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TORONTO, FEBRUARY 24, 25 AND 26, 2004

5TH ANNUAL M&A VALUATION FOR CFOs

"VALUING HIDDEN LIABILITIES"

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presented by

©Richard M. Wise, FCA, CA•IFA, FCBV, ASA, MCBA
CHARTERED BUSINESS VALUATOR

of

Wise, Blackman
Business Valuators • Forensic Accountants
Montreal, Quebec

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While a business may have many off-balance-sheet *assets* — perhaps in the form of intellectual property, valuable dies and moulds, litigious claims, etc. — there may also be a number of off-balance-sheet *liabilities*, whether contingent, actual or "latent". The due-diligence process, properly conducted by the purchaser in a proposed merger or acquisition, should uncover such exposure.

As the term "fair market value" assumes informed and prudent parties, it is a fundamental assumption that the purchaser be apprised of all relevant information relating to the acquiree. This would include information regarding the assets, business prospects and future potential as well as all of the risks and liabilities that will be assumed as part of the transaction. The due-diligence process will raise various issues and should identify concerns and potential liabilities that would not otherwise appear on the target's financial statements or be otherwise obvious.

As an earlier panellist noted, chief financial officers have their fingers on the pulse of finance, accounting, negotiations and business analysis and play a key role in evaluating the risks, not only of integrating one business into another, but what the acquiror may be inheriting. Working with business valuation consultants and other analysts as well as legal counsel, "skeletons in the closet" can often be located before the deal is consummated. Issues involving hidden and/or potential liabilities can normally be resolved; if not, the deal might have to be aborted.

This paper proposes to identify potential risks and possible hidden or latent liabilities, many of which, unfortunately, are the types which are discovered only *after* the deal is consummated if the due-diligence review is not carefully planned. Also, depending on the type of industry in which the business operates, there may be some specific exposures and potential liabilities that are characteristically common across the board.

While many potential, latent and and/or hidden risks and related liabilities cannot be meaningfully quantified, the following areas must nonetheless be addressed by the purchaser and its financial and legal advisors. Adjustments to the transaction price may address certain concerns; price-adjustment clauses may be appropriate; and specific forms of structuring the deal may be yet another way for the purchaser to protect itself from hidden liabilities.

1. HIDDEN 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 that relates to the ongoing operations of the facility.

As with income tax warranties, which are typical in any share purchase, environmental-risk exposure to a purchaser is generally covered through representations and warranties given by the vendor. Often, an environmental assessment will be performed by environmental engineers/ scientists prior to closing.

Routine environmental assessment is critical to any corporate compliance program. A routine audit will help avoid problems before they begin; in other cases they can, as a minimum, identify smaller problems such as spillage, discharges, etc., before they become major problems. For example, routine auditing can help companies to:

- reaffirm with all levels of management and employees the value of seeking to improve compliance and pollution-prevention efforts;
- integrate the management of the various environmental media;
- prioritize compliance concerns;
- budget for environmental problems;
- generate protocols and checklists which help facilities better manage themselves;
- provide a forum for lower for lower-level employees to report any information concerning violations;
- focus facility managers’ attention on current and upcoming regulatory requirements;

- ensure that requirements are met for mandatory disclosure and reporting; and
- anticipate and respond to emergency situations.[1]

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 law in the past and is violating them currently. In cases where there is not a 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 to perform a clean-up of the property being acquired as well as neighbouring properties which have the potential of being adversely affected. In a share (versus assets) transaction, the purchaser might be held liable for past spillages and/or discharges which may have contaminated adjacent properties. Again, in practise, these types of exposure are dealt with by representations and warranties provided by the vendor. Even then, the purchaser should ensure, to the extent possible, that the vendor will, if called upon, be able to honour its obligations.

It is not unusual for environmental issues to materially affect the price paid in a transaction. If environmental risk does exist, it is difficult for the purchaser to obtain an indemnity from the vendor because the latter would not wish to pay for a third party's carrying out of remediation, because:

- Even though the vendor would have sold the acquiree, there would still be an outstanding "long-term" liability; and
- If the vendor 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.

