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Today's faculty features:

Michael A. Ellis, Partner, **Buckingham Doolittle & Burroughs**, Cleveland

Terri Krivosha, Partner, **Maslon**, Minneapolis

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CONSIDERING A SALE?

Take early steps to protect your talent

Michael Ellis, Partner | Buckingham, Doolittle & Burroughs
216.615.7302 | mellis@bdblaw.com

BUCKINGHAM

Are you a business owner who is thinking about selling your businesses? It's never too early to plan ahead to protect the future success of the business. In many instances, counsel is not hired until after a confidentiality agreement or subsequent letter of intent has been executed. Business owners may view these agreements as "boilerplate" or non-binding. However, the failure to adequately protect the potential seller in these agreements from the loss of employees may be extremely harmful to the business.

Before making a definitive decision on whether to make an offer for a business, a buyer needs to obtain certain confidential information about the company. This information is not limited to financial information, but includes information regarding the operations of the company and its personnel. In the scope of its investigation, key employees, whether they are engineers, salespeople or programmers, may be identified by the potential buyer. Unless the initial confidentiality agreement or letter of intent contains a prohibition that precludes the potential bidder from soliciting the employment of such personnel, the bidder may be free to hire such individuals should the bidder elect not to pursue the acquisition. Most confidentiality agreements do not address the issue of employees.

By hiring key employees, a potential buyer may achieve some of the goals of an acquisition without making any payment to seller. In one instance, I am aware of a competitor, contemplating an acquisition, that hired the key engineers of the potential seller when the parties could not agree on price. In this case, the company had neither non-competes with such employees nor an agreement with the potential acquirer against hiring or soliciting the hire of such employees. The loss of its employees significantly affected the potential seller's business, and it took years to recover.

A second employment concern for a business owner in a sale setting is ensuring that the non-compete agreements it has in effect with its employees are transferrable to a buyer. Buyers recognize the value of employees and may condition their offers on obtaining non-competes from certain key employees. If employees are aware that their non-competes are crucial elements to the sale, they may demand additional compensation or a separate payment from the buyer before executing a non-compete. Buyers are likely to subtract the cost of these payments from the payment due the seller.

Accordingly, it is important that the non-compete agreements a business owner utilizes include a clause that allows these agreements to be assigned, without the need for an employee's consent, to any purchaser of all or substantially all of the assets of the company. In the absence of such a provision, the agreements can't be assigned by the employer without the employee's consent. As noted above, obtaining such consent could be costly. Including these assignment clauses from the beginning will save the employer from paying for them at the time of a sale.

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CONFLICT ISSUES IN THE SALE OF CLOSELY HELD BUSINESSES

TENSIONS AMONG FAMILY MEMBERS

by Michael Ellis
Partner | Buckingham, Doolittle & Burroughs

BUCKINGHAM

IN BRIEF

The sale of a family business or any business with multiple owners creates potential conflicts among the owners as well as potential issues for the attorney representing the sellers.

Among these issues are those related to employment/consulting agreements, noncompete agreements, indemnification clauses, and dispute resolution as part of the sale.

Identify these issues early and the sale process will go smoothly.

Identify whether conflicts arise among the owners to levels requiring separate legal counsel.

The sale of a business is often the largest and most important business decision an individual will encounter during the ownership of the enterprise. If the business has multiple owners, particularly family members, the process can become more stressful due to the various interests and conflicting positions that may arise.

CONSULTING/EMPLOYMENT AGREEMENTS

In most sale transactions, the active managers receive consulting or employment contracts from the buyer for service post-closing. To ease the transition period, often the buyer will want the former managers to stay with the business for several months or a year or two. In other instances, long-term management

retention is a critical component of the sale. The amount of the compensation paid could be perceived as part of the purchase price if the amount is in excess of what would typically be paid to a third-party manager. In addition, the length of any consulting or employment agreement, as well as the benefits demanded by an active manager, may put such individual at odds with the other owners. Such manager may be prepared to stop the sale because his or her demands will not be met. This creates an irreconcilable conflict for the attorney handling the sale. Often this potential conflict is known at the beginning of the sale process, and the sale attorney should advise the manager to engage separate counsel. At times, the conflict does not arise until midway through the process. At that point, the sale attorney must recommend the manager retain separate counsel so that the attorney can fulfill his or her duties to the other owners.

