PURCHASE AND SALE OF A BUSINESS

A CASE STUDY

Presenters:

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The Transaction – First Try

The transaction was originally structured as a share purchase agreement and we were engaged in September 2021.

The Buyer was a US search fund and this was to be their first, or one of their first, acquisitions.

Unfortunately, the LOI had already been signed when we were engaged. This became important with respect to the drafting and negotiation of the stock purchase agreement.

The Purchaser provided the form of share purchase agreement in November. Unfortunately, it was a US stock purchase agreement where they had basically just changed the names.

Our client asked us to redraft the agreement with an explanation added to the agreement for every change that we made to the originally sent version.

It took us three weeks to revise it and complete the schedules, etc.

Once both parties had reviewed the revised agreement it was clear that there were many outstanding issues that hadn't been considered when the LOI was entered into.

Issues
Materiality Scrape

A “materiality scrape” is a provision contained in a purchase agreement that effectively eliminates, for indemnification purposes, any materiality qualifiers in a representation and warranty when determining whether a breach of the representation and warranty has occurred.

“All representations and warranties made herein will be deemed to have been made without any references as to materiality or “material adverse effect” for purposes of determining (a) whether there has been a breach requiring indemnification and (b) the Losses with respect thereto.”

For example, if a purchase agreement contains a materiality scrape, a representation and warranty that states “the Seller company is not party to any material litigation” would be read, in determining whether a breach of that representation and warranty has occurred for indemnification purposes, as “the target company is not party to any litigation.”

In other words, the statement is read as if the word material was never included in the first place – the materiality qualifier otherwise applicable to the representation is “scraped” away.

Materiality Scrape (cont'd)

A materiality scrape provision can be a single or double scrape. A double materiality scrape applies to determining both: (a) whether or not a breach has occurred and (b) the amount of indemnified losses resulting from that breach. A single scrape applies the materiality scrape to the determination of losses resulting from a breach, but not as to whether or not the breach occurred.

This clause is not common in Canada in transactions under $20 million dollars, but in the US, it has become standard for almost all M&A transactions over the last 15 years.

Solution

1. materiality scrape does not apply to determine if a breach has occurred, it does apply to calculate damages.
2. Indemnity basket – a large aggregate threshold was set prior to the Buyer being able to bring an indemnity claim.
3. Limited time period on survival of the representations and warranties (other than fundamental representations and warranties) and indemnification cap equal to purchase price

Sole Remedy

The Purchaser wanted Indemnification **and** the ability to use all other remedies available at law – i.e., sue and unlimited damages. We negotiated so that the indemnification provisions were the sole remedy.

Fundamental Representations and Warranties

Fundamental representations are that “fundamental” to the bargains or deal. For example:

- I own the shares or the company owns the assets being sold;
- Seller is duly organized, validly existing and in good standing;
- Seller has power and authority to own its assets and enter the agreement;

In our transaction, Seller tried to add in representations as fundamental – i.e. on IT systems, I.P. environmental matters, sufficiency of inventory - that are not fundamental

Black Hat

Representation Buyer asked for (and wanted to be fundamental)

Without limiting the generality of the foregoing, Company has not, and is not currently, engaged in black hat techniques including but not limited to SEO practices, as well as paid for reviews, keyword stuffing, cloaking or using private link networks.

Contingent Consideration

This issue is the one that ultimately led to the share purchase transaction not proceeding. Under the terms of the transaction, a large portion of the purchase price was contingent and consisted of a performance bonus, a revenue share and payment for the inventory.

The inventory payment was unsecured, didn't begin for four months and was paid out over 24 months. The parties were ultimately not able to come to agreement on the inventory payment portion of the purchase price as the Sellers were not comfortable "giving away" their inventory to be paid over two years when they were no longer in control of the business.

We had some protections built in (for example, if contingent consideration isn't paid, non-compete is null and void). Further repayment of the inventory amount was subordinated to the Buyer's credit facility and subject to the Buyer being in compliance with the terms of the credit facility at all times.

The Sellers decided not to proceed with the transaction in February, 2022.

The Transaction – Take Two

The transaction was resurrected as an asset purchase agreement in March, 2022 with the parties agreeing that rather than buying all of the assets, the Buyer would buy the assets of one division of the Company.

