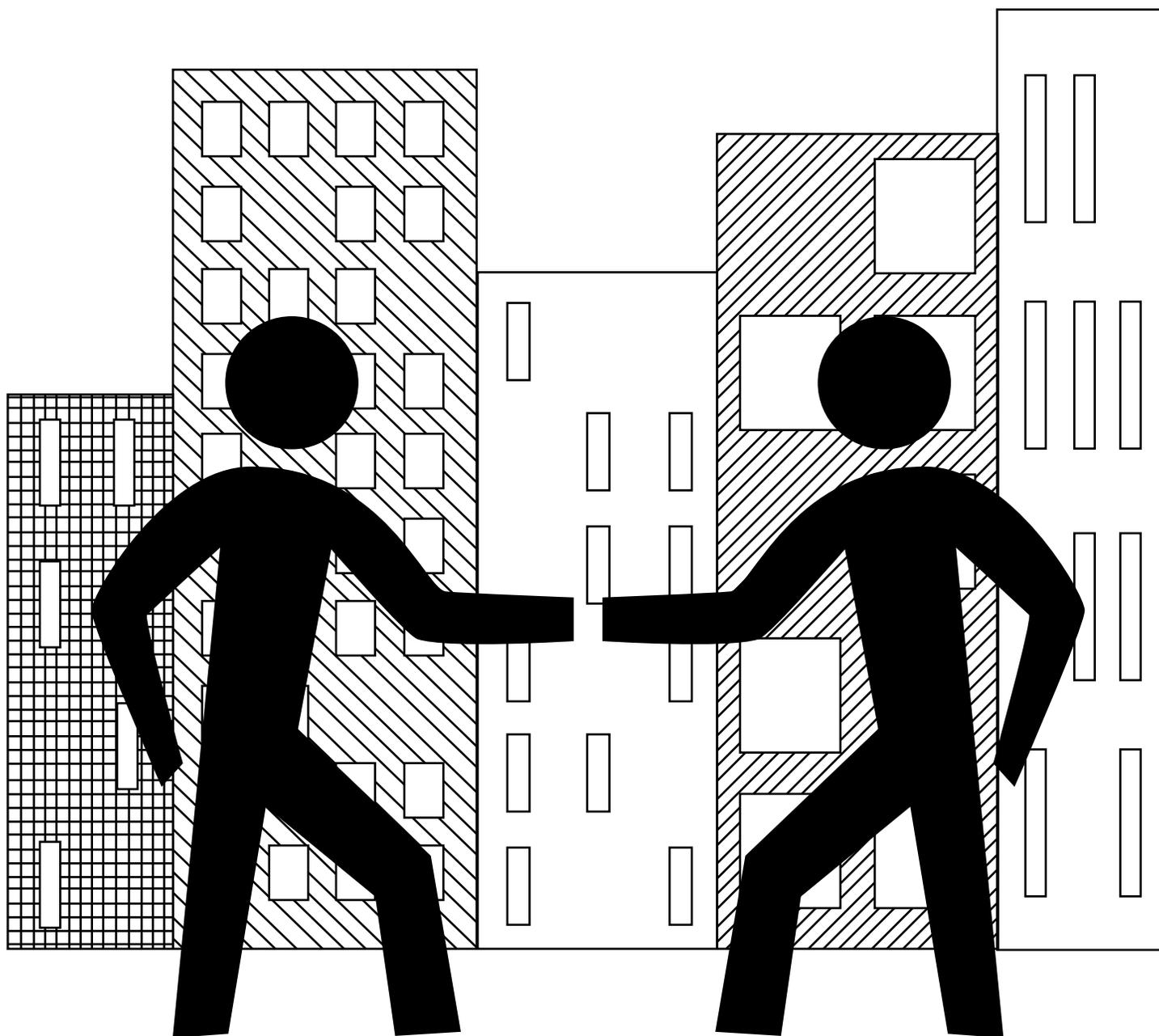


GUIDE TO SELLING A SMALL BUSINESS

a resource tool for small businesses in North Carolina



This guide is authored by the North Carolina Small Business and Technology Development Center (SBTDC), a multi-campus center of The University of North Carolina System. It functions as The University's business and technology extension service. Initially researched and outlined by Kevin McConnaghy, State Program Director of Strategy and Growth Services, this guide served as a template for a Strategy & Growth Services engagement. Dan Tracey, a Law Extern, improved the draft guide last year. It was then further refined, edited and revised this past semester by another Law Extern, Laura Burkett.

