

Let's Make a Real Deal; looking beyond price in mergers and acquisitions

*Howard E. Johnson, MBA, CA, CMA, CBV, CPA, CFA
Campbell Valuation Partners Limited*

(This article was published in **CMA Management**, June, 2002, pgs.31-33)

Corporate acquirers and vendors often focus primarily on obtaining the best price when negotiating the purchase or sale of a business. However, the 'best price', being the lowest price in the case of the buyer and the highest price in the case of the seller, may not represent the 'best deal' for either party. The 'deal' is a function of the price paid or received, as well as the terms of purchase and sale that are agreed to. The terms pursuant to which an open market transaction takes place have significant implications to the parties involved, and their importance frequently is under-emphasized by both purchasers and vendors. The terms of a transaction include such things as:

- whether the assets or the shares of the business are acquired;
- the form of consideration used to satisfy the purchase price;
- the provisions of management contracts and non-competition agreements; and
- vendor representations and warranties.

As a general rule, in the absence of available non-capital tax losses in the vendor's corporation, purchasers prefer to buy the underlying assets of a company as opposed to its overlying shares. This is because purchasers of assets typically do not assume any undisclosed liabilities of the vendor. Furthermore, in Canada, a purchaser of assets generally benefits from an income tax perspective due to a 'step-up' in the cost base of depreciable capital property. In addition, where a purchaser acquires 'goodwill' pursuant

to an asset transaction, a portion of that goodwill is deductible for income tax purposes. Conversely, a purchaser of shares is not entitled to these income tax benefits and as a result, often discounts the price it is willing to pay pursuant to a share transaction.

Vendors normally prefer to sell the overlying shares of their business due to the tax advantages of doing so. A sale of shares is taxed as a capital gain, only 50% of which is taxable. Further, where the vendor is an individual, he or she may be eligible for the \$500,000 lifetime capital gains exemption on qualified small business corporation shares. Conversely, a vendor of assets often triggers negative tax consequences, including recapture of capital cost allowance previously claimed, as well as tax on 'goodwill' that is sold. The result often is a reduced amount of net after-tax proceeds to the vendor.

The form of consideration refers to how and when the purchase price is paid. Seldom does a purchaser pay the entire purchase price in cash at closing. As a minimum, purchasers typically insist on retaining some amount as a holdback to cover liabilities and contingencies that the parties agree are the responsibility of the vendor. The agreement of purchase and sale should address the portion of the purchase price that is held back, when will it be paid, what rate of interest (if any) it will bear, and the circumstances where the purchaser would have a claim against the holdback amount.

The purchase price often is paid in a form other than cash. Other common forms of consideration include a share exchange, vendor take-back, and earn-out. Where a Canadian acquirer issues treasury shares in exchange for all of the outstanding shares of a Canadian corporation, and no cash or other consideration is involved, the transaction normally is tax-free from the standpoint of the vendor. Vendors sometimes over-emphasize the tax advantages of a share exchange, and often do not adequately consider the risks involved. In particular, the shares received as consideration may not be readily liquid due to restrictions imposed by the purchaser or securities exchange regulations, or because the block of shares received is far greater than the average daily trading volume in the public equity markets. As a result, the net proceeds generated by the vendor

following its ultimate sale of the purchaser corporation's shares often are less than anticipated.

Vendor take-backs refers to situations where the vendor agrees to accept payment from the purchaser over time. In most cases, the vendor receives a note payable from the purchaser corporation. While vendor take-backs may increase the number of eligible purchasers by providing a source of transaction financing (which in turn should improve the vendor's likelihood of securing a good deal), vendor take-backs can be risky. In addition to the payment schedule and applicable rate of interest, the agreement of purchase and sale should address what security is provided by the purchaser, and the recourse that the vendor has against the purchaser in the event that the vendor take-back is not paid.

Earn-outs refer to an arrangement whereby some or the entire purchase price is contingent upon the prospective operating results of the vendor's business. Earn-outs effectively transfer risk from the purchaser to the vendor, since the vendor will not be paid (at least to the extent anticipated) unless results are obtained. Accordingly, where a vendor accepts an earn-out, it normally does so in exchange for the opportunity to receive a higher price upon meeting the agreed performance measures. In structuring an earn-out, the purchaser and vendor should address the basis of measurement (revenues, operating profits, and so on), the length of time the earn-out is in place, and whether the vendor has an opportunity to 'catch up' should agreed targets be missed in a given year. Earn-outs tend to be more acceptable to vendors where they will be actively involved in the business following the sale, and therefore can influence the prospective operating results.

Management contracts and non-competition agreements are more common where the vendor is an individual who was actively involved in the business prior to its sale. In most cases involving privately held companies, the purchaser wants to retain the vendor for some period of time to ensure a smooth transition. Management contracts frequently range from 6 months to 3 years in duration, and sometimes include lucrative payments

for achieving specified operating results. Non-competition agreements are used to prevent the vendor from competing with the divested business for a specified period of time (normally 1 to 5 years) within a specified geographic territory. Vendors entering into management contracts and non-competition agreements must ensure that the provisions are not overly restrictive in light of their intentions following the sale.

Vendor representations and warranties are formal assurances that the vendor provides the purchaser regarding the affairs of the vendor's corporation. These assurances effectively transfer the risk of 'unknowns' between the purchaser and vendor. Common representations and warranties include those regarding the payment of taxes, the existence of environmental liabilities, and so on. The parties to a transaction must address the level of assurance provided by the vendor (i.e. 'best of knowledge' or 'absolute knowledge'), the length of time the assurances are in place, any minimum and maximum claim amounts, and the quality of the covenant provided by the vendor in the event that the representations and warranties are breached.

In the end, there is much more to business acquisitions and divestitures than just negotiating the best price. The terms of the transaction, including whether assets or shares are acquired, the form of consideration, management contracts and non-competition agreements, and vendor representations and warranties, have a significant impact on the overall deal and whether it meets the objectives of both purchaser and vendor.

Howard Johnson (hjohnson@cvpl.com) is a partner with Campbell Valuation Partners Limited in Toronto (www.campbellvaluation.com) and co-author of *The Valuation of Business Interests* (Canadian Institute of Chartered Accountants, 2001).