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Law Firm for Business

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Selling a Business, Buying a Business or Business Acquisition

(M & A Transaction for Small Business, or Mergers & Acquisitions)

Business Owner's Planning & Due Diligence Response Checklist to Buyer

or

Buyer's Preparation for Due Diligence Inquiry to Seller

For Business Owners Contemplating a Business Sale (or Business Purchase)
Checklist Applies to Both Asset Purchase and Stock Purchase Deals

(Seller: Expect These Requests, Deal Term Discussions & Negotiations From A
Buyer)

(Buyer: Use This List to Conduct Initial Due Diligence on Seller, For Discussions of
Deal Terms and Negotiations)

I. Company Legal Preparation; Business Prep With Legal Implications

A. Company and Principal Information – Legal Due Diligence

Seller to provide a list of, or copies of these corporate law items:

1. Legal Name of Business, date, and state of incorporation.
2. FEIN of the business.
3. Full Names of all officers, directors with middle initials, and socials.
4. List of shareholders, and their percentages of ownership. Are the majority shareholders active?
5. What percentage of vote is required to pass an issue of Shareholders? Can Seller secure that vote? Director's vote required, and how many?
6. Ownership/Stock Records in order. Provide a clear stock ledger or LLC ledger of historical ownership, and current ownership as it stands today. If one is not yet in writing, ask your lawyer for a template to prepare one.
7. Address of company addresses of other remote offices, and addresses of all property owned or rented by company.
8. Articles of incorporation and all amendments.

9. Annual Reports filed with Secretary of State: The latest one or two reflecting shares outstanding, authorized shares, and paid-in-capital on file with the state.
10. Corporate Record Book in order.
 - Do not create one if none exists.
11. Resolutions electing officers and directors; approving corporate actions, authorizing signers on contracts, authorizing and financial access, authorizing sale of the business.
 - Do not do the work of updating many years of corporate resolutions or minutes if they are not yet completed.
 - Instead, provide your lawyer with just a simple bullet point list of factual things that have changed since the last minutes or since formation if no minutes written. The lawyer will do one single cumulative set of minutes for you.
12. Qualifications to do business in other states in which the Company does business.
13. Trademark protection of business name, either a filing made or a common law "commercial use" trademark.
14. County and City licenses.
15. Founders' Shareholder Agreement, if any. (Do not create one if not.)

B. Shareholder Equity List and Shareholder List. Seller to provide:

1. Shareholder List (Stock ledger or LLC ledger) (reflecting owners; % owned)
2. Stock certificate, if any, or create "Lost Certificate" Affidavit.
3. Shareholder Agreement, if any.
4. Voting percentage of shareholders required to pass an issue on which shareholders are entitled to vote; which items require or allow shareholders' vote.
5. What % of SH approval is required to sell the business, or even assets of the business?
6. Corporate Resolutions and Corporate Filings that effect share ownership (changes to authorized or issued shares, share redemptions, new shares issued, stock splits)
7. Corporate Resolutions reflecting shareholder and director vote required to approve sale of business, even if sole shareholder.

[Next Item only relevant if Seller has previously raised money from investors to fund the company, or if Buyer is raising money to Buy Seller's Business:]

8. For Stock Sold to Outsiders, Seller to provide copy of these:
 - Offering Memo – Disclosure document
 - Investor Agreement
 - Shareholder Agreement
 - SEC Notice filing on Form D for private placement.
 - State Securities Filings on Form D

C. Permits and Licenses

1. Are all business activities actions under valid permits? Federal, State, City, County
2. Copies of permits and licenses

D. Regulatory Compliance

1. Compliance with industry Regulations
2. Tax Compliance, including Sales Tax and Payroll Tax, in other states?
3. Environmental compliance
4. Labor and employment law compliance, including labor unions if applicable.
5. Securities law compliance if shares have been sold or issued to any investors.

