The life cycle of a deal

Part 1: types of acquisitions and first steps

20 December 2021

By: Ted Maduri | Christopher Pejovic | Rownock Zamani (Articling Student)

Although the life cycle of a deal varies depending on the type of the transaction and the industry of the target business, many life cycle stages are similar. Part 1 of the Life Cycle of a Deal series sets out the types of acquisitions and the first five stages of a deal's life cycle.

Types of acquisitions

Generally, there are two types of acquisitions:

- an asset acquisition; and
- a share acquisition.

In an asset acquisition, the purchaser acquires a specific set of assets and liabilities of the target. In a share acquisition, the purchaser acquires a controlling interest or all of the issued and outstanding shares of the target.

A transaction may also be an amalgamation, whereby the amalgamated corporation assumes all assets, rights, and liabilities of each amalgamating corporation. An amalgamation is rarely used as a standalone acquisition structure. It is most commonly used in the context of a share acquisition when the purchaser is amalgamating with the target post-closing.

There is greater flexibility in an asset acquisition as the buyer has control over which assets/liabilities are being acquired. In line with this, there is reduced risk. In a share acquisition, the buyer acquires the whole business. For various reasons, a vendor prefers a share acquisition, while a purchaser prefers an asset acquisition.

Stage 1: A vendor should examine their goals and their business

Selling a business is like selling a house: it should have a "curb appeal". To attain that “curb appeal", the vendor must first examine its business and the specific goals it is trying to achieve with the transaction. Following are some of the questions a vendor should ask when examining their goals.

What do you want to do and when?

Objectives usually include a combination of business, personal and tax considerations. Preparing for and executing a sale may take up to 12 months. The actual sale process, including negotiating with the preferred buyer and closing the deal, often takes up to half of that time.

What is your business worth?

Typically, different industries have different valuation multiples or conventions. The management team and other key employees, intellectual property, goodwill, customer lists, and earning capacity are likely considered the most valuable assets of the target. However, buyers may value these core assets differently: a financial buyer may value the current management team more than an industry buyer with its own management team in play already.

Whose help do I need?

The vendor will need to engage lawyers and accountants with transaction experience. M&A advisors can help identify prospective buyers and market the vendor’s business to them.

For more information, please see: Getting your business ready to sell.

Stage 2: A vendor must prepare their business for sale

When a buyer is preparing to purchase a business, they perform a version of a home inspection. To prepare for this “home inspection”, the vendor must conduct vendor-side due diligence.

- *General corporate documents*: The vendor should have their lawyer review the minute books and all extra-provincial registrations.
- *Accounting records, taxes and financial statements*: The accountant should confirm that all financial and accounting records are complete, accurate and up to date.
- *Material agreements*: Buyers will want to see copies of all of the material agreements into which the company has entered. Material agreements should also be reviewed for any change of control provisions (if you intend to sell the shares in your company) or assignment provisions (if you plan to sell just the assets).
- *Intellectual property*: The vendor should confirm that all trademarks, patents, copyrights and business names are duly registered and protected. If the vendor has any IP developed by contractors or if the business uses any improperly obtained software, they must confirm that they have the proper assignments from their contractors and obtain legitimate software copies.
- *Labor and employment/human resources*: A critical question is whether the existing employees will be retained. If employees are not being retained, it must be determined who will be responsible for notice and severance.
- *Real property*: If the vendor own real property, the vendor must deliver a clean title to the real property they are selling.
- *Licences and permits*: Depending on the business, a vendor must review what licenses and permits are needed to operate their business and whether they are in good standing.
- *Disputes and litigation*: If the business is involved in litigation, a potential buyer will want to know the amount of the claim(s) and the likely outcome of the lawsuit(s).
- *Other*: The vendor should remove all stale liens and update/populate the data room with all relevant documents for the buyer to review.

For more information, please see: Seller due diligence: Are you ready for buyer’ questions?

Stage 3: Drafting a non-disclosure agreement

Once a vendor has found a potential buyer, it will need to share valuable secrets with the buyer or investors. In light of this, all parties should sign an effective non-disclosure agreement ("NDA").

Ensure key confidential information is covered

The first step is determining what information is confidential and the degree to which a party should attempt to protect it under an NDA.

Specify proper use

An NDA has two significant features: (1) a specific description of the purposes for which confidential information may be used, and (2) a blanket prohibition on using it for anything other than the prescribed purpose.

Stipulate protective measures

Parties should consider the level of care taken to avoid disclosing confidential information.

