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CHAPTER 23

BUSINESS EXIT PLANNING & PREPARATIONS — CRITICAL LEGAL CONSIDERATIONS

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Overview

This chapter addresses critical legal issues applicable to the process of "exit planning" for business owners.

With a greater awareness in these areas, the professional is better equipped to assist his or her client and the client's legal advisors to (1) assess areas of vulnerability which a potential buyer might use to negotiate lower exit transaction values and (2) develop a plan for eliminating or mitigating the impact of such areas of vulnerability and thereby yield higher exit transaction values.

Learning Objectives

By the end of this chapter, you should be able to:

- understand the importance of legal aspects of exit planning preparations;
- identify some of the basic legal investigations necessary to getting organized in order to engage in proper exit planning;
- identify some of the more common business "skeletons" or "value threats" which can impact the exit planning process; and
- better assess the impact of "value threats" to a potential buyer and learn ways to eliminate, manage and/or mitigate their impact on the exit planning process.

INTRODUCTION

To the seasoned professional, any client who is undergoing the exercise of implementing an individual pension plan, retirement compensation arrangement and/or universal life insurance policy is already embarking upon the process of examining ways to extract value from his or her business on a "tax-preferential" basis and "better prepare" for his or her eventual retirement.

In my experience, clients who match this profile are often ready to consider a more holistic approach to a full exit from their business. Exit (or succession) planning will need to be tailored to the individual owner and to the nature of his or her expected or anticipated exit. The nature of the exit will ultimately depend upon the identity of the purchaser of the business.

Generally, there are three primary categories of purchasers to consider in any exit/succession planning exercise:

- family members (whether active or passive in the business);
- key managers/senior employees of the business; or
- a third party purchaser (which may be a strategic buyer such as a competitor or key customer/supplier of the business, or a purely financial buyer such as a private equity fund, merchant bank or angel investor).

GETTING ORGANIZED — WHAT'S IN YOUR CLOSET?

This part will quickly examine certain "places" where lawyers can and should look to assess whether a particular business may have problems or deficiencies which may give a potential buyer a reason to withdraw from negotiations, or ammunition to negotiate lower exit transaction values.

Public Searches

There are a number of publicly available searches which you can undertake against corporations and individuals when it comes to exit planning preparations. The more typical searches fall into the following categories:

- corporate existence/profile
- bankruptcy
- *Personal Property Security Act* (PPSA)

- *Bank Act*
- real property
- executions/court judgments
- litigation

Corporate searches will report on whether a given Canadian federal or provincial corporation has an "active status" and will also identify the subject corporation's current directors, officers, registered office address and a listing of publicly filed documents (such as articles of incorporation, articles of amendment, annual reports, *etc.*). It will be important to review these searches and to confirm that the applicable corporate information is accurate or to rectify any deficiencies. In some cases, this search will indicate that a given corporation's status is in "default" and permit the lawyers to rectify any governmental deficiencies prior to the applicable governmental authority taking any steps to prematurely terminate the corporation's existence or status.

Although hopefully not applicable, it is always desirable to obtain searches against key individuals and corporations to confirm that no filings have been made and that no proceedings either by a party seeking creditor protection or by creditors seeking enforcements of their rights against a given debtor are underway.

PPSA searches (and the equivalent searches in other relevant Canadian provinces or foreign jurisdictions where key business assets are located) will identify secured creditors of relevant corporations and individuals. Hopefully, the results of these searches will only show known current secured creditors, but surprises do sometimes appear. For example, sometimes a creditor who has been paid in full some time ago will continue to appear on this search if the parties forgot to process the necessary discharge before the expiry of the original registration period. Other times, a person may have filed a PPSA registration without the knowledge of your client (this person may be either a disgruntled unsecured creditor who did not get paid or a potential creditor whose deal was not concluded with your client). A potential buyer will obtain PPSA search results against the target business and its individual owners, so you might as well check these databases first and correct any inaccuracies well before your exit negotiations commence.

In Canada, security interests may sometimes be filed/registered by banks under federal banking legislation in addition to filings under the PPSA, and it is important to obtain these results as well to ensure they are accurate.

To the extent that real property (*i.e.*, land and buildings) is proposed to be sold to a potential exit buyer, it would be prudent to obtain full title searches and identify any issues which a buyer may object to or use as a basis to negotiate better exit pricing.