NONCOMPETE AGREEMENT

On a related issue, often there is only one owner involved in the business while the other owners remain in the wings or uninvolved. In connection with the purchase of the business, the buyer will expect the owners to provide noncompetition covenants that preclude the owners from entering another business that competes with the sold business. The nonactive owners will generally have no problem providing a noncompetition agreement, whereas the active owner may have an issue agreeing to anything that deprives him or her from engaging in activities that have been his or her livelihood for years. The active owner may insist on compensation for this prohibition. From the buyer's perspective, the noncompete is part of the purchase price. To the buyer, how the purchase price is allocated and paid among the owners is generally not a critical issue.

If the active owner has at least a majority of the business, there is generally not a separate payment to him or her in consideration of the noncompete. Where the manager has a minority ownership interest, however, it is not unusual for the individual to insist upon and to receive separate compensation for such a covenant. The size of such payment could put the owners in a conflict situation, and the attorney who is handling the sale of the business must be cognizant of the conflict that has arisen among these clients. Obviously, any payment made entirely to the active owner reduces the size of the payments made to the nonactive owners. If the active manager receives an employment or consulting agreement, a noncompete provision may be contained in this agreement abating, to a degree, the need for a separate payment.

One caveat is that several states, including California and Oklahoma, do not recognize noncompete provisions in an employment setting as a matter of public policy; however, even these states will enforce noncompete provisions from owners selling their business. Consequently, even if noncompetes are contained in employment or consulting agreements, buyers will also insist such provisions be included in the sale agreement or an ancillary agreement.

INDEMNIFICATION CLAUSES

A third area of potential conflicts arises in the provision of indemnification. In the sale agreement, the sellers will generally provide the buyer representations, including, among other items, ownership of the assets, the lack of environmental or tax issues, the collectability of receivables, or the condition of the building or equipment used in the operations of the business. Buyers will look to all of the owners of the business to give these representations. The nonactive owners are reluctant to provide indemnification with respect to facts relating to a business of which they have little knowledge. The active manager may be willing to provide such representations, but will be reluctant to be responsible for more than his or her pro-rata share, particularly if his or her ownership

percentage is substantially less than 100 percent. From the perspective of the active manager, all owners have participated for years in the profits of the business and should then also participate in the provision of standard representations.

This area of conflict is often resolved by placing a portion of the purchase price in escrow for a certain period, generally 12 to 24 months. The escrowed monies provide the sole source of funds available to the buyer for breaches of representations or warranties. Funds that remain available for distribution to the sellers after the end of the escrow period are then distributed pro-rata among the owners. In lieu of an escrow, often a portion of the purchase price is evidenced by a promissory note. The buyer can utilize offset rights under the note to satisfy the indemnification obligations.

From a seller's perspective, obviously an escrow is preferable because it eliminates the risk that the buyer will financially be unable to make note payments or allege false or weak claims for indemnification. So long as the buyer has the funds due to the seller, the buyer remains in a stronger position. If neither buyer nor seller has control of the funds, there is an incentive for both sides to reach agreement on the disputed claims. However, ensuring all buyers have the funds available at closing to pay the full purchase price is not always possible, and taking a note may be the only avenue available to effect the transaction.

Buyers will generally want the sellers' indemnities to be joint and several. A buyer will not want to chase multiple sellers for their pro rata shares. Minority owners generally refuse to give indemnities for the full indemnifiable amount. A majority owner often will be prepared to provide the full indemnification, provided all owners execute a contribution agreement. The contribution agreement requires all owners to reimburse, pro rata, any owner that is obligated to pay more than its proportionate share.

