

# Negotiating Asset & Share Purchase Agreements: Fundamental Considerations

I. Berl Nadler  
Paul Lamarre

February 27, 2014

DAVIES

# Negotiating Asset and Purchase Agreements



- **Form of the Transaction:**
  - Assets vs. Shares; Amalgamations
  - Consideration
  - Legal and Regulatory Issues
  - Acquisition Agreements

- **Assets vs. Shares; Amalgamations**
  - Direct acquisition of the assets or indirect acquisition of shares or other ownership interests
  - Form of the acquisition is driven in part by income tax considerations
  - Control can be attained using either form of acquisition

# Share Sale vs. Asset Sale

- As a general rule, from a tax perspective a vendor will prefer a share sale and a purchaser will prefer an asset sale
- Preferences will typically come down to applicable tax rate for the vendor and the purchaser's ability to avoid taking on historical tax liabilities and access or create valuable tax attributes

- Where only capital gains would be realized on an asset sale, the combined tax rate (of the corporation on the sale, and the shareholder on the distribution of the proceeds) will be generally the same as the individual tax rate on a share sale
- A share sale becomes advantageous to the vendor where ordinary income would be realized by the corporation on a sale of assets (e.g., on the sale of inventory and, in certain cases, depreciable property)

- The vendor may also be able to reduce its gain on a share sale by way of:
  - access to the \$800k lifetime capital gains exemption, generally available for individuals who have held the shares for at least 24 months where the corporation is a "CCPC" and principally carries on an active business in Canada
  - safe income dividends, which can allow a corporate shareholder to reduce its gain through the payment of tax-free dividends by the target corporation out of tax-paid earnings
  - tax-free rollover, where the vendor receives shares of a Canadian corporation as consideration for the sale

- A purchaser of shares acquires all of the assets, but also all of the liabilities of the corporation; enforcing indemnities can be time consuming and expensive
- Where the purchaser carries on a similar business, it may be able to make use of losses of the target corporation to shelter income from its business; losses are typically valued at between \$0.05-0.10 per \$1

- A purchaser can, in certain circumstances, structure a share purchase in such a way as to "bump" the cost of non-depreciable capital property of the corporation to an amount equal to the lesser of the fmv of the property and the purchase price for the shares
- The purchaser cannot, however, "bump" depreciable property in this way; if the purchaser wants to be able to increase the cost of depreciable property for tax purposes, it generally must acquire the assets



- Purchasers often prefer to buy assets
  - Increase the tax cost of all assets, in particular depreciable assets
  - Avoid acquisition of undesired liabilities
  - "Cherry pick" the contractual obligations and other liabilities of the acquired business
  - Obtain more significant and precise disclosure
  - Opportunity to enter into new contractual relationships

- Sale of assets can lead to negative tax implications for sellers
- Profits on inventory, recapture on depreciable capital property, are taxable as income
- Additional tax on distribution from the company
- GST/HST, PST and land transfer tax are generally paid by the purchaser, causing a depressed purchase price where not recoverable or exempt

# Amalgamations

- Two amalgamating corporations combine and continue as one corporate entity
- Tax-free "rollover" may be available on exchange of shares
- Generally, shareholders of the acquired corporation receive cash through the issuance of redeemable preferred shares of the newly amalgamated corporation
- Amalgamations are similar to share transactions from an employment perspective

# Share vs. Asset Transaction

The principal difference between the two types of transactions from an employment perspective is that:

- the employment relationships are generally unaffected in a share purchase context since there is no change in identity of the employer
- in an asset sale, the identity of the employer changes
- successorship rights

# Asset Acquisition



- Can pick and choose employees and terms and conditions of employment
- Offers of employment
- Terminations of employment
- Employees not actively at work at closing

# Consideration



- Securities vs. Cash
- Earn-Outs
- Holdbacks to Cover Contingencies

# Securities vs. Cash



- Simplest form of consideration is cash paid in full at closing
- Method preferred by most sellers and least desired by most purchasers
- Purchasers may offer shares or other securities of the purchaser itself, a subsidiary or other affiliate of the purchaser or of an investee corporation of the purchaser
- Attracts securities law regulation
- Seller may be entitled to a tax-deferred rollover

- The payment by the purchaser of a portion of the purchase price is contingent on earnings of the acquired business during a specified period of time after closing
- Form of Payment:
  - Cash or securities
- Term of the Earn-out
- Formula for Earn-out
- Distribution of Payments
  - Timing
  - Conditions



