ACQUISITION OF A PRIVATE BUSINESS: LEGAL DUE DILIGENCE OUTLINE

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Legal due diligence is a critical component of the acquisition process. However, it is time consuming, expensive and disruptive. Therefore, it is important not to lose the forest for the trees! This document is a general high-level outline of key components. The document is prepared for reference by an Ontario solicitor representing a client seeking to acquire a private business that primarily operates in Ontario.

What is Due Diligence?

- In the context of an acquisition of a business, due diligence is an INVESTIGATION that seeks to determine the VALUES and RISKS of the target business.
  - Does the transaction make sense for your client, the purchaser?
    - How will the proposed transaction BENEFIT your client?
    - How will the proposed transaction HARM your client?

What are the Objectives of Due Diligence?

- Identify and minimize risks and post-closing surprises for your client. Risk cannot be eliminated – without risk your client will not make any money!
- Assist with the negotiation of the transaction documents and provide support for positions taken during negotiations.
- Identify and manage pre-closing obstacles to completing the acquisition.
- Increase your client’s knowledge about the target business and, if applicable, the industry in which it operates.
- Help your client assess the value of the proposed business and the costs associated with completing the proposed transaction.
- Help your client structure the transaction in the most advantageous manner.
- Verify the vendor’s representations and warranties in the purchase and sale agreement.
- Verify the opinion of vendor’s counsel, or, if no opinion is provided, confirm that the vendor has the power, capacity and authority to close the proposed transaction and that the transaction documents have been duly executed by the vendor.
• Limit your professional liability.

**Asset Purchase vs. Share Purchase**

• Generally, there are two ways in which your client may acquire a business:
  o Your client may acquire the ASSETS of the target business.
  o Your client may acquire the SHARES of the target business.

**Asset Transactions**

• If your client is acquiring ASSETS, 
  o Seek to identify WHAT your client will be purchasing and where the VALUE of the business is:
    ▪ Inventory
    ▪ Personal property
    ▪ Real property
    ▪ Intangibles
      • Rights under contracts
      • Licenses
      • Customer lists
      • Goodwill
      • Intellectual property
        o Trade-marks
        o Trade-names
        o Trade secrets
        o Patents
        o Copyrights
        o Industrial designs
    ▪ Receivables
- Prepaid expenses
- Books and records
- Licences and permits

- Determine whether any other party has an INTEREST in the target assets.
  - A third party, such as a creditor, a tradesperson or a governmental authority, may have a lien on the assets which would need to be discharged prior to transfer.
  - Determine the location of the assets and run the proper personal property searches in the relevant jurisdictions to identify potential charges against the target assets.

- Identify ISSUES with TRANSFERRING the target assets to the purchaser.
  - Ensure that your client will have the same rights as the vendor under any transferred contract after the closing.
  - Determine whether there is a need to obtain THIRD PARTY CONSENT from another party or any governmental authority.
  - Determine whether there is a need to NOTIFY any third party or governmental authority PRIOR to closing the transaction or AFTER closing the transaction.
  - The obligation to obtain consent and to notify may arise contractually or under law. If consent or notification is required prior to closing, this will impact pre-closing communications to third parties regarding the proposed transaction.
  - Determine whether there is a need to RENEGOTIATE any provision of a transferred contract.
  - Determine the extent of any transfer taxes that your client will have to pay (GST, PST, HST, Real Property Transfer Tax).
  - Determine the need to obtain or have transferred to your client any special licences or permits in order for your client to use the assets and operate the target business in the manner desired.
Identify the LIABILITIES and OBLIGATIONS of the target business that your client will assume.

- Your client may assume liabilities and obligations of the vendor by contract under the transaction documents or by operation of law.
  
  - Contractual assumption of liabilities:
    
    - Liabilities under commercial arrangements relating to the time period after closing
    - Post-closing obligations of the vendor to transferred employees
    
    - Restrictive obligations (e.g., non-solicitation, non-disclosure and non-competition obligations assumed under transferred contracts)
    
    - Other obligations of the vendor (e.g., the assumption of certain litigation)
    
  - Successor liabilities:
    
    - Environmental liabilities related to real property acquired in the acquisition
    
    - Unpaid workplace safety and insurance premiums
    
    - Unremitted retail sales tax
    
    - Severance obligations for past service of transferred employees
    
    - Unfunded pension plan obligations
    
    - Successor employer obligations under collective bargaining agreement

- Determine the nature of the VENDOR
  
  - Does the vendor have the power, capacity and authority to sell the assets?
  
