

IN Brief

SUMMER/FALL 2002

A FEW THOUGHTS ON SELLING YOUR BUSINESS

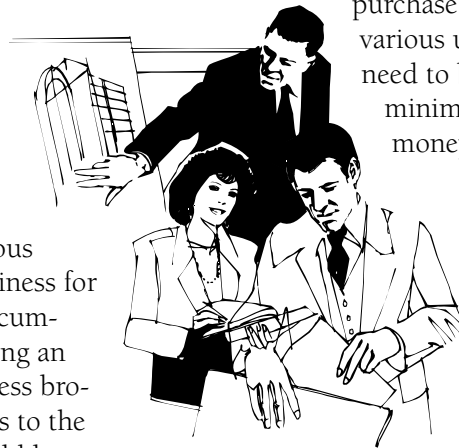
by Richard T. Keppelman

A substantial portion of our business practice consists of representing buyers and sellers of businesses. This article provides a few pointers for business owners who may be considering a sale in the foreseeable future.

■ **Involve Professionals Early.** Our typical business client has successfully established and operated a business and learned much along the way, often through a process of trial and error, but has never sold a business. Our business lawyers have been through the sale process many times and had many occasions to observe the “error” side of our clients’ learning curves. We can help you avoid serious mistakes, position your business for sale, and, in appropriate circumstances, assist you in engaging an investment banker or business broker to bring qualified buyers to the table. Your accountant should be an integral part of the early process as well.

■ **Structure Can Be As Important as Price.** Once you have seriously-interested buyers on the scene, you should understand how to compare competing offers and develop a framework of critical terms *before* you agree on a price. A few illustrations: (i) in the case of a manufacturing company with heavily-depreciated assets, a sale of the corporate stock could leave almost twice as much after-tax money in the shareholders’ pockets as a sale of the un-

derlying corporate assets at the same price; (ii) if there is to be an asset sale, the delineation of assets sold and assets retained, and an accounting protocol to distinguish between them, is essential to an understanding of what a nominal price would actually leave in your pocket; (iii) if there is to be seller financing, the terms need to be managed to maximize your chance of receiving the full price bargained for; and (iv) the buyer will want the terms of the purchase agreement to put you at risk for various unknowable contingencies; these need to be controlled from the start to minimize the possibility of giving money back after the closing.



■ **Due Diligence.** A sophisticated buyer (or one represented by sophisticated counsel) will expend substantial effort to assure itself that the presentation made by the seller is accurate and that there are no undisclosed legal problems or

other booby traps. This “due diligence” process typically includes (i) direct inspection of the seller’s facilities, books and records, (ii) specific representations and warranties contained in the purchase agreement, and (iii) review of lists and underlying documents furnished by the seller pursuant to the purchase agreement. The buyer negotiates for the right to sue the seller and its principals, personally, or withhold payments on account of any seller financing, if any of the representations or warranties turns out

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UP-FRONT INVOLVEMENT OF COUNSEL WILL ACTUALLY SAVE LEGAL FEES IN THE LONG RUN, BECAUSE THE TRANSACTION IS MORE LIKELY TO PROCEED CLEANLY AND DIRECTLY TO CONCLUSION.

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If interested, please contact Attorney Robert B. Levine at rlevine@ldlaw.com or (860) 676-3259.

STOCK OPTIONS AND OTHER INCENTIVES FOR THE EMERGING COMPANY

by Lawrence J. Marks

As a growing, middle-market business law firm, we represent many aggressive start-up businesses — founded by entrepreneurs who see big potential and a clear exit scenario in the form of an initial public offering, corporate buy-out or the like. In order to get there, they need to bring aboard other bright, aggressive people who will want a piece of the action. This article is a very brief summary of the more common alternatives.

■ **Non-Statutory Stock Option.** This is perhaps the simplest form of stock option. It provides to the recipient the right to buy a specified number of shares at a specified price over a specified period of time and under specified conditions. Assuming that it is set up properly, there are no tax consequences to the company or the recipient until the option is exercised, at which time the recipient will have ordinary taxable income equal to the excess of fair market value at the time of the exercise over the exercise price. The company will have a corresponding deduction.

