REPRESENTING THE SELLER IN THE SALE OF A SMALL CLOSELY-HELD PRIVATE COMPANY

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OVERVIEW

For purposes of this presentation, it is assumed that the seller is a closely-held private corporation ("Seller") owned by one individual or a small group of cooperating shareholders ("Owner") who are considering selling substantially all of the assets or capital stock to a third-party purchaser ("Purchaser").

The Challenge: Prepare and document the purchase and sale of a business in a professional and cost-effective manner.

Inherent Tension in the Process: There is an inherent tension between the effort needed to deliver high-quality legal services that meet the Owner's goals and needs without having a disparate financial impact on the transaction costs incurred by the Seller (and indirectly the Owner).

Impact on Smaller Transactions: The basic financial metrics of smaller M&A transactions are such that legal costs often represent a higher percentage of the overall transaction costs when compared to larger transactions.

THE PLAYERS AND THEIR EXPECTATIONS

The Owner: The personal background, experience and financial expectations of the Owner will all have a material influence on any proposed sale transaction.

The Seller: The soundness and attractiveness of the Seller's business to a potential Purchaser will have an important impact on the negotiations, due diligence and the actual structure of the transaction. If the Seller's business is doing well, the relative strength of the Seller's bargaining position vis-à-vis the Purchaser will be improved. Conversely, if the Seller's business has unfavorable trends or problems it will tend to improve the Purchaser's bargaining position.

The Purchaser: The Seller's future business prospects and the Purchaser's goals for the business will be the driving influences on how the Purchaser approaches the transaction. The Purchaser's experience, sophistication and financial strength are also important elements in the sale and acquisition process.

Others: Occasionally one or both of the parties engage an investment banker or third-party advisor for discrete issues (e.g. intellectual property, environmental, tax and pension issues). The Seller will often have an accountant or auditor who will be called upon to provide information and assistance on certain financial matters.

THE BASIC FORMS FOR A SALE OF A BUSINESS AND RELATED ISSUES

There are three basic forms used in the acquisition and sale of businesses:

- Statutory business combination (e.g. mergers, consolidations and share exchanges);

- Stock purchases; and
- Asset purchases.

The sale of a private closely-held business most likely will be structured either as a stock or asset sale. The consideration may be all cash or a combination of cash and equity. The payout of all the consideration may occur at the closing or may be paid or earned over a period of time subject to the satisfaction of certain conditions. Although there are pros and cons for both stock and asset acquisitions, as a general proposition a Seller will prefer a stock sale over an asset sale which may leave behind certain liabilities or assets that remain the responsibility of the Seller. Also, asset sales are often more complicated and time consuming than stock sales.

THE STARTING POINT

Initial discussions and negotiations: Every transaction involving the purchase and sale of a business has a starting point. A proposal may come from any numbers of sources, including:

- a competitor;
- existing management;
- an investment banker;
- strategic investor; or
- private equity fund.

The early discussions on a proposed transaction will almost always involve senior management (and often the Owner) of the Seller.

Early involvement of professionals: As discussions evolve toward negotiations of specific terms and conditions of the transaction, the need for professional input on a myriad of potential issues increases. Failure to recognize and address certain critical issues in the early stages can later lead to mistrust among the parties as well as delays and costly changes.

THE RELATIONSHIP: SELLER, OWNER AND LEGAL COUNSEL

The closely-held private company may bring with it a different client-counsel relationship. Unlike a larger established corporation where the attorney often deals with senior management and the board of directors, a closely-held company is often owned by one or a small group of Owners who may also hold executive positions. In the case of the closely-held private company, the attorney is likely to have considerable interaction with the Owner, particularly if the Owner is also an officer. Often the decision-making power rests with Owner with the board fulfilling a more pro-forma function.

As a consequence of this relationship certain structural and governance issues may arise when the Owner decides to sell the business, including:

- The Owner may be required to be a direct participant in the sale of the business, including being a party and signatory to the sale agreement.
- The Owner may be asked to make certain representations and warranties as well as being subject to certain covenants and indemnification requirements.
- Although the legal costs of the transaction most likely will be borne by the Seller, the attorney is most likely to be perceived as representing the Owner.