Any buyer will be concerned about existing litigation involving the target business (or its owners) and/or formal judgments obtained against the target business (or its owners). Litigation and execution searches will reveal any pending lawsuits or actual judgments which you and your clients will want to identify long before negotiations with a potential exit buyer commence.

Material Agreements

Every business enters into contracts (of varying degrees of importance) in order to govern its relationship with various key stakeholders, such as shareholders/founders, employees/contractors, customers, suppliers, landlords, equipment lessors and bankers, to name just a few. In the context of exit planning, these various agreements need to be identified, catalogued and reviewed to ascertain their impact, if any, on the exit planning process. For example, do these material contracts contain provisions which give a key stakeholder a right to terminate the contract if its approval is not first obtained prior to any "change of control" or "assignment" to a new party? In other cases, material contracts may not obtain consent or approval requirements, but may merely give a third party some favourable rights to increase prices, extend terms or obtain some benefit (*e.g.*, golden parachute) should a buyer terminate the agreement following the exit, *etc.* In any event, material contracts are clearly an area of critical examination for any client seeking to prepare for an exit transaction.

Note: Special consideration should be made in the case of company obligations under pension or other benefit arrangements. Corporate pension and benefit documentation should be carefully reviewed to ascertain how they may impact exit planning. For example, to what extent might unfunded obligations need to be "topped-up" prior to closing or what hidden charges or benefits might create a future cost to a buyer not otherwise known to it at the time of the exit closing?

Material agreements may also exist at the individual level in the form of personal guarantees which the owners have given to lenders and other key suppliers relating to the business. In such case, it will be important for these personal guarantees to be addressed as part of the exit

transaction. Other types of material agreements which involve the individual owners include shareholder loans and corporate-owned insurance policies. A proper exit planning exercise will consider how these agreements need to be addressed with a potential buyer as well.

Apart from restrictions on ownership changes, material agreements should be reviewed from the perspective of "risk allocation". In cases where contractual terms involving customers of the business include limited warranties, liability exclusions and liability limitations, your client may be able to demonstrate fewer "customer skeletons" to a prospective buyer of the business.

Industry-Specific and Other Regulatory Considerations

Certain businesses will need to obtain and maintain key governmental licenses, permits and registrations under industry-specific municipal, provincial and/or federal government legislation. Proper exit planning will involve the identification and listing of these key licences, permits and registrations, and an understanding of any special conditions which a buyer may or may not be able to satisfy and/or whether or not these key licences, permits and registrations may be transferred to a potential buyer. Where a buyer is a competitor of the business, it will likely have its own industry-specific registrations, licences and permits.

Even in cases where there may be no unique industry-specific regulation which imposes any special licensing or permit requirements over the target business, it may be prudent for your client and your client's counsel to consider the impact of other Canadian federal and/or provincial legislation as part of your exit planning preparations. For example, notices and/or approvals from the federal Competition Bureau or Industry Canada under the *Competition Act* (Canada) or *Investment Canada Act* (Canada), respectively, may be required as part of the exit transaction depending upon the size of the deal and the size/residency of the buyer and seller. In the context of an exit structured as an "asset sale", the provisions of Ontario's *Bulk Sales Act* and *Retail Sales Tax Act* (among others) may also need to be considered.

Review of Corporate Records/Minute Books

Although every corporation is required by law to maintain its corporate records on an annual basis, many corporations do not have current and up-to-date minute books and corporate records. As part of any exit planning (and any tax audit planning), corporate minute books should be

reviewed by counsel to ensure that the following matters are properly provided for:

- changes in registered office
- changes in board size
- changes in director and officer appointments and resignations
- issuances, redemptions and transfers of shares
- declaration of dividends and bonuses
- shareholder loans and loan security
- approval of material transactions/contracts
- authorization of articles of amendment and name changes
- approval of financial statements
- fixing/changing of fiscal year end
- appointment of accountants/auditors
- shareholder agreement approvals

While most minute book "deficiencies" can be rectified, it is important to identify these well in advance of any exit negotiation, particularly where the exit transaction is likely to take the form of a sale of shares, since the buyer will likely want certain legal opinions relating to share capital which your client's legal counsel may be unable to give unless the minute books are in proper condition and in good standing prior to the closing of the deal.