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(1) See T.J. Kelly Jr., "Liabilities and Enforcement", chapter in *Environmental Law Handbook* (13th Edition), Government Institutes, Inc. (Rockville, Maryland: 1995), page 510.

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

Accordingly, to avoid these and similar types of issues, an environmental audit should be performed and the purchaser and vendor should negotiate between themselves a price that would be fair to the purchaser, considering that the purchaser will have the task and responsibility of complying with the environmental law requirements.

The number and size of potential penalties and adverse consequences continue to increase, as do the government resources for identifying violators and punishing them. Therefore, it has become increasingly important for those who advise corporations on environmental matters to (a) fully understand the range and potential combinations of liabilities that companies (and individuals) may face; (b) anticipate the numerous sources of potential enforcement action and involve as many of them as possible in the process of resolving matters; and (c) develop and implement a corporate compliance program for preventing/minimizing liabilities to the extent possible, keeping in mind that enforcement officials may have free access to self-evaluative materials.[3]

The publication, *Environmental Crimes*[4], describes how to avoid creating liabilities and minimizing liabilities once an investigation may have begun.

2. FRAUD

It is particularly difficult to determine whether there may be, lurking, potential criminal allegations against the acquiree for alleged fraudulent practices. If there are, and if such types of allegations are warranted, they may expose the company to loss of goodwill and reputation as well as to financial loss. Enquiry should be made concerning senior employees who had left the company within the two or three years preceding the date of the proposed transaction. Files including correspondence and claims from third parties should be reviewed.

Also, depending on the nature of the business, there possibly have been one or more the following:

- bribes;
- kickbacks;
- deceptive advertising;
- falsification of customs invoices;
- submission of misleading applications for lines of credit, government grants and subsidies;

(3) *Supra,* footnote 1, *op.cit.*, page 512.

(4) C. Harris, R.C. Marshall and P.O. Cavanaugh, *Environmental Crimes* (Shepard's 1994), Chapter 10.

- conspiracy regarding employment insurance; etc.?

Enquiry should be made as to whether any of the company’s senior management personnel or directors have been involved in major civil litigation, criminal proceedings, regulatory commission violations, Securities Commission or income tax investigations[5]

3. POTENTIAL TAX LIABILITIES

As noted earlier, probably the most typical warranties given by the vendor relate to taxation. Canada Revenue Agency (“CRA”) might perform a tax audit (income tax, goods and services tax, etc.) a few years after the transactions and reassess the company for taxes that related to taxation years prior to the transaction.

A worst-case scenario is when the net income on the company’s previous financial statements was suppressed fraudulently (through tax evasion). In such event, the company could face significant interest and penalties. (Neither the penalties nor the interest would be tax deductible.) For example, assuming that there was $200,000 of undeclared income, taxes, interest and penalties, in aggregate, could well exceed $300,000 as shown below:

Federal income tax	$ 66,000
Provincial income tax	36,000
Penalties (civil) — federal and provincial	51,000
Interest thereon — say	81,000
Fine imposed for tax evasion (equals federal income tax evaded)	66,000
TOTAL TAXES, INTEREST AND PENALTIES	$300,000

Technically, under paragraph 239(1)(f) of the *Income Tax Act*, the fine could be up to 200% (rather than the $66,000 above which equals the federal tax evaded). Actions taken by CRA are not limited to income tax evasion. CRA will also attack fraud perpetrated by “entitlement fraudsters”, including government incentive-grant fraud (such as that alleged by the RCMP to have been committed by some executives of Cinar[6]).

(5) See Section 3., *infra*.

(6) According to the *Financial Post* (of the *National Post*), April 15, 2000, such information was obtained after the RCMP and the Sûreté du Québec raided the offices of the Société de développement des entreprises culturelle.

