Earn-outs — provisions giving the seller of a business additional consideration if the business hits certain performance benchmarks — can be a win-win for both business buyers and sellers. Earn-outs can provide a source of funds for business buyers that can save a deal that otherwise couldn’t close, and they can provide a method for buyers to share risk with sellers. If a seller predicts great things for the future of his business, an earn-out is a way for the buyer to make the seller “put his money where his mouth is.” If the rosy projections prove true, the seller shares the upside and gets a higher price than he would have gotten otherwise. If the business doesn’t hit the projections, the seller shares the downside. This helps to keep the seller’s projections honest and realistic, can help the parties overcome negotiation hurdles, and provides an incentive for the buyer and seller to work together for the future success of the business.

However, earn-outs can serve a different purpose: they can be a crutch when parties can’t agree on a purchase price for the business. Too often parties use an earn-out to close a gap where they either should have properly negotiated the price or — if they couldn’t agree on the price — should have walked away from the deal. In such situations, instead of aligning the parties’ interests and helping them work together, earn-outs mask a disagreement. Deal-makers sometimes say that in these situations the parties traded an agreement on price today for a lawsuit tomorrow. More often than not, the cost of the lawsuit will far outweigh any benefit that may have been obtained from the earn-out.

What should deal-makers do to maximize the benefit and minimize the risk of an earn-out? First, they should ensure that the particular deal lends itself to an earn-out. Does the earn-out accomplish legitimate goals? Does it provide needed seller financing thereby enabling the deal to close? Does it create risk-sharing based upon good-faith projections? After the sale, will the business

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any midmarket companies have long recognized the need to grow their businesses by acquiring smaller companies and businesses. In many cases, particularly, in the current challenging low growth economy, acquisition may be the only means to significantly increase market share. It may also be the only viable avenue to acquire certain technology, vertically integrate company products and supply chains, procure attractive talent and brand recognition or expand geographically. For owners of companies looking to sell their businesses in a few years, an acquisition or two of other companies can add the “wizz,” revenue and profitability growth necessary to effect a future successful liquidity event. In valuing businesses, size does matter; and a business that has successfully managed several acquisitions will often command premiums in the M&A marketplace both on account of increased earnings and the demonstrated talent of its management in successful acquisitions. In a significant portion of acquisitions, however, buyers fail to achieve their original financial, strategic and business objectives—in many cases, spectacularly. Business activity after business activity have concluded that at least half, if not more, of businesses acquired failed to generate the desired results in either shareholder value or financial goals. As U.S. economist and writer, Irwin Stelzer, said, “when it comes to mergers, hope triumphs over experience.”

There are numerous reasons why this is the case. All too frequently, the strategic objectives for the acquisition have not been well thought out or articulated, due diligence on the selling company is incomplete, post-closing integration of the business is poorly implemented and there are, sometimes insurmountable, cultural differences between acquirer and acquiree. Sometimes, it appears that what drives the desire to acquire is the perception of the need to acquire, akin to the need of individuals to accumulate goods. To afford greater than anticipated integration costs or be unable to weather the inevitable storms of life which will involve greater due diligence and integration challenges. Also, having an experienced team of both internal resources and outside advisors is critical. Team members should include the members of management with responsibility for both the integration and the acquisition, human relations, and integration technology staff, internal or external finance and tax personnel, seasoned M&A counsel and public relations. The overriding strategic goals for the acquisition should be understood by all team members, and divisions of responsibility in the due diligence process, deal negotiations and post-closing integration should be articulated. Those responsible for integration, HR and IT staff, should be engaged up front and not just before the closing of the transaction. The extent that input from others is needed should be identified early in the process. For example, the time to speak to the buyer’s bank or CPAs to determine if the need for lender consent to a change in liens, and other conditions in the purchase agreements—seller representations, warranties and indemnifications, purchase price escrows and holdbacks to secure the seller’s indemnification responsibilities, and the like. However, these negotiations should not be done in a vacuum without consideration of what the parties’ relationships will be after the closing. In a 2013 study by Shareholder Representative Services, two-thirds of the sampled transactions resulted in post-closing issues relating to indemnification claims, purchase price adjustments and/or achievement of earn-outs. To the extent that the buyer will be relying on the employment or services of the former owners of the acquired company post-closing, the buyer and its counsel should consider the impact of possible post-closing disputes on that working relationship and seek to negotiate provisions which reasonably protect the buyer, but are less likely to harm ongoing relationships.

