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CBA SKILLED LAWYER SERIES 2016

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MANAGING DEAL RISK: DRAFTING FINANCIAL TERMS

APRIL 19, 2016

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ANATOMY OF A DEAL

KEY COMPONENTS

1. Planning and Managing an M & A Deal
2. Structuring the Deal: Asset vs. Share Transactions
3. Negotiating the Deal: Preliminary Agreements
4. Investigating the Deal: Effective Due Diligence
5. Financing the Deal: Secured Loan Transactions
6. Drafting the Deal: The Purchase and Sale Agreement
7. Managing Deal Risk: Drafting Financial Terms
8. Closing the Deal: A Transactional Lawyer's Toolkit

LARGE M&A DEALS

1. Raising Capital: Private Placements and Public Offerings
2. Cross-Border Deal Considerations: US and Europe
3. Corporate Governance: The Role of Directors
4. Regulatory Issues: Competition and Anti-Corruption Compliance

COLLATERAL AGREEMENTS

1. Drafting a Shareholder Agreement
2. Drafting a Commercial Lease Agreement
3. Drafting an IP Licensing Agreement
4. Drafting an Employment Agreement

Presenters

Greg Hollingsworth
Lawson Lundell LLP
Vancouver

Robin Schwill
Davies Ward Phillips & Vineberg LLP
Toronto

INTRODUCTION

Fact scenario (throughout the series): Jupiter considers the acquisition of Blur:

- Blur is a privately held CBCA company
- Blur has three individual shareholders (who have a USA)
- Blur has valuable licensing and distribution arrangements
- Blur owns valuable IP, including patents
- Blur conducts manufacturing in Canada and in China
- Blur owns manufacturing facilities in Canada
- Blur has other owned and leased real estate
- Blur's workforce is unionized

INTRODUCTION

Fact scenario (throughout the series): Jupiter considers the acquisition of Blur:

- See Supplemental Materials for financial statements of Blur as at the December 31, 2015 Closing Date

Overview

- Accounting Terminology in Purchase and Sale Agreements
- Purchase Price Formula and Post-Closing Adjustments
- Earn-Outs and Reverse Earn-Outs
- Escrows and Holdbacks
- Addressing Financial Risk in Agreements (Case Study)

Accounting Terminology

- CPA Canada and the "Handbook"
- What is "GAAP"
- Referring to Auditors in Agreements
- Other Key Accounting Terms

Source: Google Images

CPA Canada Merger

- As of 2015, the CA, CMA and CGA designations and their respective governing bodies been merged into the single “CPA” designation with “CPA Canada” as its national governing body

- Why the merger?
  - Public confusion over which accountants do what
  - Streamlining of administration akin to other professions (medicine, engineering, law)

CPA CHARTERED PROFESSIONAL ACCOUNTANTS

CA

CMA

CGA

Source: Google Images

CPA Canada Merger

- CPA: "Chartered Professional Accountant"
- CICA no longer exists (now replaced by CPA Canada)
- CICA Handbook is now called the "CPA Canada Handbook"
- Former CAs, CGAs and CMAs will use the new "CPA, CA", "CPA, CGA" or "CPA, CMA" designations a 10 year transition period after which the designation will simply become "CPA"

Source: Google Images

CPA Canada Merger

Impact on M&A Agreements:

- Common in Agreements to appoint an auditor or accountant to do various things
- Old Wording: "Independent Accountant" means a nationally recognized firm of Chartered Accountants agreed to in writing by the Vendor and the Purchaser
- New Wording: "Independent Accountant" means a nationally recognized* firm of Chartered Professional Accountants agreed to in writing by the Vendor and the Purchaser
- When referring to the Handbook in agreements, etc. should now be referring to the CPA Canada Handbook and not the CICA Handbook

* *Query what is "Nationally Recognized"*

Source: Google Images

What is GAAP?

Common Warranty in M&A Agreements:

> The Financial Statements present fairly, in all material respects, the financial position, assets and liabilities of the Company as at the date of the balance sheet, and its expenses, revenues and results of operations for the year then ended, in accordance with GAAP applied on a consistent basis

What is GAAP?

