

# Selling Your Business

If your business has been a success, you've probably had to pour most of your time, energy, and money into it for what may seem like forever. You may see your company as an extension of yourself, and it may be hard to even imagine life without it. In some cases your entire family may have depended on the business, discussed it endlessly around the dinner table, used it as an education and a proving ground for the children, and practically made it into another family member!

On the other hand, your business may have been only marginally successful, and something you can't wait to get rid of. Or, perhaps you entered into the business with the idea that it would be a short-term opportunity and that you'd sell out whenever you got a decent offer.

Whatever your situation, selling your business will be one of the most important things you'll ever do, because unlike virtually every other business decision you've made over the years, *you'll only do this once*. You get a single chance to put a price tag on possibly years and years of effort — and once you sign the sales documents, it's over.

You'll come out way ahead, both financially and personally, if you make an effort to understand the steps in selling, formulate your plan carefully with the help of your professional advisors, and, when the time comes, take the time to negotiate a price and terms that satisfy your reasons for getting out of the business.

Even if you think you're many years away from selling out, you should consider what your heirs or successors would have to do if you died unexpectedly. If you don't have a workable exit strategy in place, you (or your heirs) may have no choice but to liquidate the business and sell off the assets piecemeal, getting *nothing* for the goodwill you've built up over the course of the years. Here are the major issues you need to think about when it's time to sell your business:

- **Initial issues in selling out:** how should you time your decision and choose experts to help, and what legal/ethical pitfalls do you need to avoid?
- **Valuations of small businesses:** how does the market put a price on a small business, and what can you do to maximize your own business's value?
- **Finding a Buyer:** what do you need to know about working with a business broker, creating a selling memorandum, and other marketing concerns?
- **Structuring the deal:** what are your options as to terms, paying particular attention to the tax implications of various alternatives?
- **Financing the deal:** what should you know about seller financing, and third-party financing through leveraged buyouts?
- **Completing the deal:** from the Letter of Intent through due diligence to the closing, what are the typical steps you can expect to go through in the sales process?

## Initial Issues in Selling Out

Before you actually begin the process of selling your business, there are a number of issues you should consider:

- **Defining your priorities:** what aspects of the sale are the most important to you?
- **Timing your decision:** what's the best time to sell your business, and how long will it take?
- **Choosing professionals:** what kind of professional help will you need, and how will you find it?
- **Legal/ethical considerations:** does your position as a partner, shareholder, officer, or director of the business affect your ability to sell out? How careful must you be in describing your business and disclosing problems to potential purchasers?

### Defining Your Priorities

At the outset, it's important for you to sit down and do some serious thinking about what, exactly, you want from the sale.

Do you want an all-cash deal, so that you can wash your hands of the thing? Or would you be willing to finance part of the sales price? Is it important to you that your daughter, for example, remains with the business? Are you looking for a buyer who'll continue your business traditions? Do you want certain tax advantages in exchange for a lower purchase price? Is there some minimum price (say, a round number like one million dollars) that you must get in order to be happy?

If you're thinking of selling because you want to retire, it's a good idea to think about how much money you need to retire on. Then, you can compare that with the value of your business to see whether your plans are realistic, or whether you can afford to be more flexible on terms of the sale.

As with most things in life, you'll have to make some compromises. Rarely does a sale completely meet all of the seller's objectives — or all of the buyer's. The old adage of "your price, my terms" is generally true. If you insist on getting all the money at closing, you'll almost surely have to compromise on price. On the other hand, if you're willing to finance part of the deal, you may get a higher offer. The more flexible you can be on terms, the closer you'll get to realizing the top-dollar value of the business.

As you're reading through this module, you should keep asking yourself what you really need to get from the sale. Eventually you'll be able to come up with a list, in order of priority. When you interview business brokers or mergers and acquisition specialists, give them a copy to see whether they agree with your goals. And keep a copy of your

list in front of you as you go through the sometimes frustrating process of negotiating your sales contract.

## Timing Your Decision to Sell

When's the best time to sell your business?

In a perfect world, you'd sell when the national economy was humming along toward a peak in the business cycle, when your industry was "hot" among Wall Street investors, and when your particular business was having a banner year with next year looking even better. That's the time you'd be most likely to receive the most cash on the barrel. The same considerations come into play if you receive an unsolicited offer to buy your business — you'll get the best offers when you are riding high.

However, even the brightest economists can disagree about where the economy is headed at any given point in time, and your industry's moment in the sun may have passed years ago (or may never come). Your decision to sell out will probably have much more to do with your personal circumstances than what's happening on Wall Street. The point we're making is that, everything else being equal, you should aim to sell when things are good, rather than not-so-good or downright ugly.

**Internal factors are important.** Regardless of the state of the economy or your industry, there are a number of things you can do to shape up your business to make it more attractive to purchasers. Much as a homeowner would give the house a new coat of paint, repair anything broken, and even put some big flowerpots on the front porch before putting the house on the market, you should spruce up your business as much as possible. This is likely to take a year or more, unless you want to make it completely obvious to purchasers that you were "window dressing" in anticipation of selling out.

**Start planning early.** On average, once your business is on the market, it will take about a year to find a buyer and complete the deal. If you are planning to sell to family members or key employees, there are special opportunities to save money and taxes, but many of the more creative methods can take three to five years to put into place.

All these factors make it clear that if you know you'll want to sell by a certain point in time, you should start planning for it at least a couple of years in advance. After all, the classic definition of "market value" is the price at which property would change hands between a willing buyer and a willing seller, *neither being under compulsion to buy or sell*, and both having reasonable knowledge of relevant facts. While a deal can sometimes be put together in six months or even less, plainly, your best chance of receiving market value for your business is to allow plenty of time for the sale. Otherwise, you may feel pressured to take the first offer you get, or to accept terms that are less than favorable to you. Worse yet, you may not find a qualified buyer at all.

