

Suite 504**PURCHASE OF AN ENTERPRISE**

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504.01 BUYING A BUSINESS

The idea of running a small business appeals to many would-be entrepreneurs. But the fantasy often loses its allure when faced with the realities of dealing with the business plans, investors, branding and legal issues. For those disheartened by such risky undertakings, buying an existing business is often a viable alternative.

If you get it right, there can be many good reasons why buying an existing business could be the right move for you. Remember, though, that you will be taking on the legacy of the business' previous owner, and need to be aware of every aspect of the business you're about to buy.

Choosing a Business

Finding profitable businesses for sale at reasonable prices can be difficult. Business owners often have an inflated idea of the market value of the business. There are, however, many resources for finding profitable businesses for sale.

Ideally your business needs to fit your own skills, lifestyle and aspirations. Before you start looking, think about what you can bring to a business and what you'd like to get back.

It is useful to consider:

- **Your expectations in terms of earning** – what level of profit do you need to be looking for to accommodate your needs?
- **Your commitment** – are you prepared for all the hard work and money that you will need to put into the business to get it to succeed?
- **Your strengths** – what kind of business opportunity will give you the chance to put your skills and experience to good use?
- **The type of business** – limited company, partnership etc - that you're interested in buying.
- **The business sector you're interest in** – learn as much as you can about your chose industry so you can compare different businesses. It's important to take the time to talk to people already in similar businesses.
- **Location** – don't restrict your search to your local area. Some businesses can be easily relocated.

Once you have determined that you want to purchase a business, you must decide on the purchase price. This will depend on a number of factors, including whether you are going to purchase the balance sheet (includes both assets and liabilities) or just the assets.

504.02 ADVANTAGES & DISADVANTAGES

Advantages

Among the many favourable aspects to buying an existing business is the drastic reduction in start-up costs. Some of the ground work will already have been done in getting the business up and running. In addition, cash flow may be immediate because of existing inventory and receivables. Therefore, it may be easier for you to get finance as the business will have a proven track record. Other positive side effects include existing goodwill as well as a business and marketing plan should be in place. Existing employees should have experience you can draw on and many of the normal problems will have been discovered and solved already.

Disadvantages

Among the biggest downsides to buying a small business is the initial purchasing cost. Because developing the business concept, customer base, brands and other fundamental work has already been done, the costs of acquiring an existing business may be greater than starting up a new business. Other possible disadvantages include hidden problems associated with the business and receivables that are valued at the time of purchase, but later turn out to be non-collectable, has a positive track record. You will need to honour or renegotiate any outstanding contracts the previous owner leaves in place. Check to see why the business is being sold talk with staff and see if the business has been run badly and if staff morale is low. How would they feel about a change in ownership?

STEPS TO COMPLETION

Professional Help

The first step is to seek professional help. Professional help is invaluable as you go through the negotiation, valuation and purchase process. A qualified attorney should be enlisted to help review the legal and organizational documents of the business you are planning to purchase. An accountant can help do a proper evaluation of the financial condition of the business. You may find it useful to contact the professional organisations to get advice and help on finding a solicitor or an accountant.

Research

Once you've found a business that you would like to buy, it's important to conduct a hard, objective investigation. Look into every aspect of the business, verifying whether the owner's stated reasons for selling are legitimate, and double checking every detail for accuracy. Shortlist two or three businesses which you are interested in and include the best time to buy. Check the definitions which follow and make sure the business is worth buying.

504.03 HOW TO VALUE A BUSINESS

Valuing a business can be one of the most worrying parts of buying an existing business.

There are several valuation methods you can use. For specific advice on valuation methods see Suite 506.

Once you have considered all the factors listed in this Suite and you can then decide how much you want to offer, or whether you want to buy it at all.

If you do decide to make an offer, and agree a price with the seller, a period of time is allowed for you to verify that all of the information you have been told is accurate. This is known as due diligence.

Due diligence

Having completed your research, you should verify the information. A period of time is allowed for you to access the business' books and records. This is known as **due diligence**. It should give you a realistic picture of how the business is performing now, and how it is likely to perform in the future.

Don't start due diligence until you've agreed a price and terms with the seller. For a down payment they may agree to take the business off the market during your investigation.

The investigation period is negotiable – but most small businesses need at least three to four weeks.

Due diligence is about much more than the finances of a business. You need to come out of this period knowing exactly what you are getting into, what needs to be fixed, what it will cost to fix them and if you are the right person to take on this business.