- Earn-out payments will generally be treated as additional capital gain in the year received, provided all such payments are made within 5 years of the sale; otherwise, there is a risk that the payments will be taxed as ordinary income

# Earn-Outs

- **Less common in Canada than in US**
  - Can. 3% (10% - 2008); US 29%
- **Pros**
  - Incent seller to keep involved in business
  - Reduce buyer's initial investment and overall risk
  - Built in set-offs for indemnities as effective holdback
- **Cons**
  - Complicated, time intensive and expensive to negotiate
  - Increased risk of litigation

# Holdbacks to Cover Contingencies

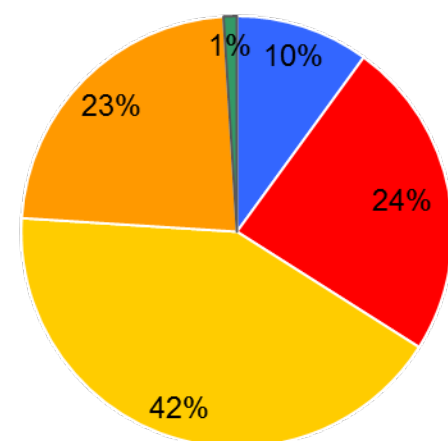
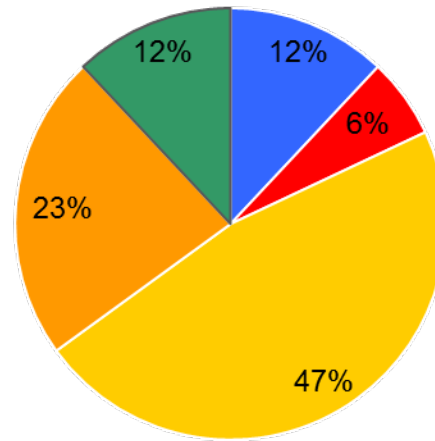
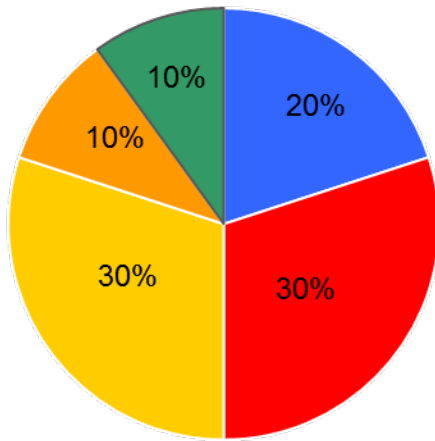
- Portion of the purchase price is held back in escrow
- Purchaser draws from trust account to cover successful claims made under indemnity provisions
- Seller may still be required to recognize the gain immediately for tax purposes on proceeds not yet received

# Escrows/Holdbacks

- Fees usually split 50-50
- Interest usually accrues to seller
- Claims
  - 33% result in claims; 67% no claims
  - Working capital 32%
  - Purchase price adjustments 23%
  - Fees & Costs 14%
  - Financial statements 11%
  - Taxes 7%
  - Undisclosed liabilities 7%

\* Source: JP Morgan 2012 M&A Holdback Report

# Escrow Amount as a Percentage of Purchase Price



■ <3% ■ 3 to 5% ■ 5 to 10% ■ >10 to 25% ■ >25%

Source: ABA 2010 & 2012 Canadian Private Target Studies and ABA 2013 US Private Target Study

# Escrow/Holdbacks

- Duration of Escrow
  - 18 months 30%
  - 12 months 27%
  - 24 months 10%
  
- Multiple escrows (23%)
  - General indemnity claims
  - Purchase price adjustments
  - Working capital or other adjustments

# Private Deals

## PRIVATE DEALS - ECONOMIC TERMS: PURCHASE PRICE ADJUSTMENTS / EARNOUTS

Post Closing Adjustments and Earnouts/Deferred Consideration as a Percentage of Total Private Deals



% of Private Target Deals with Post-Closing Adjustments and Earnouts/Deferred Consideration by Industry

Industry	% of Total Deals	Post Closing Adjustments	Earnouts/Deferred Consideration
<a href="#">Commodities</a>	6%	33%	8%
<a href="#">Consumer Goods/Svcs</a>	11%	69%	20%
<a href="#">Energy</a>	13%	61%	6%
<a href="#">Financial Services</a>	9%	61%	17%
<a href="#">Healthcare &amp; Pharma</a>	13%	53%	24%
<a href="#">Infrastructure</a>	2%	71%	35%
<a href="#">Manufacturing</a>	12%	74%	11%
<a href="#">Media &amp; Entertainment</a>	4%	38%	15%
<a href="#">Other</a>	5%	75%	22%
<a href="#">Real Estate</a>	2%	24%	6%
<a href="#">Technology</a>	18%	66%	22%
<a href="#">Telecommunications</a>	2%	57%	7%
<a href="#">Transportation</a>	3%	72%	6%

