BUSINESS VALUATION REVIEW

“*CAVEAT AESTIMATOR*: EVALUATING HIDDEN LIABILITIES AND RISKS”

by

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Any proper valuation analysis would include information not only regarding the assets, future prospects and potential of the business, but will also consider the risks and liabilities that will be assumed by the purchaser as part of the transaction. While a business may have a number of off-balance-sheet *assets* — perhaps in the form of intellectual property, valuable dies and moulds, tools, litigious claims, etc. — there may also be a host of off-balance-sheet *liabilities*, whether contingent, actual or latent, as well as specific risks. As many of these may not be apparent at first glance, the business appraiser must attempt to identify any such exposure that is neither reflected on the subject’s financial statements nor otherwise apparent. This article provides a partial checklist as to the areas that the purchaser’s business valuator may wish to visit.

“Skeletons in the closet”, including hidden and/or potential liabilities and risks, can normally be identified from management interviews, a review of files and documents and, in some cases, from external sources. Some industries typically face constant exposure, e.g., environmental liability in the case of certain manufacturers, or loss (or suspension) of a license in the case of regulated businesses.

In the open market (as opposed to the notional market), adjustments to the negotiated transaction price may address such types of concerns. The use of price-adjustment clauses, or the specific way the deal is structured, may be a means for the buyer and seller to address hidden liabilities or risks that may not be evident. In notional “fair market value” determinations, however, the business valuator must express his or her valuation opinion in terms of money or money’s worth as of the effective valuation date; hindsight is inadmissible.

While some of these potential off-balance-sheet liabilities and risks may be obvious, there are those that might not immediately come to mind.

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1. FOREIGN OWNERSHIP

In valuing a Canadian business, a U.S. valuator should be aware of restrictions imposed in certain cases by the Canadian government on foreign investment.

The Department of Industry, through Industry Canada, administers "notifications" of new investments and applications for foreign-investment approval. Other than with respect to new investments by non-residents that would have a significant effect on the public interest, or on Canada's "national identity" or "cultural heritage" (e.g., publishing, filmmaking, videos and music investments), new business ventures by non-Canadians are subject to either an approval measure or a notification requirement, depending on the size and degree of control of the investment. Also, to limit the growth of foreign-controlled businesses in specified Canadian industries, foreign control is restricted in the banking, media, airline, insurance, trust, and loan industries. The purchaser must inform Industry Canada of the new investment within 30 days of the transaction. No further information is required unless the investment is an acquisition of an existing business by a non-Canadian and exceeds the specific size and percentage-of-control thresholds noted below.

U.S. investors are exempt by the *North American Free Trade Agreement* (NAFTA) in certain situations.

Excluding the exceptions, an investment review by the Canadian government will be made when a foreign entity acquires control of an existing Canadian business and either of the following two conditions exists:

1. The business is being acquired *directly* (rather than indirectly through the acquisition of the non-Canadian parent of the Canadian business) and the assets of the business have a value of at least Cdn. $5,000,000; and

2. The business is being acquired *indirectly* (through the acquisition of a parent company outside Canada) and the Canadian assets have a value of at least Cdn. $50,000,000. (Where the Canadian assets represent more than one-half of the total value of the deal, in which case the above-noted $5,000,000 threshold applies).

Any direct and indirect investments by non-Canadians, which exceed the notification thresholds, will be reviewed by Industry Canada for purposes of assessing the net benefit to the country. If the acquisition of a Canadian business might give rise to implications regarding Canada's national identity or cultural heritage, they will be subject to review by Industry Canada, whether or

not the above-noted thresholds apply. Under NAFTA, the thresholds are more favorable for U.S. investors, in that they are higher.

Industry Canada considers a number of specific factors when assessing the net benefit of an acquisition to Canada in order to ensure that no detriment to Canada will result from the transaction.[1] These include for example, the effects on competition within Canadian industries, the compatibility of the activities of the acquiree with the industrial, economic, and cultural policies of the federal and provincial governments concerned, the effect of the investment on Canada's competitive position in world markets, and so forth.

Therefore, particularly when considering the *market* for the business when determining fair market value, a U.S. business valuator should have regard to the foregoing, as applicable. A Canadian business valuator would also have regard thereto, because who says the market must be limited to *Canadian* purchasers? This was a critical issue in the valuation of Canadian Regional Airlines during the arbitration hearings last year between Air Canada and the Competition Bureau in Ottawa, because the voting shares of domestic airlines in Canada cannot be more than 25% foreign-owned.