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GUIDE TO SELLING A SMALL BUSINESS

Key steps, documents, explanations, and definitions

The following guide contains an overview of the key steps and documents involved in the sale of a small business. The table of contents roughly follows the timeline of the transaction.

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PREFACE

Business owners may choose to sell their business for any number of reasons, but a prepared seller should have a legitimate, marketable reason for selling the business. Potential buyers will always ask about the seller's motivation for exiting. A reasonable and straightforward answer removes uncertainty in the mind of the buyer and ultimately makes the business more attractive. Common internal and external motivations for selling include:

internal

- retirement without a viable succession plan
- recent success, leading to relatively high valuation
- lost desire to run the business
- personal financial needs
- change in lifestyle

external

- downturn in the business cycle
 - governmental regulation
 - increasing competition
 - market shift requiring additional investment
-

ADVISERS

involve competent advisers early.

Selling a business is a daunting exercise even when the owners are well prepared. Given the endless number of stumbling blocks on the path to a successful sale, it is critical that a seller engages appropriate advisers early on in the pre-sale process. A potential buyer is likely to have a team of professional advisers assisting throughout the process, as well.

who should I hire?

Every transaction is different and requires different types of assistance. At a minimum, the seller needs the assistance of an experienced accountant and lawyer that have guided clients through the sales process in the past. Additionally, management consultants or valuation experts can help the selling business owner understand the value of the business and how it can be improved prior to sale.

should I hire a broker?

Business brokers or investment bankers¹ may or may not be hired to assist in the marketing and negotiation of the sale. Competent brokers have assisted in the sale of many businesses and can add value through their network of potential buyers, knowledge of comparable transactions, and experienced negotiation tactics, among other areas. Depending on the anticipated time commitment, many small business owners choose to carry out these functions themselves.

A professional broker will require clients to sign an Engagement Letter creating a contractual arrangement between the selling company and the broker. The general components of an Engagement Letter include:

- *A description of the services provided.* The description may be comprehensive and include: identification of prospects purchasers, creation of selling memorandum and marketing documents, assistance in negotiation of sales agreement and related agreements (employment, non-compete, etc.), and guidelines for conducting due diligence
- *How the broker will be paid.* The broker's compensation is typically a percentage of the total payment, ranging from 10% on smaller deals to 1% on deals in the tens of millions. All fees are negotiable
- *The length or "term" of the agreement.* Typically, the term is 12-24 months and may include a "tail" payment whereby the broker will still receive some payment if a sale is consummated prior to the end of a specified period of time (i.e. during the tail). The "tail" clause prevents the seller from kicking the broker to the side once a deal is lined up.

PRE - SALE DOCUMENTS

Prior to beginning the sales process, a business must ensure its own house is in order. This involves collecting or drafting the key business formation, organizational, operational, financial, and sale-related documents that a buyer will ask to examine prior to closing a deal. It is critical that the selling business begin organizing these documents prior to beginning the sales process because delays in the later stages of the sales process can cause serious problems with the sale and may even kill the deal.

Whether a business must have all, most, or just a few of the documents listed below depends on its size and the requirements of potential purchasers. Sophisticated purchasers or larger businesses may expect to see an audit from a regional accounting firm, whereas accounting software print-outs may suffice for smaller companies. Regardless of the size of the business, the financial statements must be cleansed of profit-avoidance expenses to reflect true profit (“Seller’s Discretionary Earnings”). Another common snag is the presence of “change of control” provisions in contracts. These provisions provide executives with certain payments and benefits, are often triggered by a change in ownership, and may require some action on the part of the selling party when there is a change in control of the business.

