TOP 10 DEAL PITFALLS

WHITE PAPER

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Introduction

This white paper describes 10 deal pitfalls (in no particular order) that each have the capability to derail a deal, some more effectively than others. All of these pitfalls are fairly common, although some owners are prone to fall into more pits than others. As you examine this list, you will notice that all of the deal pitfalls are owner failures. It is rare that a financial or legal glitch is so significant that it can not be overcome by an owner's transaction advisory team. Before and throughout your Exit Planning Process, refer to each of these pitfalls to assure that you don't fall into them. Avoiding these pitfalls will allow a smooth exit on your terms.

Indecision

The process of deciding to sell a business—a business that an owner has created and nurtured—naturally involves some level of indecision: Is this the right time to sell? What will I do after I sell? If I wait, will I be able to get more money for the business? Will I be able to get as much money as I can by selling today? These are questions that an owner must answer, usually with the help of his or her advisors.

Given all of the uncertainty surrounding a business sale, some owners are tempted to stick a toe in the market to test the waters. They enter the market in an effort to determine what their businesses are worth. This seems logical, but the results can be disastrous.

These owners often go into the market unprepared. They have not gathered the information that buyers need to make an offer that reflects the true value of the business. Usually, they have not assembled a team of professional advisors. As a result, buyers either make no offer at all or they make an offer that is significantly lower than what it could have been had the seller possessed all of the pertinent information. Sellers typically reject these deflated offers and pull the business from the market. Unfortunately, this false start does not end the process. In fact, it often damages the business' future salability.

Ultimately, these sellers return to the market. Usually, with the help of their advisors, they return better prepared. However, they return to a marketplace that has been tainted. The market's new perception of the business, rightly or wrongly, is either that (a) the seller is flighty, unable to commit to the sale process, or (b) there is something inherently wrong with the company for sale. If not, why didn't it sell the first time the seller put the company on the market? Thus, these perceptions must be overcome by a seller's investment banker and attorney when they could have been avoided completely with proper planning.

Don't create potential roadblocks. Don't go to the market unless and until you are committed to completing the sale process. The best way to prepare yourself is to begin assembling your Exit Planning Advisor Team today. Otherwise, you may taint the marketplace and damage your company's salability years in the future.

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Negotiating the Deal Solo

There are several good reasons why savvy sellers surround themselves with experienced professional advisors. These sellers recognize that while they are experts in what they do, they are not experts in negotiating the sale of a business. If the idea of flying solo attracts you, ask yourself: How objective will you be when the buyer's financial experts begin to pick apart the value of your company, like vultures circling a carcass? When and how will you find the time and energy necessary to keep your business running full speed while concurrently working through the countless issues and distractions that come up during the negotiation of a deal?

No business owner can juggle all of these necessities successfully. There's simply too much to consider and not enough time for one person to consider all factors. Business owners need the assistance of an investment banker, a mergers and acquisitions (M&A) attorney, a CPA, and (usually) a transaction intermediary (depending on the size and complexity of the deal, the transaction intermediary is either a business broker or an investment banker), among others. When this transaction team, which includes the business owner, is working together, the probability that the transaction can be brought to a successful close skyrockets. "Successful" means that all of the promises in the letter of intent are delivered at closing.

Each advisor acts as a buffer between you and the buyer. These buffers are crucial, as they give you the time and distance necessary to make rational decisions about proposals that arise during the sale process. Remember, you've grown your business from its infancy. Critical evaluations of what is essentially your baby might cause you to act irrationally or based entirely on emotion, which are roadblocks you must avoid to assure a successful sale. Inevitably, buyers will propose a change of terms or request additional items. Your advisors are in a better position to evaluate these changes in light of the entire deal. Additionally, advisors enjoy an objectivity that the owner (i.e., you) cannot. They dispassionately view a business that the owner views passionately. Too much passion at the negotiating table is not a good thing.

Poor Preparation

Although poor preparation can kill a deal, it usually only leads to a smaller check for the seller upon sale. Owners who enter the marketplace poorly prepared will leave money on the table, money they could have had if they had done their homework. In this context, the seller's homework is to find seasoned advisors who will steer the transaction to a successful conclusion.

