

When Opportunity Knocks - Purchasing a Business

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The perfect opportunity presents itself. A manufacturer has approached you to buy a nearby dealership; or a nearby dealer (who will still be a “pin on the map”) wants to know if you’d like to buy him out. What do you do now? Following is an outline of the “action steps” necessary when purchasing an existing business.

Letter of Intent

The purchase of a business often commences with a “letter of intent.” The letter of intent is designed to be a non-binding, generalized outline of the transaction. It contains proposed terms of the transaction including: its structure (asset purchase vs. stock purchase); the purchase price and terms of payment; and possibly other items to help make sure the parties are “on the same page.”

Confidentiality Agreement

The next steps involve the signature of the confidentiality agreement and the commencement of the preparation of the purchase agreement. The confidentiality agreement is a legally binding agreement where the seller discloses information requested by the buyer that is relevant to the transaction. The buyer may not further disclose the information or use the information for his/her own benefit or purposes.

The issuance of the confidentiality agreement commences the “due diligence” process. Due diligence can mean different things to different people. At its most basic level, due diligence is the process where the buyer seeks and obtains information from the seller he/she feels necessary to evaluate and close the transaction. The acceptable completion of due diligence is normally a pre-condition to closing.

Purchase Agreement

The purchase agreement is a detailed description of “the deal.” It is a legally enforceable document. While all provisions of the contract remain important, the most significant sections to the buyer are: the purchase price and terms of payment; the representations and warranties of the seller; and the covenants of the seller.

In most cases, the buyer will require that the transaction be structured as the purchase of the seller’s assets. Since the buyer is buying an ongoing business as part of the overall transaction, the seller may be able to negotiate some amount in excess of the replacement cost of the assets. This “blue sky” or “good will” or “operating value” is sometimes allocated to customer lists, or non-compete agreements. It is also common for the seller to receive a consulting agreement or “attractive” lease payments as part of a transaction.

Determining the purchase/sale price is more of an art than a science. Most often the parties have a strong feeling as to pricing. It is quite common for accountants, appraisers, bankers and manufacturers to be involved in pricing decisions. Your Association may also be a terrific resource in helping parties to a transaction “come together.”

Commonly transactions are structured so the buyer pays 75 percent of the purchase price at closing and the seller receives a promissory note for the remaining 25 percent of the purchase price. The promissory note is often secured by a lien on the assets, but is “second” to bank financing.

Buyers should remain keenly aware of the representations, warranties and covenants of the seller contained in the purchase agreement. The representations and warranties of the seller are statements of the condition of

the assets (in particular) and the business (in general) upon which the buyer is relying. While they are not a substitute for “due diligence,” if the representations and warranties contained in the purchase agreement are, or turn out to be, untrue, the seller is liable to the buyer for whatever damages the buyer sustains as the result of the untrue statement.

Common representations and warranties of the seller include (but are NOT limited to): due organization of the seller; authorization/approval of the transaction by all relevant parties (including, but not limited to, banks and franchisors); compliance with all laws (including, but not limited to, employment laws, tax laws and environmental laws); condition of and sufficiency of the assets; and that nothing is undisclosed.

The covenants of the seller are actions the seller agrees to take prior to or at closing. Common covenants of the seller include (but are NOT limited to): prior to closing of the transaction the business will be run in accordance with past practices; and the seller will comply with all post closing requirements (such as obtain the release of any liens on assets by payment of sales proceeds).

In order to provide a “fund” to protect the buyer from any breach of purchase contract provisions by the seller, it is common for the length of the promissory note to be approximately equal to the length of time that the representations, warranties and covenants of the seller “survive.”

Often, there are “last minute adjustments” to the purchase price. This is particularly true as it relates to inventory, and/or the condition of assets. Although the buyer may offer the seller’s employees an opportunity to become employed by the buyer, a common condition in a purchase agreement is that the seller will terminate all its employees immediately prior to closing. This action has numerous implications to both parties, but the seller is normally liable for unused vacation and sick pay, as well as any COBRA responsibilities.

Closing

Closing is when the documents of transfer are signed and money is transferred. Documents of transfer include, but are not normally limited to: bills of sale, assignments of contracts, transfers of franchise, and deeds. Often, buyers require attorney opinions as well as certificates of officers. It is also extremely common for sellers to direct that a portion of the sales proceeds be directed to pay seller’s debts.

In closing, the purchase/sale of a business is a process, not an event. In some ways it is analogous to a marriage. “Dating” is the letter of intent. The confidentiality agreement is “going steady.” The purchase agreement contains the “vows,” and the closing is the “wedding.”

Prudent use of your professional counselors: your attorney, your C.P.A., your banker and your Association, can help smooth this “process” and help you make the most of your perfect opportunity