1964

Buy-sell agreements

Rudoph J. Englert

Recommended Citation
Haskins & Sells Selected Papers, 1964, p. 188-199

Buy-Sell Agreements

by Rudolph J. Englert
Partner, New York Office

Presented before the Thirteenth Annual West Kentucky Conference on Accounting, Kentucky Dam—May 1964

Not being an attorney, I cannot tell you how to draft a buy and sell agreement, our topic for discussion today. However I should like to discuss with you some of the problems and decisions that must be made before a buy and sell deal can be consummated. Let us start at the point where two parties have just agreed to buy and sell and disregard the numerous reasons why some companies wish to sell and why others are looking for companies to acquire.

PRICE

The first problem to be solved is the determination of the sales price—if a cash transaction, the amount of cash; if a stock transaction, the exchange ratio. Usually financial analysts are engaged to study the companies and submit reports suggesting the price or exchange ratio. Among the factors they consider are:

- Earnings
- Dividends
- Market values
- Book values
- Growth pattern.

Management reviews the reports after they are received and considers various other factors such as:

- Caliber of the management of the company being acquired
- Advantages of the services of an established sales or research organization
- Peculiar features if any of the company being acquired.

After all factors have been considered and management has arrived at its conclusions, the final price or exchange ratio is determined by negotiation between the managements of the two companies.

FORM OF DEAL

The next problem to be resolved is the form of the deal to be consummated. It may be in the form of:

- cash or stock

- a taxable or non-taxable transaction
- a purchase or a pooling of interests.

Here are some of the problems to be encountered under these different forms.

Cash—General

A cash deal will be taxable and for accounting purposes will be considered a purchase. In a cash deal, the acquiring company invariably wants to buy assets and assume specific liabilities rather than to buy stock and thereby assume all the liabilities, whereas the selling stockholders prefer to sell their stock and report the sale as capital gain rather than sell the assets and then be required to liquidate the company to obtain the cash.

If to conclude the deal it is necessary to purchase the stock, the acquiring company can protect itself against the assumption of undisclosed liabilities by providing for an escrow fund to be held for a period of years to pay such undisclosed liabilities.

Cash—Tax

Under the 1939 Code, this form of transaction presented many problems requiring care. Thus in setting up the transaction care had to be exercised, first, to avoid a double tax if assets were sold, i.e., tax on the company for the profit on the sale and tax on the shareholders for the liquidating dividend, and second, to enable the acquiring company to obtain the total purchase price as the tax base of the assets acquired.

Because of the many problems in this type of transaction as shown by the number of cases litigated, Congress, in the 1954 Code, substantially eliminated them. It is now possible, regardless of whether assets or stock are purchased, for the seller to pay only one capital gain tax and for the purchaser to obtain the total purchase price as the tax base of the acquired assets.

If it is necessary to purchase the stock, the selling stockholders still report their profit as a capital gain. The acquiring company, if it so desires, can obtain the total purchase price as the tax base of the assets under section 334(b)(2), if it has acquired such stock within a twelve-month period and if it liquidates the acquired company within two years from the date of the purchase of the stock.

If the assets are purchased, the acquiring company automatically obtains the total purchase price as the tax basis of the acquired assets. The selling stockholders, if they so desire, can limit the tax to the stockholders' capital gain only, under section 337, by voting the company into liquidation and then selling the assets and liquidating the company within twelve months. Under this section the profit or loss from the sale of the assets is not recognized to the company.

Note that to obtain the benefits of these two sections it is necessary to comply with various conditions. There may be situations where it would be more advantageous not to have the provisions of these two sections apply. For example, if assets are purchased and the selling company suffers a loss from the sale, the selling stockholders would vote the company into liquidation after the sale is consummated, thus having the loss recognized by the company for tax purposes; if stock is purchased, and the purchase price is less than the book value of the assets, the acquiring company could operate the acquired company for more than two years and then liquidate it under section 332, thus obtaining the higher tax base as recorded on the acquired company's books.

