

Mergers and Acquisitions

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Selling a Business: The Legal Issues

Thinking of selling your business? Beyond determining the selling price you are willing to accept, there are quite a few legal issues that need to be considered.

The first issue that you will have to consider is whether you should sell the assets of the business (both tangible and intangible) or the shares of the corporation (if incorporated) that runs the business. For the purposes of this newsletter, we will assume that the business is incorporated. Each of these approaches has certain advantages and disadvantages for the seller:

Share Sale

Advantages for the seller include:

- the ability to possibly use capital gains exemptions to reduce taxes payable on the purchase price received
- favourable tax treatment (as a capital gain) even beyond the capital gains exemption
- not retaining any liabilities of the business, including liabilities in connection with the possible termination of employees
- a less complicated legal transaction

Disadvantages for the seller include:

- the inability to retain any existing losses of the corporation
- the inability to retain certain assets, unless transferred out of the corporation prior to closing

Asset Sale

Advantages for the seller include:

- the ability to retain certain assets which the seller does not wish to include as part of the sale
- possibly using certain losses in the corporation to offset the income arising on the sale of the assets
- a more favourable structure if selling one division of a corporation while retaining another

Disadvantages for the seller include:

- any liabilities of the business not specifically assumed by the buyer will remain the responsibility of the seller
- having to obtain third party consents to transfer certain assets to the buyer

- possibly being left with unwanted assets which may be hard to dispose of when not selling the business as a complete package (such as obsolete inventory or equipment, or aged accounts receivable)
- possibly having to terminate employees that the buyer does not want to retain, and being obligated to pay them in lieu of giving them notice of termination
- at least some part of sale proceeds will be treated as ordinary income, rather than as a capital gain subject to lower tax inclusion
- a more complicated legal transaction

Typically, you will want to sell shares in order to take advantage of the capital gains exemption, while a buyer will prefer to buy assets to limit its possible liabilities. On some occasions a buyer will only wish to proceed with the transaction if it can purchase assets. In such instance, you may be able to insist upon a higher purchase price to make up for the lost tax savings on an asset sale. Similarly, if you insist upon a share sale, you may be able to offer a slightly lower sale price to make the deal more attractive to a potential buyer while still ending up with more after tax money than if you had completed an asset sale.

Getting your business ready for sale

If you are thinking of selling your business, one of the things you should do is to think about what the business will look like to a potential buyer. Is your corporate house in order? You may need to:

- bring the minute book of the company up to date
- ensure legal agreements with suppliers, customers, landlord, employees, agents, licensees, etc. are all in writing and duly executed
- clean up the balance sheet (such as cleaning up receivables, selling off obsolete or excess inventory)
- not take on extra staff, buy expensive furniture or art or other unnecessary or non-core items

The Letter of Intent

Once you have agreed with the buyer as to whether assets or shares are to be sold, your lawyer or the buyer's lawyer will often prepare an agreement called a "letter of intent". A letter of intent is a relatively straightforward document setting out the fundamental terms of the transaction. These will include the type of purchase (shares or assets), an approximate list of assets or types of assets to be purchased and liabilities to be assumed (in the case of an asset purchase), the purchase price (or a 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 confidentiality provisions are included to ensure that the buyer does not make improper use of the information about the business if the purchase and sale transaction is not completed. The buyer may ask that the letter of intent include permission to enter into discussions with key employees and suppliers prior to closing. In addition, the buyer will typically require that the letter of intent include provisions restricting your ability to sell the business to anyone other than the buyer for a fixed period of time.

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 set out in the letter of intent have been met and final documentation agreed upon. If the letter of intent is non-binding, it can be a simply worded expression of the buyer's interest to buy the business after it has 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.

Generally, after a letter of intent has been signed, the buyer will engage in a more detailed review of the business, reviewing its financial statements, operations and contracts to ensure it wishes to purchase the business. This process is

called due diligence. Often during this process, the buyer will instruct its counsel to begin preparing a detailed share purchase agreement or asset purchase agreement to reflect the terms and conditions of the transaction.

Fundamental Terms of the Share Purchase Agreement or Asset Purchase Agreement

Regardless of whether you and the buyer agree to the sale of shares or assets, the parties will enter into a more extensive purchase agreement (either a share purchase agreement or an asset purchase agreement) which will contain all of the terms and conditions of the transaction. In such agreement, the buyer will require the seller (and perhaps its principals) to give various representations and warranties about the operations of the business that you are selling. These are statements of fact as to the status or condition of certain items, such as the inventory, equipment, customers, suppliers, employees, contracts, leases, financial statements, taxes and any law suits of the business. The buyer will also want to know that the assets that you are selling are free and clear of all third party claims (unless specifically agreed to by the buyer), or that you actually own properly issued shares of the corporation that operates the business, again free and clear of third party claims. Your lawyer will review the representations and warranties with you to ensure that they are accurate and to ensure that they are reasonable in scope. Your lawyer should also discuss with you the length of time which the representations and warranties are to remain outstanding after closing as possible liabilities of the seller.

