

PREPARING THE EXIT STRATEGY

Key steps to take for anyone pondering whether to sell their company

by R. Paul Meier

Judging by recent sales activity, 2005 promises to be an active year for business sales. National and international mega-deals, such as the battle between Verizon Communications and Qwest Communications International Inc. to acquire MCI Inc., have been prominent in news headlines. Locally, some of the successful companies on *Washington CEO* magazine's list of Top 150 Private Companies in Washington state have recently changed hands, including Bothell-based athletic footwear and apparel company Brooks Sports Inc., acquired by Russell Corp. for approximately \$115 million in late 2004.

If you are a business owner or executive, it is never too early to begin preparing your company's "exit strategy." Of course, it is much more desirable to think about the rewards of the exit rather than the process necessary to get there.

Planning ahead, however, will help you avoid the many pitfalls that can arise when you sell your business. Below are suggestions, which certainly are not exhaustive, for better positioning your company for sale.

Valuation and Price

"How much is my company worth?" This is the first question asked by almost every seller.

There are many valuation formulas, such as valuations based on business assets, discounted cash flow, or a multiple of revenues. An analysis of these formulas would be an article by itself. Your best bet is to speak with a professional appraiser to discuss your options. Appraisal fees obviously vary, but a preliminary analysis of your company's value can usually be obtained for an approximate cost of \$5,000 to \$10,000.

Obtaining an independent appraisal of your company's value will be helpful. If nothing else, you will be better armed if you have this information when you negotiate price with potential buyers. However, the price at which you sell your company may have little to do with its appraised value.

Ultimately, the price at which you can sell is the amount a buyer will willingly pay to purchase your company. Price will be affected by various factors, such as supply and demand for your type of business, other market forces (e.g., interest rates), and the form and structure for payment of the purchase price.

Protection for the Buyer

It may be easier to reach agreement on the purchase price if you give the buyer protection against undisclosed liabilities. A portion of the purchase price may be held back by the buyer for this purpose.

The buyer uses the holdback to satisfy or reimburse itself after closing for liabilities you had an obligation to disclose but failed to do so. Carefully defining the scope of your representations and warranties under the purchase and sale agreement is always important, but this is especially the case when a holdback is involved.

Holdbacks usually expire on a specified date after closing, at which time the holdback funds are delivered to the seller, less any amounts the buyer used for undisclosed liabilities.

If the buyer raises concerns about the value or future potential of your company, an earn-out can also be a helpful way of resolving the deadlock. An earn-out requires the buyer to make future payments to you if predefined financial milestones are met after the sale.

However, earn-outs should be entered into cautiously, because a portion of your purchase price will be based on the buyer's performance after closing. The financial milestones for payment of the earn-out need to be clearly defined. You should also have the right to audit the buyer's business to verify the buyer's performance.

Maintaining Good Records

Keeping your books current may seem an obvious point, yet it is often overlooked in the day-to-day effort of running a business.

Aside from making the company look disorganized, having outdated or incomplete books and records will cause you to waste valuable time either attempting to locate missing documents or explaining to the buyer why they do not exist.

If you have not already done so, begin the process now of reviewing and updating your corporate books and records on a regular basis. Do not wait until a potential buyer is knocking on your door. A good place to start your review is with the books and records corporations must maintain under Washington law, which include the following:

- Annual and special board-of-director meeting minutes or consents electing officers and approving significant corporate actions.
- Annual and special shareholder meeting minutes or consents for elections of directors and other matters.
- A stock ledger listing the registered shareholders of the corporation.
- Financial statements for the past three years (preferably audited by a certified public accountant, although this is not required by law)

- Accounting records
- Corporate organizational documents, such as articles of incorporation, bylaws and any shareholders' agreements.

Some of these documents may be more critical to the buyer of your company's stock than to the buyer of your company's assets. This is because a buyer of assets generally (but not in all cases) takes the purchased assets free of the liabilities of the selling company. However, even the buyer of assets will likely want to review some of these documents.

Watch Those Contracts

Reviewing contracts in advance of a sale is important for several reasons.

First, it is not unusual for contracts to prohibit assignment by one party without the other party's consent. An asset sale in which your company's contract rights and obligations are transferred to the buyer will likely be an assignment. However, as a general rule, a stock sale is not an assignment unless otherwise stated in the contract.

If you are required to obtain the other party's consent to a contract assignment, choosing the appropriate timing to approach the other party is critical. It is best not to do so prematurely if you are trying to keep your plans to sell confidential.

However, if you wait too long, the lack of consent to a key contract assignment can delay closing of the sale. The appropriate time to begin the process of obtaining consents depends on many factors, such as the type of contract, your relationship with the other party, and the time frame for closing.

If possible, negotiate contracts up-front so that you are permitted to assign the contract without the other party unreasonably withholding its consent. For example, your assignment to a buyer of equal or better financial standing should be permitted.

Another important reason for reviewing your contracts is to confirm expiration and renewal dates. For example, will any of your contracts expire and/or need to be renewed around the same time you intend to sell your company? For the most flexibility, try to negotiate contracts with renewal options instead of long-term commitments that cannot be terminated.

Finally, check to see if you have the ability to cancel any money-losing or other undesirable contracts. These contracts will likely hurt your purchase price in a sale or may scare away potential buyers.

The sale of a business is a significant undertaking. By planning ahead, you will improve your chances of a successful sale at the highest possible price.