One final point: it's best not to try to sell right before your major leases or other key contracts expire. When prospective purchasers look at your business, they'll want to be able to predict what they'll need to spend for rent, labor, materials, supplies, and all the other major items. They won't want to have to renegotiate key contracts right off the bat, or take the chance that a lease may not be renewable at all. If you *must* sell right before

a contract is scheduled to expire, we suggest that you try to renegotiate it early, so that you'll get a favorable rate (or at least a predictable one) locked in for your purchaser. At the same time, have your lawyer make sure that the contract will be assumable by a new owner, or you'll have gone to a lot of trouble for nothing.

### **Assembling Your Expert Team**

Even if you've been a determined do-it-yourselfer from day one, selling your business is not a job you should attempt to do alone. Even for a relatively small business, there's a myriad of federal, state, and local regulations and tax issues to consider, not to mention one or more extremely important contracts to negotiate. Selling your business is something you'll probably do only once — there's no opportunity to take a trial run or build up any experience before you do the real thing.

Another consideration is that the process of selling can take a lot of time. The more involved you get with it, the less time you'll have to spend actually running the business, at the very time when you need your business to run most successfully. You'll be much better off leaving some of the work to experts who've crafted dozens of deals, instead of spending a lot of your time trying to reinvent the wheel.

There are a number of team positions that you must fill, although it's possible that the same individual or firm may fill more than one of these:

- **accountant**
- **lawyer**
- **business broker**
- **business appraiser/valuation expert**
- **tax expert**
- **banker or other financier**, if third-party funding is needed.

Not all of these positions need to be filled for every small-business sale — much depends on the size and nature of your company. However, at a minimum, you'll need to involve your lawyer and accountant. Even a small sole proprietorship will need a lawyer to look over the sales contract— if this document is not worded correctly you may not only fail to get all your money, but you can also be exposed to potentially huge liability claims by the purchaser, creditors, customers, employees, etc. The sale will have tax consequences that must be sorted out, and state laws typically require certain papers to be filed whenever a business sells all or most of its assets. If a partner or a corporation is involved, the complexity of the deal will quickly mushroom.

### **Selling Out: Accountant's Role**

If you're thinking of selling your business, it's likely that your accountant will be one of the first people you turn to for advice. If you've used an accountant regularly to prepare your tax returns and draw up financial statements, he or she will be very well acquainted with the financial shape of your business. Most probably, your accountant also has

other clients in similar businesses and can tell you how you compare to them. So, your accountant will be in a good position to know whether your business would be attractive to a potential buyer, and can give you some good ideas on how to make it more attractive.

Your accountant will also be essential in drawing up the historical and projected financial statements and other data required to place a proper value on your business, and in gathering and organizing financial data requested by the buyer during the due diligence phase of negotiations.

If you haven't been in the habit of getting audited financial statements, we strongly suggest that you do so now. If the accountant you've been working with is not a CPA, he or she may be able to recommend someone who can perform this service for you. Another possibility is to use a business appraiser or valuation expert who is also a CPA and can provide the audited statements as part of placing a value on the business.

As two of the key people in the team you're assembling to complete the sale of your business, it's very important that your accountant and your lawyer work well together. If they don't communicate frequently, they may end up duplicating some of each other's work, which means you may have to pay twice. In fact, you may want to use an attorney that your accountant recommends, or vice versa, specifically because you'll know that they respect each other and can cooperate.

### **Selling Out: Lawyer's Role**

Along with your accountant, your lawyer needs to play a key role in your plans to sell your business, and in drawing up the legal documents that will carry out those plans.

Many small business owners have established a relationship with a business lawyer over the years, and as a matter of course decide to have this lawyer handle the sale. If your business is a small one or your attorney is very experienced in all aspects of transition plans, this may very well be a wise course of action.

However, realize that your present attorney has a built-in incentive to dislike any deal you may propose: if you sell your business, he or she will probably lose a client. Consequently, whether they realize it or not, some lawyers who represent small businesses may tend to "pick apart" a deal by finding so many roadblocks that your deal falls to pieces, or drags on so long that the other party loses interest.

For that reason, you may decide to use an attorney who specializes in mergers and acquisitions and who actually enjoys putting a deal together. Most larger law firms have M & A specialists on staff, though these experts don't come cheap. However, when you're talking about a once-in-a-lifetime deal, it's well worth it to get the best legal advice that you can afford. If your deal will be too small to interest a high-profile attorney, he or she might be able to recommend an associate who would be interested.

If you are working with a business broker or M & A agent, he or she may be able to recommend an attorney who's successfully guided other businesses through a sale; however, in most cases, it's best to hire the lawyer first so he or she can examine the broker's listing agreement before you sign it.

As with any professional, the best way to find a good lawyer is through word of mouth: ask your current lawyer, accountant, other business owners, or retired owners if they liked the attorney they used. Once you've collected a few names, interview them to see whether they can take on your case, what the fee schedule is, and most importantly, whether you feel comfortable with their knowledge, experience, communication style, and level of integrity.

**Retainer agreements.** Ordinarily, your lawyer will expect you to sign a retainer agreement and to pay some substantial portion of the fees up front. It's to your advantage to sign such an agreement, since it will lay out the scope of the services the attorney will provide, and put the fee arrangement in writing.

The two key parts of the retainer agreement are the statement of the attorney's services and the fee arrangement. The contract should state the attorney's hourly rates (many charge a higher rate for court time or other specified services), or the flat fee if you're paying on that basis. If a flat fee is involved, it's very important that the agreement specify what services are included for that fee. The contract should also specify whether you'll have to reimburse the attorney's costs in addition to the flat or hourly fee. It may state the billing schedule (for example, that you pay an up-front retainer of several thousand dollars against which hourly fees are charged; when the retainer is used up, you start paying monthly bills), and whether and how much interest will be charged on unpaid balances.

