BASIC COMPANY LAW - 1985

CHAPTER 7

ASSET PURCHASE TRANSACTIONS

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RESPONSIBILITY OF COUNSEL

A lawyer's involvement with asset purchase transactions usually involve four inter-related phases:

1. Making the deal - This includes assisting in negotiations, advising the client and preparing the legal documentation or agreement to evidence the deal;
2. Search and investigation - This involves both searches to be conducted under the direction of the lawyer and recommendations which a lawyer should give to his client regarding those business and financial matters which should be investigated in the course of preparing to buy or sell a business;
3. Preparing for closing - This involves the procedure of co-ordinating with other counsel, lenders and their counsel, and the client to ensure that all documents, funds and personnel will be ready and available at the time of closing;
4. The closing - This involves responsibility for the proper execution of all documents, release or receipt of funds, sub-searches, filings at appropriate registries and release of documents.

Asset purchase transactions, whether they be small or large, potentially involve questions of corporate law, tax law, corporate finance, real property, employment law, labour law, government controls, contracts and a variety of other aspects of the practice of law.

A lawyer's role in an asset purchase transaction includes drafting, advising, negotiating, searching and when all else fails making coffee for clients while documents are being retyped at the last minute.

REASONS FOR ASSET PURCHASE

Most business purchase transactions in Nova Scotia are undoubtedly by way of an asset purchase, as opposed to a share acquisition. Income tax considerations may make an asset purchase advantageous to one of the parties. In an asset purchase transaction the parties can select assets and liabilities to be included in the transaction to serve their wishes, so that only certain of the assets are purchased and only certain of the liabilities are assumed. This may be particularly attractive to the purchaser who has limited funds and cannot afford to buy all assets, such as accounts receivable, and who is reluctant to assume responsibility for all disclosed or undisclosed, known or unknown, actual or contingent, forms of corporate liability. The limitations on financing for a share purchase transaction as appear in the Companies Act and the Canada Business Corporations Act may also favour an asset purchase. A lawyer should advise his client on these matters, as well as give consideration to the particular facts in the case at hand in order to provide advice for the decision to go by way of assets or shares.

It is important that a lawyer face all of these issues and seek advice from other counsel in or outside his firm and accountants where necessary in order to serve in a professionally competent manner.

LETTERS OF INTENT

Often, clients wish to have a deal agreed upon quickly, even if it is not to be closed until a few weeks later. Both the seller and the buyer want to strike a deal when it is available and at this point in time lawyers become pressured to draft something overnight that is short and simple but fully protects the client's interest. This I suggest is an impossible task and clients should be advised that it is not in their interest to expect all of the varied and complicated aspects of an asset purchase transaction can be dealt with that quickly and in a brief document.

Since it does make good sense that two business people will want to strike a deal while the iron is hot, some lawyers have successfully used letters or memorandums of intent. Such documents can meet the requirements of speed and brievity in preparation, and yet can have qualifying provisions or escape clauses enabling more complicated issues to be dealt with at the time the formal agreement of purchase and sale is being prepared for execution. Nevertheless, the lawyer should make an effort to ensure that the essential terms are dealt with in the letter and preferrably that there is a provision included to the effect that the letter is not legally binding upon the parties. It does serve the purpose of outlining the key points in a simple and clear fashion and evidencing the handshake and moral commitment between the parties. On the other hand, it does have the inherent risk of evidencing a legally binding commitment without the benefit of a properly drafted agreement. Clients should be advised accordingly so the decision whether to use a letter or memorandum of intent is made with awareness of the conflicting risks.

PARTIES & BUSINESS

It should be resolved early who are to be the parties to the agreement. Usually the name of the vendor and purchaser is known, unless because of tax or other legal advice there is going to be an internal reorganization on the part of either the vendor or purchaser. However, it is important to determine whether other parties such as shareholders will be guaranteeing the obligations of the vendor and purchaser or alternatively will be joining in with some of the covenants. There is a precedent for an asset purchase agreement which follows and for purposes of this precedent I have assumed that the shareholder of the vendor is joining with the vendor and the shareholder of the purchaser is similarly joining with the obligations of the purchaser.

It is essential to clearly define what portion of the business is to be the subject of the sale transaction, what assets are to be sold and what liabilities if any are to be assumed.

