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# BUYING A BUSINESS

A practical step-by-step guide to buying a business

# I. INTRODUCTION

This guide gives an overview of the legal process of buying a privately or family owned business. It is a practical guide providing checklists and identifying legal issues that commonly arise on a typical business purchase.

Although business acquisitions are complex, and two are rarely the same, they do roughly follow similar paths.  This guide provides a conceptual framework both for those that are familiar with the business acquisition framework and for those that are unfamiliar, to enable planning and documenting of business acquisitions so they are completed quickly and efficiently.  It concentrates on the key legal issues which usually arise in such transactions.

*Accounting and tax issues are not covered by this guide and will need separate advice from your accounting and tax advisors.*

# 2. THE LEGISLATIVE FRAMEWORK

Before entering any transaction, consideration should be given to the applicable New Zealand law, in particular the Companies Act 1993 (Companies Act), Overseas Investment Act 2005 (OIA), the Commerce Act 1986 (Commerce Act) and any industry specific legislation relevant to the business.

## Companies Act

The Companies Act is the primary legislation regulating company law in New Zealand. Key aspects of the Companies Act relevant to the sale and purchase of a business are:

- *Major transaction approval:* All "major transactions" entered into by New Zealand companies must be approved by a special resolution (requiring no less than 75% approval) from the company's shareholders. A major transaction is an acquisition or disposal of assets or the incurring of liabilities with a value greater than half the value of the company's assets before the transaction. Typically, a company selling all its business and assets must obtain special resolution approval from no less than 75% of the company's shareholders. Likewise, a company acquiring all such business and assets may also need to obtain special resolution approval from its shareholders.

- *Share dealing by directors:* Directors of privately held companies need to be aware of section 149 of the Companies Act, which provides an insider trading regime for directors of privately held companies when dealing in shares in their companies. Section 149 provides (broadly) that directors of a company who hold price sensitive, non-public information obtained in their capacity as a director or employee must pay no less than "fair value" when buying securities in that company and must receive no more than "fair value" when selling them. If a director violates these provisions he or she will be liable to the other party to the transaction for the difference between the "fair value" of the securities and the price actually paid.

## Overseas Investment Act

New Zealand has a regime that regulates foreign investment. This regime is governed by the OIA and the Overseas Investment Regulations 2005 (together the "OIO Legislation"). Consent under the OIO Legislation is required before an "overseas person" acquires certain types of "sensitive" land, or if it acquires over 25% of the shares in a company or assets where the value of the consideration or assets exceeds NZ$100 million.

Usually in a privately held or family owned business purchase to an "overseas person", the main OIA threshold to consider is whether the acquisition includes "sensitive land". Whether land is sensitive land or not will depend on the land and the neighboring land. Sensitive land can include:

- land zoned for reserve, public parks, recreation purposes and open space;
- non-urban land;
- land subject to a heritage order under the Resource Management Act 1991 or by Heritage New Zealand Pouhere Taonga; and
- land neighbouring the above land.

If consent is required, the parties may make their acquisition agreement conditional on consent being obtained.