**Whom does the attorney represent?** The agreement should also define exactly whose interests the attorney is looking out for. Theoretically, all parties to the transaction (i.e., each individual partner or shareholder of the business being sold and each individual purchaser, plus the business entity itself if incorporated) should have a separate attorney. Obviously, this can get very expensive and impractical if there are a number of shareholders, so many attorneys will agree to represent more than one party if proper waivers are signed.

For example, the attorney may agree to represent you individually as majority shareholder and to represent your corporation as well, provided you sign a disclosure document. The document will state that you recognize the potential differences between your interests and those of your company, but you agree to the dual representation anyway.

However, we don't advise that you go so far as to have only one attorney representing both the buyer and the seller — that situation presents a *real* conflict of interest, rather than just a potential difference, and few attorneys would agree to such representation

anyway. Any time there is a real conflict of interest, the parties in conflict should retain separate counsel (for example, if some shareholders want to sell but others do not).

### **Selling Out: Broker's Role**

You don't need to list your business with a business broker or agent in order to sell it. You may already have a good idea as to who the likely purchaser of your company would be — perhaps a key employee or a relative — in which case the marketing power of a broker won't be necessary. You may have gotten unsolicited offers to purchase your business. Or, you might decide to place ads yourself in the business opportunities sections of several newspapers or trade publications, to see if you can find a buyer without having to pay a broker's commission.

However, if you don't already have a buyer lined up, it's likely that you can benefit greatly from increased exposure to a large pool of potential buyers. A business broker can provide this for you. Perhaps even more important, a broker can guide you through the process of selling based on experience gained from many similar transactions.

A broker can contact likely purchasers (including competitors, suppliers, major customers, and investors known to the broker) directly and tell them the key facts about your business, without "naming names" until the contact has shown definite interest. The broker can also screen interested parties for financial ability and other criteria that you specify, so you won't waste time talking to unqualified buyers.

The type of broker you work with will largely depend upon the size of your business. As a general rule of thumb, business brokers are interested in listing companies valued at several hundred thousand dollars or more, although the cutoff point depends on the part of the country we're talking about. If your business is worth more than one million dollars, you may want to hire a mergers and acquisitions intermediary — a more sophisticated type of agent who functions as a consultant for both buyers and sellers and whose organization may even have in-house valuation specialists and financing available. Stock-exchange-listed and other truly large companies valued at \$50 million or more will go to an investment banker (technically, a securities brokerage firm) for the additional services required in a large, complicated deal.

In a number of states, a business broker must also maintain a real estate license. Consequently, you may find real estate agents who do business brokerage as a sideline, and who are willing to take on listings that are below the normal cutoff. But as a rule, because brokers are compensated by a commission based on a percentage of the sales price, very small businesses may find it hard to locate an agent willing to take on their listing. Instead, they'll have to try to locate a prospective buyer on their own, or sell off their assets as best they can.

As with any professional, it's a good idea to ask the broker about recent sales he or she has handled, and for the names of satisfied clients you can contact. Make sure you

follow up on these references. The main advantage to using a broker is experience, and you want to be sure your broker has some.

**Fees and listing agreements.** As you'd expect, the main drawback to using a broker or other agent is the fee. You'll be expected to sign a listing agreement, which will lay out the fee schedule. Usually, brokers' fees are contingent, meaning that they are paid only if and when the business is sold.

Business broker's fees may range as high as 10 to 12 percent of the sales price for a smaller business. Businesses over \$1 million may be charged using a formula such as "5 percent of the sales price up to \$1 million; 4 percent of the sales price between \$1 million and \$2 million; and 3 percent of any sales price above \$2 million." If you go to a mergers and acquisitions professional, you may also be charged for costs and expenses, and may have to agree to pay a minimum fee whatever the sales price. In some cases, the fee will be split between your agent and an agent hired by the buyer, or you may be able to convince the buyer to pay some or all of your broker's fees during price negotiations.

Generally speaking, the larger your business, the more wiggle room you'll have in negotiating the fee structure. On the other hand, the most successful mergers and acquisitions intermediaries have more business than they can easily handle right now, and can name their price.

One clause you should attempt to have written into the listing agreement is that the fee will be paid at the time you receive the purchase price, not at the time the deal is closed. That way, if you wind up financing a good portion of the price over a number of years, you'll pay the agent only as you actually get the money.

Your listing agreement will be for a specified period of time — if a buyer is located within that period, the agent will be entitled to the fee. Anything under three months won't give the agent enough time to effectively market your business. Conversely, if the time period is too long, you won't be able to switch agents if you find that yours is not working effectively. Since you can always agree to extend the listing period, we suggest you initially list for no longer than six months so you can be sure your agent will get moving quickly.

You may also be able to negotiate a clause stating that if *you* find a buyer on your own (for example, one of your key employees decides to purchase) you don't have to pay the broker's fee. Without this clause, the broker usually must be paid if a buyer materializes during the listing period, regardless of who actually finds the buyer.

As with any legally binding document, we advise you to run the listing agreement past your attorney before you sign it.

**Confidentiality.** In the course of representing you, your broker may learn all sorts of confidential information about you and your business — information that could be

damaging if it gets into the wrong hands. For that reason, the two of you should sign a confidentiality agreement stating that all information about your business is deemed valuable and confidential, and that the broker can only disclose it to qualified buyers for the purpose of evaluating the acquisition decision. This agreement should be included in your listing agreement, and should be examined by your attorney before you sign.

