

Maximizing business value

Planning ahead for future liquidity events **Interviewed by Leslie Stevens-Huffman**

In the hectic times that accompany the launch of an entrepreneurial venture, often the last consideration for the CEO is how to establish a structure that will maximize the value of the business when it is eventually sold. However, if there was ever an opportunity to “begin with the end in mind,” it is before the first sales are actually booked, new client contracts are signed and the form of business entity is chosen.

As the business grows, knowing how the value of a business will eventually be established is vital when making decisions that will maximize the purchase price when the time comes to sell the business.

“If you wait until you receive an offer, it may be too late or very costly to remedy the situation,” says Steven J. Untiedt, a partner with Procopio, Cory, Hargreaves & Savitch LLP, a San Diego law firm. “I have heard some investment bankers estimate that the value of the business can be reduced by as much as 25 percent or more if you don’t anticipate and structure correctly in advance of a sale.”

Smart Business spoke with Untiedt about what CEOs should know as they establish a new business, or how they can take the necessary steps to re-position their existing company.

How can a lack of planning affect the purchase price of a business?

The purchase price of a business is often determined using the company’s earnings before interest, taxes, depreciation and amortization (EBITDA). The value of a business may equal some multiple of EBITDA, which varies depending on the type of business and industry that you are in. Therefore, anything that negatively affects earnings will have a significantly greater negative impact on the purchase price of your business. For example, if an important customer contract cannot be assigned or transferred to the buyer, the buyer will significantly discount the purchase price because of the negative impact on the potential earnings of the business. Sometimes going back and fixing these problems can be very costly.



Steven J. Untiedt

Partner

Procopio, Cory, Hargreaves & Savitch LLP

Why does the form of the business entity matter upon a sale?

When it comes to closely held corporations, most buyers are interested in purchasing the assets of the company; they are not interested in acquiring ownership of the entire company by purchasing its stock from the shareholders.

If the founders initially elected to incorporate as a ‘C’ corporation, there will be two levels of tax that will be levied upon the proceeds of the sale; one at the corporate level (because the corporation will recognize income upon the sale of its assets) and one at the shareholder level when the net sales proceeds are distributed to the shareholders as a dividend. As a result, the shareholders could end up with 35 percent to 40 percent less than they would otherwise have received, after taxes.

Is there any way to mitigate the adverse tax consequences of being a ‘C’ corporation?

Certainly paying attention at the outset and electing to establish the entity as a tax ‘pass-through’ entity (such as an ‘S’ corporation or limited liability company), when possible, is the best way to go. An ‘S’ corporation can always convert to a ‘C’ corporation

in the future, if the need arises. Initiating any of these solutions sooner rather than later, before the business appreciates significantly, would be prudent.

At the time of sale, it may also be possible to negotiate an allocation of the purchase payments for tax purposes that lessens the adverse tax consequences.

How can CEOs best structure client agreements to obtain a maximum value when the business is sold?

Make certain that you pay attention to the boilerplate provisions in any agreements that the company enters into, such as those provisions that relate to assignment of the contract. It is best if these agreements give you the ability to assign the contract to others upon the sale or a merger of the company, and that the assignment can be accomplished without requiring the approval or consent of the other party to the contract. The value of a contract will be discounted if its assignability is in doubt.

How can promising someone an ownership interest in a closely held company affect the sale?

When a commitment of stock or other equity in the company is made to a key employee or some other person or entity, without properly documenting it, CEOs often do not anticipate how that will play out upon a future sale or merger — especially in the early days when the business is struggling. Even oral or ‘napkin’ promises may be enforceable. The ownership of the company must be clarified and documented prior to any sale or merger, and you may have to obtain a release from any persons or entities who claim an ownership or other interest in the business.

STEVEN J. UNTIEDT is a partner with Procopio, Cory, Hargreaves & Savitch LLP. Reach him at (619) 515-3281 or sju@procopio.com.

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