



**Vermont Bar Association**  
**139th Annual Meeting Seminar Materials**

**Selling a VT Business:  
Maximizing Value for Seller**

**October 13, 2017**  
**Hilton Burlington**  
**Burlington, VT**

**Speakers:**

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# Vermont Bar Association Business Association Section

2017 Annual Meeting – October 13, 2017

## Selling a Vermont Business: Advanced Issues in Private Sale Transactions

# Presented by

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# First Steps in Selling a Business

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Business Sense • Legal Ingenuity

# Preparing to Sell

- Pre-offer audit of business and legal matters
  - Owner-management alignment
  - Corporate clean up
  - Financial statements and projections
  - Contract defaults
  - Litigation
  - IP registrations and documentation
- Develop a sales story

# Exit Strategies

- Asset Sale
  - All or Substantially All Assets
  - Partial Sale of Assets – Spin off of a business line or division
- Equity Sale – Stock or Membership Interests
  - Sale of all equity
  - Partial sale of equity
    - Cash out equity sale
    - Management buyout
- Merger
- Initial Public Offering

# Structuring a Deal

- Review of deal structures and considerations
  - Buyer Side
  - Seller Side
- Analysis of alternative exit strategies
  - Tax considerations
  - Risk considerations
  - Execution considerations

# Buyer Tax Consideration

- Critical to focus on Tax Issues at LOI Stage
- Asset Deal – Purchase Price Allocation
  - Categories: tangible assets, intellectual property, goodwill, non-competes
  - Step up in basis
- Stock Deal
  - 338(h)(10) election
  - Using a reverse mergers structure



# Seller Tax Consideration

- Who are the taxpayers?
  - C Corporation & C Corp stockholders
  - Pass-through equity holders (S corp shdrs; LLC members)
  - Optionholders
  - Holders of phantom stock and other incentive payments
- What is the applicable tax rate?
  - \*these are rough numbers; consult your tax advisor!
  - Corporate tax rate – (Fed, 34%) (VT, 8.5%) Long-term cap gain / dividend rate – (Fed, 15 or 20%) (VT, effective 5.4% - 3-year holding period)
  - Ordinary income & short-term capital gain (Fed, 25 to 39.6%) (VT, 6.8 to 8.95%)
  - Federal surtax – 3.8% (investment income, if over \$200k/250k)
- Be aware of “Hot Assets” - unrealized AR, inventory and other depreciated property

# Seller Tax Consideration

- How can we maximize tax efficiencies?
  - Minimize amount of income taxed at ordinary income rate or short-term cap gain (purchase price allocation)
  - Maximize use of accumulated tax losses and tax credits
  - Look at timing of deductions for closing day payments
  - Look at timing of income realization (installment sale/earnouts)
  - Pre-closing tax planning vehicles (family and charitable)
  - Evaluate Pre-Closing Restructuring (F Reorg)
- Plan for exit –
  - At time of formation (choice of entity)
  - More than a year before the transaction
  - Individuals may look to recognize loss in tax year of sale

# Buyer Liability Considerations

- Asset Purchase
  - Bulk sale provisions and taxes
  - Non-legal liability vendors, employees, customers
  - Statutory (e.g. ERISA, environmental)
  - De-Facto Merger Doctrine
  - Where is the recourse?
- Stock Purchase/Merger
  - Extensive liability exposure
  - Structural protections become key – earnouts, holdbacks, escrows, seller notes, etc.

# Seller Liability Considerations

- Asset Purchase
  - Full disclosure
  - No recourse against stockholders/members
- Stock Purchase
  - Buyer will be looking to shift risks back to Seller
  - Buyer will be looking for “credit” to back reps and warranties
- Protect clients with strong philosophical approach:
  - We will fully disclose
  - You will complete diligence
  - Recourse against sellers is only for knowing misrepresentations

# Letter of Intent

# Letter of Intent – Buyer Considerations

- Exclusivity/No Shop
- Due Diligence Review and Access
- Deal Structure addressing tax and liability issues.
- Contingencies (financing, due diligence, third party consents, regulatory, key employees).
- Key Purchase Agreement Terms (reps and warranties, indemnification).

# Letter of Intent – Seller Considerations

- Judgment call as to what goes in the Letter of Intent
- Seller wants anything critical to tax treatment covered
- If “hot assets” are involved, address allocation of purchase price
- Less detail on reps and indemnification is probably better
- Keep exclusivity short
- Closing contingencies – be clear, keep to a minimum, and time-limit them
- Address buyer’s hiring and staying requirements, if any  
(treatment of employees, employee options, compensation and benefits)
- Include limitations on recourse against seller/stockholders
- Typically, the seller wants less in the Letter of Intent
- Auction deals typically do not have Letters of Intent

# Description of Competitive Sale Process



# Strategies Behind Establishing a Sale Process

- Critically important to assemble deal team, comprised of key members of management, financial and legal advisors, accountants, and, potentially, consultants.
- For any mid-size or large business, typically only a small subset of management is informed of transaction at early stages.
- Discuss timing considerations and establish timeline
- Consider tax planning and accounting requirements (status of financials?)
- Make sure sale process aligns with objectives.