business formation

- Articles of Incorporation
- bylaws
- capitalization table
- stock certificates
- board of directors resolutions
- board of directors meeting minutes

organizational

- license agreements
- intellectual property (patents, copyrights, trademarks)
- staff list with hire dates and salaries
- employment agreements
- employment policy manual
- organizational chart
- business procedures manual

operational

- business licenses, registrations, certifications
- building leases or deeds
- equipment leases, deeds, and maintenance agreements
- litigation or settlement agreements
- inventory list with value details
- product/service descriptions, price lists
- supplier and distributor contracts
- business plan
- client list and key client contracts
- marketing plan and related materials
- list of future opportunities for growth

financial

- 2-3 years of financial statements
- Seller's Discretionary Earnings (SDE) calculation
- key financial ratios and/or trends
- aged accounts receivable and accounts payable reports
- outstanding loan agreements
- bank and credit card statements
- Corporate or Schedule C tax returns
- promissory notes
- security agreements
- personal guarantees
- insurance policies
- description of liens and all UCC filings
- escrow agreements
- depreciation schedule from tax return

transaction-related (created during pre-sale process)

- mutual non-disclosure agreement
- selling memorandum
- letter of intent
- note for seller financing (if necessary)

VALUATION

think like a buyer.

A company is worth what a qualified buyer will pay. It is helpful for a selling business owner to understand that buyers typically value a private company in one of three ways:

1. multiple of financial performance

In a multiples valuation, the buyer typically looks first to either the selling company's top line sales or its profit before subtracting interest, tax, depreciation, and amortization.² Whether the valuation uses sales or profit will depend on the specific industry of the selling business. In owner-managed businesses, it may make sense to restate the profit if other quasi-business expenses and perks are paid to the current owner out of what would otherwise be profit. A buyer will adjust the value it is using based on the historic trends of the company. Finally, the appropriate financial metric (sales or profit) is then multiplied by a number (the "multiple") to determine the business's value. The multiple used will vary based on whether sales or profit is used, the business's historic financial performance, and the business' industry.

2. net asset value

If the selling business is not generating a profit or its sales do not exhibit a reliable trend, it may be valued based on its net asset value, which is calculated by subtracting the total value of the company's liabilities from the total value of the company's assets. If possible, a business should consider delaying its sale until it can show at least a year of revenue or profit growth.

3. discount cash flows

If the selling business has operated for long enough that a buyer can reliably forecast future financial performance, then one might argue that the business is worth the total of all the future cash it will provide to its owners. Annual cash flow in the forecast period (typically the net income after tax) is added then "discounted" based on the expectation that a future dollar will be worth less than a dollar today.

general valuation advice

- Use advisers! Competent brokers, accountants, and lawyers will have an informed opinion as to what the selling business is worth based on past experience, the current market, and the underlying financials of the business.
- When potential buyers evaluate acquisition candidates, total annual revenue is often their primary gauge of the size and potential of the business. Top-line sales growth can often justify a higher sales price.
- Don't overlook physical assets. Potential buyers are evaluating your company based on the overall value; a tidy appearance can go a long way to demonstrating an organized culture.

² This calculation is referred to as "EBITDA." EBITDA is a measurement of a company's operating profitability and represents "Earnings Before Interest, Tax, Depreciation, and Amortization."

THE SELLING MEMORANDUM

The selling memorandum, or “selling memo,” is the principal sales and marketing document a company uses to generate buying interest. The goal of the document is *not* to solicit an offer; it is to convince the potential buyer’s to do further investigation of the selling company and eventually present an offer. Therefore, a selling business should tailor its selling memo according to both the size and complexity of the business *and* the requirements of potential buyers. Advisers should be able to help the selling business owner include industry-specific details.

As a summary document, the selling memo should not include sensitive commercial information that could be damaging in the hands of competitors. Be sure to keep track of the number of copies of the selling memo distributed and to whom. Specific sections of the selling memo typically include:

1. *executive summary*³

2. *key selling points.*

- What are the selling business’ competitive advantages in its market?
- Who are the key customers?
 - » The business should refrain from disclosing sensitive customers or clients or consider a nondisclosure agreement

3. *how does financial performance reflect the business’ success?*

4. *description of business*

- Brief history of company and core business model
 - » How does the company make money?
- What are the key physical assets of the company, how are they owned (outright, equipment finance, mortgage, etc.), and where are they located?
- Who are the key personnel that are likely to remain with the company following the sale?
- What is the intellectual property?

