

## ***Velocity Law, LLC***

*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)**

*For Business Owners Contemplating a Business Sale or Business Purchase  
(Asset Purchase or Stock Purchase)*

### **Business Owner's Planning & Due Diligence Response Checklist to Buyer or Buyer's Preparation for Due Diligence Inquiry to Seller**

(Seller: Anticipate These Questions, Discussions & Negotiations From Buyer)  
(Buyer: Use This List to Conduct Initial Due Diligence on Seller)

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#### **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?  
Alternatively, Directors?
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 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 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. Corporate Resolutions and Corporate Filings that affect share ownership (changes to authorized or issued shares, share redemptions, new shares issued, stock splits)
6. Corporate Resolutions reflecting shareholder and director vote required to approve sale of business, even if sole shareholder.

*[Item 7 only relevant if Seller raised money from investors to fund the company, or if Buyer is raising money to Buy Seller’s Business]*

7. For Stock Sold to Outsiders:
  - Offering Memo – Disclosure document
  - Investor Agreement
  - Shareholder Agreement
  - SEC filing on Form D for private placement
  - State Securities Filings

**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 compliance
5. Securities compliance if shares have been sold or issued to any investors

**E. Intellectual Property and Business Agreements**

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. Agreements related to IP
6. Nondisclosure and Noncompete agreements signed by employees, contractors, and others
7. License Agreements
8. Customer List
9. Vendor List
10. Email domain names, web domain names, email addresses, web based services, software and other, with log in credentials for them.
11. Distribution Agreements with Suppliers, Industry Alliance Partners, Customers
12. Agreements With Suppliers
13. Sales contracts
14. Other Agreements with Customers
15. Agreements with Employees and 1099 Contractors
16. Government Contracts
17. Stipulations and Legal Settlements
18. Website legal Issues

**F. 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, plus amount and risk of loss.
2. Threatened law suits, litigation or regulatory action.
3. Regulatory compliance
  - Filings made and cleared if required
  - Regulatory actions previously filed and resolved..
4. Cybersecurity breaches? (See Section on 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?

**G. Real Estate, Vehicles and Titled-Assets**

1. Real Estate owned. Location, title, purchase price and date. Value if known. Condition if possible. Improvements made.
2. Titled Assets (larger assets for which titles exist: Vehicles, cars, trucks, forklifts, boats, larger machines or equipment or warehouse equipment)

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

1. May only be relevant if Buyer is assuming the Lease. However, Lease does affect net worth and general market value of company.
2. 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.

**I. Cyber-Security Audit and Update.**

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

**J. 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 other contract management list.

**K. 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/a 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. 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.

**L. 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 nonsolicitation 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

**M. 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?

**N. 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**) is 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.

### **O. 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

### **P. 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?

#### **Q. 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 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.

#### **R. 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

**(Transaction Preparation, Common Deal Terms, and Expectations – Starts on next Page)**

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## **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. 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).

### **C. 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.

**D. Noncompete Agreement - Buyer Will Impose on Seller after Closing**

1. Seller: Expect to agree to a noncompete agreement, nonsolicitation agreement (non-raiding), nondisclosure of trade secrets, and NonDisparagement 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).

**E. 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.

## **F. 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

## **G. Reps and Warranties**

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

**H. Closing Adjustments and Post-Closing Adjustments to Purchase Price**

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

**I. Escrow Hold Backs**

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

**J. 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.

By: Nancy Fallon-Houle © 2018