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Confidentiality Agreements

Confidentiality Agreement – A pact that forbids buyers, sellers, and their agents in a given business deal from disclosing information about the transaction to others.

The M&A Dictionary

It is common practice for the seller, or his or her intermediary, to require a prospective acquirer to sign a confidentiality agreement, sometimes referred to as a non-disclosure agreement. This is almost always done prior to the seller providing any important or proprietary information to a prospective acquirer. The purpose is to protect the seller and his or her business from the acquirer disclosing or using any of the information provided by the seller and restricted by the confidentiality agreement.

These agreements, most likely, were originally used so that a prospective acquirer wouldn't tell the world that the business was for sale. Their purpose now covers a multitude of items to protect the seller. A seller's primary concerns are to insure that a potential acquirer doesn't capitalize on trade secrets, proprietary data or any other information that could essentially harm the selling company. A concern of the prospective acquirer may be that similar information or data is already known or is being developed by his or her company.

This can mean that both parties have to enter into some discussion of what the confidentiality agreement will cover, unless it is general in nature and non-threatening to the prospective acquirer.

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Confidentiality Agreements (continued from front page)

A general confidentiality agreement will normally cover the following items:

- ◆ **The purpose of the agreement.** It is assumed that, in this case, it is to provide information to a prospective acquirer.
- ◆ **What is confidential and what is not?** Obviously, any information that is common knowledge or is in the public realm is not confidential. What information is going to be disclosed? And what information is going to be excluded under the disclosure requirements?
- ◆ **How will confidential information be handled?** For example, will it be marked “confidential,” etc?
- ◆ **What will be the term of the agreement?** Obviously, the seller would like it to be “for life” while the buyer will want a set number of years – for example, two or three years.
- ◆ **The return of the information will be specified.** For example, if the sale were terminated, then all documentation would be returned.
- ◆ **Remedy for breach** or a determination of what will be the seller’s remedies if the prospective acquirer discloses, or threatens to disclose any information covered by the confidentiality agreement.
- ◆ **Legalese.** Obviously, the agreement would contain the legal jargon necessary to make it legally enforceable.

One important item that should be included in the confidentiality agreement is a proviso that the acquirer will not hire any key people from the selling firm. This prohibition works both ways: the prospective acquirer agrees not to solicit key people from

the seller and will not hire any even if the key people do the approaching. This provision can have a termination date for example, two years post-closing.

Tips on Maintaining Confidentiality

- ◆ Use a code word or name for the proposed merger or acquisition.
- ◆ Don’t refer to any principal’s names in outside discussions.
- ◆ Conversations concerning the merger or acquisition should be held in private.
- ◆ Paperwork should be facedown unless being used.
- ◆ All documents should be kept under lock and key.
- ◆ Important data maintained on the computer should be protected by a password.
- ◆ Faxing documents should be done guardedly.

The sale of a company involves the disclosure of important and confidential company information. The selling company is entitled to protection from a potential acquirer using such information to its own advantage.

The confidentiality agreement may need to be more specific and detailed prior to commencing due diligence than a generic one that is used initially to provide general information to a prospective buyer.



Gathering Information on a Company for Sale

Assume you are considering selling your company and you have asked an intermediary to visit and see your business for the first time. Here is what most likely will happen.

First, you should allocate two to three hours for questions and a tour of your plant. In addition, you should be prepared to supply the following information if available.

Please note that the following is based on the assumption that the business is a manufacturing company. Most of the information supplied would be similar for most medium to large companies.

Business:

To break the ice, it is easiest for you as the owner to give a quick historical overview of the company. For example, when it was started, major changes and developments, etc. An owner should provide how a typical order is handled from point of entry including how a buyer's credit is checked, how the order is entered into the system, and how it is scheduled for manufacturing or as a stock item, etc., in order to provide a sense of how efficiently and thoroughly the company executes orders. Also, the core business(es) should be explained. Is it a niche business? What makes the business unique? Is the business seasonal or cyclical? Also, is the company a C or S corporation?

