Houser Henry & Syron LLP

LegalSpotlight

Buying or Selling a Business

Selling or buying a business can be an exciting and rewarding experience. Optimal results can be achieved for both buyer and seller with flexibility and creativity, careful preparation and strategic planning. While the sale of a business may take a year or less to achieve, **planning** *should begin well in advance, even before it's a firm thought.*

This booklet highlights what sellers and buyers can do to ensure a successful transaction.

SELLERS

Think like a Buyer—Maximize the Business Value

Consider What the Sale Should Achieve

A critical first step for sellers is determining what they want the sale of their business to achieve. It is important to think through the implications for the seller personally, for their family, their employees, their key customers and suppliers. An owner often derives a great deal of self-worth and purpose from the business. He needs to prepare for life after the sale of the business and visualize what he will do with his time.

How will the seller's financial situation be affected by the sale? Often a seller's wealth largely depends on the business; sellers will need help with the transition from receiving an income stream from the business, to generating a reliable income from investments.

What is a Business Worth?

Although business owners may have a price in mind, a business is really worth whatever a buyer is willing to pay. Sellers need to have a realistic idea of the value of their business at the outset. Sellers should employ expert help to determine the fair market value of their business. A valuation should also highlight the strengths and weaknesses of the business. This will give the sellers the opportunity to enhance the value of their businesses prior to its sale.

Preparing a Business for Sale

Sellers need to look at their businesses as if they were an outside buyer and dispassionately evaluate their business' strengths and its weaknesses. Then they need to tackle the weaknesses whether they are: improving profitability; building a better reputation; diversifying customers or products; building a management team; reducing debt; upgrading processes; or settling litigation. Often remedying these challenges takes time but addressing them will definitely increase the value of the business and the ultimate purchase price. Unfortunately, some sellers do not prepare their businesses for sale and instead they are forced to sell when a crisis occurs and in those cases, the sellers inevitably sell for less than the business could be worth.

Anticipating the Buyer's Requests

The owners can anticipate a buyer's due diligence, by performing searches against both himself (as the seller) and the business. The results can uncover issues which can be addressed early on in the process, such as discharging any old security registrations against the company's assets and settling outstanding litigation. Dealing with these issues early paves the way for a smooth negotiation and closing.

Seller's To Do List

To enhance the value of a business and facilitate a smooth sale, a seller and his advisory team should take several steps:

- **Organize the financials:** Aim to have a minimum five years' worth of complete financial statements for the business. Make sure all business tax returns have been properly prepared and filed, including discretionary expenses and transactions. If there has been any financing obtained or security given by the company, plan to disclose this information as well.
- **Organize incorporation documents:** A buyer will likely review the company's incorporation documents and its minute book, which should accurately reflect the company's history, including its directors, officers, shareholders and any significant transactions. For a share sale, one should ensure the history of the shareholders has been recorded correctly. Mistakes or missing records will alarm the buyer and delay the sale.
- **Resolve any litigation or other claims:** If possible, obtain a release from the other party. A buyer will not want to assume these liabilities. Outstanding claims will likely discount the purchase price.
- **Employee records need to be accurate:** If the business doesn't have signed employment agreements, a buyer will need to know the terms of employment for each employee. Severance needs to be assessed to determine if the seller or the buyer will be liable for employee turnover. Identify the employees who are necessary for the company's continued success.
- **Review the company's leases:** If the company operates out of leased premises, a buyer will need to know the terms of the lease and whether it is assignable. The same applies to leases of equipment.
- **Review supplier and customer contracts:** If the business doesn't have written contracts, document the key terms of its relationships. The buyer will need this information to understand the business and assess its value.
- **Identify special licences or permits:** Any of these items required to run the business will either need to be transferred to the buyer or the buyer will have to apply to obtain them.
- **Identify inspection and maintenance records:** Ensure any records for critical equipment of the business are readily available. If a business owns real estate, a buyer will likely require an environmental inspection of the property.
- **Document receivables:** Prepare information regarding receivables, including their aging.
- **Consider tax planning opportunities:** Discuss with the advisory team how best to take advantage of any tax planning opportunities such as estate freezes, family trusts and holding companies, which can lead to tax savings.

