

Mergers and Acquisitions

March 2008

Purchasing a Business: The Legal Issues

Looking to buy a business? Here are a few things to consider. First of all, learn everything you can about the business you are looking to buy. By fully understanding the nature and operations of the business, you will be better able to determine what you are willing to pay for it.

Once you have a good sense of the nature and operations of the business, the first issue that you will have to consider is whether you should buy the assets of the business or the shares of the corporation (if incorporated) that runs the business. Each of these approaches has certain advantages and disadvantages for the buyer:

Asset Purchase

Advantages for the buyer include:

- the ability to pick and choose which assets you wish to purchase
- the ability to pick and choose which leases, contracts and other liabilities that you are willing to assume
- the ability to decide which employees you wish to retain and which employees you do not wish to retain
- the avoidance of lawsuits (the buyer will not be subject to any lawsuit against the corporation running the business)
- not being responsible for the corporation's unpaid taxes or other statutory withholdings (such as employee remittances)

Disadvantages for the buyer include:

- a more complicated legal transaction
- the need to obtain third party consents to transfer certain assets
- the purchase of certain assets will be subject to the payment of PST; and possibility of some disruption in business operations

Share Purchase

Advantages for the buyer include:

- a less complicated legal transaction
- the purchase of shares is not subject to PST
- minimal disruption in business operations
- possible use of tax losses of the purchased corporation

Disadvantages for the buyer include:

- being subject to all of the liabilities of the business (both known and unknown);
- being required to take on all contracts and performance obligations of the business;
- being subject to all lawsuits of the business

Typically, a buyer prefers to purchase assets to limit its possible liabilities while the seller prefers a share purchase in order to capitalize on a variety of tax savings. Sometimes, however, a seller may be willing to lower the purchase price because of the favourable tax treatment it receives when selling shares.

The Letter of Intent

Once you have decided whether to purchase shares or assets, often the next step is to have your lawyer prepare an agreement called a letter of intent. A letter of intent is a relatively straightforward document that may be signed by the buyer and the seller setting out the fundamental terms of the transaction. These will include the type of purchase (shares or assets), a list of assets to be purchased and liabilities to be assumed (if it is an asset purchase), the purchase price (or formula to determine the purchase price), an approximate closing date and certain conditions of closing. The letter of intent will typically contain confidentiality provisions and rights of inspection of the physical assets of the business as well as the books and records, including the financial records, of the business. The letter of intent may even give the buyer permission to enter into discussions with key employees and suppliers. In addition, the letter of intent will usually also provide that the seller will not attempt to sell the business to anyone other than the buyer for a fixed period of time. If you wish to ensure that the seller will deal exclusively with you and will not try to sell the business to someone else, you should try to

enter into a letter of intent with the seller at the earliest possible opportunity.

There are two different types of letters of intent, binding and non-binding. A non-binding letter of intent does not obligate the parties to complete the purchase while a binding letter of intent will provide that the parties are obligated to complete the purchase once certain conditions have been met and final documentation agreed upon. If the letter of intent is non-binding, it can be a simply worded expression of your interest to buy the business after you have examined it more closely. If it is binding, the parties will have to specify in greater detail each of the fundamental terms and conditions which are to be reflected in the definitive purchase agreement. Your lawyer will help you determine whether the letter of intent should be binding or non-binding.

Generally, after a letter of intent has been signed, the buyer will engage in a more detailed review of the operations of the business. This process is called due diligence. Once the due diligence has been completed, if you are still willing to proceed with the transaction, your lawyer will then prepare a detailed share purchase agreement or asset purchase agreement.

Getting What You Pay For

Irrespective of whether you chose to purchase shares or assets, the share purchase agreement or the asset purchase agreement will include various representations and warranties (basically statements of fact which the buyer can rely on) from the seller about the operations and condition of the business. The purchase agreement is a much lengthier document than the letter of intent and is used to ensure that you get what you are paying for. That includes assets free and clear of all third party claims (unless specifically agreed to), or all of the shares of the corporation that operates the business. The seller will be required to represent and warrant that the corporation actually owns the various assets to be purchased or that the shares to be purchased have been properly issued and are owned by the seller free and clear of all third party claims. The representations and warranties contained in the

purchase agreement may also help elicit further information about the business which may not have been initially disclosed by the seller.

The purchase agreement will also contain important conditions of closing, such as:

- obtaining proper releases from the seller and from applicable third parties
- ensuring the purchased shares are properly transferred
- obtaining the proper assignment of leases and agreements in an asset purchase
- obtaining numerous other required closing documents

Your lawyer will also help ensure that the buyer complies with all statutes that apply to the transaction. In either type of acquisition, several statutory requirements may apply to the transaction. For example, all share purchases will be subject to compliance with the provisions of the *Securities Act* (Ontario), while asset purchases will be subject to the provisions of the *Bulk Sales Act* (Ontario) and the *Retail Sales Tax Act* (Ontario). Both share purchases and asset purchases may be subject to the provisions of the *Investment Canada Act* and the *Competition Act* (Canada). Application of these statutes will depend upon the size and nature of the transaction and the residency of the buyer.

