OSLER

Selling your business 101: Initial preparation and getting to a deal

SEPTEMBER 17, 2018 49 MIN READ

Related Expertise

- Emerging and High Growth Companies

For emerging and high growth companies, deciding to sell a business is an important consideration that requires careful planning and extensive preparation. However, determining you are ready to sell is only part of the process. It's imperative to not only understand why you want to sell your business — this will often be the first question a buyer will ask — but to initiate the planning stages one-to-two years before the anticipated sale.

Preparation for a sale involves assembling a multi-disciplinary team (consisting of M&A counsel, accountants, tax advisors, etc.) and also determining the core team at the company that will be "in the know." It also involves assessing and managing risk, and answering fundamental questions such as who the likely buyers will be, what your floor price is, whether you're willing to agree to an earn-out, etc. This presentation by Chad Bayne, Co-Chair of Osler's Emerging and High Growth Companies Group, details key considerations when selling your emerging and high growth company, from initial planning stages to closing a deal. Available in both webinar and PowerPoint format, the goal of this presentation is to help you navigate the following issues:

- Initial preparation to sell your business
- Answering the fundamental questions including who the likely buyers will be and whether you're willing to take shares back of the buyer
- Assessing and managing risks
    - ensuring all arrangements are properly documented and signed
    - ensuring your minute book is up to date
    - building a data room
- Accounting and tax planning considerations
- Process and getting to a letter of intent
- Getting to a deal and closing

Transcript

Selling Your Business 101: Initial preparation and getting to a deal from **Osler, Hoskin & Harcourt LLP**

For more information, contact Chad Bayne, Co-Chair of Osler's Emerging and High Growth Companies Group, at cbayne@osler.com or 416.862.4708.

This presentation is part of Osler's Emerging and High Growth Companies 101 series, designed to help emerging ventures navigate through the various issues and legal requirements they will encounter throughout their growth cycle.

Video transcript

CHAD BAYNE: I'm going to try to make this as business focused as possible. Won't get too much in the legal minutia of selling a business. There's some stuff at the end because ultimately, at some point, you're going to cross into the legal aspects of selling a business, but we're going to try to focus as much as possible on sort of just the thought process, the planning process, et cetera, to get you from point A to point B. And if you have questions, just put your hand up. We'll do this informally as possible. It's kind of boring if I'm sitting up here talking the whole time. So if you have questions, just interrupt.

OK, so there's a lot of content here so we may run a bit over if people want to stay a bit longer. But the areas that we're going to focus on is the first obvious point is why sell your business, and then we get into the initial prep work that we'll end up doing. There's some fundamental questions you're going to have to answer with respect to selling a business. Part of the planning process is assessing and managing risks with respect to the business.

There's accounting aspects to selling a business. There's tax planning. Then there's actually the process and getting to a letter of intent to actually sell the business and then getting to an actual deal because just a letter of intent is just an indication of interest and then non-binding indication, and then getting to a deal and actually closing it so when you actually hand over the keys as it were and get the check.

OK, so why sell? Well, this is going to be the first question a buyer is going to ask when it comes down to it in terms of why you want to sell a business, and there's a whole myriad of reasons. Now, in our group, we typically focus on a lot of the latter reasons, but for an owner-managed business, it could be retirement. It could be a dispute with a partner. It could be illness, death. The owner could be overworked. It could be boredom.

There's a whole myriad of reasons, but you should understand sort of why you want to sell, and as a result, that may guide you as part of the process in terms of the fundamental questions you're going to have to ask yourself in terms of price, et cetera, but also how you're going to manage this process going forward. Do you need to sell? Is this just going to be potentially an option to see what the market will bear? So again, there's a whole bunch of reasons. No answer is right. Just it's a question of you have to figure out why you want to sell it.

OK, so this is where we get into selling a business is you don't wake up one day and say we're going to sell it, and then two weeks later, you sell the business. It usually doesn't happen that way. Most of the time, you're going to start planning usually one or two years in advance of actually getting to the point where the business is going to be sold. A lot of that planning is starting to put together your team to the extent you have counsel that will advise you– hopefully, it's us– accountants, tax advisors, bankers, other advisors that may be helpful in terms of assembling sort of to guide you through the process.

Your planning options are going to vary greatly depending on how the business is ultimately owned. If you're just an owner manager, it's a much easier consideration. You have no external investors. You bootstrapped the business and maybe a couple of founders. It's a much easier sales process than potentially a company that's venture-backed or has external investors because they will likely have a say in the matter in terms of when you're going to sell and how you're going to sell and who you're going to sell to or potentially going to sell to.

So that will have to factor into it. And to the extent that you're considering a sales process with respect to the VC backed company, which is a lot of the companies we deal with, that will be an ongoing conversation with the board of directors and the investor base, the key investors in the company to start iterating through that process.

One of the most important things with respect to prepping for a sale is who is actually going to be in the know at the company. You can't tell everybody because that's probably the worst thing that could possibly happen in terms of everybody knowing that the company is potentially in play for a sale.

So they'll usually be a core group of either the founder, senior management, members of the board, whatever the case may be, and the board will typically be involved throughout the process, but it may be a subset that will sort of direct the steering of the transaction and the process.

But you have to figure out who those people are, and there may be people that will be brought into the loop father through the process, but they'll probably be a core subset, CEO, CFO, maybe the COO of the business, whatever the case may be. But those people will be the ones ultimately guiding the process initially.