GAAP:

Generally Accepted Accounting Principles

GAAP is more than just the Handbook

The "Law" doesn't come from just one source ….neither does GAAP!

Sources of GAAP include:

- CPA Canada Handbook – Accounting (formerly the CICA Handbook) which includes, inter alia, IFRS (Part I of the HB) and ASPE (in Part II of the HB)
- Emerging Issues Committee Abstracts
- Foreign Accounting Recommendations (i.e. FASB)
- Textbooks, Articles and Journals
- Common Practice in a Particular Industry
- Accountant's Professional Judgment applying fundamental accounting principles

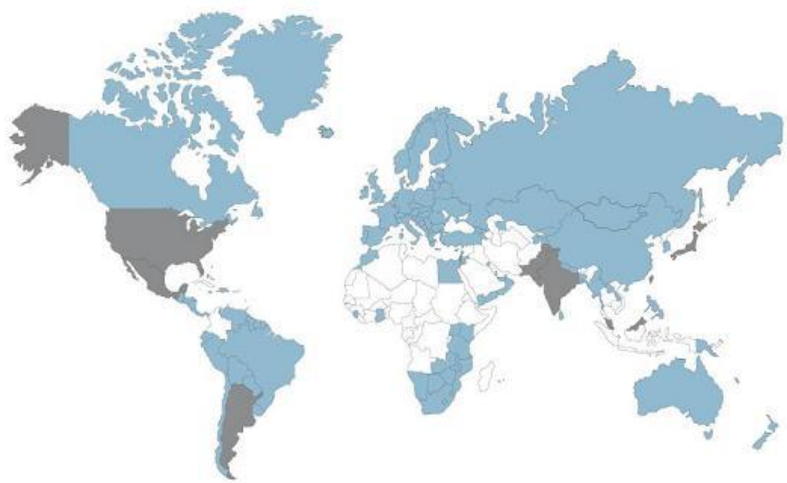
***** When defining GAAP, do not limit your definition exclusively to the CPA Canada Handbook recommendations so as to pick up these other sources of GAAP.*

IFRS

- IFRS = International Financial Reporting Standards
- Accounting standards set by the International Accounting Standards Board or “IASB“ (based in London, UK)
- IASB has 14 members from a diverse range of countries
- Since January 1, 2011, all “publicly accountable enterprises” in Canada are required to apply IFRS

Why the Change to IFRS?

- Worldwide Movement: Over 120 Countries have moved to or are moving to IFRS
- FASB (U.S. Accounting Standards setter) and IASB working on a number of convergence projects
- Canadian entities that account using IFRS will gain better access to international debt and equity markets
- SEC now permits IFRS Accounting - if used eliminates need to reconcile Canadian GAAP to US GAAP when filing in the U.S.



Blue – IFRS required or allowed
Grey – Working towards IFRS Convergence
White – Has not yet adopted IFRS accounting

Source: Google Images

GAAP is still Alive and Well!

GAAP

vs.

IFRS

Common Misconceptions :

1. **Canadian GAAP ceased to exist and has been replaced with IFRS.**

   FALSE: IFRS Standards have been incorporated into Canadian GAAP such that Canadian GAAP now includes IFRS standards

2. **The CICA Handbook has been discarded and replaced with IFRS.**

   FALSE: IFRS Standards have been incorporated into Part I of the CPA Canada Handbook – Accounting such that the CPA Canada Handbook will now include those standards. Former GAAP has largely been preserved in Part II of the CPA Canada Handbook – Accounting (Accounting Standards for Private Enterprises)

IFRS vs ASPE – Both are GAAP!

IFRS (International Financial Reporting Standards):

1. Part I of CPA Canada Handbook - Accounting
2. Applies to Publicly Accountable Enterprises:
   - Entities that have issued debt or equity instruments on a public market
   - Entities that hold assets in a fiduciary capacity for a broad group of outsiders
   - Crown Corporations
3. Private Enterprises can elect to use IFRS

ASPE (Accounting Standards for Private Enterprises):

1. Part II of CPA Canada Handbook – Accounting (similar to pre-IFRS GAAP)
2. Applies to Private Enterprises that do not elect to use IFRS

How should GAAP be defined in M&A Agreements?