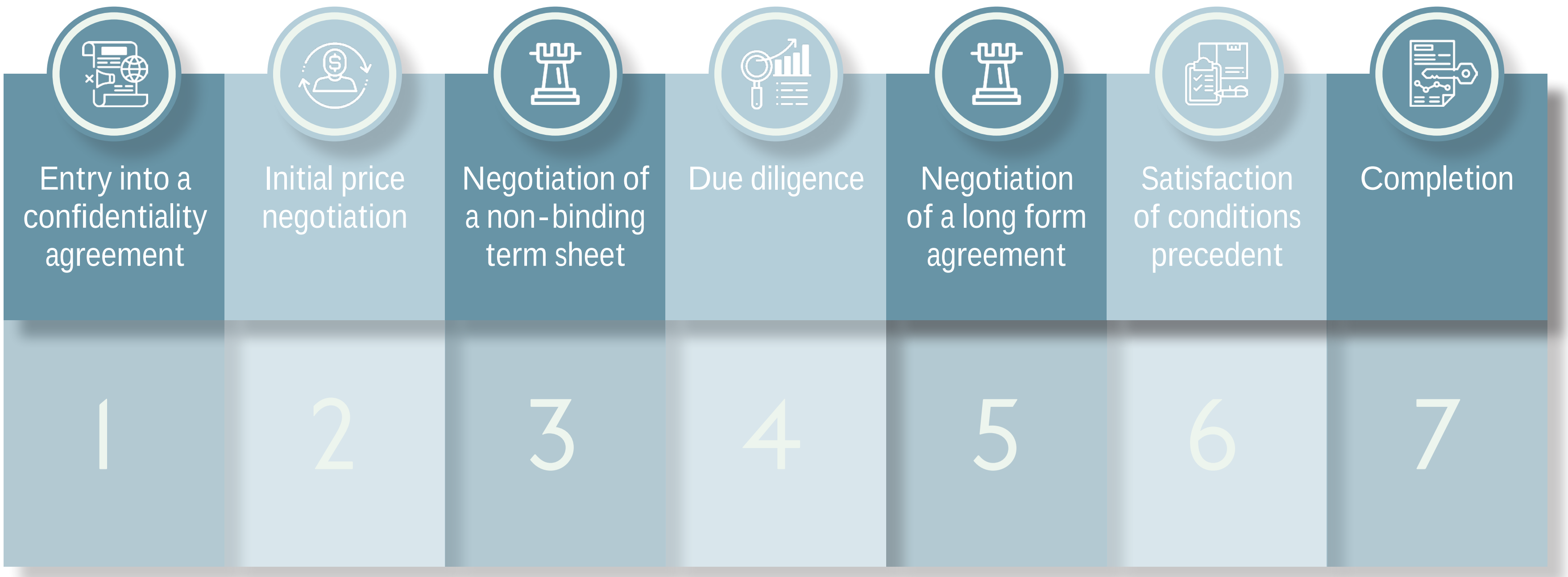
## Commerce Act

The Commerce Act governs competition law in New Zealand and is administered by the Commerce Commission. To promote competition in New Zealand markets, the Commerce Act prohibits the acquisition of the assets of, or shares in, another company if that purchase would have the effect, or likely effect, of substantially lessening competition in any New Zealand market.  The Commerce Act applies equally to New Zealand and overseas companies where the transaction affects competition in New Zealand.

Commerce Commission clearance may be necessary for implementing certain transactions.

# 3. PURCHASE PROCESS

A sale and purchase typically follows these phases:




Some of these steps may not occur (or may be simplified) in some transactions.

The steps in the typical process are summarised on the following pages.

# STAGE 1

## ENTRY INTO CONFIDENTIALITY AGREEMENT

As a first step, parties usually enter into a confidentiality (or non-disclosure) agreement before exchanging sensitive information. A confidentiality agreement provides protection that information will not be used or disclosed by the other party, except:

- to limited people; and
- only then for those people to use the confidential information to assess the proposed acquisition (and not, for example, to compete).

A confidentiality agreement can be one-way (where only the vendor is providing the confidential information) or mutual (where both parties are providing information).

*Free, automated one-way and mutual confidentiality agreements can be found online at advisme.*

# STAGE 2

## INITIAL PRICE NEGOTIATION

Commonly after the buyer has conducted a high level analysis of the fundamental financials of the business (based on information provided under the confidentiality agreement):

- the valuation methodology to be used is determined by the buyer; and
- an ‘’understanding” of the purchase price for the business (or how it will be calculated) is informally agreed in principle between the parties.

This price understanding is normally non-binding, and often a range.

Often, buyers will obtain specific separate advice from accounting and tax advisors (sometimes including a professional valuation of the business will be obtained). Often valuation differences may be resolved contractually (for example, by including earn-out or deferred consideration mechanisms).