■ **Incentive Stock Option (“ISO”).** This is substantially similar to the non-statutory stock option, except that the ISO is subject to various restrictions and may be granted only to a person who is legally an employee of the company. The ISO is more tax advantageous to the recipient (and less so for the company) in that there is no taxable event when the recipient exercises the option. When the recipient ultimately sells the stock, any gain is taxable at capital gains rates. The company has no deduction.

■ **Restricted Stock Award.** A restricted stock award is a conditional “gift” of stock in the company which will have a “substantial risk of forfeiture” if specified events do or do not happen over a specified period of time. The advantage of the restricted stock award is that the recipient is typically entitled to vote the shares, receive dividends and otherwise exercise the rights of a stockholder from the beginning. Assuming substantial risk of forfeiture, the recipi-

ent pays no tax at the time the award is made but, at the time the “substantial risk of forfeiture” goes away, the recipient will have to pay tax on the full fair market value of the stock at that time. This can be a serious problem for the recipient, who may have no right or ability to sell the stock and yet be forced to pay state and federal taxes, possibly in the neighborhood of 40-45% of the full fair market value of the stock.

■ **Phantom Stock.** This is an arrangement whereby the employee or other recipient receives a contract right to be compensated at some time in the future on a formula intended to mirror what the person would have received had he or she actually owned stock and sold it. There are no rules or set format for phantom stock arrangements; they tend to be customized for each company. The tax rules are simple: whenever the payout is received, it is treated as a cash bonus and taxable as ordinary income.

■ **Stock Purchase Plans.** This arrangement allows employees and others to purchase company stock at something approximating fair market value. Assuming a purchase at fair market value, there are no tax consequences up front. The recipient is taxed at capital gains rates when he or she sells the stock. The primary disadvantage of this plan is that it requires the recipient or other person to come up with real, hard cash at a time when the value of the company may still be speculative.

■ **Accounting Treatment.** The accounting treatment for stock compensation programs has
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PERSONAL LIABILITY FOR YOUR BUSINESS DEBTS?

by Michael Goldman

One of the primary reasons for doing business as a corporation or limited liability company is to avoid personal liability for the debts incurred by the business; however, merely incorporating or organizing as a limited liability company does not guarantee protection. You need to conduct your company's business in a way that respects it as a separate legal entity and maintains a clear separation between the company's business and your personal affairs. The body of law with respect to corporations has evolved over decades of court cases in Connecticut and other states. In the case of *Bastan vs. RJM & Associates, LLC*, decided on June 4, 2001, the Connecticut Superior Court confirmed that traditional case law applicable to corporations in this regard also applies to limited liability companies. While there are no hard and fast rules as to the factors a court will consider in determining whether to impose personal liability on a shareholder or member (or "pierce the corporate veil," as it is called) observing the following list of dos and don'ts should help reduce the risk:

■ **Do hold your business out to the public as a separate legal entity.** Your stationary, business cards, purchase order forms, invoice forms, checks, contracts and the like should all

(Stock Options, cont'd)

become somewhat complex and remains in flux as of the writing of this article. For businesses contemplating a public offering within a three-year time frame, or for whom "GAAP" earnings are otherwise important, we recommend consultation with a skilled accountant before establishing a course of action.

■ **Caveat.** The foregoing is a much-simplified description, intended only to provide a framework for further understanding. The granting of stockholder status to employees carries implications which may not be appropriate in many situations. We urge our clients to consult with us before making any decisions with regard to stock compensation plans. **L&D**

include the full legal name of the business entity, including the appropriate appendage indicating legal status (e.g., Acme Widgets **Inc.**, Main Street Services **LLC**, etc.).

■ **Do make clear the capacity in which you are acting.** When acting on behalf of the company, be clear to the parties you are dealing with that you are acting as an agent or representative of the company, not individually. Your business cards, correspondence, contracts and the like should indicate your status as an agent or representative of the company (e.g., John Doe, **President**, Richard Roe, **Manager**, etc.).

■ **Don't commingle funds.** The company should have its own bank account or accounts, which should be used for all company business and should not be used to pay your personal expenses (as was done in the *RJM & Associates* case mentioned above).