One of the key reasons for using a business broker is that he or she can contact potential buyers and whet their appetite by telling them the general facts about your business without revealing your name. Before you sign the listing agreement, you'll want to ask the broker what information would normally be revealed, at each stage of contact with potential purchasers. The contract should state that you have the right of final approval before any information is released. You should also require your broker to agree that any party who's interested, after receiving the general overview of the business, must sign a confidentiality agreement with you before learning any more details.

### **Selling Out: Appraiser's Role**

The role of business appraiser or valuation expert is an example of a job that might be filled by your accountant, by your mergers and acquisitions consultant, or by a specialist (usually a CPA) you hire for this purpose.

Your need for an appraisal, and the kind of appraisal that will be done, really depends on the size and complexity of your business. If you are a small service company with few assets, or have only common assets like cars, real estate, and office equipment, you may not need to hire an appraisal specialist — your regular accountant's assessment of your book value may be adequate. You may also choose to rely on your business broker's assessment.

However, in many cases, it's worth the time and money to hire an experienced business appraiser. The value of your business depends on a very large number of interrelated factors. If you're to receive the full value of the business, but avoid setting the price so high that it drives away all potential buyers, you really need the analysis of an expert. Moreover, when buyers question your price during the negotiation process, it helps to be able to point to the precise reasons why your business is so valuable.

An appraisal from a business valuation expert can also be essential to prove the value of your company to the IRS, particularly if you are selling or giving it to relatives or other "insiders." If you embark on a gifting program that involves giving some stock to your children each year, you may need to get an *annual* appraisal for IRS purposes.

### **Selling Out: Tax Expert's Role**

It is absolutely essential that at least one of the members of your team be an expert in dealing with the tax aspects of business sales and acquisitions. This person may be your accountant, your lawyer, or even your mergers and acquisitions consultant. You

may also decide to hire a specialist solely for this purpose, most likely a lawyer associated with or recommended by the lawyer who is handling your sale.

Depending on how your deal is structured, you may face an enormous tax bill upon the sale of your business, or next to none. There are a lot of opportunities to save money here; unfortunately, the IRS has set up an almost infinite number of hoops you must jump through in order to take advantage of them. What's more, the tax laws, regulations, and IRS interpretations are constantly changing, so those hoops are moving targets.

Taking advantage of tax-saving opportunities requires planning well in advance of signing the sales documents, so be sure to read our discussion of tax aspects of the sale and consult with your own tax expert before you begin serious negotiations with any buyer.

### **Selling Out: Banker's Role**

In most cases where third-party financing will be needed to complete the sale of a business, it will be the buyer who selects the lender and negotiates for financing. We mention the banker as a member of "your" team only to emphasize that it's to your advantage to cooperate with lenders as much as possible. Thinking of the lender as a team member may help you to share the necessary information and work with the lender to get the deal closed.

### **Ethical Issues in Selling Out**

The subject of ethics in business is one that gets little attention in the press — at least, until someone goes to jail for insider trading, or is investigated for price-fixing discussions with competitors. However, we think that *you* should pay attention to it, especially when it comes time to sell your business.

Aside from the moral implications, you need to recognize that selling a business is a high-stakes transaction, especially for your buyer. Your potential exposure to a lawsuit can be huge, if the buyer spends a lot of money and foregoes other opportunities to buy a business that is not what it appears to be, or if you have partners or shareholders who feel they are not getting what they deserve out of the deal.

For that reason it's important to observe the letter of the law regarding the following:

- disclosure obligations to potential buyers
- fiduciary duties to any partners, co-owners, and shareholders

In general, it's always important to conduct yourself in an ethical manner, and make it clear to everyone around you that you have a policy of always doing so. If something goes wrong and you do get sued, being able to prove that you had "clean hands" can go a long way in reducing your liability.

## Valuation of Small Businesses

The value of a typical small business should be greater than the total values of its hard assets. For a buyer, the key is that an ongoing business has everything necessary — equipment, location, and inventory if applicable, not to mention experienced employees, suppliers, business processes, and a customer list — all in place, in the right amounts for successful operation of the business.

But how do you put a price on this intangible asset, which is frequently referred to as goodwill or going-concern value? Moreover, how do you determine the true market value of the hard assets used in your business? The answer is that you make a business appraiser a key player on your selling team.

Many business owners don't want to spend the time or money to have an appraisal done. However, the result is often a price that's unrealistically high and turns off many potential buyers, or a price that's unnecessarily low and keeps the owner from cashing out at full value.

Business appraisers are generally CPAs. As a profession, they have established a number of ways to quantify the value of key aspects of your business, and roll them up into an overall figure. As part of the process they will write up a valuation report, which explains in detail how they arrived at their final value. Having a valuation document prepared by an outside expert adds a great deal of credibility to your asking price, because the buyer will be able to see exactly how you arrived at your final figure.

Keep in mind that if you sell out to a larger company, you'll probably be dealing with MBAs who are used to seeing sophisticated financial analyses. They will be much more comfortable going through with the sale (and much more impressed with your management ability) if you have a detailed appraisal prepared.

On the other hand, remember that value is in the mind of the beholder. A professional valuation can tell you the price that an average buyer might pay for your business. However, when it comes to negotiating with an *actual* buyer, the appraisal is just a starting point. A particular buyer may have a strong strategic reason for acquiring your company, and may be willing to pay a premium over what the average buyer might offer. Another buyer might simply be looking for certain assets to augment his or her own business, and may not be willing to pay for your company's going-concern value at all. It's important that you and your business broker size up the particular buyer's reasons for acquiring your business before naming a price.

### Key Factors for Buyers

It's important to recognize that the things you love about your business are not necessarily the same things that a buyer will love. You may appreciate a lot of the intangible benefits you get from being your own boss, from your status in the community, from knowing that you provide a good product to your customers and a

good working environment to your employees. Possibly you value some of your perks even higher than the salary you take out of the business.

