

Seller due diligence: Are you ready for buyers' questions?

By *Ted Maduri*

When buyers consider purchasing your house, a key part of the process is a home inspection. In much the same way, when a buyer is preparing to purchase your business, they perform a version of home inspection – a process which includes, but is not limited to, reviewing all your corporate records and contracts and carrying out on-site visits to inspect key assets. To ensure you pass the “home inspection” with flying colors, you should conduct seller-side due diligence. This means collecting all of the information in which potential buyers would likely be interested, going through it to make sure it is complete and accurate, and presenting it in the way that is most favourable to your business.

In a separate article, we explored some of the steps that an owner-manager must take to get the business ready to sell. In this installment, we review one of the most important steps in this process, seller-side due diligence and discuss specific areas of concern.

1. General corporate documents

While it is always a good idea to keep your books and records timely, when preparing for a deal, have your lawyer go through your books and records to confirm they are complete, accurate and up to date.

2. Accounting records, taxes and financial statement

Have your accountant confirm that all your financial and accounting records are complete, accurate and up to date. Your company’s accountant should also confirm that all of the businesses’ tax returns (income and HST) have been filed, confirm that all tax remittances have been made and identify any tax assets (eg, loss carry-forwards) that you may need to consider when selling the business.

3. Material agreements

Buyers will want to see copies of all of the material agreements into which the company has entered. Material agreements may include:

- customer agreements
- supply agreements
- credit or loan agreements
- real property or equipment leases
- shareholders agreements
- employment agreements for key employees
- collective agreements (if unionized)
- government licenses/permits and authorizations that are necessary to run the business and
- any other agreements that create current or contingent rights or obligations for the company.

Having a good document management and retention system in place prior to selling the business can make it much easier to compile and deliver copies of material agreements to prospective buyers. Are there any business arrangements which are

incomplete or undocumented? If so, it would be advisable to get them updated or in writing so that there is no ambiguity about the fact that they exist and the specific terms of the business's rights and obligations under them.

In addition, material agreements should be reviewed in advance to see whether there are any change of control provisions (if you intend to sell the shares in your company) or assignment provisions (if you plan to sell just the assets) that may be triggered by the sale. For example, if there is a major agreement with a customer that makes up 30 percent of the revenue of your business, and the agreement states that it will terminate automatically if the company is sold, you need to know this in advance so that you can take steps either to remove this provision of the agreement or otherwise be able to demonstrate to a potential buyer that it will not lose an important customer if it buys your business. This is why it is important, if at all possible, to avoid having such provisions in the contracts you negotiate in the first place or to work hard to avoid client/customer concentration issues.

4. Intellectual property

For some businesses, the most valuable asset they have is their intellectual property. You should confirm that all of your trademarks, patents, copyrights and business names are all duly registered and protected. Have you had any intellectual property developed by contractors? Does the business use any software which has been improperly obtained? If so, now is the time to confirm you have proper assignments from your contractors and to obtain legitimate copies of software. See our articles regarding intellectual property [here].

5. Labor and employment/human resources

The issue of whether employees (both staff and management) will be kept on after a sale is often key for buyers and sellers alike. Staff and management may be more important to a financial buyer as, unlike an industry or strategic buyer, a financial buyer will not have the ability to run the business itself after the acquisition without keeping all or most of the existing management team in place. If employees are not being retained, a key aspect of the negotiations may be to determine who will be responsible for notice and severance. You will need to ensure that the proper amount of notice (or pay in lieu of notice) is given to departing employees in accordance with applicable law. If the employees are unionized, you will need to make sure that any necessary consultations with the union are undertaken in a timely manner. Applicable legislation and/or the collective agreement may require that any negotiations with potential buyers are disclosed to the union at an early stage. Generally speaking, the buyer of a union operation will step into the shoes of the seller for all purposes with the union.

6. Real property

Does your company own real property and, if so, can you deliver clean title to the real property that you are selling? A real estate lawyer can help determine what is registered on title to your property and whether any such registrations will make it harder for you to convey the property to a buyer. It is therefore important to conduct proper due diligence on each piece of property that you buy before the purchase is complete. Once a sale is imminent, you may want to begin discussions with a title insurance company. Many buyers expect title insurance policies, which protect sellers against certain defects in title, to be put in place as a condition of sale of real property. In other jurisdictions, a thorough land title search of the real properties owned by the business may be useful. Are real property leases properly documented and in good standing? For example, do you have copies of lease agreements and renewals? Leases generally constitute material contracts of the business so they should be reviewed carefully to see whether the landlord needs to consent to a change of control of the company or any assignment of the lease as a consequence of the sale. You should attempt to have such restrictions removed or at least conditioned when you first negotiate the lease, although landlords tend to be particularly insistent that such restrictions be included.

7. Licences/permits/environmental

Consider which licences and permits you need to operate your business. Are these in good standing? Can these be assumed

by a new owner of the business or are they subject to restrictions or termination in the event of a change of control or assignment? If your business depends on its permits, you should ensure that you have adequate processes in place to ensure that your business remains compliant with the requirements of those permits.

If you operate an environmentally sensitive business, consider putting a more general environmental compliance plan in place that ensures that you comply with permits and environmental law overall and that creates a record of compliance that could be shown to a prospective buyer. When a sale looks possible, if your company has not recently undergone an environmental assessment, you may want to consider having a Phase I environmental assessment (EA) done prior to starting the sale process. The Phase I EA will help you become aware of any environmental issues, particularly ones that might constitute a “deal breaker” or have a material effect on the purchase price. Note however, savvy buyers may request copies of any such assessment, meaning that you will likely have to disclose both the good and bad news revealed by the assessment.

8. Disputes and litigation

If the business is involved in litigation, a potential buyer will want to get an idea of the amount of the claim(s) and the likely outcome of the lawsuit(s). Also consider threatened litigation or whether there is anything else that could come back to haunt you, such as a disgruntled former employee. If you think there is anything which may fall into this category, you should discuss with your lawyers whether, how and when to disclose such information and, perhaps more importantly, whether you can take any steps to resolve the issue prior to putting the business up for sale or at least prior to closing.

Conclusion

Prior to allowing buyers to review and investigate your business, you should conduct your own due diligence. Conducting seller-side due diligence should begin even before a transaction is contemplated. Getting into the rights habits *ie*, reviewing material contracts for change of control provisions will save you time and money down the road. Remember: presenting your business in the most favorable manner can help position your company to negotiate for the optimal purchase price.

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