The EXIT Planner

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WHAT'S INSIDE

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TOP TEN DEAL PITFALLS

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Owners are their own worst enemies.

The mission of **The Exit Planner** is to provide owners with a wide range of information about how best to exit their businesses. In past issues we've discussed tax strategies, key employee incentive plans, family transfer issues, growing through acquisition and many other exit-focused subjects.

This issue is directed at what prevents the exit planning process from proceeding to its logical conclusion—exit. What stands between you and a successful business transfer? What causes an owner to be left at the station, bag in hand, as the Exit Train roars past? Why are some owners able to "leave their businesses in style" and others never seem to leave at all? In most circumstances, the experienced transaction advisor can readily identify the problem.

You.

Pogo is right. We have located the road block and the road block is the owner of the business.

Why? If there were but one simple reason, the answer would likewise be simple. You might suppose that, as an attorney, I'm thankful for complex issues and answers that require legal input. But I'm not. The problems that prevent a successful business sale are typically not tax-driven or key-employee-driven or even negotiation-failure-driven. The problem I'm referring to prevents legal, tax and negotiation issues from even reaching the table for discussion. So shape up owners!

How do owners become their own worst enemies? Ned Minor, leader of the sales and acquisitions department of the law firm of Minor & Brown, P.C., describes in this issue of **The Exit Planner** ten owner-induced deal disasters ranging from poor preparation to loose lips.

True, not all problems originate with the owner and in fact, some deals should fail based on lack of merit. But it is most disheartening for a transaction advisor to witness a deal falter when it could and should have succeeded in bringing the owner permanent financial security.

NEW ITEM

Beginning with this issue, on page 6, we will include a short article regarding an issue that faces business owners as they plan to exit their businesses. Investment banker, Joe Durnford, describes the effect the elimination of pooling accounting is likely to have on the merger and acquisition market as well as on the privately held business owner.

"I HAVE SEEN THE ENEMY AND HE IS US."

by Ned A. Minor

–Pogo

This article describes ten deal pitfalls (in no particular order) that all share the capability of derailing a deal, some more effectively than others. All are fairly common although some owners are prone to "fall" into more pits than others. As you look over the list, you will notice that all of the deal pitfalls are owner failures. This is because it is rare indeed that a financial or legal glitch is so significant that it can not be overcome by an owner's transaction advisory team.

EP INDECISION

The process of deciding to sell a business—a business that an owner has created and nurtured—naturally involves some level of indecision. Is this the right time to sell? What will I do after I sell? If I wait, will I be able to get more money for the business? If I wait, will I be able to get as much money as I can by selling today? All of these are questions that an owner must answer, usually with the help of his advisors.

Given all of the uncertainty surrounding this decision, some owners are tempted to stick a toe in the market to test the waters. They go to the market in an effort to determine what their businesses are worth. Seems logical but the result can be disastrous.

These owners go into the market unprepared. They have not gathered the information that buyers need to make an offer that reflects the true value of the business. Usually, they have not assembled a team of professional advisors. As a result, buyers either make no offer at all or they make an offer that is significantly lower than what it could have been had the buyer possessed all of the pertinent information. Sellers typically reject these deflated offers and pull the business from the market. End of story? Unfortunately not.

Ultimately, these sellers return to the market. Usually, with the help of their advisors, they return better prepared. They return, however, to a marketplace that has been tainted. The perception in the market, rightly or wrongly, is either that: a) the seller is a bit of a "flake" unable to commit to the sale process; or b) there is something inherently wrong with the company for sale. If not, why didn't it sell the first time the seller put the company into play? These perceptions must then be overcome by a seller's investment banker and attorney. Don't create potential roadblocks. Don't go to the market unless and until you are committed to completing the sale process.