# STAGE 3

## TERM SHEET

Once the parties have an agreed in principle on the price, they may enter into a term sheet (also known as a “heads of agreement” or “memorandum of understanding”) to record the basic terms, anticipated structure and timing of the deal.

*Binding / Non-Binding*

A term sheet may be legally binding, whether in whole or in part. It is important to state expressly whether the term sheet is binding or not (if the term sheet is silent, it will be presumed to be binding). Usually, the parties will agree that the term sheet is not legally binding except for certain provisions, for example, confidentiality, costs and exclusivity.

Even if a term sheet is non-binding, it may clarify the parties’ positions and draw out issues at an early stage. It should be borne in mind however that, even if a term sheet is expressed to be non-binding, a party may develop expectations that the transaction will conform to the term sheet. This can reduce flexibility later – so a party should not enter into a non-binding term sheet lightly or with no intention to do the deal as proposed.

The general content of a term sheet is set out on the following page.

Term Sheet Checklist

| | |
|---|---|
| | Parties (which must be the correct legal entity to be enforceable) |
| | Structure of purchase (shares or assets) |
| | Price and payment terms (including seller loans, earn-outs etc) |
| | Conditions precedent |
| | Restraints of trade |
| | Timetable and process |
| | Warranty and security expectations |
| | Exclusivity provisions (how long the deal is “exclusive” between the parties, this is often binding) |
| | Confidentiality (this is often binding) |
| | Costs (this is often binding) |
| | Termination rights and dispute resolution |
| | Law and Jurisdiction (if a buyer is an overseas person) (this is often binding) |

*A free, automated non-binding term sheet for a basic sale and purchase can be found online at advisme.*

## Structure - Sale of assets vs sale of shares

A key decision will be whether it is shares of the company conducting the business, or the assets of the business, which will be sold and acquired.

Typically a seller will have firm views on what suits them better, usually from a tax perspective. Although purchasing shares is usually more efficient from an administrative viewpoint there is the often significant downside that all the history of the company will be inherited (including its tax history).

It is important tax advice on the structure of the purchase is obtained before entering into the term sheet. Not only could changes to the structure be difficult to negotiate after the term sheet is entered into, but the term sheet may provide evidence that the transaction was subsequently altered for the purposes of tax avoidance.

Some key considerations relating to asset and share sales are included on the following pages.

## Overview

- In general terms, asset sales <u>are not</u> preferred by sellers, as:
- The seller retains the corporate shell and, unless liquidated, continue to be exposed for any known or unknown liabilities that exist within it;
- There is greater work involved in selling assets, typically with more third party consents being required; and
- There may be exposure for tax on depreciation recovered.
- However, assets sales do have some advantages for a seller and these are set out in more detail below.
- By contrast, asset sales <u>tend to be favoured</u> by buyers, as they have the ability to control what seller liabilities they choose to take over.

## Detailed Comparision

| Advantages of an Asset Sale (from Seller's Perspective) | Disadvantages of an Asset Sale (from Seller's Perspective) |
| --- | --- |
| • An asset sale allows the seller to choose which assets are sold and which are retained.<br>• The selling entity is the company, so warranties/ obligations in the SPA tend to be borne by the seller company rather than the ultimate shareholder. However, this protection is often eroded as most buyers require personal guarantees or other security from shareholders.<br>• The purchase price may be able to be distributed tax free by a post-sale liquidation of the seller company. | • An asset sale allows the buyer to cherry pick which assets it will purchase and which liabilities it will assume. The seller may be left with assets and obligations it does not want.<br>• The buyer assumes no liabilities, unless it specifically agrees to do so in the SPA. Seller companies will typically retain trade creditors, any potential liability for taxes or other claims against the seller company relating to the period before completion.<br>• The seller company's exposure to residual liability post sale may be dealt with by a subsequent liquidation. However, this cannot be entirely relied on, as a liquidation may be prevented or delayed by the terms of the SPA itself or by the existence of contingent liabilities (e.g. warranties, tax obligations). |

