GETTING YOUR CLIENT READY TO SELL

BRAD WHITLOCK
Scheef & Stone, L.L.P.
brad.whitlock@solidcounsel.com

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Brad L. Whitlock

RESUME

Brad Whitlock is a partner with Scheef & Stone, L.L.P. His practice focuses on business transactions, including mergers and acquisitions (including stock and asset purchases and tender offers), securities matters (including representation of issuers, underwriters, venture capitalists, and private equity and hedge funds in connection with public and private offerings of debt and equity securities), and lending transactions (including the representation of lenders and borrowers in connection with loan documentation). He also has considerable experience representing companies in connection with their general legal needs, including labor and employment, contracts, and real estate. He was a partner in the corporate section of a large Dallas-based law firm for many years and has served as the general counsel for a large Dallas-based manufacturing company, where he was responsible for all of the legal aspects of the company.

Mr. Whitlock was named as one of the best lawyers in Dallas in the May 2003 issue of *D Magazine* and as a Texas Super Lawyer by *Texas Monthly* magazine from 2003-2009. He was also included in the 2005 and 2006 editions of *The Best Lawyers In America*.

MEMBERSHIPS

In addition to his law practice, Mr. Whitlock is involved in many bar and professional activities. He is a past Chair of the Business Law Section of the State Bar of Texas. From 2002-2003 he served as Chair of the Corporation Laws Committee of the Business Law Section and he has helped draft sections of the Texas Business Organizations Code. Mr. Whitlock has served as chairman of the Securities Law Section of the Dallas Bar Association, as Chairman of the Texas Business Law Foundation, and on the Council of the Business Law Section.

Mr. Whitlock has served on the board of several civic organizations, including the Greater Dallas Youth Orchestra and the Arts District Friends. He is a 2001 graduate of the Leadership Dallas program sponsored by the Greater Dallas Chamber of Commerce and served as chair of the Chamber's Leadership Advisory Council.

PUBLICATIONS/SPEAKING ENGAGEMENTS

Mr. Whitlock is the co-author of the four volume *Texas Practice Guide—Business Transactio*ns published by Thompson Reuters/West. This treatise analyzes a number of Texas contracts, including employment agreements, technology agreements and service agreements. Mr. Whitlock is also a frequent speaker on a variety of transactional topics.

EDUCATION

Mr. Whitlock received his J.D. degree from the Southern Methodist University School of Law where he was a member of the *Journal of Air Law & Commerce* and a Hatton W. Sumners Scholar. He received his B. A. degree from Westminster College in Fulton, Missouri.

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Selling a business is not for the faint at heart. Most sophisticated buyers will leave no stone unturned in examining a potential purchase target. This is particularly true for publicly traded companies, which have expanded due diligence duties imposed on them by the Sarbanes-Oxley Act of 2002. To make matters worse, most companies are not operated with a view toward being acquired. This combination can often make for an arduous, and sometimes contentious, review process. Troublesome issues ranging from the identity of the business owner to the conduct of day-to-day operations can, if not properly addressed, cause a transaction to fail. The wise attorney will anticipate these issues and will advise his or her client on what to expect throughout the process.

1. COUNSEL YOUR CLIENT ON WHAT TO EXPECT

Most business owners are not prepared for the challenges they will face in selling their business. They are used to running their business, not selling it. They are used to running their business to make a profit, not for the purpose of selling it to someone else. The details that are important to a buyer are not necessarily important to an owner/operator. That is why it is important for an attorney to sit down with his or her client before the process starts and let them know what they should expect.

The attorney should first ascertain who from the client knows about the acquisition and whether the sale will be kept secret from some or all of the seller's employees. Any secrecy concerns should be communicated to the buyer and its counsel. The attorney should next advise the client on what to expect from a documentation standpoint. While a discussion of acquisition documents is beyond the scope of this paper, most purchase agreements include the same basic elements: a description of what is being sold, a recitation of the purchase price, the details of how the purchase price is to be paid, a list of representations and warranties about the business, the conditions to closing the transaction, and an obligation to indemnify the buyer for breaches of the representations and warranties. Of these elements, the representations and warranties and the indemnification obligations often create the biggest problems for sellers. Again, it is incumbent on the attorney to explain the need for these sections and the nuances involved in negotiating and drafting these sections.

Attorneys should also counsel their clients about the due diligence process. Many business owners are taken aback by the sheer volume of the buyer's due diligence request list. Counsel should explain the need for due diligence and should work carefully with the client to respond to the due diligence request. Convince the client that not all requested items will be germane to the seller's company and that "n/a" (not applicable) is an acceptable answer to a requested item. Counsel should also consider the use of a virtual electronic data room to expedite the due diligence process. There are numerous commercial services providing these virtual data rooms and in many instances they are well worth the money. The seller can scan all pertinent items and post them to the data room at the seller's convenience. The buyer or its representatives can review the posted items at their convenience, without having to disrupt seller's operations or even be physically present at seller's facilities (which can help to maintain the secrecy of an acquisition). The downside to the virtual data room is the relative lack of security. While access can be password-protected, there is still an element of uncertainty regarding who will review the document. If security and confidentiality are of paramount concern, a virtual data room might not be a good choice.