# Competitive Sale Process

- Find potential buyers
  - Who does this?
    - Investment banker
    - Business broker
    - Seller's board and management
  - Cast a wide net
    - Make a large list (10 – 40)
  - Distribute teaser
    - Short description (1 page or less)
    - Usually on a blind basis

# Competitive Sale Process

- Nondisclosure Agreements
  - Parties
  - Liability for breaches by representatives
  - Non-use and non-disclosure
  - Choice of Law and Jurisdiction
  - Specific Performance
  - Attorney's Fees
  - Non-solicitation / Non-hire

# Competitive Sale Process

- Data Room and Disclosure Management
  - Limits of NDAs – Bidders can't “unsee” sensitive information
  - Access to information increases as the process advances
  - Access to Management and Employees
  - Strategic Buyers and Competitors
  - Relationship Between the Data Room, Schedules and Representations and Warranties.

# Competitive Sale Process

- Prepare and distribute Confidential Information Memorandum (CIM)
  - Typically 15 – 30 pages
  - Efficient way to distribute confidential info in a controlled way
  - Limited info; no trade secrets
  - Enough for initial bidders to make an informed initial statement of interest
  - The quality of initial statements depends on quality of disclosure
  - Business description
  - Management structure
  - Basic historical financial information
  - Future opportunities
  - Simple financial projections
  - Marketing document
  - Financial advisors take the lead

# Competitive Sale Process

- Solicit initial statements of interest
  - Round 1 Process Letter
  - Describe preferred deal structure
    - Typically zero debt, zero cash
    - Stock or asset deal
    - Set expectations on price range
    - Disclosure of all of buyer's contingencies
  - Set timetable (typically, give 3 – 4 weeks for response)
  - Consider form of Purchase Agreement
  - Set forth guidelines for bid process

# Competitive Sale Process

- Preemptive bidder
  - How to you handle a buyer who wants exclusivity?
    - Clear communication
    - Clear expectations on requirements for grant of exclusivity
  - Impact on the sale process

# Competitive Sale Process

- Evaluate Round 1 bids, shorten list (5 – 8)
  - Strategic buyers
  - Financial buyers
  - Offers are rarely apples to apples
  - Factors to consider
    - Price
    - Quality of buyer
    - Financial ability
    - Contingencies
    - Impact on management
    - Other terms



# Competitive Sale Process

- Management presentations
  - Meet and greet
  - Object is to get to know counterparty
  - Interactive, but keep at high level
  - If with competitors, consider having counsel attend

# Competitive Sale Process

- Open data room with Level 2 information
  - Sensitive Information
    - Employee lists/compensation
    - Customer list
    - Pricing information
    - Trade secrets
  - Consider who has access when adding disclosures
  - Limit to listed members of buyer's evaluation team
  - Consider second level NDA

# Competitive Sale Process (cont'd)

- Solicit Round 2 bids
  - Round 2 Process Letter
    - Ask for best and final price
    - Sources of financing
    - Approval and contingencies
    - Time to closing set timetable (typically, give 4-6 weeks for response)
    - Additional diligence requirements
    - Intention as to management
    - Require final markups of purchase agreement
      - 5 to 7 days in advance of bid date

# Competitive Sale Process

- Review offers, select to top 2 or 3
  - Manage for at least 2
  - Parallel path negotiations
  - Select buyer and move to closing
- Multiple work streams (final diligence, negotiation of final deal terms, documentation, plan for employee assimilation)
  - Critical to move on schedule

# Legal Due Diligence/Data Room Review – Buyer

- Review charter documents for required approvals
- Review loan documents UCC records for liens and debt payoffs
- Review material contracts for assignability and termination provisions
- Identify lead time items – 3<sup>rd</sup> party consents, regulatory approvals
- Review registered IP (trademark, patent, domain names) for proper ownership
- Stock Deal/Merger vet capitalization
- Cross check against reps and warranties

# Select Issues in Negotiating the Purchase Agreement

# Purchase Price Adjustments

- What is Net Working Capital and Why is it Important?
- Purchase Price Typically adjusted based on the amount by which the Net Working Capital of the acquired Business is greater or less than an agreed upon target.
- Defining “Net Working Capital”
  - For the Seller, more detail is typically better
  - Ensure that the same accounting methods are used, consistently applied.
  - Aged receivables
  - Inventory issues

# Purchase Price Adjustments (continued)

- Setting the Target Net Working Capital
  - Typically based on historical levels maintained by the business in prior periods in the ordinary course of business
  - Important to understand the impact of seasonal fluctuations in the NWC requirements of the business.
  - Client and the banker/financial advisor should be heavily involved in determining the appropriate target



# Purchase Price Adjustment (continued)

- Closing price based on estimate of NWC. Typically impossible/difficult to calculate with precision until after the closing.
- Inventory counting
- Closing Statement
- Final Closing Statement
- Dispute Resolution Process
- Separate Escrow for Net Working Capital Adjustment?