And then you got to think about, OK, so if I sell the business and after the exit, then what? So you've sold the business. You've sold whatever you've been working on for the last number of years. Then what are you going to do? So part of this, you have to think about it will go into coming into the fundamental questions as to, are you going to be stuck around the company? Are you going to basically go cash out on a beach somewhere. You may not be allowed to go cash out on a beach somewhere because the buyer may want you to stick around depending if you're core to ultimately the business that's being sold.

So you have to think about– it's an important factor to think about when you actually set out to sell it because the worst thing will be you sell the business, the ink is dry, and you're like, oh, my God, you have seller's remorse in terms of why did I sell, or what am I going to do with my life now that I've sold? For a lot of serial entrepreneurs, it's fine. That's part of what they live for, and ultimately, they'll spend a couple of years just taking some time off, and they'll go out and figure out what their next thing is going to be.

OK, these are the actual really important questions that need to be asked, and you have to ask yourself as potentially an owner of the business, but you also have to ask other owners and if there's investors, et cetera, as to is this the right time to sell. And the right time to sell could be a factor of whether there's consolidation happening in the marketplace, your competitors are being bought. Is the company just generally in high demand because it's doing something unique in the market? It's actually generating lots of revenue and potentially generating a lot of profit as well.

So you have to think about the fundamental characteristics of the market and whether or not it makes sense at the time. Your investors maybe– it comes back to, oh, why do you need to sell as well? Your investors may be looking for a liquidity option at this point. You're just maybe done, and you're just like, forget it, I don't care. If this is it's the right time because it's from a personal perspective you just can't deal with it anymore, or it could be the case where fundamentally the business is not going in the direction that you'd hoped, and it's best to sort of cash out and take off whatever you can at this point.

So as part of that, then you have to think about who would the likely buyers be. So oftentimes, the most likely buyer for a business is somebody you're working with as a partner, especially in the tech space, whether it's a customer or a reseller or a strategic partnership or whatever the case may be, a joint venture or whatever. Those are usually the most likely buyers because they've been working with the business for a long period of time. They see the potential value. They see the synergistic relationship between the two businesses. So it makes it much a very natural fit.

Another potential buyer is a strategic. So when we talk about strategics, they differ from financial. A strategic is another company. Now when I differentiate that from an existing partner, it's somebody that may not be involved with the business to date, but there is a necessarily synergistic fit between your business and their business, whether it fills a hole in their product suite or service offering or whether it just makes a lot of sense from a differentiation perspective or they're potentially a consolidator, which is a form of strategic buyer.

And so Constellation Software is a great example of this, and OpenText is somewhat of a consolidator now, but they're essentially a strategic, and they have their own business like in the case of OpenText and their own products, but they essentially buy up a lot of businesses and verticals to essentially– and it's a bit of a financial engineering play, but that's another potential opportunity depending on the size of the business.

Private equity is the other big category, and there's lots of activity in the private equity realm in terms of mid-sized private equity firms, larger private equity firms like the giant private equity firms depending on the size of the company, and these businesses are ultimately going to buy– these investors are ultimately going to buy the business with a view of potentially reselling it in three to five years or consolidating with other players in the marketplace and then reselling the whole package together by achieving certain synergies between the businesses and ultimately selling it as a package.

One thing people don't really think about a lot when we start sitting down and having conversation is what is your floor price for the business. If somebody offered you that price, would you sell? A lot of times, it's like, well, we'll see what comes up. But I think if you're going to embark on a process to essentially sell, you have to understand what you're willing to sell a business for. And it may be unreasonable, and that's fine because ultimately the business is worth more to you in your hand than it is in terms of the money that you may receive for it.

So you have to really think about what that floor price is, and ultimately your investors to the extent you're a venture-backed company have a floor price as well because as a result, they're ultimately looking to make a return on their investment, and they will have a say in terms of whether or not it's the right time to sell.

For example, you may make a decent return on getting a couple of million dollars, but your investors who may only get their money back will say no way in hell. You're sticking to this for the next little bit, or otherwise, we're going to replace you type of thing. So that's really important to understand where sort of your bottom line is here, and anything above that, you're willing to take.

Another important aspect of this is not all deals are cash-only deals, although we all like them to be cash only because they're simple to do, and they're the best because you have the flexibility going forward in terms of having the cash in your pocket. But oftentimes, especially in the private space dealing with tech companies, a lot of times shares are used as consideration, and it's a question of whether or not you're willing to take shares back from the other company.

So part of selling a business is ultimately getting liquidity and putting cash in your jeans. Taking back shares from other companies, you're just inheriting somebody else's problem at the end of the day, and whether or not you get liquidity on the shares– now it's one thing if it's public company shares. It's a whole other thing if it's private company shares. So those are things that you need to consider as well as whether or not you're willing to take back some equity. Some people are fine with. Other people, it's like cash only.

And another aspect of this in a lot of private equity deals you see, the senior management team and core founders that are still around the business having to do a management role. So this is not necessarily you taking back shares of the buyer per se. You're basically keeping some of your equity in the company on a go forward basis to essentially align yourself with the investors so that you'll all exit with a higher price at the end of the day. If you're not willing to potentially do that and stick around for a number of years, then potentially private equity buyers are not the right parties for you in terms of actually going out and soliciting buyers.

