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

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Mary Hanson

About the BusinessAdvisor

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

Mary Hanson has a law degree from the University of Wisconsin and an MBA from the University of Southern California. She has practiced business law exclusively for more than 30 years.

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.

Her interests include flying and World War II.

Her law office is located in the Del Amo Financial Center, 21515 Hawthorne Blvd. #885, Torrance, California. She can be reached at (310) 543-1355 or by e-mail at mhanson@bizadvisor.com

MISTAKES TO AVOID IN BUYING A BUSINESS

by Mary Hanson

Buying a business requires a great deal of work and buyers must be prepared to do their homework. The homework includes both the many aspects of the potential acquisition and the issues involved in buying a business. There are many opportunities for buyers to make mistakes that increase a buyer's risk.

Here are a few "Don'ts" for the buyer of a business:

Don't get stuck agreeing to a purchase price suggested by the seller. The seller's asking price should be viewed as an asking price only. An appropriate purchase price should only be determined after the buyer analyzes the business based on his or her own situation and capabilities.

Different buyers should have different prices for a particular business, based on the different advantages and disadvantages of each buyer's situation. A business can have great value to one buyer and no value to another. For example, the greatest value is to a competitor in the same business if the competitor can consolidate the two businesses into one, saving on facilities, technical systems, personnel, and other combined business operations.

A business that is losing money should only be attractive to a buyer who has adequate funds to make the purchase, cover losses, and implement changes to make the business profitable.

Whether the buyer plans to operate the business as it is or combine it with another business, the buyer must make his or her own determination of how profitably the business can be operated and what that profitability is worth to that buyer.

An interested buyer must make his or her own estimates of revenues, expenses, cash flow, break even points, and capital requirements from his or her own knowledge of the business and business environment. The buyer's estimates must be obtained by independent investigation and must not rely upon the accuracy of the seller's information.

Don't buy a corporation, limited liability company, or any entity unless that entity is needed for the buyer's business plan. A seller normally benefits from an entity sale both from a tax and a liability standpoint. The seller will only pay tax on the sale of corporate stock at personal capital gains rates, and the seller avoids some liability. Since acquisition of the entity includes the liabilities as well as the assets of the business, a seller often benefits by being relieved of liabilities, while the buyer takes the risk of acquiring a broad range of liabilities.

A buyer may wish to purchase an entity in order to acquire certain assets that cannot be transferred, or to benefit from some permit or exemption from regulatory requirements that cannot be transferred or acquired anew, or to take over lucrative contracts of the seller. In such a situation the buyer must be particularly cautious to be certain the risks associated with the purchase of an entity are minimized and the

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"A buyer's most effective protection from claims and liabilities … is the ability to withhold payments to the seller."

benefit gained from taking over the entity is worth the risks.

Don't do anything to make the sale quick, easy, simple, or convenient. Anything done – or not done – to make the transaction quick, easy, simple, or convenient will very likely benefit the seller – but at substantial detriment to the buyer. The circumstances of a seller and a buyer are very different. A seller benefits from a sale in which the buyer pays too much, too soon, without taking steps to protect the buyer from becoming liable for the seller's obligations. A buyer benefits from a thorough and cautious review of the entire business, including the assets, the liabilities and challenges of the business. In addition, a buyer must take certain legal steps to avoid inheriting liabilities of the seller.

Don't make an asset purchase without complying with bulk transfer laws, using an escrow, or otherwise taking steps to assure that the buyer will not face "successor liability." Many state laws impose liability on the buyer of a business if the buyer does not take certain steps in the purchase process. "Bulk transfer" laws require a buyer to use an escrow, publish a notice, and pay claims from a seller's vendors before any payment is released to the seller. The buyer is liable to vendors if the purchase is made without compliance with the law. In California a buyer will be liable to the State Board of Equalization for a seller's unpaid sales tax if a tax clearance is not obtained prior to the release of all funds to the seller. And a buyer can be liable to the Franchise Tax Board and Employment Development Department for unpaid obligations of the seller under similar circumstances. In California an escrow holder does a number of things that benefit a buyer, including taking the steps to comply with bulk sale requirements, obtaining clearances that protect the buyer from successor liability, and checking to make sure liens are removed prior to the transfer of assets.

Don't enter into a letter of intent, memorandum of understanding, or other preliminary agreement unless it serves a buyer's purpose. An agreement established prior to a complete review of the business is likely to set out a purchase price and purchase terms that turn out to be inappropriate. It can be difficult or impossible to negotiate better terms or a more appropriate price after a written agreement has been executed. Even if it is called a non-binding agreement, negotiations between the buyer and the seller may be heavily burdened by the expectations created by the premature agreement.

There are two circumstances in which a buyer may benefit from a letter of intent. If there are a number of interested buyers, one buyer may seek an agreement that requires the seller to negotiate exclusively with that one buyer before pursuing sales with the other buyers. This avoids the auction environment that benefits the seller by requiring interested buyers to compete with one another. And if the buyer knows that the purchase price and key terms are beneficial to the buyer, the buyer may wish to get the seller committed to those advantageous terms early on. The buyer will typically be able to complete a purchase with the advantageous terms, but still be able to walk away from the purchase if the due diligence review uncovers some unacceptable business condition. The non-binding nature of the agreement enables the buyer to back out.