Needless to say, in most cases exposure to income tax reassessments does not arise solely because of tax fraud or tax evasion; rather, there may be legitimate disagreements as to deductibility, classification of assets for capital cost allowance purposes, timing of recognition of income and/or expense, whether an item should be capitalized rather than expensed, transfer-pricing issues, valuation issues in non-arm's length transactions, reasonableness of certain expenses, allocation of price among assets acquired or sold, etc. As there can be — and most often there are — genuine, good-faith differences between the taxpayer and CRA, there still remains a risk that the acquiree can be reassessed. Should a matter be contested, there may be substantial costs incurred in defending a reassessment before the Tax Court of Canada and in possible subsequent appeals.

In another area, potential liabilities may result from how the deal is structured. For example, in an asset purchase rather than a share purchase, goods and services tax would be imposed under Section 165 of the *Excise Tax Act*[7]. In circumstances where a supplier (whether or not a registrant) has made a supply of a business or part of a business that was established or carried on by the supplier to a recipient which is requiring ownership, possession or use of all or substantially all of the property necessary to carry on the business or part of a business as a business, there may be relief from the GST.

Retail sales taxes may also become exigible on the sale of tangible personal property or goods, the tax being payable where the property (or goods) is/are located. Certain exemptions from the retail sales tax are available with respect to inventories, real property and other assets, depending on the province.

Finally, 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, of course, appearing on the financial statements, are matters that must be addressed in evaluating and assessing the financial aspects of the deal.

4. POTENTIAL FUTURE LOSS OF CUSTOMERS OR CLIENTS, SUPPLIERS, KEY EMPLOYEES

The potential risk of losing valuable customers, suppliers, key employees and/or other intangible assets must be carefully assessed. There have been a number of instances in which a business was acquired, and shortly thereafter, a major customer was lost. In some of these cases, there had been frequent exchanges of correspondence between the company and the customer prior to the transaction date (perhaps several months' correspondence). While the writing was on the

(7) RSC 1985, c. E-15.

wall, disclosure was never made by the acquiree to the purchaser and hence lawsuits ensued with respect to lack of full disclosure.

The due-diligence process must also include a review of supplier relationships with respect to continuity, reliability and harmony. Key employees whose services may be lost for whatever reason must be considered in assessing risk. From another perspective, if there are conflicts, and a key employee is being "squeezed out" of his or her position (or even out of the company), does the company face exposure to a potential wrongful-dismissal suit?

In certain cases, a key employee may also own shares of the company. Might the company also face the risk of a shareholder-seeking an oppression remedy under the relevant business corporations act?[8] In some of these cases, the lawsuit is a double-barrelled one: the company may face simultaneous lawsuits for both alleged wrongful dismissal and shareholder oppression.

5. TECHNOLOGY RISKS

A conference in the United States presented by the Business Litigation and Insurance Law Committees of the Defense Research Institute[9] introduced its subject matter by stating that increasing investment in, and reliance on, information technology is creating entirely 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.

The due-diligence process should attempt to identify, with respect to the acquiree, potential risks and exposure that the target may be facing in connection with an infringement claim.

6. OTHER RISKS AND POTENTIAL LIABILITIES

In addition to the types of risks noted above and the potential liabilities resulting therefrom, there are host of other risks that could give rise to liabilities which would generally never be obvious from a review of the acquiree's financial statements. The following is a list of some of the areas that may require enquiry and investigation during the due-diligence process:

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(8) For example, under section 241 of the *Canada Business Corporations Act*.

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

(a) Product liability

- Imagine if Firestone Tire were acquired, say, two years ago — well before the much-publicized recall. Even with appropriate due diligence, how would the potential liabilities be quantified? How would be it quantified today?
- Litigation resulting from product liability is not infrequent, and unfortunately does not surface until generally after the acquisition has been completed.

(b) Warranties and guarantees

- The Canadian Institute of Chartered Accountants *Handbook*[10] notes that there are certain unlikely contingent losses which, if confirmed, would have a significant adverse effect on the financial position of an enterprise, and it is desirable for such unlikely contingent losses, which might include guarantees on behalf of others, to be disclosed.
- Are there possible loan guarantees with respect to which the company may be called upon to honour?
- A manufacturer that warrants its products or services has an obligation to cover the costs of providing the warranty work for units which have been sold. Where an acquisition has taken place, customers or clients 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 (if, on the other hand, the financial statements of the acquiree include a warranty reserve liability which is deducted from the purchase price, no valuation may be necessary).[11] With respect to guarantees, these might arise where the business was not the borrower but rather a guarantor — in which case there should be an analysis or investigation as to the likelihood of the acquiree being called upon in future to make good.