And this sort of goes hand-in-hand with the next point is, how long are you willing to stay with the buyer in a retention arrangement? If you're a core employee, like if you're a key founder or key employee with the business, key technical person, key salesperson, whatever the case may be, the buyer may oftentimes, especially in the tech space, is going to want you to stick around.

How long? It could be two years. It could be three years. It could be four years. Average is two to three years, probably average three years. But that's important because we've had situations where the founder's like, I just want to cash out and hit the trail and start traveling the world. I'm like, yeah, I don't know if that's going to be possible given the circumstances. So as a result, that may factor into whether or not you can sell the business at all or the price a buyer is willing to pay for the business.

A lot of early stage businesses, especially when you get into businesses that are not priced necessarily on business fundamentals like multiples of revenue or whatever the case may be, and they're just basically priced on the team and the potential opportunity with respect to the technology that is being built, so essentially we call a acquihire or an acqui slash tech acquisition. A lot of that value is going to be associated with the team sticking around for a number of years. So if you're in sort of those circumstances, which is a relatively small acquisition, it's going to be very hard to do the deal unless the team is willing to stick around.

And then oftentimes as part of a transaction, you may see an earn-out, which sort of goes hand in hand with the retention arrangement. But it may not. It may just be whether or not there's future upside to the extent you have a number in your head that you're willing to sell the business at, but what if somebody comes to you and says, well, we'll give you X, which is 30% lower than your price, but we're willing to pay you out in an earn-out that you may get to that point and exceed it.

And you have to determine whether or not you're willing to take that sort of trade as to giving up essentially somewhat of control over your business with the view that you may ultimately get future upside going forward with respect to that business through some sort of earn-out mechanism.

Lawyers hate earn-outs house because they're one of the biggest areas of litigation in an M&A transaction. There's always a fight associated with them. It comes down to the ability of the team to ultimately run the business versus the ability of the buyer essentially running the business or having the freedom to change course with respect to that business after they've purchased it. So there's extreme tension between the two when you enter an earn-out. And there's always the debate as to what actions can the buyer take, what actions can't the buyer take with respect to that business during the earn-out period. Any questions?

All right, so this is now when we get into the point of preparation with respect to the sale. So as we say, we start planning well in advance. Buyers are going to do extensive due diligence on you, and they're going to turn over every stone. They're going to look at every possible scenario with respect to the business and look for any issues.

Everybody who they hire on their side from an advisory perspective are going to look for issues because the more issues they find, the better they look to their client and the more they can justify the fees that they're charging as part of the transaction. So if they can save their client money, then they've basically paid for themselves. So as a result, you need to really think about where the potential skeletons are and try to figure out how to address them.

Buyers will actually, if they uncover enough issues, they'll potentially try to recut the deal. The sellers will have to take on risk. There may be increased adjustments with respect to putting money aside to cover those potential issues. They may reduce the purchase price. Or they may just walk away and say, the hell with it, we're not wasting your time.

So it's really important, and this is part of– as I've sort of plugged the practice– it's what we try to do is try to always have you ready for a financing or a sale so that we clean you up as much as possible all the way through and put in sort of good practices with respect to employment and all those other things.

Again, part of it is with a company growing quickly, there's always issues in terms of documents don't get signed, documents don't get properly filed, things are missing. So part of the task of preparing in advance is actually going through and taking an inventory and try to figure out where the gaps lie, where the risks lie, and then try to address them before you start the process.

It's way better in a process to know what the issues are because oftentimes the buyer, through the diligence process, is going to know the company as well as the sellers will. And sometimes the argument is even better because of the amount of diligence they've been doing on the business. So it's always better to be– in any negotiation, it's always better to have the information at hand so you can address it before the buyer starts using it as leverage.

OK, so once you've actually gone through that process of starting to prepare, then you got to understand where the problems lie. So you need to understand what potential legal risks are associated with the situation you have. Like for example, if you haven't signed IP assignments with respect to certain key employees and they were key contractors and have worked on the code base, that could be a problem. Or if you haven't just documented potential transfers of intellectual property or you don't have rights to use certain data with respect to the commercial application of your business, then those could be problems.

In a deal I did probably about 13 years ago now, 12, 13 years ago, we were on for a fairly large Canadian corporation that was buying a business from another Canadian corporation, and this business was all based on data. What we found through our diligence process is– and the seller had no idea in terms of what they were actually selling.

But we found out through the diligence process that the seller did not have the rights to even be in the commercial application of the business. They actually essentially scraped most of the data from public source– not public sources, from commercial sources that they used in other applications in the overall business, but they didn't have the right to actually take that data and make a commercial product with it.

So as a result, the deal had to go on hold for six months, nine months, I think, while the seller obtained licenses for all the data in terms of the business they were running to ensure that they could actually use it, which ultimately put in a different cost loading into the business because all these new licenses now cost millions of dollars to obtain. As a result, as you can expect, the purchase price went down considerably because the business that was being sold had a certain cost profile to it. Now it had a completely different cost profile.

That's an extreme case, and that was a large Canadian public corporation that was running that business so it could happen to anybody. But it's really important to understand those risks, and it's really painful to start solving those in the course of a transaction rather than trying to address them well in advance.

Like I said before, it's always better to be proactive than reactive to any sort of situation. Have the information at hand with you when you're going through the process so that you can have the appropriate explanations or take steps to mitigate why these certain things are where they are.