DISPUTE RESOLUTIONS

Finally, multiple owners will have multiple views on the resolution of disputes that may arise post-closing. Although the agreement of all or the majority of the owners may be necessary to sell the business, if an issue arises over an indemnification claim or interpretation of a contract provision, the buyer will want to deal with only one representative of the sellers. Accordingly, the definitive agreement should specifically appoint a single representative or small committee with authority to negotiate on behalf of all sellers disputes that might arise with the buyer. This representative should not be the active manager if such individual is, post-closing, an employee or consultant to the buyer. This creates potential conflict by placing the individual between the current employer and his or her former partners.

The sale of a family business or any business with multiple owners creates potential conflicts among the owners as well as potential issues for the attorney representing the sellers. If these issues are identified early and are properly addressed, however, the sale process can go smoothly.

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PLANNING BEYOND THE SALE OF A BUSINESS:

UNDERSTANDING WORKING CAPITAL ADJUSTMENTS

by Michael Ellis
Partner | Buckingham, Doolittle & Burroughs

BUCKINGHAM

Planning for the sale of a business must extend beyond the close of the actual transaction. Preparations must be made to simplify the resolution of disputes that could arise between buyers and sellers. Litigation in connection with the sale may occur over a variety of reasons, including breaches of the seller's representations and warranties, or determining post-sale milestones that trigger contingent purchase price payments. The most common post-sale dispute, however, involves determining the working capital of the sold business. The difference between a buyer's determination of working capital at closing and the amount perceived by a seller is often tens or hundreds of thousands of dollars. The poster child for the importance of this issue is the 2015 dispute between Westinghouse Electric and Chicago Bridge & Iron, where the dollar differential was in excess of $2 billion. Litigation lasted over two years.

To operate a business in its traditional manner, whether the sale of the enterprise is an equity or asset sale, all buyers expect that the business will be left with sufficient working capital to operate on a day-to-day basis. The parties must recognize that a business is not a stagnant creature. Every day, products are shipped, receivables are collected, and invoices are paid. The sale price should not be affected by the happenstance of a day's collection of receivables or that the closing occurs the day prior to the weekly check run. The absolute value of the business doesn't change; therefore, neither should the purchase price.

In planning for the sale, the parties should agree on what is a normal working capital amount, as well as the elements of working capital. Working capital generally consists of accounts receivables, inventory, and other current assets less accounts payables, accrued payroll, customer deposits, and other current

liabilities. Cash is generally retained by a seller, even in equity sales. Accordingly, cash is excluded from the working capital calculation.

The parties often average the month's ending working capital amount over a six- to twelve-month period. The seasonality of a business may necessarily be factored into account. Further, in a fast-growing business, a working capital target based on anticipated growth may be more appropriate than one based on historic performance. This is especially true if the purchase price is primarily based on anticipated future revenues or profits. The parties agree that if the actual working capital is over the predetermined amount, the buyer will pay the difference. However, if the actual working capital is below the target, the purchase price is reduced. Recognizing that working capital will change daily, rather than agreeing on a fixed number, parties may agree on an average range. This eliminates the need for a seller to micro-manage the business in the days preceding the sale. Moreover, it may also negate a seller's tendency to accelerate the shipment of product to a date before closing and convert inventory into higher-valued receivables. For example, if the range is between $1 million and $1.2 million, then a price adjustment occurs only if the actual number is above or below the range.

In many instances, a buyer in an asset transaction will not want to acquire any liabilities (other than contracted obligations for future performance). In those instances, the working capital adjustment will look only at current assets. In some instances, however, a buyer may assume vacation and sick-day accruals to employees. Otherwise, although the seller may make these payments at closing, when the employee takes the time off, there will be no payments to him or her, potentially creating an employee morale issue.

In setting both the working capital target and the closing date working capital amount, it is critical that the parties utilize the same measurements. Measurements utilized by the seller in its operation of the business are often not used by the buyer in determining the closing date amount. To illustrate, a buyer will insist on utilizing GAAP accounting practices. These rules would impose bad-debt reserves and/or inventory reserves for slow-moving or obsolete items that were not factored in setting the target number. Many private or small businesses do not utilize such reserves. The inclusion of these reserves would then artificially reduce the purchase price amount where there has been no true change in the business. Other adjustments may be proposed by a buyer that depart from the practices used by a seller. On the other side of the equation, if a buyer accepts that there will be no bad-debt reserve, the seller may be asked to guaranty collections. If a receivable isn't collected within, for example, 90 days from closing, the seller will pay the buyer the receivable amount, and the receivable is transferred back to the seller.

