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EVANS AND ASSOCIATES

VALUATION ADVISORY SERVICES

# The Business Value Manager

*Advice  
for business  
owners,  
investors and  
service providers  
on how to build  
value and wealth  
through  
investment in  
closely held  
companies.*

## Why Deal Structure Is Critical In Merger and Acquisition

Sellers are wise to recognize that when experienced buyers evaluate a potential acquisition, they carefully assess its *risk*. One of the first and most important risk assessments is the consideration of whether to purchase the **stock** of the target from the shareholders or all or selected corporate **assets** from the corporation.

While most of the well-publicized acquisitions of public companies are stock transactions, in the middle market, both stock and asset sales are common. Buyers and sellers should be aware of the advantages that each structure provides. Too often, parties on one side of a transaction will insist on only one possible structure without considering creative ways to close the deal with a different structure. Generally, the advantages that a given structure provides to one side create corresponding disadvantages for the other side. Therefore, both sides in a deal are wise to recognize the consequences that the structure creates as they form their negotiating strategy. (In general, sellers prefer stock sales, which provide the advantage of having taxation occur only at one level. Conversely, buyers typically prefer an asset acquisition, where they receive a stepped-up tax basis in the assets acquired and reduce their risk by acquiring only identified assets

and liabilities.) Because the circumstances of each transaction vary, each side should seriously evaluate both stock and asset structures to identify and quantify the pros and cons involved, particularly the risk and

*“...each side should seriously evaluate both stock and asset structures ...particularly the risk and net after-tax cash flow consequences to ultimately negotiate the best possible deal.”*

net after-tax cash flow consequences to ultimately negotiate the best possible deal. The following is a brief overview of the advantages and disadvantages when the transaction

is structured as a stock sale and as an asset sale.

### **Stock Transaction**

Generally speaking, in a stock transaction, all of the tangible and intangible assets and all of the liabilities, including unknown and contingent liabilities from current or prior acts of the seller and its agents, are acquired by the buyer. These include the unknown “skeletons in the closet” that buyers fear so much.

### *Seller's Viewpoint*

In general, sellers strongly prefer a stock sale because as long as the stock was held

*(Continued on page 2)*



## Common Seller and Buyer Motivations

### Seller Motives

- Personal desire to leave due to age, poor health, family pressure, burnout
- Owners' need for estate planning
- Lack of a successor, including conflicts among family members and owners or loss of key people
- Need for additional capital to finance growth
- Weak or declining performance or growing financial difficulties
- Presence of strategic disadvantages that cannot be overcome as a stand-alone business
- Market or industry conditions that create strong sale prices

### Buyer Motives

- Expand product lines or geographic markets
- Obtain better growth opportunities
- Enhance profitability and cash flow through revenue enhancement or cost reduction
- Enhance competitive strengths or reduce weaknesses
- Acquire needed technology or capacity faster than through internal expansion
- Prevent competitors from entering that market
- Better employ surplus capital or management
- Diversify to minimize risk

*(Continued from page 1)*

for more than one year, shareholders only pay tax *once*, at the personal level on the difference between the sale price and their cost basis in the stock. This tax is computed at long-term capital gains tax rates, which are generally more favorable than ordinary income tax rates.

A stock deal causes buyers to accept all known, unknown and contingent liabilities of the company, which can substantially increase their risk. As a result, buyers frequently demand extensive representations and warranties to be part of the sale agreement to protect them from unknown potential liabilities that may accompany any acquisition of stock.

Thus, sellers should identify and, where possible, make any necessary changes to minimize the risks to which the buyer may be exposed in acquiring the sellers' company. By taking

these steps, the seller may make a stock deal sufficiently less risky to a potential buyer that the transaction can be structured as a stock purchase.

### Buyer's Viewpoint

A major disadvantage in a stock acquisition for the buyer is assumption of the target company's fixed assets at their existing tax basis, which is often after substantial depreciation already has been deducted. Thus, the buyer is able to write off far less of the acquisition cost, although some special tax elections may be available to avoid this consequence.