Some benefit obtainable through the use of section 337 and section 334(b)(2) has been taken away by section 1245, added to the Internal Revenue Code by the Revenue Act of 1962. This section is often referred to as the depreciation "recapture" section and provides that the portion of the gain from the sale of depreciable assets, other than buildings, to the extent of depreciation taken subsequent to 1961, shall be taxable as ordinary income. Thus in a section 337 liquidation, only the portion of the gain in excess of the depreciation taxable as ordinary income would be non-taxable; and in a section 334(b)(2) acquisition, the acquired corporation would have to pay a tax at ordinary rates on the portion of the computed gain on the depreciable assets, other than buildings, to the extent of the depreciation taken since 1961.

The Revenue Act of 1964 added section 1250 to the Internal Revenue Code providing similar, although less inclusive, treatment to gains from the sale of buildings as to depreciation taken subsequent to 1963.

Cash—Allocation

When assets are purchased for cash or when stock is purchased and the acquired corporation is liquidated under section 334(b)(2), the purchaser has problems of allocating the purchase price over the assets acquired. Naturally, the purchaser wants to allocate as little as possible to goodwill since this asset is not depreciable or amortizable for tax purposes. On the other hand the seller, if he has sold assets, prefers to allocate as large a portion of the sales price to goodwill as possible, for this will give him capital gain. When this problem is present it is extremely important to consider it as early in the negotiations as possible.

The best solution would be for the buyer and seller to agree on the allocation and specify it in the contract. The allocation would not necessarily be binding on the Commissioner, but if the allocation is realistic and made at arm's length, usually it will prevail.

If the allocation is not covered in the contract, a suggested method to follow would be to allocate their full value to cash, and assets equivalent to cash (all marketable securities, accounts receivable, and inventories having a readily realizable market value). The balance of the purchase price should then be prorated over the other assets such as land, buildings, machinery, and patents on the basis of their market value. Goodwill, if present, would be allocated an amount based on its computed value. If market values are not available, book values may be used, but consideration must be given to any unusual factors such as obsolete plant, the effect of accelerated depreciation, and patents having a value in excess of recorded cost. It is important that all details of the computations be made as complete as possible and be retained for use in connection with any subsequent discussions with the Internal Revenue Service.

Determining the value of goodwill is usually the most difficult part of the allocation. This is so because goodwill may be the result of various factors such as the holding of patents, copyrights, and trademarks, or the business' reputation for honest and efficient service, or advertising.

The following factors should be considered before a computation of goodwill can be made:

1. A general survey of the business should be made in the same manner as in determining the purchase price. This survey should indicate whether any goodwill does exist. For example, if the company had been losing money; there would be a presumption that no goodwill existed.
2. It should be established whether any consideration was given to goodwill at the time the purchase price was agreed to.
3. If the purchase price exceeds the value of the tangible and physical assets. If the purchase price is the greater, goodwill and the amount of the excess is, to some extent, a measure of value of the goodwill. Conversely, if the value of the tangible assets exceeds the purchase price, the presumption would be that there is no goodwill.
4. If a payment for a covenant not to compete is included in the contract, it is important that it be clearly defined. Payment for a covenant is ordinary income to the seller and an amortizable asset to the buyer; payment for goodwill is capital gain for the seller and a non-amortizable asset to the buyer.

It is necessary to show clearly that the covenant was considered to be a separate and distinct item, so that it will not be held that the primary purpose of the covenant was to permit the enjoyment of the goodwill and, therefore, that the payment was for goodwill.

If from a survey of all the facts there is indication that goodwill is present, but the amount thereof is not determinable from such facts, the amount of goodwill is usually computed on the basis of a formula. Simply stated, it is: Capitalize the excess of average annual net earnings over the earnings attributable to tangible property.

In determining average annual net earnings, the statements of earnings must be reviewed to eliminate any unusual or abnormal items. Also in determining the number of years to be used in determining the average, any abnormal years should be eliminated. The average annual net earnings used in the formula should be representative of the past normal earnings and what may reasonably be expected to be earned in the future.