Initial viewing and valuation

Be discreet – owner may not want staff to know they are selling, but be thorough and record key findings.

Arrange finance

Lenders generally require:

- Details of the business/sales particulars
- Accounts for the last three years
- Financial projections – if no accounts are available
- Details of your personal assets and liabilities

There are several possible sources of finance you could consider. For specific advice, see Suites 406 and 408.

Make an offer

If you make your initial offer by phone, follow this up in writing. Head your letter **subject to contract** and include this phrase in all written communication.

Negotiation

Before completing the sale, try to negotiate an overlap period so you have time to become familiar with the business before taking over. Record all the main points agreed.

Completion

Even after you reach an agreement on the price and terms of sale, the deal could still fall through. You have to meet certain conditions of sale to complete, including:

- Verification of financial statements
- Transfer of leases
- Transfer of contracts/licences
- Transfer of finance

Looking after existing employees

There are regulations that govern what happens to employees when someone new takes over a business. These apply to all employees when a business is transferred as a going concern, meaning employees automatically start working for the new owner under the same terms and conditions. For more information see Suite 606.

Employment tribunal awards

When you buy an existing business, you might decide you need to employ fewer staff. But be careful about making any changes, as an employee might take a case to an employment tribunal for unfair dismissal or unfair selection for redundancy. It's best to consult your attorney before making any such changes. For more information see "dismissal and making an employee redundant" Suites 606 and 608.

Inform and consult employees

If you do want to discuss reducing employee numbers or reorganising staff, it's a good idea to do this once you've completed the due diligence period, but before you take over the business. As the new employer you should inform and consult all employees – including employee representatives – who may be affected. Again please consult Suites 606 and 608 for more information.

Pensions

As their new employer, you do not have to take over rights and obligations relating to employees' occupational pension schemes put in place by the previous employer. However, if you don't provide comparable pensions arrangements, you could theoretically face a claim for unfair dismissal.

IMPORTANT CONSIDERATIONS

Fair Market Value

Most people believe that a business should be sold for fair market value. A valuation requires a thorough analysis of several years of the business operation and an opinion about the future outlook of the industry, the economy and how the subject company will compete.

Goodwill

Goodwill is defined as the characteristics of a business or individual that cause customers to return to that business or person. Goodwill is considered in almost every type of business valuation and clearly contributes to the tangible value of a business.

Sales Agreement

The sales agreement is the key document in buying the business assets or the stock of a corporation. It is important to have an attorney make sure the agreement is accurate and contains all of the terms of the purchase.

Financing

It may be important at this time to consider the financing of the purchase. If you have the proceeds in place, then you can proceed to pre-closing activities. If you need to obtain financing, look at options available for loans.

Letter of Intent

A letter of intent usually creates a non-binding offer to purchase the business, and is usually needed in order for the seller to provide sensitive information about the business. It should spell out the proposed price, terms, and conditions for the sale of the business. The letter should also state that either side may revise or quit for any reason.

Confidentiality Agreement

Often required by the seller, a confidentiality agreement indicates that you won't use the information about the seller's business for any purpose other than making the decision to buy.

PRE-CLOSING – DUE DILIGENCE

Tax Returns

Review the business' tax returns from the past three to five years. This will help you determine the profitability of the business and also determine whether any tax liability is outstanding.

Financial Statements

Examine the financial statements from the business for at least the past three to five years. Also make sure that the statements are accompanied by an audit letter from a reputable CPA firm. Don't accept a simple financial review by the business itself.

Contracts and Leases

It's important to discover all the obligations that the business is subject to. Also be aware that you may also have to work with the current landlord to assume any existing lease on the business premises or negotiate a new lease. If you acquire an existing lease from another lessee, you may have to pay the previous lessee for the privilege. The cost of acquiring your lease may be amortized over the remaining term of the lease.

Important Documents

Numerous documents should be checked during an investigation. They include:

- Real & personal property documents
- Bank accounts
- Customer lists
- Sales records
- Supplier/purchaser list
- Contracts
- Advertisement materials
- Inventory receipts/lists
- Organization charts
- Payroll, benefits and employee pension/profit sharing info
- List of employees
- Certification by: government and local government
- List of owners

Business Structures

It's important to find out how the company is structured legally. The type of business structure used will affect your purchasing strategy as well as the eventual price.