- The attorney's respective relationships with the Owner and the Seller needs to be considered when providing corporate governance and best practices advice.

LETTER OF INTENT

At some point, the discussion among the parties will have progressed to such a level that it makes sense to memorialize in writing the understanding of the parties as to the basic terms and conditions of the transaction. The manner in which this understanding is memorialized typically takes the form of a "letter of intent" or "LOI." The alternative is to proceed directly to drafting the stock or asset purchase agreement which is more likely to occur in smaller transactions.

The purpose of the letter of intent is to provide the blueprint for building the purchase agreement. The initial draft or term sheet may come from the principal parties, but at some point the attorneys typically have a go at the final LOI. Although there is no uniform or master LOI in public circulation, a LOI should address the important features of the transaction, including pricing and payment procedures, due diligence, no-shop or exclusivity provisions, confidentiality, closing dates, the status of certain assets and the absence of material changes and litigation.

Although there is no clear consensus, most attorneys feel that while a comprehensive LOI may take time and money to prepare it serves to sort out important issues and possible disagreements before the drafting of the purchase agreement. Another way to look at this issue, is that if the parties cannot reach an understanding on the LOI the prospects for a successful deal are highly suspect.

DUE DILIGENCE

One of the potential major costs of a transaction involves due diligence. Most due diligence is performed by the Purchaser, its attorneys or other third-party professionals retained by the Purchaser. In smaller transactions the volume of materials and issues to be reviewed can often be held in several boxes. Due diligence in larger transactions can involve a dedicated room where all the material records are maintained or an online data room.

It would seem that due diligence is largely a concern of the Purchaser, but the Owner's perspective on due diligence can be influenced by several matters:

- Is the consideration in the form of cash or does it include equity in the Purchaser? If so, the Owner will want to conduct its own due diligence on the Purchaser and its prospects.
- If the Owner is a direct party to the purchase agreement, does the Owner know of any material misstatements or omissions in the agreement or exhibits for which the Owner could be held responsible?
- If the Owner is a party to the sale agreement, does the Owner have a basis for making various representations and warranties?

MANAGING THE DUE DILIGENCE PROCESS IN A COST-EFFECTIVE MANNER

Although the Purchaser will be conducting a substantial portion of the due diligence, the Seller often has preparatory and "clean up" issues to address. Also, the sale of a private closely-held company may bring several issues to the due diligence process that may not occur in the sale of a larger established company, including:

- Incomplete or poor record keeping practices.
- Inattention to following basic corporate formalities and governance requirements.
- Employee compensation and benefits practices that may not comply with all legal requirements
- Use of non-GAAP accounting practices and financial statements.

The early identification of potentially problematic due diligence issues is critical to managing the process in a cost-effective manner. Very early in the process, the Seller and the attorney (as well as other outside professionals used by the Seller) should focus on due diligence. The particular matters at issue, the proposed remedies, the parties responsible and the time schedule should be specifically addressed early in the process. The more these tasks can be handled by the Seller's staff, the greater the potential cost savings. Ideally, the Seller should appoint one in-house employee as the "go to" person for due diligence issues.

BASIC STRUCTURE FOR THE SALE OF A BUSINESS

The sale of a business can involve many variations, but the principal segments of a typical agreement for the sale of a private closely-held business include:

- Introductory material (i.e., opening paragraph and recitals);
- Definitions and usage;
- The price and mechanics of the sale of the business;
- Representations and warranties of the Seller and shareholders;
- Representations and warranties of the Purchaser;
- Covenants of the Purchaser and Seller;
- Conditions to closing;
- Indemnification and remedies;
- Termination procedures; and
- General Provisions (miscellaneous clauses).

The price and mechanics of a sale (e.g. working capital tests and adjustments, escrows, etc.) are critical and typically generate the earliest significant negotiations and work among the parties. Other segments of a sale agreement that will often consume substantial time and effort of the Seller, Owner and their attorney include those dealing with representations and warranties, covenants, conditions to closing, indemnification and remedies.