E. Intellectual Property and Business-Related IP

➤ Currently Existing Intellectual Property and Documentation of Ownership:

1. Trademark filed? Alternatively, name cleared? Common law trademark rights?
 2. Patents filed? Pending?
 3. Trade Secrets?
 4. Who owns each item of IP? Ownership documented? Assignments of IP? Licenses? Payments made to transfer ownership?
 5. Is IP protected?
 6. Website legal Issues
 - Who Owns Website Content?
 - Hosting, Access, Renewals
 7. Email addresses and Phone Numbers of business, provide list and mechanism to transfer them.
 8. Domain names, web domain names, email domains, email addresses, web-based services, software and other, with log in credentials for them.
 9. Agreements related to current IP – Are They in place and signed?
 - Nondisclosure and Noncompete agreements signed by employees, contractors, and others.
 - License Agreements
- Disposition or Transfer of Intellectual Property with the Business Sale:
10. Which elements of IP are being sold vs which are being kept by Seller?
 11. Who will own which elements of IP?
 12. Restrictions on IP left remaining in the business?

F. Business Agreements or Arrangements.

1. Customer List and Contracts
 - Customer List, Contacts
 - Customers Contracts
 - Sales contracts
 - Delivery Agreements with Customers
 - Government Contracts
2. Vendor List
3. Agreements with:
 - Suppliers,
 - Distributors (inbound or outbound)

- Industry Alliance Partners
- 4. Agreements with Employees and 1099 Contractors
- 5. Non-competes, stipulations or Legal Settlements With any Customers or Suppliers

G. Legal Liability and Potential Legal Liability

Provide information as to any items below, of which you have knowledge, or indication, including any actions, pending actions, threat, or indication of actions of:

1. Lawsuits filed or pending, and status.
 - Amount at issue, and evaluation of likelihood and risk of loss.
2. Threatened lawsuits, litigation, or regulatory action.
3. Regulatory compliance infractions or enforcement actions
 - Filings made and cleared if required.
 - Regulatory actions previously filed and resolved.
4. Cybersecurity breaches, or risk even if not breached? (See "Technology" below)
5. Tax regulator actions.
6. Tax liens (property tax, payroll tax, sales tax, or income tax) filed on equipment or property, or against the principals? If so, provide info.
7. Judgment liens filed on equipment or property? If so, provide info.
8. Criminal actions against company or owners, officers, directors?
9. History of sexual harassment or discrimination by management of any employees?

H. Real Estate, Vehicles and Titled-Assets

1. Real Estate owned. Location, title, purchase price and date. Value if known. Condition if possible. Improvements made. Landlord if rented.
2. Titled Assets (larger assets for which titles exist: Vehicles, cars, trucks, forklifts, boats, larger machines or equipment or warehouse equipment)
3. If landlord, what is status of tenants. Covid related eviction stalls

I. Lease Agreement Obligation (Office, Plant, Warehouse): Seller to provide Real Estate Lease info and copy of Lease.

1. Only relevant if Buyer is assuming the Lease. However, Lease does affect net worth and general market value of the business.
 - Buyer and Seller may need to guarantee lease, with some landlords!
2. Not relevant if Buyer is not assuming the Lease.
 - Lease Termination Issues with Landlord?
3. Location, title, term, duration, obligation, property owner's name and contact information.
 - Length of lease? Time remaining? Penalty for breaking lease, even if sale?
 - What is security Deposit? Refundable?
 - Monthly rent? Escalating rent rate clause in Lease?
 - Rent payment amount expected in next lease term?
 - Is Lease assignable?

- Default provisions, timing? Delayed payments permitted, and under what circumstances?
- Personal Guarantee required for assignee. Is your personal guarantee still required?
- What options are property owner considering as lease waivers for Seller?
- Who pays utilities under existing lease? Under a new lease?
- If Lease is for a building owned by the Seller, provide research on market rate for rent, to confirm that lease rate is within market range.