Review of Existing Corporate Structure

Proper exit planning preparations would not be complete without a thorough examination of the existing corporate structure of the target business and consideration of the various assets which are (or are not) intended to be sold to a potential buyer.

For example, if holding corporations constitute part of the corporate organizational structure, do the shares of the holding corporation need to be sold to the buyer in order to take advantage of any available capital gains exemption to individual sellers? If so, will a buyer likely be prepared to purchase the business at the "holding company" level? The answer is typically "yes", but the seller will need to be responsible for any "skeletons" at both the operating company *and* holding company levels.

Will non-core assets inside the holding company (or the operating company) need to be "cleared out" prior to the sale because they are to

be excluded from the sale? If so, what are the tax implications of these purifying transactions?

If the sellers intend to retain key real property (held in a separate company) used by the business and lease that same property to the buyer as part of the deal, has a suitable lease been put in place before closing? If not, this will need to be addressed as part of the exit transaction.

IDENTIFYING SKELETONS — WHAT ARE YOUR "VALUE THREATS"?

This part will review the types of "skeletons" which, in my experience, are somewhat common and which the client's legal and other advisors should pay careful attention to as part of the exit planning process. In practical terms, you should really think of these "skeletons" not merely as unseemly warts or blemishes on the otherwise shiny complexion of the stellar business your client wants to present to a potential buyer, but as "value threats". By "value threats", these skeletons may either cause a buyer to completely abandon the sale process or (more likely) be used by a buyer opportunistically to extract better pricing or other deal terms from your client.

Minute Book Deficiencies

As mentioned above, a review of most corporate minute books will reveal minor (and often major) issues. Some of these problems are simply matters that have not been noted in the corporate records. In any event, they are most often able to be corrected if identified early enough. The area of greatest concern often relates to whether corporate shares have been validly issued, since many exit transactions are structured as share sales. Most buyers' counsel will (time permitting) insist on receive closing legal opinions from the seller's counsel pertaining to corporate existence and other typical minute book matters, so it is important to identify and address minute book deficiencies early in the process.

Asset Ownership and Encumbrances

Where the core value of a business rests with ownership of a key asset or group of assets, any problems with "title" to such asset will cause major issues with your client's buyer. The most obvious example of this is in the area of intellectual property and, in particular, ownership of the copyright subsisting in source code comprising software.

Under Canadian law and absent an express "assignment of title", ownership of the copyright subsisting in computer software remains with the author of the copyright. In the case of employees, the copyright created in the works they author belongs to the employer, but this is not the case with independent contractors. As a matter of practice, where a non-employee individual contractor and/or software development company built all or part of any key proprietary software used in and/or exploited by your client's business, you should ensure that some form of development agreement was signed and/or that intellectual property rights (*i.e.*, copyrights) were assigned from the developer to the owner of the selling company. Otherwise, title issues will likely arise and create significant problems for your client in executing an exit strategy.

Similar "chain of title" issues might exist with other key assets such as real property.

Additionally, as noted above, a review of the public search results might indicate certain "stale" PPSA encumbrances which will need to be discharged given that your client has long since paid off the debts owed to the applicable secured party. In other cases, registrations which were intended to only encumber specific assets (*e.g.*, motor vehicles or leased equipment) may have been filed to broadly cover all of your client's assets. In these cases, a buyer will want to see a letter from such secured parties confirming that their security does not extend to the assets being acquired by the buyer and that they release the buyer from any claims against such assets. Obviously, from a buyer's perspective, any unacceptable asset encumbrances will need to be addressed before closing, and your client will want to avoid any last minute surprises in his or her deal.

Share Capital Ownership Issues

Simply put, who owns your client's company? You are likely tempted to respond by saying "the client". However, consider the following questions:

- Were the legal formalities relating to any historical share redemptions or share purchases followed properly?
- Were any options or similar rights granted to any former employees, contractors or others early on in the evolution of the business?
- Were any creditors granted any rights to convert their debt into shares?

If the answer to any of these questions is "yes", your client may not be the 100% owner of his or her business, and there may be "phantom" owners who may surface during the exit process if you and your client are not careful in your exit planning.

Opportunistic Litigation

There are often a number of historical (or current) third parties who have unresolved disputes with your client and are just looking for some additional leverage to coerce a settlement. The exit process may be the leverage they are looking for. Once word gets out to the trade that your client is engaged in the sale process, all sorts of opportunistic plaintiffs may emerge from the shadows and commence real (or frivolous) litigation or complain to some governmental or regulatory agency.

