IS MY BUSINESS SELLABLE?

CONSIDERATIONS FOR CREATING AN OPTIMAL EXIT STRATEGY

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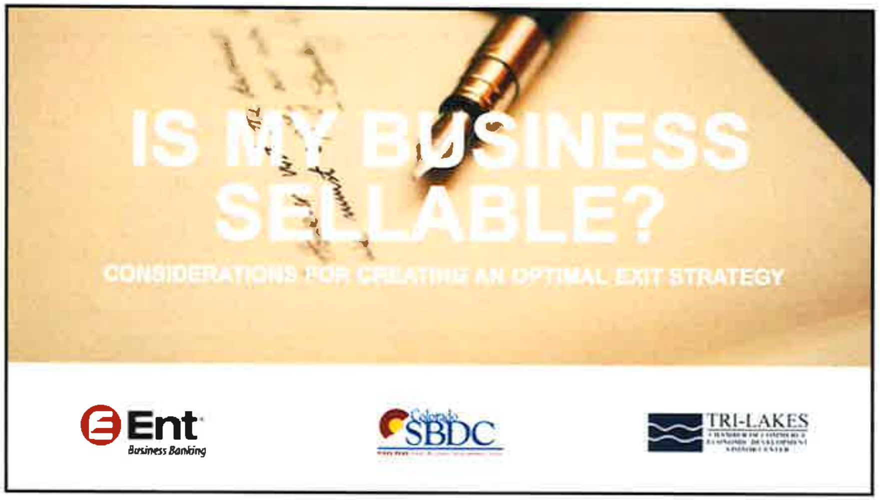

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Is My Business Sellable?

Considerations for Creating an Optimal Exit Strategy

5 things to know about exit planning

- 1) Understanding your financial need
- 2) Business valuation: What is my business worth?
- 3) What are the value drivers of the business?
- 4) Who will be a good buyer?
- 5) Transitioning and retaining key employees

Understanding Your Financial Need

- Develop a realistic expectation as to the amount of net proceeds and when the net proceeds will be received.
- Gross proceeds will oftentimes have expenses against them, such as taxes and legal fees.
- In addition, seller financing occurs in approximately 70% of small business sales and the amount of seller financing averages 50%.
- I encourage plotting out a chart showing the estimated net proceeds and the estimated time frame the money will be received.
- If the current estimate of incoming cash flow does not meet your goals, you can use it to determine how much the value needs to increase to do so.

Business Valuation

- How much is your business worth?
- Is that value transferable?
  - Enterprise Goodwill vs. Personal Goodwill
- A business valuation can provide a starting point, where are we now?
- The outcome of the preliminary valuation should include 3 key areas
  - 1) Starting value
  - 2) What areas are driving up value (good indicators)
  - 3) What areas are hurting value (negative indicators)
- Establish goals to improve the value of your Company, include clear and objective goals

Business Valuation Methods

- Rule of Thumb
  - Not a great method, better used as a sanity check
- Asset Method
  - Used for asset intensive companies or in a liquidation setting
- Income Method
  - Most used method for small business.
  - Based on a defined benefit stream and discount rate (or capitalization rate)
- Market Method
  - Based on comparable company sales
  - How "comparable" are other companies?

Business Valuation Reports

- There are 2 types of valuation reports
  - 1) Calculation of Value
  - 2) Conclusion of Value
- Calculation of Value
  - Uses on of the previously mentioned methods
  - Procedures are agreed upon with the client
  - Not all procedures are performed, making the cost cheaper
- Conclusion of Value
  - Uses all of the methods mentioned earlier
  - Procedures determined by the valuator
  - All procedures are performed, making the cost more expensive.

Value Drivers of the Business

- Maximizing the drivers of value is key, but first you must identify those drivers.
- Examples of value drivers:
  - Large market share
  - High barriers to entry
  - Recurring revenue
  - Product differentiation
- Once drivers of value are known, goals can be quantified to improve value
- Develop metrics to track progress

Analyzing Who Will be a Good Buyer

- Do you know who the potential buyers are?
- Is there a market for businesses like yours?
- Do you have key employees or family that may be interested?
- Listing a business on the open market is not ideal in most cases.

