SELLING THE FAMILY BUSINESS

For owners of family businesses, the process of selling their businesses can be one of life's most stressful events. Often the owners have close emotional connections to their business. These owners identify with the products, services and good name of the company and feel a special responsibility to their employees. Their business usually is the sole or major source of their livelihoods. Sometimes these business has been family owned for generations. For some family business owners, their business determine their roles in life, their places in society, and perhaps the core of their identities.

When these owners sell, they can experience great stress for three additional reasons. First, the transaction is a one-time event for which they have no prior experience. Second, the stakes are high. How well the sale is accomplished can have a lasting effect on the financial security of the owners and their families. Third, many owners feel a need to keep these transactions secret so as not to upset their employees, customers and suppliers. Thus, these owners are left feeling alone, unable to discuss what they are doing with their normal confidants.But of all the stress factors large or small, the most universal is the fear of failure. After the seller has gone through all the time, trouble and expense of the selling process, the big fear is that the buyer will back out. Then the owner is left wondering if the family jewels are now nothing more than damaged goods.

This article deals with how lawyers can assist their clients in reducing the stress and risks while making the process run as smoothly as possible. It assumes the lawyers have the technical expertise to handle these transactions. It also assumes that clients want their lawyer to do more than draw up a contract. It deals with lawyer-client relationships where the lawyers serve as councilors to their clients and describes a process for educating the client in advance about how the sale process works and how to deal with the most common danger areas.

Like so many things in life, timing is crucial. To get the best price, the business should be sold on an upswing, with three consecutive years of good, improving financial statements. Obviously, it is worst to sell when the financial picture is bleak or when the owner - the key employee - has just passed away.
When there is time to plan, the lawyer should advise the client to follow this ten-step process:

Step 1: Assemble the transaction team
Step 2: Define what is being sold
Step 3: Evaluate the price range and structure of the transaction
Step 4: Resolve any problems within the business
Step 5: Develop a marketing plan
Step 6: Negotiate the sale and execute the letter of intent
Step 7: Prepare and execute the purchase agreement
Step 8: Undergo mutual due diligence
Step 9: Close
Step 10: Celebrate

Step 1: Assemble the transaction team - A well-advised seller will put together a team of advisers and consultants. Depending on the nature of the business, the team will include the following whose roles are discussed in the later steps:
. Lawyer
.CPA
. Business appraiser
. Real estate appraiser
. Environmental auditor
. Business broker/real estate broker . Investment banker
. Banker

When confidentiality is a major concern, the lawyer often manages this team for the owner.

Step 2: Define what is being sold - Owners may neither be willing nor able to sell their entire businesses. Perhaps they are only interested in selling certain operations and retaining others. With family businesses, it is particularly important to determine who are the actual owners. Various family members, whether or not they are active in the business, may be owners. All of them will have a say in any sale. In addition, the business real estate often is owned in family limited partnerships or limited liability companies that can have a different ownership/management structure from the operating business. In any event, the real property owner needs to decide whether that real estate will be sold or leased.There is also the question of whether all the assets can be sold. For instance, when a franchise is involved, the whole transaction is subject to the franchisor's approval. When there are key contracts with the government or other customers, a key question is whether the buyer will be allowed to take over the contracts. For example, if the prospective buyer is in competition with one of the main customers, that buyer may not be allowed to continue that contractual relationship and so the value of the business is diminished for that particular buyer.

Step 3: Evaluate the price range and structure of the transaction. Often, before marketing the business, the potential seller will want an appraisal of what the business is worth. This can include both an appraisal of the real property and an evaluation of the business as a going concern. Depending on the nature of the business, trade groups in that industry can be very helpful in providing information on how to value it.

While many sellers think in terms of price, that really is only the first part of the calculation. The real key is what the seller will net after taxes. Usually the seller is better off selling corporate stock than assets. The gain on a sale of stock is usually taxed at the favorable capital gain rates while the gain on an asset sale is taxed at the higher ordinary income tax rate. With an asset sale, there is also the risk of tax recapture items such as depreciation.