**Cash is king.** However, buyers tend to look at a business in a much more cut-and-dried way. The essential thing that most buyers will be interested in is earnings and cash flow. They'll want to know that your business will provide a stream of dollars that's predictable, steady, and high. Some buyers prefer to look specifically at cash-flow statements, while others will focus on your income statement to examine earnings before interest and taxes (EBIT). Still others will place the most weight on earnings before interest, taxes, and depreciation (EBITD). The point is, your income stream is key. You need to prove the size and regularity of your positive cash flow, preferably with audited financials going back at least three years.

A very important aspect of your cash flow and earnings is their ability to be replicated in future years, *without your presence*. If your professional expertise or salesmanship is the main reason the business makes money, you will have a hard time convincing the buyer that the cash stream will continue in future years.

Buyers are most concerned about the future earnings of your business, and less concerned about the past. However, the future is difficult to predict with any degree of certainty, so most valuations are largely based on your historical financial statements. You will, however, be expected to provide projected financial statements that show how the business might be expected to perform after the sale. You may also want to emphasize your future plans: new products in development, promising new distribution methods, and other items that should contribute to income growth in the future.

**Secondary factors.** A secondary consideration for most buyers will be the verifiable assets of the business: the real estate, equipment, patents or trademarks, and even such things as inventory, customer lists, and contractual relationships you've established. These items are the buyer's "insurance" — things that can be sold or used elsewhere if the earnings stream dries up. Here's where owning your business location and equipment, rather than leasing them, can be important.

Buyers will examine your key financial ratios to see how your business compares to the industry average, to other acquisitions they may be considering, and to the criteria for purchases they have set up for themselves. A key consideration is that your business have a clean balance sheet with low debt. The buyer may have to increase the debt burden in order to make the acquisition, and won't want total debt to be too heavy for the business to support. Furthermore, a low debt load is more evidence that your business has a strong flow of earnings.

Some buyers will be interested in knowing that you have an experienced manager or team of employees in place to take over when you leave. They'll want to know that you have groomed your successors, and that the successors will stick around. Other buyers will be looking for a business to actively manage, and will want to avoid long employment contracts with existing managers.

Buyers will also prefer that you have a lot of documentation available for your business. They'll be taking a close look at what the papers actually say during the due diligence process, as negotiations proceed. But the very existence of documentation like sales reports, production reports, employee organization charts, job descriptions, operations manuals — all that paperwork you've tried to minimize or avoid up to now — serves to tell your buyer a lot about your business, and also increases his or her comfort level with the professionalism of your management style.

### **Add Value Before the Sale**

Regardless of the state of the economy and of your industry, there are any number of things that you can do to improve your business's appeal to buyers before the sale. The main problem is that a lot of these things take time. If you need to sell right away, you're not going to be able to add much value. Consequently, it's possible that a lot of the potential value of the business will go down the drain.

**Improve your income.** Since cash is king, the most essential step you'll want to take is to clean up your income statement. One way is to have your accountant recast your financials to reflect the way the company should look with new owners. However, some buyers (particularly larger corporations) are turned off by this procedure. They will judge you only by your true, audited financials. If you want to be able to hook these buyers you have to clean up the *business itself*, not just the statements.

Basically, this means doing whatever it takes to increase your EBIT (earnings before interest and taxes). This may mean something as simple as increasing your advertising expenditures, hiring another salesperson on a commission basis, or keeping your store open an extra 10 hours per week to generate more revenues, and taking a hard look at your expenses to see whether you can reduce them. For example, this may be the time to drop some of the perks the business provides to you or your family members. You may also want to have your accountant capitalize certain items that might otherwise have been expensed, and review your depreciation and inventory reporting methods. Ideally, you'd start working on this three years before the sale, since most buyers will want to see three years of financials.

**Improve your assets.** Also take a good look at the assets of the business. Certainly, you'll want to sell off or dispose of any unproductive assets or unsalable inventory. The buyer won't want to pay you for them, and they will only drag you down — better to get what you can from them now, and write off any losses that may result. The business may own certain assets that are primarily there for your personal use (the most common example is a company car) but that you want to retain after the sale; now's the time for you to "buy" the asset from the business, perhaps at the current book value.

If the business owns real estate, you might consider removing it from the business and placing it in a limited partnership, so that it will not be transferred in the sale. You can continue to lease it to the new owners, or to someone else, and retain an income stream. This is a judgment call — for some businesses, the real estate provides the

main appeal to buyers and you won't get much for the business without it. Your business broker should be able to tell you whether this is true for you.

Another move you may want to make is to replace any machinery that's nearing the end of its useful life, and do any necessary repairs and upgrades. The average buyer wants to purchase a turnkey operation, meaning that all they have to do is walk in, turn on the lights, and the business will operate with no immediate need for investment on their part.

You'll also want to metaphorically put a new coat of paint on the entire place — not that you should spend a whole lot of money on this, but be sure that your location is clean, your landscaping is fresh, any areas open to the public are decorated appropriately, etc.

**Clean up potential liabilities.** You should make an effort to clear up any pending or potential legal problems, such as product liability claims, employee lawsuits, IRS audits, insurance disputes, etc. A buyer who purchases only the assets of your business (instead of corporate stock) generally won't get stuck with inherited legal problems; however, the very existence of lawsuits or other problems may raise red flags in potential buyers' minds or even turn them completely off.

One concern that buyers increasingly have is whether there might be any lurking environmental problems on your property. Where problems turn up, it's possible that any and all former owners can be held accountable by the government for very expensive cleanup costs.