DATES FOR ADJUSTMENT, CLOSING & PAYMENT

In straight forward transactions it may be possible to have every aspect of the transaction consummated on one date, which is the closing date. This would mean that the inventory and other variable assets could be counted the night before or early on the morning of the closing, all cash payments would be made on the closing day and the deal completed at that time. There is no question that this is the simpliest and best method if possible.

However, some circumstances may prohibit this procedure and may require an adjustment date for purposes of counting variable assets and determining the price (which may take place

over a period of a number of days) and closing date for the actual transfer of assets. The first date is generally called the effective date, while the second is in fact the closing date. Arrangements must then be made for profits or losses during the interim period and some form of joint consultation or management. In some instances, the purchaser is hired under a management agreement and operates the business under the name of the vendor for the interim period. In other instances, the vendor continues to operate the business for the account of the purchaser and the purchaser is entitled to have a representative present or to be consulted with regard to major business decisions. Another procedure followed is to hold the closing and in fact close on the first date with a basic amount of the purchase price paid to the vendor on closing and provision for payment of the balance, once calculated, by no later than a specified date in which case the vendor may wish to have security or require a specified sum to be held in trust.

Some clients prefer to have a fixed lump sum price established at the beginning, and hold firm to that price straight through to the closing date. Clients should be cautioned of the risk involved with fixing a price in this way where there are variable assets such as accounts receivable, inventory which could make a substantial difference to one or both of the parties and could make a fixed price unfair. It is reasonable to fix a price for fixed assets, with the provision for other assets to be counted by the parties together or calculated by an outside auditor.

It is desireable that the price be allocated amongst

various assets in such a manner that the maximum tax benefit can be obtained.

If the purchaser is to assume certain trade liabilities of the vendor, then the amount of these liabilities must be calculated as of the adjustment date and applied against the purchase price otherwise payable. I believe it would be fair to state that in most small business transactions in Nova Scotia, the purchaser does not assume the liabilities of the vendor, and does not purchase the accounts receivable of the vendor.

DEPOSITS & HOLDBACKS

Quite often, a deposit is made at the time the asset purchase agreement is executed. The agreement should specify what is to happen to the deposit in the event that the transaction is not consummated. It should make provision for the disposition of the interest earned on the deposit. In some instances, a deposit is refunded in the event that the purchase transaction does not go through, unless the purchaser has defaulted. In other instances, the deposit is made strictly non-refundable, unless the vendor defaults. If the purchaser's obligation to purchase is made subject to arranging financing and the purchaser is itself a newly incorporated company, or there are other close offers being turned down pending the purchaser confirming financing, then the vendor may require a significant non-refundable deposit.

There is most always a portion, being the most significant portion, of the purchase price paid on closing, and the lawyer acting for the vendor must ensure that funds are available for the purpose at the required time.

In some transactions there is a holdback. This is usually the subject of negotiation. The agreement should indicate whether the amount being held back may be used in some manner to indemnify the vendor in the event of any breach on the part of the purchaser. It must be determined whether the holdback represents simply an unpaid balance or is an amount to be held in trust by a third party. The purchaser may require security for the holdback if it represents an unpaid balance and may want to have some limits on the extent to which any such holdback may be applied by the vendor to offset against amounts the vendor claims it is entitled to by way of indemnity.

REPRESENTATIONS & WARRANTIES

It is customary that an asset purchase agreement provide extensive representations by the vendor. Some agreements also provide limited representations on the part of the purchaser. A number of representation and warranty clauses appear in Article 4 of the precedent.

I wish to refer to some of the representations and warranties which are frequently the subject of negotiation and disagreement.

FINANCIAL STATEMENTS

Undoubtedly, the vendor has shown financial statements and data to the purchaser as an inducement to enter into the transaction and that the purchaser may well have used this information for purposes of obtaining financing. It would seem reasonable for the purchaser to require the vendor to make representations regarding the accuracy of the financial statements

and the fact that there has not been a material deterioration in the financial position of the business since the date of the statements. While there is no doubt that such a representation would be included in a share purchase agreement, vendors are sometimes reluctant to have such a provision in asset transactions. The statements are obviously important for the purchaser to have and rely upon because of bulk sales legislation as well as the significance of the data for the decision of the purchaser and would be well advised to insist on such a representation.

GOVERNMENTAL STANDARDS

The purchaser should ensure that the business of the vendor and its assets comply with all of the governmental standards and regulations. It is quite possible that existing business operations have been "grandfathered" by governmental agencies or officials including municipal authorities, licensing bodies, fire marshalls and so forth. Therefore, the vendor should be requested to represent that its licenses and authorities are in good standing and meet all standards necessary for the purchaser to operate the business. The purchaser may also want to do an independant review and check to be personally satisfied.