One advisor, the CPA, is usually already on board. The company's existing CPA is a good choice to provide key financial information to the investment banker. The existing CPA also knows the history of the business and can explain how things have been done financially and why.

Next, the owner must find an M&A attorney. Often, a seller's existing attorney is not experienced in transaction work. In those cases, the seller must look for an M&A attorney with significant deal experience (i.e., he or she has recently and successfully closed numerous deals). If necessary, when vetting M&A attorneys, ask the attorney for a list of

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references (clients) for whom he or she has successfully closed deals. When interviewing attorneys, a seller should look for both experience and a mind-set that doesn't come naturally to attorneys, one that goes beyond simply avoiding risk.

By training, attorneys seek to protect their clients from risk. They do this by identifying issues that create risk and negotiating to avoid or to minimize them. Selling a business is risky business. Of course, you *want* an attorney who limits your risk, but you *need* an attorney who can close the deal advantageously, which may seem contradictory at first glance. Thus, you must use an attorney who can weigh risk and work through and around it legally. For example, in the warranties and representations that any buyer will require you to make, being in compliance with every federal, state, and local law, ordinance, regulation, and code will be near the top of the list. An inexperienced M&A attorney may balk at that language and attempt to negotiate it out of the contract. That effort will waste a good deal of his or her time and your money, because the buyer's attorney won't allow it. An experienced M&A attorney will attempt to insert language that indicates that your company, *as best you can know*, is in compliance. That qualifier is great if your attorney can successfully negotiate its insertion. But what if the buyer won't budge? At that point, your attorney may advise you to scrap the deal because the risk is too great.

An experienced M&A attorney will take a longer view of the issue. If the seller believes, after conducting thoughtful and comprehensive due diligence, that there are no compliance problems, there probably aren't. If issues do arise after closing, contrary to the seller's warranty and representation that there were no issues, the seller will be obligated to fix it. Keep in mind that whether the seller sells the business or not, he or she will be obligated to fix any compliance problems. As a business owner, would you rather pocket several million dollars at closing with the chance that you might have to put some back to remedy a compliance problem, or would you rather keep the business and still have to deal with the potential compliance problem? A seasoned M&A attorney can help you weigh these risks and guide you through these issues without losing sight of a successful closing.

Choosing an investment banker or a business broker is your last assignment. First, you must know what you are looking for. The investment banker will perform all of the research and due diligence (on your company and your industry) to identify and qualify preselected buyers. The investment banker is the advisor who approaches potential buyers, discerns exactly what they are seeking in an acquisition, and tailors the package (i.e., the offer of your company) to meet their requirements. He or she convinces potential buyers that your company not only meets its requirements but also exceeds them. Convinced buyers are the ones who pay top dollar for a company. An investment banker is the one advisor who can lead the controlled-auction sale process.

So, how do you find this financial wizard, mind reader, and high-powered salesperson all rolled into one? Ask your M&A attorney or CPA for references. Meet with a few investment bankers to determine whether this is the person you want representing you and your company in the marketplace. Ask for a list of previous clients and references. Check those references carefully, and then make your decision.

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A business broker typically buys and sells businesses with values of less than $5 million. Few investment bankers represent companies with a value less than $10 million. The gray area between $5 and $10 million is inhabited by both experienced business brokers and local or regional investment-banking firms.

You are the final member of your team. You must have confidence in the expertise and guidance of all of your advisors. Everyone on the Advisor Team must work closely, so choose your team carefully. Of course, we can help you determine good fits for your team, so please don't hesitate to contact us.

Hiding (or Minimizing) Problems From Your Advisors

Don't succumb to the temptation of hiding your company's blemishes from your advisors. While it may be your style to gloss over or omit mention of certain issues or problems with vendors, customers, or others, it is deadly to do so with your Advisor Team. No matter how embarrassed you may be about a prior sexual harassment claim or questionable tax-reporting practices, you must reveal *everything* to your advisors. Failing to do so can destroy the sale of your business, now and in the future.