Retaining Key Employees

- Key employees can be a value driver for your business
- You must be proactive to retain these employees
- Every employee is different, a boiler plate approach will not work
- Important things to consider:
  - Communication
  - Address concerns
  - Should retention agreements and/or bonuses be used?
- If you have key employees, this will be an area of concern for a potential buyer

Other key information

Considerations for Creating an Optimal Exit Strategy

Seven Ways to Cash In

- "Inside" Options
  - Intergenerational Transfer
  - Management Buyout
  - Sale to Existing Partners
  - Sales to Employees
- "Outside" Options
  - Sale to Third Party
  - Recapitalization
  - Initial Public Offering (IPO)
  - Orderly Liquidation

Nearly 50% of Exits are not Voluntary

- Frequently, we think of exit planning as being something we do when we are ready
- However, nearly half of all exits are due to the 5 D's
  - Death
  - Divorce
  - Disability
  - Distress
  - Disagreement
- Have you taken steps to protect you and your family from the 5 D's?

Don't Leave Money on the Table!

- Owners are leaving $$$ on the table due to poor planning and focusing only on income generation instead of enterprise value
- Income does not automatically translate into value
- According to the Business Reference Guide, 70-80% of business that are put on the market do not sell!

Myth Vs Reality

- Myth:
  - Exit planning is something you do when you are ready to leave your business
- Reality:
  - Exit planning is a long-term business strategy! It is about developing a management system to keep the Company focused on building value that can one day be monetized.

Three Keys to a Successful Transition

- Develop a strategy to maximize the value of the business
- Ensure you are personally and financially prepared to maximize net proceeds.
- Ensure you have a plan for what you are going to do next.

- Interesting stats:
  - According to Price Waterhouse, 12 months after selling, 3 out of 4 business owners "profoundly regretted" the decision to sell!
  - According to Family Firm Institute, only 30% of all family-owned businesses survive into the second generation, 12% survive into the third, and 3% operate beyond that

Tax Considerations

- It is important to consider the net proceeds, as stated a few times in this presentation.

- One of the largest expenses of selling your business is the taxes that are paid as a result.

- Asset vs. Stock Sale, what is the difference?

Asset Sale Basics

- When a business sale is structured as an asset sale, that means you are buying a group of assets that constitutes a business
- Each asset must be valued and agreed to
- After all tangible assets are valued, the remaining value that is "left over" is called Goodwill
  - For example, a business is sold for $500,000.
    - The tangible assets, inventory, equipment, and computer, are valued at $250,000
    - The remaining $250,000 is assigned to Goodwill.
- What does this mean for tax purposes?

Asset Sale Taxation Basics-Seller

- Let's use the same example as presented on the previous slide.
- Business sold for $500,000, how is that taxed?
- The $250,000 for tangible assets is taxed at ordinary income rates. The amount allocated to inventory is treated like you sold the inventory and the amount allocated to fixed assets is treated as if you sold the equipment.
- Assuming a 30% combined tax rate, that would be approximately $75,000 in taxes.
- The $250,000 treated as goodwill is subject to capital gain rates. Assuming 20% combined tax rate, that would be $50,000
- Total estimated taxes would be $125,000.
- Allocation between tangible assets and intangible assets is a key discussion point. The higher the allocation to intangible assets, the better for the seller

Asset Sale Taxation Basics-Buyer

- On the flip side, the buyer gets better treatment if the allocation to tangible assets is higher.
- This is because tangible property such as equipment and computers, can be written off much faster by the buyer. Sometimes, immediate expensing is possible.
- Intangible property (goodwill) is written off over 15 years. So, the deduction is much slower for goodwill.

Stock Sale Taxation Basics

- Seller
  - In a stock sale for $500,000, that is treated as a capital gain transaction.
  - The sales price minus the basis in the stock equals the taxable gain.
  - The taxable gain is subject to capital gains rates
  - Assuming no basis, the taxes at 20% would be $100,000
- Buyer
  - In a stock purchase, the buyer gets no immediate deduction
  - Instead, the buyer gets basis in the stock purchased
- Asset sales are more common, but stock sales can come into play if there are legal or other non-tax considerations, such as existing contracts with buyers

Installment Sale Basics

- If the Seller finances a portion of the transaction, installment treatment can be used.
- This means that you only pay tax on the money you actually receive, as you receive it.
- This can spread the tax hit out over several years, but any ordinary income is not eligible for installment treatment. Think inventory and unrealized receivables.