5. *market overview*

6. *financials*

- Include income statement and balance sheet showing historical performance and the key financial ratios.

3

A short, one-page summary of the selling memo built from the Executive Summary section is helpful in the early stages of negotiation.

FORM OF TRANSACTION

In most cases, the sale of a company's ownership interest occurs one of two ways:

1. Sale of stock⁴
2. Sale of assets

sale of stock

A stock sale transfers the actual ownership of the business entity (whether a Corporation or LLC) to the buyer, which includes all the assets (inventory, licenses, money, furniture, etc.) and liabilities (interest payments, legal judgments, etc.).

Future liabilities are also transferred since the owner of the stock will be responsible as the business owner going forward. Therefore, when the selling business has taken actions that may expose it to liability in the future, a buyer will likely avoid buying the stock. However, the sale of stock is a much simpler transaction to document and if the business is losing money a buyer may want to purchase the entity and the loss carryover for tax reasons.

sale of assets

In an asset sale, the selling company receives cash or stock and the buyer purchases all or some of its assets and assumes all or some of the selling company's liabilities, and leaves the actual business entity owned by the seller.

An asset sale requires a more detailed agreement than a stock sale. The agreement must specify which assets are to be purchased and which liabilities are to be assumed. This requires attention to detail and can be time consuming. It is typically used when the buyer or seller would like to carve out certain assets and/or liabilities from the transaction. For example, a buyer might require an asset sale if:

- Environmental liabilities, dormant legal claims, or other actual or potential liabilities that would be time-consuming and expensive for the seller to address
 - The business cannot produce sufficient ownership records to confirm that the buyer is actually purchasing 100% of the selling business' stock
-

⁴ If the business is a Corporation, this will take the form of a sale of stock. If the business is an LLC, it will take the form of the sale of the members' interest in the company.

FINDING THE RIGHT BUYER

The process of identifying the correct buyer for your business is relatively simple, but requires forethought and discipline on the part of the sellers.

step 1: generate a list of all potential buyers.

Half of all sales of businesses that sold for \$500,000 or less were to a buyer in the same city. The seller should begin looking close to home⁵ and also consider the following groups of potential buyers:

- competitors
- suppliers and customers that may be interested in vertical integration
- company insiders (management, family members)
- private equity or investment funds (these investors will typically partner with either an existing company insider or hire professional management with industry experience)

step 2: prioritize the list of potential buyers based on the selling business' requirements and the capabilities of the buyer. Key differentiators include:

- financial capacity
 - » Will the buyer pay with cash, a loan, the seller's cash (seller-financing), or stock?
 - » How the purchaser plans to pay for the company directly impacts the seller's taxes, time to close, seller's future involvement in the business, and additional aspects of the deal
 - » See **Exhibit I** for a detailed explanation of the various ways a buyer may pay the seller and the implications for the seller
- acquisition experience/track record
- purchaser's acquisition appetite – are there any known or published acquisition preferences?
- cost savings or synergies in the deal
- sufficiently developed infrastructure to absorb the selling business
- cultural fit – does the selling company's management like and trust the potential buyer?

⁵ Market Pulse: Quarterly Survey Report, PEPPERDINE UNIVERSITY SCHOOL OF BUSINESS AND MANAGEMENT (2013), available at http://bschool.pepperdine.edu/appliedresearch/research/pcmsurvey/content/marketpulse_13q4fin.pdf ("If you're a small company, you have almost a 75 percent chance of finding your buyer within a 50-mile radius.").

step 3: contact the potential buyers.

The selling company's management or owners may contact potential buyers if a personal relationship exists, but in the absence of such a relationship, the selling company's adviser (investment bankers, consultants, or a broker) can engage potential buyers in discussion without disclosing the identity of the potential selling company.