| Advantages of an Asset Sale (from Seller's Perspective) | Disadvantages of an Asset Sale (from Seller's Perspective) |
| --- | --- |
| • Some of the purchase price may be able to paid tax free from the seller company to shareholders by way of repayment of shareholder loans (to the extent that these loans exist).<br>• The sale is likely to be zero rated for GST as the business is sold as a going concern and with benefit of property leases.<br>• Imputation credits and tax losses are retained within the seller company and can be utilised in the future. | • Asset sales are more involved from the seller's perspective as:<br>• title to the sale assets must be transferred (e.g. land (if applicable), intellectual property, vehicles);<br>• transferring employees must be transitioned to new employment agreements with the buyer and this becomes a matter of negotiation with each employee;<br>• charges over assets need to be released (which can be protracted and time consuming);<br>• counterparty consent will ordinarily be required to novate or assign contracts and leases to the buyer.<br>• The seller must consult with employees in relation to their transition to the buyer. If employees elect not to accept employment with the buyer, the seller will be responsible for redundancies.<br>• If third parties do not consent to the novation or assignment of contracts, the seller will be left with the liability under that contract (although liability can be apportioned as between seller and buyer in the SPA through an appropriate mechanism).<br>• It may be that certain assets, such as government licences, resource consents and permits, cannot be assigned and the buyer would have to apply for those afresh.<br>• If receivables are transferred to the buyer, the seller may have to repurchase those receivables if they are not paid or become bad debts.<br>• Intra-group arrangements (leases, supply agreements etc.) would need to be identified and properly transferred. These may need to be documented (if not already in place).<br>• The parties will need to agree a consistent allocation of the purchase price between the different classes of assets being sold, such as plant and equipment, inventory, goodwill etc. This often requires negotiation. A sale of depreciable assets in excess of book value would give rise to depreciation recovered and cause the seller to incur a tax liability. |

## Share Sale

| Overview |
| --- |

- In general terms, share sales are preferred by sellers as:
- They provide the seller with a "clean break" – all of the assets, employees, contracts and liabilities remain with the company, unless otherwise agreed;
- they are simpler to execute, with fewer steps required to complete the transaction (no transfer of employees, fewer third party consents etc.);
- there is (subject to negotiated warranties/ indemnities in the SPA) no ongoing risk to the seller of liability associated with the business on a go-forward basis; and
- the purchase price is likely to be received tax free, with no need to go through a liquidation process.
- On the other hand, buyers of shares often require more comprehensive warranties and indemnities from sellers to protect against liabilities that they are inheriting in the company. In particular, they require a seller indemnity for tax liabilities that relates to the period prior to completion (generally for up to 7 years).

| Detailed Comparision | |
| --- | --- |
| Advantages of a Share Sale<br>(from Seller's Perspective) | Disadvantages of a Share Sale<br>(from Seller's Perspective) |
| • All assets, employees, contracts and liabilities are transferred with the company.<br>• Potential claims and liabilities of the company pass to the buyer on acquisition, together with all duties, obligations and liabilities under contracts entered into by the company (unless otherwise negotiated as part of the deal process, for example, deal warranties and indemnities).<br>• Share sales are more "seamless" from a third party perspective. Sometimes, customers, suppliers and other third parties may be unaware that a change in ownership has occurred.<br>• The seller will not need to obtain counterparty consent to the assignment of contracts, leases or licenses, but may need to obtain consent where there is a change of control provision in the contract (this being less common). | • Unless otherwise negotiated, the seller cannot retain any assets of the company.<br>• The liabilities remain with the company whose shares are sold. As a result, the buyer will generally expect more comprehensive warranties and indemnities than in an asset sale to provide protection against potential liabilities. The exposure under these warranties can be mitigated through pre-sale disclosure, qualifications and limitations (including liability caps, minimum thresholds and claims period).<br>• A buyer will generally seek tax warranties and a tax indemnity from the seller, as the buyer will not want to take on tax liabilities that relate to the period before completion of the sale. This indemnity is often capped at the purchase price but remains in place for around 7 years post sale. |