J. Cybersecurity Audit and Update.

1. Have a cyber-security audit done by IT firm (your law firm can recommend one).
2. Implement needed repairs and take needed precautions.
3. If you have been breached or hacked, fix the leak, implement prevention. Address legal liability going forward for leak consequences, including notification to customers and vendors. Disclosure to Buyer Required.
4. Lack of cyber-security can detract from your company's value, netting a lower selling price.
5. Buy Cyber Insurance

K. Contracts. Provide a list of contracts, agreements, and arrangements of every type, whether in written contact form, or in email discussion form, or as in informal hand-shake deal, including:

1. Customer
2. Vendor
3. Employees
4. Financial, loans
5. Licenses for Use (both as a licensee or licensor)
6. Joint Venture, Revenue Sharing, partnership agreements
7. Distribution Agreements
8. Supplier Agreements
9. Every type of contract or agreement listed in this schedule.
10. List terms of obligations under Contracts, and what dates, time duration, \$ amount in an excel sheet or another contract management list.

L. Debt & Uniform Commercial Code (UCC) Lien Filings. Seller to provide list of:

1. Debt, loans, lines of credit, credit cards, credit agreements, factoring arrangements, merchant cash advance agreements, loans from Shareholders to Company, loans from Company to Shareholders, outstanding or aging vendor /supplier payments, and other liabilities.

2. Uniform Commercial Code (UCC) financing statements or liens.
 - Before putting company up for sale, do a UCC Lien search on your own company name, any d/b/or assumed name, and on all the owners' and officers' names. If you have ever borrowed for the company in your personal name, then certainly do a UCC lien search on your personal name.
 - Bank and lenders typically file a UCC lien against the company when they lend the company money to buy: Equipment, fixtures, property, inventory, leasehold improvements, leased property, personal property and more.
 - Are any UCC Financing Liens Filed against the Company or the Owners?
3. Research and Clear any lingering UCC Financing Liens for debts previously paid. Lender should have filed a discharge of UCC lien when debt paid, or when lien is no longer active. However, many lenders fail to discharge or cancel liens they filed against you.
 - Allow weeks of time working with lender to get old liens cleared.
 - Cannot sell the business until liens are cleared, even if liens are filed in error.
 - Buyer will deduct amount of liens from your Closing proceeds.
 - Find and clear liens before Buyer's due diligence and well before Closing
4. Documentation of Debt, such as loan agreements, if any.

M. Employees List

1. List of Employees, titles, roles, responsibilities, compensation including owners' compensation.
2. Clean house and terminate ineffective people. They detract from the value of Company (Do not leave them around for Buyer to address).
3. Employment Agreements and noncompete agreements or non-solicitation agreements in place with key employees and those who are key employees, or those who work with trade secrets
4. Decision on who will stay, and who will go, after Closing.
5. Benefits information
6. Retirement contributions
7. Employee Benefit Plan and Trust documents
8. Union information, if applicable

N. Assets & Equipment List. Seller, to provide list of:

1. Assets, equipment, tools, computers, and leases that run the business.
2. Equipment, leasehold improvements, and other assets list with acquisition dates or refurbishment dates, and supporting documentation.
3. Vehicles owned by, or paid for by, the business.

4. Depreciation Schedules from tax returns (For equipment & improvements).
5. Warranty documents on equipment and improvements.
6. Inventory: Take inventory, organize, and document inventory. Be realistic about obsolete inventory and consider removing it from balance sheet or inventory list. Or consider a realistic price Buyer should pay for it.
7. Supplies Inventory: (Same as "Inventory").
8. Intellectual property ("IP"): General description of IP to transfer at Closing, such as customer lists or trade secrets.
9. Trademarks: Identify Common law or filed Trademarks; Document first use and filing dates if filed; provide issued mark info.
10. Patents: Filed Patents if any; Documentation and description, document first use and filing dates if filed; provide issued patent info.
11. Debt on assets or company? Prepare a list of debt in the company name or in personal name against company assets. Are any UCC Financing Liens Filed?