- **Confidentiality is very important during this step** – don't "give away the farm." Sellers may send potential buyers a one-page summary document that contains only very high-level business and financial information. Once a potential purchaser demonstrates sufficient interest and signs a non-disclosure agreement, the selling company's management or adviser can send the selling memo and set an initial meeting or conference call among the parties. Valuable strategies to consider when contacting potential buyers include:⁶
 - » preparation of a confidentiality agreement in advance that includes an expiration date and a commitment to confidentiality by both parties
 - » creation of a separate email account for prospective buyer inquiries
 - » use of a non-business phone number
 - » preparation of a selling memorandum⁷
 - » withholding detailed information until there is a signed letter of intent⁸

6 Curtis Kroeker, When Selling a Business, Confidentiality is Key, INC.COM (June 26, 2013), available at <http://www.inc.com/curtis-kroeker/confidentiality-business-sale.html>.

7 Refer to the Forms of Transaction section for more information regarding the selling memorandum.

8 Refer to The Closing section for more information regarding letters of intent.

LETTER OF INTENT AND NEGOTIATIONS

The Letter Of Intent (“LOI”) is a non-binding agreement between the buyer and seller. Its purpose is to list the key terms and conditions upon which the purchaser proposes to buy the business. Depending on the type of transaction and the preferences of the potential buyer, a **Term Sheet** or **Memorandum of Understanding** may be used instead of a LOI. The purpose of each agreement is the same. These three documents are not essential to a sale, yet they are effective starting points for more serious negotiations and due diligence. An LOI is also helpful if there is more than one potential buyer because it helps the seller compare the terms and conditions of each offer.

What is it? The LOI may include as many terms and conditions of the transaction as the parties may choose, such as: the proposed purchase price, timeline to closing, form of payment, source of financing, future seller involvement in business, etc. In a cash deal, for example, the LOI may spell out the funding source to show the seriousness of the buyer. While these terms are almost always non-binding, the LOI may include other terms that bind the seller, such as:

- A **non-disclosure** forbids public disclosure of the deal or information learned through negotiations
- An **exclusivity** or “**no-shop**” period during which both parties stop talking to other potential deal partners.

A word of caution: An LOI is not a done deal. In 2013, 30 percent of brokered deals and 31 percent of investment banking deals fell through after an LOI was signed.⁹ Prior to beginning negotiations with a potential buyer, the seller should establish with their advisers clear objectives for the transaction. Referring to these objectives either privately or publicly during the negotiation process will limit emotional tangents and keep the selling parties anchored on important points.

negotiations

This is where experienced advisers literally pay off. They should know your market and what selling terms are normally included or excluded from a sales agreement. Additionally, conducting negotiations through an adviser can shield the seller from the pressure and emotion associated with the sale of a business.

-
-
- | | |
|--|---|
| <ul style="list-style-type: none">• Move quickly when possible - delays can hinder buyer interest and may lead to concerns• Most advisers recommend that the selling business refrain from negotiations until it has a signed letter of intent or term sheet that lays out the buyer’s proposal | <ul style="list-style-type: none">• Understand the buyer’s motivation to buy the company<ul style="list-style-type: none">» How will they make money now or in the future?• Don’t let negotiations turn personal |
|--|---|

⁹ Ilan Mochari, When It Comes to M&A in 2014, You Might Be Your Own Worst Enemy, INC.COM (Jan. 8, 2014) (citing research from Pepperdine University’s Graziadio School of Business and Management), available at <http://www.inc.com/ilan-mochari/2014-mergers-acquisitions-trends.html>.

DUE DILIGENCE

due diligence

Due Diligence is the investigation of another company by reviewing documents and interviewing people with knowledge of company. The buyer wants to verify the assumptions that underlie the deal struck in the Letter of Intent. The selling company's role in the due diligence process is to timely respond to the buyers' due diligence requests. Additionally, the seller should keep due diligence off site, if possible, so as to avoid disturbing the business's operations. Thorough document preparation during the pre-sales period will increase the odds of a quick and smooth due diligence process.