The Simple Definition:

"**GAAP**" means generally accepted accounting principles in Canada from time to time

If you want IFRS GAAP:

"**GAAP**" means generally accepted accounting principles in Canada from time to time including, for the avoidance of doubt, the standards prescribed in Part I of the CPA Canada Handbook - Accounting (International Financial Reporting Standards) as the same may be amended, supplemented or replaced from time to time

If you want ASPE GAAP:

"**GAAP**" means generally accepted accounting principles in Canada from time to time including, for the avoidance of doubt, the standards prescribed in Part II of the CPA Canada Handbook - Accounting (Accounting Standards for Private Enterprises) as the same may be amended, supplemented or replaced from time to time

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Auditors - What is an Audit?

- Financial Statements are prepared by management NOT by the auditor
- Financial Statements are ultimately the responsibility of management
- Auditor's role is to conduct a series of verification tests, and based on those tests, report on whether, in the auditor's opinion, the financial statements present fairly the company's financial situation.

Source: Google Images

Auditor Independence

- Auditor Independence must be maintained if the Auditor's audit opinion is to be objectively given free from influence of management
- In the case of Enron, Arthur Andersen failed to remain independent – ultimately leading to the collapse of the firm
- Fundamental Principle: An Auditor cannot audit their own work

Source: Google Images

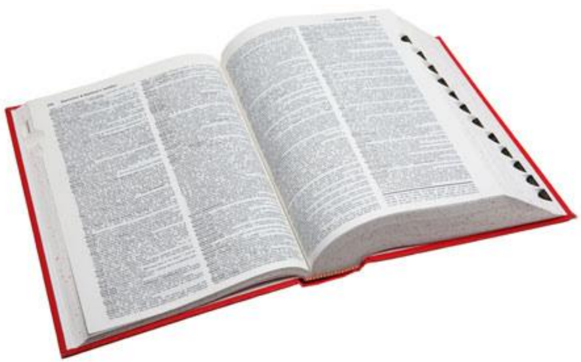
Auditor Independence

Impact on M&A Agreements:

- Do not assign tasks in an agreement to an Auditor that will require the Auditor to audit their own work (e.g. determination of final purchase price in the case of a dispute)
- The auditor's role should be limited to auditing figures that have been prepared by others
- Non-audit tasks should instead be assigned to an Independent Accountant who is not also the Auditor
- When in doubt, ask the Auditor if the matter is an engagement that they would be prepared to accept.

Source: Google Images

Other Key Accounting Terms



See Supplemental Materials for (non-legal) definitions/explanations of some of the key accounting terms that are frequently encountered in M&A transactions

Source: Google Images

Purchase Price Formula and Post-Closing Adjustments

Source: Google Images

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Typical Purchase Price Formula in M&A Agreements

Purchase Price Equals:

Base Purchase Price

$\pm$ Working Capital Adjustment

- Indebtedness *

- Other Liabilities not captured by Working Capital Adjustment *

Final Purchase Price

* Not typically adjusted for in asset purchase agreements where it is possible to exclude these liabilities from the transaction

Working Capital Adjustments

- Post-Closing Adjustment to the purchase price of a business
- Post-Closing item because closing date balance sheet numbers typically not available for a number of weeks or months after closing

Source: Google Images

Why are Working Capital Adjustments Necessary/Desirable?