With respect to contingent consideration, the cash component of the purchase price as a percentage was increased, the Sellers agreed to take equity in the Buyer and the amount of the inventory payment was reduced and the Sellers were allowed to continue to sell the inventory post closing (in addition to the Buyer selling inventory) with such Seller sales reducing the amount of the inventory promissory note.

Tax Efficiency

"The parties and their representatives will work together in good faith to create a hybrid purchase and sale structure that is most tax efficient for both parties in accordance with the transaction structure set forth in Schedule "B" hereto."

We attempted to add this to the LOI. The Buyer's legal counsel refused but verbally agreed to consider it if the parties were able to come to agreement on the form of asset purchase agreement.

What is a Hybrid Sale?

- Share sale: Vendor use LCGE if shares qualify as QSBC.
- What if buyer insists on buying assets of the target to maximize tax pools and not inherit liabilities?
- Hybrid sale:
  - Bridge the gap between two sides by enabling the vendor to access the LCGE and yet allowing the purchaser to acquire assets with high tax basis
  - Operating entity still has the same capital gain from selling assets, but Vendor personally claim LCGE to receive part of the proceeds personally.
- Hybrid relatively low risk since *Geransky* case in 2001. However, recent *Foix c. La Reine, 2021 TCC 52; under appeal,* renewed worries about s.84(2) applying to Hybrid transactions. In our view, provided no part of the hybrid transaction is to indirectly extract excess cash inside target, CRA should not be successful to applying s.84(2). Hopefully, the appeal decision will shed more light.

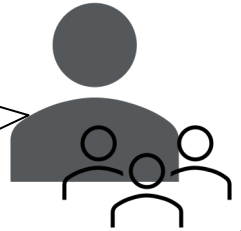
Negotiating to get the Hybrid agreed to

March 18th

Moodys

Please find attached our proposed acquisition structure. We should have a call so I can walk you through this, as it leads to a fairly simple acquisition structure once the steps are complete.

Our loan can only be used for asset acquisitions and an asset purchase agreement attached to our credit agreement is the only approved form of acquisition agreement. Regardless of the tax treatment, the proposed structure would be considered an equity acquisition under our credit agreement and would require special consent from our lender. We provided the signed LOI to our lender already because it needed to be sent two weeks prior to closing. To switch structures now would require us to seek special consent and then restart the two-week time period. We also are not sure what the lender would require to provide special consent if we were to seek it. Our strong preference is to stick with the structure proposed in the LOI. Can you please discuss with your client and see if they are comfortable moving forward with the asset sale contemplated by the LOI and definitive documents we sent?

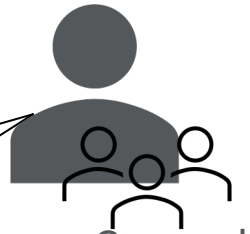


Buyer Counsel

Moodys

we have spoken to our clients. The net results to them as a result of the plan are materially better. They are quite significant. It is important to them and they are prepared to move the closing date two weeks as per below. As such, we are asking that you please reach out to the lender to seek the special consent.

We will discuss internally and get back to you. To be clear, an additional two weeks is the minimum this change in structure could set back the closing. We can't predict whether our lender will provide consent or how long it will take.



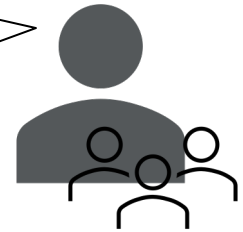
Buyer Counsel

March 21st

Our leadership team reviewed the documents provided and we had a call this morning with the stakeholders.

Unfortunately, [redacted] will not accept this structure and it's been made clear that we need to keep it as per the signed LOI (an asset deal) to move forward.

I know this isn't what you wanted to hear but it's the only way we can use our credit facility to close the deal.



Buyer

[redacted] look at the timing. I told them on Friday at 7:17 pm their time we knew it would delay closing. So I doubt their lender was still open after 7 pm on Friday. And they told us this morning at 1030 their time. I don't actually think they tried. Please revise the email below as you see fit.

