

Share transaction issues in small business buy-outs

This paper examines the issues which arise when a small business is acquired by way of a share purchase of the company which owns and operates the business, rather than where the assets only of the existing trading business are sold to another party. The paper will concentrate on a situation where all of the shares in the company have been acquired rather than the purchase of a part interest. However, the due diligence requirements and many of the issues which arise on a full buy-out apply equally to a partial buy-out.

1. Advantages and disadvantages of a share sale v asset sale

1.1 Advantages

- There is no stamp duty payable on the purchase of shares in a non listed company which is not a land rich company. A company is land rich if it has real property assets in excess of \$1million and those assets constitute more than 60% of the total assets of the company.
- There may be tax advantages available to the buyer or seller, particularly if tax losses can be carried forward.
- For the seller, there is an advantage in that the liabilities of the company are generally assumed by the buyer.

1.2 Disadvantages

- There is greater complexity in a share purchase than an asset purchase leading to higher costs.

- For the buyer, there is a disadvantage in that the buyer assumes the liabilities of the company.

2. Preparing for sale

2.1 Identify assets being sold

In a share sale everything owned by the company forms part of the sale. It is often the case that the company which owns the business also owns some private assets such as motor vehicles which are not intended to be sold as part of the sale of business. It is therefore necessary for those assets to be transferred out of a company before the shares are sold.

2.2 Assets owned by a related entity

Sometimes assets such as real estate, major plant and equipment and trade marks are owned by a related entity and leased or licensed by the operating company. A decision needs to be made about whether or not all of these assets are intended to be sold, or only a right to lease is being granted. For example, sometimes the business owns the freehold from which the business is sold. However, rather than including the land in the sale, a decision may be made to retain it and lease it to the company.

It may be that shares in more than one entity are to be sold or a restructure of the group of companies may be required prior to the share sale to make the sale more tax effective for the seller. Depending on the size and complexity of the business, this may require a complete restructure or a rollup of the business into a new holding entity.

2.3 Shareholder loans

It is reasonably common for privately owned companies to owe money to their shareholders or for the shareholders to owe money to the company. It is important that these loans be identified and dealt with, or a procedure for releasing them be put in place before the contract is negotiated. That is, if the shareholder loans are to be forgiven or the company is to repay the debts, this should be dealt with before the contract is signed, or else must be adequately dealt with in the contract.

2.4 Review financial records

Ideally before the business is marketed for sale, the seller's accountant should review the financial records, profit and loss and balance sheet with a view to making sure those records are accurate and reflect the business actually being sold before those records are made available to a buyer. For example, it may be that adjustments need to be made for personal assets and expenses.

3. Taxation issues

Both the seller and the buyer need to consider capital gains tax and others issues arising from the transaction. The client should be specifically instructed to obtain specialist advice on these issues from a qualified tax accountant.

The buyer also needs to obtain advice from their accountant about the structure of ownership of the shares in the company. That advice should include and take into consideration the buyer's intention in relation to the company in the future, such as whether or not it intends to bring in another partner, to publicly list the company or to sell.

4. Due diligence

The main due diligence requirements are:

- The title to the shares and capacity to sell the shares need to be established.
- There needs to be a financial investigation of the company, the shares in which are being acquired.
- There needs to be an investigation of the assets of company.
- There needs to be an investigation of the liabilities for company.

The scope of the due diligence needs to be discussed and agreed with the client and their other advisors (such as accountants, surveyors, valuers, building, equipment and pest inspectors).

Due diligence is either carried out before a sale contract is entered into, or after contract. An obligation of confidentiality by way of deed (or as part of the sale contract) should be entered into by the buyer before due diligence information is released by the seller. If due diligence is carried out before contract, then the buyer will want to secure an exclusive negotiation period. If carried out post contract, the buyer will prefer a very widely drafted due diligence clause.

If a full due diligence is carried out before contract, this enables the contract to be tailored for the issues identified during the due diligence. However, this is often not possible. The seller will be reluctant to disclose full information if it does not believe the buyer is committed. The buyer will

often be reluctant to spend the money required for a due diligence if the seller is not compelled to sell.