If real estate will be part of the sale of your business, you should make every effort to see that there are no leaking underground storage tanks, asbestos, lead paint, hidden hazardous waste, or other nasty surprises around the property. If it's reasonable to conclude that problems are unlikely, an environmental transaction screen conducted at your attorney's direction may be all that's necessary.

However, to be safe from future claims, you'll generally have to obtain a satisfactory Phase I environmental audit by an environmental consultant. The Phase I report will document the clean condition of your property at the time of sale, and provide evidence that any problems must have been caused by subsequent owners. The price of an audit depends primarily on the amount and type of real estate your business owns, but can also vary among environmental professionals. Like any other major expenditure, you should get estimated bids from several licensed consultants before hiring one.

If problems turn up during the Phase I audit, a Phase II environmental audit may be required to investigate the problems and determine how to clean them up. If it turns out that problems are so extensive that you can't realistically fix them before the sale, you'll probably have to reduce your asking price for the business. As an alternative, you may want to consider trying to sell the business without the problematic assets. Simply not telling the buyer about existing problems is *not* an option; in fact, a number of states

require you to sign a disclosure form that reveals any and all problems you know about. This is one area where your lawyer's advice will be very important.

## **Recast Financial Statements**

One thing that virtually all small business owners do to "dress up" their business before a sale is to recast historical financial statements for the last three to five years, and draw up projected statements that reflect how the business would look with a new owner.

If you're like most small business owners, you've operated your business in a way that's calculated to minimize taxes. You may have given yourself and family members as many perks and benefits as possible, kept your children on the payroll, plowed a lot of profits back into capital improvements, etc. These and other tactics are designed to keep your profits (and your taxes) low, perhaps artificially so.

Now, however, you want to make your company look as profitable as possible. Ideally, you would take steps to improve your actual earnings for several years before putting the company on the block. If time does not permit (or in addition to) this step, you can have your accountant adjust your past income statements to reflect what would have happened if you:

- removed your salary and perks, and those of family members you don't expect to remain with the company
- removed any expenses or income that would not be expected to recur or continue after the sale (for example, income or expenses associated with discontinued products, or gains or losses from the sale of any business assets)
- removed any investment or other nonoperating expenses or income
- removed interest payments on any business loans, since you'll be removing such liabilities from the balance sheet.

Furthermore, your accountant can adjust your past balance sheets to:

- Remove any assets that will not be sold with the company.
- Remove any obsolete or slow-moving inventory. Value the remaining inventory at current replacement cost.
- Value your remaining balance-sheet assets at current fair market value.
- Write off any accounts receivable that are uncollectable.
- Write off any loans the company made to you.
- Remove other debt that will not be assumed by the buyer.

Your accountant may have some other ideas; for example, you may have expensed some costs that could have been capitalized.

Finally, you should have your accountant take these recast financials and use them to project how your future statements are likely to look for the next five years, making reasonable assumptions about future growth or decline in income, expenses, value of

assets etc. In most cases, that means assuming that trends established over the past several years will continue; for example, if revenues have increased by 5 percent a year, it's probably reasonable to assume that growth will continue at that rate.

## **Business Valuation Formulas**

So, you've examined your company's historical financial statements, thought carefully about your prospects for future growth, and perhaps had your accountant recast your statements to reflect how new ownership would affect your company's earnings and cash flow. You've also considered the market value of any real estate, equipment, inventory, and other hard assets that would be transferred in the sale, as well as the intangible aspects that make your business appealing.

But how do you boil all of this down into an asking price for your business?

Hopefully, you'll take our advice and hire an expert business appraiser to do this for you. The process can be very complex and time-consuming, and takes quite a lot of experience to do well. There are a number of valuation methods that business appraisers have at their disposal, and even choosing the correct method (or more likely, the correct combination of methods) to use in a given situation can be considered more of an art than a science.

Here's a rundown of the major approaches commonly used to put a price tag on small businesses. We're not going to overwhelm you with details, since a lot of variables, mathematical formulas, etc. come into play with virtually every method. Our object here is simply to give you a feel for the process that your appraiser will be going through.

Business valuation methods fall into the following categories, depending on what their major focus is:

- **business assets**, including book value and liquidation value methods
- **historical earnings**, including debt-paying ability, capitalization of earnings or cash flow, gross income multipliers, and dividend-paying ability methods
- **a combination of assets and earnings**, namely, the excess earnings method
- **the market** for similar businesses, including comparable sales, industry rule of thumb, and p/e ratio methods
- **future earnings**, namely, discounted future cash flow or earnings methods
- **Interactive Business Valuation Calculator**

## **Structuring the Business Sale**

Hopefully, you've been thinking a lot about your priorities, about what you really want to achieve by selling your business. At this point we'll go into some more detail about the various terms you might consider as part of the deal.

Terms drive price, and you should arrive at a general agreement with the buyer about the major terms before you start talking dollars. You may even include a short list of your absolute requirements as part of your selling memorandum, so that buyers who can't meet your minimum terms won't use up your precious time.

Some of the terms you should be considering are:

- **What, exactly, are you selling?** Which assets will go with the company, and which (if any) are you going to keep? Are your key contracts transferable to a buyer? If your business is incorporated, will you sell stock or assets?
- **How much of the purchase price** do you need to receive at closing? Will you consider an installment sale? An earnout?
- **To what extent will you remain** involved in the company, after the sale?
- **How will tax considerations** affect your net proceeds from the sale?
- **Price:** once you've got a feel for what terms the buyer will accept and what you can live with, you can begin to negotiate the price.

**Some general advice about negotiating terms.** Some business advisors say that you should let your broker or intermediary do all your negotiating for you — that you should not talk directly with the buyer until almost everything has been settled. A broker may be better able to remain objective, without giving too much away. Other business advisors say, you are the best representative of your company and of your own expectations from the sale, and buyers will respond better to direct contact with you.