Moodys

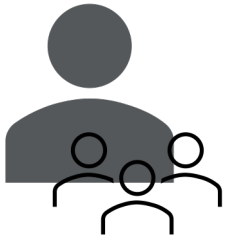
Seller
to all Parties

I just wanted to let you know that this is very disappointing news [redacted]. The combined tax savings to us are approximately $800,000 CDN. That is more than the value of the share equity we agreed to take to help you do this deal and almost as much as the inventory payment. Our counsel told us that this is the first time he has seen a buyer say no to this plan in over twenty years of experience. [redacted] the APA that was sent across to us wasn't in very good shape. It looks like it is a precedent in an asset sale for all of the assets of a business (rather than a portion of the [redacted] assets), which isn't the case here and which is pretty disappointing as it only drives our costs up.

We would like you to reconsider our tax plan and to see if you can get the lender on board. Also, we have instructed our counsel to remove our holdcos and us personally from the agreements as you are only buying some of the assets from a continuing operating company. We will also need to have a discussion to agree on the "migration" concept built into this agreement so that it is papered properly and goes smoothly.

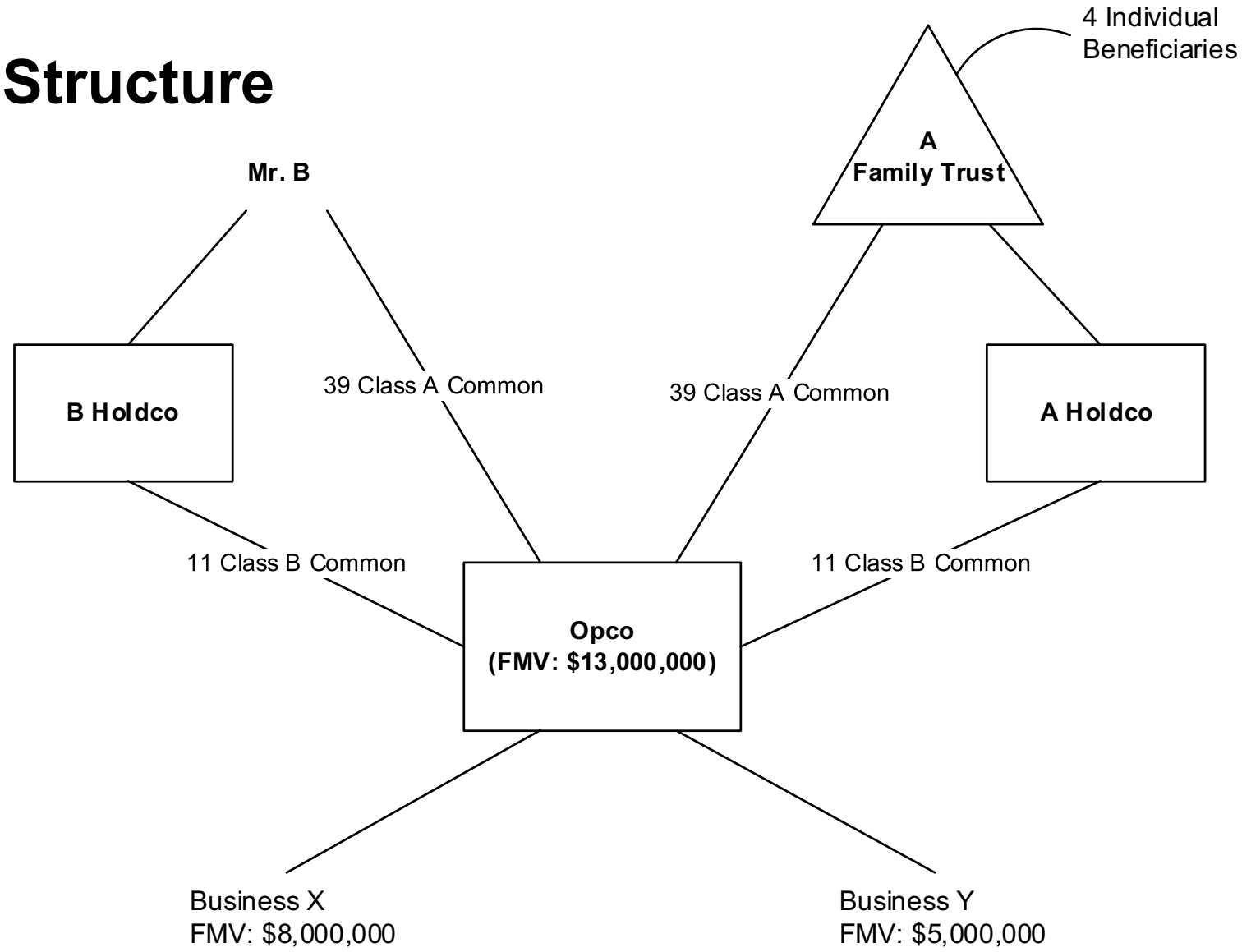
Give me a couple days. We'll exhaust all options on our end. We completely understand the impact this has for you [redacted]