REPRESENTATIONS AND WARRANTIES

<u>Seller's Representations and Warranties</u>: The Seller's representations and warranties are usually comprehensive and will cover a broad range of important matters including the company's organization, authority, capitalization, financial statements, intellectual property, material contracts, litigation and tax matters. In a seasoned company these reps and warranties can often exceed 20 separate matters. The Purchaser typically will hold firm on the basic elements of the Seller's representations and warranties.

<u>Owner's Representations and Warranties</u>: In a closely-held company it is quite likely that the Purchaser is going to want the Owner to be a party to the sale agreement and to provide some basic representations and warranties to the Purchaser. At a minimum, the Owner can expect to be asked to provide representations and warranties with respect to organization, authority and ownership. The

more active the Owner has been in the company's management and day-to-day affairs the more likely the Purchaser will seek expanded representations and warranties.

Important Considerations: Early in the drafting process the Seller, Owner and counsel should identify any exceptions to the representations and warranties they are being asked to provide. Counsel should attempt to limit the scope of these representations and warranties by use of certain exceptions and qualifications such as "knowledge" and "material". Careful drafting of the related disclosure schedules is also important.

OTHER KEY SEGMENTS OF THE PURCHASE AGREEMENT

Covenants and Other Agreements: The Seller will typically covenant and agree that between the date of the parties signing the purchase agreement and the closing date, or certain later dates, to either follow or abstain from certain actions. The Purchaser and the Owner may be asked to agree to certain covenants and future agreements as well. Although these covenants and agreements are often important they typically don't produce difficult negotiation or drafting issues. The failure to comply with such a covenant or agreement, however, could be a material breach of the purchase agreement and jeopardize the closing.

Indemnification and Remedies: One of the most heavily negotiated segments of a purchase agreement involves indemnification. The tension in this segment is based on the Purchaser's desire for protection and the Owner's desire not to have continuing responsibility for a business it no longer owns. Baskets and caps are often included in this section and can result in intense negotiation between the parties as well. Because of the importance of this segment of the purchase agreement, the Seller and Owner should focus on indemnification and remedies early on in the drafting process.

SUMMARY

Most sales of a private closely-held company should permit the preparation and delivery of quality legal work in a timely cost-effective manner. Although each transaction is unique, there are certain practices and procedures that can help achieve this goal. The collective management of these tasks can result in increased efficiencies and cost savings.

Early in the sale process the parties on the sell side should:

- Review charter documents, board and committee minutes, organizational records, regulatory filings, stock ledgers, etc. Any needed corporate clean-up should be initiated and completed.
- Review the company's financial performance and historical financial practices with the company's auditors.
- Identify any unique issues (e.g. intellectual property, environmental, pension, tax matters) that may necessitate engaging third-party expertise outside the company. Retain and consult with such experts as the situation requires.
- Review any pending or threatened litigation with legal counsel handling the matter and develop a clear understanding and explanation of the status and any risks associated with such litigation.
- The Owner should determine what are the basic minimum terms and conditions he is willing to accept. These minimum terms and conditions should be made known to any potential Purchaser.

As the sale process evolves, the parties should:

- Assign one party to oversee due diligence and document production.
- Prepare and update check lists and conduct periodic all-hands status reports among the principal parties.
- Review and monitor the company's financial performance and operating trends.
- Review and monitor outside business trends and regulatory matters that could impact the company.
- Keep any shareholder or board of directors constituencies apprised of the status of the transaction and any new material developments.

When the basic terms and conditions are agreed to, the parties should continue with all five of the steps identified above and:

- Ideally, prepare and sign an LOI or term sheet before starting the drafting a purchase agreement.
- In those cases involving an auction process or where there are multiple potential purchasers, consideration should be given to circulating a draft purchase agreement prepared by the Seller with the basic terms and conditions the Seller expects to be reflected in any offer.
- Address critical issues early in the drafting process. The Seller and Owner should quickly identify exceptions to any representations or warranties that may be difficult to provide. Do not delay confronting and resolving important issues. Frequently the resolution will require changes throughout the purchase agreement.
- If a new problem emerges, prior to approaching the Purchaser, carefully review the issue, develop a clear understanding and proposed solution.

* The author wished to acknowledge the assistance provided by Jake Murphy, an associate at Murphy & Weiner, P.C., in the preparation of this article.