

A practical guide to buying and selling a business



A COURTESY GUIDE PREPARED BY SWAAB
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OVERVIEW OF THE ACQUISITION PROCESS

TIMETABLE

- > Identify target / Invitation to tender
- > Initial investigation
- > Offer/Auction
- Confidentiality Agreement
- > Terms Sheet
- Exclusivity Agreement
- > Due diligence
- > Exchange (sign contracts)
- > Completion

TARGET IDENTITY

A prospective purchaser will try to identify targets using various methods, including:

- > an intermediary engaged to find a buyer for a company
- > approaching potential vendors / target companies directly
- > being approached by the vendor / target company directly.

TERMS SHEET / HEADS OF TERMS

This document is a summary of the main commercial terms as agreed between the vendor and the purchaser. It should also include a timetable for completion.

The Terms Sheet usually remains subject to contract and is non-binding (except for the confidentiality provisions). It is often prepared with the assistance of lawyers in order to ensure that all relevant issues are covered at an early stage.

Tax advice should also be taken at this stage to ensure that the most tax effective structure for both parties to the transaction can be agreed.

CONFIDENTIALITY (NON-DISCLOSURE) AGREEMENTS

A vendor should ensure that a prospective purchaser has signed a confidentiality agreement before any confidential information about the vendor or target company is disclosed. These provisions can be included in the Terms Sheet or in a separate agreement.

EXCLUSIVITY AGREEMENTS

It is advisable for a purchaser to seek an exclusivity period from the vendor. This will allow the purchaser a free run to complete the acquisition without the threat of being “gazumped” by a third party.

A negative agreement (sometimes called a **lock out**) is valid. This is an agreement **not** to negotiate with a third party for a specified period of time. However positive obligations (sometimes called **lock ins**) are unenforceable as obligations cannot be imposed on a party to negotiate an agreement.

Break fee arrangements are also sometimes used in transactions. This is an agreement for the vendor to pay the purchaser’s costs if the vendor withdraws from the transaction (for example if the vendor has found another buyer willing to pay a higher price).

DUE DILIGENCE

This is the process of investigating the target company/business and will focus on the material commercial, financial and legal issues affecting the vendor's business, including:

- > material contracts (eg. a **change of control**¹ or consent to assignment provisions);
- > material assets;
- > rights to intellectual property;
- > employees;
- > existing/potential litigation;
- > insurance; and
- > other risks.

The purchaser will usually prepare a due diligence report and will attempt to get the vendor to **warrant**² the accuracy of the report. Issues raised in the due diligence process can lead to price adjustments and/or additional warranties or indemnities being given by the vendor to provide the purchaser with some comfort.

SHOULD YOU BUY ASSETS OR SHARES?

If shares:	If assets
Simplicity – the only asset being acquired is the shares	Certainty – the purchaser only acquires the assets it wants
All-inclusive – all the assets and liabilities in the target company are acquired	Cherry pick – the purchaser is not obliged to acquire all the assets or any of the liabilities
Lower stamp duty on share sales (but note land rich duty may be applicable)	Higher stamp duty on asset sales but may be able to off-set with capital allowances (eg. on plant and machinery)
Wider warranties and indemnities are required as all assets, liabilities and risks are being transferred	Certain warranties are still required
Usually change of control clauses will require third party consent	Assignments of supply contracts require third party consent
No requirement to transfer employees	There may be issues relating to transfer of employees
Possible use of target's tax losses	No advantage from target's tax losses
Can acquire "control" of target with less than 100%	Requires 100% approval of the target

You should speak to a tax adviser to determine whether the purchase of assets or shares is the best approach from a tax perspective.

1 A Change of control provision in a contract allows the contract to be terminated where the ownership of a party to the contract changes.

2 Warranties – see page 4

3 Gearing means the amount of debt taken on by a company compared to the amount subscribed for shares in the company.

4 Interest cover means the amount of profit made by a company compared to the amount of interest it has to pay each year.

PRICING THE TARGET

VALUATION FACTORS

These include:

- > Profit Projections
- > Profit Margin
- > **Gearing**³ (debt : equity ratio)
- > **Interest Cover**⁴ (profit : interest payable ratio)
- > Cashflow (positive/negative and working capital requirements)
- > Balance Sheet (net asset values)
- > Sector/competing business comparisons/industry average/industry rationalisation
- > Importance to purchaser's business/competitive advantages
- > Adjustments to reflect how the purchaser will run the business
- > Non-financial factors (management team, public perception, prospect of profits).