Conclusion

Successful Growth Through Acquisitions

by James J. Scheinkind, Partner, Snell & Wilmer L.L.P.

Acquisitions can be a very valuable strategy for midmarket companies to achieve their goals, but can also create considerable risks. Through proper strategic planning, due diligence and integration, midmarket companies greatly increase the odds of a successful acquisition.
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Rutan & Tucker, LLP has the knowledge and expertise to structure, negotiate and close all aspects of domestic and international mergers and acquisitions, financings and securities transactions. They are just a few of our recent notable transactions. We have experience covering a broad spectrum of industries and sectors, such as healthcare, education, software, construction, food and consumer products, aerospace, and oil and gas, among others. Whether you are a private business owner contemplating an exit or growth transaction, a private equity fund evaluating or exiting on your portfolio, or a public company making strategic moves, we look forward to being your partner and trusted advisor in achieving your business objectives.
Unlocking the Value of Your Business: Position Yourself to Maximize Deal Proceeds

by Matthew O’Loughlin, Corporate Partner, Manatt, Phelps & Phillips LLP

As businesses continue to face a period of generally anemic economic growth, our clients frequently ask us to help them gauge M&A market trends and determine whether it is an opportune time to sell their business, divest select assets or operations or make strategic acquisitions. Macro-level economic conditions most certainly influence market confidence and are key factors in setting general and industry-specific valuation multiples. This being said, the challenge for any business considering a sale transaction – whether a closely held business, a private equity portfolio company or a public company – is to maximize deal proceeds irrespective of the macroeconomic climate.

From a seller’s perspective, it is extremely disappointing to go through what can be a long, cumbersome and expensive deal process, only to learn that the offers for the business are below what was initially expected based on a peer valuation multiple. Many business owners are particularly attuned to deals that have been completed by their industry peers and competitors, and they often expect the same or better result. In doing so, they discount or otherwise fail to take into account some of the unique factors that may have enabled their competitor to receive a premium valuation. Worse yet, they may ignore some steps that they could take themselves to better position their own business to achieve a more favorable outcome.

Our goal in any M&A process is to add value for our clients above and beyond documenting the transaction and managing the deal process from strictly a legal perspective. In broad terms, we look to assist our clients to achieve premium outcomes. In this vein, we routinely counsel our clients that are contemplating a sale process to engage with their advisors (e.g., legal counsel, investment bankers and accountants) in a pre-transaction phase to analyze the true value propositions in the business and to devise a strategy to best position the business for the anticipated market. While investment bankers generally take the lead in the valuation and positioning analysis, our experience is that the combined effort of lawyers, accountants, bankers and management results in the best outcome and helps empower the banker to achieve the best result. The same holds true for sell-side engagements led by management. The following are some examples of value propositions which can often be front and center in the mind of a buyer but which fail to be recognized – and maximized – by sellers. By “value proposition,” we are referring to aspects of a business that are accretive and/or defensive in nature to the future operation of the business by the buyer.

➢ A Better Mousetrap vs. A Bird in the Hand: Value does not always follow product or service efficacy, but a true, objective analysis of your products and services compared to those of industry peers is imperative to understanding your competitive position. However, recognize that even if you don’t have the best “mousetrap,” you may nevertheless be able to receive a premium outcome following a sale transaction completed by the market leader. In M&A, it is not uncommon for “runners-up” or “bridesmaids” to benefit from a valuation standpoint when strategic buyers look to make a defensive play after a key competitor has just purchased the market leader. Further, if you are in a “hot” industry, do not assume it will stay that way.

➢ Employees and Assembled Workforce: It may sound melodramatic, but in some industries there is a “war” for talent. The whole objective for a transaction in the mind of the buyer may be to acquire your technical personnel, or to assemble a strategic workforce in a single move. Are you analyzing your business in the same way a buyer will analyze it?

➢ Financial Statements: Sellers often (and rightly) look at ways to improve their financial position and performance prior to a sale process, but they often focus on financial statement line items that do not impact the buyer’s valuation, or on generating extraordinary results that will be quickly dismissed or discounted by a sophisticated buyer.

