Private Company Governance: Preparing for Sale

By Doug Raymond and Erin McKevitt

Deciding to Sell

It frequently is said that the two most important decisions a board can make are appointing the CEO and deciding whether to sell the business. Sometimes the owners' insistence or extrinsic circumstances will trigger an expedited need to undertake a sales process, including factors such as an unexpected death or the owners' urgent need for liquidity. More frequently, the decision can be made over time, and deliberately, after consideration of all relevant factors and constituencies. In these deliberations, the directors must be guided by their fiduciary duties of care and loyalty. Deriving directly from the most central principles of agency, the duty of care requires that the director act "with such care, skill and diligence as a person of ordinary prudence would use under similar circumstances." This care requires, among other things, that each director be reasonably informed of the material aspects of any proposed board action and take sufficient time to consider any proposed action. The duty of loyalty, on the other hand, "requires that corporate directors devote themselves to corporate affairs with a view to promote the common interests and not only their own, and they cannot directly or indirectly utilize their position to obtain any personal profit or advantage other than that enjoyed by their fellow shareholders." That is, directors may not use their role as such for personal gain or to advance interests that are not aligned with those of the corporation.

In many jurisdictions, including Delaware, the directors' obligations run to the stockholders — when they take action it must be in the best interest of the owners. In other states, including Pennsylvania, the director's obligation runs to the corporation and its interests, and not only to the shareholders of the corporation. Among other things, this means that the directors are not required to treat any constituency's interests as dominant or controlling when evaluating the best interests of the corporation. Although the directors may consider the interests of shareholders and may give their interests primacy, they are not required to do so, nor are directors required to give priority to shareholder interests over the interests of any other constituency. For example, when evaluating the best interests of a Pennsylvania corporation, the board may consider, to whatever extent it deems appropriate:

1) The effects of any action upon any or all groups affected by such action, including shareholders, employees, suppliers, customers and creditors of the corporation, and upon communities in which offices or other establishments of the corporation are located.
2) The short-term and long-term interests of the corporation, including benefits that may accrue to the corporation from its long-term plans and the possibility that these interests may be best served by the continued independence of the corporation.
3) The resources, intent and conduct (past, stated and potential) of any person seeking to acquire control of the corporation.
4) All other pertinent factors.

In considering whether a sale is the best course of action, the board should undertake a broad and comprehensive analysis. The board should consider not only the decision to sell, but also the timing of a sale and the potential impact on the business of the distraction created by a sales process. The board should also consider whether to explore alternative options, including an initial public offering, a private debt or equity offering, a joint venture or obtaining minority investors. In considering these issues, the board should evaluate the status (and success or failure) of succession planning; any unresolved or intractable disputes among owners, directors or management; and the liquidity requirements of the owners — as well as the capital needs and constraints of the business. The board should also consider whether to walk away entirely or to possibly seek to roll over equity and retain a stake in the business. Other issues to address at this stage include the impact of a possible sale on employees, customers and other stakeholders. The board should pay particular attention to importance of management continuity during the sales process and the need to retain essential employees. It may be necessary or prudent to put in place success or retention bonuses to help keep key employees during what can be an extended process.

The board should also look into the impact on a proposed sale of prevailing economic conditions, tax issues and technological change in their industry. The board should consider the potential impact of the following additional considerations on the sale process or price.

- Any contingent liabilities (e.g., pension obligations, environmental or intellectual property liabilities).
- How a bidder would evaluate future growth potential, supplier concerns, customer concentrations and intellectual property considerations.
- The strength of the company's industry and the impact of broader industry trends.
- The potential for distraction created by the sales process, including the risk that the news might leak to employees, customers or competitors.
- Whether to broadly market the company or instead offer it only to a very few potential buyers, either strategic or financial (see below).

Addressing Conflicts of Interest

Another important consideration in contemplating a sale is identifying and addressing potential conflicts of interest. Conflicts may exist where directors or shareholders have interests in the transaction that are different from those of the company and its shareholders generally. For example, a conflict is present where an officer, director or shareholder sits "on both sides of the transaction," as when the officer may lose their employment if the company is sold, or if a shareholder is the party offering to buy the business, or if a director has a business relationship with one or more potential buyers. Transactions in which some shareholders may receive "different consideration" than the other shareholders also implicate conflicts of interest. However, simply because a transaction may implicate a potential conflict does not mean the transaction should be avoided all together. The board should first consider the type of conflict and develop an appropriate mechanism to deal with any identified conflicts.