The rates used for computing the return on tangible assets and for capitalizing the excess earnings depend on the facts in each case. Practice has varied quite widely, but in a nonhazardous business the ones most commonly used are 8% and 15%; in a hazardous business those most commonly used are 10% and 20%.

After an amount has been computed for goodwill, or more correctly the value of intangibles, an allocation thereof should be made, if applicable, to any other factors that may have given rise to such excess earnings. For example, part of the excess earnings may be due to the abilities of the president of the company or to a star salesman or to some valuable patents or copyrights.

Stock—General

Some of the problems encountered in acquisitions consummated through an issue of stock are of interest. This type of transaction is usually non-taxable and for accounting purposes is handled as a pooling of interests. However, this type of transaction may sometimes be considered a purchase and therefore taxable, either because the transaction is deliberately set up to be so considered or because through error in setting up the transaction, some of the conditions that have to be met for non-taxability or a pooling of interests are not met.

Stock—Non-Taxable

Stock acquisitions that are non-taxable are considered as reorganizations and must comply with all the provisions of the reorganization section of the Internal Revenue Code. These sections are very technical and must be strictly followed to get the benefits of their provisions. Section 368(a)(1) describes the types of transactions qualifying for non-taxable treatment as follows:

A. A statutory merger or consolidation.

B. The acquisition by one company, in exchange solely for all or a part of its voting stock, of the controlling stock of another company; control for this purpose means 80% of all voting stock and 80% of all other stock of the company.

C. The acquisition by one company, in exchange for its voting stock, of substantially all of the properties of another company.

Reorganization—Statutory Merger

In the usual statutory merger or consolidation, a new company issues its stock and securities in exchange for the stock and securities of the companies to be merged. The principal advantage of this type of reorganization is that it permits the issuance of preferred stock and securities without affecting the basic non-taxable aspects of this transaction. However, if the principal amount of securities received exceeds the principal amount of securities surrendered or if any securities are received and no securities are surrendered, then gain is recognized to the stockholders.

This type of reorganization must comply with state laws and requires the approval of the stockholders of both companies. As a result of these requirements it may be more advisable to adopt one of the other reorganization plans.

Reorganization—Stock for Stock

If the transaction is a stock-for-stock deal, care must be exercised that the acquiring company issue only its voting stock and not pay any cash. If it should pay any expenses of the selling stockholders, the entire transaction will be considered taxable. Also, the acquiring company must have control of the acquired company after the acquisition, which means that it must acquire at least 80% of the voting stock and 80% of all other stock of the acquired company. If control is obtained, it is permissible for the acquiring company to acquire the stock of minority holders or dissenting stockholders by payment of cash. However, to preserve the non-taxable character of the transaction for those stockholders receiving stock, no stockholder may receive both stock and cash.

Reorganization—Stock for Property

In a stock-for-asset deal, it is necessary that the acquiring company acquire substantially all of the assets of the acquired company. What constitutes substantially all assets is not defined but if approximately 90% are acquired it is safe to assume that the transaction will qualify.

In this type of reorganization the assumption of liabilities is not considered the payment of cash and does not affect the non-taxable character of the transaction. However, if any cash is paid, for example, by the acquiring company to dissenting stockholders a special rule is provided to determine whether the transaction remains non-taxable. Briefly stated, this rule is that the total of cash paid and liabilities assumed cannot exceed 20% of the market value of assets acquired (section 368(a)(2)(B)).

Usually, the acquired company in this type of reorganization is permitted to retain sufficient cash to pay all expenses incurred in the transaction.

Stock—Tax Ruling

Even though it appears fairly certain that a transaction will be non-taxable, it is advisable to obtain a ruling from the Internal Revenue Service. This can be of great value to stockholders who can just refer to the tax ruling to substantiate their tax treatment of the transaction.

If there is any doubt concerning the non-taxability of the transaction it is imperative that a tax ruling be obtained and a provision should be included in the agreement that if the ruling is unfavorable the transaction can be canceled.

