

December 2009

Reporter

Business & Corporate Law

by Ara A. Babaian, Esq.

**Business Topics: Part I
Key Issues to Consider in Anticipation of a Major Transaction**

Are you considering a major transaction for your business, such as a sale, merger, private placement or debt financing? These types of transactions are very important to the stakeholders in your company and to the future success of the business, and they are often time-consuming and costly. Below are key issues that often arise in these transactions, and any one of them can become a major obstacle to closing your transaction. In addition, in a major transaction, the business owners will be asked to make certain representations and warranties about the business that can make them personally liable for any breaches. Addressing these issues in advance can prevent them from becoming pitfalls and make for a smoother process.

Maintain reliable financial information. It is critical to work with your in-house financial staff or your CPA to prepare financial information upon which you and other decision-makers can rely. Developing effective audit and internal control procedures is an integral part of this effort. Doing this will allow you to gauge how your business is performing, indicate whether your business is able to meet its debt-servicing obligations or its vendor obligations, and demonstrate the value of your business to other participants in the transaction. Further, it will show that your business is organized and well-managed. Having three years of financial statements is recommended, as well as having the financial statements reviewed by an outside accounting firm. Of course, audited financials are ideal, but not necessary for most privately held companies.

Talk to your banker. Senior vice president at Comerica Bank, Ray Boyadjian, says that it is critical to meet with your

banker face-to-face on a quarterly basis. It creates an open exchange of information so that your lender may respond more proactively to both up and down cycles in your business. In preparing to meet with your banker, you should be able to speak about both positive and negative trends in your business, and you should bring relevant documents, financial statements and projections.

Anticipate issues arising in a due diligence review.

Before you embark on a major transaction, a useful exercise is to ask your counsel for their form of due diligence checklist, review that checklist, and see how your company matches against it. For example, one of the items typically requested in a due diligence checklist is an organizational chart. Does your company have one? Does that chart effectively convey the responsibility and chain of reporting in your company? In addition, as part of your due diligence review, you should review your various contracts, leases, licenses and permits to determine what third-party consents you need to consummate the transaction. Of course, before entering into any negotiations with third parties, be sure to have them sign a non-disclosure agreement to protect your company's confidential information.

Be prepared to discuss your liabilities and offer

solutions. All businesses have problems of one sort or another. When preparing for a major transaction, it is important to identify the significant issues facing a business, actively address the issues, and package them before meeting with prospective business partners. These issues run the

gamut—contracts that are up for renewal, problematic leases, tax liabilities, litigation or potential claims, employee disputes, product defects, expiring patents, infringing technology, as well as issues such as the concentration of customers (*i.e.*, a small number of customers representing a large percentage of the business). Recognizing these issues and being able to talk frankly about them are important. But if you are able to offer solutions, then the liability may not seem as profound in the eyes of the buyer. In the end, some potential buyers may not go forward with the transaction or there may be an adjustment of the purchase price, but, generally speaking, to avoid problems in the future, more disclosure is better than less.

Obtain a valuation of your business. A third-party valuation will give you a good idea of the range of values for your company. Frequently, a business owner is too close to the business to be able to gauge its value. A valuation of the company's tangible and intangible assets, and of the factors driving the value of the company, will give you assurance that the buyer is paying the right price in your transaction or the investor is getting the appropriate interest in the company in exchange for its equity investment.

Separate your divisions. In some transactions, only certain divisions within a business are sold or merged with another business, or there are some excluded assets which will not be part of the sale of the business. As such, the business owner will need to be able to divide the assets and employees of one division from another. This effort covers a broad range of topics—including human resources issues (such as preparing your employees for the sale of a division and possibly terminating some employees); computer systems that will need to be separated so that the correct data is transferred to the purchaser; and reviewing contracts to ensure that ongoing obligations are met by the seller and buyer. Also, once you sell off a division, will you still need the same space, or will it benefit your business to go into a smaller space with lease terms that make sense for the trimmed down company?

Get the help of professionals. Prior to embarking on a major transaction, it is critical to meet in advance with your professional advisors, such as lawyers, accountants and investment bankers or financial advisors. These professionals can help you identify issues and prepare the company for

the transaction. For example, advance tax planning with an attorney or accountant may save you a lot of money later.

Maintain your corporate records. Maintaining and updating the corporate records of your business on a regular basis saves a lot of time and prevents confusion during a major transaction. For corporations, this means, at a minimum, adopting annual shareholder and director minutes, and for other entity types, this usually means maintaining an operating agreement or partnership agreement, as well as (for all entity types) maintaining books and records and making required state and tax filings. If your company is a small business and it is sued, the plaintiff may try to “pierce the corporate veil” by claiming that your business is a sham and thereby seek to recover any damages from your personal assets. Observing corporate formalities helps defend against this claim. In addition, maintaining your corporate records and observing good corporate practices shows the other participants in a major business transaction that your company is organized and ready to embark on a large transaction. Worrying about these details in the midst of a complex transaction will take away resources from the business and the transaction itself.

Keep your employees through the transaction. Often a company's value is closely tied with key individuals whom the company employs. Because a certain amount of confusion and uncertainty is involved with a major transaction, it is critical to retain these employees. One way to do that is by entering into retention agreements with them. Another way to incentivize employees is with equity incentive plans such as stock option or other equity plans, so that the employees are motivated to stay with the company through the end of the transaction and beyond.

Complex corporate transactions present many challenges and require many resources. Business owners should not attempt to handle these transactions on their own. Many areas of expertise are involved, from tax and accounting to legal, M&A advisory to investment banking and valuation service, as well as other fields that specifically relate to the company's business. Proactively addressing the issues presented in this article at the beginning of the process will smooth the path for a successful business venture.

The next article by Ara Babaian will address key issues to consider in the operation of your business.

If you have any questions regarding this bulletin, please contact Ara A. Babaian at (310) 281-6344 or ababaian@ecjlaw.com. If one of your colleagues would like to be a part of the Business & Corporate Law Reporter mailing list, or if you would like to receive copies electronically, please contact Brandi Franzman at (310) 281-6328 or bfranzman@ecjlaw.com.