Business Advisor
a resource for business owners
FROM THE LAW OFFICE OF MARY HANSON

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About the BusinessAdvisor

The Business Advisor is written and published by Mary Hanson, a business attorney in Torrance, California.

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She provides legal services related to owning, operating, buying, selling, and structuring businesses. Her clients are business owners in many different industries. She handles corporations, LLCs, new businesses, new ventures, and a broad range of contracts and business decision-making.

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CHECKLIST FOR BUYING A BUSINESS

by Mary Hanson

The buyer of a business needs to proceed with great care in order to avoid overpaying for a business, purchasing a business that does not fulfill the objectives of the buyer, or ending up with unanticipated liabilities.

A buyer must have his or her plan for what he or she wants to accomplish with a business purchase, his or her own requirements for a desirable acquisition, and what he or she is willing and able to pay. After carefully crafting a purchase plan, the buyer must then negotiate acceptable purchase terms that advance the objectives of the buyer.

Most purchase transactions include similar steps and issues. Here is a checklist of some of the issues that a buyer should anticipate in the purchase of a business:

- Plan the structure of the purchase. Most buyers are best advised to avoid purchasing shares of stock. Purchase the assets of the business from the business entity rather than purchasing the entity. The buyer needs to form his or her own corporation to purchase the assets from the existing owner of the business assets.

  The buyer of a corporation takes over the whole ongoing business – not only all assets, but also all liabilities, claims, contracts, and tax circumstances. Unknown liabilities and claims that have not yet been made still belong to the corporation, and therefore to the purchaser of stock. If a tax auditor shows up after the closing and finds tax liabilities from three years ago, the new buyer will have to deal with an unpleasant and potentially costly problem.

- Identify all the assets to be included in the purchase of the business, including intangible assets. Consider customer lists, logos, the business name, telephone numbers, computer programs, copyrights, and anything else needed to operate the business. If certain equipment, property, or programs are leased from someone else or owned by one of the business partners, negotiate with the other parties to obtain all the assets needed for operation of the business.

- Hire qualified professionals to assist with the purchase planning and negotiation. A business person highly experienced in the operation of the type of business being purchased should be a key advisor in identifying good acquisitions and avoiding industry problems. An experienced CPA is needed for review of the financial condition of the business and calculation of the tax consequences of the purchase and the business structure. An experienced business attorney should be able to make sure the purchase documents advance the buyer's objectives and avoid unwanted liabilities.

- Conduct a rigorous investigation of all aspects of the business. The due diligence procedure is usually the most important step in making a good purchase.

- Review at least the past 3 years tax returns and financial statements. Obtain financial reports up to the

"A buyer's best protection from risk is a rigorous review of all aspects of the business."

most recent completed calendar month. Verify information with bank statements and other sources of information.

- Review all contracts of the business for benefits and liabilities in order to determine which contracts are needed or wanted in the purchase of the business. Make sure desired contracts are assignable. A contract that is not assignable needs the agreement of the other party to the contract.
- Check all sources of information on the business. Check the ownership of any assets that are registered or recorded. Check for liens on the property. Vehicles are registered with the Department of Motor Vehicles in California and liens on vehicles are recorded there. Real property and liens on real property are recorded with the County Recorder. Copyrights and trademarks may be federally registered with the Copyright Office and Patent and Trademark Office. Liens on personal property are recorded in the office of the Secretary of State.
- Do a credit check on the sellers (including the corporation and its shareholders if the business is incorporated). Buying a business that has a poor credit history or entering into a contract with an individual with poor credit is not recommended.
- Check public records for the status of a corporate seller and for litigation involving the selling corporation or individuals who own the corporation. Check for judgments and bankruptcies. Check state records regarding proper payment of taxes.
- Check business records and third parties for terms of contracts, employment benefits, insurance coverage, supplier information, and customer information. Review government permits and licenses, and the condition of physical assets and facilities.

A buyer purchasing just a few assets or a customer list to add to the buyer's existing business may not be concerned about the business operations. However, most business purchasers plan to continue business operations and need to know the true profitability of the business.