EMPLOYEES

There are a number of issues pertaining to employees and trade unions which are of serious concern to both the vendor and purchaser. Section 10 of the Labour Standards Code provides that in the event of a sale of a business, including transfer of shares, the period of employment of all employees shall be deemed to have been employment with the purchaser and the continuity of employment is not broken. There is no similar provision for

non-unionized employees falling under jurisdiction of the Canada Labour Code, apparently leaving it to be resolved by the common law. As a practical matter, the parties usually negotiate which employees are to be given continuing employment by the purchaser, thus leaving the vendor with the responsibility and cost of terminating the employment of the others. This is often a very difficult issue to deal with, since it is one that can be expensive and is highly sensitive. In the absence of the issue being addressed, the purchaser is left with the responsibility of being a successor employer by virtue of the Labour Standards Code. The Agreement should clearly specify the responsibilities of each party.

This problem is further compounded in Nova Scotia because Section 67A of the Labour Standards Code provides an employee whose period of employment is ten (10) years or more shall not be discharged or suspended without just cause. Often, it is these longer term employees whom the purchaser does not wish to have on board and at the same time because of Section 67A of the Labour Standards Code, dismissal by the vendor can be a prohibitive cost if not legally very difficult. Again, this is usually a highly sensitive area of negotiations. Incidentally, there is no similar ten (10) year provision in the Canada Labour Code.

The purchaser should be assured that there are no outstanding complaints in the office of the Labour Standards Tribunal, or possibly the Humans Right Commission, which might reflect a problem which it will inherit.

It should be determined whether there are any employment contracts or side agreements or bonus arrangements and therefore the vendor should be required to give a representation that there are none, or must disclose those which exist. The purchaser should study any situation of this nature since it indicates a problem which it will have to deal with following closing. There should be a representation that there has been no increase in the rate of salaries or wages and no bonuses since a specified date or known departure from the schedule of remuneration as given by the vendor to the purchaser. The arrangements with employees related to the vendor or its shareholders deserve close scrutiny.

The agreement should also represent and disclose any amounts owing by employees to the employer or vice versa, since a purchaser will want to review a situation of this nature.

It is worthy of note that Section 98 of the Workers Compensation Act provides in the event of a change of ownership or employer, any unpaid assessment owing at that time may be levied against any successive owner or employer but only in proportion to the relative payrolls of the first owner (i.e. the vendor) and the second owner (i.e. the purchaser) unless the parties agree otherwise. Some asset purchase agreements have provisions confirming whether the parties agree to such pro rata sharing under Section 98, or provide for some other means of adjusting the workers compensation account for the current year including any deficit or surplus which may subsequently arise.

Pension plans, employee stock option plans, employee incentive plans, deferred profit sharing plans, group plans and

benefits should all be disclosed and reviewed with appropriate negotiations for adjustments to the purchase price when necessary.

TRADE UNIONS

Both the Trade Union Act of Nova Scotia (Sections 29-30) and the Canada Labour Code (Sections 143-144) have provisions which specifically provide the purchaser with successor obligations in the event of the purchase of a business. If there is a purchase of shares, then there clearly has been a purchase of the business. If on the other hand there has been a purchase of only some assets, not including goodwill or the business name, then there may be room for argument that at law there has not been a purchase of a business. However, a lawyer acting for any purchaser should advise the purchaser of the law respecting successor obligations for trade unions and a purchaser should enter into a transaction assuming that it will be obliged to be a successor employer. This being the case, the vendor should be required to represent that there is no certified trade union, no application for certification or unfair labour practice complaints of which it is aware. If there is a trade union, then it should be determined whether there are outstanding negotiations, and the present status of any disputes, grievances, arbitrations, unfair labour practice complaints and so forth should be clarified.

In some instances there are businesses which have been certified under the Trade Union Act, which do not have an active union. This should be disclosed to the purchaser, who should assess the risks of a union becoming reactivated following the

purchase transaction and the union spreading into present operations of the purchaser.

Collective agreements should be disclosed by the vendor and reviewed by the purchaser and its lawyer in detail. Obviously, the purchaser will have a direct interest in the monitary provisions, but the non-monitary provisions may also be of consequence to it. These include senority rights, union memberships, and check off provisions. If the purchaser is already unionized, these provisions will have to be compared with existing collective agreements to determine the consequences to the enlarged operation. Some collective agreements have unusual provisions providing job protection in the event of merger, virtually preventing any loss of employment attributable to any form of merger. This could inhibit efforts to attain the objective of intergration and transfer of operations between two plants and consequently frustrate the whole purpose of the purchase.

