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Buying and Selling Businesses

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Introduction

The opportunity to purchase an established business promises a future of freedom and financial gain, however the ultimate decision is not one to be taken lightly. You'll need to decide whether the move is the right one in the first place, then have the confidence and know-how to undertake due diligence, negotiate the deal and follow through with the transaction. The same goes for those looking to sell their business and move onto their next challenge.

Manage these factors poorly, and you can risk what you've worked so hard to achieve. Get them right, and you'll enjoy immense personal reward and satisfaction for your hard work.

In this eBook, we will cover some of the most important issues that should be considered before you sign on the dotted line, from understanding the sale and purchase process to avoiding the most common potential pitfalls. For further clarification on any of the information we provide, simply contact the team at Coleman Greig Lawyers at any time.

Snapshot of a Typical Sale/Purchase Process

1. Information Memorandum issued.
2. Confidentiality Agreement/NDA executed.
3. Due diligence and disclosure documents.
4. Negotiation of sale and purchase documentation.
5. Execute sale/purchase documentation.
6. Satisfaction of conditions precedent, preparation for settlement, including items such as;
   - offers of employment and settlement adjustments;
   - settlement/completion;
   - attend to ASIC and other regulatory filings;
   - calculate any relevant post completion price adjustments; and,
   - integration into the business.

We suggest that you start considering and addressing these issues as early on as possible so you are aware of all issues from the outset, to ensure you're making a fully informed decision and so that the process can flow as smoothly as possible should you proceed with the transaction.

The Structure of the Transaction

When considering the sale or purchase of a business, it is important to consider whether it should be a sale of the business (which will comprise a collection of specific assets and specified associated liabilities), or whether it should be a sale of the entity that owns the business (that is, the company or trust). Relevant considerations include, but are not limited to:

- if the vendor is a company or trust, whether it has assets other than the business to be sold;
- whether the purchaser is prepared to accept all the liabilities of the company, and rely on due diligence enquiries and the vendor's warranties (sale of shares) or would prefer the comparative certainty of assuming only specific liabilities (sale of business);
- taxation consequences for the vendor and the purchaser (e.g. CGT and GST consequences);
- stamp duty consequences given that duty on business sales is generally higher than on share sales; and,
- employee entitlements that may be crystallised, for example redundancy and long service leave obligations.

While we have focused on the issues relating to the sale of the business as an asset and not a sale of shares of a company that owns the business, it is worthwhile considering the advantages and disadvantages of acquiring an existing business (irrespective of the structure used) compared to starting a business from scratch.

Advantages

When buying the business, a purchaser will acquire:

- an existing customer base and existing contracts;
- existing suppliers;
- existing plant, equipment, stock and material;
- knowledge of the business from the current owner (particularly if the owner will be engaged as an employee or consultant for a period following completion);
- established premises (to the extent that such premises exist and are necessary for the conduct of the business);
- goodwill associated with the name and location of the business; and,
- financiers, who may be more willing to lend money to assist in the acquisition of an existing business with a trading record.

Disadvantages

When buying a business, a purchaser must consider:

- preservation of, and extracting real value out of, the goodwill or reputation of the business;
- employment issues including the departure of key individuals from the business;
- inheriting plant and equipment that is obsolete or faulty; and,
- that the business may have no real intellectual property that is transferable or the business may have failed to adequately protect its intellectual property.

A future of freedom and financial gain

Pre-Contractual Negotiations

Once the structure of the sale has been settled upon the parties will then start considering the key commercial issues of the transaction. The pre-contractual negotiations between the parties are the cornerstone of any agreement and consideration needs to be given to exactly what is being acquired. The assets of the business will of course vary from business to business but usually include:

- plant and equipment;
- stock in trade;
- intellectual property and associated licences;
- equipment leases and service agreements;
- the rights of the vendor under material contracts;
- the right of occupation of a premises; and,
- goodwill.

Each party will have their own views on the value of each of these components but also how that price is apportioned between these various assets. It is often very important at this stage that the vendor and purchasers:

a) Ensure that their accountant is involved in considering the structure of the sale to ensure that financial issues are dealt with and understood (including GST, CGT and stamp duty);

b) Undertake due diligence to ascertain the nature of the business and consider items such as:

  - the proper legal identity of the parties;
  - confirmation of the ownership of all assets purporting to be sold;
  - whether any other persons should be joined as a party to the agreement as co-warrantors (such as directors and senior executives);
  - who will act as covenantors on things such as the warranties;
  - whether any guarantors will be required;
  - a review of historical and forecasted sales figures;

- the profitability of the business, including some forensic review of the financials to aid with any relevant add backs or other anomalies in the figures;
- the costs that the business incurs to generate its revenue;
- key contracts with suppliers, staff and customers;
- the assets of the business;
- the employees of the business; and,
- the longer term (balance sheet) liabilities.