We're exploring if there's a slight change or other format we can do. I'll let everyone know

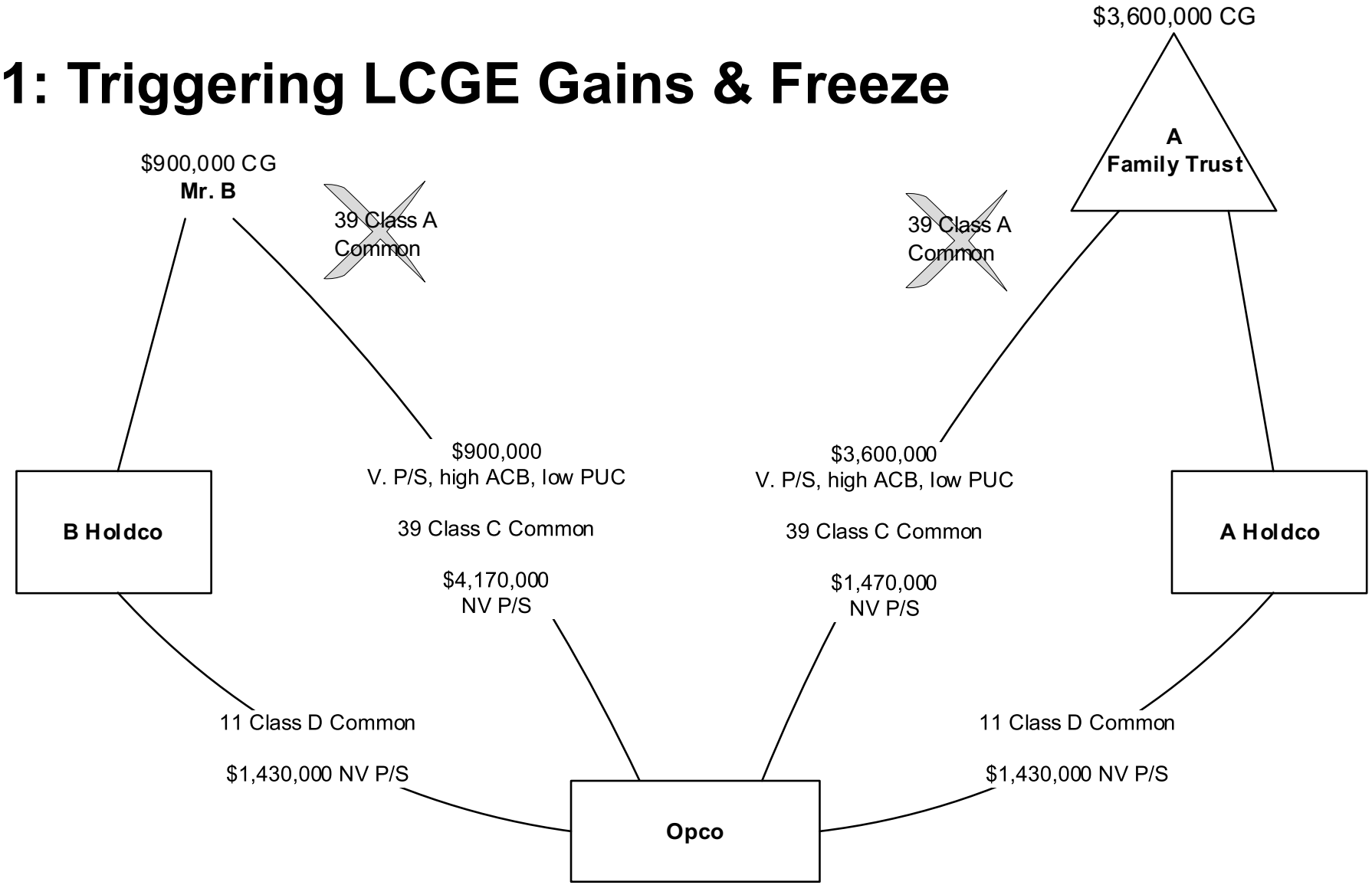


Buyer

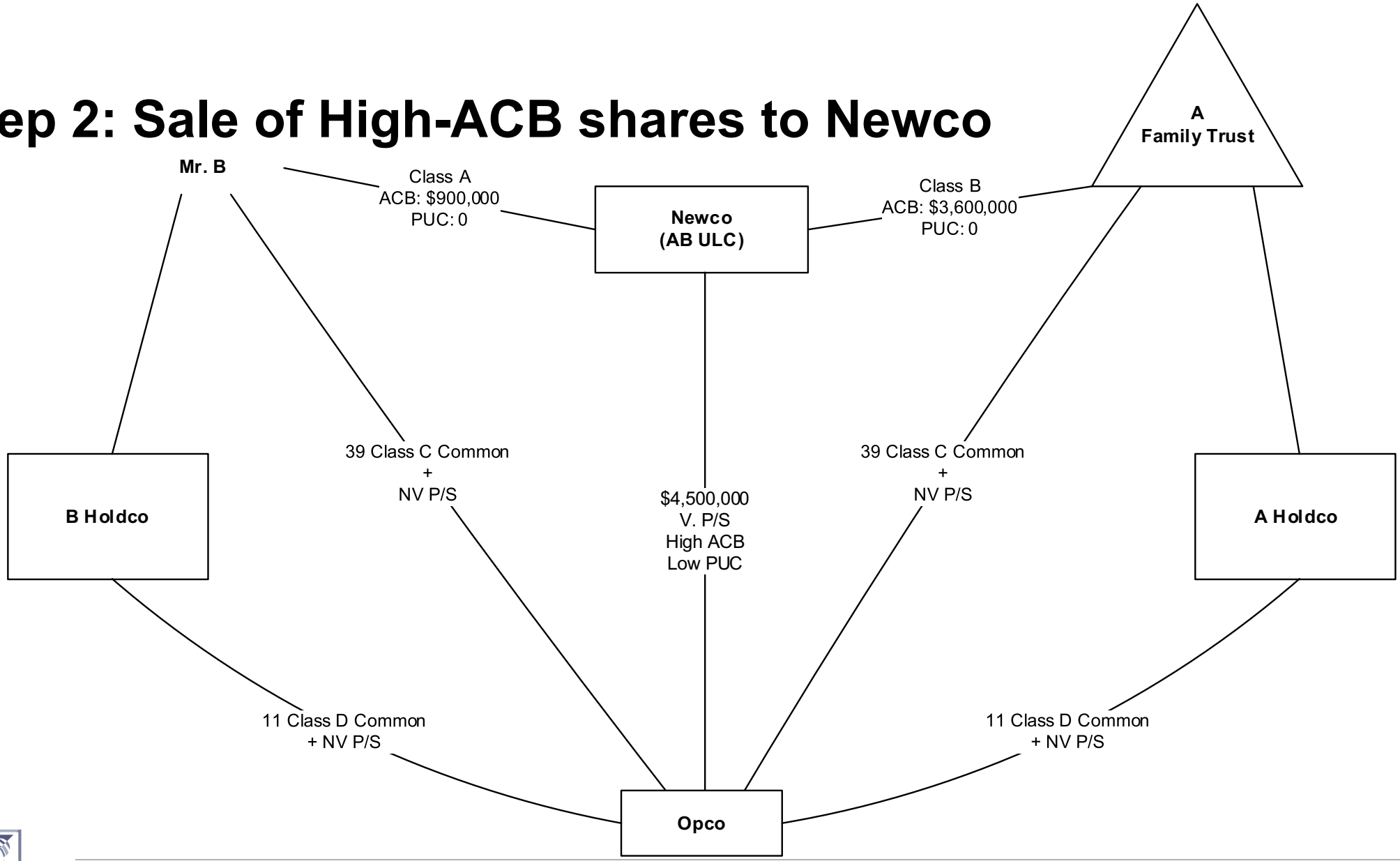
