Business Transfer to Employees/Managers

September 14, 2015

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Because of the demographic context, the rate of business transfers has been rising steadily in Quebec over the past few years. Whether unexpectedly or as part of a succession plan, certain key employees can show the potential and ambition to take over from the current owner. In this issue of *Lavery Business*, we look at a number of aspects that are of particular importance when a business is being transferred to its employees or managers.

DUE DILIGENCE REVIEW AND REPRESENTATIONS

Whether the company is selling its share capital or its assets, a due diligence review gives the buyer a detailed picture of the company's situation[1]. In the case of a sale to key employees, this process is usually simplified since the buyers already have in-depth knowledge of their employer's operations and business prospects, so that many of the legitimate concerns of a buyer less familiar with the company will probably not arise.

Because of this in-depth knowledge, the seller may be tempted to reduce the number and the scope of its representations in the purchase agreement. The seller's representations generally cover a multitude of facets of the business, including its financial and fiscal position, environmental obligations, the condition of its assets, labour relations, any ongoing or potential litigation, and any unfavourable changes that may have taken place. They are a way of transferring risk from the buyer to the seller: if a representation proves false or erroneous after the sale is closed, the buyer will have recourses. In this way, any gaps in the information usually available to a buyer are partially offset by the seller's representations. In the case of a sale to employees, the seller can claim that the greater availability of information to the buyers justifies significantly reducing the number, scope and temporal extent of the seller's representations.

FINANCING

Transferring a business to employees often poses a particular challenge in terms of financing. In a sale to a third party, the seller normally requires the potential buyer to demonstrate the capacity to pay. The potential buyer must have access to sufficient cash or financing, which a group of employees usually does not have. The seller's participation in the financing may then become a key piece making it possible to put the deal financing together. This participation typically takes the form of a balance of sale payable after the closing according to terms and conditions agreed on by the parties.

While balances of sale are certainly used in other contexts as well, sales to employees almost always involve a balance of sale. The balance of sale generally has two objectives: to complete the financing arrangement and to place funds out of the seller's reach—funds that the buyers could claim if they had a complaint against the seller after the closing. The importance of this second objective must not be underestimated. In fact, buyers who pay the entire sale price at the closing frequently require some of the money to be placed in escrow for a given length of time, precisely to this end.

If there is a balance of sale after the closing, the prudent seller will seek to protect his debt through various mechanisms, discussed below.

PROTECTING THE BALANCE OF SALE

A seller wishing to protect his debt will often seek to include monitoring and control mechanisms in the purchase agreement; for example, he may require regular financial statements enabling him to monitor any changes in the company's financial position. Furthermore, the requirement to maintain certain financial ratios may enable the seller to demand reimbursement of the balance of sale should the company's financial position deteriorate. However, the financial institutions participating in the deal financing and in the company's activities are liable to impose restrictions in this regard.

Another measure designed to protect the seller's debt is to require the seller's consent for certain decisions that could have a negative impact on the company's financial position. This enables the seller to exercise some control over the cash available and thus ensure that the buyers have the money to pay the balance of sale. If the buyers make such a decision without the seller's consent, this generally constitutes a breach of contract leading to loss of the benefit of term. In other words, the entire balance of sale would become due and payable as of such breach.

To ensure payment of the balance of sale, the seller may require that certain assets of the company be charged with a hypothec. The financial institutions participating in the deal financing and in the company's activities would then require prior hypothecs in order to ensure reimbursement of their debts; nevertheless, the seller would hold a real security giving him priority over unsecured creditors.

There are other ways of protecting the balance of sale, a detailed analysis of which is beyond the scope of this short article. Suffice it to say that they generally include a guarantee provided by the buyers' shareholders or legal entities related to the buyers; life insurance on the buyers or their officers; if the seller retains shares in the company operating the business until complete and final payment of the consideration, inclusion of the seller's right to veto certain decisions in a shareholder agreement; and the seller's subscription for shares conferring effective control. Use of any of these mechanisms depends on several factors, in particular each party's negotiating power, the size of the balance of sale, and to what extent the parties desire real transfer of control of the company as of the closing date.

CONCLUSION

One objective in any purchase transaction is to achieve a balance between the interests of the seller, who wishes to limit his liability and protect his debt, and those of the buyer, who wants protection regarding the representations and warranties made by the seller and also wants to manage his cash without too much interference from the seller. Although there are certain unique aspects to the sale of a business to employees, these same objectives apply.

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[1] See Issue 24 (March 2015) of *Lavery BUSINESS*, in which M[e] Valérie Boucher and M[e] Catherine Méthot discuss the main steps in the sale of a business.