(c) Foreign exchange risk

- Does the company operate, purchase and/or sell internationally? If so, does it protect itself with currency futures, and for what future term?

(d) Currency risk

- Is there a risk of the purchaser not being able to repatriate funds from the country(ies) in which certain of its businesses are being conducted?

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(10) Paragraph 3290.17.

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

(e) Oppression remedy risk

- Are there shareholders, or even creditors, who may be, or have reason to take steps in filing claims under the oppression remedy provisions of the relevant corporate statute?[12]

(f) Patent, copyright, trademark and trade name infringement risk

- Are there possible intellectual property infringement claims that may be made by another party? In 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 are not duplicative of those included in the recovery of lost profits).[13]
- Due diligence should be exercised in connection with potential allegations by third parties with respect to copyright infringement, trademark infringement, trade-name infringement, patent infringement, and unfair competition. The chief financial officer of the purchaser might consider obtaining insurance coverage for risks and exposures associated with intellectual property, (regardless of whether the target is considered "old economy" or "new economy").

(g) 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?

(h) Risk of losing distributorship agreement(s)

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

(i) Risk of losing customers/clients (retention factor)

- Correspondence with customers/clients should be reviewed. Are there complaints? If so, what is the nature thereof?

(j) Political risk (where a change in government may cause hardship to the acquiree)

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(12) For example, section 241 of the *Canada Business Corporations Act*.

(13) For a discussion involving damages resulting from intellectual-property infringement, see Richard M. Wise, "Quantification of Infringement Damages", *Protecting & Managing Intellectual Property Assets*, Federated Press (Toronto, 1997); and Wise, "Valuation of Intellectual Property", *Making Sense of Intellectual Property*, The Meredith Memorial Lectures, McGill University Faculty of Law (Montreal, 1996)

(k) Penalty clauses in existing contracts

- Has the company been “delivering” as promised (or pursuant to the agreement)?
- Are there potential penalties, damages or negative effects from poor deliveries?

(l) Supplier risks

- To what extent does the company rely upon one or two major supplies, 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? Do they have good working relationships with the unions (where there is a unionized workforce)?
- 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 acquiree? Depending on the particular status as of the relevant date, it may be possible to quantify this liability.

(m) Weather risk

- In certain industries, weather may have a bearing on the fortunes of the business. Such industries include, in particular, ski resorts, lodging, transportation, fruits and wheat crops, etc.[14] Adverse effects caused to the business by the weather can potentially cause a company to default on certain of its borrowing covenants, thereby subjecting it to adverse risks and liabilities.

(n) Pension liabilities

- The purchaser should ensure that the acquiree does not have any unfunded pension obligations. In this connection, there should be evidence from an actuary that there is adequate provision in this regard.
- If the plan is not properly funded, the purchaser may be liable to fund it adequately. The liability to the purchaser could be extensive because it is calculated on per-employee per-year basis.

(o) Expropriation

- For many businesses, location is critical. Is there the possibility 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?

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(14) In the case of *Arctic Gardens Ltd.* v. *CIBC*, 1993 RJQ 1086, one of the issues addressed by the court was the effect on plaintiff’s business of the weather.

(p) Litigation

- The chief financial officer should meet with counsel to ensure that there are no lawsuits instituted and/or pending against the acquiree. Representations should be received and, in any event, a search should be made as to whether lawsuits or other claims have been filed against the company and, if so, what the status is. On the other hand, to the extent that there are lawsuits but the acquiree has filed a counterclaim against the plaintiff, the net effect should be evaluated to the extent possible. Where proceedings have been instituted, it is unlikely that the purchaser would want to inherit the problems and exposure with respect thereto. Where the possible exposure is material, the transaction may be structured in a different way, subject to the relevant legal issues and constraints in such a case.
- Even if the acquiree, itself, is not involved in any significant litigation or threatened by pending or unsettled claims, it is possible that the industry may be facing legal problems or potential litigation.
- Moreover, there may be potential antitrust problems; perhaps a review has been commenced by the Competition Bureau.
- While there is no precise mathematical formula for evaluating the possible results of legal proceedings, the following factors impact on an assessment of the risk inherent in such proceedings:

