

INSIGHTS + NEWS

Corporate Insights: Top Considerations When Preparing to Sell a Company

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Have you received an offer to buy your company? Congratulations! But there is work ahead.

The first step is to understand the specific deal structure, be it an asset sale, equity sale or merger. The owners should also work with tax advisors to determine if the transaction will be taxable or tax-free.

Consider how difficult it may be to obtain internal approvals. If the company has a “crowded” cap table, equity holder approval may require some effort and steps should be taken to make sure this can be completed efficiently.

Contemplate if the buyer wants to leave anything behind, such as certain debts or obligations. This can be dealt with in different ways under each deal structure.

Aside from equity holder and board consents, make sure you are aware of any other regulatory or contractual third-party consents required to consummate the transaction. For many smaller businesses, a good amount of enterprise value is tied to the company’s contractual relationships.

Examine whether any of these contracts require the counterparty’s consent to the contract’s assignment to the buyer. Does the contract deem a change of control of the company an assignment of the contract? Asset sales typically require more third-party consents than equity sales.

Seller’s Financial Statements and Projections: Normally, a buyer will want the target company’s financial statements for the previous three years, either audited or unaudited (depending on the business). During the due diligence process, a buyer will also likely want to see a target’s balance sheets, income statements, cash flow statements, and tax returns. This will help the buyer evaluate required working capital as well as any potential earn-out milestones.

Timeline to Market, Negotiate and Close: Time kills many deals, and deal fatigue is a real phenomenon. The longer transactions take, the more likely market conditions can change, the buyer or seller’s financial position can change, or sellers can have second thoughts about selling their business. The timeline of any deal varies based on size and complexity.

Generally speaking, for most private, middle market deals, 60-90 days is a realistic timeline from signing a Letter of Intent (LOI) to closing. LOIs generally have an exclusivity period between 120 and 180 days.

Areas of Concern: The indemnification section in a definitive agreement is often one of the most heavily negotiated

components of a deal document. Indemnification protects a party from losses associated with, for example, a breach of a representation or warranty, like an insurance policy, such that a seller will defend, hold harmless and make whole, the buyer, for any losses in the event the seller breaches any representation or warranty. Sellers are also usually indemnified for limited matters.

When negotiating indemnification, typically, the seller wants to limit (1) the duration of time for which its indemnity obligation continues post-closing, and (2) the amount for which a buyer may seek indemnity. The buyer aims to carve out certain representations and warranties as “fundamental representations” that will not be subject to the same indemnification limits. It is important to understand your business’ vulnerabilities and risk tolerance for an indemnity claim. Other points to consider are deductibles, representation and warranty insurance, and indemnification escrows.

Key Personnel: Founders often form key relationships with people within their organizations who have had a significant hand in increasing the company’s value. Identify who they are and socialize the terms of their employment with the buyer. This is particularly important if you are discussing an earn-out. Buyers and sellers may want to consider certain incentives (financial or otherwise) in order to maximize value retention through the closing, and value realization post-closing. Businesses that focus on client service will want to pay special attention to this issue.

Non-Competes: As a founder, be prepared to potentially continue to provide service to the company post-closing under an employment agreement and to be bound by a non-competition agreement should you separate from the company. Despite the recent FTC decision, non-competes are still valid under a limited “sale of a business” exception. A buyer will want to prevent a seller from using its newly acquired deal proceeds from starting a new business and applying its know-how and experience to directly compete with the sold business. It is important that a seller understand the parameters of any proposed non-competition agreement, and if necessary, negotiate for certain carve-outs such as small minority shareholding, board seats not involved in the day-to-day activity, or pre-existing side ventures that the seller would like to continue post-closing.

Licensing: It is important for buyers and sellers to understand their respective obligations to properly transfer licenses from seller to buyer, or alternatively for the buyer to obtain new licensure so that the business can continue operations on day one post-closing.

REAL ESTATE CONSIDERATIONS

It is important that real estate issues are properly addressed in the transaction, as they can materially impact the outcome of the deal.

Leases: Is the business being purchased party to a lease agreement concerning the underlying property? Acquiring companies should pay special attention to the terms of the lease. The acquiring company may desire to enter an assignment and assumption of the acquired company’s interests in the existing lease. Where required, make sure that landlord consent to any assignment and assumption is received but also that proper prior notice is given to the landlord in accordance with the terms of the lease agreement. In the event of an equity sale, an exception for a change of control transaction contained in the existing lease agreement could potentially eliminate the need for landlord consent. Lastly, if the current lease has any guarantors, those guarantors will likely want to be released from the lease in the event of an assignment and assumption of lease.

Ownership of Property: It is also important to consider whether the company being acquired own real property. In these instances, the acquiring company may have the option to purchase such real property as part of the acquisition of the seller. If so, the acquiring company, as part of its due diligence process, should consider having a detailed title examination completed and purchase owner’s title insurance. Further, the acquiring company should contemplate obtaining an ALTA survey of the property prior to the expiration of its due diligence period.

Assessments and Inspections: Acquiring companies may consider performing Phase I or Phase II environmental site assessments, depending on the nature of the target company's business, to determine if there are any unknown environmental liabilities. This may apply regardless of whether the target company leases or owns the real estate where the business is located. It may also be beneficial to have an inspection of the property and the buildings located there completed, if under the terms of the existing lease agreement concerning the property, the tenant is responsible for the maintenance, repair and replacement thereof and the acquiring company has agreed to be bound by the terms of the existing lease pursuant to an assignment and assumption of lease.

Subordination, Non-Disturbance and Atonement Agreement (SNDA): When a target company does not own the real estate where the business is located, the acquiring company should inquire as to the existence of an SNDA between the target company and any lender holding a mortgage on the property. If no SNDA exists, it may be advisable that the acquiring company enter into an SNDA as a requirement under the assignment and assumption of lease between the target company and acquiring company.

There are many considerations to take into account when buying or selling a company. If you need guidance in the process, please ask the authors or your Bowditch attorney.