Other Tax Considerations

- For the buyer, sales tax may be due on the purchase of any tangible assets.
- Opportunity Zones may be utilized to defer capital gain for the sale of a business. The rules here are intricate and beyond the scope of this class, but you should be aware that the potential exists.
- Colorado capital gain subtraction. Again, this is a detailed conversation and does not apply to any Goodwill sold as part of an asset sale, but stock sales and any capital gain from tangible property sales MAY be eligible.

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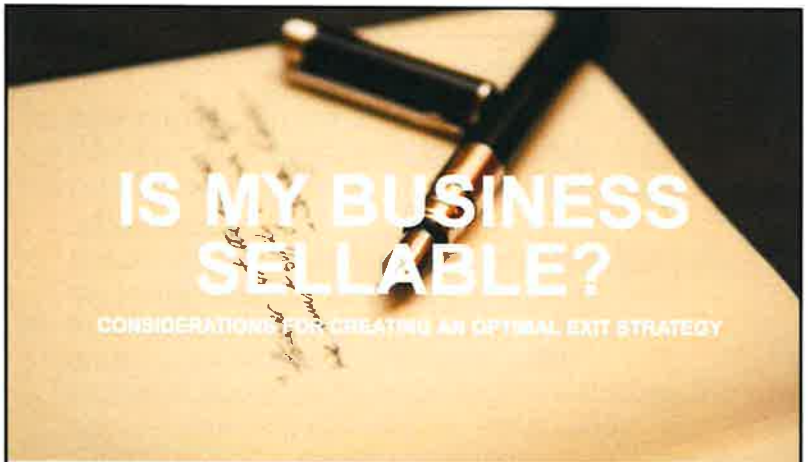

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LEWIS BRISBOIS

Is My Business Sellable

– A Legal Perspective –

with

John G. Lubitz, Lewis Brisbois Bisgaard & Smith LLP

Is My Biz Sellable Workshop

November 6, 2019

What do you have to sell?

One of the first questions to ask when considering the sale of your business is "what do I have to sell?

- Real Estate – Owned or Leased?
- Personal Property/Equipment – Owned or Leased?
- Intellectual Property – Has it Been Protected?
- Contract Rights and Obligations – Term – Are They Assignable – Termination Rights?
- Other Assets Specific to Your Business.

Intellectual Property

Prior to beginning to prepare for the sale of a business, and in addition to identifying and protecting other business assets, both real and personal, a business owner must identify and protect its brand/goodwill. This is done through the protection of the businesses intellectual property.

- Trademarks
- Domain Names
- Copyrights
- Patents
- Trade Secrets
- Trade Names

Trademarks

- **Definition:** A trademark is a brand name. A trademark or service mark includes any word, name, symbol, device, or any combination, used or intended to be used to identify and distinguish the goods/services of one seller or provider from those of others, and to indicate the source of the goods/services.

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Trademarks

- **Registration**: Although registration of a mark is not mandatory, it has several advantages, including notice to the public of the registrant's claim of ownership of the mark, legal presumption of ownership nationwide, and exclusive right to use the mark on or in connection with the goods/services listed in the registration.
- Unregistered marks are "common law" rights and are generally limited to geographic area where mark is used.

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Trademarks

- **Federal Registration**: United States Patent and Trademark Office.
- As long as trademark continues to be used registration can be renewed every 10 years in perpetuity.
- Strength of trademark defines scope of protection it is accorded by the courts and USPTO – the stronger the trademark, the more extensive its scope of legal protection against infringement.
- Descriptive marks generally should be avoided n favor of stronger marks that contain suggestive, arbitrary, or fanciful/coined subject matter.

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Trademarks

- **State Registration**: Colorado Secretary of State.
- Colorado state trademark registration if for term of five years and may be renewed for like periods in perpetuity.

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Domain Names

- **Definition**: Domain names are used to identify one or more IP addresses. For example, the domain name *microsoft.com* represents about a dozen IP addresses. Domain names are used in URLs to identify particular Web pages. For example, in the URL *http://www.;lbbs.com/*, the domain name is lbbs.*com*.