The buyer's goals of due diligence are to:

1. uncover the material issues that could be involved in the acquisition of the selling company
2. better value the selling company
3. draft appropriate documents that address unique aspects of the sale
4. identify impediments to closing the deal

The buyer typically engages the following parties to assist in due diligence:

- **attorney** – looking for legal/regulatory issues
- **accountant** – looking for financial misstatements or risks
- **adviser** – may also conduct financial investigations
- **buyer's executives/employees** – looking into commercial operations of the selling company

Depending on the size of the acquisition, the buyer may require the seller to setup a "data room." This is either a physical and/or an electronic storage site to house all key documents related to the transaction and is most common in larger deals. The data room can be a critical record of the disclosures upon which the parties in the transaction rely since it insures all parties are negotiating, drafting, and ultimately executing an agreement based on the same information.

confidentiality

Another important element of the due diligence process is the confidentiality agreement. The buyer typically begins the due diligence process with the signing of a confidentiality agreement that may require: the parties to safeguard non-public info, discontinue any current and future discussions that might lead to an alternative transaction, freeze hiring, and other specified terms or conditions. In certain circumstances, it may be appropriate to sign the confidentiality agreement in the early stages of the negotiations, before reaching the due diligence stage.

SALES AGREEMENT

The sales agreement may go by different names and contain slight variations depending on the type of transaction. Below is a list of provisions common to most sales agreements.

identifying information

Legal names and location of the seller, buyer, and businesses

subject of the sale

In an **asset sale**, the sales agreement will identify all assets (inventory, accounts receivable, etc.) purchased by the buyer and any liabilities that will be assumed by the buyer. Typically an asset sale will be structured such that the buyer will purchase the business free of certain or most liabilities. In a stock sale, the sales agreement will describe the ownership structure of the selling business and identify the seller's stock that is to be transferred to the buyer

purchase price

This section should include the amount to be paid for the subject of the sale described above, in addition to payment terms describing when and how the payment will be made to the seller

the closing

- date
- location

representations and warranties¹⁰

Representations are statements of fact about the business, and a warranty is a promise to make the recipient whole if the statements turn out to be untrue.

- *By the Seller*
This section allows the seller to list its promises regarding the current condition of the selling business that may or may not have been reviewed in due diligence (e.g., the seller has title to the assets it is selling, the sale is authorized by the legal owners of the business /assets the financial statements are accurate, all material info has been disclosed to buyer, etc.)
- *By the Buyer*
A buyer's representations and warranties are short and typically focused on the ability to pay. If the selling company's owners are receiving stock as payment, this section may be more developed

¹⁰ Previously Disclosed Letters. Depending on the size of the sale, the parties' attorneys may each draft a "previously disclosed letter" that list out the exceptions to the representations and warranties in the sales agreement. The purpose of this letter is to provide helpful information in transferring the business to the other party and to protect the company writing the letter from liability.

seller's covenants

This section lists the specific actions that the seller promises to undertake in order to complete the transfer of the business to the buyer; such as, continuing to pay employees during the transition, change contracts where necessary, and other agreed upon terms. The seller's covenants are a potentially sensitive negotiating point since the buyer is basically dictating how the seller should run its business during the due diligence period

conditions to closing

This section will include any requirements the buyer or seller want to impose on the other party prior to closing. For example, in a third-party financed transaction, the seller may require that the buyer apply for, receive, and provide evidence of the financing. Additionally, shareholder and board of director approval may be required.

remedies

Define the allocation of costs associated with due diligence, legal fees, accounting fees, and other expenses in the event the sale does not occur

confidentiality

The sales agreement should contain a provision that requires a prospective buyer to maintain the confidentiality of the seller's sensitive financial and business information for the duration of the negotiations and possibly even after the sale of the business.

post-sale involvement

Address how the seller or owner will transition out of the business, and how and by whom the management and employees of the business and the suppliers, vendors, distributors and other stakeholders will be notified of the change in control and/or ownership of the business.