EP NEGOTIATING THE DEAL SOLO

There are several good reasons why savvy sellers surround themselves with experienced professional advisors. These sellers recognize that while they are experts in what they do, they are not experts in negotiating the sale of a business. If the idea of flying solo attracts you, ask yourself how objective will you be when the buyer's financial experts, like vultures, begin to pick apart the value of your company? When will you find the time and the energy necessary to keep your business running full speed while at the same time working through the countless issues and distractions that come up during the negotiation of a deal?

No business owner can keep all the balls in the air. He or she needs the assistance of an investment banker, a transaction attorney and a CPA. When this transaction team, which includes the business owner, is working together, the probability that the transaction can be brought to a successful close skyrockets. "Successful" means that all of the dollars promised in the letter of intent are delivered at closing. No money is left on the table.

In the paragraphs below, we will look more closely at the specific functions of each advisor. But all of the advisors act as buffers between you and the buyer. This is crucial as it gives you the time and distance necessary to make rational decisions about proposals that arise during the sale process. Inevitably, buyers will propose a change of terms or request additional items. The advisors are in a better position to evaluate these changes in light of the entire deal. Additionally, advisors enjoy an objectivity that the owner cannot. They dispassionately view a business about which its owner is passionate. Too much passion at the negotiating table is not a good thing.

EP POOR PREPARATION

Although poor preparation can kill a deal, it typically just dents the purse of the seller. Owners who enter the marketplace poorly prepared will leave money on the table. They will not leave the closing with as much money as they could have had they done their homework.

In this context, the seller's homework is to find the sea-

soned advisors who will steer the transaction to a successful conclusion. The first advisor, the Certified Public Accountant, is usually already on board. The company's existing CPA is a good choice to provide the key financial information to the investment banker. The existing CPA also knows the history of the business and can explain how things have been done financially and why.

Next, the owner must find a transaction attorney. Often, a seller's existing attorney is not experienced in transaction work. In those cases, the seller must look for a transaction attorney with significant deal experience (he or she has recently and successfully closed numerous deals). Ask the attorney for a list of references (clients) for whom he has successfully closed deals. When interviewing attorneys, a seller should look not only for experience but also for a mindset that doesn't come naturally to attorneys. By training, attorneys seek to protect their clients from risk. They do this by identifying issues that create risk and negotiating to avoid or to minimize them.

Selling a business is risky business. Of course, you *want* an attorney who limits your risk, but you *need* an attorney who can close the deal advantageously. What you must find then, is an attorney who can weigh risk and work through and around it. For example, in the warranties and representations that any buyer will require you to make, expect being in compliance with every federal, state and local law, ordinance, regulation and code to be near the top of the list. An inexperienced transaction attorney may balk at that language and attempt to negotiate it out of the contract. That effort will waste a good deal of his time and your money because the buyer's attorney won't allow it. An experienced transaction attorney will attempt to insert language that indicates that your company, *as best you can know*, is in compliance. That qualifier is great, if he can successfully negotiate its insertion. But what if the buyer won't budge? At that point, the lawyer may advise you to scrap the deal because the risk is too great.

An experienced transaction attorney will take a longer view of the issue. If the seller believes, after conducting a thoughtful and comprehensive due diligence, that there are no compliance problems, there probably aren't. If, contrary to the seller's warranty and representation that there are none, one does, in fact, arise after closing, the seller will be obligated to fix it. Keep in mind that whether the seller sells the business or not, he or she will be obligated to fix any compliance problem. As a business owner, would you rather pocket several million dollars at closing with the chance that you might have to put some back to remedy a compliance problem or would you rather keep the business and still have to deal with the potential compliance problem? A seasoned transaction attorney can help you weigh theses risks and guide you successfully through these issues without losing sight of a successful closing.

Choosing an investment banker is your last assignment. First, you must know what you are looking for. The investment banker will perform all of the research and due diligence (on your company and your industry) to identify and to qualify pre-selected buyers. The investment banker is the advisor who approaches potential buyers, discerns exactly what they are seeking in an acquisition, and tailors the package (the offer of your company) to meet their requirements. He convinces potential buyers that your company not only meets their requirements but actually exceeds them. Convinced buyers are the ones who pay top dollar for a company.

