PLDW
CORPORATE &
BUSINESS

CLIENT ADVISORY:

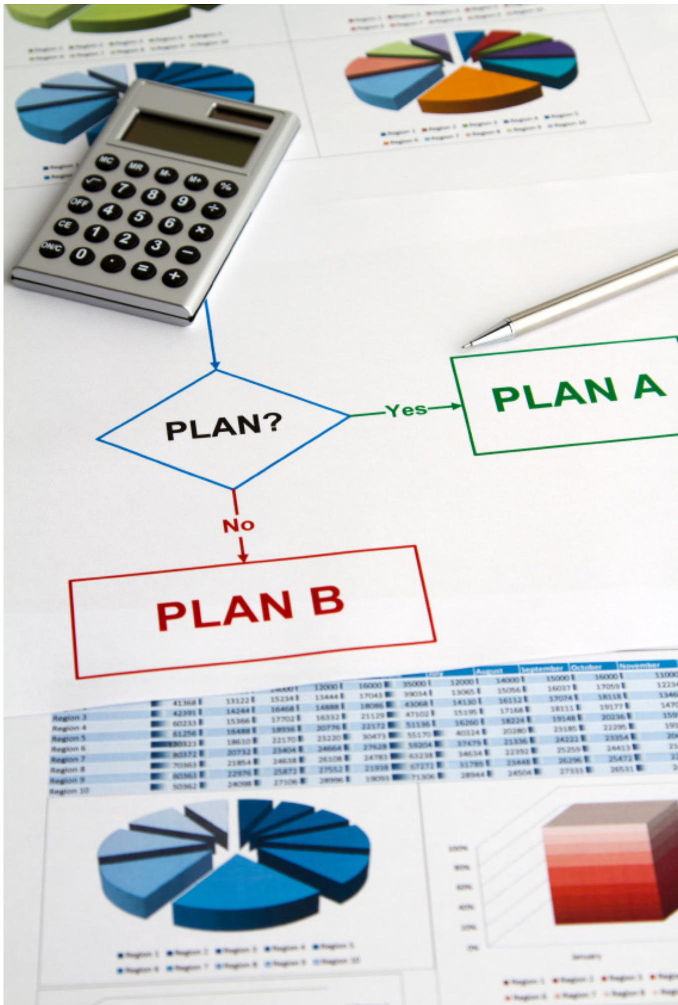
KEEPING YOUR OPTIONS OPEN: SUGGESTIONS FOR SUCCESSFUL COMPANIES IN THE CURRENT ECONOMY

Perhaps the current economy can best be described as slowly recovering. Economic cycles will always have peaks and valleys. During down times in the cycle, some companies will feel the stress more than others. Those that do maintain their vitality will do so through innovation or by reinventing themselves. PLDW recently published a Client Advisory, which offered several options for distressed companies to consider in the current economy. Below are a few suggestions that may be useful for successful companies to think about.

Buying Back Equity from Minority Owners

Many privately held companies have minority owners. However, most privately held companies do not pay regular dividends and for a variety of reasons, they are often unlikely to be sold in the foreseeable future. While their shares have value, the stock of private companies is an illiquid asset, which produces little or no current economic benefit to the owners. Companies with available cash may want to consider whether an offer to buy back the shares held by minority owners could create a "win-win" situation for both parties. From the perspective of the minority owners, the opportunity to cash out an otherwise illiquid asset may be attractive for any number of reasons. Even if they do not have a current need for the funds, the sale of their shares in a privately held company would give them the opportunity to invest in publicly traded securities or other more liquid assets.

From the company's perspective, there may be a number of benefits to reducing the number of shares outstanding. These could include elimination of owners who are not actively involved in the business and permitting the company to offer equity compensation to key service providers with a less dilutive impact upon majority owners. Before initiating a redemption of shares held by minority owners, two things should be kept in mind.



First, redeeming less than all of the shares held by a minority owner may produce adverse tax consequences to the selling shareholder under section 302(b) of the Internal Revenue Code, including ordinary income rather than long term capital treatment of sale proceeds and loss of the seller's tax basis in the stock. Secondly, the mechanics of implementing the stock buy-back should be carefully planned in the context of laws of the state where the company is organized. While it is usually an achievable goal, there are sometimes legal traps for the unwary.

Growth by Acquisition

It is inevitable that some companies may not survive the slow economic recovery and others may at least consider a sale, which, in better times, would not have been considered. For companies that are doing well despite the economy, this may be an ideal time to grow further by acquisition and thereby increase market share, acquire valuable proprietary technology or complimentary lines of business on attractive terms. Seeking potential acquisition candidates, either directly or through an intermediary (who may or may not initially disclose the identity of the potential buyer) can often produce some interesting responses.

One thing these potential sellers are likely to have in common is a belief that their companies are worth more than most buyers are willing to pay. However, that need not be an insurmountable hurdle. The typical way to bridge that gap is through a so-called "earn-out." In essence, this is a contingent purchase price, which provides for an initial fixed sum, plus an adjustment that is contingent upon the target company achieving certain specified post-closing performance targets. Earn-outs can be an effective way to bridge the company valuation gap, but the devil is in the details. In general, the best approach for both buyers and sellers is usually to base the earn-out on a financial metric that cannot readily be influenced by the buyer, who will be in control of the business during the earn-out period. For example, if the earn-out is based on a gross revenue target, it is likely to be less problematic than an earn-out based on pre-tax profit, which can be impacted by numerous variables, and can lead to post-closing disputes, even when both parties are acting in good faith.

If we can provide further information on any of the foregoing topics, please feel free to contact us.

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