Both types of transactions will also be subject to the provisions of the *Income Tax Act* (Canada). Proper structuring of the transaction with advice from your lawyer and accountant may help minimize the applicable taxes for both the buyer and the seller.

Employees of the Business

What happens to the employees of the business that you purchase? In the case of a share purchase, the corporation that you are purchasing will continue to employ all of the employees after the closing of the transaction. If you want to terminate the employment of any of the employees, you will likely have to do so after the transaction has been completed and the corporation will be required to provide notice of termination or payment in lieu of notice. In the case of an asset purchase, you will have the ability to retain

certain employees and to require the seller to terminate others. Your lawyer should be involved to ensure the employees that you do not wish to retain are properly terminated by the seller prior to closing the transaction, and that adequate provisions are put in place to ensure that you are not liable for termination payments or any other obligations relating to any terminated employees.

Searches and Consents

Your lawyer will typically perform a variety of searches against the corporation running the business and perhaps the individual who owns the corporation. Searches under the *Personal Property Security Act* (Ontario) are standard as are searches relating to bankruptcy and law suits. Other searches may also be performed. Your lawyer may also be of assistance in determining what operating licenses should be held by the business being purchased, and assisting in their transfer to the buyer, or in the application for new licenses if they are non-transferrable.

When purchasing shares, your lawyer should review the minute book of the target corporation to ensure that the seller is registered as the proper owner of shares to be purchased, and to ensure that such shares have been properly issued to the seller or transferred to the seller. Additionally, minute book reviews often reveal interesting information about a business leading to further questions for the seller about the business operations.

In conjunction with an asset purchase, several third party consents may be required from landlords, equipment lessors, customers and suppliers. Ensuring that such assignments are properly documented can be the key to a successful asset purchase.

Non-Competition

As the buyer of a business, you may wish to ensure that the seller or the principal of the seller does not subsequently engage in a competing business or solicit customers or employees of the business. Non-competition, non-solicitation and non-disclosure issues should be discussed.

Such discussions should resolve around what is desired, what is required, what is reasonable in the circumstances, and what will be legally enforceable.

Other Documentation

While the share purchase agreement or the asset purchase agreement will be the fundamental agreement that defines the transaction, many supporting documents will also be required. Various other transfer and assignment documents, resignations, releases, legal opinions from the seller's lawyer, statutory filings, minute book cleanup documents, a bill of sale, or other documents may be required in conjunction with either type of transaction. The buyer's lawyer and the seller's lawyer will prepare and negotiate these documents to ensure that the purchase assets or purchased shares are properly transferred to the buyer and that all statutory hurdles have been cleared.

What About Financing?

Your lawyer can be of assistance with respect to your financing requirements. Your lawyer may be used to prepare the required documents or, if they have been prepared by a lender, to ensure that the documents reflect your understanding with respect to security, interest rates, financial covenants, etc. Your lawyer will also ensure that your obligation to complete the purchase transaction is conditional on financing, if required. Your lawyer may be required to provide the lender with legal opinions as to the proper authorization and execution of all financing documentation.

Legal Costs and Timing

Typically, the purchase of a business will not be completed in less than 6 - 8 weeks. While very simple transactions may be completed in 3 - 4 weeks, complex transactions may take 2 to 3 months or more from initial discussions with the seller to final closing.

Legal costs will depend on the complexity of the transaction and the amount of work required to negotiate and prepare all of the required closing documents.

Thinking of buying assets from an insolvent business

There are a number of differences to buying a solvent business, including:

- *typically lower purchase price, possibly at near liquidation value*
- *more potential complications involved in structuring a deal with a trustee in bankruptcy, a court appointed receiver or privately appointed receiver, instead of with the business owner*
- *increased risk due to the lack of usual representations and warranties*
- *purchase may require court approval, or the approval of a trustee in bankruptcy acting in best interests of secured creditors*
- *you may need to apply to court for a vesting order to obtain clear title to the purchased assets*

Thinking of buying part of a business

This situation raises many unique issues, including:

- *is control of day-to-day operations important to you, and are you willing to buy enough of the company to obtain control?*
- *will you be able to obtain the remaining shares if you want them? If so, at what cost?*
- *will the seller be able to force you to purchase the remaining shares? If so, at what cost?*
- *a shareholders' agreement should be signed at closing setting forth the rights and responsibilities of the buyer and seller after closing*

Pallett Valo LLP Business Law Group

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Rev.03/08