O. Financial Statements & Tax Returns. Seller to provide to Buyer, and to Sellers and Buyers Accountants and Lawyers:

1. Financial Statements for past [#] years. Ask Buyer's accountant, or Buyer's Lender, how many years needed],
 - Balance Sheet
 - Income Statement
 - Statement of Changes in Financial Condition [may be optional]
 - Statement of Shareholders or Owners' Equity
 - EBITDA (Earnings before interest, tax, depreciation, and amortization) (**EBITDA**): A measure of a company's operating performance; evaluates company's performance without factoring in financing decisions, accounting decisions or tax environments.
 - Salary info on employees all, both those who are staying and those who are leaving.
 - Salary + K-1 + Dividend info on selling shareholder (s), plus personal expenses charged to business.
 - Assets List
 - Depreciation Schedules
2. Business Tax Returns for [#] years. Buyer's accountant or Buyer's Lender will dictate number of years.

P. Revenue and Cost of Sales

1. Customer Lists

2. Order Backlog
3. Sales in pipeline
4. Leads
5. Cost of Sales
6. Obtain detailed list from accountant and have your own accountant review for items the Buyer may request in due diligence.
7. Marketing efforts and plans, and other Revenue generators.
8. Website, e-Commerce, Portals, Social Media

Q. Supply Chain

Soundness and security of your supply chain, especially after Covid economy.

R. Technology

1. Web presence
2. e-commerce capability if appropriate
3. Electronic payment mechanism
4. Operational Systems
5. Operational software
6. IT strength and Use of technology internally and externally
7. Interview IT staff and outside IT firm.
8. Back Ups / Disaster Recovery
9. Does IT Increase Revenue, Decrease Costs, Increase Productivity, Increase Information about Company
10. Social Media Presence
11. Cloud-based services
12. Architectural design and review
13. Technology and Software Subscriptions
14. List of Software Licenses; examine license compliance.
15. How well are open-source fundamentals managed?
 - Accurate real time inventory of the open-source components in use
 - Policies for open-source use and processes for selecting, approving, and tracking.
 - Identify and remediate vulnerabilities.
16. Cybersecurity
 - Understand Due Diligence on Cybersecurity in M&A
 - Culture of Security
<https://www.wsj.com/articles/companies-sharpen-cyber-due-diligence-as-m-a-activity-revs-up-1520226061>
 - Analyze risk.
 - Threat protection in place
<https://www.wsj.com/articles/where-the-cybersecurity-threats-are-1513653001>
17. Other Tech issues
18. Post-acquisition planning to integrate technology....is it possible?

S. Company Processes and Documentation

1. Document processes = create transferrable institutional knowledge. Draw out of owners' head, or from heads of employees. If institutional knowledge is "all in 1 or 2 heads", especially if the heads are leaving, then business will take a significant reduction in value for undocumented processes.
2. Train others in Processes and Documentation. Replace employees resistant to helping create or follow processes.
3. Be prepared to provide documentation to Buyer for due diligence review.
4. Have processes in place that streamline the Company's business.
5. Hire, groom and train your replacements.
6. Involve Company's accountant, involve an M&A Accountant, and your company's acquisitions counsel (M&A counsel), at the beginning, well before starting the Sale transaction process.
 - If your professionals do not have experience on a business sale transaction, then hire specialty accountant and counsel who have expertise in selling or buying businesses, before signing LOI.
 - Terms in the LOI can "stick", and purchase price terms must allow for deductions from PP for various issues.
 - NFH can recommend good accountants.

T. Management In Place

1. Have excellent Management in place to fill Seller's shoes.
2. Keep only great employees in "line positions", and in management.
3. Houseclean employees before company up for sale.
4. Buyer will meet management, key employees, and supervisors.
5. Buyer will request list of Officers, Managers and Key employees, and their roles.
6. Legal – Employment and Noncompete Agreements in Place

