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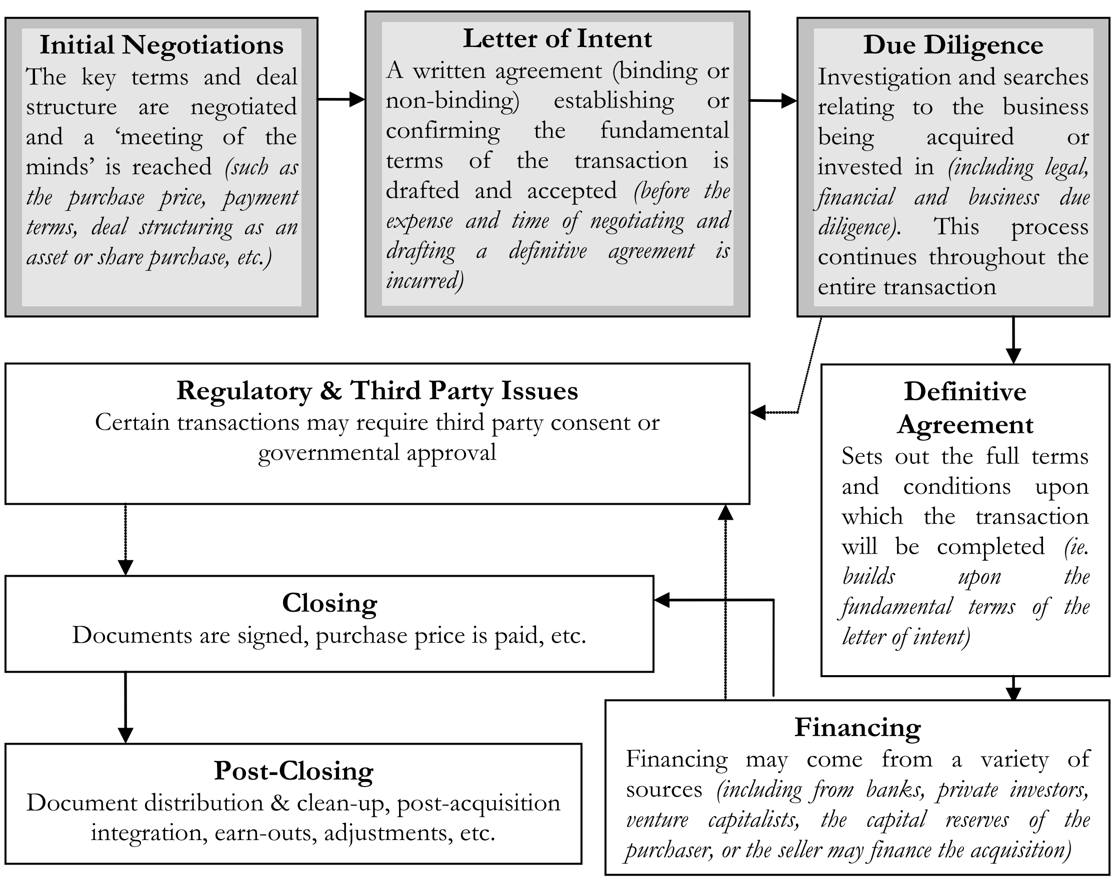
THE ACQUISITION PROCESS:
STRUCTURING THE DEAL, NEGOTIATING THE LETTER OF INTENT & CONDUCTING DUE DILIGENCE



Initial Negotiations: Asset vs. Share Purchase Transaction

The initial question in any acquisition is whether the transaction should be structured as an asset purchase or share purchase. The answer depends upon a number of factors, including: timing, risk allocation (i.e. the liabilities, claims and encumbrances associated with the business), ease of implementation and tax consideration.

In a share purchase transaction, the purchaser acquires the corporation itself, with all of the underlying assets and liabilities. A share purchase is generally faster to complete and less complex than an asset acquisition – and it avoids many of the practical problems associated with a transfer of particular assets (such as the common requirement to obtain consent from third parties - although this may be required in certain cases - or to have the assets re-titled in the purchaser's name). From a vendor's perspective, a share transaction may be more tax advantageous than an asset purchase. This is because no GST or PST is payable on the sale of shares: tax liability is limited solely to taxes on any applicable capital gains (which in itself receives favourable tax treatment in comparison to tax on income). Moreover, taxes paid on capital gains may be minimized further if the business qualifies for a capital gains exemption as a Small Business Corporation. On the other hand, the vendor in a share transaction is unable to retain any existing losses (if any) in the corporation in order to off-set against future income.[1]

