GUEST COLUMN: LAW

Selling Smarter: Minimizing Legal 'Skeletons'

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Every entrepreneur who has taken the risk to start and build a business is curious about what his or her business is worth and what is involved in selling it. These days, few business founders plan on running their businesses until retirement and, with the world awash in private equity and mega M&A deals taking up the headlines each day, selling your business is a very hot topic. While it is commonly known that sellers want to 'sell smarter' (i.e., maximize their after-tax sale proceeds), what is not commonly known is what's involved in getting there.

Not surprisingly, preparation is essential. This article will focus on the legal aspects of business exit preparations—minimizing the legal 'skeletons' which can erode your overall deal price and increase the cost and time to do your deal.

Legal exit preparations involve a 3-step process: first you need to undertake various due diligence investigations (i.e., public searches, review of minute books and key contracts, etc.), next you need to identify any 'skeletons' and consider what options exist to remedy or neutralize them, and last you need to create and implement a plan to manage these skeletons. While you may be thinking "my business is squeaky clean", it is a rare business that does not have some 'warts' that a buyer can and will exploit to your detriment.

The consequences of failing to consider legal issues in your exit preparations can involve significant delays in getting your deal done, higher than necessary legal and other costs and, in extreme cases, the death of your deal.

While every company is different, some of the more 'typical' skeletons I have encountered are as follows:

- former employees and/or consultants were issued shares that have been forgotten about and they can't be located at closing and your buyer is concerned that he/she can't buy 100% of your business;
- there are no shareholder agreements with minority shareholders that permit the majority owner to 'force them' to sell their shares to a buyer desiring a 100% purchase;
- you don't want to sell your real estate but the real estate is owned by the operating company which your buyer wants to acquire;
- a key contract has a 'change of control' restriction and you are not certain what it will take to obtain the 'consent' of an important supplier or other third party;
- you are afraid that a few former employees might commence an opportunistic lawsuit once they find out you are 'in play';
- you failed to acquire full ownership of some critical intellectual property developed by a former independent consultant; and
- your accountant is concerned that the business has failed to properly collect and remit PST and GST and a tax audit could result in very significant unpaid taxes plus interest and penalties.

For each of the above 'skeletons', there are usually a number of possible options available to either neutralize or at least mitigate their impact on an actual sale event. However, the range of options is usually greatest long before a buyer is sitting at the table.

In summary, I will leave you with my '8 Best Practices' when it comes to legal exit preparations:

1. Control Share Capital: Be aware of both (a) who owns your company's shares and (b) whether you can force a sale by all shareholders at the time of exit.
2. Control Key Contracts: Identify which 3rd parties have been given rights to consent to your exit transaction and try and either impose an 'acting reasonably' requirement or try and negotiate the deletion of these restrictive terms during your next renewal discussions. Stay organized and maintain a formal list of key contracts that you update annually.
3. Control Assets: Ensure all proprietary assets are, in fact, legally owned by your company and that any encumbrances or liens filed against such assets are maintained or discharged in the ordinary course. You should also be mindful of the quality of your assets (e.g., determine whether any environmental issues are in issue).
4. Control Corporate Structure: Update and maintain corporate minute books on a regular basis to ensure they reflect all historical transactions. Consider isolating the ownership of passive vs. operating assets and distinct/multiple businesses in different corporations. Essentially, keep your overall corporate structure 'buyer friendly' to the extent possible.
5. Control Tax Risk: Solicit feedback from your accountants regarding areas of potential federal or provincial tax audit risk (i.e., income, GST, PST or payroll taxes) and areas where you may not conform to GAAP. Buyers may use areas of tax exposure and non-GAAP compliance to negotiate a lower purchase price.
6. Control Opportunistic Litigation: Identify disgruntled former employees, partners, customers or others who might commence a lawsuit once they learn of your exit plans in order to extract their 'pound of flesh'. Consider early settlements (and full releases) if possible or anticipate the issues and enhance your leverage before litigation is commenced.
7. Control Regulatory Issues: Identify all key industry/governmental license and permits (including any special conditions which might affect same) and determine if these are transferable to your buyer or if regulatory approvals are necessary.
8. Control Legal Compliance Risk: Determine areas where your business may not be in full compliance with applicable domestic or foreign laws (e.g., privacy, consumer protection, industry specific rules, etc.) and assess the materiality of such non-compliance to your potential buyer.

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