Products:

You will want to provide a description of the products, their price points, their market share, the rate of new products developed, and the number of SKUs in the product line. You will want to include details such as whether 20% of your products equals 80% of the sales and conversely whether 80% of the sales is generated by 20% of the customers. In addition, how are the products priced?

Competition:

An intermediary will want to have an idea about the competition faced by your business. Which are the major competitors, based on size, location, breadth of product line, pricing and whether they have a competitive advantage? Consider financial resources, automation, sales coverage, dealer network, and longevity. Is the competition national, international, regional, or all of the above? To what extent is it a relationship business or will customers exhibit little loyalty? Are the customers likely to single source, double source, or more?

Market:

You will want to give the intermediary an idea of your market. How big is your market? Is it a commodity business (price driven)? Is it fragmented by lots of small companies? Is it impacted by large Fortune 500 companies or impacted by foreign competition? How fast is the market growing? What affects the business (and how)? Examples would be the economy, the weather, military spending, etc.

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Questions a Potential Seller May be Asked

- ◆ Why is the company for sale?
- ◆ How long has the business been for sale?
- ◆ Are there other stockholders, and if so, what is the ownership breakdown?
- ◆ Do you have the authority to sell or is it the decision of the board of directors?
- ◆ Who will be doing the negotiations?
- ◆ What is the rationale or methodology in determining the price of the business?
- ◆ What is the owner's total compensation?
- ◆ Is there any pending litigation or prior litigation?
- ◆ Are there any contractual obligations such as with employees, vendors, customers, landlords, or intermediaries, non-competes, buy/sell agreements, etc.?
- ◆ Are there any "soft assets" like uncollectable receivables?
- ◆ Would the owner stay on for a transition period?
- ◆ If you miraculously received \$500,000 in the company, how would you use it?
- ◆ How do you grow the business?
- ◆ What differentiates this company from competitors?
- ◆ What is the culture of the company?
- ◆ What is the company's most important resource?
- ◆ What haven't we talked about that I should know, or what have I overlooked?

Gathering Information on a Company for Sale (continued from inside page)

Sales:

What are the sales for the past few years and what are projected sales? You should be able to describe the average sales cycle from original sales call to receipt to order. What is the channel of distribution, i.e., direct sales, sales reps, distributors, catalogue, telemarketing, direct mail, trade shows, etc.? What are the sales costs? Do you export or import or have you considered strategic alliances or joint ventures? Tell the intermediary about the sales manager and the sales team. What is your return policy and how large a factor is product returns on total sales?

R&D:

How much time, effort, and money do you devote to new product development, or new manufacturing process innovation? Does the company have any patents or licenses?

Plant/Manufacturing:

How large is the plant? Is it leased or owned? What is the plant capacity? Could production be increased by 50% in the same facility? How many production people and how many people altogether are there in your company? What are the sales per employee and how does that relate to the industry average? Is the manufacturing fully integrated or is it sub-assembly? Who are your largest vendors and what terms do you receive on their invoicing? Do you use "just in time" (JIT) inventory and how much of your inventory is in "work-in-

process" (WIP)? What are the bottlenecks? Describe the quality control (QC). What is the reject rate? What are the labor rate, bonuses, benefits and average age of the work force? (If the average is 55, it could be a problem.) What are the capital equipment needs in the next few years?

Management:

Describe the roles of your management team; e.g. What are your major problems and concerns? Who do you use for advisors; e.g. consultants, lawyers, accountants? As CEO, what are your strengths and shortcomings? What contractual arrangements or incentive plans do you have with the management team? Do you have a management chart?

Financials:

Are the financials certified? Does the company provide monthly financials? What *key benchmarks* do you use to monitor the company's progress; e.g., gross margin, inventory, inventory turnover, working capital, sales per employee? What percentage of your receivables are over 90 days? How do you handle collections? When and how do you implement price changes? Are all your major accounting functions computerized; e.g., purchases, sales, inventory? What sort of product liability does the company carry? What are your financial projections and how do you figure them out?

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