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Things to Consider Before Buying A Business

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Often, the buying and selling of a business generate more litigation than any other kind of transaction. There are a number of reasons for this. The seller of a business wants to get maximum dollar, and often will "guild the lily" a bit about the business and its prospects to a prospective buyer. The buyer is usually

quite excited about the new endeavor and may overlook a few warning signs that the business is not as spectacular as s/he thinks. Once the buyer purchases, s/he might discover that the business is not as profitable as expected, is more difficult to run than expected, or is just nothing like what was anticipated. Buyers will often look to sellers and their representations about the business to save them from a money pit. And sellers often get (understandably) upset when the buyers accuse them of fraud and refuse to pay the balance of what was owed as the purchase price. Consequently, a lawsuit begins.

There are things you can do when buying a business to minimize the chances of problems.

While this situation is not all that unusual, there are things you can do when buying a business to minimize the chances of problems. The first thing you should do is to slow down and consider the purchase logically, not emotionally. Make sure you understand the business and thoroughly investigate its condition. Make sure that you are paying a fair price for the business. Think through the ramifications of the sale and your operation of the company, and plan for it at the time of purchase. And finally, decide when and how you will pay for it, and put appropriate conditions on payments. This article discusses each of these things in more detail below.

Investigating The Company

This is one of the most important parts of the purchase, though often buyers overlook this or spend little time doing it. Before

buying a business, you should take a good look at it. It's silly to spend a lot of time and money acquiring a business if you don't really know the details of what you are getting.

What are the company's strengths and weaknesses? What kind of reputation does it have? See if there are any comments about the company on the internet generally (use internet search engines to look), on social networking sites (such as Facebook or MySpace) or on review sites (such as Yelp!).

Review the company's financial records. Try to examine at least three years worth of the books and tax returns. Is business trending up or down? Is the product (or products) sold by the business a "hot commodity," or is it part of a trend that is now going away? Are there key employees that make the business valuable? If so, what guarantees are there that they will stay with the company once you buy it? If there are key employees, consider entering into a term contract with them as part of the purchase agreements, so that they will not leave and make the business less valuable after you own it. What kinds of insurance does the business have, and is it transferable, or will you have to get coverage as part of your purchase? You don't want to buy a company, have someone slip and fall on the premises on your first day as owner, and not have any insurance coverage for the accident.

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Review the company's contracts, including any written contracts with customers, suppliers, management and employees. Your goal in doing this is to determine whether the contracts are adequate and protect you from future problems.

What kinds of licenses and permits are necessary to operate the business? Does the business have them, and are they transferable? If not, do you have them or do you know how to get them?

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Is there a history of litigation involving the company? If so, are there problems that can be fixed that will minimize future litigation? If you are buying a company that is a litigation target, based on past history, you need to be prepared for that. This can involve purchasing proper insurance coverage, as well as performing a litigation audit and, perhaps, having one or more attorneys on retainer in order to deal with litigation-bound issues as they arise.

Interview the employees – even those who recently left the company or were fired. Employees (even disgruntled ones) are often in the best position to tell you the real-world problems with the company, so you are not caught unprepared for them if you buy it. How long do the employees normally stay at the company? A high employee turnover can be a warning sign of something wrong with management, or an

indication that the company is not paying its employees fair wages or giving adequate benefits.

Look at company obligations – Liabilities. A contract with a customer for future business may look good at first blush. But what are the company's obligations under the contract, and what will it receive? Was a large payment made at the beginning of the contract, with smaller payments in the future? Same thing with contracts with suppliers. Are the payments for future goods purchases reasonable, or overwhelming? If they are beneficial, when does the contract expire, and will you have to pay more for goods/services crucial to the business in the future? Look at the history of worker's compensation claims and disability. Are any employees currently on disability? These are all continuing obligations of the company that you will take on as a company liability, unless there are contract provisions to deal with them.

Look at the management team. They are the most crucial to the future success or failure of the company. Have they been there a long time? Is the team stable? Interview them personally and get a feel for whether you will "jive" with the company's management style and personnel, or whether there will be problems.

Examine the company's business plan, if it has one. Is it realistic? Has it been followed to date? What kind of competition is there in the market? Realize that if there is a lot of competition, this limits the company's ability to grow in the future – or even to maintain its current profitability.

Undertaking a good, thorough review can be time-consuming and expensive now, but not as time-consuming or expensive as dealing with uncovered problems after you own the company.

Paying A Fair Price

Deciding what to pay for a company is not that difficult if you have done a proper investigation of the company before entering into a deal. Many buyers of businesses will enter into a tentative deal to purchase. They then have a certain period during which they undertake a "due diligence" investigation of the company. This could be as little as two weeks or as much as six months, depending on the size of the business and the amount of investigation that is necessary. After the investigation, they can then decide whether to pay the original price, whether it needs to be adjusted based on the investigation, or whether to back out of the deal altogether. These rights need to be spelled out in the purchase contract, or you will be stuck with the original price in the contract.