Pre-Sale Structure



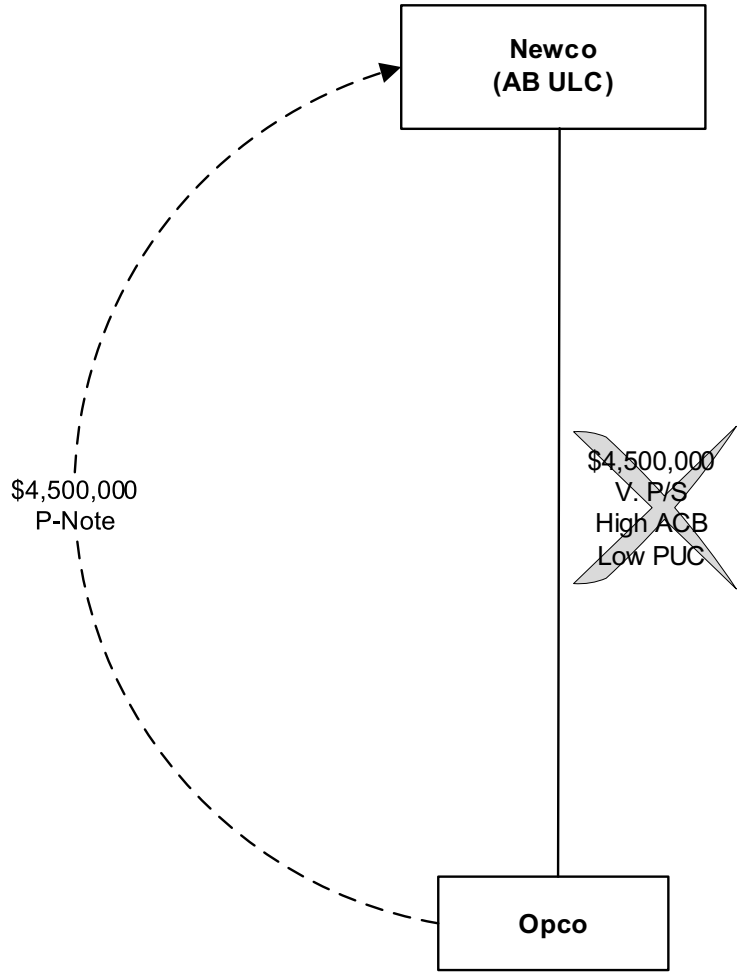
Step 1: Triggering LCGE Gains & Freeze



Step 2: Sale of High-ACB shares to Newco