We think that you'll have to use your judgment about how you want to handle this. Some business owners are superb salespeople, and could probably close the deal better than their business broker. On the other hand, some are not good "people persons" and are better off leaving the negotiations to a pro. The size and price range of your business may also play a part in your decision, since a broker will be more willing to spend a lot of time doing shuttle diplomacy if he knows he'll be making \$50,000 or more on the sale. On smaller deals, the broker may do little more than to locate potential buyers and introduce them to you.

We do advise you to arrive at some general agreement with the buyer — either directly, or through your broker — before getting your lawyer and tax advisor involved. Getting lawyers juiced up about a deal too soon is usually a mistake, since they tend to get caught up in the tiniest details rather quickly. And since you're paying these professionals by the hour, it's often best to make sure you can reach a basic agreement with the buyer before the legal fees clock starts ticking. You can also save money by getting some of the initial dancing around out of the way before calling in the professionals.

Now, you may very well want to hold some preliminary, general conversations with your attorney, accountant, and/or tax expert even before any buyers turn up, just to be sure that you understand your options. In fact, we recommend that you do. We're just suggesting that in the usual case of a fairly straightforward sale of stock or assets, you

may not have to involve the professionals in negotiations with a particular buyer until you're fairly sure that the deal will fly. Just make sure the buyer understands that *anything you agree on is subject to your attorney's later review and approval*. After the letter of intent is signed, there will be plenty of time for your respective attorneys to hash out the details.

### **What, Exactly, Is for Sale?**

Although it may seem obvious, you should give some thought to exactly which of your assets will be sold with the company. You may have already removed unproductive or nonessential assets from the business in the course of getting it ready for sale. If not, consider doing so now. If you have assets that aren't needed to run the business, the buyer isn't likely to pay extra for them — you may be better off retaining these assets and selling them yourself.

There may be some valuable assets in the business that you want to keep, such as real estate or equipment that you want to lease to the buyer (or someone else). You may also be the owner of valuable patents, trademarks, or copyrights that you want to retain and license back to the buyer. This can become an important negotiation point. If you retain some of the assets, the purchase price will be lower, thus making the business more affordable to a larger group of buyers.

In particular, retaining real estate used in the business can provide you with a steady stream of rental payments for years to come. Particularly if you have a buyer who's tight on cash (such as your child or another young entrepreneur) you can keep the real estate for now, and perhaps sell it to your buyer at some point down the road.

### **Will You Sell Assets or Stock?**

If your business is incorporated, you have a very important decision to make: will you sell the assets of the business, or the stock? (Unincorporated businesses don't have this option, or this decision). In most cases, selling stock is better for you, but selling assets is better for the buyer. This is one of the most important terms in a sale of an incorporated business. If you agree to the buyer's demands for an asset sale, you should insist on a higher price because of the significantly higher taxes and liability risks you'll face.

With a C corporation, tax aspects are the main reason for the seller's preference for selling stock. Simply put, if you sell the stock, you'll pay capital gains tax on the sale, based on your tax basis in the stock (i.e., what you paid into the corporation in exchange for the stock). In contrast, if you sell the assets, you are essentially taxed twice: first, upon selling assets to the buyer, the corporation will pay capital gains tax on the value of the assets over their existing basis to the corporation. Second, when the corporation is liquidated, you'll personally pay capital gains tax on the excess of the net proceeds of the sale, over your existing basis in the stock.

With an S corporation, you can usually avoid this double tax. However, the other main reason that sellers prefer stock sales, while buyers prefer asset sales, does apply to both C corporations and S corporations. The reason is that with a stock sale, any unknown liabilities the company may have are transferred to the new owner. With an asset sale, the liabilities would remain with the seller. Some examples might be future product liability claims, contract claims, lawsuits by employees, pension or benefit plan liabilities, etc. stemming from seller's ownership of the company.

Now, with careful legal drafting, these general rules can be altered in the sales contract. For example, in an asset sale, the contract can state that the buyer will assume certain liabilities of the seller. Because third parties won't be bound by the terms of the contract, the contract can also include escrow arrangements or indemnification clauses that will remove some of the buyer's risks, by stating that the seller's money will be used to pay for claims. However, if the drafting is not perfect and anything is left out, the general rules will kick in.

There are some reasons why the buyer may prefer a stock sale in certain situations. If the corporation has a good credit rating, the buyer may want to buy stock. Certain contracts such as leases, supply contracts, or employment contracts may have been written between the corporation and the third party, and it will be easier for the buyer to maintain these contracts if the stock is transferred. Stock sales may also be simpler to carry out since there's no need to transfer and retitle every single asset.

In earlier years, stock sales used to be quite rare, particularly for smaller companies. However the trend is now in the opposite direction: the popularity of stock sales is increasing, with such sales comprising about 44 percent of transactions for midsize companies since 1995. The bottom line is that if the buyer insists on an asset sale, make sure you get paid for it!

### **Tax on Stock or Asset Sales**

If your business is organized as a corporation, you have a choice: you can either sell the stock in the corporation to the buyer, or you can have the corporation sell its assets to the buyer, leaving the corporate "shell" in your hands.

Tax aspects are the main reason that C corporation sellers usually prefer to sell their stock, while buyers prefer to buy the assets. With a C corporation asset sale, the seller will be taxed twice: the corporation will pay tax on any gains realized when the assets are sold, and then the shareholders will pay capital gains tax when the corporation is liquidated. In contrast, if you sell the stock, you'll pay capital gains tax on your profit from the sale, generally at the 20 percent long-term capital gains rate (15 percent starting May 6, 2003).