As I said, it can be very time consuming and very expensive to correct these issues during a transaction, and the reality is some issues are going to require paying money to resolve. It's not as simple as just saying, oh, sign this document. People are going to say, well, why do I need to sign this document?

In a transaction I worked on probably again, 14 years ago now, 13 years ago– I was a mid-level associate– for a large tech company where we did a bunch of diligence, and we asked as part of it because the paper was terrible with respect to the company, we asked for a bunch of confirmatory IP assignments to ensure that everybody assigned their IP to the company before it was sold, all the people that were working on the company.

Two of the developers refused. And I said, well, I recommended to the client that they should not proceed on the transaction as a result of not getting these two people because there's more to the story than them just resisting not signing this paper. The client said, no, we have to do this deal. And it's very typical of big public corporations. Once the momentum is there to close a deal, they got to close the deal.

So they close the deal, and no sooner than the ink dried, the cash moved to the sellers, a statement of claim was dropped basically claiming that all the IP that was developed was owned by those two individuals. And this essentially went to litigation, which was found in their favor. It was settled.

Ultimately, most of the purchase price ended up being shifted to the two people that ultimately developed the technology. And ultimately, it could have been resolved by not closing the transaction, and they could try to get the paper signed or try to figure out why these people wouldn't sign and try to sort things out. So as a result, it was a very expensive lesson to be learned. But at the end of the day, it got resolved with a lot of money, though. It's something that probably could have been resolved during the transaction rather than after.

With all this in terms of assessing risks and understanding risks, you need to understand what representations and warranties that the target, the company, and the sellers will need to make with respect to the company. These are basically statements. This is where the allocation of risk occurs between the buyer and the seller. The buyer is going to ask the sellers or the company and its owners that stand behind it to make a bunch of statements about the company. And they all have to be true as of closing. Otherwise, the buyer will have a claim against the sellers.

So as a result, you should have a good understanding in talking to your legal advisor– again, hopefully us– to walk through the types of representations and warranties that would be typical in a transaction to sell the business. And some businesses will have different depending on what you're doing to the extent it's a consumer business that's basically doing an actual physical product with product liability may have different issues than a typical SAS software business.

OK, so this part of the process is being ready. Ensure all your arrangements are properly documented and signed. Again, we talked about the IP assets and having sufficient rights. I just gave you two anecdotes in that of situations where the sellers didn't have the rights, or the actual company didn't have the rights, sorry.

Minute book– make sure it's up to date. Your minute book is actually the corporate bible as it were. All this– say, because if your agreements are not properly documented and signed or your minute book is not up to date or messy, the buyer and its advisors are going to draw conclusions from the poor recordkeeping. They see these messes, and they're like, well, what else have we not seen? What else do we not know?

So it's going to start asking questions, and it's going to make them much more apprehensive about what they're seeing rather than a company that's completely got their act together, has a data room assembled, has everything properly indexed, et cetera, and ready to go. Again, it's best to put on a good first impression because it makes the transaction go a lot easier, and it puts a lot of worries aside with respect to the buyer in terms of what they're looking at ensuring that everything's there.

Building a data room is actually important. There's no transaction that I've done in the last I don't know how many years now that there won't be a data room, like since I started practicing law I guess. Now it's all electronic. It used to be in a room in a law firm, typically in a meeting room where you'd see reams and reams of binders, and you sit there and go through it. Now it's all electronic, and people can review documents at their leisure.

But it's important to start building this. Even though a buyer will have its own due diligence request list, it's better to get one from your counsel and start putting it together in advance. And actually, what we recommend is given the fact that most companies are venture backed, start putting a data room together sooner rather than later and then just continue to add to it. And then you can turn off and turn on aspects of it or move documents to specific folders if you just want certain subsets to be seen. We find it way better than trying to start from scratch.

The companies that start from scratch as part of a transaction when we get to an LOI sign, and it's like you get the diligence request list, and they're like, oh, God, we got to assemble things. And it takes weeks. It could take months to get things, and it could put a huge delay on the transaction. And the buyer may just get bored and walk away. So we strongly recommend to get this done in advance. And most of the companies that are going through financings, especially everything post-seed start this process, and then companies that are going through a sales process just build on top of it.

OK, so I'm not an accountant, but I know enough about accounting to know what you need to do with respect to getting ready to sell a business, and these are just some of the things that I wanted to highlight. Again, the whole accounting aspect is a totally different conversation with one of our accounting colleagues.

But there's a few things that you should always sort of tick off, one of which is ensure that your statutory remittances are done. A lot of companies we see haven't necessarily done that. They're doing payroll by hand. They're not doing it through a third-party provider or whatever the case may be and haven't actually remitted income tax, CPP, EI to the government, and that's a huge red flag for buyers. So that's the first thing you should check off. Most businesses do it, but again, it's just a box that you should check off.

Tax returns as well, a lot of businesses forget that they have to file taxes. Most businesses are always in a loss scenario, especially the high growth venture scalable businesses for quite a while because they're trading off profit for growth, but you should ensure that they're still filed, your income tax returns, your HST returns. If you have foreign subsidiaries or foreign tax returns, make sure that those are all done because the buyer is going to look for them, and they're going to ask for them, and they're going to try to match up with what you've done from your books and records with your tax returns in terms of the diligence they're doing.