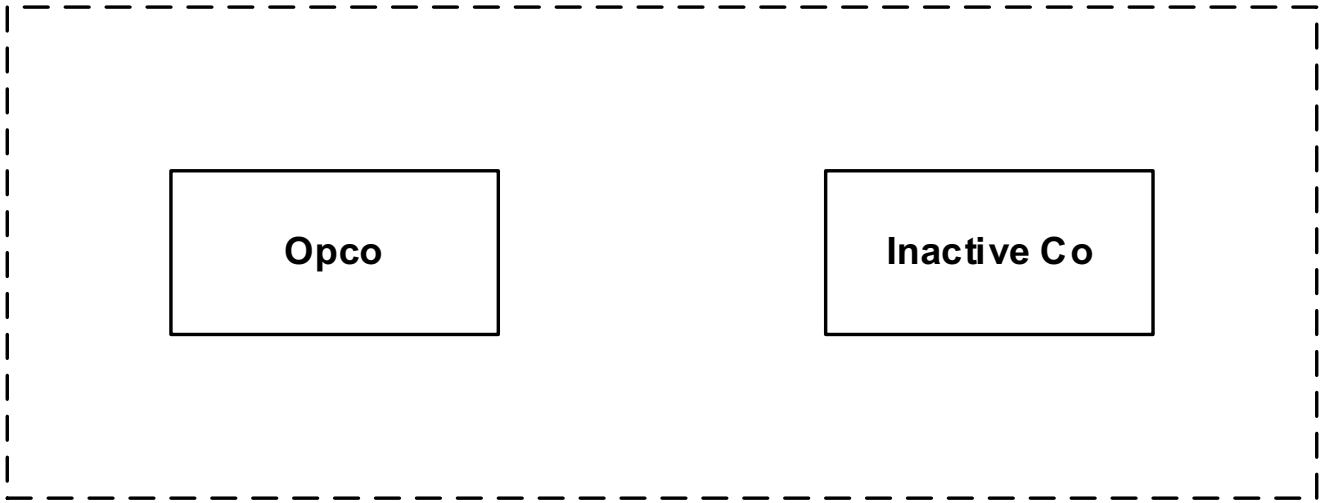


Step 3: Redeem P/S of Opco held by Newco



- Ensure Newco and Opco are “connected”, and Newco has “substantiated interest” in Opco

