business to key employees. He uses a detailed case study to illustrate the method that best achieves an owner's objectives.

We at The Exit Planner, are happy to answer any questions you have about articles that appear here We also appreciate suggestions from readers about the Exit Planning topics that they wish to see addressed. We welcome your comments regarding our newsletter. You can address your questions, comments or suggestions to: John H. Brown, President, Business Enterprise Institute, 650 S. Cherry Street, Suite 1100, Denver, Colorado 80246 (303) 321-2242.

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