| Advantages of a Share Sale (from Seller's Perspective) | Disadvantages of a Share Sale (from Seller's Perspective) |
|---|---|
| • In a share sale, the existing employment relationships remain intact and continue despite the change of shareholding. However, consultation with employees will still be required regarding the transition to new ownership. This consultation will be more limited than in an asset sale.<br>• It is likely that fewer encumbrances over assets will need to be released.<br>• Intercompany arrangements may not need to be disturbed and can remain in place.<br>• No need to agree asset price allocation. No GST issues, as no GST payable on share sale.<br>• The purchase price is paid directly to shareholders and will normally be received tax-free. | • The seller will have personal exposure under the warranties and indemnities.<br>• Share sale will result in the loss of company imputation credits and tax losses. Some pre-completion structuring may be desirable to use up imputation credits. |

## Property being purchased

With an asset purchase the term sheet should state with accuracy the property being purchased (for example, fixed assets, stock, receivables, contracts, IP and goodwill), and any assets being excluded.

Price and payment terms

The most important term. Although often at the term sheet stage the price may still be subject to confirmatory due diligence, the parties should at least agree in principle:

- The price range or how the price will be calculated (based on a multiple of EBITDA, for example);
- Whether there will be any adjustments to the price (for example, stocktake or working capital adjustments);
- Whether the price is all paid up front in cash or on deferred terms (for example, on an-earn out basis).

On an asset purchase, it also should be indicated whether the purchase price is plus GST or GST inclusive.

Conditions Precedent

Common conditions precedent may include finance and due diligence, solicitors approval, any required regulatory consents, landlord consent, key customer or supplier consents, the transfer of key employees, board and possibly shareholder approvals.

Restraints of trade

To protect the goodwill of the business being acquired, buyers will often insist on lengthy restraints of trade being provided from the seller, its directors and shareholders and related parties (for example, family trusts and related companies). These will need to be considered carefully by the seller in light of its future plans and will need careful drafting by the buyer to ensure enforceability.

Timetable

A term sheet should include a timetable of actions, responsibilities and target dates to get the parties from the term sheet stage to completion quickly and efficiently. Typical timetable elements will include due diligence, signing definitive agreements (including who provides initial drafts), satisfaction of conditions and the completion date.

Warranty and security expectations

Although rare to include detailed warranties in a term sheet, the parties may wish to include:

- a general statement to the effect that warranties typical of transactions of this nature are expected; and
- details of any expected warranty security arrangements (for example, personal guarantees or escrow).

Although typically non-binding, providing this clarity early may prevent differences over the warranties preventing the transaction from signing or proceeding.

Exclusivity provisions

A term sheet provides the potential opportunity for a buyer to commit the seller to exclusively negotiate with the buyer about the sale of the business for an agreed term. This is favourable to the buyer, but may not be for the seller and should be considered carefully.

A quid pro quo to a seller agreeing to exclusivity, might be a “break fee” payable by the buyer (or the seller or both) to pay a fee or reimburse the other for professional costs incurred if the other walks away from the deal. A break fee signals commitment but can also raise complex legal issues and should be treated with caution and never entered into without legal advice.

# STAGE 4

## DUE DILIGENCE

Commonly conducted after entry into the term sheet (but also sometimes after entry into the definitive acquisition agreement), the due diligence process allows a buyer to verify its understanding of what is being purchased and confirm its proposed price. Financial due diligence by the buyer's accountants and tax advisers is typically conducted alongside reviews performed by the buyer's lawyers.

A checklist of areas commonly examined by lawyers in a typical asset purchase is set out here, although this list will vary depending on the structure (for example, asset purchase checklists tend to be narrower in scope and share/company checklists more exhaustive) and the nature of the business (for some businesses, environmental/ contamination risk may be an area of focus, for example).

Due diligence can become costly for the buyer, and time consuming, and very disruptive for the seller, if the seller is not properly organised or prepared for the due diligence process.