DEAL TERMS, TRANSACTION PREP

II. Transaction Preparation, Common Deal Terms, and Expectations

A. Valuation – Seller's Expectations & Action Items

1. Realistic Value:

- Have realistic expectations as to fair market value of the Business. Sellers can be blinded to wear & tear, shortcomings, outdated aspects, peeling paint, need for “facelift”.
 - Have a person in place, groomed to replace business owner, unless Buyer will be that person. Company will experience an immediate drop in value when owner leaves, if :
 - Owner has not transferred knowledge to another employee or owner,
 - Owner’s processes not documented for Buyer.
 - Buyer will pay less than your perceived value if owner(s) not staying and business does not have flawless documentation.
 - The future value is what the Buyer intends to accomplish by paying you a lower price and growing it to a higher price. Seller cannot value it on what it “could be, if grown” (that was your job, or now is the Buyer’s job).
 - “Past salary not taken” does not accumulate value, and Seller will not likely be able to draw that out when Seller leaves.
2. Use a professional valuation expert.
- Do not use your own accountant to value, except to determine “Book Value” or as an initial screening tool of value. However, to determine the deal pricing value, use a valuation expert.
 - Valuation is a specialty, even among accountants. (One can even earn a valuation certification, CVA.).
 - Third party, objective, valuation is required for credibility of valuation.
3. Understand and accept the valuation “deductions” for issues such as:
- Privately held company,
 - Minority Discount (Percentage Ownership of less than 100%),
 - Company has only one business development person, creative person, or operational person, who is leaving. “All Infor in 1 or 2 heads” phenomenon. (Protect from this by placing others into management.)
 - Your “accrued, but unpaid, salary”, or your “below market salary”, does not add value to, or allow add-backs to, financial statements or value of Company.
 - Other deductions discuss with your accountant or your valuation expert.
4. If selling to other shareholders, check Shareholder Agreement, LLC Agreement, or Buy Sell Agreement, for any mandated valuation method, and might even be something odd like “book value”.
5. Make the valuation happen in advance, by doing everything to maximize value!

B. Prepare to Answer Business Questions From Buyer

1. Which Employees will leave when you sell? Which ones would you recommend eliminating?
2. Which Customers will leave when you sell?
3. Why are You Selling?
4. What are your plans for after you sell? What Industry? What Job? Retiring?

C. Consulting Agreement for Seller Staying on With Buyer; Earn Out Agreement

1. Seller Employment at Company after Closing: Will Seller work part-time or full-time for this company after Closing? Alternatively, full-time for a limited duration, then part-time? Alternatively, will Seller bow-out altogether?
2. Is Seller one of the Business Development people? If so, can historical business revenues be maintained (or will they be emaciated) without Seller and Seller's relationships? Alternatively, can Buyer assume the Biz Development Role? In addition, can Seller continue Biz Development role during consulting period....this affects valuation of Company.
3. Determine how long is realistic for Seller to stay to make the hand over to Buyer:
 - Not too long. If Seller stays too long, can generate tension to Buyer.
 - Not too short. If Seller stays too short, the business might suffer from lack of sufficient "graceful handoff" consulting.
4. Consulting Fee to Seller would be reasonably commensurate for future work (not necessarily the same as prior salary, likely less than prior salary).
5. Earn-Out for Seller? Discuss Price and Duration.
6. Noncompete for Seller? Scope and Duration (See item earlier in this outline).

D. Seller Financing - Installment Loan Agreement

How will Buyer Pay for the Purchase Price? Options after Earnest Money Deposit:

1. Cash at Closing. Alternatively, Cash Deposit, and remaining Cash at Closing.
2. Installment Loan Payments.
 - Loan payments referred to as a "Seller Note" or "Seller Take Back Note".
 - Buyer, keep in mind:
 - The Loan Payments are separate from Consulting Payments.
 - Loan payments are due regardless of whether Seller stays onboard, consults, or otherwise helps the Company, or leaves, or continues to generate business; because these Loan Payments are the payment for the purchase of the business.
 - Buyer withholding the Loan Payments is a violation of the Purchase Agreement and can trigger litigation.