I have found it extremely useful to include as an exhibit to the purchase agreement an example of working capital as of a prior historical date and a statement that the closing date working capital must be determined utilizing the exact same accounting principles as were used in determining the example's working capital. The example may also show all categories of current assets and current liabilities used in the calculation, even if the dollar amount in a category in the example is zero. By listing all categories, disputes are eliminated as to whether a current asset or liability is to be included.

Once the buyer prepares the closing date working capital statement, the seller generally is given 20 to 30 days to review the statement. If the seller agrees with the conclusions, the closing adjustment amount is paid either by the buyer (if the working capital target is exceeded), or by the seller (if there is a deficiency). If the seller disputes these calculations, the buyer and seller generally are provided a few weeks to see whether they can resolve the dispute themselves. If they can't, the matter should be referred to a neutral accountant for resolution.

Due to the nature of the conflict, a working capital dispute is best resolved by an accountant rather than by a judge in a lawsuit or by an arbitrator. Restrictions are often placed on the accountant to decide wholly in favor of one side or the other on individual matters and not to try and mediate a compromise. Selection of the accountant should be made before a dispute arises, and the name of the independent accountant should be specified in the purchase agreement. Accountant fees can be either split equally between the parties, or paid by the party who fails to prevail in the dispute resolution.

Finally, sellers must be aware that, similar to a holdback or escrow utilized by buyers to protect themselves against breaches of the representatives and warranties, buyers generally want a short-term holdback or escrow for the working capital adjustments. Buyers generally do not want to chase sellers for monies owed. If there is already an escrow established for the buyer's benefit for breaches of representations or warranties, then including the working capital holdback should not be an issue. However, if there is no existing escrow, then a short-term holdback is likely more cash efficient.

As noted at the beginning of this article, controversies on working capital adjustments are the most common dispute between buyers and sellers. Careful planning in the purchase agreements can greatly diminish such issues.

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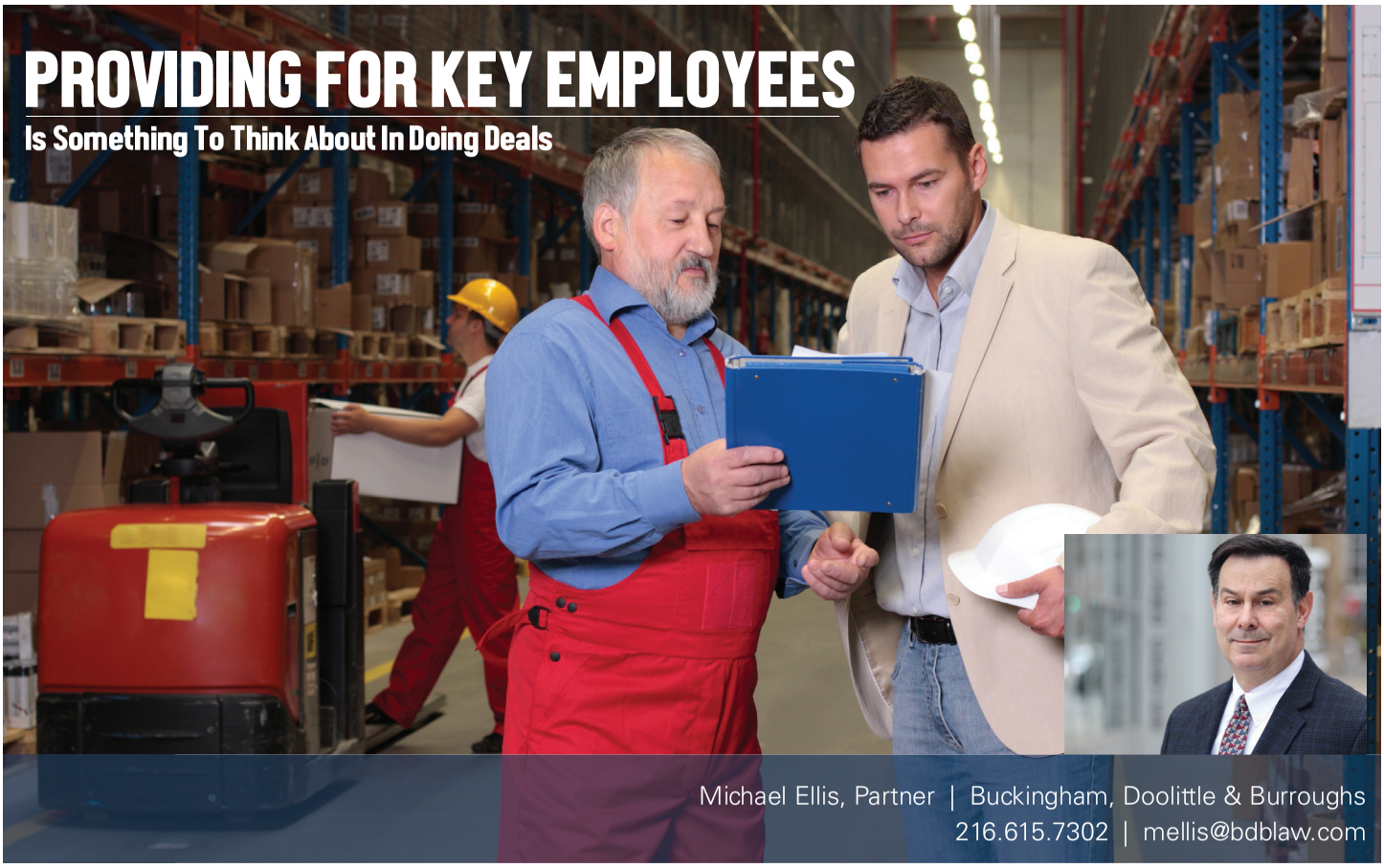
PROVIDING FOR KEY EMPLOYEES