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Domain Names

- **Every domain name has a suffix that indicates which top level domain (TLD) it belongs to. There are only a limited number of such domains. For example:**
  - **gov** - Government agencies
  - **edu** - Educational institutions
  - **org** - Organizations (nonprofit)
  - **mil** - Military
  - **com** - commercial business
  - net - Network organizations
  - **ca** - Canada
  - **th** - Thailand
- **Because the Internet is based on IP addresses, not domain names, every Web server requires a Domain Name System (DNS) server to translate domain names into IP addresses.**

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Domain Names

- **Registration**: Domain names are obtained, and thus, registered through authorized private vendors called "registrars" (i.e., "GoDaddy.com").
- Registered on a first-come, first-served basis and will be registered as long as they are not identical to a previously registered domain name.
- Registration provides owner with the right to use domain name for a finite period of time – one, two, five or ten years.

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Copyrights

- **Definition**: "A work of original authorship fixed in a tangible medium of expression."
- **Protection**: Copyright arises immediately upon creation of a copyrightable work. Protection is automatic - no formalities are required to obtain protection.
- **Registration**: While not required, registration in the U.S. Copyright Office remains a prerequisite to obtaining important financial remedies (i.e. statutory damages and attorneys' fees), and for U.S. copyright owners, a prerequisite to commencing a court action for infringement.

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Copyrights

- **Copyright Notice**: The symbol © or the word "Copyright" or the abbreviation "Copr." followed by the year of first publication and the name of the copyright owner.
- While "notice" is no longer required to preserve copyright, it does help in combating copy and precludes an "innocent infringer" defense.

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Patents

- Patents can be obtained for inventions that are new, useful, and non-obvious to persons knowledgeable in the field of the invention.
- Excludes others from making, using, offering to sell, selling, or importing the invention as defined by the claims of the patent.
- Protects underlying ideas and concepts that make the invention useful (Copyrights only protect the expression of an idea).

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Patents

- **Registration**: United States Patent and Trademark Office (PTO).
- **Term**: Utility patents are effective for a period of 20 years from the date the application is filed with the PTO. For patents based on applications filed before June 8, 1995, the patent term is the longer of 20 years from the application filing date or 17 years from issue date.
- Patent may not issue for two or more years following the application filing date.

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Trade Secrets

- **Definition**: Proprietary information that an employer makes significant efforts to keep secret.
- Cannot protect information that has already been disclosed to the public.
- May require other protections – patent, copyright, trademark.
- Colorado Uniform Trade Secret Act (CUTSA)

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Trade Secrets

Protection:

- Identify and label confidential information as "Confidential" and/or "Trade Secret."
- Limit access to necessary employees only.
- Use password protection, encryption, or other physical methods to keep information private.
- Maintain access logs to track disclosure of trade secret information.
- Use updated non-disclosure, confidentiality, and non-solicitation agreements to cover potential trade secret information.

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Trade Secrets

- Injunctive and monetary relief for trade secret misappropriation.
- Action for misappropriation must be brought within 3 years after misappropriation is discovered, or should have been discovered exercising reasonable diligence.
- Trade secret rights may be conveyed, assigned, transferred, or licensed for use by third-parties.

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Trade Secrets

Existing Employees:

- Include specific provisions in employee handbooks and employment contracts obligating employees to assign intellectual property such as trade secrets and patents conceived or developed in the course of employment.
- Insert non-disclosure provisions in employee handbooks, review policies with employees periodically (e.g. annual review), and obtain signed acknowledgment from employee.
- For key employees, consider separate, narrowly tailored non-disclosure, non-solicitation, and/or non-compete agreements. Additional consideration may be necessary.

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Business Exit Strategies

While there are a number of ways to exit a business all the way from selling your business to just merely shutting it down, the focus of the workshop is on selling your business. Again, while there are a myriad of ways to structure the sale of a business, all of the methods basically break down to two types of transactions -

- A sale of the assets of your business, or
- A sale of the ownership structure of the business entity.

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Asset Sale

As the title implies, this approach consists of the sale of all assets of the business separate from the business entity – the limited liability company / corporation / partnership / etc.

While not as simple a transaction as the sale of the entity itself (i.e., stock or membership sale), this transaction provides certain protections for the purchaser, in that it allows the purchaser to isolate and not assume certain liabilities (taxes, judgments, debt, etc.) of the business.

Sellers need to be careful when establishing the value of certain assets as if values are set too high this could trigger a depreciation recapture.

