BUYING & SELLING A BUSINESS

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INTRODUCTION

Buying or selling a business is a complex affair. There are many aspects to consider, the structure of the deal, financing, and your contractual obligations. Successfully navigating all this complexity requires good business sense, strategy, and ongoing guidance from trusted experts. At EKB, we have over fifty years of experience helping our clients to obtain favourable outcomes in their transactions. Whether you're looking to purchase a promising business or aiming for a successful exit, we're here to help.

Every transaction is unique, but there are some common pitfalls to avoid, just as there are strategies that are proven to work. EKB is committed to helping businesses succeed, which is why we've put together *Buying & Selling a Business* to help guide you forward.

BUILDING A TEAM

People looking to buy or sell a business are talented and skilled business operators – or at least aspire to be! What they usually do not have, however, is a wealth of experience actually going through the process of buying or selling a business. For this reason, it can be critical to assemble the right team of experienced advisors to help guide you through the process. Even if you are a veteran dealmaker with multiple successes under your belt, you will still want (and probably already have) a good team to act as a sounding board and to ease the administrative burden of managing all of the details that go into deal, freeing you up to focus on big picture items.

Roles to Fill

Think of a deal team like a sports team. A good team has strong performers in every position – even some of the less glamorous spots. Another team might have a great starting quarterback, but lack the supporting role players – and be the weaker team because of it. When filling out your deal team, you will want to do an honest assessment of the roles that you can fulfill, roles that your existing team can handle, and roles where you will need to bring in professional advisors. Here are some of the key roles you will need to ensure are expertly staffed:

FOR BUYERS

Risk Management — Risk management is one of the buy team's central responsibilities. Buyers want to ensure that they are buying a business that is actually what the seller represents it to be and that it is free of hidden defects. If any skeletons in the closet do emerge after the deal is over, the buyer wants to know that they have recourse against the seller. Risk is managed through strong contractual provisions and by conducting a thorough look under the hood of the target business from a legal, accounting, tax and operational perspective in a process often called "due diligence".

Market Intelligence — Having a good sense of what is typical in similar deals – or what is "market" – can help a buyer frame its negotiating posture and structure the deal. This can be important both on deal price (e.g., what a similarly sized competitor recently sold for will be a good indicator of market price) and softer deal terms (e.g., the length of the seller's non-compete). Often this is an area where the advice of professional advisors – especially those that do deals for a living – will be helpful.

Negotiation — A deal almost always entails dozens if not hundreds of negotiations of varying sizes and importance. Buyers are often most interested in negotiating the lowest price and in creating enough optionality in the deal to give themselves multiple "outs" in case they decide not to close. Ultimately the buyer will want to make the final call on the give and take on key deal points and the related negotiating posture. However, there will be many smaller and idiosyncratic negotiations that are often best left, at least initially, to other members of your team – either to engage their specific expertise or to preserve your status (in the eyes of the seller) as final arbiter on critical issues. Again this is an area where professional advisors that have experience in negotiation can be helpful additions to your team.

Project Management — Even simple deals normally involve hundreds of pages of documentation and dozens of steps that need to be coordinated in sequence in order to be completed successfully. Bigger deals are only more complex. Someone on your team will need to be responsible for making sure all workstreams are progressing on schedule, that there are no last minute surprises, and that everything that needs to get done does, in fact, get done. While this may seem like a trite role, effective deal management is an acquired skill and can greatly reduce stress on the buyer and costs that result from delays.

FOR SELLERS

Deal Marketing — Getting the best price for your business is often a matter of finding the right buyer. Or rather, finding the right group of potential buyers that you can pit against each other in a bidding war. Sometimes your likely buyers will be obvious – perhaps your existing management team or a close competitor in your area. Other times, sellers are better served by marketing their business more broadly to financial buyers that are not direct competitors or to companies looking to expand into your market. Accessing a broad group of potential buyers, either through your own set of contacts or through a broker, can help drive the best price.

Negotiation — Negotiation points that sellers will be most interested in are usually maximizing the sale price, limiting liability for representations and warranties post-closing and eliminating uncertainty that the deal will not close. As with buyers, sellers are often best served by letting other team members stake out some of the preliminary negotiation points, saving their "deal capital" for key battles.

Project Management — While the buyer's team typically is in charge of tracking and updating most of the deal documents, the seller's team will be equally invested in ensuring the deal closes smoothly and on time. Good project management is key to ensuring this occurs.

Tax — As a seller, you are likely coming into a large amount of money. That is the good news. The bad news is that you may owe a large portion to the government in taxes. While it is usually difficult to avoid paying any taxes, you may be able to structure your affairs and the transaction in a way that minimizes or defers the amount of tax you will pay. This is a task that almost always requires professional assistance from a tax expert. Tax planning with a view to optimizing tax paid on a sale is best done well in advance and in conjunction with the seller's personal tax and estate planning.

Professional Advisors

As noted, buyers and sellers are likely to supplement their existing team with professional advisors. Here is a list of some of the different types of advisors you are likely to encounter on deal:

Legal Counsel — Transactions of any size need lawyers. They prepare and review the documents needed to affect the transfer of the business. They can also assist you in conducting due diligence and advise buyers of the legal risks associated with the purchase of the business. They are often, though not always, the chief negotiators and project managers for both the buyer and the seller. An experienced lawyer that has been through many business sales can become the center of gravity for your team – helping advise you of risks, developing negotiating strategy, and coordinating with other members of your team to ensure a successful closing.

Accountants — Just like they need lawyers, transactions need experienced accountants on both sides of the table. A good accountant can be especially useful to buyers. Making sure, through the due diligence process, that you understand the financial side of the business and how the seller is preparing its financial statements is critical.

Investment Banker/Broker — Sellers may consider hiring an investment banker or broker to help market their business. Sometimes this won't be necessary – you may have already found your best or only logical buyer. Other times, you will want to access the broader network that your investment banker can tap into to find the best buyer (and best price). Investment bankers can also provide strategic planning advice for sellers, such as when to go to market and how to best position your business relative to its competitors, and be valuable sources of market intelligence. Sometimes buyers will want to engage an investment banker as well for advice on deal structuring, as a source of market intelligence and as a potential source of financing.

Other Specialists — Depending on the unique nature of your deal, you may need specialized additional help. For instance, if you are buying a business with potential environmental liabilities, you will likely want to engage an environmental consultant to perform a site assessment. Or, if your transaction is highly tax driven and neither your existing counsel nor accountant is a tax expert, you will need to bring in a tax expert. Other types of specialists that may appear on transactions can include regulatory experts, PR consultants, real estate appraisers, insurance specialists, actuaries and many others.

Finding the right professional advisors to round out your team can be critical for achieving the best outcome in your deal. If you do not already have a good list of candidates for each role you need filled, you should get recommendations from trusted friends in your industry or from your existing advisors who will often know of other professionals with good standing in their fields. You may want to interview several professionals for each role, so that you can evaluate who brings the best skill set to your team and who you will be most comfortable working closely with throughout the life of the deal.

Letters of Intent

A letter of intent is not always a necessary step in negotiating a proposed transaction, but preparing and signing a letter of intent will often help the parties (and their advisors) focus on the key issues.

A letter of intent is helpful when:

- the parties to a proposed transaction have reached the point (usually relatively early in the discussions) when both will want to see something in writing that sets out the material business terms, both so that they can ensure that they are in general agreement concerning those terms and so that they can instruct their lawyers to begin putting together the actual binding agreement.
- the potential buyer wants the potential seller to agree not to sell the business to a third party for a specified period – from the buyer's standpoint, this "standstill" justifies incurring the costs associated with further negotiations and due diligence.
- the potential seller wants the potential buyer to put up a refundable deposit to demonstrate that it is serious about continuing the negotiations.

As the name suggests, a letter of intent is usually non-binding (although it may include clauses that the parties agree are binding e.g. a standstill provision or clauses that deal with a deposit and confidentiality provisions).

Aside from setting out the material business terms, the keys to a letter of intent are:

- the letter of intent states that the parties and their lawyers will negotiate a fully-binding agreement based on the terms – from a negotiating standpoint, it is always difficult to seek to change a material term between the time the letter of intent is signed and the time the binding agreement is finalized; for that reason it is often preferable to set out the material terms as broadly as possible e.g. if it is unclear at this early stage if the buyer will want to buy assets or shares then it is worth reflecting that uncertainty in the letter of intent.
- although a letter of intent commonly refers to the parties negotiating the binding agreement in good faith, it is critical that the letter of intent confirm that the parties have no obligation to reach a final, binding agreement. Even so, it is important to keep in mind that a court may find that a party which does not make a genuine effort to participate in the negotiations contemplated by the letter of intent has failed to act in good faith and is liable to compensate the other party for the costs it incurred (or any losses it can demonstrate it suffered e.g. as a result of a standstill provision contained in the letter of intent).