After identifying the type of conflict, the board should determine the best way to address the conflict so it does not affect the board's evaluation and negotiation of the potential transaction. In general, courts apply the business judgment rule to actions by the board of directors. This involves a very strong presumption that the directors were fully informed and acted in good faith in the best interest of the company in their decision-making. However, in certain instances where there are conflicts present, courts may apply a more stringent standard of review, asking whether the deal process was fair and whether the directors obtained a fair price.

In general, the number of conflicted directors or shareholders determines the appropriate strategy to proceed with the transaction. If any officers or a minority of directors have a potential conflict, the board should screen the conflicted individuals from participation in negotiations with potential bidders and from discussions about the transaction. If a majority of directors are interested, the board should create a well-informed independent committee to negotiate and consider the transaction. Alternatively, or additionally, the board can obtain the fully informed and uncoerced approval of the disinterested shareholders.

If a controlling shareholder is conflicted, the board should adopt greater protections. Under Delaware law, in these situations the board should condition the transaction on the approval of a well-informed independent committee *and* obtain fully informed uncoerced approval of the unaffiliated minority shareholders.

If a special committee is necessary, the board should establish the committee before beginning any "substantive economic negotiations." Under Delaware law, the committee can consist of as few as one director; however, in practice, it is recommended that the committee have at least three directors to increase objectivity and decrease potential scrutiny. The board should ensure the committee remains fully independent and disinterested. The committee should have the authority to choose its own independent legal and financial advisers to aid in the decision-making process. Finally, the independent committee must have a broad grant of authority to act and negotiate on behalf of the company.

Positioning the Company for Sale

In deciding whether to put the business up for sale, the board, with management and the owners, should identify the company's core value proposition and refine the company's focus accordingly. Examples that frequently drive value include cash flow/EBITDA, competitive position, relationships with customers, strategic considerations, management/sales, intellectual property and growth potential (either organic or through M&A).

The board should work with management and the owners to conduct diligence on the company to prepare for sale and to candidly determine areas of strength and weakness. The board should review a range of issues for possible concerns, including: financial reporting, corporate records; shareholder agreements; material contracts and related party transactions; third-party relationships; assets; employee relations/benefits; legal claims; antitrust issues; insurance coverage; the strength of management; the strength and security of information systems; customer relationships; required approvals; contingent liabilities; and real estate, environmental and intellectual property issues.

After conducting diligence, the board should work with management and the owners to increase the company's value and prepare for the deal process. The board, management and owners should also address any issues that arose during diligence and, if possible, take corrective actions to minimize buyer concern. Further, the board, management and owners should evaluate opportunities to increase value arising from the diligence process. At some point in the process, the company should prepare an electronic data room where the company's information can be made available in a controlled environment to potential buyers. The data room should include enough detail to allow potential buyers to value the company and to conduct legal/financial diligence; however, the company should limit the amount of confidential/sensitive information disclosed, so that it is not compromised if the sale falls through. The company should also develop tax, legal and human resources strategies for the sales process and the sale itself. Additionally, a realistic timeline should be developed for sale to instill a sense of urgency, avoid deal fatigue and protect value. The board, together with the owners, should assemble a deal team in which they have complete confidence, and which should include representatives of the board, management and the owners, as well as accounting, finance and legal advisors. The choice of the right deal counsel and financial advisers can be critical to the success of the transaction.

Identifying the Right Buyer

The board, with management and the owners, should carefully consider to whom they should market the company. Strategic buyers include competitors, suppliers and customers that seek access to markets, talent, market share, proficiencies or intellectual property. These buyers are typically focused on the operations of the company. They tend to have greater industry knowledge and often offer higher valuations. However, these buyers often replace or reduce management roles (and frequently other employees as well), which can affect culture, morale and customer loyalty. Some strategic buyers move more slowly through deal processes. The board should also consider potential antitrust issues in deciding to sell to a strategic buyer. Finally, the board should be mindful of the risk of disclosing sensitive or competitive information if the deal fails.

Financial buyers, such as private equity funds, usually are focused on financial returns over a five- to seven-year period. They seek companies with strong cash flows, industry positioning, cash conversion, growth opportunity, credit and leverage. These buyers tend to fund transactions with debt and are concerned with management strength, EBITDA and cash flow. Current management and shareholders often remain involved and hold equity in the company after the sale. These buyers tend to have access to capital to fund growth opportunities (including acquisitions). Financial buyers tend to be more flexible with deal structure and less likely to disrupt morale, culture and customer loyalty.

Conclusion

In sum, the decision to sell is a monumental milestone in life of the company. To position the company for a successful sale, the board should take an active role in every step of the process, from deciding to sell to preparing for sale to choosing the right buyer. Finally, the board should be mindful to uphold its fiduciary duties of care and loyalty throughout the entire process.

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