Don't Put Off Until Tomorrow – Recommended Actions to be Taken in Advance of the Sale of a Closely Held Business

By Paul T. Rushton, Esq.

Sales of closely held businesses have become increasingly common in recent years, with business owners making the decision to sell due to factors such as their age, lack of succession options, and increased interest from private equity and strategic buyers. Due to the increased likelihood of a sale to a third party, as well as certain other developments in the merger-and-acquisition (M&A) market for closely held businesses, business owners should consider taking certain steps in advance of the sale of their business. By addressing such issues before the commencement of the sale process, business owners can more effectively and efficiently prepare for the sale of their business.

Increased Sales and Other Changes to M&A Market for Closely Held Businesses

Historically, it was less typical for business owners to sell a closely held business, with such owners frequently focused on transitioning the business to the next generation of a family-owned business or the next tier of management or other professionals working in the business. However, in recent years, these normal succession options have become less reliable, with younger family members, managers, and other professionals passing on opportunities to become owners of the business. As a result, many closely held business owners find themselves in the unenviable position of reaching an age when they desire to (or must due to health reasons) transition ownership and management of their business without having a clear path for doing so within the business.

At the same time as these internal changes have become apparent, the M&A market for closely held businesses has also changed significantly, with both a higher volume of activity and more varied suitors for closely held businesses, including, most notably, increased interest from private equity firms. Accordingly, business owners are increasingly turning to third party suitors, rather than internal options, as the means to effectuate their exit strategy from their closely held businesses.

With more sophisticated suitors involved, sales of closely held businesses have also become more complicated. For example, a pre-closing restructuring of an S Corporation under Section 368(a)(1)(F) of the Internal Revenue Code, commonly referred to as an F Reorganization, is frequently required in the final days leading up to the closing to ensure that the transaction is treated as an asset acquisition for U.S. federal income tax purposes and to avoid concerns about whether the S Election for the selling entity was properly filed and maintained.

Recommended Steps to be Taken in Advance of the Sale of a Closely Held Business

In light of the increased likelihood that a closely held business will be sold to a third party and that the transaction may require a pre-closing reorganization of the selling entity, it is now increasingly important for business owners to prepare in advance for a potential sale. In that

regard, business owners should consider taking the following actions before the commencement of the sale process:

Create and Update Virtual Data Room

In connection with the sale of a business, the potential purchaser and its representatives will conduct an extensive due diligence review of the business and require the selling party to upload numerous documents and information related to the business to a virtual data room (VDR). Additionally, the purchase agreement for the transaction will require that the selling party represent and warrant as to various issues concerning the selling party and its business, with any exceptions to those representations and warranties to be set forth in schedules to the purchase agreement.

To reduce the stress associated with producing such documents and information during the sale process and to increase the likelihood that the disclosed items will be accurate and complete, business owners should compile the documentation and information that is likely to be requested by a potential purchaser in advance of the sales process. Further, to allow for ease of reference and updating of such documentation and information, it is prudent for a closely held business to create its own VDR for such purpose. The documentation and information included in such internal VDR can then be easily produced and transferred to a VDR established by the potential purchaser or its counsel during the due diligence process.

The ancillary benefits of such approach include the ability to more efficiently manage the closely held business prior to the sale through the use of the internal VDR and the opportunity for the business owner to identify and correct issues identified during the compilation of the documentation and information to be included in the VDR. For example, if a business owner determines as part of this process that documentation likely to be requested by the potential purchaser is incomplete and/or unavailable, the business owner can ensure that such documentation is created and/or completed in advance of the commencement of the sale process.

Reorganize Now

As noted above, potential purchasers oftentimes require that the owners of an S Corporation effectuate an F Reorganization in the final days before the closing of a sale transaction. As a result, the owners must take such additional action at a time when they are addressing the myriad items that must be satisfied as a condition of the transaction.

Accordingly, to avoid the need to address the F Reorganization in those final days, practitioners should consider recommending that the owners of an S Corporation effectuate the F Reorganization in advance of the closing of the transaction. In that regard, there is minimal cost associated with effectuating an F Reorganization and the use of a holding company during the continued operation of the business has ancillary benefits.

Conduct Valuation to Plan for Sale

To allow business owners to properly plan for their retirement and appropriately consider offers to purchase their business, they should consider having a valuation of their business conducted by a qualified business appraiser in advance of the sale process. In so doing, business owners can make better decisions about when to hire a broker to sell their business and/or to evaluate whether unsolicited purchase offers are worth considering. A valuation can also be used to plan for and report gifts of equity interests of the business to family members and/or equity awards to employees, as further described below.

Gifting and Key Employee Considerations

Finally, business owners should consider in advance of the sale of the business if they desire to gift any equity interests of the business to a family member for estate planning purposes and/or make any equity award to key employees. By taking those steps before the initiation of the sale process (and preferably well in advance of the sale process), the value of such gifts and awards can be reduced for tax purposes (as compared to the valuation of such gifts/awards if effectuated at a time when a bona fide purchase offer has been received by the business owner from a third party). Further, such equity awards can be tied to vesting schedules that will assist with the retention of such key employees through the closing for the sale.

About the Author

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