Although a letter of intent is often written in a deliberately non-threatening and informal manner, it is still a critical document and should be prepared with the help of a lawyer.

Non-Disclosure Agreements

Every potential business transaction involves confidential information that at least one party does not want to provide to the other party unless it can be confident that the recipient:

- will not disclose the information to anyone else.
- will not use the information for any purpose other than to bring the proposed transaction to fruition.

These basic confidentiality provisions can be included as binding clauses in an otherwise non-binding letter of intent. However, if the proposed transaction is not at the point where a letter of intent is appropriate, or if (as is often the case), confidential information will be disclosed very early in the discussions, then a separate non-disclosure agreement is appropriate.

The key terms in a non-disclosure agreement include:

- defining what information constitutes "confidential information" – from the disclosing party's standpoint, this should be as broad as possible (and it should specifically include any analyses prepared by the recipient based on disclosed information); from the recipient's standpoint, it is preferable, if possible, to narrow the scope to limit inadvertent disclosure e.g. by including a provision that verbal disclosure is only treated as confidential information if the disclosing party confirms in writing after a meeting at which the verbal disclosure was made that it is to be treated as confidential information.
- confirmation that the recipient can disclose the other party's confidential information to its advisors and to persons who need to know the information to permit it to be assessed by the recipient as part of negotiating the proposed transaction.
- confirmation that entering into the agreement does not obligate either party to reach an agreement on the proposed transaction or even to continue the discussions.
- confirmation that the recipient is obtaining no rights to the disclosed information and that it will immediately return (or destroy, in the case of analyses prepared by the recipient) all disclosed information on the demand of the disclosing party.
- making no representations concerning the completeness or correctness of the disclosed information – these representations should be sought by the recipient in the transaction agreement.

It is common for the recipient to acknowledge that the disclosing party will be irreparably harmed if the recipient breaches its obligations under the non-disclosure agreement and that the disclosing party is entitled to an injunction to halt any unauthorized disclosure or use.

It can become a contentious issue if the recipient wishes to impose a time limit on its obligations to keep the disclosed information confidential and not to use it for any other purpose. This is often an issue with large organizations, which are unwilling for logistical reasons to agree to a permanent restriction. From a disclosing party's perspective, there would have to be a compelling reason to allow a party (and potentially a competitor) to use the disclosed information if the proposed transaction does not complete.

DUE DILIGENCE

Due diligence is the comprehensive evaluation of a business performed by a buyer in preparation for a potential purchase.

A buyer performing due diligence is looking to establish the assets and liabilities of the target business and to evaluate the business' commercial potential. This process helps the buyer determine the value of a business so it can decide whether to proceed with a purchase, what the appropriate purchase price should be and how it wants to structure the deal.

Types of Due Diligence

Due diligence covers a broad range of enquiries and encompasses a wide variety of issues. The types of due diligence a buyer will perform (or a seller will permit) depend on the nature of the transaction, but examples of the different types of due diligence and what they may entail are:

Legal Due Diligence — Reviewing material contacts, identifying regulatory approvals and conducting searches to identify liabilities.

Financial Due Diligence — Reviewing financial statements, accounting records and policies.

Tax Due Diligence — Reviewing tax returns, tax assessments and reassessments.

Business Due Diligence — Reviewing business plans and lists of customers, suppliers and competitors.

Operational Due Diligence — Reviewing the assets used in the business and the business' insurance policies and coverage.

Human Resources Due Diligence — Reviewing employee policies, operational charts and collective bargaining arrangements.

Environmental Due Diligence — Reviewing environmental assessments and conducting inspections.

Advisors can assist both buyers and sellers with managing the due diligence process and can help identify the type of enquiries that should be made as well as evaluate the results of those enquiries.

Scope of Due Diligence

As with the type of due diligence, the scope of the due diligence performed in connection with the acquisition of a business will vary depending on a number of factors.

Some factors that impact the scope of due diligence in the purchase of a business are:

Buyer's Knowledge — Who the buyer is and its level of knowledge of the business and the industry will dictate the level of due diligence required. In the case of a management buyout, the buyer may be familiar with what assets and liabilities the target business has and will not need to conduct much due diligence, while a financial buyer unfamiliar with the business will want to conduct extensive due diligence to see if the business will be a good investment.

Business Type — The type of business being acquired may impact how much due diligence needs to be done to evaluate the assets and its liabilities.

Seller Disclosure — The seller's willingness and ability to easily disclose information about the business will affect the amount of digging the buyer has to do.

Cost — The size of the purchase price and the buyer's budget may set a low threshold for funds that can be put towards due diligence.

Timing — Parties looking to close a transaction quickly may not leave time for much due diligence.

Often the last two factors, timing and cost, will have the largest effect on the amount of due diligence conducted in connection with the purchase and sale of a business.

The size of the purchase price will often limit what a buyer can justify spending in order to get a comprehensive understanding of the assets and liabilities of a business. In other cases, a buyer may want to move quickly to acquire a business because of an attractive price or acquisition opportunity and there may not be time to conduct much due diligence.

In some cases one party will have the leverage to dictate the amount of due diligence performed in a transaction, but most often the type and scope of the due diligence is something negotiated and agreed to by the parties at the outset. Buyers and sellers should discuss the subject of due diligence early on, so both parties are aware of what will be involved and the cost and the timeline of the process.

Effects of Due Diligence

Given that the ultimate goal of due diligence is to evaluate the commercial value and potential of a business, the most basic effect the process can have is helping a buyer decide whether or not to purchase a business.

In addition to helping a buyer decide whether or not to go forward with the purchase of a business, evaluating the assets and liabilities of that business can have other effects on the transaction, such as:

- informing how the parties structure the terms of their deal.
- identifying potential risks and liabilities to be addressed in a purchase agreement with representations, warranties and indemnities.

Due diligence can also help a buyer better understand the industry it is moving into, so it can successfully run the business post-closing.

Considerations for Buyers and Sellers

There are numerous issues and considerations that both buyers and sellers should be alive to during the due diligence process, but a few points to keep in mind are:

- sellers marketing their businesses should consider what information potential buyers will be looking for in the due diligence process. Gathering this information early so it can be easily provided to would-be buyers can decrease the time and cost of the due diligence process. A seller should consider conducting an examination of their operations prior to offering the business for sale. This can alert the seller to problems and issues that will be raised by potential buyers and allow the seller to remedy the problems or issues or provide explanations. The process will also assist in the collection of information and documents that will be required for the due diligence process.

- buyers and sellers should be aware of the privacy issues and concerns in play when they are reviewing and disclosing information about a business during due diligence, especially issues and concerns relating to the disclosure of information concerning the employees of a business.

- buyers and sellers should be aware that in some cases searches and enquiries made to government regulators during the due diligence process could result in an audit or inspection of the business. The parties should evaluate the risk of this happening and decide how to proceed if an audit is triggered.

- buyers and sellers should consider how (or if) a purchase agreement will address "sand-bagging". Sandbagging occurs when a buyer learns through due diligence that a representation made by the seller about its business is untrue and the buyer then closes the deal and seeks to enforce indemnity provisions after closing.

There are numerous issues and considerations to take into account when conducting due diligence and your advisors are a great resource to help you understand and manage the process.

DEAL STRUCTURE: ASSET PURCHASE VS SHARE PURCHASE

When buying or selling a business, one of the most important considerations is whether the deal should be an asset purchase or a share purchase. This decision will have significant implications, both in terms of the immediate costs incurred, and the ongoing operation of the business.

As a general rule, sellers prefer share sales and buyers prefer asset sales. This conflict is resolved by negotiation between the parties, which normally includes a compromise on the purchase price or other terms to facilitate the transaction.

While many variables will affect how a deal is structured, the following are four important factors to consider when determining the structure of the purchase agreement:

Liabilities

A share purchase may consist of the transfer of all, or a controlling interest in, the shares of the target company from the seller to the buyer. In theory, a share purchase will not be as complicated as an asset purchase since the only property being transferred is the shares themselves. However by purchasing the shares of a corporation, the purchase acquires not only the assets, but also the liabilities of the company.

If certain steps are not taken before a share purchase, the seller will be free from most future liabilities while the buyer will inherit all of them. Potential liabilities could include unforeseen environmental cleanup costs, tax liabilities, or pending lawsuits. For this reason it is crucial for the buyers to perform thorough due diligence to fully understand the target's business, its risks and potential unrecorded liabilities.

An asset sale is often complicated by the fact that all assets must be conveyed from the seller to the buyer. This is offset to a certain extent by the fact that the buyer may pick and choose which assets (or liabilities) it will purchase or assume and those it will leave to the seller.

