PRIVATELY HELD COMPANY

the report on transaction issues

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## IN THIS ISSUE



## Some Thoughts on Valuing/Pricing a Business

- A professional valuation is important, but the resulting value is usually not the purchase price. The business will be bought for whatever the seller will take for it.
- Lenders tend to look at fixed assets; buyers tend to concentrate on cash flow.
- Buying businesses goes beyond the numbers – and the price. Many buyers drop the ball by failing to romance the seller. A buyer's insensitivity to the owner can destroy a deal and possibly create a stubborn seller when it comes down to a selling price. On the flip side, sellers need to be aware of having a "nobody is good enough for my 'baby'" mentality when meeting potential buyers for their business.
- Sellers are often selling their legacy, so the dynamics of the deal are often more important than the price.
- For businesses without audited statements, sellers (and buyers) will want to make sure that the financials agree with the tax returns.
- Price doesn't kill deals, terms do.
- Sellers should show "real" earnings without a lot of adjustments and add backs.
- The decision makers should be consulted at every step of the way. That is a big reason to involve business intermediaries in the deal from the beginning.
- Sellers should be prepared to accept a lower selling price for lack of management depth, reliance on just a few customers, and regional versus national distribution.

## Representations and Warranties

The representations and warranties on the Purchase and Sale agreement take effect the date of signing. According to the book, *The Art of M&A—A Merger Acquisition Buyout Guide* by Stanley Foster Reed, the conditions in the representations and warranties are:

> "...intended to disclose all material legal, and many material financial, aspects of the business to the buyer. The seller also gives assurances that the transaction itself will not have adverse effects upon the property to be conveyed. The buyer should be aware that lenders providing acquisition financing will require the buyer to make extensive representations and warranties about the target as a condition to funding."

**The important issues to focus on for representations and warranties are litigation, undisclosed liabilities, financial statements, and taxes.**

Representations and warranties are very important in the sale of a company and, according to Reed, cofounder of the Merger Week at Northwestern University, "a buyer or seller will be able to back out of the agreement if he or she discovers that the representations or warranties of the other party are untrue to any material extent." The phrase "no material adverse change" or "not material to the transaction" is key. In fact, the buyer or seller may insist on inserting the word material when referring to liabilities, litigation, etc. While the word "material" can be construed as ambiguous, the parties can set a dollar threshold that defines materiality in particular circumstances.

The important issues to focus on for representations and warranties are litigation, undisclosed liabilities, financial statements, and taxes. Regarding the latter, for example, if the sale of the company is a stock transaction, the following representations and warranties would be appropriate:

- Seller has filed all required tax returns.
- Seller has paid all the taxes due.
- Adequate tax reserves are reflected in the balance sheet.

An explanation of the basket provision is also used to protect the seller, by indemnifying the buyer for damages only up to a certain amount. Furthermore, there is usually a cut-off date in which the buyer can seek claims from the seller, e.g., "three years is the outside limit." One way to facilitate the buyer's claims is to allow him or her to offset these amounts from the note due to the seller. Another method, for example, is to set up an escrow account equivalent to 5 to 10% of the purchase price.

The Purchase and Sale Agreement defines the parameters of *both* the purchaser's and seller's representations and warranties. The heaviest negotiating near the closing date usually involves the representations and warranties as well as the indemnifications. Also, the representations and warranties normally account for the largest part of the Purchase & Sale Agreement. The investigation then *follows* the execution of the Purchase and Sale Agreement and obviously occurs (or should occur) *before* the closing. If an adverse material fact surfaces after the closing, the seller will have to compensate the purchaser based on a breach of representation. The following seller's representations and warranties are the most important:

1. **Financial Statements.** A closing audit is imperative to verify the authenticity of all the items, particularly inventory, receivables, and payables. Then a post-closing adjustment is factored into the final floating payoff at closing.
2. **Assets.** The buyer wants to be sure he or she is gaining full title to the assets, particularly as it pertains to such items as intellectual property, patents, etc. Also, the buyer wants assurances that the machinery and equipment are in good working order.
3. **Taxes.** Not only is it critical to verify tax liability if it is a stock purchase, but if it is an asset purchase, it is important to assure there are not liens on assets because of failure to pay taxes.
4. **Employee Relations.** Employee contracts and employee benefits are very important, even in asset sales. If a new owner takes away an employee's privilege, knowingly or unknowingly, then the new owner will be walking into a hornet's nest.
5. **Environmental Issues.** Many transactions in today's M&A business are being negated because of environmental liabilities. Even if the buyer leases the premises, instead of buying the

*Continued on next page.*

## Representations and Warranties *(continued from previous page)*

property, it does not mean that as a tenant the new owner would not be held responsible in part for the contamination caused before his or her arrival. Unfair? You bet!

6. **Pending and Potential Litigation.** This becomes a bigger issue with a consumer-product company because of the exposure to our litigious society. Sellers will want to place a time period and/or "cap" on their total responsibility. Usually the buyer ends up sharing some of the risk for previously-made products.
7. **Authorization.** To sell the company from stockholders, directors and/or third parties (like the bank), you will need authorization.

The seller will, in effect, be expected to insure to the buyer that:

- All liabilities are represented.
- All contracts are disclosed.
- All wages and taxes are current.
- All insurance is current.
- All bonus plans are disclosed.

While most of the burden for representations and warranties lies with the seller, the buyer may be required to warrant that the acquisition does not violate their loan agreements or if stock is to be used, that it is properly authorized.

Obviously, if the transaction is a stock sale in which the buyer assumes all the assets and all the liabilities, the representations and warranties are more lengthy and complex. Often the buyer is only willing to undertake a stock transaction based on the tightness and thoroughness of the representations and warranties.