So, how do you find this financial wizard, mind reader and high-powered salesman all rolled into one? Ask your transaction attorney or CPA for references. Meet with a few investment bankers to determine if this is the person you want representing you and your company in the marketplace. Ask for a list of previous clients and references. Check those references carefully, then make your decision.

You are the final member of your team. You must have confidence in the expertise and guidance of all of your advisors. All of you must work closely so choose your team carefully.

EP HIDING (OR MINIMIZING) PROBLEMS FROM YOUR ADVISORS

Don't succumb to the temptation of hiding blemishes from your advisors. While it may be your style to gloss over or omit mention of certain issues or problems with vendors, customers or others, it is deadly to do so with your advisory team. No matter how embarrassed you may be about a prior sexual harassment claim or questionable tax reporting practices, you must reveal all to your advisors.

All successful business owners go through the uncomfortable—but necessary—process of showing all of their business's flaws to their advisors. Your advisors will devise strategies to cure or minimize these flaws. Don't tie their hands by hoping no one will discover your company's imperfections. Rest assured that a buyer will uncover everything—good and bad—about your business. When they discover the "wart" you tried to hide, your credibility will be shot and it is highly unlikely that the deal will close. If it does close, the purchase price, in all probability, will be reduced. This can be avoided by confiding in your advisors.

EP HIDING (OR MINIMIZING) PROBLEMS FROM THE BUYER

As discussed above, it is critical that a seller reveal any and all problems to his advisors. Experienced advisors will devel-

op workable strategies to minimize the impact those problems can have on the transaction. Some sellers, however, don't see the value in revealing the problems to the buyer as well. To repeat, a buyer will discover, sooner or later, everything about your company. If you claim to put your cards on the table and hide one or two up your sleeve, your credibility will evaporate. It is your advisors' job to show you how to put those cards on the table in such a way as to keep your company in play.

Similarly, you must provide all of the information that you can—no matter how insignificant or immaterial *you* think it might be. For example, you will be required to list every contract to which your company is party. While you may not believe that a particular written or oral agreement is important, you must let the buyer decide. If your attorney is not pushing you (and helping you) to collect *all* of the information about your company, you may not have chosen an experienced transaction attorney.

EP THE LONE RANGER

This is no time to indulge your fantasy of single-handedly fighting the enemy and bringing peace and prosperity to the wagon train. You have assembled your advisory team, so use it. Don't ever communicate with the buyer or any member of his advisory team without your advisors' knowledge and consent. You may, in fact, be the one designated to approach a buyer about a particular issue. That will happen only as part of a strategy developed by your advisory team. Should you be tempted to communicate with the buyer without the knowledge of your advisors, you may derail the transaction. Why? Approaching a buyer about an issue, on your own and without advisory team agreement, will create confusion. Confusion will stall the process as it takes time to sort out the intent of the message and its affect on the rest of the transaction.

Finally, lone rangers do not impress buyers. If you want to seriously impair your appearance of sophistication and credibility, this is one surefire way to do so.

EP BECOMING DISTRACTED

Understandably, sellers become wrapped up in the sale process. It is the advisors' job, however, to keep the owner focused on the business and not on the process. The owner cannot afford to let the sale process distract him from his primary duties—running a successful business. If he becomes distracted and the company's earnings dip, or worse yet plunge, his advisors will have to explain that dip to the potential buyer. Good advisors know the best ways to deliver unpleasant messages but they can't change the content of the message.

An owner must continue to run the business as if the sale was not happening or the results can be catastrophic. An owner must tend to his existing customers and continue to cultivate new ones. He must keep his key employees motivated and on board. Be prepared to assist your advisors, but don't take your eye off the ball.