- Analyze the profit margins and future prospects of the goods and services provided by the business. Determine whether profit margins are being squeezed by market conditions and whether they might be increased.
- After purchase price negotiations, payment term discussions, lenders' information, interest rates, and information about the obligations of the business have been obtained, update the financial projections for the business. The purchase may be less attractive or unattractive after the details of profit margins, cash flow, debt service, and working capital requirements are more clear.
- Negotiate terms that include the involvement of the seller and key employees to encourage customers to continue to do business with the new owner. Try to negotiate a provision that reduces the purchase price if some customers do not continue to do business with the new owner.
- Determine whether any existing employees are needed for successful operation or transition of the business. If certain employees are key to the operations, get commitments from them early in the negotiation process.

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- Negotiate the appropriate level of training and consulting services to be provided by the seller.
- If employees are to be terminated as part of the sale, make clear in the purchase agreement that the seller must terminate employees prior to the closing and that the seller will be liable for unemployment benefits.
- If the selling business holds customer deposits or has out-standing gift certificates or promotions, the buyer and seller need to negotiate a workable plan to transfer the customers and their deposits to the buyer. Failure to account for prepayments means that the buyer will be providing goods and services for which the seller already received payments.
- Include a plan for collection of receivables. Whether the seller keeps the accounts receivable or the buyer purchases them, co-operation is required for seller's assistance in collecting receivables for the buyer or the buyer's co-operation in delivering funds received to the seller.
- Don't pay full price for accounts receivable. The agreement should provide for an adjustment of the purchase price for receivables that are not paid. If there is no adjustment in the purchase price for uncollectible receivables, the amount paid for them should be deeply discounted.
- Make sure the seller is required to pay accounts payable and other past obligations of the business. The buyer should only be liable for obligations specifically listed in the purchase agreement as obligations assumed by the buyer.
- Get the seller's warranty that equipment is in working condition, that the seller has clear title to the assets to be transferred, that accounts receivable are collectible, that financial records are accurate, and that all information provided about the business is true. A buyer also needs the seller's warranty that there are no undisclosed liabilities, lawsuits, governmental proceedings, or known problems facing the business.
- Don't rely on the seller's representations and warranties about equipment, title, customers, reports, liabilities, government actions, and financial records as a substitute for investigation. A buyer's best protection from risk is a rigorous review of all aspects of the business.
- Obtain an indemnification agreement from the seller (and individual owners, if the seller is a corporation or other entity) against liability arising from prior operation of the business and from the consequences of the seller's failure to disclose information accurately. This indemnification (hold harmless) is really a type of insurance in which the seller agrees to cover the buyer against third party claims. But don't rely on an indemnification as a substitute for an insurance policy, proper due diligence, or other steps to reduce the likelihood and impact of third party claims.
- Require the seller to accept installment payments, a note, or other stretched out payment arrangements in order to give the seller an interest in the buyer's success. This provides the buyer some leverage if the seller's cooperation is needed in the future. Purchase documents should include a buyer's right to reduce or offset payments to the seller if the buyer finds it necessary to pay customer claims,

"Purchase the assets of the business from the business entity rather than purchasing the entity."

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Publisher's Note

Have a detailed plan before entering into any discussions or negotiations for the purchase of a business. A buyer needs to be operating from his or her own plans and willing to walk away from any potential purchase if he or she cannot structure or negotiate a transaction that meets his or her own objectives.

Most buyers do not have a background in financial planning and need the assistance of an experienced accountant for tax planning, cash flow projections, allocation of purchase price, and investigation of the true financial circumstances of a business. Most buyers do not have unlimited funds with which to cover losses or unexpected expenses if the plan for the purchased business was inadequate in predicting cash flow, taxes, debt service, claims, needed capital, and other expenditures.

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vendor bills, unpaid taxes or other obligations of the seller.

- Obtain non-compete agreements ("covenants not to compete") from the seller (and from the active shareholders if the selling entity is a corporation). California law supports non-compete agreements related to the purchase of a business.
- Include all necessary contingencies in the purchase agreement. The closing and transfer of the business needs to be contingent upon the buyer's satisfaction with the buyer's financial review and due diligence, upon the buyer's obtaining a lease on the business premises, on obtaining needed licenses or permits, upon the buyer's obtaining financing on terms acceptable to the buyer, and upon anything else that could make the purchase of the business undesirable if not obtained.
- Obtain tax clearances and releases from the Employment Development Department ("EDD") and from the State Board of Equalization in California to avoid liability for a seller's unpaid payroll tax obligations and sales tax obligations. State laws often authorize agencies to pursue the buyer of a business for unpaid obligations of the seller. BA