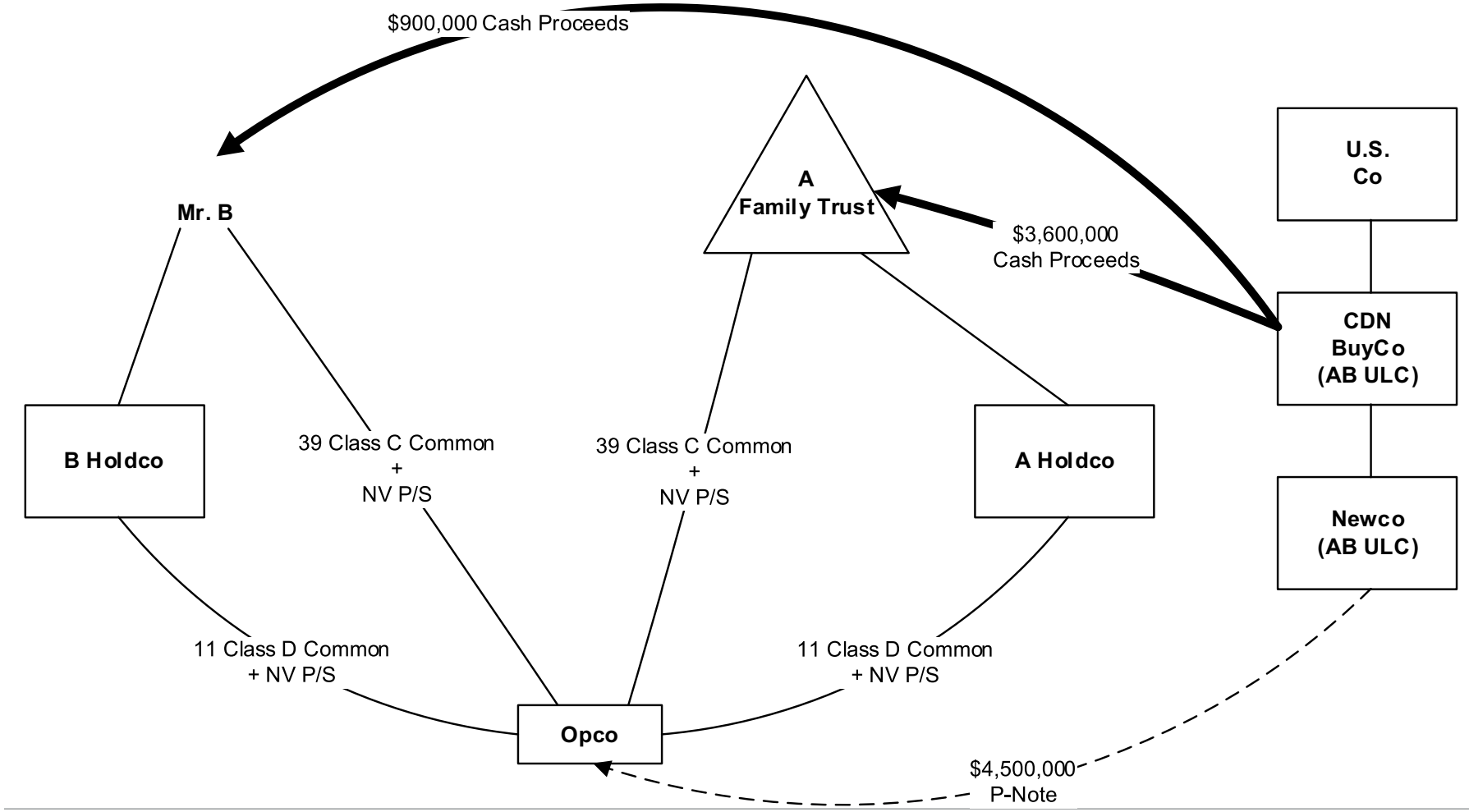
Step 4: Amalgamate Opco with another corporation