- Desirable on a share purchase where cash is being stripped out of the company prior to closing, or on an asset purchase where cash is an excluded asset, otherwise Vendor can be motivated to "unjustly" enrich themselves by:
  - Pressuring customers for payment prior to closing causing bad will with customers;
  - Delaying payment to suppliers prior to closing causing bad will with suppliers

Source: Google Images

Working Capital Adjustments

[Net]* Working Capital = Current Assets – Current Liabilities

- Current Assets
  - Cash and Marketable Securities
  - Accounts Receivable
  - Income Tax Receivables
  - Inventories
  - Prepaid Expenses
- Current Liabilities **
  - Bank overdraft
  - Accounts Payable
  - Accrued Liabilities
  - Income taxes payable
  - Deferred Revenues and Deposits
  - Current portion of long-term debt

* The term “Net Working Capital” is commonly used in M&A Agreements, but is typically given the same definition as the accounting concept of “Working Capital”

** Common exclusions from Current Liabilities definition in Purchase Agreements include the current portion of long-term debt (separately adjusted); future income tax liabilities or deferred taxes (not “true” liabilities)

Simple Working Capital Adjustment Provision

The Purchase Price shall be adjusted as follows (the "Working Capital Adjustment"):

(a) if Net Working Capital as finally determined as at the Closing Time is greater than Target Net Working Capital, the Purchase Price shall be increased by an amount equal to the difference and the Purchaser shall, within 5 Business Days of such final determination, pay an amount equal to such difference to the Vendor by way of certified cheque, bank draft or wire transfer or direct deposit of immediately available funds to such bank account as may be directed by the Vendor; and

(b) if Net Working Capital as finally determined as at the Closing Time is less than Target Net Working Capital, the Purchase Price shall be decreased by an amount equal to the difference and the Vendor shall, within 5 Business Days of such final determination, pay an amount equal to such difference to the Vendor by way of certified cheque, bank draft or wire transfer or direct deposit of immediately available funds to such bank account as may be directed by the Purchaser, such payment to constitute a refund of purchase proceeds previously paid by the Purchaser.

Complex Working Capital Adjustment Provision

1. A Target Working Capital figure is agreed to by the Parties (i.e. the normal level of working capital required to run the business)

2. Working Capital at closing is estimated, and the amount paid by the Purchaser at closing is adjusted depending upon whether estimated working capital is:
   (a) Greater than the target (upward adjustment to closing payment) or
   (b) Less than the target (downward adjustment to closing payment)

Complex Working Capital Adjustment Provision

3. Following Closing, a Closing Balance Sheet is prepared (as at the Closing Date):
    - Sometimes audited or reviewed;
    - Sometimes simply agreed to by the parties
    - Mechanism included to resolve disagreement (e.g. referral to an Independent Accountant for determination)

4. A Final Working Capital figure is determined from the final Closing Balance Sheet

Complex Working Capital Adjustment Provision

6. If the Final Working Capital is greater than the Estimated Working Capital, the Purchaser makes an additional payment to the Vendor.

7. If the Final Working Capital is less than the Estimated Working Capital, the Vendor refunds to the Purchaser a portion of the consideration previously received by the Vendor.

8. Often, a Price Adjustment Escrow is used to protect the Purchaser from a potential downward working capital adjustment.

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Blur Corporation – Estimated Net Working Capital at Closing

Estimated Net Working Capital (December 31, 2015):

Current Assets:			
- Cash	$400,000		
- Accounts receivable	230,000		
- Inventories	300,000		
- Prepaid Insurance	102,000	$1,032,000	
Current Liabilities:			
- Accounts Payable and Accrued Liabilities		420,000	
Estimated Closing Net Working Capital			$612,000
Target Net Working Capital (Assumed)			$650,000
Adjustment to Estimated Purchase Price (Reduces proceeds to Vendor at closing)			($38,000)

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Blur Corporation – Final Net Working Capital

Closing Net Working Capital (December 31, 2015):

Current Assets:			
- Cash	$423,429		
- Accounts receivable	246,981		
- Inventories	300,034		
- Prepaid Insurance	102,000	$1,072,444	
Current Liabilities:			
- Accounts Payable and Accrued Liabilities		353.580	
Closing Net Working Capital			$718,864
Estimated Net Working Capital at Closing			$612,000
Working Capital Adjustment Amount (Purchaser Makes Additional Payment to Vendor)			$106,864

Full Purchase Price Adjustment Alternative

- Appropriate where agreement contains a number of different post-closing adjustments (not just a working capital adjustment)
- Adjustment mechanism mirrors the working capital adjustment with the exception that:
  - The full Purchase Price is estimated at closing (not just the working capital adjustment amount) with the parties agreeing the various component parts of that estimate
  - Adjustment is based on the Purchase Price as finally determined vs the Estimated Purchase Price which was used to calculate proceeds paid at closing.