An understanding with the seller should be obtained to the effect that appropriate resources of the seller will be committed to preparing for and assisting the due diligence process. For due diligence to be effectively and efficiently performed the seller should have the requisite business records well organised before the commencement of due diligence and readily available for inspection.

Due diligence reports from advisors (lawyers and accountants) add value to the buyer and highlight unexpected commercial opportunities or risks identified during the review – but the costs of doing this may be prohibitive, depending on the size of the deal.

*Always talk to your lawyer and accountant to check the costs of their involvement in due diligence and whether an estimate can be provided.*

# STAGE 5

## THE LONG FORM AGREEMENT

Drafting the long form agreement often takes place during or immediately after an initial due diligence phase. A long form agreement is often then signed, conditional on a more detailed due diligence investigation.

The long form agreement sets out in detail the agreed terms of the term sheet (as varied based on the results of due diligence). If no term sheet applies, often the long form agreement is drafted by the lawyers or a business broker.

Issues of contention that arise time and time again in long form agreements include the giving of warranties. Buyers rarely wish to invest in a business that the seller will not support by warranty, whereas sellers generally expect that if the opportunity for due diligence has been provided to the buyer, then the buyer should rely on its own judgement.

Typical responses by a seller to warranties include that the seller cannot be expected to provide warranties on matters:

(a) outside their knowledge and belief;

(b) that relate to the future and over which the sellers have no control; and

(c) within the scope of the due diligence review of the buyer.

Inevitably these matters turn out to be much of a ‘’horse trade”, with the end result usually a reflection of the relative bargaining strength of the parties. Both parties generally acknowledge those warranties of key importance, and those warranties not of key importance are often left to be dealt with once all other commercial issues are resolved.

# STAGE 6

## SATISFACTION OF CONDITIONS PRECEDENT

Following signing of the long form agreement, a buyer (and often the seller) typically have an obligation to use "best endeavours" to fulfil the conditions precedent before a particular date.

Often a buyer will consider that if an agreement is conditional on due diligence or obtaining finance, that it will be easy to declare the agreement at an end if it changes its mind on the merits of the acquisition. In effect, an agreement conditional on due diligence is not really an agreement, but an option to buy.

However legally this may not always be the case – legal advice should always be sought before entering into a conditional agreement.

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# STAGE 7

## COMPLETION

The period between satisfaction of the conditions precedent and completion can often be a hectic one, particularly if complex financing arrangements are required. A buyer's obligations will generally be to:

(a) put in place its financing;

(b) provide the seller with the transfer, assignment and novation documentation.

Meanwhile, a seller will in this period be arranging signing of all the transfer, assignment and novation documentation, along with discharges of all securities over assets being sold.

Completion takes place (and the purchase price paid by the buyer) once the buyer's solicitors are satisfied all the transfer, assignment and novation documentation is signed, and the buyer's solicitors are satisfied that discharges of the seller's finance securities have been obtained.

Following completion, the buyer's solicitors will typically attend to registration of all relevant documentation, and wrap up any loose ends required to complete the acquisition.

# DISCLAIMER

This guide is intended as a general overview of some of the key legal issues that are likely to be relevant to buying a business in New Zealand and the process involved. It does not claim to be comprehensive or provide specific legal advice or other advice. It is not possible to provide comprehensive advice, whether legal or otherwise, on the matters that may apply in your particular circumstances without knowing those circumstances. Accordingly, matters that you consider to be important, or that may otherwise be considered important, to your particular circumstances or business may not have been addressed in this guide, or may not have been addressed in sufficient detail for your purposes. Consequently, this guide cannot act in any way as a substitute for obtaining your own legal advice and other advice. This guide hasn't been updated since 1 August 2019 to take account of any subsequent events or changes in law, and we have no duty or responsibility to do so. While every endeavour has been made to supply accurate information, errors and omissions may occur. Accordingly, we do not accept any liability for any loss or damage which may directly or indirectly result from any advice, opinion, information, representation or omission, whether negligent or otherwise, contained in this guide.

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