All successful business owners go through the uncomfortable but necessary process of showing all of their business' flaws to their advisors. Your advisors will devise strategies to cure or minimize these flaws, but they need to know what they're working with. Consider your advisors your business' doctors: If you lie to your doctors about your illnesses, they will have no way to diagnose, treat, and cure your ailments. Don't tie your advisors' hands by hoping no one will discover your company's imperfections. No matter what, a buyer will uncover everything—good and bad—about your business. When buyers discover the wart you tried to hide, your credibility will be shot, and it is highly unlikely that the deal will close. If it does close, the purchase price, in all probability, will be greatly reduced. This can be avoided by confiding in your advisors.

Hiding (or Minimizing) Problems From the Buyer

As discussed above, it is critical that a seller reveal any and all problems to his or her advisors. Experienced advisors will develop workable strategies to minimize the impact those problems can have on the transaction. Unfortunately, some sellers don't see the value in revealing their companies' problems to buyers as well. Remember, a buyer will discover everything about your company sooner or later. If you claim to put your cards on the table and then hide one or two up your sleeve, your credibility will evaporate. It is your advisors' job to show you how to put those cards on the table in such a way as to keep your company in play.

Similarly, you must provide all of the information that you can, no matter how insignificant or immaterial *you* think it might be. For example, you will be required to list every contract to which your company is party. While you may not believe that a particular written or oral agreement is important, you must let the buyer decide. If your attorney is not pushing you (and helping you) to collect

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all of the information about your company, you may not have chosen an experienced M&A attorney.

The Lone Ranger

Your Exit Planning Process is no time to indulge your fantasy of single-handedly fighting for your company and coming out the obvious hero. You have assembled your Advisor Team, so use it. Don't ever communicate with the buyer or any member of his or her Advisor Team without your advisors' knowledge and consent. There may be times in which you are the person designated to approach a buyer about a particular issue. That will happen only as part of a strategy developed by your Advisor Team. If you fall prey to the temptation to communicate with the buyer without the knowledge of your advisors, you may derail the transaction. Why? Approaching a buyer about an issue, on your own and without Advisor Team agreement, will create confusion. Confusion will stall the process, as it takes time to sort out the intent of the message and its effect on the rest of the transaction.

Finally, lone rangers do not impress buyers. If you want to seriously impair your appearance of sophistication and credibility, this is one surefire way to do so. A truly impressive owner knows his or her weaknesses and supplements them with well-rounded advisors.

Becoming Distracted

Understandably, sellers get wrapped up in the sale process. Thus, it is the advisors' job to keep the owner focused on the business rather than on the process. The owner cannot afford to let the sale process distract him or her from his or her primary duty: running a successful business. If he or she becomes distracted and the company's earnings dip, or worse yet plunge, his or her advisors will have to explain that dip to the potential buyer. Good advisors know the best ways to deliver unpleasant messages, but they can't change the content of the message.

An owner must continue to run the business as if the sale were not happening. To do otherwise can be catastrophic. An owner must tend to his or her existing customers and continue to cultivate new ones. He or she must keep key employees motivated and on board.

Be prepared to assist your advisors, but don't take your eye off the ball. Your top priority is to continue to run your business to increase its value. Delegate the sale process to your advisors.

Overlooking Third-Party Consents

Every business maintains contractual relationships with a variety of third parties. While the number of these relationships varies, they typically fall into one of four categories:

- Landlord.
- Lender/lien holder.
- Major customers/vendors.
- Minority shareholder.

You may have to secure the consent of these parties before completing the sale of your company.

In the case of a landlord, leases typically require you to obtain the landlord's consent before you transfer the lease to another party.

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Landlords are generally willing to grant such consent, but they will only do so after having established the new tenant's financial credibility. Granting consent for the transfer of your lease is usually not near the top of your landlord's priority list. Your landlord does not share your sense of urgency. If your company is a tenant of a number of properties (e.g., retail outlets), the mechanics of identifying who, in each case, has the power to sign the consent and placing the forms in that person's hands can become quite involved. This is why it is so important to identify the necessary consents early in the process and begin securing them as soon as your attorney authorizes you to do so.

