

SELLING A PRIVATE COMPANY

Introduction

This paper concerns a sale of shares in a proprietary company (limited by shares) (the **target**). Of over a million companies in Australia, most are proprietary companies.

The target

A company is a legal person, distinct from its shareholders and officers. Shareholders hold shares in the company, but do not legally own the assets of the company. The company may have up to 50 shareholders (more if they are also employees).

If a target is trustee of a trust (particularly a unit trust), the assets of the trust are owned by the beneficiaries of the trust, and not by the company. In that case a buyer's primary concern will be to become a beneficiary of the trust, and the shares in the company will be secondary.

This paper assumes that a target is not a franchisee or holder of some government licence where special statutory rules may apply on what must be disclosed to a prospective buyer, or who can be a buyer.

The shares

Shares are personal property, capable of transfer and (in the legal sense) are situated where the Register of Members is kept. At least 1 share must be on issue, but there may be any greater number. Shares may be of different classes, with different rights; they may have different issue prices and may perhaps not be fully paid-up when sold.

The seller of shares

A seller of shares may be another company, a superannuation fund, a trust or an individual.

Who the seller is, is relevant:

- If the seller is a poor credit risk and may not be able to satisfy a warranty claim, a buyer may want the seller's warranties to be supported by a guarantee from a reputable third party, or want some of the price to be held back after settlement until it is clear that no warranty claim will arise or be unsatisfied.

- To the capital gains tax (CGT) the seller pays if the price of the shares exceeds their cost base:

If the seller is an individual, a trust or a company (but not a superannuation fund) and held the shares since before 19 September 1985, the shares may be wholly exempt from CGT.

If the seller is an individual or trust (but not a company or a superannuation fund) and held the shares for at least 12 months, any capital gain is reduced by 50%. [If the seller is a superannuation fund, a 33% discount may apply.]

If:

- o the seller is an individual and they (or their spouse) are at least a 50% shareholder;
- o the assets of the seller and their related entities have a total net value of less than \$5 million; and
- o at least 80% in value of the target's assets are used in a business;

then one or more of these small business CGT concessions may also apply:

- o the 15-year exemption (if the shares were held for at least 15 years and the seller retires or is permanently incapacitated)
- o the 50% small business reduction
- o the retirement exemption (full CGT exemption for the amount of a deemed eligible termination payment)
- o the replacement asset rollover (deferral of CGT on the capital

gain until a later sale of the replacement asset).

- If the seller exchanges shares (or options for unissued shares) for similar securities in a buyer company, a capital gain on the original securities may be deferred under a scrip for scrip roll-over.

For CGT purposes, the shares are disposed of when the sale contract (albeit conditional) is made, not when the sale settles. Also if the final price depends on how the target performs after the sale (earnout payments), the CGT situation is more complex.

Apart from being a shareholder, a seller may have other commercial relationships with the target that need to be adjusted or terminated as a result of the sale. The seller might be a lender to (or borrower from) the target, a guarantor of the target's liabilities, an officer or employee (or both) of the target, the owner of an invention or trade mark or business name used by the target, a lessor of land or plant to the target, a supplier (or customer) of the target. As an example, perhaps the target can pay to the retiring employee/seller an eligible termination payment with a favourable after-tax outcome.

The buyer of shares

A buyer might be an outsider, or an existing shareholder or director (or other officer) of the target.

Who the buyer is, is relevant:

- If the buyer is a director, they must take care not to be guilty of improper use of their position to gain advantage for themselves, improper use of information (or worse, insider trading) or oppressive conduct. If the target is a family company, there is potential for a fiduciary relationship to exist between the buyer/director and the seller, with extra complications.
- If the buyer is not a resident of Australia, Foreign Investment Review Board requirements may be relevant.
- If the buyer is already a large player in the same market as the target, the *Trade Practices Act* rules against anti-competitive mergers may be relevant.
- If the buyer is a poor credit risk and may not be able to fund the price at settlement, the seller may want a deposit on signing the

sale contract or a guarantee from a reputable third party in favour of the seller.

Sell the shares or sell the target's assets?

A seller may prefer to sell their shares rather than the target sell its assets to the buyer. The reason is tax. If the target sells its assets to the buyer for a profit, the target must pay income tax. That after-tax profit may however attract further tax in the hands of the shareholders if the target then pays a dividend, reduces its share capital or winds up and the available franking credits may not be sufficient to allow the receipt to be tax free to the shareholders. Also, the shareholders effectively lose the benefit of CPI indexation (as accrued before 30 September 1999) on the target's capital assets because while the target may receive an indexed amount on the sale (non-taxable to the target), that amount is taxable when passed down to shareholders.

A buyer may prefer to buy assets from the target for various reasons. Maybe a company structure is not a tax-effective way to hold the assets into the future. Maybe the buyer is worried that, if it buys shares, there are undisclosed liabilities of the target that only surface after settlement. In choosing between buying shares or assets, the buyer may have an eye to stamp duty (see later). A buyer who buys shares so as to be able to use up the franking credits or tax losses of the target, must be aware of the anti-trafficking rules in the tax law.