- The pricing of private target transactions required fewer [post-closing adjustments](#) in Q2 2012, occurring in just 40 percent of deals. The use of these provisions had occurred in over half of private deals for the preceding 2 years.
- [Earnout / deferred consideration](#) provisions had been declining over the course of 2011, but have rebounded in 2012. The most recent quarter showed a near-average level of about 13 percent of deals.

\*Includes announced private target deals ≥ \$25 million where agreement was filed with the U.S. SEC from 01/01/2010 through 06/30/2012

# Legal and Regulatory Issues

- *Competition Act (Canada)*
- *Investment Canada Act (Canada)*



# Competition Act (Canada)



- Purchase agreement provisions should deal with the *Competition Act* review process
- Any exchange of information between the parties should be conducted pursuant to appropriate confidentiality restrictions
- Generally, purchaser leads in dealing with the Competition Bureau

# Competition Act (Canada)



- Related closing conditions
- Bureau has confirmed that it does not intend to challenge the transaction
- Deadline for obtaining approval
- "Break up" fee
- List of the other jurisdictions in which approval is needed
- Seller is not being investigated or involved in conduct in contravention of the *Act*

# Investment Canada Act (Canada)



- Transactions may be subject to review
- Purchase agreements should include representations and warranties that:
  - All necessary approvals have been obtained; or alternatively,
  - The prescribed time period for review under the statute has expired; and
  - The transaction has been approved in accordance with the provisions of the *Act*

# Acquisition Agreements

- A. Introduction
- B. Subject Matter
- C. Purchase Price
- D. Representations and Warranties
- E. Covenants
- F. Closing Conditions
- G. Indemnities
- H. Conclusion

- Pre-acquisition agreements
  - Confidentiality agreements
  - Letters of intent ("LOIs")
  - Memoranda of understanding ("MOUs")
  - Should expressly disclaim their binding nature except for certain provisions (e.g. confidentiality, term, exclusivity, non-competition or solicitation)

- Purchase agreements
  - Sole comprehensive legal code that governs the transaction
  - Should expressly provide that it alone governs the transaction and that it supersedes and overrides all prior agreements, understandings, regulations and discussions, whether written or oral, including the MOU and/or LOI
  - Generally follow a well-defined and highly precedented format

# Subject Matter

- Detailed Description of Purchased or Underlying Assets
- Shares or Other Securities
- Assets

# Purchase Price

- Manner of Payment
- Payment Mechanisms
- Assumption of Liabilities
- Determination and Adjustment of the Purchase Price
- Allocation of the Purchase Price
- In an asset sale, for tax purposes a purchaser will typically want to allocate more to depreciable capital property, but a vendor will want to allocate to non-depreciable capital property



# Representations and Warranties



- Types
  - Legal Status
  - Title
  - Factual

- Legal Status
  - Incorporation and capacity of the corporate party or other legal entity to enter into the transaction
  - Due authorization
  - Enforceability of the transaction agreements
  - Absence of any agreements by the seller to sell the relevant assets or shares to others
  - The transaction not being in violation of any other agreements, laws or judgements

# Representations and Warranties



- Title
  - Title of purchased shares, purchased assets or corporate title of the acquired corporation or other legal entity to underlying assets used in the business
  - When consideration is securities, proof of the purchaser's title to the securities

# Representations and Warranties



- Factual
  - Condition of tangible property
  - List of agreements to which the purchased business is bound
  - Standing of agreements and the existence of any defaults
  - Compliance by the purchased business with applicable law and regulation

# Representations and Warranties



- Factual
  - Identification of any third party or regulatory consents, approvals or filings
  - Quality of books and records
  - Existence of and status of any outstanding litigation
  - Customer lists
  - Tax status
  - Environmental law compliance
  - Employees and employment contracts
  - Unions
  - Pension and Benefit plans, accruals, litigation, statutory plans

