

THE BIGELOW COMPANY LLC

Is There Value in a Pre-Sale Legal Audit?

Identifying and revealing legal issues can actually work in your favor with an acquirer, provided that you can document your efforts to resolve those issues.

If you hate nasty surprises, the answer is yes. If there are any legal issues that could affect the sale or the future value of your company, it's better to find out about them long before you're asked to "open the books" to a prospective investor.

In the process leading up to the closing of a sale of your company, potential acquirers and their teams of \$500/hour lawyers will subject every aspect of your enterprise to a level of scrutiny that you've probably never before experienced. In today's marketplace, there's no place to hide in the due diligence process.

A good legal audit has a financial cost, and yes, it feels somewhat invasive. But those costs are nothing compared to the hassle (and potential disaster) of discovering a legal issue in the stressful weeks leading up to a closing.

A Legal "Audit" is Not a Legal "Opinion"

When you commission a legal audit, the lawyers are on your side. Their job is to scrub the business from a legal perspective, looking for potential problems that need to be fixed. They're there to help, and to play the devil's advocate, anticipating what prospective investors will look for.

A legal audit is something like a home inspection, which many savvy sellers today commission prior to putting their house on the selling block. It will show you where the problems lie and help you decide (in private) what you may want to do about them. If the problems can't be easily solved, the audit gives you time to present the problems to your future buyer in the most positive light. Buyers appreciate a seller who shows them the "skeletons" before they open the closet on their own.

Would You Recognize the Legal Skeletons in Your Closet?

We're not talking about fraud or gross negligence here. Ninety-nine percent of the legal issues we encounter involve anomalies in corporate structure, contracts, and tax reporting. Unfortunately, good intentions and squeaky-clean business ethics won't protect you from the havoc these anomalies can cause with an investor.

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Anticipating and preempting an acquirer's questions allows you to frame legal issues on your own terms, and keeps you in the driver's seat.

The most common legal issues we encounter are related to:

Tax filings for corporate status

See the following story about a family business sale that almost collapsed due to problems with their S Corporation filings.

State tax filings

For companies doing business in multiple states, this might be a major headache. We've encountered many cases of incorrect filings and/or unpaid taxes. You need to be sure that you're paying the correct taxes in each of the states in which you do substantive business.

Intellectual property

Are your patents, copyrights, and proprietary processes protected properly? How is your information protected?

Key employees

Are you (and ultimately, your potential acquirer) protected against losing key people? Do you have confidentiality, conflict of interest, and non-compete agreements in place? Are your employees properly incented to stay with the company after a sale?

Environmental issues

Have you identified and addressed potential environmental problems? Does your paper trail show a good faith effort to comply with government regulators?

Acquirers Expect Documentation – Not Perfection

Most of the legal issues we encounter are not showstoppers – unless they surface too late in the process to be addressed. What's really at stake here is your credibility and control over the process.

Acquirers hate surprises, and they don't like to find out that the seller has failed to identify or address an important problem. When they find one, they tend to step up their level of scrutiny on all issues and are less likely to accept the seller's information at face value. In the intensive weeks prior to closing, this can shift the balance of power into the acquirer's court and put the seller on the defensive.

This "Lesson Learned for Building and Capturing Value" reflects knowledge and insights we've gained working with privately held companies throughout North America.

For more information about The Bigelow Company, visit www.bigelowco.com or call us at 603-433-6000 for a confidential discussion of your unique situation.

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A Pre-Sale Legal Audit Would Have Spared Nutragen's Owners a Lot of Heartburn



This tale of near disaster would never have been told if the owners had discovered and resolved their problem in a pre-sale legal audit.

After three generations of family ownership, the shareholders of Nutragen Pharmaceuticals decided to capture their value in a \$100 million sale to a strategic buyer. We were down to the wire, a few short weeks before closing, when the deal almost collapsed.

In their due diligence process, the buyer found out that Nutragen had not filed its most recent S Corporation tax return properly, due to a simple administrative error. The potential liability? Nearly \$30 million in additional capital gains taxes on the transaction. The buyers were unwilling to assume this liability, and the sellers were not interested in losing a third of their captured value to the IRS.

A potential deal breaker

After the issue surfaced, the sellers determined that their lawyers and accountants had improperly executed the most recent corporate filings. The \$30 million dollar question on the table was whether or not the IRS would recognize the owners' true original intent and treat Nutragen as an S Corporation anyway.

We hired a nationally known accounting firm and their best forensic accountants, who went back to Nutragen's original auditors and lawyers and got their support to build the fact pattern and a case to the IRS. Based on previous related experience, our team was reasonably confident that the issue would be resolved in the owners' favor.

The Bigelow Company's advice to the client/seller: "There's still some risk that you may have to pay additional taxes and penalties. You need to do what's right for your family. If you can't live with the risk, then walk away from this deal." The sellers accepted the potential consequences and went forward with the transaction. Months later, the IRS agreed to honor the company's documented intent and treated them as an S Corporation.

Fortunately for Nutragen's owners, this tale of near disaster had a happy ending. But it was a tale that would never have been told if the owners had discovered and resolved their problem in a pre-sale legal audit.