■ **Don't suck your company dry.** You can pay yourself an appropriate salary for your services rendered, but you should not make substantial distributions to yourself at times when the company is insolvent. In order to help minimize potential exposure, the transactions you conduct with the company should appear as arms-length transactions to an independent third party.

■ **Do maintain corporate formalities.** With respect to corporations, maintain a minute book and document board of directors' authorizations and/or approvals for major business transactions; hold Annual Meetings of the shareholders and directors. If you have a limited liability company with a board of managers, it's a good idea to observe the same formalities for it.

■ **Don't mislead.** Don't mislead vendors, customers and others regarding the solvency of the company or its financial ability to honor obligations. Making a contract or commitment which you know that your company will not be able to honor falls into this category.

Unfortunately, despite your desire to limit your personal liability, economic circumstances and bargaining power may require that you voluntarily agree to assume personal liability. For example you may be asked to personally guaranty bank loans or lease obligations. You should pay attention to these matters and not sign personal guarantees unless absolutely necessary. **L&D**

YOU NEED TO CONDUCT YOUR COMPANY'S BUSINESS IN A WAY THAT RESPECTS IT AS A SEPARATE LEGAL ENTITY AND MAINTAINS A CLEAR SEPARATION BETWEEN THE COMPANY'S BUSINESS AND YOUR PERSONAL AFFAIRS.

(Thoughts on Selling, cont'd)

to be false. We urge our clients to discuss potential problems with us up front, so that they can be disclosed at the right time and in the appropriate context. Improperly managed disclosure (or complete lack thereof) can result in substantial delay, friction and additional legal expense — and, in some cases, a complete collapse of the sale transaction.

■ **Controlling Legal Expenses.** The legal expenses involved in selling a business tend to be significant; you want to use your counsel effectively so as to control transaction costs and maximize the value of the services you do pay for. It is my perception that up-front involvement of counsel will actually save legal fees in the long run, because the transaction is more likely to proceed cleanly and directly to conclusion, rather than having to be renegotiated and restructured in response to previously misunderstood or unaddressed matters. A substantial portion of the seller's counsel's time will be taken up with the so-called "due diligence" elements of the transaction and the corresponding

representations, warranties and schedules included with the purchase agreement. A modest amount of time spent with your counsel in understanding this process, and a commitment on the part of the rest of your management team to assist counsel in responding to disclosure requests, should save significant legal expense. The use of inexperienced counsel will tend to drive up expenses as a result of ineffective attempts to negotiate inconsequential matters, failure to anticipate problems and the like. In the end however, legal fees are typically a relatively small percentage of the transaction (especially in comparison to the business broker or investment banker's fees), and it's probably not productive to focus too much attention on this element.

■ **Selecting Counsel.** We presume that most readers of this article are using Levy & Droney as their counsel and would consider no other for a sale of their business. For any other readers, we urge that you entrust this critical process to experienced corporate counsel, and if you have any doubts, call us. **L&D**

FIRM HAPPENINGS

DANIEL E. KLEINMAN and **DENTON HOPPER**, our Land Use Planner, were panelists at a seminar entitled "Working with the Farmington Planning and Zoning Commission" which was sponsored by the Farmington Chamber of Commerce.

DANE R. KOSTIN will co-chair the 2003 Barristers Ball along with Michele Kostin, the Honorable C. Ian McLachlan and the Honorable Cynthia Swienton.

JOEL MANDELL has been reelected to the Board of Directors of the New England Land Title Association.

JOSEPH B. SAPPINGTON will be moderating a CBA seminar October 3, 2002 on Toxic Mold Litigation & Sick Building Syndrome. Clients who have an interest in attending this seminar should contact Atty. Sappington for further information.

HERBERT G. ISAACSON has been elected President of the Connecticut Horticultural Society, a statewide organization of more than 800 gardeners and nurserymen.

RICHARD T. KEPPELMAN has been elected Treasurer of the Connecticut Opera Association.

JOMARIE T. ANDREWS has become a member of the International Council of Shopping Centers, which is an organization providing networking and educational opportunities in the area of real estate (particularly shopping center) development.

ROBIN M. PEARSON is speaking at a seminar in East Hartford on September 18, 2002 on Zoning and Land Use Law in Connecticut. Sponsored by Lorman Education Services, it is directed to lawyers, developers and land use officials. **L&D**