4.1 Title to the shares

Where a business acquisition is occurring by way of share purchase, additional due diligence is required in relation to company records and title to the shares being sold. The issues which you need to address to ensure legal title are as follows:

- that the seller holds the shares as the legal owner;
- there is adequate evidence of ownership such as a share certificate and entry on the register of members;
- that there is no notice of outstanding equitable interests in relation to the shares;
- that the seller has legal capacity to sell;
- that there will not be any difficulty in getting the directors' consent to transfer the shares on completion of a sale.

It is no longer common to issue share certificates in privately held companies. Therefore proving title may be difficult. You will need to inspect the company register as a party needs to be entered as the shareholder in the share register to be a member of the company (See section 231 of the Corporations Act and *Maddocks v D J E Constructions Pty Ltd (1982) 56ALJR 359*). If a share certificate is not available and the company records indicate that a share certificate was issued, a declaration from the seller should be obtained declaring it lost. Alternatively a declaration should be obtained from the directors of the company confirming the share certificate was not issued.

If it appears a share certificate was issued but cannot be located, it would be prudent to also make enquiries with the seller's lender and the company's lender as to whether they hold the share certificate as part of their security.

4.2 Company records

Companies are obliged to keep the following registers and records:

- register of members;
- register of options;
- register of debenture holders.

A company must also keep minute books in which it must record within one month:

- proceedings and resolution of shareholders' meetings;
- proceedings and resolution of directors' meetings;
- resolutions passed without a meeting;
- declarations made by the sole director.

4.3 Constitution

The constitution of the company should be reviewed for the following:

- any restrictions on the transfer of shares
- the rights attaching to the shares
- any restrictions in the constitution affecting the operation of the business.

The buyer should also investigate whether or not the seller is a party to any shareholders agreements which also affect the right to transfer shares.

4.4 Liabilities

Because the company has been operating and trading for some time, it will have incurred liabilities which can be difficult to quantify and ascertain. Examples of the types of liabilities which need to be investigated are:

- Claims for taxation (income tax, sales tax, customs duty, FBT, land tax, GST, payroll tax), outstanding debts, product liability claims, claims for damages for breach of contract.
- Employee claims, superannuation payments, long service leave accruals.
- Ongoing contractual liabilities under contracts to which the company is a party.

You need to consider and ensure that the owner of the company has not used the company for personal or other investments or other businesses in the past. For example, the company may have conducted several business divisions in the past and has since sold a business division. The main risk factor is the nature of the business and the length of its trading history.

Searches are required to identify any pending litigation. Depending on the nature of the business, you may need to investigate what insurance has been effected by the company. For example product liability or public liability insurance, and the claims history of the company.

For share sales relating to SME's it is common for the company's lender to be repaid and for new financial facilities to be put in place by the buyer's financier. If this is to occur, then releases of company charge, replacement of bank guarantees and releases of mortgage may also form part of the transaction.

4.5 Contractual Obligations

Because the company remains in existence, its existing contracts remain binding upon the company. It is therefore a critical part of the due diligence to identify any major contractual obligations, including those arising from past contracts (such as ongoing warranties under a previous sale contract). Particularly in the case of SME's this may include guarantees given by the company to secure indebtedness of the directors, related companies or other persons.

An example of an ongoing contractual obligation not discovered during due diligence is shown in the case of *Allied Maples Group Ltd v Simmonds & Simmonds* 1995 1WLR 1602. The company was a retailer and leased several premises. It had previously leased premises which it had then assigned. At the time of the share sale, the buyer of the shares was unaware that the company had previously leased a property which had been assigned and that the company was still liable for performance of the lease covenants as assignor. The assignee defaulted in the payment of rent and the company was liable to the landlord for that rent. The solicitors acting for the buyer were ultimately held liable in negligence.

Similarly there are some contracts essential to the ongoing running of the business which the buyer needs to ensure are in place (in writing – not the back of an envelope!), are not about to expire and that the company is not in default. These may include written distribution agreements, employment contracts with key employees, lease of premises, contracts with major suppliers or customers. If acting for the buyer, you should seek input from the buyer as to which ongoing contracts or rights the buyer considers essential to the continued running of the business.

4.6 Change in control provisions

It is common in major contracts such as leases and distribution agreements for a change in ownership of the company to be treated as a transfer of the company or its business requiring the consent of the landlord, distributor or franchisor. It is important that contracts are checked to see whether or not consents are required to the share sale, as a failure to do so will often be an event of default.