Employees

Unless the seller agrees to terminate certain employees prior to closing, in a share sale the buyer will inherit the target company's entire workforce, including employees it does not wish to employ. This is an especially important consideration if the buyer is planning on down-sizing or integrating the business into an existing company after the transaction closes.

In asset purchases, the buyer may be able to selectively assemble the employees of the business and leave any severance or other employment obligations with the seller. That being said, in order to avoid wrongful dismissal claims the seller will normally require the buyer to offer new contracts to all or most employees on terms that are substantially similar or identical to their existing contracts, including recognition of prior service.

Consents

An asset sale may trigger the need to obtain third party consents in order to transfer certain assets from the seller to the buyer. These may include desired contracts, leases and permits. This can be a time consuming and expensive process for the buyer.

In share sales it is just the shares of the target company that are transferred and the parties to the contracts remain the same. As such, the need to obtain a consent to transfer the contract to the buyer often does not arise. That being said, many third party contracts have "change of control" clauses, which may be applicable on a share sale and many third party contracts have no restriction on assignment which would allow the contracts to be freely assigned on an asset sale.

Tax

Tax considerations can have a large influence on whether a deal is structured as an asset or share purchase. Both the buyer and the seller will want to work with their tax advisors to determine what their tax bill will be, depending on how the deal is structured. The parties may agree to adjustments in the purchase price or to conduct reorganizations in advance of closing in order to make the transaction more tax advantageous.

The tax consequences of the purchase and sale of a business will depend on the nature of the business being bought and sold. Generally speaking, sellers prefer share sales as they result in a capital gain to the seller, of which only 50% is taxable. Further, the seller may be able to take advantage of capital gains exemptions in certain situations.

Buyer's on the other hand, usually prefer to purchase assets so they can increase the cost base of the assets being purchased and thereby increase depreciation for tax purposes. Buyers in asset transactions will typically look to allocate as much of the purchase price as they can to depreciable assets. Asset purchases however, can still result in a big tax bill depending on the assets of the business, as the buyer may be required to pay property transfer tax on land and sales tax on inventory and equipment.

The tax costs and savings can be quite significant in the purchase of many businesses, so both buyers and sellers will want to discuss the issue with their advisors.

The decision to proceed with asset or a share purchase will be determined to a large extent by the nature of the target business, as this will ultimately affect the importance of the issues identified above. In addition, many tax, legal and practical concerns must be considered to determine whether to acquire or sell assets versus shares. Choosing the wrong structure can be a costly mistake and that is why buyers and sellers should consult with their advisors before settling on a deal structure.

FINANCING THE DEAL

Buyers and sellers of businesses are usually interested in these two financing questions:

- How will the acquisition itself be financed?
- Following the acquisition, will the business need additional financing to fund its day-to-day operations?

Acquisition Financing

There are potentially an infinite number of ways that an acquisition can be financed, particularly if the seller is flexible as to the form of consideration it will receive and over what period of time it will receive it. Most sellers, however, want as much of the sale price as possible in cash, up front, on the closing date. Accordingly, most deals are financed with some combination of the following:

Buyer Cash — Most deals involve the buyer putting in at least some of its own cash. If there is a third party lender involved in the financing, they will almost always insist that the buyer has some cash at risk – or some "skin in the game." Buyers' cash is typically invested into the acquired business either as equity or shareholder loans or some combination of both. All other things being equal, buyers will usually prefer to put most of their cash in as shareholders loans, as their repayment offers a simple and tax-free way to return some capital when the business has free cash to distribute; they also receive distributions prior to equity in the event the company dissolves or goes bankrupt.

FOR BUYERS

How much cash a buyer needs to pony up is a point for negotiation with its lenders and a question of risk tolerance – more up-front cash and less debt financing can insulate the business from market shocks; whereas more debt, or leverage, and less cash can increase the buyer's potential return on investment but also make the business more susceptible to imploding if the business doesn't perform exactly as planned.

Third-Party Debt Financing — Debt financing often funds the majority of the cash purchase price. Banks, credit unions and other similar lenders will be primary sources of funding. They will typically require that their loans be secured by the assets of acquired business, giving them first right to the assets in the event the loans are not repaid. Lenders will impose restrictions on how the buyer/borrower can run its business. These "covenants" normally prohibit borrowers from, among other things, taking on additional debt, paying dividends or selling assets. Lenders may also require that borrowers meet financial ratios on a periodic basis. These financial covenants are designed to test a business's financial well-being and to give lenders an early warning when a business is not performing as expected.

Buyers that require additional financing beyond what traditional bank lenders are willing to provide may be able to access additional funding from lenders willing to accept higher risk credits. These "mezzanine" or "alternative" lenders will typically be subordinated to, and have their security rank behind, the senior bank lenders. As a word of caution, however, this type of financing is usually significantly more expensive than standard bank financing.

FOR BUYERS

It can be worth shopping your financing around to several lenders to get the package that best suits. When evaluating proposals, you will want to carefully – and conservatively – assess how the acquired business's projected performance will fit within your lenders' proposed terms. If missing your optimistically budgeted profits by 10% will put you offside the financial covenants offered by your lender, that proposal probably does not offer you enough wiggle room to withstand any unforeseen market events.

You should also beware of any personal guarantees required to be given in connection with a financing. Absent a personal guarantee, if the business is contained in a corporate entity, owners will not be personally liable on any business losses. Often, borrowers will not have enough negotiating leverage and will be forced to give a guarantee in order to obtain financing. But, it is worth exploring with your lender whether the business can borrow on its own credit without a personal guarantee, or if personal guarantees can be dropped if certain thresholds are met.

Seller Financing — In many deals, the buyer will require that at least a portion of the purchase price be paid to the seller over time. This can be in the form of straight debt, or "vender take back" financing, or a payment contingent on the business hitting certain performance milestones post-closing (see the discussion below on earn-outs for further details). Seller financing can be attractive to both parties. For buyers, it is a chance to get additional financing (seller financing is often cheaper than equivalent third party lender money) and also puts some risk of the business's performance back onto the seller. For sellers, it can be an avenue to get a higher purchase price that would not otherwise be financeable by a buyer.

FOR SELLERS

Seller financing, whether straight seller take back debt or an earn-out or other arrangement is nearly always subordinated (either in lien or payment priority or both) to the claims of the buyer's institutional lenders. This means that while seller financing may be a way to get a higher sticker price on the business, actually getting repaid on the portion that is financed can be largely contingent on the business performing as expected. If the business does not perform, the bank will recover first and the seller may be left with nothing. Sellers should be realistic about this possibility when trading a smaller amount of up-front cash for larger, deferred payments.

Other Options — Other potential financing options buyers may consider include the following:

/ **Paying with Shares:** paying all or a portion of the purchase price with shares in the buyer's business, rather than cash. For buyers, this can be a cash-lite method of completing an acquisition, but be careful of diluting your own equity too much and of the problems that additional shareholders can create. For sellers, this may be an attractive option if the buyer has a strong or growing business that fits well with the business you are selling, but beware the risks of being a minority shareholder with potentially limited rights and an indefinite time horizon to monetize your shares.

/ **Assuming Debt:** the buyer assumes some of the seller's or the acquired business' existing debts that the seller would otherwise have to pay off with the sale proceeds.

/ **Raising Third Party Equity:** this can involve finding a single partner to invest alongside the buyer or looking more broadly for passive financial investors. The far end of this spectrum could involve a capital raise through the public markets – consult your legal counsel and investment banker before proceeding very far down this path.

Post-Acquisition Operational Financing

So, you have enough cash for your equity investment and have borrowed enough to make up the remainder of the purchase price. All that is left now is to sign the deal papers and celebrate, right? Not so fast! As the saying goes, "it takes money to make money." Your business will very likely need additional financing to cover your on-going operating expenses such as rent and payroll and to smooth out any "lumpiness" in your accounts payable and accounts receivable cycles.

Operational financing sources can include the following:

Working Capital — Usually, buyers will negotiate a certain minimum level of working capital that the seller must leave in the business on the closing date. Working capital is the net difference between the current assets and current liabilities of the business. Or, basically, cash plus accounts receivable plus inventory minus accounts payable and other short term liabilities. If the buyer has negotiated this number correctly and the business is not working capital intensive, then the business may not need on-going working capital financing and may be able to operate purely on cash flow generated by its operations. An example could be a web-based business with minimal overhead - no employees or lease payments.