See Supplemental Materials for suggested wording for full Purchase Price Adjustment (adapt wording for complex working capital adjustment)

Earn-Outs
and
Reverse Earn-Outs

Source: Google Images

Earn-Out:

- Portion of purchase price determined based on the post-closing performance of acquired business
- e.g. Purchase Price = $X plus % of EBITDA in years 1, 2 and 3
- Generally used where uncertainty exists as to the appropriate valuation for a company

Earn Outs – (CRA Position)

- Earn-Out Payments are fully taxable as income (not capital gains) under s.12(1)(g) ITA.*

  **Note: Could argue that s. 12(1)(g) is N/A for share sales. If this is the case, CRA take the position that earn-out must be valued and reported as proceeds in year of closing (tough to do)*

- Exception #1: If satisfy CRA's Cost Recovery Method criteria, can treat earn-out payments as capital gains and not income

- Exception #2: Structure as a Reverse Earn-Out??? (Recent CRA technical interpretation may make reverse earn-outs less appealing)

Cost Recovery Method Criteria (IT-426R):

- Vendor is Canadian resident
- Vendor and Purchaser deal at arm’s length
- Gain or loss on sale of property for cash would clearly be capital in nature
- Earn-Out amount reasonably relates to underlying goodwill that cannot be valued at closing
- Earn-Out does not extend beyond 5 years
- Vendor must submit letter requesting “cost recovery method” with tax return for year of closing

Reverse Earn Out:

- Historically considered where IT-426R criteria cannot be met
- Vendor and Purchaser agree on maximum purchase price
- Reverse Earn-Out portion paid by promissory note
- Purchase Price reduced if performance targets not met
- Refund of purchase price effected by set-off against promissory note
- ACHILES HEAL: CRA Admin position is no capital gains reserve for unpaid amounts under reverse earn-outs (CRA technical interpretation 2013-0505391E5 F)

Escrows and Holdbacks

Source: Google Images

Escrow vs. Holdback

Escrow:

Amounts held back from the Purchase Price and deposited by the Purchaser with an "escrow agent" as security for:

- Post-closing adjustments to the Purchase Price (Price Adjustment Escrow)
- Future Indemnification Claims (Indemnification Escrow)

Holdback:

Amounts held back from the Purchase Price and retained by the Purchaser as security for:

- Post-closing adjustments to the Purchase Price
- Future Indemnification Claims

Escrow vs. Holdback

- Vendors typically prefer escrows (less susceptible to Purchaser insolvency risk as escrowed funds are technically the Vendor's proceeds)
- Purchasers typically prefer holdbacks (reduces the amount that the Purchaser has to fund/finance at closing)

Escrows – Special Considerations

- Escrow Agent: Either one of the law firms involved in the transaction or a 3rd party institutional escrow agent
- Income on Escrowed Funds: Who receives the benefit of the interest earned on the escrowed funds:
  - Vendor (but added to the escrowed funds)?
  - Allocate proportionately between the Vendor and Purchaser based on who receives the escrowed funds when paid out? *

* Proportionate allocation can make it very difficult for the escrow agent when issuing T5's.

Escrows – Special Considerations

- Escrow Agreement
  - Substantive provisions governing the release of the escrowed funds typically included directly in the Purchase Agreement (See Presentation Supplement for sample language)
  - Escrow Agreement typically limited to administration of the escrow by the escrow agent (i.e. escrow agent only to release funds pursuant to joint written instructions from the Vendor and the Purchaser, or by court order

Addressing Financial Risk in Agreements (Case Study)

Source: Google Images

Financial Term Issues Raised by Fact Pattern

- Public acquirer v. Private target
  - Audited v. unaudited financial statements?
- Most valuable assets likely not on target's balance sheet
  - NHL jersey production contract
  - IP (patents, industrial designs and trademarks)
  - License and distribution agreements in Asia
- Supply risk – majority of apparel is produced by RapidWear in China
  - Accounts Payable considerations
  - Inventory valuation considerations