From the buyer's perspective, however, asset sales are usually preferable. In an asset sale, the buyer's basis for depreciation is the allocated purchase price of the transferred assets. In a stock sale, the basis of the *stock shares* is stepped up to the purchase price

of the stock. However, the buyer takes over whatever basis the seller had in the assets. If the buyer had already depreciated some of the assets down to zero, the buyer can't claim any more depreciation deductions on them. Clearly, the buyer would much prefer the stepped-up basis of an asset sale.

One point to consider, when you negotiate the issue of a stock or asset sale with the buyer, is that your increased tax bill from an asset sale will usually be greater than the savings the buyer would get from such a sale. *A stock sale usually results in the lowest total amount of tax being paid to the IRS, and the most money left in the hands of the parties.* Theoretically at least, you should be able to take advantage of a stock sale by adjusting your purchase price to reflect the future tax burden to the buyer. Also, in a sale of stock, the IRS does permit the buyer to elect to have the transaction treated as a purchase of assets (i.e., buyer can get a step-up in basis for the assets), if the buyer pays tax on the difference between each asset's current basis and its fair market value in the year of the transfer.

**Delaying the second tax.** As explained above, if the seller is incorporated and sells assets, the transaction is normally taxed twice — once when the corporation sells the assets, and again when the corporation is liquidated. At the time of liquidation there will be capital gains tax imposed on the individual stockholders based on their proceeds from the liquidation, minus their basis in the stock. Sometimes this second tax can be deferred to the future, if the corporate "shell" is maintained rather than liquidated. In a family-owned corporation, the shell can become a holding company for family investments (for example, the proceeds of the sale can be held by the corporation and invested). As you can imagine, the IRS generally doesn't like this result, so in addition to the regular corporate income tax, the "shell" may have to pay personal holding company tax to the tune of 35 percent (i.e., the highest individual income tax rate in 2003 through 2010). You can generally avoid this result if the shell corporation pays out all its after-tax income as dividends.

**Electing S corporation status.** With an S corporation, there's generally just one tax to shareholders on either an asset or stock sale. If you're contemplating the sale of your business several years down the road, you may want to consider switching to an S corporation now. By doing so you can usually eliminate the double taxation on any appreciation after the date of the switch. If you go this route, be sure to get expert tax advice, and have an appraisal done at the time of the change.

## Steps to Completing the Sale

Once you've located a buyer for your company and come to an agreement as to the major terms and price, you are ready to move into the process of actually closing the deal.

The major steps involved in the sale of a business are:

- **The letter of intent:** the buyer outlines the terms and price you've informally agreed to in a written, nonbinding letter, and promises confidentiality so that you'll allow it to investigate your company further.
- **Due diligence:** the parties have a limited time period in which to investigate each other thoroughly, to see whether they will proceed with the deal.
- **Purchase agreement:** if due diligence turns up no nasty surprises, the parties' respective lawyers will hash out the details of the purchase agreement, any mortgages or financing between the parties, and any supplementary contracts such as noncompete or consulting contracts.
- **State law requirements:** state laws commonly require that the selling company's creditors be notified about the pending sale, so they can move to protect their interests. States may also require that corporate stockholders of the buyer and/or the seller vote on the transaction, that minority interests be cashed out, that the parties obtain tax certificates, transfer or buy business licenses, pay sales or transfer taxes, etc.
- **Closing the deal:** when all the details have been agreed upon, the parties will sign the contracts that transfer ownership, promissory notes, security interests, etc., as well as any documents required by third-party lenders; you get the down payment, the buyer gets possession of the business, and the transaction will be complete.

## Business Purchase Agreement

The purchase agreement for your business is one of the most important legal documents you'll ever sign. After all, many years of hard work will culminate in this single transaction, by which you'll put a dollar sign on the value of your entire operation. You don't want to have problems collecting the money due you or to have legal problems haunting you into the future, and a carefully constructed purchase agreement can be your best insurance policy for preventing such catastrophes.

Customarily, the buyer's lawyer provides the initial draft of the purchase agreement for a business. This makes sense, since the buyer has to live and work with the company while you will walk away into the sunset with the cash (theoretically, at least). However, we suggest that your lawyer should draft the sections that are most important to you. In most cases, that means the clauses containing representations and warranties about the business. Ideally, you should try to avoid or limit the making of any warranties or

guarantees for which you can be held legally accountable. You may also negotiate closely with the buyer as to which liabilities he or she is assuming, and which will remain with you. Here's where a top-notch lawyer can really save your skin. Make sure that you maintain ongoing liability insurance for any liabilities that will remain with you — for example, product liability insurance on products that were sold during your tenure as owner.

Indemnity provisions, in which you promise that you will reimburse the buyer for certain types of expenses if they occur, are often a hotly disputed area of the contract. If you agree to any indemnifications, make sure there's a time limit such as two years on the buyer's claims, and a dollar limit such as 20 to 25 percent of the business purchase price. Depending on the value of your business, you should also insist on a dollar-limit floor for claims, so that the buyer doesn't nickel and dime you to death with lots of small problems.

If you are selling the assets of your business, as opposed to the stock, you'll need to allocate the purchase price among the assets for tax reasons. The allocation should be part of the purchase agreement so there's no dispute about it later. The allocation will also have to be reported to the IRS on Form 8594 , *Asset Acquisition Statement*.

The purchase agreement is likely to be a lengthy, complicated document. For some of the more elaborate deals, the contract plus attachments can run into the hundreds of pages. You should go through it carefully with your attorney and make sure that you understand the implications of whatever is in there.

Once both parties have agreed on the language of the purchase agreement, it will be signed by both parties. The contract will state the date at which the final transfer of ownership and possession of the business will occur, and when the seller will get the money. With a signed purchase agreement in hand, the buyer can finalize any financing arrangements with outside lenders in anticipation of the closing.