Once there has been a careful examination of these issues the parties can then commence and finalise their negotiations as to the key elements of the transaction. In turn these will need to be formalised into a contract.

The assets of the business will vary from business to business

Key issues to consider

The following are some of the issues that will always need to be covered in the contract for any sale of business transaction, but can sometimes not be given the attention and forethought that they deserve:

Identification of Sale Assets

While it may sound obvious, carefully identifying and then listing the assets that are intended to be included in the proposed sale is critical. Too often we see lazy drafting in contracts such that you cannot readily identify exactly what assets form a part of the asset being sold/bought. If there are any subsequent disputes about those assets or if they have not been adequately identified in the contract, a messy legal battle can often follow.

Conditions Precedent to Agreement and to Completion

Quite often a purchaser will require certain events to occur before they agree to complete a purchase; things like the release of securities that have been given over assets that are the subject of the sale, or verification of stock levels or a certain number of key staff accepting offers of employment. If these issues are important to a purchaser they must be carefully crafted into the contract. For a vendor it is wise to assess how possible and/or expensive it may be to comply with the pre-conditions.

Payment of the Purchase Price

Is it to be paid in one lump sum? Will it be paid over a period of time? Does the purchaser want to hold back a retention sum to ensure compliance with warranties, or is a portion of the price linked to performance of the business post completion? All of these clauses require very careful consideration and skilful drafting to create certainty for both parties.

Employees

The treatment of employees of the vendor in a sale of business transaction is one of the items that we often see mishandled and misunderstood by the parties – and in many instances their lawyers. Employees can be a business's greatest asset but at the same time incur a huge liability. Careful consideration and planning around the handling of the vendor's employees is key to a successful acquisition by a purchaser. Great knowledge and skill are required to manage this element of the transaction.

Material Contracts (including the lease)

Not all contracts are equal. Simply because one business operator has a successful relationship with a customer or a supplier, this does not guarantee that the next owner of the business will. For starters, is the contract capable of being assigned? Does the other party have any power to refuse the assignment? Leases are a key example of such a contract. Very close attention must be paid to the terms of the existing contracts and careful and strategic planning should be applied to best ensure that all key contracts can and will be assigned to the purchaser.

Warranties

What is the vendor promising to the purchaser about the business? These are called warranties and can be a thorn in the side of an unwitting vendor, and the 'insurance' that the purchaser needs to feel comfortable in their acquisition. Striking a fair balance between the two can often be a challenge but care needs to be given to any concessions made by either party.

Restraints

Often bemoaned as unreasonable and unenforceable (erroneously), restraints of trade for vendors and their key personnel are critical for a purchaser to ensure that the large sum that they just paid for goodwill is not all for nothing due to a key person involved in the vendor's business setting up in competition after the sale has concluded.

Careful due diligence and strategic planning with your lawyer and accountant can help identify the key issues for any sale, and a lawyer well versed in sale of business matters can expertly craft a contract that can help you achieve your objectives with confidence and control.

Strategic planning with your lawyer and accountant

Issues that can arise after completion

Ideally once the contract has been completed, the purchase price paid and the various post completion items dealt with, the contract is filed away never to be seen again. However, various difficulties can arise from time to time, some of which are set out below.

Financial Performance Issues

The importance of involving a competent financial adviser at an early stage has already been touched upon. That is because every sale brings revenue consequences for either the vendor, the purchaser or both, that have to be managed and so far as possible competing interests accommodated. Revenue issues that can arise after completion and which can adversely affect the vendor and the purchaser can include:

(i) Valuation of the Business

Methods for calculating the value of a business are varied and can be complicated. Be sure you are using a method that is relevant to the industry that the business operates in and the business itself. Application of an inappropriate valuation methodology can have huge consequences (eg. requirements under finance arrangements), if the real value of the business is discovered to be significantly different after completion.