Audited financial statements, they're not necessary, but they're way better if you have them, especially when you're getting to a point of selling the business. They provide a lot more comfort than unaudited financials, even review engagement and of course, review engagement financials as well. Audited, so the audit firm has gone through it, put their seal of approval on it. As a result, there's just the buyer has more comfort when it actually looks at the financials that these are better reflective of the actual business.

Quality of earnings report, to the extent that the business is actually making money or making a decent amount of revenue, it's not sort of an early stage pre-revenue company. Is a worthwhile exercise to engage in? Now, especially if you're running a full on process, the buyers are likely going to do their own quality of earnings report regardless.

But it's good to have it so that you have a good assessment of the fact that your earnings are what you think they are and that they're of quality that you think they are as well. So it's good to actually engage an accounting firm to do this for you in advance of the process. Not everybody does it, but it's a good idea to go through that process.

And I notice now that EBITDA is spelled wrong, but I apologize. But that's another thing that you really want to think about terms of just getting the best value for the business is maximizing your earnings. Again, not all businesses, especially in the venture space, have earnings, but to the extent that you do, figuring out how you can essentially cut costs leading up to a sale from non-essential personnel, for example, to actually maximize those amounts just to make the business look better from a sale perspective.

And then the last thing is with a lot of owner-managed businesses, we see a lot of commingling of assets with the corporate assets. So don't because it's hard to separate, and then the buyer is always asking, well, do those actually belong to the business or not? So putting cars into a business, putting other personal expenses through the business, again, it doesn't happen as much with venture-backed businesses, although we've seen it. It's usually with an owner-managed business where you're sort of using the business to essentially provide financing for your personal life as well.

OK, this is a big area in terms of doing transactions and selling businesses is the actual tax planning that's involved. And nobody actually wants to pay more taxes than they have to. It's a necessary evil of the country we live in, but ultimately, we try to reduce those taxes as much as possible by the way we structure the transaction and the certain goodies that you can get from the government as a result of just doing some forward thinking and tax planning.

So the biggest question is whether you do a share sale or an asset sale. So they have different characteristics in terms of the taxation that occurs ultimately and the benefits that a buyer or seller might get as a result of them. Generally, buyers want to do an asset purchase or asset sale from the seller, and the reason for that is twofold.

One, it gives them full cost basis on the assets they buy so they can step up the basis and depreciate those assets based on the value that they just purchase from that. So it's a huge benefit from a tax perspective. Two, they're buying at a fair market value so if they wanted to export the assets out of Canada, they can to the extent it's a foreign buyer. Three, you can basically pick and choose what assets and what liabilities you want to take on. So it's actually very beneficial.

Sellers don't like doing it because it's usually less tax efficient. VCs really don't like to do it because it affects their carry. It affects their return profile. So they really don't want to pay tax at an entity level within the company and then get a distribution that has reduced their proceeds that they received in the transaction by the taxes paid by the company, which is a huge difference to the extent that you're paying a tax rate of 30% in a jurisdiction. Sorry, go ahead.

AUDIENCE: What is an asset for a software company? I mean, are you talking about the actual software–

CHAD BAYNE: Yeah, IP, the goodwill of the business, the actual technology stack, your contracts, customer list, all those types of things. The sellers generally don't want to do it and for the reasons I said. Now sellers will want a share sale because it gets them the best tax treatment. It's capital gains tax treatment. And the sellers actually pay the taxes, not the corporate entity. So as a result, it's much more efficient from a venture perspective in terms of a return. There's a bunch of benefits for Canadians, which we'll get into, that provide you reductions in taxes to the extent that you're selling shares.

Now, there are certain situations where you may be able to get a win-win situation doing some sort of hybrid type transaction whether or not you're just selling IP assets offshore to the buyer and then doing the share sale and basically sheltering some of that through losses or whether or not you do some sort of more complicated Gawronski, which is a type of– it's based on a case, a tax case, but basically a more complicated structure where the buyer gets the deal like an asset. So it's an asset deal for the buyer, but the seller essentially gets to use life on capital gains exemptions, et cetera as part of the sale process. It looks more like a share sale for the seller.

So why do we want to sell– oh, and the other reason why buyers don't like share sales is they take all the liabilities of the company. Now you manage that through contractual means, through indemnification regime, and the purchase agreement, but at the end of the day, you still have those liabilities.

One of the reasons why you want to sell shares is because in Canada, for Canadian individuals, the first 850,000 give or take approximately of capital gains in this country is tax free for a qualifying small business corporation. So what is a qualifying small business? Essentially, 90% of the business has to be in Canada or from Canadian assets. That doesn't mean you can't have US sales, but the revenue and everything has to be generated from the Canadian assets.

And you have to be what they call a CCPC, Canadian Control Private Corporation. So you have to be not controlled by nonresidents or public companies. It's a negative test. But ultimately, if you meet those two tests and you've held the shares for two years prior to sale, then you can access your lifetime capital gains exemption.

One of the nice things about that is you can use a family trust and basically have a bunch of beneficiaries like your kids, your spouses, your parents, your sisters and brothers, and you can maximize lifetime capital gains exemptions across every family member by using a family trust. It's a very common tax planning mechanism. Most founders will start doing it around their series A for a venture-backed company where the company is essentially more real than not at that point. Then sort of right out from the outset. Yeah?

AUDIENCE: Do some of the Canadian companies actually turn down some US investment because they want to be like, primarily owned by Canadian businesses?