The important issue is which representations and warranties survive the closing and which ones cease. Those which customarily cease at closing include warranties on equipment and guarantees on licenses. Those which often survive the closing include matters of litigation.

In summary, the following advice of Nelson Gifford is noteworthy. As former CEO of the Dennison Manufacturing Company, he was involved in approximately three dozen transactions. He said from the buyer's point of view,

> "the critical aspect of negotiations is what is stated in the representations and warranties such that the document reflects the following:
>
> > Everything you know, you told us.
> >
> > Everything you told us is true.
> >
> > Everything you didn't know,
> > you should have known."

## Laying Down the Law

There are four basic types of non-compete agreements restricting employees' use of company information:

1. **Non-competition agreement**. This agreement prohibits an employee from working for the competitor of the employer or from competing with the employer once the employee ceases employment. Such an agreement is common among employees with access to sensitive company information.
2. **Non-solicitation agreement.** This agreement prevents former employees from soliciting, contracting, or transacting business with the employer's existing customers. It is aimed at stopping employees from walking off with client lists.
3. **Non-disclosure agreement.** This agreement prevents employees from using their former employer's trade secrets, proprietary information, or confidential business information, or disclosing trade secrets to competitors.
4. **Confidentiality agreement.** This informs employees that the employer intends to keep certain information confidential.

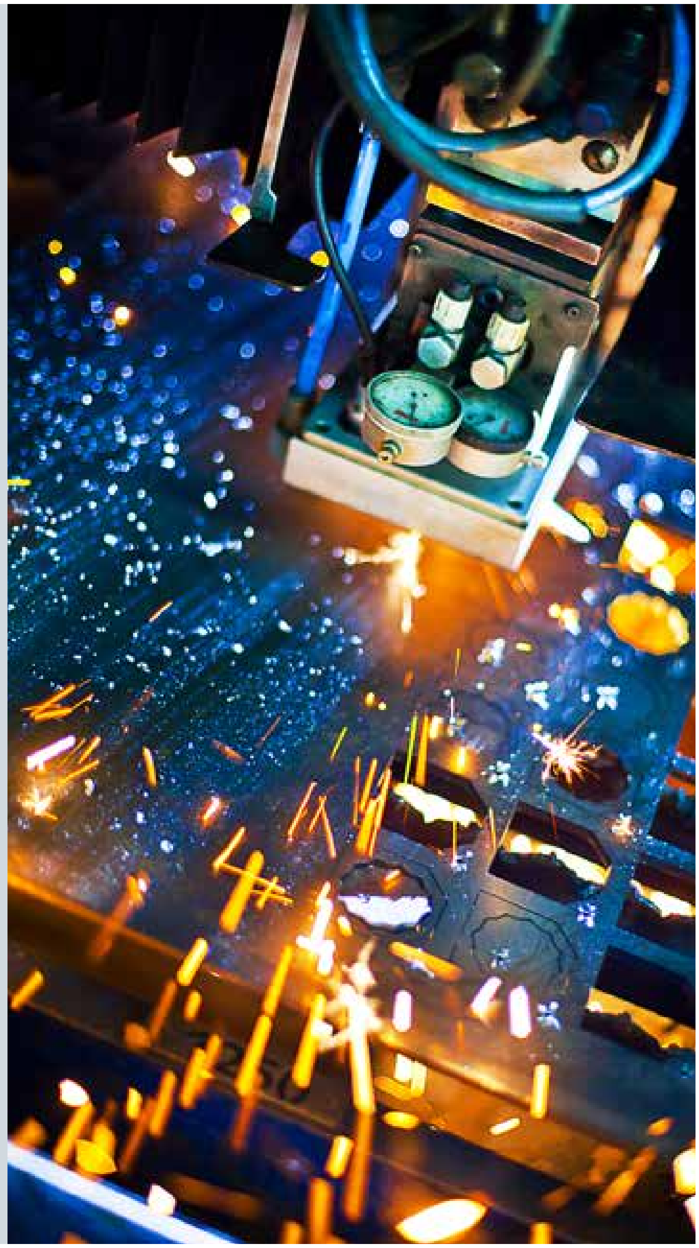
**The one that seems to be of the most concern ...is the first one.**

The one that seems to be of the most concern – and source of problems – is the first one. The other three make sense and generally are not an issue in the employee/employer relationship. With the non-compete agreement, however, consider an employee who has a job requiring skills specific to his industry and who is unhappy with his relationship with a current employer. The non-compete essentially prevents him from leaving the employ of this company and being able to utilize his specific skills. In other words, the employee, in this situation, is a captive of the current employer. It should be noted that many states do not enforce non-competition agreements.

## Key Considerations

The following questions will help a seller better understand his or her business and thereby value the company more prudently.

- What's for sale? What's not for sale? Does the sale include real estate? Are some of the machines leased instead of owned?
- What assets are not earning money? Perhaps they should be sold off.
- What is proprietary? Consider formulations, patents, software, etc.
- What is your competitive advantage? Is it a certain niche, superior marketing, or more efficient manufacturing?
- What is the barrier of entry: capital, low labor, tight relationships?
- Are there employment agreements or non-competes? Have you failed to secure these agreements from key employees?
- How would someone grow the business? Perhaps it can't be grown.
- How much working capital would someone need to run the business?
- What is the depth of management and how dependent is the business on you, the owner/manager?
- How is the financial reporting undertaken and recorded, and how do you, or management, adjust the business accordingly?



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INDUSTRY BBP EXPERT

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