All of these steps will help prepare for a successful sale. The business will be more attractive to buyers and the sale process should run smoothly.

> *When you sell your business, you have one chance to fix a value on your life's work.*

Finding a Potential Buyer

Potential buyers may come from several sources. Family members or key employees may be the first successors considered. Competitors or suppliers are another strong potential source, as are companies who already serve the same customers. An owner may find companies which are interested in using the business' distribution channels. Companies with synergies in products or services may be interested, as well as those with business cycles that peak at a different time than the business. Other interested parties may include private equity and venture capital groups.

A seller should find out why the buyer is interested in the business, and his/her future plans for it (i.e.

how it will be integrated into the buyer's life/business activities).

What price range will the buyer be willing to pay? Does the buyer have the financial ability to complete the deal?

Understanding the buyer's motives is important but not as essential as trust between the seller and the buyer. Without trust, the deal is not worth doing.

> *It is important to think through the implications of a sale—for the seller personally, for his family, his employees, and his key customers and suppliers.*

BUYERS

Investigation is Key: Evaluate, Evaluate, Evaluate

Buyers interested in acquiring a business will need to do their homework. This not only means completing due diligence on the potential acquisition, but research to ensure they've explored other businesses on the market versus the kind of business they are looking for, what financing will be required to complete a sale, and an analysis of how the business will integrate with the buyer's other assets.

For each available option, a buyer's team of advisors can assist with evaluating the advantages and disadvantages.

Buyer's Prep List

Here is a list of issues to consider when contemplating the purchase of a business:

- **What are you buying? Assets or shares?** To take advantage of capital gains treatment and exemptions, if available, a seller will usually want to sell the shares of the business. If a buyer is buying shares, they need to understand that they are assuming the liabilities of the business, including existing contracts and employees as well as the corporate history. To minimize the risk, a buyer will need to focus on actual or potential liabilities as part of its due diligence. If a buyer is buying assets, they need to determine which assets they need to run the business successfully.
- **Who is the buyer?** A buyer needs to determine the best way to structure the purchase. Should this business be merged with an existing business? Will it be a subsidiary of an existing company or a completely separate entity? Consultation with a team of advisors will help answer this question.
- **Financing:** A buyer must consider how he or she intends to finance the purchase. Is he or she purchasing it alone or with other investors? If the buyer intends to obtain traditional bank financing, he should discuss this aspect with his financial advisors well in advance. A buyer will also need to determine how he will finance the operations of the business. Will he be funding the operations directly or will he require access to an operating line of credit?
- **Promise of exclusivity:** A buyer's due diligence is one of the most important steps in the process of buying a business. Completing due diligence on a prospective company, takes time and money. To protect this investment, a buyer should ask the seller for a promise that the seller will deal exclusively with the buyer for a certain period of time. This needs to be agreed at the outset.
- **Due diligence:** Buying a business involves risk. The goal of a buyer's due diligence is to determine the extent of the risks involved and to decide whether to accept those risks and proceed with the purchase. Certain risks can be minimized by the seller's representations and warranties in the Agreement of Purchase and Sale. A buyer's team of advisors can help him understand and, where possible, minimize the risks involved.
- **Employees:** Employees are a key part of any business. A change of ownership can cause the seller's employees unease and uncertainty. After the acquisition, key employees may be a necessary and valuable resource for the buyer. It is important for buyers to put a plan in place to deal with this transition and to be aware that the relationship between the buyer and the seller's employees may or may not be successful.

  It is also possible, that the buyer does not want to employ some or all of the seller's employees. If this is the case, this will need to be negotiated with the seller. Employee terminations can be costly, especially for long-term employees, and the seller will want the buyer to be responsible for these costs.

- **Non-competition and non-solicitation:** Buyer's should discuss the future plans of the seller to ensure that the seller and its principals are restricted from competing with the business or soliciting employees or customers or the business after the sale. These restrictions can be included in the Agreement of Purchase and Sale.