Also, leasing agreements for leased chattels will often state that a transfer of ownership of the company triggers a right to call for payout or termination of the lease.

4.7 Asset due diligence

In addition to the due diligence on the company and its liabilities, the same due diligence as for a business purchase needs to occur in relation to its assets. That is, you need to ensure that all of the required assets are owned by the entity in which the shares are being acquired. You also need to ensure that the assets are not encumbered or leased and your client may need to carry

out physical inspections, building inspection, pest inspection, etc to ensure that the assets are in good working order.

In relation to trade marks, domain names, email addresses and other intellectual property, searches of the registration entities are required.

4.8 Financial investigations

A full financial due diligence is required to be conducted by an appropriately qualified accountant. This should include a review of the company's tax compliance history. Depending on the nature of the business, other experts may also be required to carry out investigations. For example where the company carries on an environmentally sensitive business, an environmental compliance audit or site testing may be required.

It is important that the solicitor liaise with the buyer's other consultants to ensure that any issues identified during the due diligence process are properly dealt with in the contract.

4.9 Other Searches

These will depend on the nature of the business being acquired but may include:

- whether the company has all approvals required to run the business (eg town planning approvals, licences (such as liquor licences or other statutory licences))
- whether any regulatory or licensing authorities need to approve a transfer of ownership of the company (eg liquor licence).
- whether the site from which the business is conducted is contaminated or likely to be contaminated and environmental compliance issues
- notices which may have been issued by council or other statutory authorities
- intellectual property searches
- bankruptcy searches and perhaps credit checks of the directors or individual sellers

In addition, the buyer will need to make specific enquiries of the seller. If the due diligence is being conducted after a contract is signed, you should ensure that the seller has an obligation to provide reasonable assistance and to answer reasonable enquiries.

5. Warranties

The nature and extent of the warranties to be included in the contract are where most of the negotiations of contract terms occur. Despite a due diligence having been conducted, warranties are still required. There will be a large number of matters which are not capable of being

ascertained by search, such as whether or not claims have been made or litigation threatened by customers of the business.

Often the buyer has had to rely on the seller providing copies of all material contractual obligations and warranties are required to the effect that the information provided by the seller is all of the information which a buyer would need to make an informed decision about the share purchase.

The relative bargaining power of the parties will also be a factor in the extent of the warranties provided. Where shares are being sold, then the following additional warranties are normally included in the contract:

- the seller has title to the shares and all rights attaching to them free from encumbrances
- the company is solvent, and no resolution or order is pending or threatened for its winding up, appointment of an administrator or composition with creditors.
- there will be no change in directors, share capital, share ownership, constitution of the company or name of the company between contract and settlement.
- there are no agreements in place under which any person has a right to call for shares in the company.
- no resolutions have been passed which have not been recorded in the company register and no resolutions will be passed between contract and settlement.
- the shares being sold are the whole of the issued shares in the company and are fully paid.
- no former shareholder of the company has any rights or claims against the company in connection with their former interests in the company and the company's corporate governance, including:
 - (a) the manner in which any amendments were made to the company's constitution and the purported effect of those amendments;
 - (b) the variation of class rights attaching to shares; and
 - (c) the exercise or non exercise of rights attaching to any shares.
- there is no restriction on the sale or transfer of the shares to the buyer except for the consent of the directors of the company to the registration of the transfers of the shares.
- the company has full corporate power to own its properties, assets and business and to carry on the business as now conducted.

Other matters which are often subject to warranties are:

1. Title, capacity and solvency of the seller
2. Accuracy and completeness of the company's financial statements
3. Company compliance with laws and licensing requirements
4. Company compliance with contractual obligations
5. No non-arms length transactions
6. Plant and Equipment.
7. Intellectual property
8. Insurance
9. Taxation
10. Company records
11. Litigation
12. Environmental compliance
13. Employees
14. Superannuation

In negotiating the warranties and the extent of liability arising for breach of warranty, other matters which need to be considered are as follows:

- whether to place a cap or a collar on the amount which can be claimed due to a breach of warranty;
- who is liable for the breach;
- for how long after settlement can claims for breach of warranty be brought;
- whether the liability for breach of warranty is joint or several.

When you are acting for a seller, you need to preserve to the seller the right to challenge tax assessments and to defend litigation in circumstances where the liability arising out of tax assessments or litigation may ultimately rest with the seller.