Operating Line of Credit — Other types of businesses will need working capital financing. For example, a builder that bids on a job with a price that includes all of its supplies and gets paid in one lump sum when the job is complete may have many bills to pay before it finally gets paid for its work. Businesses like this often finance their operations with an operating line of credit from their bank. These are usually revolving facilities that can be borrowed on, repaid and borrowed on again (as opposed to term loans which are normally drawn on only once). Availability under an operating facility is usually limited to a percentage of the borrower's inventory and accounts receivable that are eligible to be borrowed against (or "margined").

FOR BUYERS

Operating lines are typically secured against the assets of the business. If you have already borrowed acquisition debt against the assets of the business, you may have a difficult time getting an operating line from a different lender, as both lenders would want their loans and associated security interests to be first in priority. When you are shopping around for financing, it can be useful to get comprehensive proposals from lenders that encompass both an acquisition loan and an operating line of credit.

Equipment Financing/Capital Financing — Financing specific pieces of equipment or projects needed in the business is often done separately from your regular operating facility. In many cases, these will be term facilities or, in the case of equipment financing, finance leases. Financing these types of investments can allow you to spread out your capital costs over a longer period while still growing your business with necessary improvements. Usually your operating line lender will be amenable to the business incurring these new types of debt, as they add existing collateral that is usable in the business and that otherwise would not be available to the business. Equipment leasing can have accounting and tax benefits – consult with your accountant about whether this is an appropriate option for your business.

REPRESENTATIONS AND WARRANTIES AND INDEMNITIES

Representations and Warranties

Representations and warranties are all about risk allocation – even though neither party to a proposed transaction may have any actual knowledge concerning a specific circumstance, it is typical for the transaction agreement to allocate responsibility for that circumstance by having one party give a representation and warranty concerning it.

For example, it may well be impossible without undertaking significant investigations to determine if a piece of land is contaminated, and neither party is willing to take the time or spend the money to make those investigations. Without one party making any representations and warranties concerning the existence of contamination, there is no agreed allocation in the agreement of the risk that the land will turn out to be contaminated.

The most effective allocation in the contamination example is accomplished by an absolute representation and warranty by one party to the other that there is no contamination. In such a situation, the actual knowledge of the party making the representation is irrelevant as between the two parties, if there is any contamination, then the party that gave the representation is in breach of the agreement and is liable to the recipient of the representation for any losses the recipient has incurred as a result of that breach. The opposite of a full array of representations is "as is , where is", where the representations are strictly limited to such basic representations as ownership and lack of encumbrances.

The party that is being asked to give a representation will sometimes seek to limit its exposure by making the representation to its "knowledge" or to "the best of its knowledge". From the recipient's standpoint, this creates the possibility that the agreement will not absolutely allocate responsibility i.e. if the party giving the representation is able to demonstrate that it had no knowledge of the contamination, then it is not in breach of the representation if there is contamination and the recipient has no remedy for the losses it incurs.

Agreements for the purchase and sale of a business commonly contain a significant number of representations and warranties – the immediate response of the party being asked to give these pages of representations is often to blame the lawyers for over-kill. The key from the perspective of the party giving the representations is to keep in mind that the other party is seeking to allocate the risk, and that doing so may require a substantial number of representations. Having said this, every part of an agreement is subject to negotiation and a party has no obligation to provide any representations.

Generally speaking, in the context of the sale of a business, it will be the seller who is expected to give the majority of the representations and warranties. The seller will not usually have a large list of representations and warranties it needs from the buyer, while the buyer will want the seller to put in writing all the representations it made about the business when it was convincing the buyer to enter into the transaction.

The purchase agreement may also set limitations on the effect of the representations and warranties. Two limitations are often included in an agreement (and each is typically the subject of negotiation):

- the time during which the representations are effective. It is common for the party giving the representations to seek to limit the time within which the recipient can claim that there has been a breach of a representation. Different time periods may be appropriate for different types of representations. For example, a longer time may be more appropriate for representations concerning contamination than for representations concerning taxes or title to assets.
- a cap on the total liability for a breach of representations. Regardless of the losses suffered, the party giving the representations is not liable for any losses above a certain cap. It is also common in transactions with a significant value to establish an aggregate threshold of losses that must be suffered before a claim can be made.

Indemnities

An indemnity is a promise by the person who gives it that it will be responsible for certain specific losses suffered by the other party, or even by persons who are not parties to the agreement. Indemnities are a common provision in agreements relating to the purchase and sale of business.

An indemnity is often used to ensure that the person who grants it will be responsible for any losses suffered by the recipient as the result of claims made against the recipient by a third party (including claims made by a regulatory authority).

Allocating responsibility for the costs of remediating contaminated land is a useful example of how an indemnity works in an agreement. Under the BC Environmental Management Act, a person who owns land is potentially liable for all costs of remediating contamination on that land, regardless of when the contamination occurred. As such, a person who sells land is potentially liable for the remediation of contamination that occurs after it has sold the land.

It is common for the buyer and seller of the land to agree that each will be responsible for any contamination that occurred or occurs while it is the owner of the land, regardless of the potential liability imposed by the legislation. This is accomplished by the seller agreeing to indemnify the buyer against any losses suffered by the buyer arising from any contamination of the land that occurred before the sale date, and by the buyer agreeing to indemnify the seller for any losses suffered by the seller arising from any contamination of the land that occurs after the sale date.

As with representations and warranties, it is not uncommon in a transaction of a significant value for the party granting an indemnity to seek to limit the right to rely on the indemnity to a specified time period, and seek to place a cap on the total exposure under the indemnity (especially in the case of an indemnity for an unknown liability, where the cost of meeting the indemnity obligation may exceed the value the party who granted the indemnity received from the transaction).

It is also not uncommon for the agreement in a transaction of a significant value to include a specific set of steps that the party seeking to rely on the indemnity must follow, such as promptly providing notice of the claim to the party who granted the indemnity, and co-operating in the defence of the claim.

As with any assessment of the ultimate value of a potential remedy in a transaction agreement, an indemnity is obviously of value only if the person who grants it continues to be able to meet its obligation under the indemnity. For example, an indemnity from a corporate seller that immediately transfers the sale proceeds to a shareholder is pretty much useless. Where there is a genuine concern about future liabilities, a holdback of a portion of the purchase price to address those liabilities is an option for the buyer to consider.

A person may agree to indemnify more than just the other party to an agreement – for example, it is not uncommon for the person granting the indemnity also to agree to indemnify the directors and officers of the corporate recipient of the indemnity, to cover off any possibility that any of those individuals might be held liable for some or all of the loss which are the subject of the claim against the company relying on the indemnity.

THIRD PARTY CONSENTS

A key component of many business acquisitions are the contracts held by the target company. These agreements are an important part of the business and play a significant role in determining its value. These can include agreements with major customers and suppliers, leases for key locations, permits with governmental authorities, and other licenses that allow the company to operate.

Often contracts have restrictions on assignment or the right of the third party to terminate the contract on a change of control. Buyers require consents to assignment or an agreement that the change of control will not result in termination of the contract from the third party. These consents can be key closing conditions, and transactions can fail to close because a third-party consent or agreement was not secured.

When seeking the consent or agreement of a third party in the context of an asset purchase or a share purchase, timing can be crucial.

While each transaction has its own unique challenges, the following are general recommendations that can be applied to any transaction where third party consents are required:

Plan Ahead

One of the most effective ways of handling third-party consents is to identify the contracts requiring consents and their relevant counter-parties as soon as possible. Sellers will want to have an idea as to what consents will be required before seriously marketing their business. Ideally for buyers they will identify consents in the early stages of due diligence in order to fully review the target businesses' contracts and detect potential issues with acquiring consents.

After identifying the third party approvals needed to sell a business, it is important for buyers and sellers to anticipate the difficulty of obtaining and the timing of each consent and agreement and plan accordingly. For example, consents from government authorities often take more time to receive than consents from private companies. Other third parties may delay their approval by seeking to renegotiate the terms of existing agreements.

Minimize Consents for Future Transactions

The best practice is for any business to seek to reduce the number of consents in their respective agreements with third parties.

Businesses should plan for potential changes of ownership in the future and, where possible, avoid including anti-assignment clauses in their contracts. If they are required to gain consent in their third party contracts, companies should insist on including provisions that consent cannot be withheld or delayed unreasonably by the third-party.

Keep Good Records

Having detailed records of contracts and other documents reduces uncertainty and the potentially large cost associated with obtaining third-party consents. If there is a high degree of reliability in your records, it will require fewer resources to track down and obtain consents.

This will also create more confidence from the buyer that all agreements are in order. This in turn may have a positive effect on the purchase price, as the buyer will have less reason for concern that outstanding liabilities may be in existence.

The number and complexity of third party contracts requiring consents will ultimately depend on the structure of the transaction and the nature and size of the target company. Regardless of these factors, we recommend that buyers and sellers involve their legal advisors early in the process.