Examples include:

- former employees or consultants who were granted stock options;
- former employees who were terminated under less than ideal circumstances;
- resentful competitors who have lost significant market share;
- former shareholders who sold out under less than ideal circumstances;
- large customers who may allege "product liability" issues; and
- large suppliers who may threaten to terminate favourable supply contracts.

Tax Audit/Reassessment Issues

One very typical and significant area of exit planning preparations involves assessing audit risk relating to historical income, commodity taxes and source deductions. This can be particularly problematic for businesses that have made extensive use of independent contractors or for businesses that have failed to collect and remit GST or PST. As part of any exit preparations, it would be prudent for the client's tax advisors to review the operations of the business for the past three to four years, as well as tax returns covering the same period, and comment on areas of possible audit risk which a buyer's tax advisors may identify and which may give rise to potential price negotiations.

Product Warranty/Liability Issues

Part of any exit preparations should include an assessment of any isolated and/or widespread issues of product liability and the warranty/insurance-related costs associated with those issues. As noted above, the extent to which customer agreements contain limited warranties, liability exclusions and liability limitations may assist in mitigating the costs of any product liability issues and thereby reduce the impact of these issues in any exit negotiations.

Environmental Issues

Whether your client is a landlord or tenant, environmental risks are becoming more prevalent; therefore, your client should review its operations and the history of the former tenants of the premises it occupies to ascertain whether any environmental contaminants may have been created, generated, used and/or disposed of within or in proximity to such premises during the past ten years. Depending on the facts, a buyer might be expected to ask for copies of any historical environmental audits and/or requisition its own environmental audit. Any negative results of such audit will be used by a buyer to seek price and other concessions from your client; thus, it would be best to discover any environmental issues long before a buyer is at the table.

Contractual Restrictions on Assignments/Changes of Control

As mentioned above, it is critical to identify any material contracts which may be adversely impacted by the completion of a sale of the business. If a buyer's interest is dependent upon, for example, the continuity of long-term customer contracts and/or a key supplier relationship, the cessation of such relationships may be fatal to your exit negotiations.

Regulatory Restrictions on Assignments/Changes of Control

As mentioned above, it is critical to identify any legislative restrictions and/or special conditions attaching to any existing permits, licenses and/or registrations held by the business which are not transferable to the buyer. Unless the buyer has its own licenses and/or can independently obtain them, the inability to transfer key permits to it may be fatal to any exit transaction.

Domestic/Foreign Law Risk

Depending upon the industry in which your client operates, and the nature of its products, services and/or customers, your client's business will be subject to a large number of domestic Canadian federal, provincial and municipal laws of either general or specific application. It will not come as a surprise to you that many businesses are non-compliant with some of these laws (although often it is to a degree which, on balance, will not have a material adverse impact on the business). However, a proper exit planning process should identify any areas or potential areas of non-compliance with general and industry-specific laws. More often than not, your client will be quite familiar with the laws affecting its own industry but less familiar with laws of general application (*e.g.*, provincial consumer protection legislation).

Moreover, many Canadian businesses have some level of foreign business activity. This may be limited to customers that are resident in other provinces or countries or may extend to the existence of employees or agents resident in such jurisdictions and/or some physical or permanent establishment in such jurisdictions. In these cases, the business may have extensive (and often valuable) business activities in such jurisdictions and be unknowingly offside various foreign business and tax laws. In such cases, the possibility of foreign legal risk may provide a buyer of the business with leverage to negotiate favourable price concessions and/or cause it to abort negotiations.

ASSESSING "VALUE THREATS" — SEE WHAT A BUYER SEES

Not every buyer will care about every "skeleton" to the same degree. While it is incumbent upon your client and your client's advisors to undergo the process of identifying potential "value threats" as I have identified above, it may not be practical (or possible) to incur the cost and time necessary to address all of these considerations, especially when the expected exit date is well into the future.

However, if for any given "value threat" your client is able to answer "yes" to any of the following six questions, then chances are that the particular threat should be addressed sooner rather than later:

- **Impact on Title:** Does it affect or impair the very ownership to the assets or shares which a buyer wants to acquire?
- **Nature of the Problem:** Is it a recurring circumstance (as opposed to an isolated or one-time event)?