The tax problem is compounded when the seller is a C corporation and not a flow-through entity, such as an S corporation or limited liability company. Then, the after-tax proceeds of the sale remain inside the corporation and are subject to further tax on distribution to the shareholders. For this planning step, the company's certified public accountant becomes a crucial member of the seller's team, running various scenarios showing how much the seller will net depending on how the transaction is structured and the seller's own unique financial situation. Having said all this, the business owner needs to know that most buyers will demand an asset purchase transaction because that limits their risk from known and unknown liabilities and also allows them to begin depreciating some assets all over again. Thus, stock deals in the family business context are most often used with sales to family members or existing employees, and otherwise only with the most successful businesses with many suitors.

A truly crucial issue is whether the seller is willing to accept payments over time through a promissory note from the buyer, or only cash. Clearly, if the deal must be an all-cash one, the range of potential buyers is greatly narrowed. Often, another related calculation is how much debt the seller must payoff at closing to sell the assets free and clear of all liens and encumbrances (unless the purchaser is willing and able to assume that debt). Here, sellers often need to work with their bankers or other lenders in regard to pay-off calculations.

Step 4: Resolving any problems within the business - The willing seller's biggest fear is the deal falling apart. The wise seller works hard to eliminate the potential stumbling blocks to closing. By doing so, the seller makes the business more saleable, simplifies the negotiation process because there are fewer issues to resolve, and improves the odds on closing by eliminating the likelihood of deal breakers rearing their ugly heads. Some of the tasks to accomplish are similar to those done to sell a house. One cleans up the premises and paints the buildings and equipment. Clearly, prospective buyers will inspect the premises so the owner should consider the eye appeal of all facilities, machinery and vehicles and eliminate any eye-sores, such as obsolete equipment and inventory.

Other clean-ups can prove to be more difficult. Most if not all lawsuits should be resolved. If not, the business will appear riddled with problems, the handling of which the buyer and seller will have to negotiate. Therefore, claims involving customers, vendors, government agencies and employees should be resolved before the business is put on the market. A crucial matter, usually involving the CPA, is to make sure that the tax returns, the financial statements, and the books and records of the business are all in order because these usually will be among the first items the prospective buyer will want to review. When applicable to the business being sold, it is a good practice to obtain a phase one environmental assessment at this juncture. It is better to deal with environmental problems during this step than to have the prospective buyer discover them on the eve of closing and back out of the transaction. During this step, the owner should also deal with two relatively new issues. First, does the owner have control over all the necessary computer security and access codes to run the company’s computers and programs? Second, are any of the computers used in the business running unauthorized or undocumented software?

Step 5: Develop a marketing plan - The next step is to evaluate how to market the business. Often these types of sales are triggered by an inquiry from a competitor. If the owner is not receiving such inquiries, the owner can try selling the business by contacting competitors or running advertisements. The other option is to hire an agent, such as a business broker or investment banker. Obviously, the downside to hiring agents is that they will receive fees and commissions. The upside, however, is that good ones should have contacts or methods that allow them to put the business before many more interested parties than the owner can and thus obtain a higher purchase price. They also can serve as a filter between potential buyers and the seller, serving to qualify bona fide prospects. For the owner who tries to "selfmarket", the lack of a buffer can be a real problem. For in any sale of an operating business, confidentiality is crucial. There are concerns that employees, competitors, suppliers or customers will learn about the potential sale and that will have an adverse effect on the business. Thus, it is very common to use confidentiality agreements by which the prospective buyer agrees to keep the information shown to it secret and not to reveal that negotiations are under way.Particularly when the concern is that the prospect is only investigating the seller for competitive purposes, the confidentiality agreement will include restrictions on hiring the seller's employees or doing business in its territory. Confidentiality agreements are a common tool in business sales but the owner needs to know that they are not perfect because of the difficulty and expense of proving violations. Thus, the owner needs to have some sense that he or she is dealing with people or companies who act in good faith.

Step 6: Negotiate the sale and execute the letter of intent – Once a prospective purchaser is identified, the seller must recognize that the negotiations are often long. The best negotiators are patient, know what matters are crucial to them, and can actually bear to walk away from a bad deal. Here, the owner also needs to do a self-assessment. "Am I the correct person to negotiate or because of my temperament, personality or lack of experience would I be better served by having an intermediary, such as my lawyer, my CPA, the broker or investment banker, do much of the negotiating?"

If a deal appears likely, the normal process is that the buyer and seller will enter into a letter of intent. The parties use the letter to make sure they have agreed on the major terms. Usually it is a document prepared by a lawyer. The letter states it is binding as to some provisions and not binding as to others. As a practical matter, though, most parties are expected to follow the terms that are set out in the letter.