Financial Term Issues Raised by Fact Pattern

- Large and varied customer base
  - Accounts receivable valuation considerations
  - Revenue recognition considerations
- NHL Supply Contract
  - Accounts receivable considerations
  - Revenue recognition considerations
  - Deferred revenue considerations
- Certain liabilities likely not on the balance sheet
  - Retail outlet and manufacturing lease liabilities
  - Environmental liability
  - Potential regulatory liability
  - Unionized labour – defined benefit plan and OPEBs?

Audited v. Unaudited

- "Audited Financial Statements"
  - Does "audited" matter?

Audited

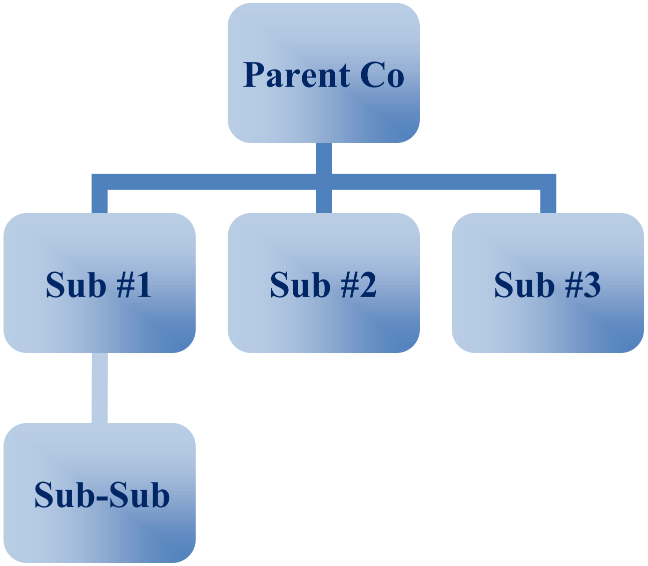
- Statistical verification of receivables and assessment of appropriateness of allowance for doubtful accounts
- Statistical verification of inventory values
- Some verification process for existence of fixed assets and assessment of appropriateness of depreciation policies
- Representations and warranties deal with these issues to some extent.

Consolidated

- Does "consolidated" matter?
- Depends on what you're buying
- Not useful for assets of one of many subsidiaries

Consolidated and Combined Financial Statements

- Consolidated Financial Statements
  - Financial statements of parent and >50% controlled subsidiaries are combined and presented as a single entity
- Combined Financial Statements
  - Financial statements of non-controlled entities are combined and presented as a single entity (i.e. combined = consolidated where consolidation not required under GAAP)



Accounts Receivable

- Large and varied customer base means perhaps greater focus on bad debts and aging
- Volume rebates and other discounts or offsets impacting collectability?
- Vendor financing?
- NHL Supply Contract – payment terms v. recording receivable?
- How are payments under licensing and distribution agreements being booked?

Inventories

- Specialized performance apparel
- High level of obsolescence?
- Most produced and supplied by RapidWear Products based in China
- Does Blur use same valuation basis as Jupiter?
- Be wary of cost allocations to the inventory account
- Foreign exchange impacts on costing?

Prepaid Expenses

- Rent and other lease payments

Accounts Payable

- Significant payable to RapidWear
- How will aged arrears or existing disputes be dealt with?

Purchase Price Adjustments

- Value being specifically ascribed to?
  - NHL jersey production contract
  - IP (patents, industrial designs, trademarks)
  - Licensing and distribution agreements in Asia
- Assumed Liabilities
  - Retail outlet and manufacturing leases
  - Environmental liability
  - Potential regulatory liability
  - Defined benefit plans

Earn Out (EBITDA) Considerations

- Foreign exchange gains and losses?
- Capitalized costs?
  - Store listing fees
  - Prepaid marketing costs
  - Pre-operating costs
  - Leasehold improvements in branded outlets
- Research and Development costs?
- Deferred revenue? (NHL Supply Contract)

Questions?

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