

SELLER BEWARE: DON'T MARKET YOUR BUSINESS WITHOUT DOING A PRESALE LEGAL AUDIT

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Selling a business involves significant risk and is something that most owners do only once in their lifetime. A seller must **“do it right the first time”** and avoid pitfalls that can result in a reduced number of interested buyers, a reduced sale price, unfavorable payment terms, a large at-risk escrow amount, or a deal that does not close. If a deal doesn't close, substantial management time is likely to have been spent, tens of thousands or hundreds of thousands of dollars in professional fees are likely to have been incurred, confidential information about the seller's business will have been disclosed, employees may leave, and a multi-million dollar payday will have vanished.

An important element of the sale process that is often overlooked by sellers is the importance of doing a presale legal audit of their business. A presale legal audit is, in our view, a necessity because every buyer and its professional advisors will conduct a “due diligence” review of the seller's business from both an operational and a legal perspective.

We have seen more than one transaction in which a buyer refused to proceed with the deal, significantly lowered the purchase price, or insisted on significantly less favorable payment terms (including large at-risk escrow amounts), when the buyer discovered during its due diligence that legal problems existed in the seller's business which the buyer (and even the seller) was not aware of when a Term Sheet or Letter of Intent was signed. This notably disadvantageous position could largely have been avoided if the seller did a proper legal audit of its business before going to market.

A seller's legal audit prior to going to market identifies legal problems and vulnerabilities that may exist in its business and becomes a roadmap to fix those problems and reduce those vulnerabilities in advance of sale. This allows the seller to present a legally clean (or at least cleaner) business to a potential buyer, disclose to the buyer legal issues it has learned about (**note: full disclosure by the seller is essential**), and avoid surprises when the buyer conducts due diligence of the seller's business.

Presale Legal Audit

A presale legal audit should include the following inquiries:¹

1. Does the seller have appropriate and enforceable intellectual property agreements with its employees and consultants that protect, to the maximum extent permitted by law, the intellectual property and confidential information of its business?
2. Does the seller have appropriate employment agreements with its employees that contain restrictive covenants and non-solicitation provisions when employees leave, and are enforceable to the maximum extent permitted by law?
3. Does the seller have well-crafted and enforceable management retention agreements with its key employees that comply with Internal Revenue Code Section 280G?
4. Does the seller have best practices security systems and policies in place to protect against the unauthorized disclosure or destruction of its proprietary information by employees, and to protect against theft or malicious intrusions by third parties?
5. Is the seller in compliance with all applicable laws and regulations (federal, state, and local) at all locations where its offices or facilities are located, including laws relating to COVID-19?
6. Does the seller have all required licenses and approvals from the federal government and any state or locality that requires its business, products or services to be licensed or approved?
7. If the seller's business involves manufacturing or assembly, does it have best practices safety systems and policies in place to meet the requirements of OSHA and all applicable environmental laws. Has a recent Phase I Environmental Site Assessment been conducted on the seller's manufacturing or assembly sites?
8. Does the seller have ongoing litigation, investigations or threatened claims, and can they be settled on commercially reasonable terms? Are there outstanding judgments or liens against the seller's business or properties?
9. Does the seller have appropriate insurance in sufficient amounts to cover the risks of its business (including product liability, professional liability/E&O insurance, cyber insurance, fidelity bonds, and employment practices liability insurance), and all insurance required by any customer contracts or supplier contracts?
10. Is the seller qualified to do business in every state in which its offices or facilities are located?

¹ Sellers with foreign operations should conduct a comparable presale legal audit of their foreign operations.

11. Are all of the seller's tax and corporate filings up to date? Has the seller paid all taxes that are due (including state and local taxes required by each jurisdiction in which it does business) and established adequate reserves for all accrued taxes that are not yet payable?
12. Are all of the seller's customer contracts and supplier contracts of sufficient quality to limit its liability?
 - Does the seller have in place a high quality form customer contract and supplier contract?
 - Does the seller have in place standard negotiating points to use in response to overreaching customer contracts and supplier contracts?
13. Does the seller have signed written contracts (and applicable extensions) with all of the customers and suppliers with whom it does business? Is the seller, and are the other contract parties, in compliance with all of the seller's contracts?
14. Does the seller know which of its contracts require consent for their assignment to a buyer or to a "change of control" of the seller's business, and whether such consent can readily be obtained?
15. If the seller has obtained a PPP loan:
 - has the seller complied with SBA eligibility requirements, including "necessity" and affiliation rules?
 - has the seller used the loan proceeds according to SBA requirements and maintained satisfactory documentation of loan necessity and forgivable use?
 - has the seller applied for loan forgiveness and, if so, what is the status of the application?
 - what restrictions are in the loan agreement regarding a sale of stock or assets by the seller without the lender's or SBA's consent?
16. Are the seller's employee retirement/401(k) plans properly structured, fully funded, and legally compliant based on IRS rules regarding coverage and nondiscrimination?
17. Is the seller in compliance with its coverage and reporting obligations under the Affordable Care Act?
18. Are the seller's employees being paid in compliance with applicable wage and hour laws for the hours they work and is overtime being correctly calculated and paid to all employees that do not qualify for exemption from overtime?
19. If the seller uses independent contractors, is such use legally compliant?
20. Is the seller in compliance with U.S. immigration laws for all of its workers who are not U.S. citizens?

21. Does the seller have anti-discrimination and anti-sexual harassment policies and training programs to minimize the risk of claims, and do such policies and programs meet the requirements of applicable laws?
22. Does the seller have a quality and legally compliant handbook and social media policy for its employees that has recently been updated? Handbooks need to be updated periodically as a result of frequent changes in federal, state, and local laws, and court decisions interpreting applicable laws.
23. Are the seller's onboarding systems legally compliant? Do the seller's files contain properly completed Form I-9's for all employees? Do the seller's background check authorization forms and procedures comply with the Federal Fair Credit Reporting Act and similar state and local laws? Do the seller's application forms comply with federal, state and local discrimination laws, so-called "ban-the-box" laws, and a myriad of other regulatory requirements.

Conclusion

Prospective buyers will be searching for problems in all of these areas, and more. When found, those problems can result in changes to the purchase price and payment terms, and may even result in the buyer walking away from the deal.

A legal audit will take time to conduct and corrective changes will take time to implement. If you are planning to sell your business, you should conduct a legal audit at least six months before bringing your business to market and, preferably, at least a year before going to market. Action today will put you in the best position to obtain maximum value for your business and to negotiate a more successful transaction tomorrow.

And, by the way, best practices suggest that business owners do periodic legal reviews of their businesses to manage day-to-day risk in today's heavily regulated and litigious environment, even if a sale is not presently contemplated.

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