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Capitalizing on the Success of Entrepreneurship: IPOS, Private Sales, Tax Aspects, Residual Interest of Entrepreneurs after Sales of IPOS - Discussion Following the Remarks of Anthony Penhale and Elizabeth Dellinger

Discussion

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want to look long and hard. At least in this, in Canada, it disappears at least when the authorities look at it.

MS. DELLINGER: Whenever people get tax advice there are about three levels of tax advice. One is: this is absolutely consistent with the Tax Code. The second category is: it is a little aggressive. It is an audit risk. If you get audited, it could be challenged. It could be restructured, and X, Y, Z could happen, which would not be quite as favorable as what we are hoping.

The third category is what I call tax fraud. You simply can't justifiably take that position and file your return, but if you are caught, you are in big trouble. I think that sort of comes under the tax plans.

MR. PENHALE: You have nuances like will, should, could. You have got a filing position but no chance in hell to succeed. Best aspect is to ask the tax advisor for the glossary and what they mean in their opinion.

MS. DELLINGER: Those are all really sort of semi-prepared remarks. I would like to open it up for questions.

MR. PENHALE: Just before you do so, I would just draw one comment on going public. Don't forget, at least in Canada, you are going to become liable for what's in the prospectus, and much like in the U.S., also, we have secondary market liability.⁴⁶ So whenever you add a sentence in the public disclosure document that you thought was great when you put it in the confidential memorandum and you are trying to put your company in the best light possible, they don't have to even show they read it, that they relied on it.

It is in the book and they relied on it, then you are liable if it is a misrepresentation. It is a long, hard exercise before you start going public, or once you are public, pay attention to what you are saying because it may be wrong, and if it is wrong, it may cost you.

PROFESSOR GORDON: I would like to open it up for questions.

MR. PENHALE: Yes.

DISCUSSION FOLLOWING THE REMARKS OF ANTHONY PENHALE AND ELIZABETH DELLINGER

MR. GROETZINGER: What's your thought on earn out clauses if a seller has a business and neither party can agree on the current fee price and agree on some downstream multiple of earnings? What would you recommend?

MS. DELLINGER: I think they are great. I think that if you have a company and you have a willing buyer and seller but can't just get together on price and earn out a wonderful way to bridge that gap and align the two interests, that being said, there are a couple of nuances.

⁴⁶ Gloria Gonzalez, *Quebec Latest Province to Mull Corporate Disclosure Law*, 41 BUS. INS. 31, July 30, 2007, at 4.

One, they always are and they should be heavily negotiated because you really got – they are tying to the performance of the company, and you really need to tie down what everybody needs. For example, the line of business is sold, and if a business is bought into the company, how does that impact you? What do we really mean by net operating income? And really drill down and have a lot of detail in what that means, whether it is on a schedule, a separate document, purchase agreement, wherever, but get a real clear understanding of what's intended.

Second, they frequently litigate. Of all the things that get litigated in a purchase agreement, earn-outs and working capital adjustments are probably the two biggest ones, so you have to be prepared for that. Have more clarity upfront.

Litigation usually happens not because someone lied but because somebody didn't have the advice. So the more work done upfront, the better. You don't see it all the time, but I tend to be a fan if you have a good deal as having purchase price issues.

MR. PENHALE: I think you can bridge that issue, and just to reinforce Betsy's point, those I have been involved in two lines of agreement, by the time all the advisors were through nobody understood it, and it was two or three pages, and then we show the end result. And they told us that just doesn't work so implementing them, making sure they are going to get the results you want and making sure if you don't get what you want you can't actually have a leg to stand on to demonstrate what it was you thought you were going to get. That's not as simple as saying why don't I just bridge that value gap.

MS. DELLINGER: I have had several occasions where we started negotiating the earn-out net drives, and that's so painful for the party on the purchase price.

DR. BARBER: I realize in your presentation you were expected to talk about capitalizing on results of IPOs and private sales and things like that and the impacts of tax and so on. But I thought you might comment as well on a successful company paying dividends. That's another way of capitalizing on success.