Important foreign-ownership tax issues may also arise when a "Canadian-controlled private corporation" ("CCPC") loses its status because it becomes foreign-controlled. In such circumstances, it can lose (a) the benefit of lower income tax rates otherwise enjoyed on business profits and (b) the potential of recovering "refundable dividend taxes" paid. In this latter respect, Canada imposes full tax rates on investment income (other than on dividends, which are taxed at a special, lower, flat rate), a portion of which tax is a permanent tax cost to the CCPC, the other portion being refundable only if and when the CCPC, in turn, pays taxable dividends to its shareholders. A CCPC might have large amounts of refundable dividend tax accumulated, awaiting a propitious time to pay dividends thus triggering the tax refund. Hence, if control of the CCPC is acquired by a U.S. buyer, any refundable tax balance is lost. As with the foreign-control issue outlined earlier, the valuator must consider this tax consequence when the most likely buyer in the marketplace is a non-Canadian.

2. ENVIRONMENTAL RISKS

A purchaser may face two types of environmental liability: One as the result of the condition of the acquired facilities as of the date of the acquisition, the other relating to the ongoing operations of the facility.

As with income tax warranties — typical in any share purchase agreement — environmental-risk exposure to a purchaser is generally covered through representations and warranties from the vendor. Often, an environmental assessment will be performed by environmental engineers or

scientists prior to closing. Routine environmental assessment is critical to any corporate compliance program. A routine audit will, at least as a minimum, identify problems such as spillage, discharges, and emissions.

Because of potential non-compliance with environmental laws, a purchaser of a business (mainly manufacturing or processing) may be exposed to charges that it violated environmental laws in the past and is violating them currently. In cases where there is no violation of environmental law (because, say, the air or water emissions are not significant and may be in compliance with the relevant environmental law), they may nonetheless be leading toward an environmental liability. (For example, claims in respect of toxic and chemical exposure are becoming more popular and are being asserted through new and novel theories such as medical monitoring.[2] It is therefore essential for the purchaser to be aware of tort and regulatory implications with respect to the acquiree's business strategies.)

In an asset transaction as opposed to a share transaction, the purchaser may have the obligation of performing a clean-up of the property being acquired — even the neighboring properties that may have the potential of being adversely affected. On the other hand, in a share (versus assets) transaction, the purchaser might be held liable for past spillages and/or discharges which may have contaminated adjacent properties. While, in practice, these types of exposure are dealt with by representations and warranties provided by the vendor, it is not unusual for environmental issues to affect the price paid in a transaction. If environmental risk does exist, it is often difficult for the buyer to obtain an indemnity from the seller, because the latter would have no desire to pay for a third party's carrying out of remediation, because:

- Even though the seller would have sold the acquiree, there would still be an outstanding "long-term" liability; and
- If the seller were to be liable for a future contingent liability, it would certainly wish to have control over the business operations and certainly over the remediation process.

Real-world buyers and sellers often negotiate between themselves a price that would be fair to the buyer, considering that the task and responsibility of complying with the environmental law requirements will be with the new owner.

For example, a more recent statute enacted in the U.S. is the *Endangered Species Act*, which may come into play where there are wetlands, in the case of a commercial business.

3. FRAUD ALLEGATIONS

In some cases there possibly might be potential criminal allegations against the company for past fraudulent practices, and if ultimately such types of allegations are warranted, they may expose the business to loss of reputation and goodwill as well as to other financial loss. While the valuator needs not be a sleuth, due diligence would suggest that certain of the company's files, including correspondence and claims from third parties, might be reviewed and discussed with management and/or counsel.

The valuator might also discreetly inquire as to whether any of the senior management personnel or directors of the company have been involved in major civil litigation, criminal proceedings, regulatory commission violations, or investigated by Securities Commissions or income tax authorities.

4. POTENTIAL TAX LIABILITIES

Probably the most common warranties given by the vendor of shares in an open-market transaction relate to taxation. The tax authorities might perform a field audit (income tax, sales tax, Goods and Services Tax in Canada, etc.) a few years following the transaction and reassess the company for taxes relating to the taxation years preceding the transaction. Typically, purchase and sale agreements address this issue. Tax evasion[3] is another story, however.