There are some common issues that arise in any business sale, once the parties get past the price, the terms, and what is being sold. The first is dealing with the real estate. If the owner also owns the real estate, there are all the varieties of issues found with selling or leasing real property, such as price, terms and environmental issues. If the owner of the business is not the owner of the real estate, then the issues become will the landlord accept a new tenant and, if so, on what terms?

The second common issue is taking and pricing inventory. The third issue (particularly in an asset sale) is who pays the accounts payable and who collects the accounts receivable? Other issues to be discussed are:
. whether the owner will stay on in some capacity for some time period,
. how the sale will be announced to the employees, customers, key suppliers and vendors, and the use of escrow accounts and noncompetition agreements.

Step 7: Prepare and execute the purchase agreement - While the experienced lawyer is accustomed to lengthy purchase agreements with numerous schedules and exhibits, the first-time seller often is taken aback if not alerted to this. Creating realistic expectations is critical in this area and in the overall process as well. Usually, the buyer's lawyer prepares the first draft. The seller's lawyer needs to discuss the entire agreement in detail with the seller. In particular, the lawyer needs to counsel the client about the importance of the wording of representations and warranties, covenants and the indemnity provision, all of which are often intensely negotiated. Sellers need to understand that buyers can use misstatements in the representations and warranties as an excuse for terminating the transaction before closing and as grounds to retain escrowed funds and recover damages after closing.

Indemnity provisions call for the seller to protect the buyer from losses and damages under certain circumstances. The buyer wants to be protected from all problems. The seller does not want to guaranty the buyers post closing success and, at most, only wants to deal with "material" problems. Having paid taxes on the sales proceeds, the former owner surely does not want to have to give back more money than was received.

Step 8: Undergo mutual due diligence
The buyer's due diligence often includes requests for the following:
Tax returns, financial statements and supporting books and records
. Key contracts
. Leases
. Insurance policies
. Employee benefit plan documents
. Employee manual
. Lists of key customers, suppliers and employees
. Information on lawsuits and claims
Corporate minute book
. Intellectual property, such as patents, copyrights and trademarks

Depending on the relationship of the parties, the due diligence period will begin after the signing of the confidentiality agreement, the letter of intent or the purchase agreement. While the due diligence period can be difficult for any seller, for the first-time seller it is often both difficult and a shock. The buyer wants so much information! (See the due diligence sidebar.) Often, the owner is attempting to meet requests for boxes of documents when the owner has not told the employees about the deal. Even the well-advised, well-prepared owner can find the continuous requests for more and more information and documents a grueling and exasperating process, particularly when

closing of the whole transaction is conditioned on the purchaser reviewing and being satisfied with the books and records of the seller. Well-advised sellers perform their own due diligence of potential buyers. Often they do this before the buyer due diligence period begins to avoid dealing with any ill-qualified suitors. The seller wants to know if the buyer has the financial wherewithal to actually close the deal, and, if the seller is extending credit for part of the purchase price, whether the buyer can make the installment payments. The seller also often wants to know if the buyer has the financial and management resources to run the acquired business, particularly if the seller is either being paid over time or is worried about the futures of its employees.

Other useful information includes whether the buyer is involved in much litigation, whether the buyer has actually closed similar transactions, and whether the buyer has been involved in aborted transactions.

Step 9: Close - Depending on the personalities of the principals and the competency of all involved, closing can be a smooth and joyous occurrence or a bumpy and tense one. With care and luck, all the details have been long since worked out and all the documents prepared and reviewed. The seller should be advised in advance that these documents are coming.

Typical closing documents include:
. Bill of sale
. Assignments of contracts, leases, intellectual property . Deeds
. Leases
. Security agreements
. Financing statements
. Mortgages
. Deeds of trust
. Certificates updating representations and warranties . Noncompetition agreements
. Employment and consulting contracts
. Allocations of the purchase price
. Corporate secretary certificates
. Escrow agreements
. Cashier's check or wiring instructions
. Promissory not

Step 10: Celebrate - No business sale can be risk free and stress free. But lawyers and clients who understand and follow the l0-step process described in this article can greatly reduce the risk and stress. In doing so, they meet the universal goal of all sellers - successfully closing the transaction. Then the lawyer and client can break out the champagne and celebrate.