(ii) The Purchase Price – Adjustments and Deferred Payments

Many contracts will require adjustments for certain events, such as amounts for accrued entitlements for staff who transition across to the purchaser. Other adjustments can relate to stock levels and other variables, which cannot be finalised until the day of completion. A vendor needs to understand exactly what the effect of these adjustments will be so as to avoid a nasty shock when they are calculated the day before or on the day of completion, leading to a significantly lower net payment being made to them.

Similarly, care needs to be taken as to any part of the purchase price being deferred – often subject to certain KPIs or key milestones being reached. If the KPIs or milestones are not thought through carefully and kept within the reasonable control of the vendor, this can lead to a situation where the purchaser does not receive the stated price, but a sum much lower (and sometimes after the outgoing proprietor has worked in the new owner's business for many months trying to achieve the objectives in order to receive the deferred payments).

Taxation Issues

Below are a number of taxation related issues that can arise.

(i) Stamp Duty

Apportionment: dutiable property - In NSW stamp duty is assessed on the combined dutiable value of all items of dutiable property agreed to be sold or transferred. The liability to duty will only extend to those assets identified as dutiable property. In the context of a sale business dutiable property includes:

- land and an interest in land (including a leasehold interest and fixtures);
- goods in NSW (subject to exclusions, such as stock-in-trade, listed in section 11(1)(j) of the Duties Act), if the subject of an arrangement that includes a dutiable transaction over other dutiable property, such as land;
- leasehold interest in land;
- intellectual property, (only considered to be dutiable property when sold or transferred in conjunction with the goodwill of the business);
- goodwill;
- statutory licences; and,
- various items of goods including fixed and moveable plant and equipment.

Non-dutiable properties that may be included in a sale of business are:

1. A business asset, being, at any relevant time:

   (i) the goodwill of a business, if the business supplied in NSW, or provided services in NSW, to a customer of the business;

   (ii) intellectual property that has been used or exploited in NSW; or,

   (iii) a statutory licence or permission under a Commonwealth law if the rights under the licence or permission have been exercised in NSW.

2. A statutory licence or permission under a NSW law (for example a taxi licence or water access licence).

3. A gaming machine entitlement within the meaning of the Gaming Machines Act 2001.

Duty is not payable on the value of the above types of property which are included in dutiable transactions entered into on, or after, 1 July 2016.

Apportionment re location of assets - Situations may arise where certain assets, the subject of a business sale agreement, cannot be isolated within State boundaries and as such will be subject to differing duties in the locations relevant to the business.

Timing - The time for stamping a document or a written statement in each jurisdiction varies from as little as one month in Queensland, 60 days in Tasmania and the ACT, 30 or 60 days in the Northern Territory, two or six months in South Australia, and three months in NSW. If the one original document must be sent to each jurisdiction, the timing requirements for certain States or Territories may not be met.

Valuation of the Goodwill - when valuing goodwill, it is important to bear in mind that goodwill will have no value unless it is capable of being transferred from one party to another. Therefore if it rests exclusively with a person(s) that will not be joining the business, the purchaser will effectively not be acquiring the goodwill, or at least not all of it. In these circumstances the goodwill may have been over valued as it will not accurately reflect the commercial or financial worth that it represents.

A contract may define methods of valuing goodwill which could take into account:

- retention of key people;
- number of year's purchase of past net profits;
- number of year's purchase of future super profits; and,
- capitalisation of maintainable profits.

(ii) Goods and Services Tax

GST liability is a real concern in relation to any contract for sale of business. At a high level, if the business is sold as a going concern with commercial leases being assigned then GST is normally not payable.

However, where the business is not sold as a going concern or the premises are mixed between residential and commercial or otherwise, GST may be payable. As set out in the Australian Taxation Office's Goods and Services Tax Ruling 2002/5 "Goods and services tax: when is a 'supply of a going concern' GST-free?", the supply of a business as a going concern may be GST-free if the following requirements are met:

- the purchaser must be registered for GST on or before the date of the supply;
- the supply must be for consideration;
- the vendor must carry on the business until it is sold;
- the vendor must supply to the purchaser all of the assets and other elements required for the continued operation of the business; and,
- both parties must agree in writing that the supply is of a going concern.

If the business is not sold as a going concern and GST is payable then a tax invoice should be issued on completion so that input credits can be claimed and GST paid, all of which is part of the process if the GST issue was considered before contracts were exchanged and addressed in pre-contract negotiations and the outcome accurately recorded. But if these events have not occurred then on completion a purchaser may be rendered an invoice for the purchase price plus GST, or if on completion the parties do not address the issue then at a later time when a BAS statement is lodged a purchaser or vendor may unexpectedly become liable.