In Canada, for example, a worst-case scenario would be when the declared net income had been suppressed through a tax-evasion scheme. In such event, the company would face significant interest and penalties, neither of which would be tax-deductible. For example, assuming $400,000 of undeclared income, there would be taxes, interest, and penalties, in aggregate, of at least $600,000, i.e., 150% of the undeclared income, as follows:

Federal income tax	$132,000
Provincial income tax	72,000
Penalties (civil) — federal and provincial	102,000
Interest thereon — say	162,000
Fine imposed for tax evasion (equal to federal income tax evaded)	132,000
TAXES, INTEREST, AND PENALTIES ON $400,000 OF UNDECLARED INCOME	$600,000

Technically, under the *Income Tax Act*[4], the fine could amount to 200% (rather than the $132,000 above, which equals "only" 100% of the federal tax evaded). Actions taken by Canada Customs and Revenue Agency ("CCRA") are not limited to income tax evasion. CCRA will also attack fraud perpetrated by "entitlement fraudsters", in the case of Canadian and provincial government incentive grants, loans, and subsidies. The business valuator should make reasonable inquiry when the company's balance sheet (or a note thereto) refers to such types of government funding.

In Canada, potential liabilities can even result from how the deal is structured. Quite apart from the typical "assets vs. shares" valuation and pricing issues, in an asset purchase, the federal Goods and Services Tax would be imposed.[5] Provincial retail sales taxes may also become exigible on the sale of tangible personal property or goods (the tax being payable where the properties or goods are located).[6] Canadian land and buildings transferred in an asset sale would subject the purchaser to land transfer tax.

These latter types of taxes are quantifiable and, while not appearing on the financial statements, are matters to be considered by the valuator.

5. POTENTIAL LOSS OF CUSTOMERS, SUPPLIERS, AND KEY EMPLOYEES

The potential risk of losing valuable customers, clients, suppliers, key employees and/or other intangible assets, including relationships, must also be considered. Many valuators have seen instances in which a business was acquired, and shortly thereafter, a major customer was lost. In many of these cases, there had been frequent exchanges of correspondence between the company and its customer(s) prior to the transaction date. While the "writing was on the wall", disclosure was never made to the purchaser — or to the valuator — with lawsuits resulting because of lack of disclosure.

A review should also be made of key supplier, employee and banking relationships as to continuity, reliability, and harmony. Will these possibly be adversely affected following acquisition? Also, if there is a reorganization or "shake-up", and a key or senior employee is being moved from his or her position (or asked to leave the company), might the company face exposure to a potential wrongful-dismissal suit? What if a key employee also owns shares of the company? Will the company also face the risk of an oppression-remedy lawsuit under the relevant business corporations act?[7] In some cases the lawsuit can be double-barreled: alleged wrongful dismissal as well as shareholder oppression.

6. OTHER RISKS AND POTENTIAL LIABILITIES

In addition to the foregoing types of risks and potential liabilities, there are host of other risks that could give rise to liabilities or exposure which would generally not raise a "red flag" resulting from a review of the financial statements. The following is a list of some additional areas that may require review by the business valuator in addressing issues that may impact "price" and, hence, value:

(a) *Warranties and guarantees*

- The Canadian Institute of Chartered Accountants official *Handbook*[8] recognizes that there are certain unlikely contingent losses which, if confirmed, would have a significant adverse effect on the financial position of an enterprise, and suggests that such unlikely contingent losses, which might include guarantees on behalf of others, be disclosed.
- Are there possible loan guarantees with respect to which the company being valued may be called upon to honor?
- A manufacturer that warrants its products or services has an obligation to cover the costs of providing the warranty work for units that have been sold. Where an acquisition has taken place, customers expect the acquiror to stand behind these warranties. To the extent possible, a value estimate should be made as to the contingent liability with respect thereto. (On the other hand, if the financial statements of the acquiree include a warranty reserve liability, which is deducted from the purchase price, no valuation may be necessary).[9]
- With respect to guarantees (where the business was not the borrower but rather a guarantor), was an analysis made as to the likelihood of the company being called upon in future to make good?

(b) *Foreign exchange risk*

- Does the business operate, purchase and/or sell internationally? If so, does it protect itself with currency futures, and for what future term? An import or export business' bottom line can be materially affects. Are foreign exchange gains and losses dealt with appropriately in the valuation?

(c) *Currency risk*

- Is there a risk of the notional purchaser not being able to repatriate funds from the country(ies) in which certain of the subject's businesses are being conducted? And if the funds can come out, what are the withholding taxes? Are they creditable against the recipient's taxes? Is there tax-treaty protection?

(d) *Oppression remedy risk*

- Are there shareholders (or even creditors) who may have reason to file an application under the oppression-remedy provisions of the relevant corporate statute? In many jurisdictions, winding-up — rather than a buy-back of the minority shares — is what is sought.

