



3 Common Misconceptions About... Selling a Business

By David J. Doyle

Although business owners are very familiar with their businesses, they will not have much experience in selling a business. In our practice we buy and sell many varieties of businesses and have noticed a number of misconceptions that vendors have about the process of selling a business.

MISCONCEPTION #1. Before the vendor sees a lawyer, the vendor and the purchaser should have settled on a price.

We often get calls from vendors telling us that they have made a deal to sell their business for a certain price. They then ask us to “paper the deal”. When we probe a little deeper we learn that the businesspersons negotiating the sale have not yet addressed many of the relevant legal issues. In our experience, at the initial negotiation stage many vendors will communicate to the purchaser the amount of money they want to put into their wallets at the end of the sale and the purchaser will communicate to the vendor the total amount of money they are willing to spend on the business. In our experience, when these approaches are used, the price the parties bring to each of their lawyers means drastically different things to the purchaser and the vendor.

One area where this difference appears is when discussing who shall be responsible to pay the liabilities of the business that exist at the time of closing. Often the vendor expects the purchaser to inherit the liabilities of the business that exist at the closing and the purchaser expects to inherit none of the business’s liabilities on closing. These liabilities can include simple items like unpaid bills or more complex issues like contingent liabilities related to inherited employees or product/service warranties. If a purchaser is going to be expected to take on liabilities that it did not know about at the time the price was set, they will often seek a reduction in the amount they pay the vendor to account for the fact that they will be paying money to third parties.

Another problematic area is that both the vendor and the purchaser tend to set the price based on the deal being structured to minimize their respective tax liability. The applicable tax statutes tend to make both the vendor and the purchaser minimizing their tax impossible. Often one side benefits from a structure and the other loses. The structure of the deal can have a very significant impact on both the vendor and the purchaser and it can result in a massive change to the purchase price.

If the vendor has already had its price negotiated down before considering these and other legal issues that can affect price, it may be faced with little negotiating room when an overlooked issue leads to a purchaser requesting a further reduction.

MISCONCEPTION #2. The vendor should always try to sell the shares of his or her corporation.

Many business owners are familiar with the lifetime capital gains exemption available to vendors on the sale of qualifying Canadian small business corporations. This exemption can eliminate the need for a vendor to pay taxes on up to \$750,000 of the purchase price paid for the shares of his or her corporation. This is an attractive option but there are a number of circumstances where an insistence on selling the shares may reduce the purchase price, increase taxes payable on the sale or make a purchaser decide they do not want to buy. A vendor may want to consider selling its assets instead of its shares in any of the following instances:

- (i) if the vendor is selling only part of its business;
- (ii) if there are large payments due from the vendor's corporation to the vendor or related persons;
- (iii) if the vendor's corporation has certain potential liabilities that will disproportionately reduce the price a purchaser is willing to pay;
- (iv) if the vendor's corporation has a particularly complicated or unwieldy ownership structure;
- (v) if the vendor's corporation has certain valuable assets that the vendor wishes to retain after closing;
- (vi) if the corporation that owns the business being sold has a tax position that allows for significant reductions in the taxes payable by the corporation as a result of a sale of assets;
- (vii) if the vendor is retaining certain post-closing rights that it wishes to pursue; or
- (viii) if the structure the purchaser wishes to pursue compromises the vendor's ability to claim the lifetime capital gains exemption.

Many deals that begin as share deals end up as asset deals because one of these items come to light during the negotiation and due diligence process. Any delay in determining the structure can sour a potential purchaser and drastically increase the legal, accounting and other fees associated with the transaction.

MISCONCEPTION #3. After the vendor sells his or her business, the vendor will have no further liability for the activities of the business.

As discussed above, whether the purchaser or the vendor will satisfy the liabilities that exist at closing is an issue that must be negotiated and agreed upon in the purchase agreement. In the event that no agreement about this issue is made, and a creditor goes unpaid, that creditor may commence legal proceedings against the purchaser and the vendor for payment. Certain creditors may even have the ability to void the sale transaction.

In addition to liabilities (known and unknown) that may exist at the closing, the closing itself can give rise to certain liabilities. If the purchaser is not hiring some of the employees of the vendor's business, the sale may give rise to a termination event that requires the vendor to provide its employee(s) with termination pay in lieu of notice. Also, if the vendor has failed to get the consent of a landlord or other party that has a contractual right to refuse the transfer of their contracts to the new purchaser, the closing of the transaction can be a breach of contract by the vendor and result in lawsuits.

Finally, if a customer, creditor or bank is not aware of the change in ownership of the business, the vendor can be drawn into litigation that arises from events that occur in the business after the closing of the sale. Personal guarantees provided by the vendor (and the shareholders of the vendor in an transaction) are not automatically released on the sale of a business. Also, absent a written agreement providing for the purchaser indemnifying the vendor for liabilities arising post-closing, the vendor may incur significant legal fees and other costs (that cannot be recovered from the purchaser) as a result of the actions of the purchaser.

Our Suggestion:

Vendors should contact their lawyers early in the transaction discussions to identify the issues that are likely to arise that might lower the price. The issues set out above must be dealt with in almost every business sale. Identifying the importance of these issues to each of the purchaser and the vendor as early as possible allows the vendor to:

- (i) take steps to eliminate potential issues before the purchaser raises them as a price-altering concern;
- (ii) identify the issues to the purchaser and, at the same time, present the purchaser with a solution that will minimize the risk to the purchaser;
- (iii) ensure that, if a discount is being given because of the purchaser's acceptance of a liability or the purchaser's willingness to structure the deal in a manner that is beneficial to the vendor, the purchaser understands the connection between the concessions so it does not try to reject the liability or change the structure while maintaining the same price; and/or
- (iv) have the purchaser's and vendor's concessions reduced to writing early in the process so that the purchaser will not attempt to re-negotiate the price closer to closing when it re-introduces some perceived risk that has been dealt with earlier.

When selling a business it is crucial that the vendor have a clear vision of the structure of the deal and have an intimate, but objective, understanding of the value of their business. By preparing a plan early that sets the preferred structure of the deal and clearly identifies what assets and liabilities the vendor wishes to transfer, the vendor will have the opportunity to direct the negotiation of price so that, even though the size of the cheque that he or she receive may be reduced a little, the amount of money that gets put into his or her bank account, and stays there, is what the vendor expected.

David Doyle is a corporate-commercial lawyer who advises his corporate clients on the sale of businesses of varying sizes and in many fields of business activity. In the event that you have any questions about the content of this paper, please feel free to contact David Doyle at 613 542-7761 or at ddoyle@vinerkennedy.com. You can review other writings of the author at www.vinerkennedy.com/articles.

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