In addition, the Office of State Revenue considers that, where GST applies to the sale of assets and is passed on to the purchaser, the GST forms part of the consideration for the sale and duty will be calculated on the purchase price inclusive of GST.

(iii) Capital Gains Tax

The completion of the sale of a business amounts to a capital gains tax event. If the business was formed before 1985, CGT is not payable by the vendor, but for businesses formed subsequently capital gains tax is payable subject to small business concessions including roll over relief. The issue can become particularly complicated where the small business roll over provisions are not available and there is some doubt that the business has been conducted without interruption since before 1985. A failure to provide evidence of continuous conduct of the business over a long period of time could mean that a substantial amount of the purchase price is eventually liable to be paid in capital gains tax.

Operational Issues

In addition to financial performance and taxation complications that can arise, there can sometimes be critical issues with fundamental elements of the business and the terms agreed to in the contract.

(i) Waiver of Conditions Precedent

Conditions precedent provide basic preliminary safeguards for a purchaser and typically cover the elements of the transaction that are critical for the purchaser to obtain a full benefit of the business.

A purchaser may waive the conditions precedent in their haste to have the transaction completed without fully understanding their relevance to the business. Where this occurs, the purchaser may be effectively waiving the right to void an agreement where certain key requirements have not been achieved. In circumstances where a purchaser has waived, or has not had the benefit of, certain conditions precedent, a purchaser may be obliged to proceed with a transaction which is of detriment to the purchaser and which may mean that the purchaser is not getting the deal they originally bargained for.

(ii) Employees

If there are certain employees that are crucial to the business and need to be retained, it is important that there be a condition precedent to the contract that they be retained for the benefit of the purchaser. If the key employees do not join the business after the sale, existing relationships of the business with customers and suppliers may be lost. In addition, if the key employees are not subject to a suitable restraint of trade, those key employees may establish a business that is in competition with the business acquired by the purchaser.

(iii) Intellectual Property

- appropriately protect the intellectual property;
- ensure that any intellectual property created by contractors is assigned to the business; and,
- properly document intellectual property licences.

Where this has not happened, the vendor may not own all rights and title to the intellectual property and may not have the right to transfer or assign such intellectual property. In this situation, a purchaser may discover after completion that the vendor does not own the intellectual property it has purported to transfer or that a third party has an interest in the asset.

(iv) Leases

Often, when negotiating a sale of business agreement, the lease of the premises at which the business is conducted will form part of the transaction. In circumstances where the vendor has failed to secure the assignment of the lease prior to completion, the lessor may not grant to the purchaser the benefit of the lease. When this occurs:

- the purchaser may be required to re-negotiate a new lease on terms that are substantially less favourable than those previously provided to the vendor; or
- the purchaser may have to leave the location. This can result in the loss of a significant proportion of the customer base and, consequently, the goodwill of the business; or,
- the purchaser may incur significant costs in moving to another location and negotiating a lease with a new landlord.

As a matter of law the vendor/lessee remains liable to the lessor in the event of a default of the purchaser, unless released by the lessor on assignment. If the purchaser lacks the financial capacity to maintain the lease, or if the purchaser causes damage to the premises, the vendor could be liable for significant amounts of money if:

- the vendor does not fully co-operate with the due diligence requests and endeavours of the purchaser;
- the vendor and purchaser agree to a short time-frame for the conduct of due diligence;
- the due diligence is limited in its scope, for example, limited to the financial affairs of the business only; or,
- the purchaser waives the opportunity to conduct a due diligence.

We aim to develop long term relationships with you

If the due diligence relating to a business is inadequate, the purchaser may not be made aware of something that could materially affect the business and assets it is purchasing prior to completion. In those cases, the purchaser's only recourse may be the warranties provided in the contract and the pre-contractual representations and warranties of the vendor.

(vi) Breaches of Warranty

Where there has been a breach of warranty, under a properly drafted agreement proceedings can be commenced (sometimes) within a defined period of time. In addition to imposing a defined period of time in which to bring warranty claims, a vendor may also seek to limit its exposure to a certain monetary amount. As a practical matter, and to stop vexatious warranty claims, it is not unusual to include a minimum claim amount. Unless there is a minimum claim amount on a "per claim" basis, the vendor may be burdened by multiple possible claims.