METHODS OF PRICING (FORMULAE)

These include:

- > **Enterprise Value**⁵
- > **Price earnings ratio**⁶
- > Return on investment
- > Cash flow
- > Net asset value
- > **Dividend**⁷ yield
- > Return on Assets / Capital Employed
- > EBITDA (Earnings Before Interest Tax Depreciation and Amortisation)

TYPICAL PROVISIONS IN SALE AGREEMENTS

CONDITIONS PRECEDENT (TO COMPLETION)

Types

- > Material Adverse Change condition
- > Conditions precedent in other documents (to be completed at same time) must be satisfied or waived
- > Execution of other documents
- > Regulatory approval (for example, the Australian Competition and Consumer Commission or the Foreign Investment Review Board)
- > Customer, landlord, supplier consent to change of control or assignment of contracts
- > Satisfactory due diligence to be carried out
- > Satisfactory finance to be put in place
- > Undertakings received (for example, relating to future conduct)
- > Approval of transaction by shareholders
- > Payment of debts by target company prior to completion
- > Notifications, filings and consents to be made
- > Admission of shares to listing

5 Enterprise value means the value of the shares plus debt less cash

6 Price earnings ratio means the comparison between the valuation of the shares and the dividends paid on the shares, and is a formula commonly used to compare companies in the same industry sectors.

7 Dividend means the part of the profits of a company which it decides to pay to its shareholders.

8 Completion is also known as Closing.

Issues

If the contract is conditional or if the takeover process will take time to put into place, it is usual to have a gap between exchange (signing) of contracts and **completion**⁸ (handing over the money) of the transaction. Typically, in the period between exchange and completion the following issues arise:

- > operations (for whose benefit the target is run and who bears the business risk)
- > warranties (whether these should be repeated at completion and whether the vendor should have the right to make further disclosures at completion)
- > fulfilment of conditions precedent
- > right of rescission for the purchaser in certain circumstances (for example, where there has been a material adverse change in the business)
- > **Long-stop date**⁹ for satisfaction of the conditions.

PURCHASE PRICE

Types

This can be by way of:

- > cash (funds are provided by the purchaser and/or a third party lender);
- > shares (in the purchaser); or
- > debt (a loan from the vendor).

Issues

- > Adjustment of price after completion by reference to **completion accounts**¹⁰ / earn-out mechanism **contingent consideration**¹¹
- > Deferred consideration
- > Retention (or **escrow**¹² arrangements)
- > Guarantees (for payments, warranties and other obligations)
- > **Right of set-off**¹³

Adjustment of price through earn-outs

- > Earn-outs are a mechanism to split the purchase price between an upfront payment and payments based on the performance of the business after completion
- > It can bridge a divide between the buyer and the seller in negotiating the price
- > It rewards the seller for the achievement of its financial targets
- > It binds the seller financially to the business for a period after completion
- > It cushions the buyer from paying too much on completion for the potential (but not yet realised) value of the business
- > It is often the subject of dispute due to the complexity of some earn-out calculations (including provisions to deal with management charges, exceptional costs and tracking revenue if the business is integrated with another of the buyer's businesses)
- > It is important to base the calculation on clear criteria and to include contingency arrangements in the event that the buyer on-sells the **business**¹⁴.

⁹ The long stop date (also known as the Sunset Date) is the date when the contract will automatically terminate if the conditions precedent have not been satisfied or waived

¹⁰ Completion Accounts are revised financial results as at the date of completion prepared after completion.

¹¹ Contingent consideration is a part of the purchase price which is only payable on the occurrence of a certain event.

RESTRICTIVE COVENANTS ON VENDOR/KEY EMPLOYEES/SHAREHOLDERS

Types

- > Non-solicitation of former clients/employees/customers/suppliers
- > Non-dealing with former clients
- > Non-competition with the sold company or business
- > Non-disclosure of confidential information or publication of the deal

Issues

These covenants will apply to the vendor to ensure that the business acquired by the purchaser is protected. The Courts will enforce any restrictions which are reasonable in scope, area and time for the protection of the target.

EXCLUDING LIABILITY

Methods

- > Exclude specific assets and liabilities from the acquisition
- > Due diligence (to identify problems)
- > Indemnities (for specific problems)
- > Warranties

Warranties (representations by the vendor)

The purpose of warranties is to:

- > Obtain information;
- > create a mechanism for adjusting the purchase price;
- > create a mechanism for sharing risk;
- > protect against undisclosed liabilities.

A sale agreement will usually contain many clauses limiting the vendor's liability for breaches of warranty (relating to time, maximum liability, insurance, conduct of claims, recovery from third parties and many more). However where fraud is involved liability cannot be excluded. The warranties will be qualified by the contents of the **Disclosure Letter**. This letter is given by the vendor to the purchaser and contains information relating to the business where it is inconsistent with the statements in the warranties.

The purchaser will not be able to make a claim against the vendor for breach of warranty where the vendor has previously disclosed the inconsistency to the purchaser. Sometimes the purchaser will retain a proportion of the purchase price for a period of time to ensure that if there is a breach of warranty, sufficient funds will be available to pay any claim (see escrow conditions on page 7).

INDEMNITIES (RESTITUTION)

The purpose of indemnities is to:

- > protect one party from a specific liability; and
- > reimburse that party for a specific loss.

Typically, claims under indemnities are made on a \$ for \$ basis and are not qualified by disclosures or restricted by clauses limiting liability.