Calculation of Purchase Price

Pricing a business is difficult and buyers and sellers will have differing views on the proper price. Sellers are concerned about leaving money on the table and buyers are concerned about overpaying.

Because price usually comes up early in the negotiations, the parties are often discussing the price before what is being purchased has been settled. The buyer and seller need to be sure they are talking about the same transaction before seriously discussing price.

There are many things that affect the purchase price for a business and many are deal specific but all transactions have a number of common factors. All buyers and sellers should ask the following questions early on in negotiations:

- what is included in the sale and what is to be retained by the seller?
- what liabilities are to be assumed by the buyer, to be satisfied on closing and to be retained by the seller?
- what is the most advantageous deal structure when considering tax (commodity taxes and income taxes), closing costs, liabilities, warranties and indemnities, transfer of employees, capture of the goodwill of the business?

Both buyers and sellers should consider having the business valued by a third party. Buyers and sellers should realize the valuation is merely someone's opinion (albeit an opinion that can be useful in the price negotiations) and there may be reasons that the business is worth more or less than the valuation provided.

For the seller, there may be a number of factors that would lead to different price, such as the timing of the closing, the continuation of the business, continuation of employment for the employees of the business, and the structure of the transaction. For buyers there may be synergies with existing businesses, entry to a desired market or acquisition of relationships.

Coming to a purchase price is difficult and more of an art than a science. At the end of the day, it is the number the buyer and seller agree to. That being said, there are a number of recognized ways of calculating the purchase price. There are two basic approaches; the first set are based on the underlying value of the assets of the business, usually working from the balance sheet for the business, and the second look at the benefit generated by the business and calculate a value based on the benefit generated, usually working from the income statement for the business. Some of the more common are as follows:

Asset Based or Balance Sheet Methods

- **Book value:** the balance sheet values of the assets being acquired minus the liabilities being assumed. This method is not usually accepted by sellers as often the balance sheet value of the assets being acquired are less than the fair market value of the assets. This is because assets are often depreciated faster than the market value will indicate and because there is often goodwill that has been generated by operating the business that is not reflected in the balance sheet.

- **Liquidation value:** the expected value of the assets if sold individually minus the liabilities being assumed. As this is the expected value on wind-up, it is the lowest value any seller should accept.
- **Replacement value:** the current replacement value of the assets less the liabilities being assumed. This method is not usually accepted by buyers as it tends to overstate the value of the assets.
- **Modified book value:** the calculation is the same as book value but the value of the assets is adjusted to reflect current market value of the assets.

Benefit Based or Income Statement Methods

- **Multiple of gross revenue:** this is an agreed multiple of gross revenue or sales. This method is not often used as it does not reflect either the underlying value of the assets or the return on the potential investment.
- **Capitalization of current revenues:** the form this most often takes is measuring either EBITDA (earnings before interest, tax, depreciation and amortization) or normalized EBDITA and multiplying the amount by a factor. This is the most common method of valuation of businesses we see. Normalized EBITDA is a calculation that excludes non-recurring amounts and amounts that are not directly related to the business, such as personal expenses of the seller, salaries that are not at market rates or that are for functions not required by the business and includes amounts for goods or services that are provided at a discount by the seller or related parties to the business. The multiple is a point of discussion between the seller and the buyer. Both sides will look to the current market and try to determine what "market" for businesses of the type being sold is. What this does is give an expected cash flow from the business and impute an agreed upon rate of return on the investment being made by the buyer.
- **Capitalization of future revenues**: the form this takes is often like an EBDITA calculation using projected earnings. This method is more common for businesses that are growing. When this method is used we most often see the seller remaining involved in the business for a period of time and a portion of the purchase price being held back to ensure that the expectation of future growth actually occurs or the purchase price being calculated in part on the future performance of the business.

What a seller often thinks of as the business may to a seller be a number of businesses. The most common example is a business that owns the land on which it operates. Buyers of the business will often only be interested in the business and will not be that interested in the land but will want a lease in place so the business can continue operating following closing. If the seller wants to also sell the land, the buyer will want a lease in place before the sale completes and, because there is a range of rental rates for land, the seller can determine whether it is more advantageous to have a higher lease rate which will reduce the EBDITA for the business and increase the revenue for the land or a lower rate which will increase the EBDITA for the business and decrease the revenue for the land.

While the purchase price is important, the structuring of the purchase price can be just as or even more important. What is being purchased and how the purchase price is paid can have a significant impact on the net amount the seller receives and on the operating income of the buyer in the coming years.

Allocation of Purchase Price

Allocation of the purchase price largely comes into play when the transaction is an asset purchase or a hybrid purchase.

For share purchases, the entire purchase price is allocated to the shares being purchased. Sometimes there can be an issue if there are a number of different classes of shares being purchased, particularly if there are a number of shareholders holding different classes of shares. We will not deal with the allocation of the purchase price on a share sale in this article, but this is something buyers and sellers should discuss with their advisors.

On the purchase and sale of assets one of the most important tax aspects is the allocation of the purchase price among the various assets. Generally, the seller will want to minimize the amounts allocated to depreciable assets, limiting the amount of recaptured capital cost allowance. The buyer on the other hand will want to allocate as much as possible to depreciable property so as to maximize future tax deductions. The buyer also will want to consider the effects of commodity tax (in particular property transfer tax and provincial sales tax) when allocating the purchase price among the assets.

Earn Outs

An earn out is a part of the purchase price calculated based on the future performance of the business being purchased. An earn out is most often a post-closing adjustment to the purchase price.

Earn outs are useful in a number of circumstances, but we most often see them when there is a disagreement or uncertainty about the future performance of the business. In order to be effective, the purchased business cannot be integrated with the other businesses of the buyer during the earn out period and the accounting for the acquired business needs to be kept separate from the other businesses of the buyer. In order for the earn out to work, there needs to be confidence that the business will be operated in a way that will allow the business to perform as anticipated by the seller. This often means the seller and/or current management will want/need to continue to manage the business during the earn out period.

The earn out is a deferred payment of the purchase price, and as such, the seller should consider security for the payment.

One of the problems with earn outs is agreeing to an appropriate measure of performance. The seller and the buyer will have different objectives for the business. The seller will have a shorter term view of the business and will want to maximize the metrics in that period, while the buyer will be concerned about long term and sustainable performance. The income tax on earn outs can be complicated and tax advice should be sought.

WORKING CAPITAL

Working capital is usually defined as current assets less current liabilities. It can be thought of as the amount of current investment needed to operate the business. Whether the acquisition of the business is structured as a purchase of shares, a purchase of assets or as a hybrid, we see working capital adjustments in most transactions.

Basically the working capital calculations and adjustments work as follows:

/ the parties agree on a normalized or target amount of working capital that is necessary to operate the business;

/ the transaction closes on the assumption that there is the right amount of working capital in the business but with a provision that once the closing financial statements for the business are prepared, the parties will make an adjustment to the purchase price;

/ the accountants do the closing financial statements sometime after the closing and calculate the actual working capital based on the financial statements;

/ the actual working capital is compared to the normalized or target working capital; and

/ if the actual working capital is more, the buyer makes a payment of the difference to the seller and, if it is less, the seller makes a payment of the difference to the buyer.

The above description is working capital in its simplest form. After negotiation working capital is rarely calculated or processed in its simplest form. Some things that are often negotiated are as follows:

/ the definitions of current assets and current liabilities to account for anomalies in the business and for changes contemplated to operations.

/ who will prepare the closing financial statements and the process of approving the financial statements.

/ the ability to and methods of challenging the financial statements and calculation of actual working capital.

/ holdbacks and security for the payment of the working capital adjustment.

/ the time for payment of the working capital adjustment.

/ rights of set off for the working capital adjustment.

Often the most contentious negotiation is the amount of the normalized or target working capital, as this can have a large effect on the value of the business.

TAKE-BACK FINANCING AND SELLER SECURITY

In some cases, to help facilitate the sale of a business, a seller may agree to finance a portion—or in some cases all—of the purchase price paid by the buyer.

Seller "take-back financing" is not uncommon in commercial transactions, especially transactions where some of the cash needed for the purchase price is not available to the buyer from traditional lenders.

Take-Back Financing

FOR BUYERS

For buyers, take-back financing is advantageous in situations where they could not otherwise raise funds to cover the purchase price. This is often the case where the target business assets' are not valuable enough to back a loan from a traditional lender covering the entire purchase price.

Take-back financing can also save buyers the time and cost of being approved and arranging a financing with a traditional lender. If the terms of the take-back financing are discussed from the outset of the transaction, the requirements and timeline can be worked out with the seller as the deal progresses.

FOR SELLERS

For sellers, take-back financing is advantageous in situations where the buyer would not otherwise be able to complete the purchase (or complete the purchase at the desired purchase price) but for the financing made available by the seller.