2. IDENTIFY THE ACTUAL SELLER

After advising the client about what to expect, one of the next issues to be addressed in an acquisition is the identification of the actual seller. If the transaction is a sale of assets by an entity, then the nature of that entity (corporation, limited liability company, etc.) will have to be determined and that entity, as the seller of the assets, will have to be a party to the acquisition agreement. Many purported "corporations" end up being mere sole proprietorships where the owner operates with the word "Inc." or "Company" in the name. At other times, the individuals who own the business think they have incorporated, but cannot really tell you when or how they did so. In some cases, the owners may have filed articles of incorporation many years ago, but taken no further action since then. One of the first steps toward a successful acquisition is to have the company's organizational papers completed and updated. The attorney should review the company minute book and make sure that the book includes all formation documents and amendments, a copy of the company's operating document (whether bylaws for a corporation, operating agreement for a limited liability company, or partnership agreement for a limited partnership), plus all minutes (properly executed) for all company proceedings.

3. IDENTIFY WHO OWNS THE SELLER

Equally important is the ownership status of the target entity, regardless of the form of the transaction. In an equity sale or business combination, the owners will have to be parties to the acquisition agreement. An asset sale will require the approval of some percentage of the owners, and a purchaser is likely to want at least some of the owners to make representations and warranties regarding the business. Companies, especially privately held companies, often will have ownership problems that can complicate a transaction. In reviewing the company minute book, counsel should endeavor to trace the ownership lineage of the company. In an ideal world, the attorney should be able to trace the ownership of the company from formation through the present day, with no ownership gaps. Special attention should also be paid to the existence of any preferred or other special ownership interests that would give a group of equity owners the right to block or otherwise control a possible acquisition.

Special attention should also be paid to the identity of the owners. In one deal I worked on, a stock purchase could not be consummated because the primary shareholder had placed a percentage of his company's stock in the name of his minor children. This stock was not in the name of a custodian or trustee, or given as a uniform gift to minors, but placed directly in the name of the minor children, who did not have contractual capacity. Since the buyer could not wait the twelve or so years it would take to consummate the transaction, the deal fell through. The shareholder eventually went to court and had the court re-apportion the shares. He sold his business several years later, although at a reduced price.

Business owners are also quite cavalier when it comes to employee ownership of the business. For some reason, owners often equate employment with the right to own stock. They often will issue shares to the employee in recognition of hard work and then, upon termination of employment, "take back" or cancel the stock issued, without any consideration or written agreement permitting the owner to do so. Variations on this theme include employee options to purchase stock or participation rights in the event of a sale of the business. These hidden rights can suddenly appear in the middle of a transaction and impede the ability of the parties to close the transaction. A multimillion dollar transaction nearly did not close when it was discovered that the seller's uncle, who worked for the business when it started, had a large ownership stake given to him when he worked for the company. Neither the seller nor his uncle paid any attention to this purported ownership, until millions of dollars were involved. The seller eventually sold the business, but not before paying a significant portion of the sale proceeds to his proverbial "long lost uncle".

4. LOOK OUT FOR INSIDER TRANSACTIONS

Another roadblock to a successful sale can be the existence of insider transactions between the target and its owners. One of the most common insider situations is where the company does not own its occupied real property (or equipment) but rather rents it from the company's owners or their affiliates. Often, there will not be a formal lease arrangement, but rather just an unwritten agreement to pay rent, if rent is paid at all. This situation gives rise to several issues that have to be addressed. The first question to be answered is whether the leased property will be included as part of the sale. If it is to be included, it has to be integrated somehow with the sale of the rest of the business and the acquisition documents. If the property is not to be included, the buyer will likely not be content with an unwritten month to month lease. Instead, a formal lease should be entered into by the parties. Often the rental price of the excluded property is as heavily negotiated as the purchase price itself. As a side note, in valuing the target business, the effects of any insider transactions (whether favorable or unfavorable to the company) will be considered by the buyer. Also, it is common for a seller who owns many entities to tie those entities together financially. Thus, a potential purchaser might find that a target's assets have been pledged to secure obligations of a sister company or, even worse, the target has guaranteed the sister company's obligations. For these reasons, an attorney for a seller needs to analyze all of the company's operations to identify potential problem areas.

5. IDENTIFY CONTRACTUAL PROBLEMS

Another problem common to privately held companies is that significant assets may not be owned outright but instead be held pursuant to leases or licenses from third parties. Without detailed disclosure documents or financial statements to serve as a guide, the existence of these relationships may not be ascertained until well into the acquisition process. In addition to their impact on the valuation of the business, these agreements may be a hindrance to consummation of the transaction because of a prohibition on assignment or change of control. Their existence may also have an adverse impact on the ability to operate the business after the acquisition, such as a material license that expires six months after the closing date. In starting the acquisition process, an attorney for a prospective seller should comb the company files to identify all material contracts, make sure those contracts are signed and complete (one would be surprised how many unsigned contracts are sitting around in company files), and compile them in one place (or send them to the virtual data room) for the buyer to review.

6. BEWARE OF ACCOUNTING ISSUES

A company's accounting systems and methods can also create problems in the acquisition process. As mentioned before, the Sarbanes-Oxley Act has forced publicly traded companies to focus not only on the financial statements of acquired companies, but also the process that goes into preparing those statements. It has been suggested that private companies, even though they are not subject to Sarbanes-Oxley, nevertheless follow the requirements of that statute wherever possible, so that they do not preclude themselves from being acquired by a public company.

Other accounting issues can create acquisition problems as well. Issues such as revenue recognition, proper classification of employees/independent contractors and valuation of assets are just some of the issues that purchasers will identify as problematic. Going from the seller's accounting methods to the buyer's accounting methods, particularly when the seller uses non-GAAP accounting methods, can create significant problems for the businesses' combined financial statements. For this reason, an attorney would be wise to visit with the seller's CPA before beginning the acquisition process and analyze a seller's financial statements in detail.

A wise and experienced business broker once said that every deal must "die" three times before it finally closes. By eliminating some of the more common causes of death described above, a diligent attorney can help ensure an easier acquisition process for his or her client.