Don't rely on an agreement to protect the buyer from liability. There is no substitute for checking, reviewing, analyzing, and questioning every detail of the business, complying with bulk transfer laws,

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making sure liens are removed and vendors are paid, and obtaining clearances to avoid successor liability to state agencies.

While a good purchase contract will include representations and warranties of the seller and an indemnification provision making the seller liable to the buyer for expenses that should have been covered by the seller, such a provision does not eliminate problems. The most blatant limitations of an indemnification provision are that a seller may not be willing or able to honor the contractual obligations and that the contract merely gives the buyer the right to pursue the seller for the failure to pay. Contract terms placing financial obligations on a seller have serious weaknesses when the seller does not have assets to pursue, when the buyer entitled to indemnification does not have funds to pursue the seller, and when the cost of pursuing the seller is greater than the amount owed.

A good purchase agreement requires the seller to indemnify the buyer for breach of representations and warranties (e.g., some tax payment was not made despite a representation and warranty that all taxes were paid), for breach of covenants under the agreement (such as a covenant not to compete), and for any bills, expenses, and liabilities arising prior to the sale. A good agreement gives the buyer the right to withhold payment to the seller if the buyer does face liabilities that are indemnified by the seller.

Don't pay the entire purchase price up front. A buyer's most effective protection from claims and liabilities arising from the business prior to the purchase is the ability to withhold payments to the seller. A buyer can be faced with liens on assets, successor liability to state agencies, claims from vendors or customers, unpaid bills, inoperative equipment, and many other liabilities. If a buyer pays the entire purchase price up front, the buyer has no future payments against which to offset the amount the seller may owe the buyer.

The best purchase terms for a buyer provide for payment of the purchase price over time, subject to reduction or offset if the seller fails to meet contract obligations. The agreement terms should be drafted to provide the seller with incentives to pay the seller's obligations, observe the covenants of the agreement, and assist the buyer in acquiring a successful business.

If a business is based on an unproven concept or has a poor track record, the buyer may wish to offer a purchase price that is adjustable if the business turns out to do well. One approach is for the buyer to agree to make additional payments contingent upon the success of the business (based on the business meeting targets for revenues, retention of certain contracts, retention of certain customers, etc.) The buyer needs to make the determination of what occurrences justify additional payment, and how such payment should be structured.

An earn-out provision can require the buyer to pay a higher purchase price in one or more future payments based on the achievement of financial objectives. The use of an earn-out provision allows a buyer to offer a potentially higher price in a situation in which a business concept is unproven or the business to be acquired has a poor track record. If the seller has confidence in the success of the business, he or she may be willing to sell the business for a lower price, subject to being adjusted upward if the business is financially successful. The buyer's only commitment is to the lower price, and the buyer only pays the adjusted higher

"Don't wait until purchase terms have been negotiated before getting tax and legal advice."

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21515 Hawthorne Blvd. • Suite 885 • Torrance, California 90503 • (310) 543-1355

Publisher's Note

Only the buyer can make the key decisions involved in purchasing a business. He or she knows best his or her financial circumstances, personal abilities, and level of comfort with the risks involved.

Professional assistance is needed, even when a buyer has been through numerous purchases and sales. Where a purchaser has not been highly involved in a number of business purchases, the learning curve is too steep. It's not realistic for a buyer to think he or she can quickly acquire the knowledge needed to negotiate a good purchase agreement without the assistance of professional advisors.

A buyer needs to listen to and learn from his or her advisors, and take the steps recommended. Waiting until an agreement is negotiated, ignoring advice from experienced advisors, and cutting corners on due diligence reviews to save money are big mistakes. Getting and taking good advice at the beginning of the process puts the buyer in the best position to negotiate a successful purchase.

Mary Hanson
Attorney/Publisher

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price if the business hits the targets set in the agreement.

A buyer may also use the payment structure to incentivize individuals, improve the tax treatment of the purchase price, or encourage compliance with non-compete covenants. If performance by a key individual is important, payments might be made payable to that individual rather than the selling entity. The buyer should remain open to a variety of payment structures until the circumstances of the business and involvement of key players are clear.

Don't wait until purchase terms are negotiated before getting tax and legal advice. Advice is most valuable in the early planning stages, when good advice can promote the right structure, lower risk, and lower taxes, and put the purchase process on the right track. Advice, tax planning, and legal work in the later stages of a purchase usually have much less impact. If too many issues are not resolved in the buyer's favor in the beginning of the process, it can be difficult or impossible to negotiate a purchase price and payment terms that reduce the buyer's risks. The work of the buyer's advisors in the later stages can amount to just lessening the impact of a bad agreement.

Don't hesitate to take charge. The buyer should be the leader in a business purchase. A buyer has to be prepared to tell a seller what the seller needs to do to fix problems with the business, to instruct his or her team of legal, accounting, and tax professionals on what they need to do, and to walk away from the transaction if the business doesn't look good. A buyer must actively pursue his or her own game plan to make a successful purchase. BA