Is Something To Think About In Doing Deals



Michael Ellis, Partner | Buckingham, Doolittle & Burroughs
216.615.7302 | mellis@bdblaw.com

BUCKINGHAM

It may take a village to raise a child, but it takes dedicated, hard-working employees to grow a successful business. Many owners of businesses recognize this fact and, upon the sale of the business, take a portion of the purchase price and allocate such funds among either a handful of key personnel or all company employees.

Where allocation is to all employees, a point system generally is used, based primarily on length of service, job description and salary. In those cases where owners reward only select employees, the benefit often is provided as a stay bonus. The period surrounding a sale of a business is a trying time for the seller and his or her employees. Often, attention paid to the sale process results in a loss of focus on the business operation. It is critical that an owner have one or more trusted employees that can assist the owner in gathering the necessary information required by the potential buyer, as well as ensuring the business runs smoothly by maintaining focus on the company's sales and operations.

A stay bonus provides a financial incentive for an employee to remain with the company through the sale and, on occasion, a period after the sale. The company pays the employee a fixed dollar amount of additional compensation to stay through the sale. Often, only a portion of the bonus is paid at the time of sale, with the balance paid three to six months after the sale. The commitment to stay often aids the seller if a portion of the sale proceeds is contingent on the performance of the company after the sale (an "earn-out"). The seller is more likely to achieve the post-

sale targeted performance if there are fewer unanticipated changes in the business, including loss of key personnel. In requiring continued employment to receive the second payment, the buyer is assured of no disruption in operations. Of course, the balance of the payment may be made if the buyer terminates the employee's service. Many times, a stay bonus commitment may include both a "confidentiality provision" as well as a non-compete covenant from the employee, if such a commitment was not previously obtained.

By securing from key personnel these commitments early in the sale process — before a buyer has been identified — a seller can neutralize an employee's ability to demand higher compensation from a buyer as a condition to closing the transaction. Often, the seller places the money for the stay bonus or bonus pool in escrow immediately prior to the sale. This approach has the dual advantage of ensuring employees the money is there to be paid and also ensuring that the seller is able to take full advantage of the compensation payment. The sale bonus payment is tax-deductible just like any other bonus or salary payment made to employees.

