PRIMER ON ASSET PURCHASE VS. STOCK PURCHASE WHEN BUYING OR SELLING A BUSINESS

The market for buying and selling businesses is somewhat following the trend of what occurs when buying and selling real estate in terms of all the considerations each party must weigh at the timing of the transaction. Prior to making a decision to buy or sell a business, a period of due diligence should reveal pitfalls and challenges if the process is completed in a comprehensive manner. The process begins with formulating an offer in the form of a term sheet or letter of intent, which outlines the proposed purchase price and conditions of the transaction. This document, when executed, becomes the blue print for the proposed deal.

Once the parties to the transaction have agree upon the terms to be included in the term sheet or letter of intent, the seller and buyer have a decision to make as it relates to the structure of the transaction; i.e., buying and selling assets or stock. And each party to the transaction will have different reasons for preferring one structure over another in order to protect their interests. Below is an overview and considerations taken by each side when buying or selling a business:

Asset Purchase vs. Stock Purchase

In an asset transaction, the buyer is interested in purchasing the operating assets of a business instead of shares of stock in the target company. An asset deal is any transfer of a business that is not in the form of a share acquisition. If an asset transaction becomes the structure agreed upon by both parties, the seller remains as the legal owner of the entity, and the buyer becomes the owner of the individual assets owned by the company; i.e., building, equipment, licenses, goodwill. In most cases, the target company's cash is not included in an asset sale, while at the same time, a seller would retain the long-term debt obligations of the selling company. Normalized net working capital is typically included in an asset purchase agreement, which is comprised of items such as accounts receivable, inventory and accounts payable.

In most jurisdictions, an asset acquisition typically involves an assumption of certain liabilities. During the transaction, the parties will enter into negotiations relating to which assets will be acquired and which liabilities will be assumed.

Where the transaction is structured as a stock purchase, the acquisition results in a transfer of the ownership of the business entity itself, but the entity continues to own the same assets and have the same liabilities. The individual shareholder(s) will sell their interest in the company to a buyer, who assumes ownership of both assets and liabilities, which could also include potential liabilities from past actions of the business.

Advantages of an Asset Acquisition

There are several advantages to the asset purchase structure, particularly for the buyer. A major tax advantage is that the buyer can "step up" the basis of many assets over their current tax values and obtain tax deductions for depreciation and/or amortization. With an asset transaction, goodwill, which is the amount paid for a company over and above the value of its tangible assets, can be amortized on a straight-line basis over 15 years for tax purposes. In a stock deal, goodwill cannot be deducted until the stock is later sold by the buyer.

Also, in an asset transaction, the buyer has an opportunity to negotiate which liabilities, if any, it will assume in the transaction. This limits the buyer's exposure to liabilities that are large, unknown, or not stated by the seller. The buyer can also dictate which assets it is not going to purchase. For example, if the buyer determines that the seller has significant accounts receivable that may be uncollectable, the buyer would not elect to purchase the target's accounts receivable as part of the purchase price.

The exposure to unknown liabilities is always a consideration in either type of transaction; however, in an asset transaction, the buyer is typically not required to devote considerable resources during the due diligence period if liabilities are being assumed by the seller. During the due diligence period, liabilities are scheduled and become the subject of covenants. For example, the buyer could hold-back of a portion of the purchase price as insurance against unknown liabilities.

Minority shareholders in an asset sale who don't want to sell their shares can effectively be forced to accept the terms of an asset sale. Unlike the case with a stock purchase, minority shareholders do not ordinarily have to be taken into account in regard to an asset purchase. The buyer can select which employees they want to retain (and which they do not) without impacting their unemployment rates.

Disadvantages of an Asset Sale

There are several disadvantages to an asset sale vs. a stock sale for both the buyer and the seller. In an asset sale, contracts with vendors or customers are typically required to be approved by unrelated third parties to the deal, which becomes cumbersome and time consuming. It is also possible that the contracts will have to be renegotiated by the buyer. The tax cost to the seller in an asset transaction is higher, which generally results in the purchase price being increased to accommodate the requirements of the buyer. The assignability of contract rights of the seller may be limited and the assets acquired by the buyer will be required to be retitled in the name of the new buyer entity. Furthermore, employment agreements with key employees may need to be renegotiated, which could become protracted and create tension during the transition period. If the seller is required to liquidate any assets not purchased or pay any liabilities that have not been assumed, this process must be anticipated in terms of the timing of the transaction.

A stock purchase transaction is, in concept, a simpler structure and generally should be easier to close in a shorter period of time. The buyer acquires the stock of the target and unless the transactional documents are negotiated to reduce the exposure to the buyer, the buyer takes the company in the condition it finds it in as it relates to assets and liabilities. The existing contracts of the target; i.e., vendor contracts, leases, licenses, etc. will transfer to the buyer by operation of law.

The advantages of a stock transaction include the elimination of the need to retitle assets or invest in valuations. Buyers are able to assume non-assignable licenses and permits without having to obtain specific consent. This form of transaction typically avoids transfer taxes.

Disadvantages of a Stock Transaction

As simple as it might appear to proceed with a stock transaction, there are disadvantages in which the buyer and seller must consider. The main disadvantage is that an acquirer receives neither the "step-up" tax benefit nor the advantage of handpicking assets and liabilities. All assets and liabilities transfer at carrying value. In order to avoid exposure to unwanted liabilities, the transactional documents must be carefully drafted to include indemnification and hold harmless provisions. Applicable securities laws may complicate the process, especially when the target has multiple shareholders. Furthermore, some shareholders may not wish to sell their stocks, and this could prolong the process and increase the cost of the acquisition.

Summary

When buying or selling a business, determining the type of transaction, i.e. asset vs. stock, to be included in the term sheet or letter of intent is one of the most important decisions both parties need to agree upon. This decision requires comprehensive due diligence and evaluation of all assets and liabilities at the timing of the transaction. In addition to issues relating to assumption of liability, step-up in basis or transferring licenses and leases, choosing the structure of an acquisition also requires careful tax analysis, as well as a solid understanding of the benefits and consequences of each type of transaction. The buyer and seller in a business transaction will have different reasons for preferring one structure over the other in order to protect their respective interests. For more information about business strategies and legal issues, please contact PLDO Managing Principal Gary R. Pannone at 401-824-5100 or email gpannone@pldolaw.com.

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