CHAD BAYNE: There's ways to manage it through there's case law. This is sort of beyond the scope of this, but there's case law that suggests that so long as nonresidents don't control the board from an appointment perspective, then you can still maintain CCPC status through so long as you have a unanimous shareholders agreement with respect to the company.

Now, that case can ultimately always be differentiated like it can with case law. But most practitioners in the area take that point of view. And then you can sort of buttress that with potentially putting in voting cutbacks so that nonresidents don't have the majority of the votes at any time. And we do that consistently with companies that are starting to butt up against the line.

OK, so we talked about family trusts. Use of losses, most venture-backed companies have a lot of losses because they're typically not in a profit position, or if they're in a profit position when they sell, they usually still have losses that they haven't used up. So a lot of times, we make use of those losses before the transaction as part of the transaction, and we essentially step up the cost base of intellectual property.

More often than not, the buyer is a foreign buyer, and they'll want to repatriate the intellectual property out of Canada or the goodwill out of Canada and put it into a jurisdiction that they usually put all their IP or technology-related assets into one spot, whether it's in Ireland or a Benelux country or the Caymans or whatever the case may be.

So as a result of using up those losses, you don't pay any tax for sort of stepping up the value because ultimately stepping the value of the IP is a disposition for tax purposes and it results in a taxable transaction, but if you have offsetting losses, then you don't pay tax, and the resulting byproduct of that step up and then essentially the payment of tax by using losses in the company results in the creation of a capital dividend account, which allows you to essentially do two things, either move cash out of the business tax free to Canadian individuals, not nonresidents, Canadians, or essentially step up the cost base of the shares that those individuals hold.

So as a result, you can essentially use those losses to pay less tax. And then there's some other tax planning depending on the stage of the business. There's things called safe income strips and a bunch of other cool things you can do depending on the circumstances and depending on the size and stage of the business.

OK, all right, so we're at– almost at 1:00. Everybody have a few more minutes? OK, so next thing is once you've done all that, all of that work, that's one to two years worth of work to get there, now, we actually have to go start the process, which is another year potentially of your life. It could be. And usually, it's a bit shorter. But then going through that process is, OK, you need an NDA because the information that you're providing people is going to be confidential. So you'll put together an NDA with your counsel.

And then one of the things you think about is, do we hire a banker? And the process will vary considerably whether you hire a banker not. Bankers are basically tasked with the whole notion of let's run a competitive process, not necessarily an auction, but a process that will try to maximize value for the sellers. So a banker is essentially like a real estate agent, same type of thing. They basically put a colorful gloss on the business, put it in the best light, and then ultimately help you find buyers and negotiate with those buyers and try to get you the best price.

Who you hire will be largely dependent on the size and stage and type of business that you're selling. There are general bankers, and there are specialized bankers. There are bankers that will only do big deals. There are bankers that will only do mid-sized deals. There are bankers that may only do small deals. So it will really depend.

Interview a bunch. Get recommendations from people like ourselves or other people you've worked with, other founders. Your VCs will have their own opinions as well, but talk to a few because they're all different. And again, it's like working with anybody, you want you want to have a fit, and you want to have somebody that ultimately you get along with because it's going to be– it could be six months to a year of your life in terms of working with that person.

So as part of it, you're going to have to negotiate an engagement letter. Engagement letters look relatively the same. They all sort of follow a similar format. The banker will say these are the services we're going to provide. They all sort of say the same thing in different ways. The really key aspects of the engagement letter, the fees, how much you're going to pay if there's success, the expenses, what do you have to cover out of pocket, how can you terminate it, the tail– and I'll get to the d and indemnity.

Every agreement is going to have indemnity. There's nothing to negotiate there other than maybe making some minor wording changes. They're almost always the same, and they're usually fairly non-negotiable by the bank because ultimately that's just their standard form. Ultimately, the banker is not going to take on any liability unless they're basically grossly negligent or there's willful misconduct or there is fraud. That's basically it. Otherwise, you basically cover them for everything else.

Fees– fees will, again, largely depend on the size of transaction. Once you start getting up into the billion dollar range for a sale, your fees will likely be 1% to 1 and 1/2% of the transaction size. If you're much lower down, it could be 5%. It could be 6%. There could be a minimum. It will all depend.

There could be scaling depending on the circumstances for a greater incentive. If you sell for X, you get this percentage. If you sell Y, you may get this percentage. There may be additional kickers. It will depend in terms of how you want to incent. There's no hard and fast rules. It's as much art as it is science. We can give you guidance as to what the ranges are based on what we've seen. But as you get bigger and bigger, the percentages go down because of the size of the payout for the bank.

Expenses– usually you cover out of pockets for the banker. Every bank letter will come to you with no cap on the expenses. We typically try to put a cap on them so that there's some reasonable amount that you're expected to pay out of pocket. The ability to terminate– most letters come to you with, they're evergreen. They never terminate, which is a problem because if you basically stop a process and you forget about it, we get into the next point, which is the tail, which is problematic for various reasons.

We always recommend have A, the ability to terminate for convenience in these types of arrangements, but also have an end date where the agreement will terminate regardless. So if you throw it in the drawer and you forget about it like we're doing with the transaction right now with a client that they forgot they had a banker letter, and now we have two. And it gets into the next point where we have the tail.