- **Sole Proprietor** - Under a sole proprietorship, the business is owned in an individual capacity. The assets are held in the name of the owner or of the individuals who own the business. Therefore, when buying a sole proprietorship you should determine if you are buying just the assets or both the assets and liabilities.
- **Partnership** - Under a partnership, the business is owned by a group of two or more entities. This could prove more difficult therefore it is important to see the partnership agreement to make sure that the people you are dealing with have the authority to act on behalf of the partnership.

- **Corporation** - When you are buying from a corporation it is important to determine the best way to structure the purchase. You must determine if you are going to buy the corporation itself (stock purchase) or buy the assets only leaving the original corporation intact. In most situations you will be much better off buying the assets of the corporation rather than the corporate stock. The following are advantages of purchasing the assets vs. the stock:
 - It helps you avoid the liabilities of the existing business
 - It gives you significant tax advantage
 - It helps you avoid acquiring unwanted assets from the corporation
 - You are generally able to get a higher tax basis for depreciable assets, which means, there's less taxable gain to report if you later sell the assets.

There are some circumstances when purchasing the stock of the corporation has its advantages. One common example is when the corporation has a uniquely valuable asset that can't be transferred. An example of this would be a lease with an option to renew that is not freely assignable. The availability of keeping the current location may make it more advantages to purchase the stock of the corporation

Licenses & Permits

With the many tasks involved in starting a business, it's easy to overlook the important legal requirements associated with registrations, permits and licenses. In addition to the information listed here, you can seek help from the Chamber of Commerce, a lawyer, or trade association serving your business, profession or industry.

Most businesses need licenses and permits to operate. The type of license or permit you need depends on your industry and the state or country in which you are located. License and permit requirements also affect where you locate your business, how much you'll have to spend for remodelling and whether or not you'll have to provide off-street parking.

Zoning

It is important to check the zoning requirements for the area where you are acquiring your business. The zoning requirements may affect the type of business that you are intending to operate in a particular area.

Environmental Concerns

If you are acquiring real property along with the acquisition of the business, it is important to check the environmental regulations in the area.

Resources

Chambers of Commerce can be helpful in helping determine the type of business options available. Once you've determined the type of industry you're interested in, Trade Associations can be good places to find businesses for sale. More obvious examples include the classified sections of newspapers. Finally, business brokers match business sellers with potential buyers.

PURCHASE CHECKLIST

504.04 PURCHASING STRATEGY

Once you have determined that you want to purchase a business, you must decide on the purchase price. This will depend on a number of factors, including whether you are going to purchase the balance sheet (includes both assets and liabilities) or just the assets.

The sales agreement is the key document in buying the business assets or the stock of a corporation. It is important to make sure the agreement is accurate and contains all of the terms of the purchase. It is essential to have an attorney review this document. It is in this agreement that you should define everything that you intend to purchase of the business, assets, customer lists, intellectual property and goodwill.

The following is a checklist of items that should be addressed in the agreement:

- Names of Seller, Buyer & Business
- Background information
- Assets being sold; Asset Acquisition Statement (IRS Form 8594)
- Purchase price and allocation of Assets
- Covenant Not to Compete
- Any adjustments to be made
- The Terms of the Agreement and payment terms
- List of inventory included in the sale
- Compliance with the Bulk Sales laws of the state
- Any representation and warranties of the seller
- Any representation and warranties of the buyer
- Determination as to the access to any business information
- Determination as to the running of the business prior to closing
- Contingencies
- Possibilities of having the seller continue as a consultant
- Consultation/Employment Agreement
- Fees – including brokers fees
- Date of closing
- Closing or settlement sheet

CLOSING CHECKLIST

It is important during the closing to make sure that you have legal counsel available to review all of the documentation necessary for the transfer of the business.