Take-back financing can also provide sellers with monthly or periodic cash-flow and in some cases, sellers may be able to charge higher than market interest on the amount of the purchase price paid by the buyer over time.

However, take-back financing is risky for the seller as there is the possibility the buyer will default on ongoing payments and, if the buyer struggles after purchasing the business, it can be costly and difficult to recover the amount owed. These financing arrangements can also keep the seller involved with a business for longer when they may prefer to just sell the business and move on.

Even if the buyer is successful at running the business after closing, there can be restraints placed on the seller getting paid. In most transactions, the buyer will have some support from a traditional lender, either to cover a portion of the purchase price or to support the ongoing operation of the business, and the lender will likely put restrictions on when and to whom the business can make payments. This means that a seller could be stuck waiting for the business to perform to a certain level before it starts receiving payments.

Nonetheless, in some cases take-back financing can provide an option for both the buyer and seller to facilitate a purchase and sale of a business that might not otherwise happen.

Security in Take-Back Financing

If the seller provides take-back financing, the financing could either be unsecured or secured against assets of the business or the buyer.

The nature and extent of the security a buyer may provide is something that is negotiated between the parties and will also be affected by what the buyer’s senior lender will permit.

Here are some examples of the type of security a seller might take in a take-back financing situation:

Mortgages — If the business owns real property, the buyer could grant a mortgage of the property to the seller.

Security Agreements for Personal Property — If the business owns significant assets other than real property, the seller could take a security interest in those assets.

Personal Guaruntees and Security From Shareholders — The purchase agreement may provide that the shareholders of a corporate buyer provide personal security and guarantee the buyer’s obligations to the seller

Share Pledges — In situations where a buyer is purchasing the shares of a company operating the business, the parties can agree that the seller may take back the shares (and therefore the business) if the buyer fails to make ongoing payments. Sellers should be cautious about relying too heavily on this type of security, since if the buyer defaults on its obligations, it likely means the business is not performing and it may not be worth it for the seller to incur the cost and liability of taking back a failing business.

While taking some form of security is preferred in a take-back financing situation, sellers should be aware that a buyer’s traditional lender will likely require that it be paid before the buyer makes any payments to the seller, and whatever security the seller has will likely be subordinated to the lender’s security.

That said, a seller in a take-back financing situation needs to view itself as a lender and should take all the same steps a traditional lender would take when granting a loan. The seller will want to ensure that the interest rate and security the buyer provides match the risk the seller takes that the buyer may default in paying its obligations.

Sellers need to make sure that the buyers provide all required mortgages, security agreements and other documentation necessary to create the agreed upon security, as well as ensure that all registrations and filings are made so the security is valid. The seller's advisors can assist with the document preparation and registrations required to make sure that the seller has valid security in place.

ENVIRONMENTAL ISSUES

Any proposed purchase of a business that will involve the acquisition of an interest in land in BC must address the possibility that the land is contaminated and that, at some point, someone is going to have to pay to remediate that contamination. This is especially the case if the buyer is proposing to put the land to a different type of use than did the seller. For obvious reasons, the applicable legislation allows much lower levels of contamination on land that is to be used for housing than it allows for land that is used for industrial purposes.

As a policy decision, the BC legislation that governs contaminated land imposes liability on past and present owners and occupiers of the land, rather than leaving the costs of remediating contaminated land to the public purse. In doing so, the legislation deliberately casts a wide net, with the goal of having individual or entities who have (or have had) an interest in the land carry out and pay for any remediation. The starting point under the Environmental Management Act is that all persons who own or occupy (or have owned or occupied) a piece of contaminated land are jointly and severally and retroactively liable for the costs of remediating the contamination.

Both a buyer and a seller will want the transaction agreement to provide them with as much protection as possible from this potential liability. This is particularly true for the buyer, who does not want to inherit (and pay for) the sins of previous owners (unless, of course, taking on that risk is built into the purchase price).

The difficulty in allocating the risk of these potential costs in an agreement often arises out of the lack of knowledge that either party has concerning the potential contamination of the land. This is particularly the case when the seller has owned the land for an extended period of time, and activities carried on by the seller during that ownership (and/or by previous owners during their ownership of the land) raise the possibility that the land has been contaminated. The seller may never have believed that it was necessary to have any environmental investigations performed and so is no more able than the buyer to put a number on the potential risk.

At the same time, environmental investigations are potentially costly, time-consuming and intrusive, and when contamination is discovered, it may be difficult to come up with a reliable estimate of the cost of remediating the contamination.

From the buyer's standpoint, the most important issue at the outset is how to get more information – any traditional lender for the proposed purchase is going to make it a condition of the loan that the buyer has obtained an environmental report that either satisfies the lender that the land is not contaminated, or that identifies any contamination and provides a plan for dealing with the contamination.

The ideal situation for the buyer is where the seller has commissioned and paid for a comprehensive environmental report in contemplation of the sale, and has arranged with the environmental inspection company that performed the investigations and prepared the report that both the buyer and its lender are able to rely on the results of the report.

Similarly, a buyer and its lender may be able to take some comfort from an environmental report prepared relatively recently for the seller for a financing or re-financing involving the land as security – if nothing else, this will provide the buyer with a preliminary sense of the magnitude of the risk.

If, as if often the case, there are no recent reports, then the buyer and the seller need to agree how the buyer is going to get the information it (and its lender) needs. There may be circumstances in which the buyer is willing to proceed without any actual knowledge – if the price is low enough and the buyer doesn't need a traditional lender to finance the purchase, then the buyer may be willing to address the unknown risk purely through the agreement.

For ease of reference, it is not uncommon to group the clauses that relate to environmental liabilities and responsibilities in a separate section of a purchase agreement – this section typically include environmental representations and warranties, indemnities, covenants and closing conditions.

/ as is the case with all representations and warranties, those concerning the environmental condition of the land are all about risk allocation. Where the parties have little or no knowledge concerning the existence of contamination, then these are likely to be hard-fought clauses, as each party seeks to place as much of the risk as possible on the other party. In the end, taking on risk typically correlates with the price, i.e. the price for an "as is, where is" sale is typically lower than for a sale where the seller has agreed to be responsible for remediation costs. See the section on representations and warranties.

/ the most brute force (and often most appealing) allocation of risk is based on the time of ownership (i.e. contamination that occurred while the seller owned the property is the responsibility of the seller, and the same going forward for the buyer). It is common for the agreement to include indemnities from the seller and buyer for losses arising from contamination that occurs before and after the closing date. See the section on indemnities.

/ the parties may agree that one will be responsible for investigations or remediation during the period between the signing of the agreement and the closing date. If so, then it will be appropriate to include covenants to that effect and closing conditions concerning the performance and results of the investigations and remediation (or the approvals of regulatory authorities, e.g. the approval of a municipality that will only grant a zoning change if the land has been properly remediated to the applicable standards).

EMPLOYEE PRIVACY RIGHTS

The free flow of information is essential to all business transactions. Companies should be aware that inadequate understanding of Canadian privacy legislation can create obstacles to the closing of a transaction and potential liabilities for both buyers and sellers.

The following is a general overview of employee privacy rights in BC, and how they apply in the context of a business transaction.

Statutory Interplay

Privacy legislation across Canada restricts and regulates the collection, use, disclosure, storage and security of personal information. The Personal Information Protection and Electronic Documents Act, commonly referred to as "PIPEDA", is the federal statute regulating the use of personal information by private companies in Canada.

Provincial privacy legislation is applicable if the company operates in a province that has "substantially similar legislation" to PIPEDA. British Columbia is one of these provinces, and as such BC companies are governed by the Personal Information Protection Act, commonly referred to as "PIPA".

If a BC company is involved in a cross-border transaction it will still be regulated by PIPEDA, so it will need to be aware of both the Federal and Provincial statutory schemes.

Due to these variations in privacy legislation, the understanding of which statute or statutes apply to a transaction is essential.

Employee Personal Information

PIPA places statutory constraints on the collection, use and disclosure of "personal information", which is defined broadly as "information about an identifiable individual". With certain exceptions, PIPA requires that an individual must consent to the use and disclosure of this information. If an organization breaches this requirement, it may be liable to pay damages.

PIPA also limits the use of "employee personal information", which is, in some respects, subject to different treatment under PIPA than personal information generally.

As long as it used for the purpose of establishing, managing or terminating an employment relationship, PIPA allows the collection, use and disclosure of this information without an employee's consent. Employee personal information falling outside this definition is subject to the same consent requirement as general personal information.

Business Transactions

PIPA specifically addresses privacy in the context of an employment relationship and provides a framework for balancing the privacy rights of employees and the business interests of employers.