CONTRACTS & LICENSES

All material contracts, including leases, franchise agreements, supply agreements and similar documents should be required to be disclosed by the vendor pursuant to the agreement and again should be reviewed by the purchaser and its lawyer in order to ensure each is satisfactory and that all required consents or approvals are obtained.

Likewise, all licenses and permits issued by governmental authorities should be disclosed and their standing should be confirmed. All necessary governmental consents to the transfer should be obtained.

CONDITIONS PRECEDENT

The agreement should contain provisions which contemplate when either of the parties may be excused from fulfilling their obligation to consumate the closing. An example of these conditions precedent to closing appear in Article 5 of the precedent. The provisions should indicate the consequences of being released of the obligations to complete the purchase and sale.

GENERAL COVENANTS & INDEMNITIES

Among the covenants which should appear in asset purchase agreements, are those covering best efforts on the part of the vendor to maintain goodwill, risk of assets and insurance to the closing date, covenants of third parties such as shareholders and guarantors and covenants regarding management and accountability during any interim period in the event that the adjustment date is different from the closing date.

The asset purchase agreement should clearly provide that the vendor and any guarantor is to indemnify the purchaser and in turn the purchaser and any guarantor is to indemnify the vendor with regard to representations, warranties and covenants.

SALES TAX

There should also be specific provision for any indemnification which the vendor is to give the purchaser, in the event the purchaser waives provisions of the Health Services Tax Act. In particular, sub-section 9(4) of the Health Services Tax Act provides that no person shall dispose of his stock through a sale in bulk without first obtaining a certificate in duplicate from the Commissioner that all taxes collected by the vendor have

been paid. Sub-section 5 further provides that anyone purchasing stock through a sale in bulk shall obtain from the vendor a duplicate copy of the certificate and if he fails to do so he shall be responsible to the Commissioner for payment of all taxes collected. It is sometimes difficult, and frequently impossible, to obtain a certificate from the Commissioner within a reasonable working time prior to the closing date. For this reason, purchasers are usually prepared to waive the provisions of the Act, if the vendor is in a solid financial position, in exchange for satisfactory indemnification on the part of the vendor. If it is contemplated that an audit will be completed by the Commissioner within a reasonable period of time following the closing, then the parties may agree to a holdback which would then be paid at a time subsequent to receipt of the certificate.

BULK SALES ACT

It is also common for a purchaser in Nova Scotia to waive strict compliance with the Bulk Sales Act, provided the purchaser is indemnified and is satisfied the vendor is solvent and trustworthy.

Since the potential liability of the purchaser pursuant to the Health Services Tax Act and the Bulk Sales Act depends on whether the subject transaction is a bulk sale within the meaning of the Bulk Sales Act, it is worth reviewing that Act to determine if the transaction meets the definition. A bulk sale is defined in Section 5 as including any sale or transfer of a stock of goods, wares or merchandise, or part thereof, out of the usual course of business or trade of the vendor, or whenever

substantially the entire stock-in-trade of the vendor, shall be sold or conveyed, or whenever an interest in the business or trade of the vendor is sold or conveyed, or attempted to be sold or conveyed. There is jurisprudence indicating that a sale must include a stock of goods to be a bulk sale.

The Act only applies to (a) persons who as their ostensible occupation buy and sell goods, wares and merchandise, ordinarily the subject of trade and commerce; (b) commission merchants; and (c) manufacturers. It expressly does not apply to any sale by executors, administrators, liquidators, receivers, assignees for the benefit of creditors, or any public official acting under judicial process.

Compliance with the Bulk Sales Act is difficult. The procedure which must be followed includes:

(1) obtain a vendor's statutory declaration listing the creditors and the amount of indebtedness; and

(2) enter into an agreement of purchase and sale and file it within ten (10) days of execution at the Registry office; and

(3) no payment or security is to be given until after the statutory declaration is filed and 30 days since execution of the agreement has expired; and

(4) obtain written consent from all creditors of the vendor or if the purchase price is sufficient to pay in full the creditors of the vendor then to pay the whole of the purchase money or security into the hands of the trustee who shall distribute in accordance with the Assignments and Preferences Act.