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Asset Sale

In preparation for an asset sale transaction a complete review of company assets must be completed to make sure no assets are omitted from the transaction:

- Real Estate – Owned or Leased / Debt?
- Personal Property – Owned or Leased / Debt?
- Intellectual Property – Has it Been Protected?
- Contract Rights and Obligations – Are They Assignable – Termination Rights?
- Employees – Retained or Dismissed?

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Asset Sale

Documentation: depending on the assets of the business, the basic documentation of an asset sale can consist of the following:

- Deed(s) to convey real estate.
- Bills of sale to transfer personal property.
- Assignments to transfer contracts, intellectual property, debt instruments, leases, etc.
- Letters of Termination/Severance Agreements / Offer Letters related to employees.

Stock / Membership Interest Sale

The second basic structure for the sale of a business is to sell some, or all, of the evidence of ownership in the company.

- Corporations – Stock.
- Limited Liability Companies – Membership Interests.
- Partnerships – Partnership Interests.
- Sole Proprietorships – since sole proprietorships are not separate legal entities there would not be a sale of an entity (i.e., stock sale, membership interest sale, etc.), but instead a sale of assets.

(Just to name the most common)

Stock / Membership Interest Sale

The actual structure of such a transaction can take many forms:

- Merger with, or acquisition by, another company.
- Sale of the stock/membership interest to a third-party.
- Sale of one stockholder's/member's interest to other stockholders/members.
- Employee sale transactions.
- A public offering (sale of stock/membership interest).

(Again, just to name the most common)

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Stock / Membership Interest Sale

The "good with the bad!"

Documentation: depending on the organizational structure of the business, the basic documentation of entity sale can consist of the following:

- Stock Purchase and Sale Agreements / Stock Powers Agreements.
- Membership Interest Purchase and Sale Agreements.
- Partnership Purchase and Sale Agreements.

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Due Diligence

While the scope of due diligence can vary significantly based on the nature of the business, and a detailed discussion of which is beyond the scope of this workshop, the general categories of due diligence materials will consist of the following:

- Legal descriptions of all real property owned by, or the subject of unrecorded or recorded leases having the Company as a party.
- Detailed schedule of all personal property, including, without limitation, all furniture, equipment and fixtures.
- Copies of all loan agreements and other documents with amendments relating to the indebtedness of the Company and all promissory notes, revolving credit agreements, member notes and debentures, indentures, mortgages, trust agreements, security agreements and guaranty agreements.
- Detailed schedule of all intellectual property.
- Listing of all employees and employment agreements and benefit plans.
- Copies of all loan agreements and other documents with amendments relating to the indebtedness of the Company and all promissory notes, revolving credit agreements, member notes and debentures, indentures, mortgages, trust agreements, security agreements and guaranty agreements.
- Financial and tax information.
- Copies of all material sale, customer, management, service, rental, leasing, insurance or trucking, contracts to which the Company is a party either as provider or purchaser.
- Product and supply information.
- Company organizational documents – as applicable – review of ownership, sale restrictions and conditions, etc.
- Environmental matters, as applicable.

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Financing Options

While the forms of financing the sale of a business can vary significantly based on the creativity of the parties, and the nature of the business, the basic categories of financing will consist of the following:

- Conventional third-party financing. This can consist of commercial financing (including SBA and other loan programs), or private third-party financing (e.g., venture capital, angel investors, etc.).
- Seller carryback financing
  - Secured by interest being sold / guarantees.
    - Evidenced by – Promissory Note / Security Documents / Guarantees / Etc.
- Employee purchase programs.
- Public or private offerings.

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Questions?

John Lubitz is a partner in the Denver and Colorado Springs offices of Lewis Brisbois and a member of the Corporate, Real Estate, Land Use & Environment, and Banking & Finance Practices. Mr. Lubitz is licensed to practice in Colorado and Minnesota. Mr. Lubitz earned his law degree in 1983, and concentrates his practice in the areas of corporate law (including corporations, limited liability companies, partnerships, associations, etc.), general business planning and transactions, real estate, banking, oil and gas – mineral law, water law, and commercial transactions. Through his 36 plus years of diverse legal experience Mr. Lubitz has obtained a practical entrepreneurial business philosophy which allows him to provide a full range of business and transactional services to established and emerging growth companies. It is this experience which Mr. Lubitz brings to his business clients through handling all their legal and business related matters – often acting effectively as their outside general counsel.

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