Don't treat all information as confidential

The parties will need to carve out or exempt certain categories of possible confidential information.

Don't ignore third parties

Often, there is a reasonable need to disclose information to employees or professional advisors, but this should be considered on a case-by-case basis.

NDA's don't last forever

Typically, confidentiality provisions in commercial transactions survive for approximately two years.

For more information, please see: Confidentiality and non-disclosure agreements.

Stage 4: Drafting a letter of intent

Letters of intent ("LOIs") outline the key parameters of a transaction so the parties can be on the same page before spending the time and money to negotiate final legal agreements. LOIs are typically non-binding other than a few binding provisions.

- *Focus on valuation and payment*: The most important aspects of any business transaction are what is being transacted, how much it is worth, and how it is being paid and whether there are any adjustments.
- *Clearly state the key conditions to closing*: LOIs should set out any conditions required to be met before the execution of final agreements.
- *Keep things confidential*: The LOI should include a binding confidentiality provision to ensure sensitive business information is not made public.
- *Set a timetable*: Using an LOI to set out the proposed timetable will help keep the due diligence and legal negotiations moving swiftly.
- *Consider the length of the exclusivity provision*: Purchasers will often seek the assurances of exclusivity when negotiating with a vendor.

For more information, please see: Letters of Intent for buying/selling a business.

Stage 5: Conducting due diligence from a buyer's perspective

It is equally essential for a buyer to conduct a due diligence review of the target business (typically after an LOI is signed). In an extreme case, diligence findings may cause the purchaser to abandon the transaction. However, more typically, diligence findings will help guide the negotiation of contractual provisions (such as representations and warranties, indemnity provisions, conditions to closing, etc.) in the underlying definitive agreement.

The key objectives of due diligence in private M&A transactions include:

- Confirming that the vendor has good title to the business (i.e., shares) or assets being acquired;
- Locating potential liabilities or risks associated with the business or assets being acquired;
- Locating any impediments to the transaction, such as third-party consents, problematic provisions in material contracts, a required shareholder class vote, or prohibitions on transfer; and
- Confirming the transaction structure and determining what legal documents are required to complete the deal properly.

The following is a non-exhaustive list of information the buyer should examine during their due diligence review:

Minute books

The buyer's legal team should review the minute books of the target, ensuring that they:

- are organized and complete;
- properly reflect the capitalization and share ownership of the target; and
- include extra-provincial registrations in each jurisdiction in which the target operates.

The minute books should ensure that all material agreements and actions taken by the target were duly authorized and approved by directors' or shareholders' resolutions, as applicable.

Public record and registry searches

The buyer should conduct public records and registry searches. Specifically, the buyer should conduct searches regarding: status and standing, business names, bankruptcy, section 427 of the Bank Act, real estate, personal property securities, taxes, IP, and litigation. These searches will assist in confirming whether the vendor has the capacity to sell the target business or assets and ensure no encumbrances are on title. Most of these searches should be completed in the province or municipality where the target business or shares are located. However, if the assets are located in more than one province or territory, such public searches should be conducted in each additional jurisdiction.

Contracts and regulatory approvals

Several contractual provisions can significantly impact a transaction. This includes any change of control, assignment provisions and termination provisions. Many leases and other contracts contain a change of control clause, which requires a third-party's approval to lease or assign the contract if there is a change in the target corporation's control. If the corporation wants to continue to retain the benefit of the lease or contract, they will often require the landlord's or other third-party’s written consent. Moreover, the buyer should be aware of any restrictive covenants, most favoured nation provisions and lingering security interests. Finally, the purchaser should make a note of any expired contracts and whether they can be renewed.

If the business is regulated, the purchaser should confirm that the target business is in compliance with all of its regulatory approvals. Moreover, the purchaser should note if the regulators must approve the transaction.

Depending on the nature of the transaction, some of the due diligence should be conducted by legal specialists. This includes real estate, IP, and environmental matter. Legal counsel should be retained to examine specific tax and regulatory matters and consequences. Outside consultants, such as accountants and insurance specialists are sometimes retained as well.

Look for the next installment of our Life Cycle of a Deal series discussing the key terms in a purchase agreement in the upcoming ninth edition of Growing your Canadian Business.

This article provides only general information about legal issues and developments, and is not intended to provide specific legal advice. Please see our disclaimer for more details.

AUTHORS

Ted Maduri

Partner
Toronto | T: +1 416 365 3500
ted.maduri@dlapiper.com

Christopher Pejovic
Associate
Toronto | T: +1 416 365 3500
christopher.pejovic@dlapiper.com