(e) *Patent, copyright, trademark and trade name infringement risk*

- Are there possible intellectual property infringement claims that might be filed by another party? In Canadian copyright and trademark cases, for example, the owner is entitled to both the damages it actually suffered as well as the infringer's gains (to the extent the latter do not duplicate those included in the recovery of lost profits).[10]
- Due diligence should be exercised in connection with potential allegations by third parties with respect to copyright, trademark, trade-name, and patent infringement, and unfair competition.

(f) *Risk of non-renewal of licenses and permits*

- Are licenses or permits close to their expiration dates? Can they be readily renewed? At what cost?

(g) *Risk of losing distributorship agreement(s)*

- A thorough inquiry should be made with respect to the status of such agreements. Is there a risk of cancellation?

(h) *Political risk* (where a change in government may materially affect the acquiree).

(i) *Penalty clauses in existing contracts*

- The valuator might inquire as to whether the company been "delivering" as promised (or pursuant to agreements)?
- Are there potential penalties, damages, or adverse, long-term effects from poor deliveries?

(j) *Supplier risk*

- To what extent does the company rely upon one or two major suppliers, in that the failure of them to deliver product may expose the company to liability to its own customers by non-delivery? Are there long-term contracts in place? Are these suppliers stable? If there is a unionized workforce, do they have good working relationships with the union?

(k) *Weather risk*

- In certain industries, weather may have a bearing on the fortunes of the business. Such industries include, in particular, ski resorts, transportation, fruits and wheat crops, etc.[11] Adverse effects to the business from weather conditions can potentially cause a company to default on certain of its borrowing covenants, thereby subjecting it to future adverse risks and liabilities. How are these addressed by the valuator?

(l) *Pension liabilities*

- Does the company have any unfunded pension obligations? In this connection, actuarial evidence that there is adequate provision in this regard should be obtained by the business valuator, unless the audited financial statements provide adequate comfort.

- If the seller's plan is not properly funded, the buyer may be liable to fund it. The liability to the buyer could be extensive, because it is calculated on per-employee per-year basis.

(m) *Expropriation (eminent domain)*

- For many businesses, location is critical. Is there the possibility/probability of an expropriation of the property on which the target is conducting its business? Can a justifiable alternative location be found? What about zoning issues? Recently, the City of Windsor, Ontario, expropriated an entire city block of prime property, fronting on the Detroit River, to make way for the new Daimler Chrysler building. Some of the businesses affected had to move to comparatively disadvantageous locations.

(n) *Litigation*

- Management representations are typically obtained as to whether lawsuits or other claims have been filed against the company and, if so, the status thereof. To the extent that there are lawsuits, but the company has filed a counterclaim against the plaintiff, the net effect on the financial position of the company

should be evaluated to the extent possible. Where proceedings have already been instituted or commenced, it is unlikely that the buyer would want to inherit the attendant problems and exposure. (In the open market, if the possible exposure is material, the transaction may be structured in a particular way, subject to the relevant legal constraints.)

- Even if the company itself, is not involved in any significant litigation or threatened by pending or unsettled claims, it is possible that the industry as a whole may be facing legal problems or potential litigation.
- There may be potential antitrust problems; is a possible review by the Canadian Competition Bureau or the U.S. Justice Department imminent?
- Litigation resulting from product liability is not infrequent, and unfortunately does not surface until generally after the acquisition has been completed.
- While there is no precise mathematical formula for evaluating litigious claims that remain with the company, the following factors may be relevant in attempting to assess the risk inherent in such proceedings when valuing the shares:
    - The availability, as well as the credibility and ability (both actual and perceived), of fact witnesses and expert witnesses who may be called by the parties;
    - The controllable and uncontrollable costs of the proceedings (including motions and trial), to both the defendant and the plaintiff, including legal fees, expert fees, witness fees, court costs, etc.;
    - The possibility/probability of appeal by either party;
    - Interest rates — both market and pre-judgment — which may be applicable;
    - The length of time for the trial and subsequent appeals;
    - Settlement prospects;
    - Prospect of arbitration or mediation;
    - Extent and quality of documentary evidence available to the respective parties, etc.

(o) *Contractual obligations*

- The valuator should be apprised of the following, as applicable:

  - Commitments that involve a high degree of speculative risk, where the taking of such risks is not inherent in the nature of the subject's business;
  - Commitments to make expenditures that are abnormal in relation to the financial position or usual business operations, e.g., commitments for substantial fixed-asset expenditures;
  - Commitments to issue shares and/or options and warrants;
  - Commitments that will govern the level of a certain type of expenditure for a considerable period into the future.