  - Does the vendor own the assets? Does the vendor have the right to sell the assets?
  
  - What will the vendor look like AFTER the acquisition? Will the vendor be “judgment proof” or will the vendor be able to indemnify your client for any
misrepresentation, breach of warranty or breach of covenant in the transaction documents?

**Share Transactions**

- If your client is acquiring the SHARES of the target business, then it is acquiring the EQUITY INTEREST of the BUSINESS VEHICLE that operates the business.
  - The EQUITY INTEREST
    - The “purchased assets” are essentially the shares of the target business. By acquiring the shares, your client will CONTROL the vehicle that operates the target business.
    - Assuming your client desires 100% control:
      - ensure your client acquires all the equity interests in the target
      - ensure that no third party has a right to the target shares
      - ensure that no third party has a right exercisable in the future to acquire any equity interest in the target
    - Determine the capitalization of the target.
    - Confirm that the target shares were validly issued and, if applicable, properly transferred to the vendor and also to any previous shareholders.
    - Confirm that the vendor owns all the target shares.
    - Confirm that no third party has a right to the target shares (e.g., that the shares have not been encumbered or pledged). If shares are encumbered, releases and discharges must be obtained prior to closing.
    - Confirm that after the transaction closes, no third party will have a right to obtain an equity interest in the target (e.g., through options).
    - Determine whether there are any restrictions in transferring the shares and whether any third party consent or notification to a third party is required, before or after closing.
    - Determine whether the acquisition of the target shares will trigger any significant consequences (e.g., change of control provisions leading to termination of a material contract or change of control payments to key employees).
The BUSINESS VEHICLE

- Your client is acquiring the business vehicle that operates the business. Unlike an asset deal, your client does not pick and choose the assets and liabilities it wants but takes everything – warts and all!

- Identify the ASSETS used by the target to operate the business – owned assets as well as leased/licensed assets (see asset list above).

- Determine the extent to which the target’s assets are encumbered in favour of another party and assess whether it is appropriate for any such encumbrances to remain in place after closing.

- Identify the LIABILITIES and OBLIGATIONS of the target business as well as POTENTIAL liabilities and obligations:
  - Commercial agreements of the target
  - Credit agreements of the target
  - Liabilities arising from previous material transactions of the target
  - Obligations arising from governmental orders
  - Liabilities associated with assets of the target (e.g., environmental liabilities, work orders)
  - Employment and employment benefit liabilities and obligations
  - Tax liabilities of the target and other payment obligations to governmental authorities
  - Litigation
  - Restrictive obligations of target (e.g., non-solicitation, non-disclosure and non-compete obligations)

- If the target is a corporation, the liabilities will be contained in the acquired corporate entity (unless there is justification to pierce the corporate veil).

- Ensure that the target will have the same rights under its contracts after the acquisition.

- Determine whether there is a need to renegotiate any provision of a contract.

- Determine whether the target owns any equity interests in another entity.
- Understand the legal nature of the target and of the vendor.
  - Does the target have the power and capacity to own its assets and to operate the business as currently conducted?
  - Does the vendor have the power, capacity and authority to sell the target shares?

**Due Diligence on Your Client**

- Understand YOUR CLIENT, how it plans to OPERATE target business and what it plans TO DO with the acquired business after closing.
  - Will your client need any special licences or permits to operate the business?
  - Will your client operate the business as a branch, division or subsidiary?
  - What does your client need to do in order to acquire the business? Is there anything restricting your client from purchasing the business?
    - Rights of shareholders in shareholder agreement?
    - Rights of any third party under contract (e.g., consent right of creditor under credit agreement)?
  - What does your client intend to do with the business in the near future?
    - Does your client plan to roll the assets into another entity? If so, diligence may involve elements of asset purchase due diligence (e.g., review of assignment provisions in material contracts).
    - If your client has acquired shares, does your client plan to amalgamate the target corporation? If so, diligence should include review of contractual provisions restricting amalgamations.
    - If your client has acquired shares, does your client plan to transfer the target shares to another entity? If so, change of control consents should cover all proposed transfers.