In particular, PIPA allows disclosure of employee personal information as part of due diligence on closing in the context of a "business transaction", which is broadly defined to include both share sales and asset sales of a business and can also include lending transactions.

Due Diligence Disclosure

In this case the employee personal information must be necessary for the prospective buyer to determine whether or not to proceed with the transaction. There must also be a non-disclosure agreement limiting the prospective buyer's use and disclosure of the information to purposes related to the proposed business transaction. If the transaction does not proceed, a prospective buyer must destroy or return the employee information.

Post – Closing Transfer

On closing, the same employee information may be transferred, subject to the buyer using it for the same purposes for which it was collected. The information must relate directly to the organization or its business assets covered by the business transaction, and after closing those employees must be notified that the transaction has taken place and that their personal information has been disclosed to the other party.

Cross-Border Transfers

As noted above, BC companies should be aware that PIPEDA applies to cross-border commercial transactions.

Under this legislation it is generally permissible for a business to transfer its employees' personal information to US affiliates and other foreign jurisdictions, provided certain conditions are met.

First, they must ensure a comparable level of protection to PIPEDA when the information is transferred to a third party for processing and/or is still under the organization's control. A data protection agreement between the Canadian organization and the foreign affiliate may also be necessary in such circumstances, unless the affiliate's privacy policies and data protection practices are comparable to the Canadian entity's policies and practices.

Businesses must be transparent about their personal information handling practices. This includes advising employees that their personal information may be sent to another jurisdiction for processing and that while the information is in another jurisdiction it may be accessed by the courts, law enforcement and national security authorities.

REGULATORY APPROVALS

The purchase and sale of a business may impact a variety of third parties who have an interest in the transaction. Some of the most important third parties to be aware of are government regulators that monitor a business.

The purchase and sale of many businesses will be subject to compliance with certain regulations and the approval of certain regulators.

Regulatory approvals most often become an issue in the following transactions:

- where a transaction involves large companies buying and selling significant assets
- where a Canadian business is being purchased by a non-Canadian
- where the business being purchased is in a regulated industry of profession

What regulatory approvals are required for a particular transaction will depend on a number of factors. Both buyers and sellers should work with their advisors to determine what parties they will need to contact to ensure that all required approvals are obtained.

Consider Approvals Early

In the early stages of transaction both buyers and sellers need to turn their minds to what regulatory approvals will be required in order for the transaction to complete.

This is both to determine whether a transaction will be permitted by a regulator and also to determine how regulatory approval will affect the closing timeline. Regulators may have very specific requirements that buyers and sellers have to meet as well as processing times to review and consent to proposed transactions.

A seller will most likely be aware of the various provincial and federal regulators that impact its businesses, but it should research what those regulators will require when it comes to selling that business.

A buyer will also want to make enquiries with regulators in order to determine what may be required before the buyer can purchase a target business. This can also assist a buyer to become familiar with any ongoing regulatory requirements that the business is required to meet, so it can continue to meet those requirements following closing.

Competition Act

For the purchase and sale of certain businesses, parties should be aware that completion of the transaction will require meeting certain requirements set out in the Canada Competition Act.

The Competition Act is federal legislation that applies to most businesses operating in Canada. Its purpose is to maintain and encourage competition in Canada. The legislation contains both civil and criminal provisions aimed at preventing anti-competitive practices by businesses. It is administered and enforced by the Canadian Competition Bureau.

In the context of the purchase and sale of a business in Canada, the Competition Act applies in two main areas;

- where a "merger" (a broadly defined term, catching many things including the purchase of a business) is determined by the Canadian Competition Bureau to likely result in a substantial lessening or prevention of competition; or
- where the buyer and seller collectively have assets exceeding $400 million or gross revenues from sales in, from or into Canada exceeding $400 million and the parties are proposing to enter into a transaction of a certain size.

In both cases, the types of transactions that are likely to get the attention of the Canadian Competition Bureau are high profile transactions involving large companies in industries where competition is a concern.

If the Canadian Competition Bureau determines that a purchase and sale of a business will likely result in a substantial lessening or prevention of competition, it has significant powers to impact the transaction, including the ability to prevent a proposed purchase, to unwind a completed purchase or order the sale of assets of the business.

When reviewing a merger to determine if it will substantially lessen or prevent competition, the Canadian Competition Bureau will consider a number of factors including the level of economic concentration in the industry in which the business sold and the market shares of the buyer and seller.

In the case of a purchase and sale of a business involving companies with aggregate assets or sales revenues exceeding $400 million, if the value of the assets being acquired in the sale of the business exceeds $87 million, the buyer and the seller are required to:

- notify the Canadian Competition Bureau of the proposed business sale;
- pay a $50,000 fee;
- provide certain information; and
- wait at least 30 days before completing the transaction.

Investment Canada Act

Buyers and sellers should also be aware of certain requirements imposed by the Investment Canada Act on the purchase and sale of certain businesses.

The Investment Canada Act is federal legislation that regulates foreign investment in Canada and is primarily administered and enforced by Industry Canada, with some provisions under the purview of Heritage Canada.

The purpose of the legislation is to provide for the review of both significant investments (such as the purchase of a business) in Canada by non-Canadians, as well as investments that could be injurious to national security.

The basic scheme of the legislation is that Industry Canada must be notified of all investments made by a non-Canadian in a Canadian business, while investments of a certain size will be subject to review. Notification requires that the non-Canadian file a form with Industry Canada no later than thirty days after making an investment.

An investment is subject to review under the Investment Canada Act if there is an acquisition of a Canadian business by a non-Canadian and the value of the business equals or exceeds the relevant monetary threshold.

As of January 1, 2017, the review thresholds differ depending on the identity of the non-Canadian acquiring a Canadian business:

/ for private-sector investors from WTO countries, direct acquisitions are not reviewed unless the value of the business exceeds $600 million (to be increased to $800 million on April 24, 2017) and indirect acquisitions are not reviewable.

/ for state-owned enterprise investors from WTO countries, direct acquisitions are not reviewed unless the value of the business exceeds $379 million and indirect acquisitions are not reviewable.

/ for investors from non-WTO countries direct acquisitions are not reviewed unless the value of the business exceeds $5 million and indirect acquisitions are not reviewed unless the value of the business exceeds $50 million.

If a transaction is reviewed, in order for the transaction to be approved, it must result in a "net benefit" to Canada, which Industry Canada determines by taking into account a number of factors, including:

/ the effect of the investment on the level and nature of economic activity in Canada;

/ the degree and significance of participation by Canadians in the business; and

/ the compatibility of the investment with national industrial, economic and cultural policies.

Buyers and sellers should be aware that special rules apply in cases where a non-Canadian purchases a "cultural business", which includes businesses involved in the publication, distribution or sale of books, magazines, film or audio recordings.

In the case of the purchase of a cultural business, even if the purchase would not otherwise meet the threshold for review, it may be reviewed if an order directing a review is made and a notice is sent to the buyer within 21 days following the Industry Canada's receipt of notification of the purchase.

Industry Regulatory Approvals

Many businesses operate in industries or professions that are subject to regulations under provincial or federal legislation.

As an example, professional regulators such as those regulating lawyers, accountants or doctors often have rules restricting who is allowed to own and operate businesses providing professional services.

Other examples of regulated industries include telecommunications, aviation, insurance and financial services. There are numerous regulations that can apply to a business and what each regulatory body will need in order to approve a sale of that business will vary from industry to industry.

Buyers and sellers should be aware that failing to obtain required regulatory approvals before completing the purchase and sale of a business can have severe consequences such as cancellation of permits or licenses necessary to the operation of that business.

Given the consequence of failing to obtain the proper regulatory approvals, it is important to consult with your advisors to ensure you are aware of all the approvals needed to successfully buy or sell a business.

CLOSING THE TRANSACTION

After weeks (months?) of tough negotiations, an exhaustive due diligence investigation and multiple meetings with regulators, advisors and consultants, the parties have agreed on terms and finalized the documents. All that is left between you and the purchase (or sale) of this great business is the much anticipated "closing."

But, wait - what exactly is a closing and what does it really entail?

What is the Closing?

The closing is simply the moment that the buyer actually completes the purchase of the seller's business. Before the closing, the seller still owns the business and the parties can still walk away from the deal (though often with negative consequences) with the seller owning the business and the buyer still holding its pile of money. After the closing, the buyer will own the business and the seller will hold the purchase price – if a party is aggrieved it will typically be left with suing for damages under the contract.

Closing Challenges - Logistics

Most issues that arise with a closing can probably be properly described project management problems. To be sure, some issues can be external –an unforeseen event at an important piece of the business on the eve of closing – and some can be tactical – where one party delays the closing as a negotiating tactic. But, for the most part, a closing is a complicated juggling act of bringing together many different people, working on different aspects of a transaction and culminating in a perfectly ordered finale.