¹² Escrow arrangements are used where a proportion of the purchase price (cash or shares) is placed in the possession of a third party for safekeeping until certain conditions are met

¹³ Set-off is where one party can use money which is in its possession but belongs to another party to pay off a debt owed to it by that other party.

¹⁴ Swaab often include a worked examples to illustrate the consequences of a drafted provision.

FEATURES OF ASSET SALES

DEBTORS AND CREDITORS

The parties will have to agree on which of them will take the benefit of the debtors and burden of the creditors and the responsibility for collecting the debts and paying the creditors.

If debtors are excluded from the sale (ie. the vendor retains the rights to the debts), the vendor may want the purchaser to collect the debts on its behalf. The purchaser may however want to prevent the vendor from suing the nonpaying debtors as these may be continuing customers of the purchaser.

EMPLOYEES

New contracts must be offered to those employees who the purchaser wishes to transfer across. The previous contracts with these employees will be terminated if the employees accept the offers. Some employees may not be offered employment with the purchaser or may reject the offer. They will usually be entitled to redundancy payments.

There may be difficulties in harmonising the employment terms of the new employees with the purchaser's employment policies. These issues are not applicable on a share sale (as the employees remain with the purchaser) but can still be an issue in a group situation if the employees of the target company are employed on different terms to the rest of the group employees or for example, are governed by different Awards.

GST

GST is payable on the provision (supply) of goods and services. There is an exemption for the transfer of a business as a going concern. The agreement must specify if the price is inclusive or exclusive of GST. If not, and the transfer will be subject to GST, the vendor will have to account for GST and may not be able to recover it from the purchaser.

STAMP DUTY

Stamp duty is payable on asset transfers (at a rate depending on the nature of the assets and the state duty is applicable).

FEATURES OF SHARE SALES

FINANCIAL ASSISTANCE

It is generally unlawful for a company (or its subsidiaries) to give financial assistance for the purchase of its own (or its parent company's) shares (section 260 of the Corporations Act 2001). The restriction applies both to the transfer and issue of shares. Financial assistance includes gifts, guarantees, indemnities and giving security for loans. However financial assistance can be given by the target company if it is:

- > approved by shareholders; or
- > not materially prejudicial to the interests of the company or the shareholders; or

- > not materially prejudicial to the company's ability to pay its creditors; or
- > specified as exempt from the restriction (for example an **ESOP**¹⁵ or share buy-back).

TAX INDEMNITY

A tax indemnity is usually included in a share sale agreement to give the purchaser the benefit of an indemnity for any outstanding tax charges relating to the period before completion.

DIRECT TAX

Stamp duty is calculated on the total purchase price. The rate of duty depends on which state duty is applicable. Share transfers cannot be registered until the transfer form has been stamped. Stamp duty may also be payable on the amount paid for shares in a company which is **land rich**.¹⁶

SHAREHOLDER VOTING RIGHTS

5%	Can requisition an Annual General Meeting.
10.1%	Can block compulsory acquisitions under sections 661/664 of the Corporations Act 2001 (see below).
25.1%	Can veto special resolutions in general meeting, including: <ul style="list-style-type: none">> adoption or alteration of Constitution> change of name> change of company type> selective reduction of share capital> selective buy back of shares> provision of financial assistance> variation of class rights where no Constitution exists> resolution to wind up the company voluntarily.
50.1%	Can veto or pass ordinary resolutions in general meeting, including: <ul style="list-style-type: none">• remove directors from board• authorise a final dividend• authorise capitalisation of reserves• approve transaction with connected party• removal of auditor prior to the expiry of his/her term. <p>Note the distinction between a simple majority (50.1% of those present) and an absolute majority (50.1% of those entitled to vote).</p>
75%	Can pass special resolutions in general meeting (see above).

¹⁵ ESOP means an Employee Share Option Plan, which gives the employees options to acquire shares in the company.

¹⁶ A land rich company is a company which has interests in land with a value of at least \$2 million and whose total land holdings account for at least 60% of its total assets.

ACQUISITION THRESHOLDS

5%	Must notify target and Australian Securities and Investments Commission (ASIC) of the shareholding and any subsequent changes of 1% or more.
15%	Foreign Investment Review Board (FIRB) approval may be required if a foreign entity acquires 20%.
20%	Unconditional offer is required for a listed company or an unlisted company with 50 or more shareholders, where a shareholder reaches 20% or where the holding is increased from a starting point that is above 20% and below 90% (subject to the exemptions in section 611 of the Corporations Act 2001). Creep Rule – no requirement for an unconditional offer to be made if the holding of a shareholder with more than 19% increases by less than 3% every 6 months.
90%	Compulsory acquisition of minority shareholders possible under sections 661/664 Corporations Act 2001.

CONTACT US

The corporate team at Swaab is committed to working with companies to help them meet their ambitions. If we can help you with any of the issues raised in this Guide, please contact Angela Harvey. We would be very pleased to discuss any issues with you.



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For more information or for copies of other Swaab publications please visit our website www.swaab.com.au

This Guide is only intended to give an overview of the issues involved. It is not intended to be fully comprehensive or to be a substitute for legal advice.

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