Be Prepared to Walk Away

If a buyer's due diligence reveals serious problems with the target business or risks that the buyer is unwilling to assume or if the seller is less than trustworthy, a buyer should be prepared to walk away from the deal. Because due diligence can be a lengthy and expensive process, it can be tempting to push forward because of the time and money already spent. Keep a clear head. Consult with your advisors and if you don't feel comfortable proceeding, don't move forward.

STAGES OF A DEAL

Once the seller has readied his business for sale and the buyer has selected it, the next step is proceeding with the deal. The initial structure, price, terms of payment and other key conditions are usually summarized in a letter of intent. The letter of intent is normally prepared by the buyer. It is typically non-binding except for clauses which deal with deposits, confidentiality and exclusivity.

After the letter of intent is signed, the buyer's due diligence begins. A well-organized seller will have prepared a package of key documents to deliver to the buyer. The buyer's due diligence will cover operational, financial and legal aspects. On the legal side, searches and inquires will be made with relevant public offices and key documents will be reviewed.

The due diligence findings will be reflected in the purchase agreements and other documents. However, this sometimes leads to a tension between addressing problems revealed by due diligence and staying faithful to the framework laid out in the letter of intent.

If there are conditions for completing the deal, such as obtaining a landlord's consent to assign leases, then it will be appropriate to have an interim period between the signing of the agreement and the deal becoming firm and unconditional.

Bear in mind that third parties, like landlords, often have little interest in the deal and can slow the process.

After the agreement is signed and completed with the amount due on closing being paid, there may be adjustments to the price or a deferred payment. The seller may agree to stay and help as a consultant but usually those arrangements do not last long. The seller's involvement may be critical if much of the value of the business depends on personal relationships. It is often hard for a business owner to work for someone else.

> *We have distributed construction and materials handling equipment for road and construction work in Canada since we purchased an existing Canadian company. Houser Henry & Syron LLP, who came highly recommended to us, helped us to successfully complete the purchase. We have worked closely with the firm ever since. Two members of the firm currently sit on the board of our Canadian subsidiary.*
>
> *— John Patterson, President, JCB Inc., Savannah, Georgia, USA*

Smoothing the Way to Closing

To ensure a smooth closing and to save money on legal fees, buyers and sellers should:

- Stay focused on what they want from the deal;
- Keep communicating—don't leave it all to advisors;
- Address key issues at any early stage;
- Get financing ready at an early stage; and
- Deal promptly with conditions and third parties.

HOW WE CAN HELP

The key to a successful purchase or sale is to start the planning process early, even if there are no current plans in place for either. Regular maintenance of company records and operations can ensure the business is in a strong position for whatever future plans are implemented.

> *Start the planning process early. Make sure you have a clear idea of what you want to gain from the purchase or sale. Get organized, be prepared and consult trusted advisors to help you reach your goals.*

To Sellers: Many of the issues that arise in the due diligence process are long-standing ones (e.g. lack of a management team, dependence on a supplier or customer). As part of ongoing business improvement, such weaknesses should be addressed regardless of a potential business sale.

To Buyers: Be careful in the selection and evaluation process, and test every assumption before proceeding with a business purchase. Most importantly, have a clear answer to the question: "what would I do with this business?"

Both parties should invest in a trusted advisory team to work with them through the process, to a successful completion of the deal.

ABOUT HOUSER HENRY & SYRON LLP

Your business grows. You expand into new markets, hire new people, move into larger facilities, launch new products or services – and face new legal issues and challenges.

Since 1934, Houser Henry & Syron LLP has provided legal services to private businesses, helping them deal with the complexity that comes with growth and success. We understand the needs of mid-sized businesses and their owners and managers and we have the breadth of expertise and the depth of experience necessary to meet those needs.

We offer this booklet as a handy reference and as an overview of some of the questions you may face when operating a retail business in Ontario.

For more information, please contact one of the lawyers with our firm. You may also wish to visit our website, www.houserhenry.com, for an overview of our team and our services.

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