(p) *Government loans and grants*

- The company may have received government assistance in the form of loans, grants, subvention payments and/or other help. There may be requirements under the terms of such assistance arrangements whereby the company must, under certain specified conditions, repay all or a portion of these funds. The valuator should attempt to assess the likelihood of these liabilities becoming exigible, and quantify them to the extent possible.

(q) *Technology risks*

- A conference in the United States presented by the Business Litigation and Insurance Law Committees of the Defense Research Institute12 introduced its subject matter by stating that increasing investment in, and reliance on, information technology is creating entire new areas of litigation for which businesses must be prepared. System hardware and software claims, security breaches, the pervasiveness of the Internet, and burgeoning intellectual property claims are the rapid growth areas in litigation. Major insurance underwriters are developing innovative products to cover new and expanding technology risks. How has the valuator considered this, if applicable?
- The business valuator should attempt to identify potential risks and exposure that the business may be facing in connection with possible infringement claims.

(r) *Other*

- Unrecorded liabilities may also include vacation pay, sales returns, (volume and cash) allowances and discounts, loss contracts, etc. Future government legislative changes are also a risk assumed by the purchaser; however, there is no way to evaluate such a potential "liability".
- If there is a collective agreement with employees, this should be analyzed by the purchaser's valuator.
- Are there potential rebates and allowances of a material nature that may be triggered following acquisition? Has provision been made in the financial statements (or other disclosures) of the business? Depending on the particular status as of the relevant date, it may be possible to quantify this liability for valuation purposes.

7. CONCLUSION

In a section on contingencies entitled "Measurement of Uncertainty", the Canadian Institute of Chartered Accountants *Handbook* refers to the uncertainty relating to the occurrence or non-occurrence of a future event which would determine the outcome of a contingency. The CICA states that this can be expressed by a range of probabilities, which provide a basis for establishing the appropriate accounting treatment. In this regard, the business valuator might wish to analyze future contingencies in the context of three areas of a range of probabilities, by a general description as follows:[13]

(a) "Likely" — the chance of the occurrence (or non-occurrence) of the future event(s) is high;

(b) "Unlikely" — the chance of the occurrence (or non-occurrence) of the future event(s) is slight;

(c) "Not determinable" — the chance of the occurrence (or non-occurrence) of the future event(s) is cannot be determined.

In real-world acquisitions, adjustments are made to the purchase price in connection with one or more of the above-noted contingencies, which are but an example of the types of issues that may impact price/value.

Having performed the analysis, the valuator should then ask himself or herself: "Would *I* advise a client to buy for that price??"

"He is no wise man that will quit a certainty for an uncertainty."

Samuel Johnson

Endnotes

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(1) Since the enactment of the *Investment Canada Act* (1985), only one investment by a non-resident of Canada has been rejected under this process.

(2) For example, neuropsychiatric and neuropsychological claims, epidemiology and toxicology, child and adolescent development and toxic exposure, toxic shock, etc.

(3) Richard M. Wise, "Tax Fraud and *Mens Rea* Forensic Accounting", *Proceedings of the Sixth Annual Fraud Conference*, Association of Certified Fraud Examiners (Montreal: 2000).

(4) Paragraph 239(1)(f).

(5) Section 165 of the Canadian *Excise Tax Act*, RSC 1985, c. E-15.

(6) Certain exemptions from provincial retail sales tax are available with respect to inventories, real property and other assets, depending on the province.

(7) For example, in Canada it would be under section 241 of the *Canada Business Corporations Act*.

(8) Section 3290.17. The *Handbook* contains the accounting and auditing standards of the CICA as well as related recommendations to its members.

(9) If the acquiree would be reimbursed by the manufacturer for any portion of the parts and labor, this would be taken into account.

(10) For a discussion involving damages resulting from intellectual-property infringement, see *Valuing Intellectual Property and Calculating Infringement Damages*, Consulting Services Practice Aid 99-2, American Institute of Certified Public Accountants (1999); and Richard M. Wise, "Valuation of Intellectual Property", *Making Sense of Intellectual Property*, The Meredith Memorial Lectures, McGill University Faculty of Law (Montreal, 1996).

(11) In *Arctic Gardens Ltd.* v. *CIBC*, 1993 RJQ 1086, one of the issues addressed by the Quebec Superior Court was the effect of the weather on plaintiff's business.

(12) November 2-3, 2000, Chicago, U.S.A.

(13) CICA *Handbook*, Section 3290.06. In the U.S., the Federal Accounting Standards Board had also addressed this issue in Statements 5 and 11.

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