For example, the closing usually needs the buyer's bank to be ready to fund on the closing date. The bank will usually know the desired closing date, but will only be involved in the actual business acquisition transaction on the periphery and will likely not be as invested in its timely completion as the principals. At the same time, the bank will have its own strict set of requirements that it will need to satisfy (during banking hours!) in order to be ready to lend. If one small bank form is missing on the closing date among the many other documents being signed for the transaction, it potentially jeopardizes the timing of the entire transaction. The seller is unlikely to help the buyer notice the missing document as the financing would be arranged solely by the buyer. The buyer's bankers, who have other clients and, as noted, may not be as focused as the buyer on closing the deal, may not spot the problem until too late. Similar traps will exist in multiple places in multiple transaction workstreams.

Failing to meet the closing requirements on the closing date can have serious effects. At the very least, it means both parties will incur additional professional fees, as the transaction drags on. It can mean additional interest accrued on any debt incurred to fund the purchase or any existing debt that otherwise would have been paid out with the proceeds of the sale. In the worst case, it can lead to the other party walking away from the transaction or suing for damages.

What this all means is that good project management is critical, particularly for the buyer who is typically responsible for providing most of the deal documentation. You need to ensure that you arrive at the closing date with everything you need to complete the transaction. This can mean getting hundreds of pieces of paper signed, completing multiple due diligence searches, having your financing in place, receiving consents from regulators or third parties received, and many other tasks. Someone needs to oversee the entire process, making sure everything is progressing at the right speed and that it will be completed by the closing date. Often, this quarterbacking job will fall on either the shoulders of the principal or their counsel. If you do not have a lot of deal experience, it can be useful to delegate project management responsibilities to your lawyer. Whichever way you choose to go, it is important to communicate clearly with your team to ensure that everyone is aware of who is doing what and, just as importantly, anything that is NOT currently assigned to someone.

Key Closing Items – The Seller vs The Buyer

The seller's list of major concerns at closing is usually one item long: receiving the purchase price on time.

The buyer, on the other hand, has a comparatively longer list of concerns. At a minimum, it will want to consider the following:

- first, it will want to know that the business it is buying is still the same as what the seller has represented it to be. This can be particularly important where there has been a long interim period between when the buyer's initial due diligence was conducted and the closing – the business may have changed during this time. Buyers will seek assurances through a variety of means. Updates to critical due diligence searches are typically performed. Officers of the selling business are usually required to certify that all of the representations and warranties in the purchase and sale agreement that describe the state of the business continue to be true as of the closing date.

- second, it will want to know that the transaction documentation is sufficient to transfer the business to it. Buyers will rely on their lawyer in large part to give them assurances on this point – that all of the required documents are prepared and signed. Most personal property transfers easily to a buyer just by contract, but certain assets require special considerations. For instance, real property and some special types of personal property like motor vehicles have special public registration requirements to affect transfers. Shares that are evidenced by physical certificates need to be endorsed to the buyer and physically delivered to give protection against adverse third party claims that could trump the buyer's claim. Sometimes the seller's lawyer will be required to give a legal opinion to the buyer that the seller has taken all necessary corporate actions to transfer the assets and/or that the purchase and sale contract is legally binding and enforceable.

- third, it will want to ensure that it has valid recourse against the seller if there are any defects with the business that are uncovered post-closing. This requires a strong set of representations and warranties and indemnities in the purchase and sale agreement and can be bolstered by arrangements where a portion of the purchase price – the "holdback" – is held in escrow for a period to allow for the discovery of any defects.

- fourth, it will want to ensure any critical third party consents or approvals are obtained. If a contract, license or regulatory approval that is key to the business needs third party permission to be transferred to the buyer, the buyer will want to make sure these are all obtained before proceeding with the purchase. Obtaining consents is typically baked into the purchase and sale contract as a condition to the closing proceeding.

Closing Variations

Not all closings function exactly the same. Some differences between the more common variations to be aware of are described below.

"Sign and Close" vs "Sign then Close"

Some closings are structured so that they occur after the signing of the purchase and sale contract. These are "sign then close" deals. The parties are locked into the transaction after the contract is signed – with contractual penalties or at least damages claims arising if one of the parties fails to close – but the seller remains in possession of the business during the interim period and the actual closing does not occur until a date in the future (usually set in the contract). Many larger transactions are sign then close as the parties want to lock each other up, but need time to work through issues such as regulatory approvals or arranging financing.

In other deals, the purchase and sale contract is negotiated all the way up to the date of the closing and isn't actually signed until the moment the closing occurs. These are "sign and close" deals.

FOR BUYERS

Buyers may prefer to structure the deal as a sign and close transaction as it affords more optionality; no binding contract is in place until the closing actually occurs which allows the buyer to walk away without penalty if some adverse facts are uncovered in the due diligence or negotiation process. While sign then close purchase and sale contracts will typically have conditionality built into them, these may be open to interpretation and in any event it is always easier to walk away where there is no contract at all. For example, a buyer is typically not required to complete the transaction if a "material adverse change" in the business has occurred prior to the closing, but each party may have strong and differing views on what constitutes a material adverse change and whether one has actually occurred.

On the other hand, if the seller has multiple suitors for its business, the buyer may be interested in a sign then close arrangement. This is because absent a signed purchase and sale agreement or some other document granting the buyer exclusive negotiating rights, there may be nothing preventing the seller from negotiating with multiple bidders prior to your sign and close deal completing.

FOR SELLERS

Similar considerations apply to sellers. Where the business has multiple potential bidders, hitching yourself to one too early in the process via a sign then close deal potentially prohibits you from finding a better deal. Conversely, if it is a buyer's market, then locking up the buyer early on and removing some of its optionality can be a benefit to a seller looking to secure a sale.

Economic Closing Date vs Actual Closing Date

In most deals, the buyer assumes all risks and reaps all the rewards of ownership as of the date the assets are actually transferred to it – i.e., the actual closing date. In some instances, however, the parties will agree that the profits and losses of the business will accrue to the benefit or peril of the buyer as of a date prior to the actual closing. This earlier date is sometimes called an "economic closing date." Parties will sometimes use a different economic closing date where they are short on time to complete all of the required closing documentation before the desired closing date or where the business contains a lot of commodity pricing risks to the purchase price that the parties would like to lock in immediately.

FOR BUYERS

Buyers should ensure that where the economic closing date predates the actual closing date, the purchase and sale contract contains adequate promises from the seller that it will continue to operate the business in an appropriate fashion following the economic closing date, particularly where the deal is structured as a "sign then close" deal.

Electronic Closings vs Physical Closings

In the pre-internet days, it was common for closings to be conducted as follows: all of the principals and key advisors would gather in a boardroom. A junior lawyer for the buyer would be tasked with printing off and collating copies of each agreement needed to document the closing and arranging them on the boardroom table. A junior lawyer for the seller would tick through each document to make sure it was what it purported to be and that all documents were accounted for. More senior lawyers would alternate between backslapping with their client, trying to resolve any last minute issues that came up and nervously watching over their subordinates in the hopes that, if any documents were missing or incorrect, it was the other law firm's fault. Then the principals would go around the table and sign each document – of which there could be hundreds – before the final handshake and the lighting of cigars. The whole process could take hours. These types of "physical closings" still do take place from time to time, but are, for the most part, relics of the past.

Nowadays, it is much more common for the closing to be an "electronic closing." Signature pages to documents will be circulated by email to the principals days in advance of the schedule closing, often even in advance of the documents themselves being finally negotiated. The principals sign and scan back electronic copies of their signatures to their counsel who often exchanges them with their counterparts on trust conditions or in escrow prior to the closing. On the actual closing date, when the principals are ready to proceed, they simply agree that the escrow is released and that the documents can be considered signed (sealed, if necessary) and delivered. All of this typically takes place by email or telephone and is generally considered a less hectic and more cost-efficient way of conducting a closing by allowing the advisors to, in effect, collect the documentation and conduct the closing over several days behind the scenes rather than in meeting where many people – many of which are paid by the hour – are standing around and only a few are signing. So, do not be disappointed if your advisors try to steer you away from a physical closing and toward an electronic closing. While physical closings can be memorable experiences and a good opportunity to trade deal war stories, an electronic closing is probably saving you money!

Don’t Forget

Have fun. While the closing can be (and usually is) a frenetic and occasionally stressful event, it can also be invigorating to see your team come together to pull off the finishing touches of your purchase or sale. Most people are lucky if they get to be at the center of one or two transactions as a business owner in their lifetime, so be sure to take a second or two to soak it all in if you are fortunate enough to be in that position.

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