# Earnouts

- A way to bridge the gap between a Buyer and Seller when there is a disagreement about the value of the future earnings of the Company.
- Additional payments that the Buyer agrees to make if agreed upon financial milestones are satisfied post-closing.
- Heavily negotiated and deal specific
- Difficulties in protecting the Sellers

# Earnouts (continued)

- Frequent Issues
  - Setting Appropriate Earnout Targets and Measures
  - Exclusions and Adjustments
  - Post-Closing covenants re the operation of the business.
  - Impact of post-closing transactions, acquisitions, sales, financings, etc.
  - Calculation and audit rights
  - Source of payments
  - Negative Covenants under Financing Agreements
  - Subordination

# Indemnification: The Basics

- **Allocation of Risk:** As others have noted, the allocation of risk shapes every merger and acquisition, and the underpinning of that risk allocation is the right of the buyer to be indemnified.
- **What is an indemnity?**
  - An explicit obligation to compensate a party (and often its affiliates and representatives) for losses arising from:
    - Breaches of representations, warranties and covenants; and
    - Any stand-alone liabilities (for example, specified environmental, tax, labor or litigation liabilities).

# Indemnification: Limitations

- **Negotiation of Limitations:** One of the most important aspects of the negotiation of the transaction.
- **Lots of Jargon:** Tipping baskets, materiality scrapes, anti-dog kicking, no hole-poking and anti-sandbagging.
- **Key Limitations:** Duration, Dollar Amount and Scope

# Indemnification: Time Limitations

- **Survival:** Some indemnification claims can be made only during contractual “survival periods”. Notice of claims must generally be given during this period.
- **Time Period:** Varies deal-to-deal but often in the range of one to two years. Buyers typically want one full audit cycle.
- **Key Representations:** Certain reps, particularly so-called fundamental representations – ownership of the target and authorization to effect the transaction – and tax representations often survive until expiration of applicable statute of limitations.

# Indemnification: Dollar Limitations

- **Cap:** Aggregate limit on party's indemnification obligation. Range depends on number of factors (leverage, potential liabilities, industry and identity of seller (PE vs corp)).
- **Deductible / Tipping Baskets:** Deductible applies only for amounts in excess; tipping basket provides for "first dollar" recovery. Hybrids are possible.
- **De Minimis / Mini-Basket:** Establishes amount that must be suffered before an individual claim can be made.
- **Customizable and context-specific** – can have different deductibles/caps for different claims, e.g. a labor deductible, and "market" only provides guidance – indemnity package needs to be tailored to transaction.

# Indemnification: Scope Limitations

- **Known vs. Unknown Risks** – Buyer will often want coverage for certain known liabilities, particularly those that are difficult to quantify, such as environmental risks.
- **Limit to only Reps, Warranties and Covenants** – Indemnity only covers the representations, warranties and covenants included in the agreement.



# Indemnification: Items to Watch

- **Waiver of Consequential and Other Damages:**

*Example of Seller-Friendly Provision:*

**No Consequential Damages.** Notwithstanding anything to the contrary contained in this Agreement or provided for under any applicable Law, no party hereto shall be liable to any other Person, either in contract or in tort, for any consequential, incidental, indirect, special or punitive damages of such other Person, [including] [or any] loss of future revenue, [or] income or profits[, or any diminution of value or multiples of earnings damages] relating to the breach or alleged breach hereof, whether or not the possibility of such damages has been disclosed to the other party in advance or could have been reasonably foreseen by such other party.

- **Sandbagging:** Does Buyer’s awareness of a breach matter?
- **Limitations on Environmental Liabilities:** “Gold-plated” cleanups and “anti-dog kicking”
- **Fraud Carve-Outs**

# Securing Post-Closing Obligations

- Who is the seller?
- If the seller's ability to pay for indemnification claims post-closing is uncertain, common to negotiate purchase price escrows or holdbacks.
  - Indemnity Escrow – Generally range from 3 – 15% (often separate purchase price adjustment escrow)
  - Holdback – Buyer retains percentage of funds
- In last 5 years, rep & warranty insurance has become increasingly common for deals, particularly if a financial investor (such as a private equity fund) is the seller.

# Rep and Warranty Insurance

- Dramatic growth in recent years. Most commonly used on deals between \$20 million and \$2 billion. 2.5 to 4% of coverage plus expenses and fees.
- Sell-side rationale
  - PE/VC funds want to limit post-closing indemnification liabilities to distribute deal proceeds to LPs
  - Can remove specific risks – such as tax contingencies – from the table.
- Buy-side rationale
  - Bid enhancement.
  - Enhanced survival and coverage.
- Does not cover known risks. Generally have a self-insured retention (deductible), which often ranges from 1 to 3%

# Resources

- 2015 ABA Private Target M&A Deal Points Study – available on ABA website for ABA Section of Business Law members
- 2017 SRS Acquiom M&A Deal Terms Study of private-target transactions completed 2013-2016 in which SRS provided financial services, a majority of which are not required to be publicly reported.

<https://www.srsacquiom.com/resources/2017-srs-acquiom-ma-deal-terms-study/>