Sometimes a sale by the target of its assets is just too hard where, for example, suppliers and customers of the target might not all agree to the target assigning their contracts to the buyer, or they may want some concessions to allow an assignment to occur. The buyer will know however that leases, franchise agreements and other major contracts customarily deem a change in control of the target to be an assignment of the contract by the target, requiring the lessor or other third party to consent.

Marketing

A target can freely advertise for buyers of its assets, as you can see in any newspaper. Unless it is a "small business" (a \$200,000 threshold applies in South Australia) a disclosure document is not mandatory.

A seller of shares is however by law severely restricted in marketing and advertising their shares for sale. A prospectus or other disclosure document can usually be avoided, however.

Any information (even oral information) given by a seller to a buyer before sale may entitle the buyer to recover loss or even unwind the sale, if the information is misleading or deceptive. A contractual warranty of the seller can itself be misleading or deceptive. An express disclaimer of liability won't stop an action for misleading or deceptive conduct.

Take-over rules

Unless the company has more than 50 shareholders, the statutory take-over rules will not apply.

Due diligence investigation

Due diligence is an investigation of the assets, liabilities and prospects of the target.

It might occur before signing the sale contract (so the buyer can tailor the seller's warranties using what the buyer found in due diligence) or after signing but before settlement (with a satisfactory due diligence being a condition of settlement).

One assumes of course the seller can give the buyer access to the target's records and staff, as shareholders' rights of access are usually very limited. The target should always obtain a confidentiality agreement from the buyer and its advisers.

If the target is subject to the National Privacy Principles (**NPP**) under the *Privacy Act*, a confidentiality agreement between the target and the buyer helps the target comply with its obligations to safeguard the personal information the target holds. However the individuals about whom the target holds information usually need not consent to the disclosure. The Privacy Commissioner has a list of actions that a target and a buyer can take in due diligence to assist their compliance with the NPP.

The scope of the investigation depends on the situation. Due diligence will start with the financial records, taxation returns, employee information, registers, minutes and other records the target is obliged by law to keep. Title to land, patents and other keys assets are checked. Inventory may be counted and checked for obsolescence. Liabilities to staff, government (particularly tax) and customers will be assessed. Key contracts with suppliers and customers are read. The buyer may ask to interview the key staff, suppliers and customers.

In practice, a buyer may want both due diligence and extensive seller's warranties in the sale contract.

A seller may itself perform due diligence in order to find and fix any problems, before a buyer can become aware of them and ask for a reduction in the asking price.

Pre-sale re-organisation

If a sale is likely, a target might be made ready for sale by:

- updating the business plan and budget
- using up or transferring tax losses of past years or the current year (and writing off any bad debts)
- paying (franked) dividends to the existing shareholders
- unwinding loans, guarantees and contracts to which the seller is a party
- reducing to writing key contracts, or amending key contracts to be more favourable to the target
- selling to the seller any personal use items owned by the target that the seller wants, such as a car or mobile phone.

Pre-emptive rights on transfer

The Constitution (Memorandum and Articles of Association) may give other shareholders a right to buy shares that a shareholder proposes to transfer.

The usual procedure: (1) the seller notifies the target about the proposed transfer and the price; (2) the target (as the seller's agent) offers those shares to the other shareholders; (3) the other shareholders may within a set time agree to buy all or some of the shares; (4) if another shareholder agrees to buy a share on offer, but disagrees with the nominated price, a valuer is engaged to set the price; (5) if the other shareholders compete for the shares on offer, the parcel is divided between them pro rata their existing holdings; (6) if any shares are left over, the seller may sell them to an outsider at the nominated price within a set time; (7) if applicable (see below), the directors may yet refuse to register a transfer to an outsider.

The seller and buyer will both want to know whether these pre-emptive rights are likely to be exercised, or waived. The procedure can be made to work against them both, so care is required.

Directors' power to refuse a transfer

The Constitution (or the statutory replaceable rules) may give the target's directors power to refuse to register a transfer of shares for any good reason, or perhaps only for certain specified reasons.

The seller and buyer will both want to know the directors' attitude, before settlement.

Directorships and employment

A shareholder has no legal right to require the target to offer a directorship, or employment.

The buyer may be in better position if acquiring a majority shareholding, or if an existing Shareholders' Agreement assures the buyer of a directorship, or employment or both.

Target giving financial assistance

If the buyer cannot afford the entire price at settlement, it may ask the target to provide assistance, perhaps by a loan from the target to the buyer or by the target giving the seller a guarantee that the buyer will pay the price.

Financial assistance was once totally prohibited, but the rules are more relaxed now. A major relaxation is that a target may give assistance if that does not materially prejudice the interests of the target or its shareholders, or the target's ability to pay its creditors. The directors make that decision, at their own risk however. There are other, more limited, exceptions to the prohibition.

Sale contract

A written sale contract is *not* a legal requirement. In practice the parties might forego a written sale contract if they are not at arm's length or it is a straight sale (with no conditions, no warranties). [They still need a share transfer form (see later)].

