The top ten mistakes to avoid when selling your family firm

Business families who through the generations have built up corporate value are often tripped up when it comes to selling the company.

By Dennis J. White

In the annals of American business there are many notable families who have successfully built companies—sometimes over generations. Unfortunately, families are often less successful when it comes time to sell those businesses and maximize value.

The reasons are varied. Some are unique to family businesses. Others are pitfalls that can beset any businessperson who is adept at running an enterprise but not necessarily at selling it.

Here are ten common—and critical—mistakes made by family business owners when they try to sell their companies. This list does not purport to be the last word but hopefully will provide some useful guidance.

1. Failure to integrate estate and business planning

Business owners who want to provide for their progeny along with their favorite charities have a duty to implement a well-thought-out estate plan. Failure to do so means the disposition of their assets will be dictated by law, often in ways contrary to their wishes. Lack of planning also means that the tax collector will unnecessarily benefit from their demise.

In the context of a family business, any estate plan must also be integrated with planning for the business itself. Without appropriate planning, effective control of the business can be spread among a disparate group of beneficiaries with very different levels of business acumen and varied objectives. Such arrangements often result in stalemate and disaster.

One founder in poor health was actively pursing the sale of his business. Upon review of his estate plan he learned to his dismay that the documents mandated that his executors continue, not sell, the business.

Integration of the estate plan and the business succession plan is critical—the earlier the better.

2. Failure to line up the family members

Nothing is more frustrating to a buyer than negotiating with multiple family members who are of different minds as to whether to sell the business, much less what the price should be.

If the selling group appears to be in disarray, some potential buyers will not even spend the time to investigate the opportunity. What can be even more damaging is for a qualified buyer to drop out of the negotiations.

One approach is to designate a single person as the selling group’s representative and negotiator. If that is not possible, there should be a clear understanding as to how the selling group will make decisions. Lack of timely decision making can cripple a sale. There should also be a candid discussion at the outset as to what terms will be deal breakers and where the group will be flexible.

3. Failure to assemble an experienced team

Most family business leaders are superb tacticians. They know their industry, vendors and customers extraordinarily well. However, they are often out of their depth when it comes to an M&A transaction. Moreover, they often avoid or delay engaging a team to help them maximize value.

For example, some business owners engage in “self-help” by calling just the one or two parties who may have approached them over the years about selling their business without any idea of what their business is worth.

An investment banker can give
them a good sense of the value of their business in the current market. An experienced professional can also identify more potential buyers.

4. Failure to prepare for due diligence
A buyer who is truly interested will deliver to the seller a lengthy and detailed due diligence questionnaire. Everything of relevance is covered, including financial statements, intellectual property and customer lists.

All too often, inexperienced sellers are unprepared to complete these forms. They scramble to find misplaced contracts or to document informal arrangements.

Well-advised sellers anticipate the suitor’s questions by setting up data rooms, often electronic in nature, where all the information is waiting. The sales process is not impeded and the sellers come across as highly organized.

5. Failure to properly structure the deal
Buyers prefer to structure the purchase of a business as an asset acquisition so they can selectively decide which assets to buy and which liabilities of the target company to assume. By contrast, in a stock purchase or merger, the buyer ends up with all such assets and liabilities.

For a seller, an asset purchase can be problematic. First, tax is imposed at two levels—at the corporate level on the sale of the assets and then again at the stockholder level when the corporation distributes the sales proceeds to the stockholders.

If planning is undertaken early enough, the sellers can structure the operating entity as an S corporation or an LLC and avoid corporate-level tax. That is but one example of how properly structuring the transaction can reap significant rewards.

6. Ignoring the ‘money provisions’
In reviewing an acquisition agreement, sellers typically focus on just one provision—the stated purchase price. They fail to realize there are often sections in the agreement that can directly affect the cash they will receive.

For example, buyers will often seek a “true-up” for working capital as of the closing date compared with pre-closing estimates. Which party makes this calculation and the accounting rules by which it is performed directly affect the aggregate purchase price.

Similarly, where there is a gap as to the perceived value of the business, the sellers and buyers will often resort to an earn-out. In an earn-out, the sellers receive additional consideration if the business meets certain negotiated performance targets after the closing. Earn-outs can often be an exercise in wishful thinking on the part of the sellers if not carefully drafted.

7. Ignoring seller representations and warranties
The representations and warranties section of an acquisition agreement, along with the accompanying disclosure schedules and indemnification section, essentially form an insurance policy by the sellers for the benefit of the buyer. If the sellers’ representations as to the state of the company prove to be incorrect, the buyer can bring a claim for indemnification.

It is striking how many sellers fail to review the representations and thoughtfully craft the disclosure schedules. The most difficult task for sellers’ counsel is often persuading the sellers to even read the representations and warranties. The sellers must stay involved at this stage or face the prospect of post-closing problems.

8. Failure to prepare for post-closing disputes
The incidence of post-closing disputes, whether involving alleged breach of representations, balance sheet adjustments or earn-out computations, has risen dramatically in recent years.

If there is a large group of selling stockholders, they should first decide who will bear the legal costs associated with any such dispute. One approach is to leave a portion of the sales proceeds with the designated sellers’ representative until the buyer’s deadline for bringing claims has passed.

If litigation ensues and the sellers are ultimately found liable, how are damages to be allocated? One approach is pro rata, based on their respective shareholdings. But what if certain shareholders were more actively involved in running the business and negotiating the sale? Should they be expected to carry the full liability, or at least a disproportionate share? There is no correct answer here, but the issue should be considered and addressed.

9. Allowing a viable buyer to walk away
Sellers often place too much reliance on the gentleman’s handshake, but that doesn’t signify that the deal is finalized. Transactional lawyers advise their clients that the deal is never really closed until the wire transfer of the purchase price hits their client’s account.

In negotiating the acquisition agreement, every effort should be made to eliminate as soon as possible any closing conditions over which the buyer maintains control. Such items may include: any financing contingency,
completion of due diligence, director and stockholder approval on the part of the buyer, and failure by the seller to satisfy any overbroad representation. In addition to narrowing such discretionary conditions, the sellers can provide for a break-up fee if the buyer exits the deal.

The risk of a buyer walking can be addressed in a number of ways, but it should not be ignored.

10. Failure to anticipate second thoughts
No matter how attractive the purchase price or how auspicious the timing of the sale, at some point in the days leading up to closing the sellers are apt to experience second thoughts. The longer the business has been held, the more gut-wrenching those second thoughts will be.

Sellers should anticipate having these feelings. The fact that they are experiencing them does not automatically mean that selling the business is a mistake. Rather, the sellers should take the occasion to confer with their team members and satisfy themselves that they have covered all the bases.

Watch out for landmines
Many family business owners are superb operators and tacticians, but poor strategists and inexperienced deal makers. As a result, much of the value built up over the years can be needlessly squandered in the sale process. Recognizing and preparing for the vicissitudes of the sale process can prevent these business owners from being tripped up when the time comes to sell the business.