Stock—Pooling of Interests

Before discussing the requirements and effect of a pooling-of-interests treatment, consider the theory of the pooling-of-interests concept. This theory is that, when two or more companies combine and continue their prior operations, the basis of reporting for financial purposes should be the same as though the companies had been operated as a single organization from their inception. It is not necessary to combine the companies into a single company, but a parent and subsidiary set-up may be used if there is no significant minority interest remaining and if there are important tax, legal, or economic reasons for so doing. This concept is often used as a means of eliminating the necessity for reflecting in the financial statements the excess of the value of the stock issued over the book value of the assets acquired. In certain states it is not possible to use the pooling-of-interests concept in its entirety as there is a prohibition against combining companies, earned surpluses and carrying them forward as a single surplus account.

There are three requirements for a pooling-of-interests treatment:

1. *Continuity of ownership*

   The holders of substantially all ownership interests, usually limited to common stock, of the combining companies should become the owners of the resulting enterprise in substantially the proportions of their respective interests in the combining companies. If preferred stock or debt securities having no voting rights are issued or if a substantial part of the ownership interest is retired shortly before or shortly after the combination, a purchase would be indicated.

2. *Continuity of all constituents*

   The business of the combining companies should be continued in the resulting enterprise. If a large part of the business of one or more of the constituent companies is abandoned or sold, there is an indication that the transaction should be considered a purchase.

3. *Continuity of management*

   The management or power to control management of the combining companies should be continued in the resulting enterprise. If the management of one is eliminated or if its influence on over-all management of the resulting enterprise is small, a purchase may be indicated.

The absence of one requirement may not be determinative, but the entire transaction should be studied to determine whether, on the basis of all the circumstances, the combination is a purchase or a pooling of interests.

The effect of a pooling of interests is that the accounts of the constituent companies are combined as follows:

1. The carrying amounts of the assets—if stated in conformity with generally accepted accounting principles—adjusted if necessary to place them on a uniform basis, are carried forward.
2. The combined earned surpluses and deficits, if any, are carried forward, except where some legal restrictions may apply.
3. If the stated capital of the resulting enterprise is more than the stated capital of the separate companies combined, the excess may be deducted first from the total of the capital surplus and

the remainder from the earned surplus. If the stated capital is less, the difference should be shown as capital surplus.

4. If the resulting enterprise takes the form of a parent and a subsidiary, the foregoing principles should be applied in preparing consolidated statements in lieu of principles applicable in preparing ordinary consolidated statements.

Combination Transactions

In the preceding comments I indicated that taxable deals usually are considered as purchases and non-taxable deals as poolings of interests. However, there are situations where the tax and accounting treatments may be different and where the problems of both types of transactions must be considered. For example, in a stock deal, if the provisions of the reorganization sections of the tax law were not complied with, the transaction would be considered taxable and so require the allocation of the purchase price of the assets for tax purposes, and even though the requirements of a pooling of interests were present, the carrying amount of the assets would be carried forward for accounting purposes. Conversely, in a stock deal qualifying for non-taxable treatment but not qualifying for a pooling-of-interests treatment because of the absence of a continuity of management, it would be necessary to carry forward the tax basis of the assets for tax purposes but to allocate the purchase price of the assets for accounting purposes.

SECURITIES AND EXCHANGE COMMISSION REQUIREMENTS

The requirements of the Securities and Exchange Commission must be very carefully studied so that compliance with them is made.

I shall not attempt to cover all SEC requirements but briefly outline some of the forms that may be applicable. Because it takes time to clear matters through the SEC, it is important that a timetable for consummating the deal be carefully worked out.

The forms filed with the SEC are designed to give to stockholders and prospective stockholders all the information they may require for evaluating the transaction being submitted to them. The forms that may be applicable to mergers and acquisitions are:

1. *Proxy Statement*

   The Proxy Statement is used to solicit proxies in obtaining stockholder approval of mergers and acquisitions. The financial statements included in a Proxy Statement are comparable to or identical with those in a Registration Statement (exclusive of the schedules and the supplementary profit and loss information, which is usually shown in a footnote) a summary of earnings usually for five years, and pro forma statements giving effect to the proposed merger or acquisition.