    - The availability as well as the credibility and ability (both actual and perceived) of "fact" and "expert" witnesses who may be called by the parties at trial or in examinations for discovery;
    - The controllable and uncontrollable costs of the proceedings, to both the defendant and the plaintiff, including, *inter alia*, legal fees, expert fees, witness fees, court costs, etc.;
    - The possibility or probability of appeal by either party to the Court of Appeal (and the Supreme Court, if appropriate);
    - Interest rates, both market and pre-judgment, which may be applicable;
    - The length of the trial and subsequent appeals, if any;
    - Settlement prospects;
    - Prospect of arbitration or mediation;
    - Extent and quality of documentary evidence available to the respective parties, etc.

(q) Contractual obligations

- The chief financial officer in performing his or her due diligence *vis-à-vis* the acquiree should, in conjunction with his/her professional advisors, if appropriate, look for the following:

  - Commitments that involve a high degree of speculative risk, where the taking of such risks is not inherent in the nature of the acquiree'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;
  - Commitments that will govern the level of a certain type of expenditure for a considerable period into the future.

(r) Government loans and grants

- The target 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 acquisition/due-diligence team should attempt to assess the likelihood of these liabilities becoming exigible, and should attempt to quantify them to the extent possible.

(s) 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. Enquiry should be made as to whether there are any complaints outstanding with, say, the Human Rights Tribunal in conducting due diligence by the purchaser.

7. CONCLUSION

Some types of hidden liabilities (or even liabilities that are referred to on the financial statements (perhaps by way of a note) but which have not been quantified), may be reasonably estimated, such as vacation pay or unfunded pension liabilities. The types of liabilities which may be impossible to quantify would most typically relate to litigation and other possible claims. For example, even if it is known that there is a litigious claim against the target, it is virtually impossible to value such a liability with an precision.

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, a chief financial officer reviewing various aspects of a proposed acquisition might wish to analyze future contingencies in the context of three areas of a range of probabilities, by a general description as follows:[15]

(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.

The CFO and/or financial advisor, in assessing the potential risks and related liabilities, must consider all information available as of the date of the due-diligence review, taking into account any experience gained from similar transactions in the past (whether personally involved or experienced by others).

An excellent commentary on potential risks and liabilities from the purchaser's perspective is contained in a paper presented at a conference in 1993 by Warren Grover.[16]

Where the chief financial officer and his or her team believes that there may be a high degree of hidden liabilities, a recommendation can be made to the purchaser's board of directors that a holdback or escrow arrangement can be made whereby a portion of the purchase price can be

(15) CICA *Handbook*, Section 3290.06.

(16) Warren Grover, "Purchaser Liabilities: Avoid Being Stuck With the Bill", Mergers & Acquisitions — The Boom Returns, Insight Information Inc. (Toronto: November 9, 1993), page 161.

held back in an escrow account for a specified period of time following closing. While counsel for each of the parties will negotiate the terms under which the escrow agent may release any or all of the funds to the vendor, the background facts and nature of the risk and different scenarios will be assessed by the CFO and his or her team.

The CFO and others involved in the due-diligence process must be clear about their roles and responsibilities as well as the possible ramifications if the process fails. The results and conclusions drawn by the CFO, his or her colleagues and professionals with the common goal of investigating, evaluating and ultimately recommending a course of action, or offering an opinion, will impact the purchase price and the negotiation strategy.

Even if there are adjustments made to the purchase price in connection with one or more of the above-noted contingencies, the purchaser must be satisfied that there is no risk in collecting from the vendor. This may therefore involve not only attempting to evaluate the potential liability, but also the related "contingent receivable" triggered by the vendor's covenant(s). The purchaser must enter into a transaction with both eyes wide open and permit the CFO to undertake an exhaustive due-diligence process.