- **Impact on Key Relationships:** Does it materially impair or threaten the existence of any valuable relationships which the business has with any key customers, suppliers or other stakeholders?
- **Cost to Fix:** Is the cost (in money's worth and time) to rectify the "skeleton" substantial?
- **Business Continuity:** Does it materially impair the ability of a buyer to continue to operate the business following the exit in the same manner in which your client operated the business prior to the exit?
- **Who Should Bear the Risk:** Is it a risk which no buyer is likely to want to assume, and which most buyers will expect a seller to fix or accept responsibility for?

STRATEGIC CONSIDERATIONS AND MANAGING "VALUE THREATS"

In light of the six questions posed above, the following are six basic strategic considerations aimed to assist you in discussing with your clients how to handle some of the "value threats" identified by the exit planning process:

- **Assess Your Negotiating Strength:** If you believe your client has (or will have) superior bargaining strength in the exit negotiations, you may (aggressively) take the position that your client need not address any "skeletons" at this stage, and address them only if necessary after the exit negotiations have commenced.
- **Don't Wait/Start Early:** In the case of any opportunistic litigation which this process identifies, it is often prudent (and less costly) to take steps to negotiate a settlement with the other party long before exit negotiations commence. As you can appreciate, the cost of settling will likely go up once the other party learns that your client is trying to sell the business.
- **Communications and Confidentiality:** Your client needs to take steps to carefully control the exit planning process and avoid leaks wherever possible.
- **Contractual Renewals, Etc.:** To the extent that the planning process has identified any negative contractual provisions which arise in connection with any exit or "change of control", your client should try to negotiate changes (or deletions) to these provisions as part of any contract renewal talks. Obviously, the new agreements

which are being negotiated with new stakeholders from time to time should be reviewed carefully by your client's counsel to ensure that unfavourable exit provisions are not included in the final signed copies.

- **Be Proactive:** To the extent that your client is offside any important laws, consider the costs of compliance and implement corrective measures without delay and before these issues lead to litigation or regulatory action. Additionally, if there are any areas of inadvertent non-compliance with tax legislation, your client and your client's tax advisors should consider to what extent applicable tax fairness legislation or voluntary disclosure procedures might be used to reach a lower-cost resolution well before any exit negotiations commence.
- **Fix the Easy Ones First:** Your client may find that, for example, fixing minute book deficiencies and contacting old creditors to discharge stale PPSA registrations may be "low hanging fruit" in the process of implementing exit preparations.

PULLING IT ALL TOGETHER

You and your clients should consider exit planning as part of the other planning exercises undertaken in other parts of this book. Proper exit planning requires the client and the client's key advisors (including legal, tax, accounting, insurance, pension/benefits and financial) to identify key "value threats" to a successful exit, and to develop/execute a strategy to eliminate, manage and/or mitigate those threats for the sole purpose of helping the client to ultimately unlock upon exit the maximum after-tax liquid value from the client's business.

EXIT PLANNING PREPARATIONS — LEGAL CHECKLIST

The following is a non-comprehensive listing of pertinent legal matters to consider in the context of exit planning preparations:

A. Getting Organized — What's in the Closet?
   - Obtain public search results
   - Review material agreements
   - Consider legislative/Regulatory licensing requirements
   - Review corporate minute books

- Review corporate structure

B. Identifying Skeletons/Value Threats

- Minute book deficiencies
- Issues affecting asset ownership/Encumbrances
- Share capital ownership issues
- Opportunistic litigants
- Tax audit/Reassessment risk
- Product warranty/Liability issues
- Environmental issues
- Contractual restrictions on assignments/Changes of control
- Regulatory restrictions on assignments/Changes of control

C. Assessing Skeletons/Value Threats

- Consider impact on title to shares/Assets
- What is the nature of the problem — recurring vs. isolated?
- Is there any negative impact on key relationships?
- What is the cost to fix — material vs. *de minimus*?
- Can the business continue "as is"?
- Who should bear the risk?

D: Managing Skeletons/Value Threats — Strategic Considerations

- Assess your negotiating strength — will buyer let it slide?
- Neutralize potential litigants via early settlement
- Loose lips sink ships — preserve exit confidentiality
- Negotiate away third party approvals upon contract renewals
- Be proactive — address legal compliance issues early on
- Fix the easy ones first — begin at the beginning