The following items should be addressed in a closing:

- **Adjust purchase price** – This would take care of prorated items such as rent, utilities and inventory up the time of closing.
- **Review documents** required to be provided by the seller – Would this require a corporate resolution approving the sale, evidence that a corporation is in good standing, any tax releases that may have been promised by the seller. Check with your local department of corporations, Companies House or secretary of state.
- **Signing promissory Note** – In some cases the seller will carry back financing, so have an attorney review any Note documentation.
- **Security Agreements** – These documents may be necessary if you are going to finance your purchase. A Security Agreement lists the assets that will be used for security as a promise for payment of the loan.
- In America – **UCC Financing Statements** – These documents are recorded with the Secretary of State in the State you have purchased your business. (These documents are necessary if you are going to finance your business). Other countries will most probably have a similar requirement and should be check by an attorney.
- **Lease** – If you have agreed to assume an existing lease, you will be required to execute the assumption. Make sure that you have the landlord's concurrence to assumption of the lease. You may instead be required to negotiate a new lease with the landlord instead of assuming the existing lease.
- **Vehicles** – If the purchase includes vehicles you may have to execute the transfer of documents for the vehicles. You can check with your local department of motor vehicles to determine the correct procedure and to secure the necessary forms.
- **Bill of Sale** – The bill of sale will be proof of the sale of the business and will transfer the ownership of the other tangible business assets not specifically transferred on their own.
- **Patents, trademarks and copyrights** – The necessary forms may need to be executed as part of the transaction.
- **Franchise** – This will require the execution of Franchise Documents as part of the purchase of the business.

- **Closing or settlement sheet** – The closing or settlement sheet will list all financial aspects of the transaction. Everything listed on the settlement should have been negotiated prior to the closing so there should be no surprises.
- **Covenant Not to Compete** – It is a good idea to have the seller execute this agreement. This will help add to the success of your operation of the business without any interference from the previous owner.
- **Consultation/Employment Agreement** – If seller has agreed to remain on for a period of time this documentation would be necessary.
- **Complete Tax Form, Asset Acquisition Statement** – This document will indicate how the purchase was allocated; the amount and various assets. This would be important for your tax return.
- **Bulk Sale Laws** – Make sure that all bulk sale laws have been complied with in the transfer of the business assets.

BUYING A FRANCHISE

While an independent business offers freedom of choice, franchises offer the security of working with a known product or service as well as the expertise of the franchiser. For those looking to purchase an existing business, buying into a franchise can be an attractive option. While franchisees have the highest survival rate of any type of business start up, the operational and financial restrictions on franchisees are greater as well.

For those looking to purchase an existing business, buying into a franchise can be an attractive option. While franchises have the highest survival rate of any type of business start-up, the operational and financial restrictions on franchisees are greater as well. Franchise law is a complicated and highly specialized area, and it is essential to enlist the service of a qualified attorney throughout the entire process.

If you're considering buying a franchise, consider taking a workshop or reading extensively about the pros and cons of franchising before you begin shopping. Once you are operating a franchise, it's important to keep abreast of trends in your industry, changing legal regulations and other franchising issues.

504.05 WHAT IS FRANCHISING?

A franchise is a legal and commercial relationship between the owner of a trademark, service mark, trade name, or advertising symbol and an individual or group wishing to use that identification in a business. The franchise governs the method of conducting business between the two parties. Generally, a franchise sells goods or services supplied by the franchisor or what meet the franchisor's quality standards.

Franchising is based on mutual trust between the franchisor and franchisees. The franchisor provides the business expertise (marketing plans, management guidance, financing assistance, site location, training, etc.) that otherwise would not be available to the franchisee. The franchisee brings to the franchise operation the entrepreneurial spirit and drive necessary to make the franchise a success.

There are primarily two forms of franchising:

- Product/trade name franchising and
- Business format franchising

In the simplest form, a franchisor owns the right to the name or trademark and sells that right to a franchisee. This is known as "product/trade name franchising". The more complex form "business format franchising", involves a broader ongoing relationship between the two parties. Business format franchises often provide a full range of services, including site selection, training, product supply, marketing plans, and even assistance in obtaining financing.

Business format franchise

This is the most common form of franchising. A true business format franchise occurs when the owner of a business (the franchisor) grants a licence to another person or business (the franchisee) to use its business idea – often in a specific geographical area.

The franchisee sells the franchisor's product or services, trades under the franchisor's trade mark or trade name and benefits from the franchisor's help and support.

In return, the franchisee usually pays an initial fee to the franchisor and then a percentage royalty on sales.

The franchisee owns and outlet it runs. But the franchisor keeps control over how products are marketed and sold and how their business idea is used.

Other types of sales

Different types of sales relationships are also sometimes referred to as franchises. For example:

- **Distributorship and dealership** – you sell the product but don't usually trade under the franchise name. You have more freedom over how you run the business.
- **Agency** – you sell goods or services on behalf of the supplier.
- **Licensee** – you have a licence giving you the right to make and sell the licensor's product. There are usually no extra restrictions on how you run your business.