# Sandbagging

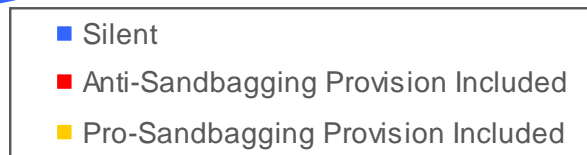
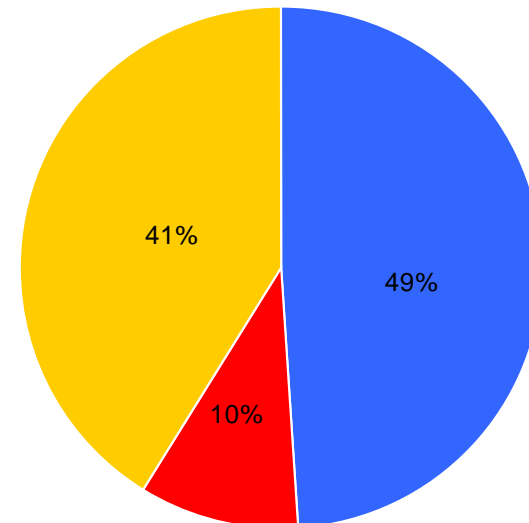
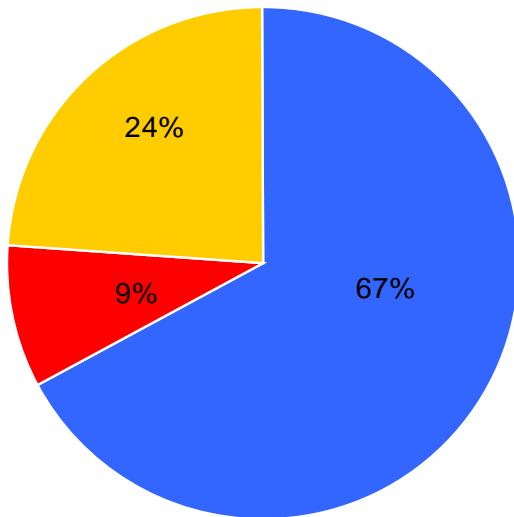
## Pro-Sandbagging

“The right to indemnification **will not be affected by any knowledge acquired (or capable of being acquired) at any time**, whether before or after execution and delivery of this Agreement or the Closing Date, with respect to the accuracy of such representation or warranty.”

## Anti-Sandbagging

“The Seller shall not be liable for any losses result from or relating to any inaccuracy in or breach of any representation or warranty in this Agreement **if the Buyer had knowledge of such breach before Closing.**”

# Sandbagging



- Purpose
  - Used to allocate risk between the parties
  - Intended to provide a snapshot of the business
  - Found universally in acquisition agreements but will vary within certain defined parameters, based on the circumstances of the transaction and negotiating leverage of the parties



- Substantive Limitations
- "Materiality"
  - Legal, status and title representations should not be subject to qualifications
  - May be appropriate to qualify factual representations
    - "material contracts" and "material adverse effect"
    - "material" compliance with laws

- Substantive Limitations
- "Knowledge"
  - Sellers attempt to qualify factual representations
  - Encumbers the purchaser with the risk of the seller's inadequate/negligent management of the business
  - Purchasers should negotiate for an "objective standard"
  - May include identification of officers who actually know or reasonably ought to know the matter in question



# Representations and Warranties



- Procedural Limitations
  - Survival periods, caps, deductibles and thresholds on indemnities for representations and warranties

# Survival Periods

- Length of survival period for representations

		
24 months	47% (31% - 2010)	8%
18 months	12% (14% - 2010)	44%
12 months	17% (18% - 2010)	22%

- Source: ABA 2010 & 2012 Canadian Private Target Studies and ABA 2013 US Private Target Study

- **Bringdowns**
  - Customary condition that the representations and warranties, which speak to the date of the signing of the agreement, are true and correct on closing
  - Purchaser will argue for the same standard agreed upon at execution
  - Seller will look for a materiality qualification

# Representations and Warranties

- Changes to the Representations and Warranties between Signing and Closing
  - Who bears the risk for any changes in the state of facts between signing and closing?
  - Sellers may be required to supplement schedules with amendments to reflect the state of reality at closing

- Contractual agreements designed to govern the parties' behaviour between signing and closing, and occasionally, subsequent to closing
- Counsel to the purchaser should develop a good understanding of the business risks associated in order to negotiate the interim period covenants

- Types
  - Conduct of the business
  - Access of the purchaser to the premises
  - Treatment of employees, offers of employment, refusals of offers, employees who are absent
  - Pension and benefit plans
  - Pursuit of third party contractual and regulatory consents
  - Effecting filings and registrations and environmental matters