In an asset purchase transaction, the purchaser selects which assets of the business (and accompanying liabilities) it wishes to purchase: it also gets to decide which assets and liabilities it wishes to exclude. Liabilities unassumed by the purchaser, particularly unknown liabilities, will remain the responsibility of the vendor. An asset purchase is often the more favourable structure for a purchaser or if the vendor is selling one division of a corporation while maintaining another. A sale of assets will generally be less favourable to the vendor from a tax perspective. This is because the sale is taxed at two levels: to the corporation when it sells its assets; and, to the shareholder (i.e. vendor) when the profits are distributed by the corporation. In an asset purchase, however, the vendor retains the ability to use existing tax losses in the corporation.[2]

Letter of Intent

In many transactions, the purchaser and the vendor will execute a letter of intent. A letter of intent (which is sometimes called a memorandum of understanding) is a written agreement between two or more parties which is meant to confirm fundamental terms or indicate interest by a potential purchaser, as well as to open a dialogue for negotiations. It is a relatively straightforward document setting out the proposed terms of the transaction. If a deal is eventually consummated, the letter of intent may memorialize the major terms upon which a definitive agreement will be based.

A letter of intent may be binding or non-binding or a combination of both. In most cases, the letter of intent will contain binding provisions – for example, terms with respect to non-disclosure, covenants to negotiate in good faith or "no-shop" provisions granting the proposed purchaser with an exclusive right to negotiate for a specified term – even if the other sections of a letter of intent are non-binding. The purposes of a letter of intent include:

- clarifying the key points of a complex transaction for the convenience of the parties;
- declaring officially that the parties are currently negotiating;
- preventing the vendor from dealing with third parties while a transaction is being negotiated;
- providing safeguards in case a deal collapses during negotiation; and,
- binding a party to the terms of a proposed transaction even prior to the completion of all applicable conditions (in the case of a binding letter of intent).

Due Diligence

Regardless of the structure of the transaction, a purchaser will ultimately be most concerned with the condition of the business it is purchasing and the liabilities it is inheriting. As a result, in addition to obtaining appropriate representations, warranties and covenants from the vendor in the purchase agreement, a purchaser will seek to protect itself by conducting a due diligence review of the business and its assets.

[1] Tax losses, if they exist, should be a key consideration when negotiating not only the type of structure to be used, but the substantive terms of the deal as well (ie. purchase price; etc).

[2] Please note that the discussion of tax preferences is in general terms. Each particular transaction is different and will result in each party having their own optimal tax structure, which may differ from the information provided in this article. Optimal tax structuring requires that your professional team include both accountants and lawyers with experience in tax planning.

A ‘*due diligence review’* is an investigation into the business, legal and financial affairs of a company. It has three purposes: to ensure that there is complete disclosure in the relevant acquisition documents; to evaluate the transaction (i.e. to ensure that a fair price is paid, risk is allocated fairly, etc.); and, to confirm the status of title, material contracts, legal compliance and other pertinent matters. A due diligence review examines four distinct sets of facts:

- those that affect the value of the assets of the business (i.e. are important assets of the business owned, leased or licensed?);
- those that affect the liabilities of the business (i.e. what are the actual and contingent liabilities of the business? Has the business provided any guarantees? Have any lawsuits been initiated or are any pending or threatened? Has the business signed any contracts that contain a ‘liquidated damages’ clause?);
- those that affect the corporate status (i.e. does the corporation legally exist? Were all previous transactions the business entered into duly authorized? Does the business have the power and authority to enter into this particular agreement?); and,
- those that become relevant if there is a change of control (i.e. do the business’ contracts permit a change of control? If so, what are the consequences of a change of control?).

This article only superficially deals with the multitude of considerations that may arise during the acquisition process. Specific deal considerations are entirely dependent upon the particular facts of your situation. Prior to making any decisions regarding a potential acquisition or sale, it is important that you first assemble a professional team of advisors, including a lawyer, accountant and banker, in order to discuss the relevant issues raised in this article. If we can be of assistance in this regard, please contact our firm at 416.920.2300.

Asset vs. Share Purchase Summary

	Asset Purchase	Share Purchase
Ability to pick and choose liabilities	☑	
Tax favourable from the Purchaser’s perspective		☑
Tax favourable from the Vendor’s perspective		☑
Consent from third party required	☑	☑
Assets need to be re-titled	☑	
Quicker and simpler process (generally)		☑
Compliance with *Bulk Sales Act* (Ontario) required (unless waived by the purchaser)	☑	
No change in status with respect to employees		☑
Establishment of new pension and benefits plan required	☑	
Due diligence required	☑	☑

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