A written sale contract may follow this order:

- *The sale.* The seller agrees to sell and the buyer agrees to buy the specified shares.
- *Conditions precedent.* Conditions to be satisfied for the sale to proceed, that may include the unwinding of commercial relationships between the seller and the target, the buyer obtaining finance, the waiver or exhaustion of other shareholders' pre-emptive rights, consents of third parties (such as a landlord), or release of any mortgage over the shares.

- *The price.* There are alternate methods for fixing a price (capitalisation of future maintainable profits, discounted cash flow, notional realisation of assets, value of net tangible assets as a going concern, capitalisation of future maintainable dividends) with the selection between them being influenced by whether a controlling shareholding is on offer and whether the target carries on an active business. It is good practice for the sale contract to specify how the price was fixed, in case of a later dispute.
- *Payment terms.* A deposit is *not* a legal requirement. Usually the price is payable at settlement, unless the final price cannot be known until later (perhaps after a stock take) or the buyer is holding back a sum as insurance against warranty claims arising after settlement or the seller is extending "vendor finance". The sale contract may oblige the buyer at settlement to put additional money into the target (as new share capital or debt), to allow the target to pay off a dividend or loan owing to the seller.
- *Title.* Beneficial title in the shares passes from the seller to the buyer at settlement. Legal title passes later when the target recognizes the share transfer in the Register of Members.
- *Settlement.* The time and place of settlement are specified. The sale contract should list all the documents required at settlement, ranging from the basic (share certificate, share transfer form, a discharge of any mortgage over the shares, consents and resignations of officers, directors' minutes approving the transfer and appointing incoming officers, evidence of the satisfaction of conditions precedent to the sale) to the more advanced (perhaps a balance sheet of the target prepared on settlement day). If the buyer, as a new director, is taking over management of the target it may be appropriate for the seller to also hand over the records and registers of the target. If the seller is resigning as an employee, his or her free resignation as such would be appropriate.
- *Warranties.* The seller's warranties may be few or many, depending on the negotiating strengths of the parties, the buyer's familiarity with the target's affairs and any potential risks the buyer demands be covered. Basic warranties are that the seller has the right to sell the shares unencumbered, the target is not nor likely to become insolvent, the last financial report complied with the statute, total issued capital is as represented by the seller, the target owns the assets as represented by the seller. A buyer is always concerned that the seller has overstated corporate assets or understated corporate liabilities. In our experience, corporate taxation and employee entitlements are of concern. Environmental risk is also now topical.
- *Indemnity.* The seller's warranties may be supported by an indemnity given by the seller, entitling the buyer to recover damages that might otherwise be too legally remote.
- *Restraint of trade.* The seller may promise not to compete with the target or damage its goodwill. A restraint of trade is void unless the buyer can prove that it was reasonable in scope, duration and geographical reach. So it must be tailored to the particular situation and not go too far. In any event the seller may be bound by equitable and statutory rules protecting the target's confidential information.
- *Liability limits.* A seller may ask that warranty claims must be notified in less time (say 2 years) than the Statute of Limitations otherwise allows (6 years). A seller may also negotiate a monetary limit of its liability under the contract. Going the other way, a buyer may ask for a third party guarantee in support of the seller's financial ability to satisfy a warranty claim.
- *Power of Attorney.* A seller may appoint the buyer as its attorney to exercise the rights attaching to the shares in the time between settlement and the transfer being recognized in the Register of Members.

Stamp duty

A sale of proprietary company shares attracts stamp duty at the ad valorem marketable securities rate of 0.06% (60 cents per \$100.00).

A land-rich company is a special case. Here the duty is the full ad valorem conveyancing rate (step up rates to 5.5% in South Australia) applied to the underlying interest in the land. A target that owns land in this State with an unencumbered value of at least \$1 million and where the land makes up at least 80% in value of total assets, is land-rich. A transfer of shares that results in the transferee having (directly or indirectly) more than 50% of

total issued shares in a land-rich company attracts the conveyancing rate of duty.

The sale contract (if any) and the share transfer form must be lodged with Revenue SA for assessment of duty. As a matter of routine, Revenue SA will requisition the last 3 years financial statements of the target in order to gauge whether the price is the real market value. [The Commissioner may substitute his own opinion of market value]. The statute makes both seller and buyer liable to pay the duty. A sale contract usually makes this the buyer's responsibility, as between the parties.

The target must not recognize the transfer in the Register of Members until stamp duty is paid. So until stamp duty is paid, the seller remains the registered holder of the shares, on trust for the buyer. The seller must hand over to the buyer any dividend paid by the target after settlement. Voting the shares is more problematic because the seller (though a trustee) might decline to attend a meeting, send a proxy or sign a written resolution, despite the buyer's wishes. A sale contract can address that.

It may be false economy for a buyer to structure a purchase as one of shares, rather than assets bought direct from the target, merely to minimize stamp duty. What the buyer saves in stamp duty may be lost in costs of due diligence and preparing the sale contract. Also keeping a company structure to hold the assets may also result in the buyer ultimately paying a higher effective rate of income tax (including CGT) in future years. Professional tax advice is required.

GST

A sale of shares is input taxed for GST purposes so GST is not payable by the seller. Any GST incurred in the transaction by either party (such as GST on legal services) is not an input tax credit.

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