Matthew O’Loughlin
Matthew O’Loughlin is a corporate partner in the Orange County office of Manatt, Phelps & Phillips LLP. He advises public and private companies, entrepreneurs, investors, private equity groups and investment banks on corporate and transactional matters (including public and private offerings and mergers and acquisitions). Some of his recent M&A engagements include representing a global investment bank in acquiring a competitor, representing a private equity firm investing in a public company, representing a large family-owned business in its sale to a private equity firm and representing a nutrition and life sciences company acquiring a competitor. He can be reached at moloughlin@manatt.com, or 714.338.2710.
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Where is your business headed? And why?

Orange County is on the move, as a crossroads of both local and international business. Greenberg Traurig is committed to helping our OC clients – from innovative entrepreneurs to major multinationals – move their businesses forward. GT’s multidisciplinary team helps clients tackle today’s legal issues and develop strategies to address the challenges of tomorrow – to keep their businesses headed in the right direction.

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Selling Your Business? Watch Out for Higher Taxes

Selling a business is never easy. In addition to making a significant life change, the financial implications are both far-reaching and involved. Taxes add to the complexity and uncertainty.

Here are a few recent changes on sell-side transactions:

- Tax rates for individuals have increased to a maximum of 39.6 percent from 35 percent in 2012 on ordinary income. Individuals are now taxed at a maximum tax rate on capital gains of 20 percent, up from 15 percent in 2012.
- Transactions resulting in capital gains will generally have an additional tax of 3.8 percent added on for the net investment income tax due to the Affordable Care Act. There is an exemption to this tax for a sale of assets from a pass-through entity such as an S-Corporation or partnership in which the taxpayer materially participates.
- California also passed an increase to top individual rates in late 2012 retroactive to January 1, 2013. This increased the top rate for individuals to 13.3 percent. Remember, unlike federal income tax, there is no preferential capital gains rate in California. Capital gains from the sale of a business in California will result in a rate of over 37 percent. Ordinary income resulting from a sale of a business can be taxed at rates in excess of 50 percent.
- When you combine all the aspects of selling a business the process can be overwhelming, but creating a team of professionals to handle each aspect of the deal will be critical to achieving your goals. Haskell & White’s tax experts have both the know-how and experience to ensure that you maximize your return on investment, no matter how challenging the tax environment. It’s not just your business, it’s your life. Let us help you get the most out of it.

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Gary Curtis
Gary Curtis is a corporate tax partner with Haskell & White. He leads the firm’s practice in mergers and acquisitions. Gary has a wide variety of industry experience including technology, manufacturing, and retail, medical and personal services. He provides compliance and consulting services to C-Corporations, S-Corporations including start-ups. His work with public and private companies includes income tax accounting accruals and accounting for uncertain tax positions. You can reach him at 949.450.6200 or gcurtis@hwcpa.com.

5 Phases to Selling a Business

Here are five phases to selling your business:
1. Presale work
2. Broker listing and offers
3. Due diligence
4. Closing
5. Post closing

Presale work
The majority of buyers purchase the assets of the business versus purchasing stock. Sellers are required to liquidate the corporation. The accounting records, financial statements, legal documents and compliance to regulations have to be ready for buyers to examine. Any existing bank lines of credit must be paid off at the time of the sale closing. If there are any issues with the assets, contracts, employee obligations it is best to take care of them prior to listing your business for sale in an effort to make your business as attractive as possible to potential buyers.

Broker listings and offers
A buyer will make an offer based upon EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). Most businesses sell between four to six times EBITDA however buyers will pay more for businesses in growing industries. It is important to work with a broker that is not only familiar with your industry but also knows your business.

Once the relationship with your business broker is established, they will prepare a business profile to present to potential buyers. Based on your profile, EBITDA and sales potential buyers will make offers. The best offers are all cash and with no future earnings obligations or earn outs. Most offers will include a holdback in the case there are unforeseen issues with the business, these funds are held in escrow for 12-24 months.

Due diligence
Once you have selected the buyer, the due diligence process will begin. This phase could be as short as 60 days. During this phase, it is imperative to keep your EBITDA consistent, any fluctuation could result in the buyer requesting a price adjustment. Ideally the due diligence period is short.

Closing
Closing will be done with an escrow agent and your attorney. Until this point all balance sheet numbers have been estimated, you now have final numbers. The funds are wired and your business is officially sold.

Post close
After closing, the buyer will have control of the business. If issues arise for liabilities not disclosed, the holdback funds will be used to reimburse the buyer.

The process of selling a business can be stressful and intimidating whether it is your first time or you have sold a number of businesses. It is paramount to surround yourself with a competent team, a strong broker, knowledgeable attorney and an experienced CPA.