# Closing Conditions

- Must be met for the parties to close
  - Types
    - Mutual Conditions
    - Seller Conditions
    - Purchaser Conditions

- **Mutual Conditions**
  - Include, the absence of any action, pending or threatened to enjoin, restrict or prohibit the consummation of the transaction and the receipt of all necessary approvals and the execution of all the principal agreements
  - Conditions in favour of each party include the truth or representations and warranties, the performance of covenants, and receipt of specific consents

- **Conditions in favour of the Purchaser**
  - Agreement of employees to continue their employment with the business
  - The absence of any material damage to the purchased or underlying asset
  - The absence of any material adverse change with respect to the business between signing and closing
  - The delivery of the appropriate closing documentation, conveyances and opinions in favour of the purchaser

- **Conditions in favour of the Seller**
  - The receipt of payment
  - The absence of any material adverse effect with respect to the purchaser or affiliate
  - The delivery of the closing documentation, conveyances and opinions in favour of the seller

- General commercial practice to include indemnities that address the rights of the parties to assert damage claims
- Standard indemnities include those for breaches of representations, warranties and covenants
- Environmental lawyers will often want specific indemnities for hazardous substances and other environmental liabilities
- Typically, full indemnity for tax; tax liability is more of an issue for share sales, though a purchaser can become liable for certain vendor tax liabilities on an asset sale as well

- In a share purchase transactions, the seller's indemnities may cover:
  - Liabilities not disclosed in the financial statements which form the basis for the purchase price
  - Undisclosed contingent liabilities (e.g. product liability claims) and undisclosed litigation that arise prior to closing



- Set out the procedure to be followed by an indemnified party asserting an indemnity claim, including:
  - Provision of notice
  - Deadlines
  - Ability of parties to take carriage of an action initiated by a third party

- **Threshold/Baskets and Caps**
  - Related to claims for breaches of the contractual provisions of the acquisition agreement itself
  - Do not apply to pre or post-closing liabilities that arise from the conduct of the business *per se* and that are subject to explicit cross indemnities



# Indemnity Caps

- Most deals include an overall cap on seller's liability
  - Can. 72% (76% - 2010); US 96%
- Size of indemnity cap trending down

		
Purchase price	40% (45% - 2010)	6%
>50% of price to purchase price	14% (17%– 2010)	0%
10% to 50% of purchase price	43% (24% - 2010)	47%
<10% of purchase price	3% (14%– 2010)	48%

- Average % of price – Can. 33.6% (26.6% - 2010); US 16.6%

- Source: ABA 2010 & 2012 Canadian Private Target Studies and ABA 2013 US Private Target Study

# Private Deals

## PRIVATE DEALS - INDEMNIFICATION: CAP AND ESCROW

Average Industry Indemnification - Cap		
Industry	% deals with cap	cap % of deal value
<a href="#">Commodities</a>	62%	32%
<a href="#">Consumer Goods/Svcs</a>	79%	20%
<a href="#">Energy</a>	82%	20%
<a href="#">Financial Services</a>	70%	25%
<a href="#">Healthcare &amp; Pharma</a>	73%	20%
<a href="#">Infrastructure</a>	76%	19%
<a href="#">Manufacturing</a>	92%	19%
<a href="#">Media &amp; Entertainment</a>	62%	18%
<a href="#">Real Estate</a>	59%	8%
<a href="#">Technology</a>	82%	20%
<a href="#">Telecommunications</a>	86%	18%
<a href="#">Transportation</a>	83%	33%
<a href="#">Other</a>	88%	16%

Average Industry Indemnification - Escrow		
Industry	% deals with escrow	escrow % of deal value
<a href="#">Commodities</a>	15%	8%
<a href="#">Consumer Goods/Svcs</a>	40%	8%
<a href="#">Energy</a>	15%	8%
<a href="#">Financial Services</a>	23%	8%
<a href="#">Healthcare &amp; Pharma</a>	46%	8%
<a href="#">Infrastructure</a>	29%	6%
<a href="#">Manufacturing</a>	49%	8%
<a href="#">Media &amp; Entertainment</a>	27%	6%
<a href="#">Real Estate</a>	18%	6%
<a href="#">Technology</a>	61%	10%
<a href="#">Telecommunications</a>	64%	11%
<a href="#">Transportation</a>	44%	9%
<a href="#">Other</a>	56%	7%

Includes 708 private target deals with agreements that have been analyzed in Business Law Advisor-M&A since 1/1/2010. Full deal briefings and advanced search are available at <http://advisor.westlawbusiness.com>

- Of 595 deals in the sample that had [baskets](#), 65 percent had deductible baskets, 31 percent had first dollar/tipping baskets and 4 percent had combination baskets.
- Of deals with [caps](#), the highest caps were found in the [transportation](#) sector at 33 percent followed closely by the [commodities](#) sector at 32 percent.
- Since the beginning of 2010, the [telecommunications](#) industry has the highest rate of deals that include escrows and also has the largest average escrow as a percentage of deal value at 11 percent.