6. Restraint of trade

It is important that the directors and selling shareholders of the company provide a restraint of trade to prevent them setting up in competition to the company so as to preserve the goodwill of the company which is being acquired by the buyer. The geographical area, period and extent of the restraint will vary from business to business. The requirements for drafting an enforceable restraint of trade are not simple and there is no one size fits all solution.

7. Key employees

Depending on the nature of the business, it may be important to ensure that key employees agree to new or amended employment conditions which may require them to remain an employee of the business for a fixed term to enable a proper settling in period by the new owners. Sometimes the outgoing owners will remain as consultants or employees for a specified period of time. A separate paper is being given today on employment issues on business sales so I will not comment on this aspect any further.

8. Guarantees and indemnity by directors

For SME's it is common for the directors of the company to personally guarantee the obligations of the company. This occurs not just in arrangements with the company's lender, but is often a requirement of credit supply terms with the company's major suppliers, hire purchase agreements, leases and other contracts such as distribution agreements, or the purchase or sale of major items of plant and equipment.

Unless the directors are expressly released from the Guarantee and Indemnity, the change in ownership of the company will not release them from their liability under the guarantee. It is therefore critical when acting for a seller to ensure that any credit arrangements in place with trade suppliers and others are re-negotiated so that the outgoing directors/sellers are released from liability and the new directors sign any new guarantees required by the trade suppliers.

9. Access to company records and books

Because directors will have liability for matters arising before the sale, it is important that the directors are given an ongoing right of access to the company books and records post settlement so that they can defend any proceedings which might be instituted against them in a personal capacity by the regulatory authority or any other persons.

10. Financial assistance for the purchase of shares

When a buyer is acquiring all of the shares in a trading company, it is common for the buyer's financier to take security over the assets of the company which triggers requirements under Part 2J.3 of the *Corporations Act*. Where financial assistance is being provided by a company in relation to the purchase of its own shares, certain obligations under the *Corporations Act* must be complied with.

Under section 260A, a privately held company may provide financial assistance for the purchase of its own shares if:

- there is no material prejudice to the company, the shareholders or the company's ability to pay its creditors; or
- shareholder approval is obtained; or
- the assistance is exempt.

The exemptions are set out in s260C and include exemptions for approved employee share schemes, subsidiaries of debenture issuers and for financial institutions.

Sometimes it is clear that financial assistance is being given, such as when the company gives a charge to secure the borrowing by its new shareholders. However, financial assistance can arise or be deemed to arise in a very wide set of circumstances. Examples are as follows:

- release of a debt owed by a shareholder to the company to enable the shareholder to sell the shares at lower price – *E H Day Pty Ltd and Day* 1966 VR464;
- purchase by a company of assets at an inflated price from the buyer of the share – *Belmont Finance Corporation v Williams No.2* 1981 All ER 396.

The buyer will often seek to rely on the fact that there is no material prejudice to the company, the shareholders or the company's ability to pay its creditors in order to avoid obtaining shareholder approval, rather than obtain shareholder approval to the financial assistance. This is due to the timeframes required under the Act and the necessity of obtaining co-operation from the outgoing directors and shareholders of the company.

Section 260B requires the company to prepare a statement setting out all the information known to the company that is material to the decision on how to vote on the resolution about the financial assistance. A copy of the notice of meeting and information statement must be lodged with ASIC. This enables creditors and other subscribers to ASIC's alert system to receive notice

of the proposed financial assistance. In addition, the company must lodge a notice in the prescribed form advising the financial assistance has been approved, at least 14 days before the financial assistance is given.

You need to check the requirements of your buyer's financier as financiers will often insist on shareholder approval to give the bank added protection. If it is likely that there will be financial assistance as defined under the Corporations Law, then this needs to be addressed and negotiated as part of a contract negotiations so that the necessary resolutions can be passed before completion.

11. Earn outs/claw backs

Earn out and claw back arrangements are not limited to share sale transactions, but are also found in asset sale agreements. Essentially an earn out is an agreement to pay part of the purchase price at a time following settlement if certain performance criteria are met during the continued operation of the business.

A claw back is the reverse; that is a right for the buyer to recover part of the price paid if certain performance criteria are not met following settlement.