For more information, please contact Ron Stumpf at ELLS CPAs, 714.569.1000 or rstumpf@ellscpas.com.

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Do you have favorable lease and capacity utilization arrangements compared to the industry? Do not assume that even strategic buyers will fully understand this value.

- Real Estate/Capital Equipment: Do you have favorable lease and capacity utilization arrangements compared to the industry? Do not assume that even strategic buyers will fully understand this value.
- Supplier and Customer Agreements: Do you have favorable agreements and relationships with suppliers or key customers? Depending on your industry, that may mean flexibility in pricing or locked-in preferred relationships. How would a sale affect these arrangements, and how is a buyer likely to benefit from them?

The principal goal in any self-sale transaction is to maximize deal proceeds. To achieve this goal, first ensure that the target company is best positioned to obtain a premium valuation, then be prepared to frame and articulate the value proposition to the buyer in the most favorable terms. Positioning your business to unlock value is no guarantee of a premium valuation, but failure to do so may serve to gift value to the buyer. A sale is the cardinal event in the life cycle of any business, so do not shortchange your deal process, the selection of your advisors or your efforts to identify and secure the value in your business.

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Do you have a customer concentration problem that could be used to justify a valuation “haircut?” It may be that this concern is the very reason you are looking to sell your business to leverage off a strategic buyer’s platform. Even in those circumstances, you should explore ways to diversify your revenue base prior to the sale process.

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buyer when modeling the business going forward. You should understand how you will be valued from a financial statement perspective and focus on those metrics. Further, you should have a keen understanding of how those metrics are likely to be impacted under “new” ownership, and then strive to frame the value proposition for the buyer in those terms.

- Intellectual Property: Intellectual property continues to be a key driver of value in most businesses. Many sellers have taken a light touch in protecting their proprietary information and obtaining appropriate trademarks and patents. By taking remedial action now, you can mitigate a buyer attacking your value through deficiencies in your IP strategy.
- Revenue Base: Do you have a customer concentration problem that could be used to justify a valuation “haircut?” It may be that this concern is the very reason you are looking to sell your business to leverage off a strategic buyer’s platform. Even in those circumstances, you should explore ways to diversify your revenue base prior to the sale process.

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be operated in such a way that the earn-out metrics can be reasonably calculated? If the deal isn’t right for an earn-out, or if there is already tension and suspicion between the parties, an earn-out is probably not a good idea.

Second, the parties should make the earn-out calculation as fair and objective as possible. The calculation should be based on an “apples-to-apples” comparison of the business pre- and post-acquisition. Changes based on the deal itself, such as interest on acquisition debt, increased depreciation resulting from an increase in the valuation of purchased assets, buyer’s home office or administrative expenses, etc., should be eliminated from the calculation.

Accounting is not an exact process and accounting issues arise in nearly every earn-out dispute. Sometimes “creative” accounting is used by a buyer to avoid or reduce earn-out payments. The best way to minimize accounting issues is to minimize the subjective elements that go into the earn-out calculation. The biggest culprit is typically reserves. The Allowance for Doubtful Accounts, Excess and Obsolete Inventory Reserve, and Warranty Reserve are all based in part on subjective estimates. And, not surprisingly, these reserve accounts figure prominently in many earn-out disputes. These and other such accounts are amenable to subjective adjustments based on accounting considerations rather than changes in performance. Thus, adjustments to reserves often lead to disagreements. The parties should agree in advance how these accounts will be valued for purposes of calculating the earn-out. The parties should also agree in advance to any changes in seller’s accounting methodology so that the earn-out is based on true performance, not accounting adjustments. It may be worthwhile to negotiate and attach to the contract a detailed summary of the accounting policies and procedures that will govern the earn-out calculation.

Another thing the parties can do is base the earn-out on revenue rather than profit. Revenue is a straightforward determination. EBITDA or profit, on the other hand, is affected by adjustments to the above-mentioned reserves, accruals based on estimates, the accounting treatment for returns, timing considerations, and many other subjective factors. The further down the income statement the earn-out metric goes, the more subjectivity enters into the equation and the more likely there are to be disputes.

