



Mergers & Acquisitions Alert

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What You Need to Get Done Now If You Want to Sell Your Company in 2012

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One of today's most discussed political topics is the expected expiration of the Bush tax cuts after December 31, 2012. If Congress doesn't act, among other things, the individual U.S. federal income tax rate on long-term capital gains will increase on January 1, 2013 for those earning more than \$200,000 per year from 15% currently to 23.8%. (An approximately 60% increase in the rate!) Furthermore, California Governor Jerry Brown intends to seek a referendum to increase the individual tax rate on millionaires from 10.3% to 12.3% after this year — a 20% increase.

The impact of these increased tax rates could be substantial on the after-tax proceeds realized by a business owner upon a sale. A typical sale transaction can take six to eight months to complete from the time the decision to sell is made. Consequently, it is important that any business owner seeking to sell his or her business in the near term take immediate steps to ensure the sale will close in 2012 before the rates increase.

The purpose of this alert is to help a potential seller assess how ready they are to complete a sale transaction in 2012 and accelerate the negotiation and completion of a definitive sales agreement. The following are some key questions every potential seller should ask to assess their readiness and some key steps they should take to make sure they are ready for a sale.

Are your corporate records up to date and accurate?

Buyers will typically require a seller to represent that its capitalization and corporate records are accurate and up to date from formation through the date of a sale. Despite the importance of these records, industry sources report mistakes in company capitalization and stock ledger records of up to a third of private companies.¹ Mistakes discovered after a deal expose sellers to liability, and mistakes discovered during a transaction cost companies valuable time and money. For companies wishing to close a sale in 2012, such a delay may be more costly than ever.

How many stockholders will need to approve a sale, is any other party's approval required, and how likely is it approval can be obtained?

Many private venture-backed companies today have gone through multiple financing rounds. Some of these rounds may have added new investors or imposed conditions that must be met or stockholder approvals that must be obtained in the event of a sale. In addition, if the company has any outstanding debt or other securities the holders of those instruments may have separate and independent approval rights. Given the added time pressure, companies should start evaluating which groups of stockholders (or other parties) will need to approve a sale and how likely it is that such

approval can be obtained. Waiting until the sale process has begun under a strict deadline can put a seller in a tough negotiating position. It may then face having to negotiate key deal terms with not only a potential buyer, but also with its own stockholders in order to obtain their approval. If the seller plans to rely upon a voting agreement, that agreement should be reviewed to confirm what type of transaction triggers a voting obligation and how extensive that obligation is. Analyzing stockholder voting rights and understanding the approval requirements under any debt or other security instruments now can prevent the complexity that would result from a three-way negotiation among the seller, the securities holders, and the prospective buyer and save valuable time.

How accessible and assignable are your company's "material" contracts, and will the terms of the contracts, particularly employee contracts, be acceptable to a buyer?

Buyers will likely want to review a seller's "material" contracts. Whether or not a contract is material depends on a company's individual circumstances, but contracts with officers and other key personnel, important vendors and customers, financing agreements, contract templates, and government contracts (if any) will likely need to be provided to a buyer. If a seller is unable to quickly locate these documents it may give buyers the impression the selling company does not efficiently run its business operations. This not only costs time, but also affects a buyer's overall impression of a company's value.

Also, contracts may require approval or a notice to permit the seller to transfer the contract to the buyer or to permit a change in control of the seller caused by the sale. Again, in a time crunch, this can put a seller in the precarious position of having to negotiate with the buyer *and* its employees, customers, vendors, and/or financing sources. Employment contracts with officers and key personnel require additional scrutiny as the buyers will likely want to retain some or all of these individuals, and the terms of their employment, severance, and any change of control payments may need to be renegotiated during the sale process. A renegotiation of compensatory agreements can take a significant amount of time and cause management to lose focus on the key terms of the sale itself. Sellers seeking to close a sale in 2012 should have their contracts evaluated by legal counsel to determine materiality and transferability and should have the terms of employment and other compensatory arrangements reviewed as soon as possible to avoid unnecessary delays.

Are your company's financial records in good order?

Providing a prospective buyer with accurate and complete financial statements is a prerequisite for any sale. While some buyers will accept unaudited financial statements, depending on the size of the transaction, most buyers will require audited financial statements for at least the last completed fiscal year prior to the closing of the sale. An audit, especially a first-time audit, of a company's financial statements can take months to complete even if there are no surprises. Companies should carefully review their internal controls and procedures, financial policies, and any "off balance sheet" transactions now to avoid any surprises that could delay the delivery of an auditor's opinion on the company's financial statements.

How strong are your company's compliance policies?

Almost all business activities are regulated in some way, but it is often difficult for companies to determine which regulations apply to their business and to further determine if they are in compliance with all applicable regulations. Buyers will, nonetheless, expect a company to comply with all applicable regulations whether a selling company is aware of these regulations or not, and to make representations to that effect in the purchase agreement. In light of this, companies should evaluate the state of their compliance with applicable governmental regulations *before* entering into a sales transaction.

How well protected are your company's intellectual property

assets?

A company's intellectual property is often its most valuable asset and, for most technology companies, may be a primary reason a buyer is interested in purchasing the company. Issues impacting intellectual property rights discovered during a transaction can delay or kill a deal. Problems found in advance can often be remedied, but these actions may take time. Consequently, companies should review their intellectual property portfolio now to determine if there are any risks with respect to their intellectual property assets.

The Bottom Line

On February 7, 2012, Federal Reserve Chairman Ben Bernanke urged Congress to finally decide whether or not to extend the Bush tax cuts past 2012. Companies contemplating a sale in the near term, however, should not wait for Congress (or California) to act. In order to ensure your company can close a sale before any increase in the tax rates, you need to begin the process now and proactively seek to identify and address any issues that could cause a delay in closing.

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Endnotes

- 1 Paul Koenig & Mark Vogel, *Tales from the Trenches*, Third Edition, printed by R.R. Donnelly and Shareholder Representative Services, Jan. 2012. ("In SRS's experience upwards of a third of the [stockholder ledger] spreadsheets received [from companies] have issues that require further clarification before distributions can be made.")
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