\*Includes announced private target deals ≥ \$25 million where agreement was filed with the U.S. SEC from 01/01/2010 through 06/30/2012

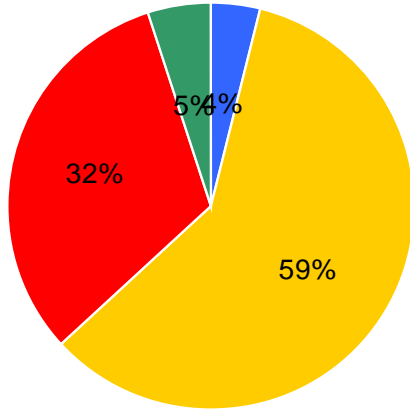
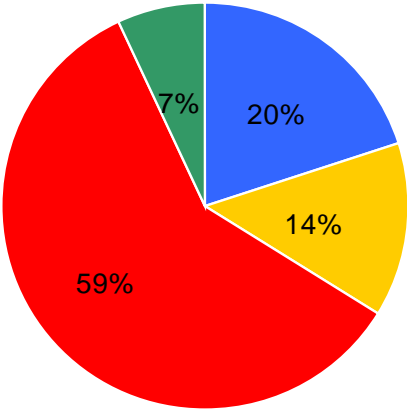
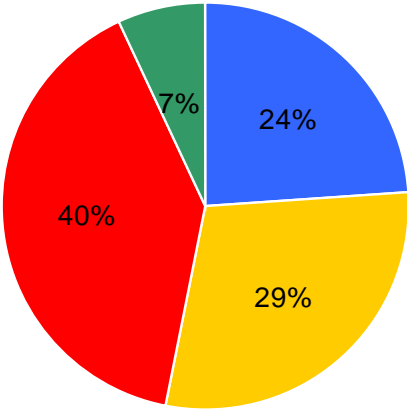
# Indemnity Caps

- Carve-out for certain reps/covenants
  - Fraud (Can. 35%; US 79%)
  - Taxes (Can. 13%; US 52%)
  - "Fundamental or Legal reps" (Can. 15% - 24%; US 15% - 55%)
  - Environmental (US 12%)
  - Breach of covenants (Can. 9%; US 28%)
  - Intentional breach (Can. 22%; US 28%)
  - Employee benefits/ERISA (US 16%)

- Source: ABA 2012 Canadian Private Target Study and ABA 2013 US Private Target Study

- **Threshold or Deductible**
  - Is the threshold a deductible, or a pure procedural threshold (i.e. tipping basket)?
  - Purchaser prefers a purely procedural threshold, i.e. a tipping basket
  - The indemnifying party will prefer to provide a threshold that is essentially analogous to an insurance deductible

# Increased Use of Deductibles and Tipping Baskets





■ No Basket ■ Deductible ■ Tipping Basket ■ Combination Basket

Source: ABA 2010 & 2012 Canadian Private Target Studies and ABA 2013 US Private Target Study

# Basket/Deductible

- First Dollar - Can. 59% (40% - 2010); US 32%

		
Avg % of price	0.43% (0.75% - 2010)	0.46%
Min % of price	0.01% (0.10% - 2010)	0.02%
Max % of price	1.80% (4% - 2010)	1.60%

- Combination basket – Can. 7% (7% - 2010; US 5%)

- Source: ABA 2010 & 2012 Canadian Private Target Studies and ABA 2013 US Private Target Study

- Exclusive Remedy
  - Provision generally provides that it is the exclusive code for asserting claims to the exclusion of any other common law rights and remedies
  - Parties may also retain their rights to equitable remedies such as injunction and specific performance where damages would not be an adequate remedy

## ➤ Net Damages

- Not atypical for damages calculations to be net of any proceeds of insurance or tax benefits
- Parties may negotiate whether insurance proceeds must actually be received or whether there should merely be an entitlement to the proceeds in order for the amount to be deducted from the damages claim