2. *Form S-1—Regular Registration Statement*

   The Registration Statement is used to register securities of a new company or additional securities of a registered company. A part of a Registration Statement is a prospectus, which must be issued to prospective purchasers of securities.

3. *Form S-14—Simplified Registration Statement*

   This form is used by listed companies to register additional stock to be issued in an acquisition; it consists principally of the Proxy Statement.

4. *Form 8-K—Current Information*

   All listed companies are required to file this form to make available current information concerning material events, changes, etc.

It must also be remembered that the exchange on which securities are listed must be kept advised of these matters. Copies of these forms filed with the SEC must also be filed with the respective exchanges. A listing application will also be required to list new stock being issued in an acquisition. A simplified form, consisting principally of a Proxy Statement, has been provided by the New York Stock Exchange.

PROVISIONS IN AGREEMENT

When two companies decide to combine, naturally they are desirous of finding out as much as they can about each other before the deal is consummated. Management will investigate management and operational policies, personnel, condition of plant, nature of business, types of products sold, etc.

The investigation of accounting policies and financial condition is usually delegated to the independent public accountants. If a complete audit is not authorized, a businessman's review of the accounts is made. This work usually includes a review of the working papers of the accountants for the other company. If the company being acquired is not too large and if there are not many stockholders, it is possible to provide an escrow fund to protect the acquiring company from loss for undisclosed liabilities, litigation, additional taxes, uncollectible accounts, etc. However, if the company is large and there are a great number of stockholders, it is not practical to provide an escrow fund. It therefore becomes necessary to make a thorough investigation in an effort to disclose all pertinent facts. Usually both parties give warranties concerning all material matters, averring to statements made as being true also at the closing date. But if no escrow fund is provided, the warranties, as a rule, do not survive the closing.

Representations and warranties sometimes made and given are that—

1. The corporation is duly organized and existing and in good standing under the laws of the state in which incorporated and is authorized to conduct its business.
2. The capital stock is validly issued and fully paid and non-assessable.
3. The financial statements, as of a recent date, on which the deal was based, fairly present the financial condition and results of operations.
4. All liabilities have been disclosed.
5. Good and marketable title is held in all real property.
6. The list of all patents, trade-marks, trade names, and copyrights is complete and no notice of conflict with the asserted rights of others has been received.
7. All material contracts are disclosed and there is no default under any such contracts.
8. All pending or threatened litigation has been disclosed.
9. The company has complied with all laws, regulations, and orders applicable to its business.
10. Provision has been made for all known or possible taxes.
11. No material transactions have occurred since the balance sheet date on which the transaction is based other than in the ordinary course of business.
12. No new capital expenditure projects will be authorized in excess of a specified amount.
13. No material adverse change in the condition, financial or otherwise, of the company has occurred since the latest financial statements submitted.
14. The accounts receivable are good and collectible in an amount not less than the net book value thereof.
15. Neither the execution of the Reorganization Agreement nor the consummation of the transaction therein contemplated will conflict with or result in the breach of the terms, conditions, or provisions of any agreement or instrument to which the company is a party.
16. The board of directors of the company has duly approved the Reorganization Agreement and the transaction contemplated therein.

The foregoing representations and warranties are illustrative only and are not meant to include all declarations and compacts that may be included in a reorganization agreement. The ones actually appearing in an agreement result from the findings of the investigations and the discussions, negotiations, and opinions of the attorneys.

In addition to the representations and warranties, various general provisions are included in a reorganization agreement. These provisos may relate to who is to pay a broker's or a finder's fee or to other matters considered necessary to stipulate in order to avoid misunderstandings or litigation after the merger is consummated.

CONCLUSION

In my remarks I have attempted to indicate some of the factors to consider in handling engagements relating to "Buy and Sell Agreements." Actually my comments are very condensed and are intended only as guidelines. Before actually embarking on such an engagement you will, no doubt, have to do some research.