The purchase agreement will also contain important conditions of closing from the seller's perspective, such as:

- obtaining proper releases from the corporation of the selling shareholders in a share sale
- obtaining proper releases from other parties such as equipment lessors, lenders, landlords and anyone else to whom the corporation or its principals (in an asset sale) or the selling shareholder (in a share sale) provided a guarantee of the obligations of the corporation

The purchase agreement will also contain important conditions of closing from the buyer's perspective, 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 legal opinions from the seller's lawyer with respect to various matters

Statutory Requirements

Your lawyer will also help ensure that you comply with all statutes that apply to the transaction. In either type of acquisition, several statutory requirements will apply to the transaction. For example, asset sales will be subject to the provisions of the *Bulk Sales Act* (Ontario) (unless waived by the buyer) and the *Retail Sales Tax Act* (Ontario). Both share sales and asset sales may also require compliance with the provisions of the *Investment Canada Act* or the *Competition Act* (Canada) depending 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 seller and the buyer.

Employees of the Business

What happens to your employees when you sell your business? In the case of a share sale, the corporation that you are selling will continue to employ all of the employees after the closing of the transaction. The buyer will inherit all of the employees of the business as the ownership of the shares of the corporation is the only thing that is changing. In the case of an asset sale, however, the buyer may advise you that it does not want to take on all of the employees of the business and may leave you to terminate the employment of those employees who will not be employed by the buyer after closing. If that happens, the corporation will be required to provide notice of termination to such employees or payment in lieu of notice. The purchase agreement should be carefully worded to ensure that the buyer is liable

for all obligations relating to the employees post closing (including any costs relating to the termination of the employees by the buyer post closing) and that you will in no way be liable for any of their actions post closing.

Searches and Consents

The buyer's lawyer will typically perform a variety of searches against your corporation and against you personally in the case of a share sale. Searches under the *Personal Property Security Act* (Ontario) to see if there are any liens registered against the seller's or the corporation's assets are standard as are searches relating to bankruptcy and law suits. Other searches may also be performed, such as searches under the *Bank Act* (Canada) and WSIB searches. In an asset sale, the buyer will also require a certificate under the *Retail Sales Tax Act* (Ontario) showing that the corporation is up to date in its payment of such taxes.

When selling shares, the buyer's lawyer will also likely ask to inspect the minute book of the corporation to ensure that it is up to date, that you are registered as the proper owner of the shares to be sold, and that such shares have been properly issued to you or transferred to you. As a result, if you are contemplating selling your business, you should ensure that your minute book is brought up to date.

When selling assets, third party consents may be required from landlords, equipment lessors, customers and suppliers. Ensuring that such business relationships are properly documented in writing prior to the buyer conducting its due diligence can be the key to a successful asset sale.

Non-Competition

In connection with the sale of your business, the buyer may wish to ensure that you do not, directly or indirectly, compete with the business being sold to the buyer. Non-competition, non-solicitation and non-disclosure issues will likely be discussed. Your lawyer should advise you as to what provisions are reasonable and what is enforceable in the circumstances.

Other Documentation

While the share purchase agreement or the asset purchase agreement will be the fundamental agreement that governs the transaction, many supporting documents will also be required. Various other transfer and assignment documents, resignations, releases, legal opinions, statutory filings, and other documents may be required in conjunction with either type of transaction. Your lawyer and the buyer's lawyer will prepare and negotiate these documents to ensure that the assets or shares being sold are properly transferred to the buyer and that all statutory hurdles have been cleared.

What if the Buyer Wants to Pay Over Time?

Sometimes a buyer may not have the money or the inclination to pay the whole purchase price at the time of closing the transaction. If you still want to complete the deal, you will want to ensure that you have proper documentation evidencing and securing the unpaid portion of the purchase price. Your lawyer will prepare a promissory note to evidence the amount of the purchase price remaining to be paid by the buyer. Your lawyer should also discuss with you what type of security would be best to secure the payment

of the amount owing under the promissory note. A pledge of the purchased shares may be sufficient in the case of a share purchase, but simply getting your shares back may not be sufficient if the buyer has run the business into the ground. The seller will often take security over the assets of the business, perhaps backed up by a personal guarantee of the principal of the buyer or of a related corporation. Other methods of taking security, including letters of credit, may also be used. Other methods of payment, such as an earn out or other type of residual profit sharing are also common.

Legal Costs and Timing

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

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Pallett Valo LLP Business Law Group

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