THE CLOSING

The closing is when the buyer delivers and the seller receives the agreed upon payment, whether it be a bank check, wire transfer, stock certificate, or other valuable consideration. In a small business sale, the signing of the sales agreement and closing are typically simultaneous. The closing may take place in-person (all parties and advisers are physically present at a single location) or virtually (signed documents are emailed and payment is transferred electronically). It is not until the closing that the owners of the selling business realize the benefit of the sale.

third party consents

The seller must manage the process of obtaining third-party consents, where necessary. The entire deal could be put in jeopardy if key clients haven't agreed to amend their contracts or a landlord fails to transfer a lease.

key closing documents:

The following documents are often essential to the closing process. In addition to evaluating whether each item on this list is relevant to the sale of your business, consider getting an opinion from a legal professional who is knowledgeable about the closing process and the documents required

1. closing certificate

certifies selling company is materially unchanged since the signing of the sales agreement -- if there is a gap in time between the signing of sales agreement and closing

2. secretary certificate

confirms that all persons signing the documents can bind the company

3. board and stockholders consents

verifies that selling and/or buying company's actions are properly authorized by the board of directors and shareholders, if necessary)

4. ancillary agreements and documentation

examples – assignment of lease or real estate, agreements with suppliers or distributors, licenses or permits held by the business, etc.

5. wire transfer instructions (if necessary)

6. filings (if necessary)

7. regulatory approvals (if necessary)

In more complicated transactions, a “closing checklist” may be prepared by either party's attorney to keep track of the documents to be signed and delivered and other actions necessary to affect the transaction.

EXHIBIT 1

<i>consideration paid</i>	<i>pros</i>	<i>cons</i>
<p>CASH</p> <p><i>It's cash!</i></p>	<ul style="list-style-type: none">• Seller walks away from closing table with deal concluded• Eliminate risk that buyer won't be able to make post-closing payments	<ul style="list-style-type: none">• It's tough to find an all-cash buyer for a business• Lump-sum payout may push seller into a higher tax bracket• Less payment risk typically equates to lower selling prices
<p>THIRD - PARTY FINANCING</p> <p><i>A lender provides a percentage of the purchase price of the business after conducting its own investigation into the business and potential buyer.</i></p>	<ul style="list-style-type: none">• Expand list of potential buyers since most people cannot afford to buy business with all cash• The third party providing the loan will conduct its own due diligence on the buyer, serving as validation	<ul style="list-style-type: none">• Post-recession bank loans can require extensive qualification process (sellers should leverage adviser relationships)• Deal may be delayed to allow third party to conduct its own due diligence on the seller
<p>SELLER FINANCING</p> <p><i>The seller finances a portion of the purchase price with a secured promissory note to be paid down with interest over time. Often the loan will have a "balloon" payment due 3-5 years after the sale with the expectation that the buyer will be able to refinance the loan with a bank at that time</i></p>	<ul style="list-style-type: none">• Demonstrates confidence in the business' ability to generate future profit• Greatly expand the number of potential buyers to include those that need financing beyond what third party can provide• May avoid higher tax rates by spreading the proceeds over multiple years• The promissory note may yield interest to the seller	<ul style="list-style-type: none">• Seller takes on the significant risk that buyer doesn't pay interest or principal on the promissory note• Upon default of note secured by business' assets, seller may end up as owner of the business again
<p>EARN - OUT PAYMENTS</p> <p><i>The seller "earns" a percentage of the purchase price based on the business hitting specified financial performance targets.</i></p>	<ul style="list-style-type: none">• Similar to seller-financing, earn-out payments demonstrate the seller's faith in the business' ability to generate future profits and also spreads taxable sale income over multiple years• May be used to bridge gap when buyer and seller cannot agree on value of the business	<ul style="list-style-type: none">• Payments are usually determined by accounting calculations that put both selling and buying parties at risk• Seller may need to stay involved to ensure business hits the specified performance targets
<p>STOCK</p> <p><i>If the buyer is a business, it may pay for the selling company with stock.</i></p>	<ul style="list-style-type: none">• Receiving stock in the buying entity may avoid all taxes• Share in future gains of the combined business	<ul style="list-style-type: none">• Most private company stock requires 6-months or 1-year holding period• Selling the stock in private market may be difficult