(vii) Enforceability of Restraints of Trade

This is a recurring area of post-sale business litigation. The decided cases focus upon the wording of the particular agreement and the reasonableness of the restraints. Getting the restraints right in terms of the activity they cover, the geographical area and time frames within which they operate is critical. However, the individuals that they cover is often glossed over. It is vital to ensure that all key persons, whether they be employees, directors or even relatives of the vendors, are properly signed up to appropriate restraints.

(viii) Misleading and Deceptive Conduct Allegations Regarding Pre-Contract Representations and Warranties

A number of judicial decisions demonstrate that purchasers are entitled to rely on pre-contractual representations and warranties made by the vendor and it is no longer sufficient just to look only to the contract as the source of a party's rights and obligations. The pre-contract period, being the period that precedes formation of the contract for sale of a business, is of particular legal significance as it is during this period that the vendor may make certain representations to the purchaser which could amount to misleading and/or deceptive conduct.

Managing the risks associated with buying or selling a business

We've covered a lot of ground about what can be a complex transaction, with a number of elements and agreements to consider.

To recap, here are our top issues to consider when selling or buying a business:

When Selling

- Ensure that the method used in valuing the business is accurate and, if relevant to your business, that there is a mechanism for valuing any trading stock at completion.
- If you agree to a deferred purchase price payment structure, consider requiring security or a guarantee in respect of the outstanding amounts. Minimise where possible the right of retention by the purchaser and always specify minimum values as to claims to be made by the purchaser for things such as alleged breach of warranties, to ensure you get as much of the deferred payments in your pocket as possible.
- Carefully consider the taxation consequences of the transaction.
- Identify the intellectual property owned or licensed by you and determine whether such intellectual property can be assigned.
- Ensure that you have received proper assignment of any intellectual property created by third parties prior to entering into the sale contract.
- If you are to remain liable under a lease or other contract, obtain indemnities from the purchaser.
- Make sure you understand the obligations under any lease and other key contracts which are to be transferred.
- Ensure proper confidentiality provisions are entered into before any sensitive information is provided and ensure adequate due diligence is undertaken.
- Be aware of the possible consequences of any pre-contractual representations made.
- Ensure that you only give warranties that you are able to comply with and that any changes are fully disclosed in writing prior to completion.

When Buying

- Ensure you use the most appropriate entity structure to acquire and operate the business.
- Ensure that the method used in valuing the business is accurate and consider whether you wish to purchase on a stock inclusive basis or whether you wish to complete a stocktake just prior to completion.
- Allow for adjustments to the purchase price in the event that anything occurs or arises that may affect the profits or value of the business, including but not limited to employee entitlements.
- Carefully consider apportionment of the purchase price for stamp duty purposes in terms of both the dutiable property the subject of the transaction, and its location.
- Review the deadlines for payment of stamp duty in each relevant location to avoid incurring late fees.
- Determine whether the business will be sold as a going concern and whether you will be liable for GST on the purchase price.
- Consider whether conditions precedent should be included in the contract.
- Identify any key personnel and whether such personnel are to be offered employment and/or whether they are the subject of an adequate restraint of trade.
- Identify the intellectual property to be purchased and the relevant owner. Obtain warranties and indemnities in relation to the vendor's right, title and interest to such intellectual property.
- Ensure that any premises necessary for the conduct of the business will be assigned or transferred to you at completion.
- Conduct thorough due diligence.
- Obtain comprehensive representations and warranties by the vendor as to the state of the business.
- Ensure the agreement contains clear terms and arrangements for the payment and delivery of possession, unencumbered title and security of tenure to what you buy.
- Obtain an indemnity from the vendor as to debts or liabilities of the business.
- Ensure appropriate restraints of trade are included in relation to the vendor.

If you're looking to buy or sell a business, Coleman Greig can guide you through the process, answer your questions and take the hassle out of the transaction for you. Our legal specialists can provide tailored advice for your situation to help you make the most informed and advantageous decision so you can proceed with clarity and confidence. Call us now on 02 9895 9200.

Why Coleman Greig?

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The depth and breadth of expertise we offer, combined with our ability to pre-empt client needs and deliver individually tailored legal solutions, continue to position us at the forefront of cutting-edge legal services and ensure that we continually surpass client expectations.

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