EP OVERLOOKING THIRD PARTY CONSENTS

Every business maintains contractual relationships with a variety of third parties. While the number of these relationships varies, they typically fall into one of four categories.

- Landlord
- Lender/lien holder
- Major customers/vendors
- Minority shareholder

Before you sell your company you may have to secure one or all of these parties' consents to the transaction. In the case of a landlord, your lease typically requires you to obtain the landlord's consent before you transfer the lease to another party. Landlords are generally willing to grant such consent, but they will only do so after having established the financial credibility of the new tenant. Initialing the consent for the transfer of your lease is usually not near the top of a landlord's priority list. Your landlord does not share your sense of urgency. If a company is a tenant of a number of properties (eg. retail outlets) the mechanics of identifying who, in each case, has the power to sign the consent and placing the forms in that person's hands can become quite involved. That is why it is so important to identify the necessary consents early in the process and to begin securing them as soon as your attorney authorizes you to do so.

In the case of lenders or lien holders, if the buyer is to assume your indebtedness, the bank, too, will want to verify the credit-worthiness of the buyer. If you plan to satisfy the liens or pay off any indebtedness, you will need to confirm that there is no pre-payment penalty for doing so.

Be sure to review contracts with your major customers and/or vendors to determine if their consent is required. Again, your attorney will determine when these parties should be contacted. You and your attorney will develop and execute a strategy to ease any concerns these customers may have about the pending transition.

And last, but by far not least, are the minority shareholders. By law, majority shareholders have a fiduciary

duty to represent the best interest of both the majority and the minority shareholders. If a transaction is structured as a sale of assets, the owner may not need the consent of the minority shareholder. If, however, the deal is a sale of stock, the majority shareholder will, in all probability, have to deliver the minority shareholder's shares at closing. Buyers are rarely interested in buying your stock and remaining in business with your minority shareholder. Negotiating with the minority shareholder is best done well in advance of closing. Sellers are often tempted to wait to inform minority shareholders of a sale until the last moment. Be aware that this strategy can lead to litigation. You should consult early in the process with your attorney on how best to deal with minority shareholders.

It is not unheard of for a minority shareholder to arrive at a closing with the sole purpose of extorting more money from the majority owner. Be prepared so that this does not happen to you.

EP LOOSE LIPS

Every seller I have ever met stresses over and over the absolute importance of confidentiality. They tell me that confidentiality is critical and they are totally justified in their concern. After assuring them that I understand their need for confidentiality, I explain that my firm takes every precaution to maintain it. For example, no reference to a possible sale is made on our bills. In this way, any employees reading the bills will see that we are conducting a "legal audit" on the company (which also explains our requests for the mounds of financial, legal, operational, personnel and product information). I assure these owners that their secret is safe with us.

Then I must warn them that in my experience, the party who cannot resist letting the cat out of the bag is—the owner. Time and time again, it is the seller who shares his secret with "just a good friend" who swears himself to secrecy. Somehow, that good friend tells another good friend, etc., etc., etc. If employees, competitors or customers detect even the whiff of a sale, the seller has every reason to be worried. At best, anxious employees become distracted and let productivity slip. At worst, they jump ship. Once a competitor sniffs blood, well, you know the rest of that ugly story. Customers become nervous and apprehensive and very easy prey for your competitors.

The owner and his team of advisors will spend a good deal of time discussing when to inform employees, competitors and customers of the pending sale. Typically, this notice will be given after the definitive purchase agreement has been negotiated and the seller and his advisors are confident that the deal will close. In many cases, if no consent is required, these parties are not told until after the closing.

EP FAILURE TO MAINTAIN PERSPECTIVE

A smoothly running transaction is an emotional roller coaster. Deals and roller coasters share ecstatic highs, dives to the deepest depths, hairpin turns and an occasional, albeit temporary, derailment. Therefore, there is no such thing as a smooth deal. Roller coasters aren't pleasure rides and neither are transactions. Every deal has multiple crisis points that place the entire transaction in jeopardy.