*"Remember, the third party in every deal is the government, so structure the transaction to minimize their take.."*

In addition to the unfavorable tax consequences to a buyer in a stock purchase, this structure also creates added potential risks for the buyer. The buyer's principal concerns usu-

ally are contingent liabilities, under-funded retirement plans, and potential product liability claims.

Stock transactions provide some benefit to the buyer, including the corporation's contracts, credit agreements, labor agreements, (unless they are specifically voided or subject to approval) and any favorable tax attributes of the seller, such as ordinary or capital loss carryforwards. Buyers may not want some of these contracts if they carry unfavorable terms.

## Asset Transaction

In a transaction structured as the sale and purchase of assets, only those tangible and intangible assets and liabilities specifically listed in the purchase agreement are transferred. While buyers tend to favor this structure because they can specifically exclude assumption of all or selected assets and liabilities, it typically works to the disadvantage of the seller.

Generally, sellers retain cash, receivables, and payables in an asset transaction. Any of a seller's debt assumed by the buyer amounts to an increase in the purchase price for the buyer and represents additional consideration paid to the seller.

*(Continued on page 3)*

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### Seller's Viewpoint

The major disadvantage to the seller of an asset sale is that the *proceeds are taxed twice*, first at the corporate level on the asset sale and second at the individual shareholder level when the corporation is liquidated and the proceeds are distributed to the shareholders. Sellers that have elected an S Corporation tax status may be able to avoid this double taxation, which may give that seller an improved bargaining position in the deal.

*“Creativity in the deal structure is essential to work out the most mutually advantageous transaction.”*

The double taxation of asset sale proceeds can dramatically reduce what the seller actually receives after all taxes are paid in an asset deal. Because an asset sale involves only the transfer of specifically identified assets and liabilities, this form of transaction leaves the seller responsible for any remaining liabilities that were not part of the sale. Sellers usually face fewer representations and warranties with an asset sale because buyers are able to identify more accurately exactly what is involved in the transaction.

### Buyer's Viewpoint

With an asset acquisition, the buyer achieves the major tax advantage of being able to carry the assets purchased at their current fair market value. This stepped-up basis allows the buyer to depreciate much of the acquisition cost.

Buyers also benefit in an asset acquisition by acquiring only those liabilities that are specifically identified as part of the sale. Thus, they avoid contingent and unknown liabilities.

In acquiring assets rather than the stock, the buyer does not acquire the target's employees, customers, or contracts. While buyers may prefer to avoid certain employees or contracts, they may have difficulty negotiating with employees, labor unions or customers, may be unable to use some of the target's licenses or permits, and cannot carry over any favorable tax attributes owned by the seller.

### **Conclusion**

Transaction structure is complicated. Those provisions that benefit one side tend to work to the disadvantage of the other side. Therefore, both sides constantly must focus on the risks that each transaction structure creates and avoids. Equally important, each side must constantly focus on both the buyer's net after-tax cost and the seller's net after-tax proceeds from the deal. The final terms of a stock transaction may involve a significantly lower price but increased proceeds to the seller and/or reduced risk to the buyer. Creativity in the deal structure is essential to work out the most mutually advantageous transaction. When both parties are aware of the tax consequences to the other of the terms of sale, they can negotiate a transaction that minimizes the overall tax consequences, and works to their mutual benefit.

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“VALUATION FOR M&A:  
Building Value in Private  
Companies” by Frank C. Evans  
and David M. Bishop,  
published by  
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www.wiley.com*

### FIRST STEPS

To manage your business as an investment and take control of your life:

- Retain qualified valuation advisors to lead the process.
- Identify and prioritize your personal and financial goals.
- Quantify
  - Your company's return
  - Your company's risk
  - Your company's worth
  - Your company's return on investment

### RESULT:

Armed with the information, you can devise the best strategy to achieve your business, personal and financial goals.

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Our team's expertise in competitive analysis, finance and accounting, merger and acquisition, risk analysis and value creation forms the basis for our opinions and advice.

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Certified Public Accountant Accredited in Business Valuation

## Shop Carefully for Valuation Expertise

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