When acting for a seller, it is obviously preferable for all moneys to be paid at settlement, rather than relying on a further payment post settlement. However, it is often the case that a higher total price will be paid if an earn out is included. Economic conditions will also dictate the commercial realities of the terms of sale. Anecdotally it appears that in the current difficult financial conditions, buyers are more likely to insist on an earn out.

Determining and adequately defining the criteria for payment of an earn out is not simple and requires clear and open communication between the buyer, seller, their accountants and lawyers. It can be difficult to identify what the causes of failure to meet the criteria are and who should bear that risk. For example changes in performance may be caused by:

- external economic factors
- buyer mismanagement
- loss of key staff (commonly occurs due to difference in management style by buyer)
- other factors beyond the control of either party (such as a takeover of a major customer or supplier).

Buyers prefer an earn out period because it acts as a form of second due diligence. That is a period during which the business is actually operating to see if what is represented is actually delivered. In addition, it gives the buyer time (and hopefully some profits) from which to pay part

of the price to the seller. Unfortunately, buyer remorse, unrelated to the operation of the business can also be a factor. That is, the buyer may simply come to view the initial agreed price as too high and seek to find a way to not pay the full earn out. Disputes about earn out payments are very common.

A related issue to earn outs is security for the payment by the buyer. A seller will usually want security from the buyer to ensure that the payment is made. Usually the buyer's financier will take first ranking security from the buyer over the buyer's personal assets. The seller may find that either security is not available or not able to be negotiated, or that the security provided is of little value, taking into account the amount owed to the buyer's main financier. If no security is taken, then the seller will be an unsecured creditor for amounts owing by the buyer under the earn out.

12. Minutes of meetings and other settlement requirements

In addition to the share transfer and any other specific title requirements, a share sale necessitates a range of corporate actions:

- change of signatory to the bank accounts of the company
- waiver of any rights of pre-emption under a shareholders agreement or the constitution of the company
- meeting of the directors approving the transfer of shares is usually required by the company constitution
- resolution authorising recording of new members in the company register
- resignation of directors and secretary and appointment of replacement directors and secretary
- notification of change of company details to ASIC
- delivery of the company register
- sometimes the registered office of the company needs to be altered, particularly if this is the seller's accountant's office.

13. Structuring for the future

The buyer should always obtain accounting advice about how their shares are held to ensure the best fit for both their current requirements, and with a view to any future sale of the shares, the bringing in of other investors or even a potential listing of the company. For example the buyer may wish to ensure that it is able to take advantage of rollover relief for capital gains tax in the future.

If there is more than one buyer or will be more than one owner of the company following settlement, then the parties should also consider entering into a shareholders agreement. Where

there are a relatively small number of owners who are directly involved in the day to day running of a business, then in reality the decision making processes tend to more resemble a partnership arrangement than those of a listed corporation. The matters commonly addressed in a shareholders agreement are:

- who has a right to appoint and remove directors. It is common for each owner to be granted a separate class of shares and for each class to have an entrenched right to appoint one director.
- which decisions can be made by the board and which require shareholder approval. It is common for unanimous (or special resolutions) to be required for issuing new shares, approval of a share transfer, borrowing money, giving guarantees, major capital expenditure and the sale of the assets of the business.
- rights of pre-emption on share transfer.
- options to purchase for default and on other triggers such as death or insolvency.
- how shares are to be valued.
- dispute resolution.

Examples of other matters which may be addressed depending on the needs of the client are:

- rights to force a minority shareholder to sell to a third party buyer of the whole of the company's shares or a right of a minority shareholder to "tag along" if the majority shareholder sells its shares.
- procedures for setting and altering annual budgets for company expenditure
- dividend distribution policies.
- obligations on parties to provide certain levels of ongoing capital contribution or loan funding
- restraints of trade

A shareholders agreement needs to be tailored to suit each individual business and the interests of its respective shareholders, which will differ depending on the number of shareholders of the company, whether their investment is intended to be active or passive and the short and long term intentions of the owners.

It may also be necessary to consider amendments to the constitution of the company to better protect the shareholders after settlement and to reflect matter agreed in the shareholders deed.

I would also recommend that where there is to be more than one owner, full job descriptions be agreed for any shareholders who have an active role in the operation of the company to avoid misunderstandings about the limits of day to day operational decision making authority.