Any bulk sale which does not comply with this procedure shall be deemed fraudulent and void as against creditors of the vendor.

I understand that in some other jurisdictions there is provision in the appropriate statute for filing an affidavit which can trigger the commencement of a six month limitation period and for application to the court for exemption provided the judge is satisfied the sale is advantageous to the seller and will not impair its ability to pay its creditors in full. In Nova Scotia we are left with the extreme choices of complying with the Act or alternatively providing the purchaser with some form of comfort against the risk of the transaction being declared fraudulent and void as against the vendor's creditors. As indicated, the most common procedure is for the purchaser to waive formal compliance with the Act in exchange for an indemnity which comforts the purchaser against the risk inherent when it ignores the Act. Other variations of this procedure include control of the disposition of the proceeds of sale so that major creditors are paid in full, or obtaining consent from major creditors. Frequently, a statutory declaration disclosing creditors and amounts is provided in addition to an indemnity.

CHECKLIST

It is useful to follow a checklist at the time that the agreement is being negotiated to insure that all the obvious areas have been covered and to serve as an ongoing schedule of searches and matters to be completed in preparation for the closing. I have taken the liberty of updating a checklist for asset and share sales which appears in the publication "Purchase and Sale of a Small Business" published by the Continuing Legal Education

Society of Nova Scotia in 1981. The checklist appears with these materials.

THE CLOSING

The closing should be a formal, well prepared and pleasant experience for both clients. It should provide the parties with an opportunity to conclude the deal under cordial circumstances. It offers an opportunity for all counsel to present the image of well prepared professional practitioners in whom clients can place confidence and for whom they have appreciation.

All too often, work is left to the last minute and lawyers exchange and change documents while clients are left impatiently waiting. Often, because of lack of co-ordination by counsel, issues are left unresolved and are negotiated at the time of closing which makes for an unpleasant and extended event and speaks poorly of the legal profession.

Therefore, as outstanding issues or problem areas arise counsel should discuss these matters with their clients in advance of the closing and negotiate with other counsel to reach agreement. Work to be comleted in conjunction with accountants, bankers, corporate officers, out of province counsel and others should all be co-ordinated by the respective counsel so that the closing itself will be well organized.

The agreement should indicate where the closing will take place. A draft copy of the proposed closing agenda should be exchanged by counsel several days in advance of the closing and should be reviewed with the clients so they are informed and are

in agreement with what will be exchanged and not exchanged at the time of closing.

All documents to be prepared in conjunction with the closing should be drafted and exchanged in advance as well. Then counsel should meet prior to the closing (possibly with the controller or similar officer of each client) to run through each item on the agenda and review all documents pertaining to each item.

At the time of closing, all documents should be on the table, sorted according to the agenda, and ready for signing. Preferably, the appropriate officer of each client will have seen and approved the documents in advance, so that at closing it is simply a matter of executing the documents and completing the procedures required by the closing agenda.

A draft suggested closing agenda based upon the precedent, appears with these materials.

LEGAL OPINIONS

The form of legal opinion should be settled as early as possible, preferably at the time that the agreement of purchase and sale is entered into. Alternatively, if the form of the opinion cannot be finalized, then the critical elements to be contained in the opinion should be resolved.

These include the scope of investigation, reliances or assumptions which may be made by the solicitor, the opinion itself, and qualifications to the opinion.

There is a form of legal opinion with these materials. If the opinion was to be used in a share purchase transaction the opinion should extend to report on issued and outstanding share capital as well as authorized capital.

The formal letter of opinion provides an introduction indicating for whom the solicitor acts, and the purpose of the agreement.

It then specifies the investigation conducted by the solicitor. Some opinions may require the solicitor to simply indicate that he has conducted such investigations as he considers necessary in order to render the opinion.

The opinion may also state certain assumptions and reliances. If opinion of other counsel is obtained, such as counsel from other jurisdictions, then it must be clarified whether the solicitor giving his opinion is entitled to rely upon the opinion of such other counsel or alternatively must accept the responsibility to the purchaser for the accuracy of such counsel's opinion.

It may also be necessary to rely upon an officer's certificate for several matters.

In some instances, the purchaser may require the vendor's solicitor to include an opinion on title to the vendor's real estate. If such is a requirement, it should be clarified who is to pay for the expense of this portion of the opinion.

Some opinions contain a paragraph indicating who is entitled to rely upon the opinion, thereby restricting or attempting to restrict the potential liability of the solicitor.