MR. PENHALE: Yeah. I touched on income trust earlier on, and this filled a need in Canada for high dividend paying corporations. In fact, that's what they were. I don't remember the exact statistics, but with the Canadian companies that are listed in the TSX, a staggeringly low percentage pay any kind of real dividend.⁴⁷

I mean, they pay a dividend perhaps banks and telecoms, but anything in excess of five percent, I think I would be impressed to find one more

⁴⁷ See *Definition of Terms*, GLOBE & MAIL: REP. ON BUS., June 29, 2007 ("Recently, the average dividend yield of companies in the S&P/TSX Equity Index was about 1.67%.")

depending on time of year. So as a venue for an investor, at least in the Canadian market, you are not going to get any real dividend. You may have some private shares but, ultimately, not the type that one would look to get the return on that income trust in Canada, which were paying anywhere, the best company seven percent. They were not so great at 18 percent.

They were great investments from that perspective, but we don't have the equivalent. We thought when the government announced they were going to tax these corporate entities now, we thought that one of the things that would happen, in fact, would be that they become great targets for U.S. private equity to buy them and spin them out in a couple of years in the U.S. market as a high dividend paying stock.

DR. BARBER: But that's normally after you have done an IPO.

MR. PENHALE: You could.

DR. BARBER: And I am saying, I know private companies that paid out a big lump dividend.

MR. PENHALE: You could accomplish that with your cash on hand on your profit or using a lead account, increasing level of debt and using the debt to do that.

MS. DELLINGER: I was going to say I had two or three categories; one company experienced growth. It is not looking to reinvest tons of money because it is very stable and a very comfortable business.

The money just flows out and sort of not well known because it is a privately held company, but the family, everybody is driving better cars. Everybody is wearing nicer clothes, and oftentimes one of the relatives is doing the payroll. It is a great way for an entrepreneur to amass personal wealth, and you can do that, and you still would have the business.

It is sort of like selling the business twice. It is sort of like a recap without the recap in some respects. You bring a lot of value out of the company. A recap is often structured with dividend, but that's really structuring technique.

One real life example of ours – and it is a public company now so if anyone wanted to backtrack, they could probably find it, that it is public, founded by a couple of guys around 1990 who grew the company, did it a number of times, sold it to an equity fund, the equity fund sold it to a new equity fund.

Every time management pulled out millions of dollars and then rolled equity back in, and they did that three times. Then this was the same company that the year 2006 did an IPO. However, three months before the IPO, the equity fund – that equity fund pulled out a \$200 million dividend.

Management's equivalent share resulted in about close to a hundred million dollars in dividend coming out for management. Then three months later they sold the IPO, and everybody pulled out a bunch more money in the IPO with the equity fund selling completely on the secondary IPO.

You know, so dividends are a good way of getting money out of the business. You make yourself a lot of money, running a lot of – not that it is permitted, but the number of expenses, business expenses – in fact, there is a lot of value channeled through that.

MR. PENHALE: On dividends and just anecdotally, I am involved where there is 50-50 shareholders, founded a company 30 years ago; in its great days had about \$600 million of revenue. Now it is about \$225. I have been involved with IPOs now for almost four years, and the purpose why I am involved is because they cannot agree on what they want to do with the business: buy it, sell it, refinance it.

It is a great business to go public with, but it is paying out between \$50 million to a hundred million dollars a year. The only reason none of them have done anything in terms of litigation, they really don't like each other, and it is amazing from my perspective this business can still generate the numbers it does when two guys who are running it supposedly because they are not really running it, they are bickering and fighting, are not involved, and you sit back and look at my counterpart on the other side and say why are we here?

Every year they pay themselves a hundred million-dollar dividend. If they weren't fighting and arguing – their managers are running it. They are just going to make plus or minus \$10 million more. Why are they arguing? Why are we here? Four years in the making, and they were paying each other dividends way before we got there. They don't talk to each other any more. They just get their check and go away.

PROFESSOR GORDON: Before we thank the panelists, I just want to mention that cocktails start at 5:30, and I guess dinner is at 6:30.

And I thank you all for today. Thank you very much, panelists.