That said, transactions are not, and should not be, complete chaos. A seller's transaction team is there to keep the deal on track or, if necessary, to get the deal back on track. If you have chosen your team well, it has the expertise necessary to do exactly that. Advisory team members know how to avoid the biggest pitfalls because they have seen them before. That's their job.

Meanwhile, it is the owner's job to stay calm. If you loose your ability to be thoughtful and rational, you will no longer be an asset to the process. In fact, you will be suffering needlessly. Again, if your advisors are skilled and experienced, your deal will close. Be patient and trust them.

EP CONCLUSION

Most business owners have only one at-bat to sell their businesses and hit a financial home run. To accomplish that, an owner must be an asset (not a liability) to the sale process. Owners must choose their advisors well. The owner must trust the advisors' experience but challenge them if any aspect of the sale process strategy is confusing or unclear. The owner must adhere to the role he or she has assumed and be patient as the process unfolds. By doing so, sellers can avoid all of these all too common pitfalls.

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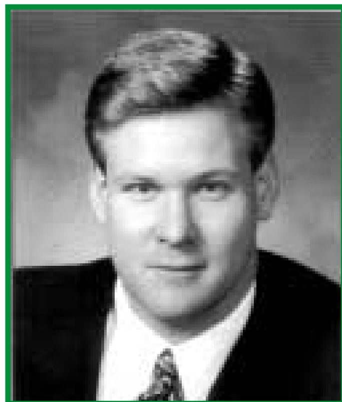
THE END IS NEAR!

by Joe Durnford



Doomsdayers expect that the elimination of "pooling accounting" in December of 2000 will defuse the current merger and acquisition boom. For those of you not intimately familiar with the complex world of merger and acquisition accounting rules, pooling of interest accounting is one of two methods allowed by generally accepted accounting practices. The advantage of pooling accounting (as opposed to Purchase Accounting) is that under pooling accounting no goodwill is created, and the net assets of the acquired company are simply added to the net assets of the buyer. Under the Purchase Accounting method, the difference between the purchase price paid and the net assets acquired is recorded as goodwill. This goodwill is then amortized over twenty to forty years and reduces the companies' net income in each of those years.

The expectation of some M&A pros is that as earnings are adjusted downward to reflect goodwill, Wall Street will undervalue buyers, especially in software and service industries where goodwill typically makes up a high percentage of purchase price. To compensate for the risk associated with a goodwill induced earnings hangover, fearful M&A watchers assume that buyers may choose to lower the prices they are willing to pay, or may elect to make few acquisitions.

Understandably, numerous roll-up companies, like US Office Products, USA Floral and a host of others, have used pooling accounting in order to use their stock as a means of consolidating highly-fragmented industries. These roll-up companies were often willing to pay up to 50 percent more for a company if they could account for the transaction as a pooling. Why? Using pooling accounting, a buyer can add the earnings of the acquired company to its own, and, because no goodwill is created that might be amortized, 2 + 2 = 4. But the 4 could then be multiplied by a high price to earnings ratio and thus create a new value. This proved particularly exciting to roll-ups who could buy earnings at 10 times net after-tax income and then have those same earnings be valued at 25-35 times net income.

The likely outcome from the elimination of pooling accounting then, is a likely increase in the number of transactions completed by the end of 2000. Owners waiting for the opportunity to sell their businesses for the highest possible earnings multiple should quickly analyze the impact of the elimination of pooling accounting. *To take advantage of pooling accounting their sales must close in 2000.*

In the long-term, Wall Street will adjust to the new rules; deals will continue to close. After all, mergers and acquisitions have become a key tool for public companies; strategically beneficial deals will not disappear. Besides, the use of pooling accounting has always been limited, and most acquisitions of privately-held middle market companies use the purchase accounting method. If you have specific questions about how all this may impact your industry or company, please contact Joe Durnford at JD Ford & Company, (888) 999-9495.

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