So the tail is basically, there's a period of time after you terminate this arrangement in which the banker will still get paid, and it doesn't matter if you work on them on a transaction with them or not in the tail period, if you basically sell the company in those– and usually it's 12 months, but it could be as low as 9, it could be up to 18. Some bankers ask for 24. Market is usually 12– you'll pay them. So it's very important that you have an end date to this arrangement. Otherwise, that tail could be in perpetuity. And it's expensive to pay two bankers.

And then one of the things you start doing with the banker is starting to consider market comparables, potential price range. They're a good source of saying, well, what do they think the company is actually worth. What does it compare to in the public markets? What are they looking at? What are the companies to the extent competitors have sold and they're public deals, what are those competitors have sold for based on and sort of gauging based on similar size, et cetera, what you would potentially sell for.

All right, so we'll go through this quickly. Process, typically what do you do? Do you prepare a CIM, so a CIM, which is Confidential Information Memorandum. Basically, it's a document. It's kind of like a prospectus light about the business or just a simple teaser, which is more like a deck. Are you running a single stage auction where everybody just puts their bids in, highest bidder wins, or is it a multi-stage process? And last year basically, it's a fire sale. You're almost always running a multi-stage process. You're never running a single stage auction. Single stage auctions are really basically like we've got to get rid of this asset. Mostly more in the bankruptcy realm or insolvency realm than typically a going concern.

So what does a multi-stage process mean? We'll get to that, but it usually means that there's levels of engagement with respect to the buyers. They'll go through stages, and you'll narrow the funnel down until you get to one buyer ultimately. Banker or you depending on how you run the process will prepare a list of buyers, potential buyers.

There could be a first stage outreach. There could be a second stage outrage. There could be a third stage outreach depending to the extent you're only looking at PE buyers, you may only reach at the PEs, and you may not reach out to strategics because you don't want to tip off strategics that you're in play.

Because you may not want to do a management role, you just want a complete cash, you may not reach out to any PEs right away. You may only say let's reach out to strategics. It will all depend, and that's a conversation with the board, with your investors, with the banker if you hire a banker.

Then once you've done your outreach and people are interested and say look at the little teaser or the CIM. And usually they'll get the initial indication. They won't get the CIM until they sign an NDA. Once they sign a NDA, there may be a CIM or there may be a more detailed teaser as a result that the potential buyers will get. Then they'll get a process letter as well.

And they'll enter into first stage of diligence, which is usually more business-focused diligence, less on the legal side. And the true sort of like tax, finance, like the deep stuff, it's really more let's understand the business, understand the business fundamentals, see if we're really interested in this business.

There may be a management presentation, and it's usually high level, not like the in-depth conversations that will happen later. These will be like a quick presentation about the business asking initial questions. Then bankers will typically ask for initial indications of interest basically to start funneling out who's actually interested in continuing the process and who's put a relatively good price in. And there might be a range of prices.

There'll be communication with the banker who usually say, well, thank you for participating, but your bid is pretty low. You may want to think about bringing it up as part of the next stage, blah, blah, blah. How can we get you there? There'll be this ongoing conversation much like selling a house.

Second stage diligence will happen at that point with the group that essentially has indicated interest. It may not be with everybody to the extent that there's some lowball offers or potential players that you may not want to have participate in the second stage at this point in time. You may hold off on them.

So you'll basically create the next list. They'll get into much deeper diligence where they'll open a secondary data room with more information. They'll be more in-depth management presentations. Depending on the process, you may put a form of purchase agreement into the data room or indicative summary of terms that you're willing to sell on. You typically prepare that with counsel. Then as part of the process, you may ask for the buyer to comment on that form of purchase agreement or summary of terms to get a better sense of what type of terms you're going to have when you get to the end.

Then you'll probably ask for bids. Bids will come in. You may go through a couple of cycles of bids depending on where you're at. If you get only one bid, you're probably going to negotiate with that one party to the extent the price is within reason. If you have multiple, you may go back and forth. You may play one off for the other until you get to a point where you're ready to negotiate the letter of intent. You may negotiate these in parallel.

And then eventually, you'll pick one, and you'll enter a exclusivity. Very rare in the private company context to not have exclusivity. Unless you have incredible amount of leverage, you'll always be picking one horse at the end of the day and entering exclusivity to negotiate a deal.

AUDIENCE: If you do that and it falls through and you're back in the market again, do the NDAs protect you from having to disclose to a deal falling through, of does that–

CHAD BAYNE: Yeah, most people have a good indication that you've essentially paused the process and you've essentially picked, and now you're having to go back to the market. Something's fallen through. So it's a tip-off that something didn't work out. Now, it could be you picked the buyer that was giving you the biggest amount of money but it's subject to financing, and so you're going to a buyer that's going to give you a more reasonable price, but they have cash on the balance sheet.

That's part of the weighing process, too. When you start looking at these bids, it's not just about the price. It's about who can actually get to closing. And there's the price they're paying, whether they have to finance the deal, all the things that they need. So whether it's all cash, whether it's cash plus stock, all these types of things, right, strategics to the extent that there's a strategic buyer, there may be regulatory approvals that are needed. So that may sway you from– a PE buyer might be a better option because there's less friction from a regulatory perspective. It will depend.

Now, if it's two big competitors, you may have to sell off part of the business as part of this. So typically in the world– we haven't had too many of those opportunities. Typically, it happens in the big corporate arena, but you could always have that situation. Or you have a situation like MacDonald-Dettwiler where the government just said, no, we're not letting you sell. So you could always have those situations where you have essentially core technology that has state significance.