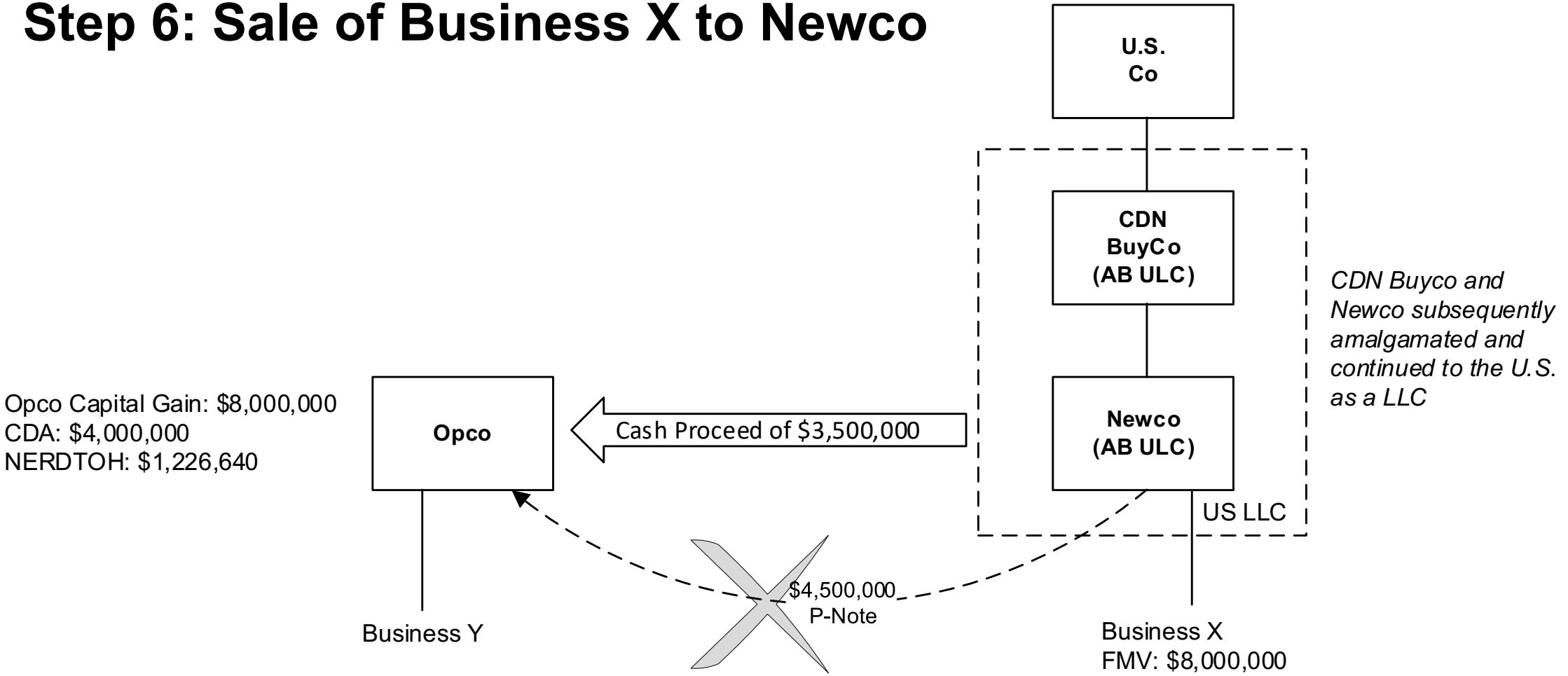
Amalgamate

- Deemed year end to ensure subsequent capital gain NERDTOH do not cause Part IV tax to Newco on Step 3

Step 5: Sale of Newco to US Buyers' Buyco



Step 6: Sale of Business X to Newco



Importance of having accounting support on an M&A transaction

The Operating Statements have been prepared in accordance with practices generally accepted in the real estate industry including in Canada, consistently applied, and are true and accurate in every respect and fairly represent and disclose the results of the business operations of the Property and all Material financial transactions of the Vendor.

The Financial Statements have been prepared ~~in accordance with generally accepted accounting principles~~ on a compilation basis, are true, correct and complete in all Material respects and present fairly the consolidated financial condition of the Vendor as of the dates or year-ends of such Financial Statements.

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