In the case of lenders or lien holders, if the buyer is to assume your indebtedness, the bank also will want to verify the creditworthiness of the buyer. If you plan to satisfy the liens or pay off any indebtedness, you will need to confirm that there is no prepayment penalty for doing so.

Be sure to review contracts with your major customers and/or vendors to determine whether their consent is required. Again, your attorney will determine when these parties should be contacted. You and your attorney will develop and execute a strategy to ease any concerns these customers may have about the pending transition.

Last but certainly not least are the minority shareholders. By law, majority shareholders have a fiduciary duty to represent the best interests of both the majority and minority shareholders. If a transaction is structured as a sale of assets, the owner may not need the consent of the minority shareholder. However, if the deal is a sale of stock, the majority shareholder will, in all probability, have to deliver the minority shareholder's shares at closing. Buyers are rarely interested in buying your stock and remaining in business with your minority shareholder.

Negotiating with the minority shareholder is best done well in advance of closing. Sellers are often tempted to wait to inform minority shareholders of a sale until the last moment. Be aware that this strategy can lead to litigation. You should consult your attorney early in the process on how best to deal with minority shareholders. It is not unheard of for a minority shareholder to arrive at a closing with the sole purpose of extorting more money from the majority owner. Be prepared so that this does not happen to you.

Loose Lips

Every seller appreciates and stresses the importance of confidentiality. To good sellers, confidentiality is critical, and they are totally justified in their concern about confidentiality.

Naturally, you might feel justified in believing that any security breach would be caused by your advisors. However, confidentiality breaches are rarely caused by advisors: Most often, the owner is unable to maintain confidentiality. Time and time again, it is the seller who shares his or her secret with a good friend who swears him or herself to secrecy. Somehow, that good friend tells another good friend, that friend tells two friends, and more people find out ad infinitum. If employees, competitors, or customers catch a mere whiff that the company is being sold, the seller has every reason to be worried. At best, anxious employees become distracted and let productivity slip. At worst, they jump ship. Once a competitor sniffs blood, that competitor

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will often go for the kill. Customers become nervous, apprehensive, and very easy prey for your competitors.

The owner and his or her team of advisors will spend a good deal of time discussing when to inform employees, competitors, and customers of the pending sale. Typically, this notice will be given after the definitive purchase agreement has been negotiated and the seller and his or her advisors are confident that the deal will close. In many cases, if no consent is required, these parties are not told until after the closing.

Failure to Maintain Perspective

A smoothly running transaction is an emotional rollercoaster. Deals and rollercoasters share ecstatic highs, dive to the deepest depths, traverse hairpin turns, and experience occasional (albeit temporary) derailments. Thus, there is no such thing as a truly smooth deal. Rollercoasters aren't pleasure rides, and neither are transactions. Every deal has multiple crisis points that place the entire transaction in jeopardy.

That said, transactions are not, and should not be, complete chaos. A seller's transaction team is there to keep the deal on track or, if necessary, get the deal back on track. If you have chosen your team well, it will have the expertise necessary to do exactly that. Advisor Team Members know how to avoid the biggest pitfalls because they have seen them before. That's their job.

Meanwhile, it is the owner's job to stay calm. If you lose your ability to be thoughtful and rational, you will no longer be an asset to the process. In fact, you will suffer needlessly, vicariously damaging your deal. Again, if your advisors are skilled and experienced, your deal will close. Be patient, trust them, and contact us with questions.

Conclusion

Most business owners have only one at-bat to sell their businesses and hit a financial home run. To accomplish that, an owner must be an asset, not a liability, to the sale process. Owners must choose their advisors well. They must trust the advisors' experience but challenge them if any aspect of the sale-process strategy is confusing or unclear. The owner must adhere to the role he or she has assumed and be patient as the process unfolds. By doing so, sellers can avoid all of these too-common pitfalls.

If you are confused about how to begin your Advisor Team selections, are not confident in your choices, or are confused by the decisions your advisors are making, please contact us today.

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