- Seller, keep in mind:
 - You likely will not receive all your money at once, instead in the form of Loan Payments, in a "Seller Note".
 - Buyer will likely request hold backs from your Purchase Price
 - Buyer Pays hold backs after conditions met or evaluated.
 - Buyer might request conditions on Buyer payments, based on financial or other milestones. Payments over time.
3. Length of extended payments from Buyer to Seller for Business Purchase Price:
 - Related to cash flow, in order to make payments.
 - Can be based on profits, but should be a fixed amount.
 - Personal guarantee required by Buyer
 - With UCC Financing Lien filed by Seller to protect Seller's security interest in the Note paid by Buyer.
 - Buyer cannot skip or terminate payments if Business does not do as well as expected unless there is a condition to payment to this effect.
 4. Discuss interest rate, fairness to parties, and appropriateness of rate to transaction.

E. Noncompete Agreement - Buyer Will Impose on Seller after Closing

1. Seller: Expect to agree to a noncompete agreement, non-solicitation agreement (non-raiding), nondisclosure of trade secrets, and Non-disparagement agreement. Goal that Seller cannot emaciate the business he or she is selling to Buyer.
2. Scope of noncompete will differ if Seller is retiring, versus moving out of state, versus going into another business, versus "staying around and consulting".
3. Noncompete must be reasonable in scope and duration; however, a much stronger, stricter, and longer noncompete is permitted where Seller selling business to Buyer (compared to a normal employee-employer situation).

F. Buyer's Due Diligence on the Company. Due Diligence is key!

1. Seller run your own background check on yourself before Buyer runs one on you, in advance of Buyer starting due diligence.
2. Seller, do a Uniform Commercial Code (UCC) Lien search and Tax Lien search on your company and yourself: Assure there are not any unknown filed liens on Company or owners.
3. Seller run a background check on potential Buyer. (I use Aurico Investigations in Arlington Heights, Illinois, a national firm that does background checks for business transactions. Contact Jeff Hovland.)
4. Seller check business sites for your business name, and correct issues.
5. Corporate due diligence, legal due diligence, accounting due diligence, marketing/sales/revenue due diligence, customer and vendor due diligence, industry due diligence.

G. Disclosure Schedules Required for Sale Transaction Closing

For an Asset Purchase Transaction or a Stock Purchase Transaction Seller to provide:

- List of all assets and liabilities Company owns and owes
- List of assets included in the sale
- List of assets excluded from the sale
- List of liabilities included in the sale
- List of liabilities excluded from the sale
- Other assets
- Insurance Policies
- Litigation
- Retirement ERISA, Benefits
- Regulatory compliance
- Accounting AICPA, best practices
- List of contracts, written and oral, into which Company has entered
- List of officers, directors, and owners (and how much the owners each own)
- List of locations of the business,
- List of employees, List of Subcontractors
- Intellectual property
- Disaster Recovery Plan (Recovery of the technology, and recovery of the owner)
- Information technology, risk management, Setup IT Plan, cyber security, exposure to threats, threat intelligence enough policies and processes, firewall, security breaches, collecting customer or patient data must be confidential you are liable;
- Privacy, Security policy for internal and external threats
- Learn where are your risk profiles, revenue risk
- IT Scalable?
- Representations and warranties in Purchase Agreement
- Risk shifting, exposure
- Relying too much on 1 or 2 heads
- Internal and external threat management
- Labor policies book, and signed
- Insure to protect valuation
- List of property owned, even if fully depreciated and not otherwise listed on asset schedule
- List of intellectual property owned, trade secrets, patents
- List of customers
- List of vendors
- List of litigation cases against Company, pending and threatened
- List of cases you have brought against others

H. Reps and Warranties

Can Seller comply with typical Seller Reps and Warranties? And Buyer?

Understand your liability if Reps and Warranties are breached later, even years after the contract

I. Closing Adjustments and Post-Closing Adjustments to Purchase Price

Buyer will impose, or attempt to impose, financial adjustments to the Purchase Price, at and after closing, based on financial changes to the company between Purchase Agreement and Closing.

J. Escrow Hold Backs

Buyer may impose an escrow hold back from the purchase price.

K. Estate Planning and Tax Considerations to Business Owners

Discuss With Your Tax Adviser and your Financial Adviser. Seller will be receiving a large one-time payment and likely payments over time. Have a plan in place to address tax issues and to invest the money.

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