All right, letter of intent, it's non-binding. It's almost always non-binding other than exclusivity and confidentiality. Key to negotiate a letter of intent is understanding what's actually market and what is not. And there's usually some categories, purchase price, what

OSLER

the form is, the timing of payment, are you looking at the business, the EV, the Enterprise Value from a cash free, debt free position, are you looking at is there working capital adjustment, is there an earn-out.

All these things factor into it, and they all depend on how the purchase price– and you can actually start comparing apples and oranges to figure out what's the better deal at the end of the day. We're doing a deal right now where the top line on the deal is less than one of the other buyers, but the earn-out is so much more significant on the back end. Even if they only get 10% of the earn-out, it's still a better deal than the other deal they were looking at.

Transaction structure, we talked about share sale, asset sale. They typically state in the LOI. It may be ambiguous and say, well, we'll think about it. What's the most tax efficient? It may be a statement about treatment of options and other equity-based compensation. Some buyers– strategics like to roll everything other than vested they'll cash out. PE usually will want to cash everybody out other than the ones who are going to enter into it a management role. So it'll all depend. And that will be a part of the discussion.

There maybe, not always, but there may be a conversation in the LOI about the allocation of liability through the indemnification regime, caps, whether there's an escrow, a hold back, or a rep and warranty insurance. It may have that. It may not. You may punt on that until later. Usually, if you've gone through a structured process, you'll have that all fleshed out because it's in the seller's interest to ensure what the liability regime is.

There may be reference to key employees and retention arrangements with respect to those key employees, and then exclusivity. So typical exclusivity is 45 days for M&A. It could be as much as 60 or 90 days. It could be as short as 30, but usually, average is about 45. And basically that means pens down with everybody else, you got to essentially work with one buyer.

All right, getting to closing quickly. They're going to do comprehensive due diligence. They're basically going to turn over every stone, legal, financial, tax, IP through the code review, business– although a lot of it's done already at that point, there might be some other additional questions– customer calls, et cetera.

A lot of this will depend, too, on who your buyer is. If a buyer is a competitor, you're going to be very judicious with the information that you're going to roll out versus a PE player, which you don't care. Unless they have a portfolio company that's in the exact same space, you don't care as much with the financial. They're looking at the opportunity, and they'll make a decision. If they don't like it, they'll just move on. So strategic is going to– they may be using it as a fishing exercise.

Transaction documents, there'll be a purchase agreement. There's a bunch of ancillary agreements depending on the deal, an escrow agreement. There could be retention arrangements. There could be a transition of services if it's an asset deal. Retention agreements we've talked about so that will be a separate stream typically with respect to a transaction.

There'll be integration planning. This step is something that the lawyers don't get involved with, but typically, the business people will be spending a lot of time figuring out how the business is going to work together and synergistically and how everything is going to fit together, reporting structure, et cetera, et cetera. So there's a lot of planning that goes on there. This is where most acquisitions fail, bad integration planning. About half of the M&A deals typically fail because of this.

Then there's some sort of communication strategy. How are you going to tell the internal employees? When are you going to announce to everybody? When are you going to press release it? How are you going to manage the market to the extent they're a public company, all those types of things. To the extent there's pre-closing tax planning, you'll end up doing that.

Then you finally get to the big day of signing the deal. That's actually when you have a deal. So we've gone through pages and pages and pages. It's actually near the end of when you actually sign the deal to sell. And then you'll go through potentially closing conditions to the extent there are any. Maybe you get to a situation where it's a same day sign and close where you basically sign and close in the same day. And then you get to closing, which is the final step. You get the money and/or shares, and the buyer gets the shares and other assets.

And that's it. Any questions? That was a quick overview of basically a couple of years of work. Yeah?

AUDIENCE: Is there a practice to have a due diligence audit so that you know that your company is properly prepared if something does happen ahead of time?

CHAD BAYNE: Usually you can work with various advisors usually on the financial side, financial/tax and on the legal side just to start kicking the tires. You may end up doing a– to the extent that you're a tech-focused business, you do a preliminary code review. To the extent you're not a tech business, and you're like– you have environment issues. You may be doing like phase one assessments and all those types of things to ensure that you have an understanding of what's out there and you work with your advisors. And you spend a good amount of time.

One of the guys we work with, we found a lot of their business is based on APIs, and he was using other people's APIs. Well, it's one thing to basically use public APIs. It's another thing when you're running a commercial business, and the conversation is like, maybe you should actually go talk to those parties and actually get a formalized API because if they shut that API off, you have no business.

So as a result, you start asking those questions, how much risk there is expected. And maybe the buyer prices that into the equation when they're buying the business, but again, those are things that you need to think about. And ultimately, the business will make a call as to what way they want to go or not. Any other questions? All right, good.

So just a couple administrative announcements before we wrap up– on your tables, there's a feedback form. If you can just take two minutes to fill that out, the feedback's valuable for planning future sessions. If there's any other topics you want us to cover, please let us know.

Our next session will be October 16. Christian Lassonde from Impression Ventures will be speaking about how venture capital firms work and the inner workings there. So stay tuned for an invite for that one. It should go out later this week. I'll leave the chat open for a couple of minutes if anyone has questions, but we'll see you in October. Thank you.