



## **Deal structure may determine the success of your acquisition**

A buyer and seller agree on a price and draft a basic term sheet. The acquisition is essentially complete, right? Unfortunately, many inexperienced sellers have this view.

What they fail to recognize is that the structure is often the most challenging aspect of any deal. Disagreement over deal structure is why many merger and acquisition transactions later fall apart.

But agreeing on a deal structure isn't always easy. The range of available forms, including asset sales and stock sales, and consideration of relevant factors such as securities and tax laws, often create conflicting goals between buyers and sellers. Add a lender to the mix, and a third set of objectives further complicates the deal structure.

Buyers and sellers need to understand these complexities. They also need to determine the amount and timing of cash proceeds during the deal process and anticipate their relative tax impact.

### **Buyer and seller preferences**

As a general rule, sellers prefer to sell stock rather than assets. A stock sale for a C corporation is taxable to the seller only if there are capital gains. Even when capital gains are realized, these taxes are lower than ordinary income tax rates.

Asset sales, on the other hand, get taxed twice: First there are capital gains taxes at the corporate level, then shareholders are taxed at ordinary income tax rates for the receipt of any dividends.

Buyers, on the other hand, generally prefer to acquire assets. Because an asset purchase gives the acquirer the opportunity to step up the cost basis of an asset to its fair market value, the result is increased depreciation deductions, lower taxes and increased future cash flow. By acquiring assets instead of stock, buyers also avoid any contingent liabilities that might transfer in a stock purchase.

### **Stock vs. asset sales**

In an asset transaction, all assets of the target business may be transferred, including real estate, equipment and inventory, and intangible property such as patents and trademarks. But in some cases, buyers negotiate to buy only specific assets, such as inventory, equipment and intangible assets, but not cash, receivables or real estate. Buyers also generally agree to assume certain liabilities of the selling company.

Although buyers enjoy tax advantages, asset-based deals can be more costly than other types of transactions. Asset sales require the legal transfer of each asset, which in some cases triggers additional transfer and real estate taxes. Also, legal fees and other advisory fees are higher with asset purchases.

Finally, many intangible assets, such as customer contracts and leases, may not be assignable in an asset sale without the consent of third parties such as lessors (property or equipment leases) or customers (supply contracts).

In a stock sale, the seller transfers shares of its company to the buyer for an agreed-upon price. In addition to the negative tax impact for buyers, disadvantages to stock sales may include more difficulty in approving the transaction if there are minority shareholders.

If the buyer wants to acquire all of the company's outstanding shares, any one shareholder could hold up the deal. Transaction costs, particularly legal fees, are generally lower with stock sales, however.

### **Avoiding deal breakers**

Sometimes, buyers and sellers have differing expectations that can cause serious disagreement and threaten the entire deal. But if this gap is not too vast and both parties are willing to work to complete the deal, compromises are often possible.

If, for example, a buyer would rather not acquire the seller's real estate, it might arrange a long-term lease of the property with the seller, providing ongoing income to the selling shareholders. If the parties are having trouble agreeing on a price — particularly because of the buyer's financing constraints — the seller might be willing to provide the bridge financing necessary to close the transaction.

Disagreements between buyers and sellers over a company's value are very common because each party typically has different future expectations. Sellers generally envision a brighter future than buyers. Constructing a payment schedule that is tied, in part, to future performance can close this gap and even help sellers receive a higher price.

### **Keep objectives in mind**

When structuring a deal, buyers need to ensure that their acquisition objectives are consistent with their financing capacity. They should also be careful not to overleverage a purchase, as they will likely need sufficient working capital for growth.

Sellers, on the other hand, need to realize that, because the cash paid at closing is most often a combination of bank debt and buyer equity, the buyer may be somewhat constrained by available capital. A willingness to receive some of the proceeds of the sale in the future could result in an increased purchase price and deferred taxes.

Maintaining realistic expectations and being willing to negotiate will go a long way toward making your acquisition succeed.