A contract for future business may look good at first. But what are the company's obligations under the contract?

You can also get assistance in determining the actual value of the business. There are professional business brokers, as well as other professionals, who will examine the business and give a fair estimate of its value. They are not usually cheap, but paying their fees to get a good valuation is often invaluable and can save quite a bit of money poured into an overvalued business later on.

Some of the ways to determine the value of a business are to look at the assets and liabilities of the business, and determine

their value. Often the assets are simply hard assets, like real estate, leases, equipment and other tangible assets. But they can also include intangible things like "goodwill."

"Goodwill" is a term used to express the likelihood of customers continuing to come to the business in the future based on their past experience. Business purchase contracts often will be structured as a sale of assets, and place little or no value on goodwill. There are tax reasons for this, and it also results because it is difficult to place a real value on business goodwill. The likelihood of past customers continuing to frequent the business depends on a lot of unclear things. For example, if there was a lot of contact between a customer and the prior owner, then it is possible that once the owner leaves, the personal relationship disintegrates and the customer will go elsewhere in the future. If the new owner changes something about the business that was significant to a past customer, then that customer also will not

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come back.

The goodwill of a business is often a big part of the reason to buy it, rather than to start your own business from scratch. But in most agreements, goodwill is not included in the purchase, or is given a minimal value, if anything. As a practical matter, that means that if you do not get any repeat customers from the prior owner, you have not overpaid for the business, since the goodwill had little to no value, based on the purchase contract and documents.

Another way to value the company is to look at its net income. But be careful about doing so, and make sure that you have an accurate assessment of the income. Last year's income might be great, but was it a "bubble," or is it consistent with prior years? Has the income been trending up or down? Make sure you know the big picture, and not just a picture over a limited time when the business was doing particularly well.

<u>Planning For Future Operations</u>

Although non-compete clauses are usually unenforceable in California, there is an exception when you are buying a business from someone. So, when purchasing a business, you should always try to have the seller enter into an agreement not to compete. That is because you don't want to buy the business and then have the seller open a competing business across the street the next day. "Non-compete" clauses against sellers of businesses are typically enforceable if they are reasonable in time (usually no more than 5 years) and geographic scope (this varies based on the kind of business involved and its customer base, but you are usually safe with a 10-20 mile radius).

How well do you know how to run this kind of business? Will you need training? How can you get training? You should answer these questions before you buy, and plan both your timing of purchase and time you anticipate investing in the business with these questions in mind. Will the seller stay on to train you? Will s/he assist in the transition of ownership and operations? Will s/he continue to act as a consultant for any period of time after the sale? If so, you should have a clear contract regarding the seller's obligations

and precise steps you expect the seller to take, the time commitment involved, whether the seller will be an employee or independent contractor after the sale, and any compensation issues. You might choose to shift some of the purchase price to a post-purchase consulting contract. That will make some of the seller's compensation contingent on his/her completing the continuing post-purchase obligations. Make sure that all of the agreements are settled and signed together, so that they are all part of a single deal – the purchase. Consider a provision in the paperwork providing an agreed amount of damages ("liquidated damages") if the seller fails to comply with the post-purchase obligations.

Method of Payment

The purchase of a business usually is paid for by an up-front, cash payment, with a promissory note ensuring that the balance is paid over time from the cash flow of the company. Sometimes, you can tie the purchase price to the future cash flow of the business, so that the post-purchase payments are a percentage of cash flow, or profits, over a specified period of time. This often can cause problems, particularly if profits decline, because the seller may believe that you are "cooking the books" if the future payments do not meet the seller's expectations.

Typically, sellers will want all – or most – of the purchase price up front, while buyers will want to pay as little as possible up front, with the balance coming from future cash flow.

If there are promissory notes involved, then they will often be secured. Typically by the assets of the business, but sometimes by other personal or real property to ensure that the promisee gets paid.

Is the business a corporation? If so, the seller – or buyer – may want personal guarantees, in order to avoid a situation where a bankrupt corporation can get rid of its obligations.

Sometimes sales are structured in such a way that the buyer buys part of the business now, operates it for a while jointly with the seller, and then purchases the rest of the business at some point in the future. If you enter into a transaction where you buy part of the company now and part in the future, you had better be sure that you can get along with the seller, and can trust him or her. This is because you will be dealing with each other as if you were partners until the purchase is complete. Essentially, you are partners until the transaction is complete and you own the business entirely.

Entering into a new endeavor is always exciting and energizing. But when it comes to buying a business, spending some time now in cold, hard analysis and proper planning will help to ensure that the excitement and energy lasts long after the purchase is complete.

If you have any questions, or if we can assist in your legal needs, please call us at (714) 907-0697

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