Third, the parties should make sure the earn-out provides incentives to both the buyer and the seller. The goals should be reasonable and obtainable, and the benefits of hitting those goals should be meaningfully shared between the buyer and the seller. If all or most of the benefit of hitting the target goes to the seller (as is often the case when an earn-out is a substitute for agreeing on the price), then the buyer has no incentive to push to hit those goals and may even have an incentive not to do so or to postpone sales or growth. Conversely, if the benefits go disproportionately to the buyer, then the earn-out probably isn’t an important deal component.

Finally, any specific issues unique to the particular deal should be considered. The contract should prevent the buyer from defeating the intent of the earn-out or avoiding legitimate payments. For example, if the buyer already owns businesses similar to the business being acquired, the contract should appropriately limit the buyer’s ability to transfer sales of the business being sold to other business units it already owns. The contract should also address the possibility of the buyer engaging in a subsequent acquisition or divestiture that affects the purchased business. And if the seller is being retained to operate the business post-close, that may cause issues with the earn-out.

The bottom line is that earn-outs are a great tool in the right circumstance, but should never be used as a proxy for an agreement on price. Earn-outs are notoriously fertile ground for disputes, but that risk can be greatly mitigated by the careful negotiation of the earn-out provision. This might seem like a hassle during deal negotiations, but if it avoids a dispute later, it’s probably worth the effort.

Robert Adel is a litigation shareholder in the Orange County office of Greenberg Traurig. His practice is focused on M&A disputes and he has litigated many earn-out and purchase price adjustment disputes, as well as representation and warranty, indemnity, investment banker fee and other disputes arising from M&A transactions.

He also handles disputes involving director and officer fiduciary duties, shareholder and partnership control, securities, and consumer class actions. Rob can be reached at adelr@gtlaw.com or 949.732.6523.
The Fundamentals of a Successful Merger

by Curtis Campbell and Jodi Ristrom, Partners, HMWC CPAs & Business Advisors

For businesses considering a merger, there are several factors that need to work together to make it successful. We typically advise clients in pre-merger financial projections, tax planning and due diligence, as well as post-merger accounting, tax and consulting services.

Pre-Merger Issues

Financial issues ultimately determine whether a merger will be viable. As such, you may find it helpful to hire a CPA as you attempt to answer these and other questions:

- Can the value of each company be agreed upon?
- How can it be structured to minimize taxes for ownership?
- What are the primary financial benefits?
- How do compensation levels compare?

You should also do thorough due diligence on all aspects of the other company (i.e., financial, operational, human resources, and sales and marketing). In some industries, it is important to give serious consideration to legal and regulatory requirements.

Valuation and Ownership

In any merger, the combined entity considers the value of each entity prior to the merger. Sometimes an owner may have a value in mind that may be very unrealistic and this breaks the deal. An independent business valuation professional can provide a resolution through developing an appraisal of each company. When the value is agreed upon, the initial ownership percentages can be derived, allowing owners to decide whether they want to infuse additional cash (or other assets) in order to increase their ownership percentage. Of course, other factors are typically considered, such as paying a premium to those owners who ‘own the relationship’ with major customers.

Tax Structuring

The tax structure of a merger is very important and can have a dramatic impact on the post-merger cash flow of a company. Capital gains planning should also be considered for personal income tax planning. Your CPA can make a big difference in helping to decide upon and execute a favorable structure for after-tax cash flow. With the right situation, certain strategies can even have immediate results and lead to better profits and cash flow.

Management Issues

Some of the greatest benefits of a merger come from integrating operational routines and then eliminating redundant positions by terminating or reassigning personnel. Keep in mind that job security, along with duties and compensation, are key issues for most employees. From a camaraderie standpoint, it is important to encourage a sense of unity and team spirit. Have clearly defined managerial roles to prevent employees from falling back to old reporting relationships and allegiances. Also, implement standard policies and procedures for all aspects of operations.

Customer Relationships

As a general rule, customers should be advised immediately after the merger (or prior to it, in some cases) and any concerns addressed. Obviously, losing major customers can significantly undermine the merged company’s performance. The entire customer relationship management process of each company should be thoroughly evaluated and integrated into an effective new system. Some companies pay ‘stay bonuses’ to key personnel to ensure that they continue with the company, especially when they have a significant impact on customer relationships.

Curtis Campbell, Tax Services, and Jodi Ristrom, Business Assurance Services, are partners at HMWC CPAs & Business Advisors (www.hmwccpa.com), one of Orange County’s largest local accounting firms. For more information, see www.hmwccpa.com or call 714.505.9000.