Multi-level marketing

Some business offer franchises that are really multi-level marketing. Self-employed distributors sell goods on a manufacturer's behalf. You get a commission on any sales you make, and also on sales made by other agents your recruit.

Be careful, as some multi-level marketing schemes may be dishonest or illegal.

504.06 PURCHASE STRATEGY

Pre-Purchase Detective Work

In addition to the routine investigation that should be conducted prior to any business purchase, potential franchise buyers should be able to contact other franchisees before deciding to invest. They should also obtain a uniform offering circular containing vital details about the franchise's legal, financial and personnel history before signing a contract.

Reasonable Expectations

Before signing, franchisees should make sure they will have the right to:

- Use the franchise name and trademark
- Receive training and management assistance from the franchiser
- Use the franchise's expertise in marketing, advertising, facility design, layouts, displays and fixtures
- Do business in an area protected from other competing franchisees. In some cases the franchisee may negotiate to have the franchiser help obtain building permits, purchase or lease equipment, signs and supplies, and construct or remodel the business premises.

Possible Pitfalls

The contract between the two parties usually benefits the franchiser far more than the franchisee. The franchisee is generally subject to meeting sales quotas, and is required to purchase equipment, supplies and inventory exclusively from the franchiser. The franchiser often has the right to terminate the franchise if it fails to operate the business according to the agreement, becomes delinquent on royalties or violates other contract specifications.

Professional Help

The tax rules surrounding franchises are often complex, and an attorney, preferably a specialist in franchise law, should assist the prospective franchisee to evaluate the franchise package and tax considerations. An accountant may be needed to determine the full costs of purchasing and operating the business, as well as assess the potential profit to the franchisee.

504.07 COSTS OF A FRANCHISE

When calculating the likely cost of a franchise, you need to take both initial and ongoing fees into account.

Initial costs

The franchisor – the company which sells you the franchise – usually charges an upfront fee. This should be a relatively low administration fee. Good franchisors make most of their profits from continuing royalties.

Your largest initial costs are usually your investment in:

- Premises
- Equipment
- Initial stock

Continuing costs

You usually pay a royalty – a percentage of sales – to the franchisor. Alternatively you may pay a management fee of some kind.

Under the terms of the franchise agreement, you may have to purchase stock from the franchisor. Check what they charge. They may mark up the prices – or they may be able to offer them to you at a discount because of their purchasing power.

You also have to pay the usual business costs – for example, rental on premises, utilities or the costs of any employees you take on. Again, check whether anything you pay for through the franchisor has a realistic cost.

Check too whether the agreement includes additional charges. For example, you may be required to pay for training, or to contribute to the cost of national advertising campaigns.

Tips on franchise agreements

The franchise agreement is crucial. Don't sign any agreement, or pay any fees or deposit, until you have taken legal advice from a lawyer. Get a specimen contract for them to review.

Areas covered by a typical agreement

- **Term** – how long does the franchise last? Will you have the option to renew it, and on what terms?
- **Territory** – what area does your franchise cover? Do you have exclusive rights to sell within it?
- **Fees** – what initial fee will you pay? What royalties will you pay on sales? Will you pay a regular management fee? Will you have to pay other costs? How are the costs worked out?
- **Support** – how much help will you get starting the business? What continuing support will you get?

- **Restrictions** – what restrictions are there on what you’re allowed to do and how you must run the business?
- **Exit** – what happens if you can’t continue in business for some reason – perhaps due to ill health? What happened if you want to sell your franchise?

Business Structure as pertains to Franchise

Once you find a business that you may be interested in, determine what type of legal entity owns the business: Sole Proprietor, Partnership or Corporation. This will affect your purchasing strategy.

SBA Workshop

In the United States and over the Internet, the Small Business Administration (SBA) sponsors a self-guided online workshop for those who are considering buying a franchise. The workshop is free and can be taken at any time.

Associations and Forums

- **The Lets Talk Business Network** provides entrepreneurial support with communities, newsletters and articles.
- **The Franchise Equity Forum** provides advice on legal issues related to protecting and expanding a franchise, as well as how to effectively communicate with your franchisor.
- **The American Franchisee Association (AFA)** is a national trade association of franchisees and dealers with over 7000 members.

In the United States the Federal Trade Commission’s (FTC) Franchises and Business Opportunities Web pages contain federal guidelines and other information potential franchisee need to know.