Unlike stay bonuses, change-in-control provisions are frequently contained in employment agreements and are generally negotiated prior to the time that a business sale is contemplated. Like stay bonuses, they are designed to provide job and financial security to an employee following a change in ownership. While once used almost exclusively in public companies for high-level executives, change-in-control provisions have become prevalent in private companies for employees in both executive and middle-management. Change-in-control provisions provide that if an employee is terminated after a business sale, he or she receives additional severance. Many times, in lieu of the additional severance, the employee receives the payment as a bonus effective at the time of sale.

Selling a business is stressful. Loss of key employees can adversely affect both the sale price and operations. Accordingly, business owners should consider stay bonuses or change-in-control provisions as a means of protecting their important assets at the time of sale.

WHAT NEXT?

After Buyer & Seller Agree on Price

Michael Ellis, Partner | Buckingham, Doolittle & Burroughs
216.615.7302 | mellis@bdblaw.com

BUCKINGHAM

Most buyers and sellers of businesses believe that the purchase price is the most important term of the agreement between the parties. There are, however, other terms that are of equal import. This article focuses on how much of the purchase price the seller is able to keep and on critical, non-purchase price terms.

Almost all sellers of privately-held businesses recognize that they need to provide representations and warranties relating to the business to be sold to the buyer. They also recognize that they will be asked to indemnify the buyer for breaches of such representations/warranties. Limiting the amount of the purchase price subject to indemnity claims, as well as establishing a threshold amount below which the buyer assumes responsibility, are important features in the sale negotiations.

The "cap" is the maximum amount that a buyer can claim against a seller for breaches of representations and warranties. Fundamental representations, such as those relating to ownership of the assets being sold, authority to sell the assets, taxes, are generally excluded from a "cap." Also excluded are claims based on intentional fraud committed by the seller. Certain representations – like environmental matters – may have their own "cap." Most other representations, such as those regarding employee claims, customer claims, or violations of OSHA or other laws, are subject to "caps." There is no average "cap;" each transaction is unique. Distressed businesses or those with significant liabilities are likely to have larger "caps" – due to the higher probability of claims against a

buyer of the business. There are numerous negotiation issues in any transaction and trade-offs occur. A seller may be willing to provide a larger "cap" in exchange for a higher purchase price or favorable resolution of other issues. Some purchase agreements are silent as to an indemnity "cap." In those cases, it is possible that claims against sellers could exceed the purchase price. If the indemnity obligation extends personally to the business owner of the business sold, such owner could end up both with no proceeds and no business. This scenario, however unlikely, illustrates the importance of establishing a "cap." In my opinion, the "cap" should never exceed the purchase price.

A "basket" is the threshold level of claims a buyer is willing to accept before seeking indemnity. Most transactions have a "basket" of between 0.1% and 1.0% of the purchase price. Thus, on a $5 million purchase price, a 1% basket is $50,000. The logic is, had this liability been known at the time the sale price was determined, that the buyer would not have altered the purchase price. There are two types of "baskets" – a "deductible" and a "dollar one." A "deductible" basket means that the buyer will accept the economic impact of the claims up to the "deductible" amount, and the seller is responsible for claims over such limit. "Dollar one" provisions make the seller liable for all claims if the claim amount exceeds the threshold. For example, utilizing a $50,000 deductible basket, the seller would be liable for only $8,000 if the claim was $58,000, but the seller would bear responsibility for the entire $58,000 if a dollar-one basket had been utilized. Under both approaches, the buyer would assume the entire claim amount if the claim was only $48,000.

There are numerous surveys prepared by investment bankers and bar associations that aggregate data on terms of purchase agreements. I often provide my clients with such surveys so they can understand the possibilities. While I emphasize there are no standard terms, because every business and sale is unique and all terms are negotiable, the mean "cap" under one recent study was just below 15% of the purchase price and the "basket" was "pegged" at 0.7%. Smaller transactions generally have higher caps and lower baskets than larger transactions. Regardless of what numbers you, as a seller or buyer, elect to utilize, the importance is to ensure you are aware of these issues.