Introduction

When purchasing a business or company, the prospective purchaser must turn his or her mind to a number of preliminary issues. This introduction is intended to point out those issues and highlight what the lawyer and client need to consider.

Due Diligence

"Due diligence" or "business investigations" is a term coined by practitioners to describe the detailed risk review of the target business or company prior to acquisition. Proper investigation of the factors may take considerable time and effort and often a prospective purchaser may be tempted to shortcut them to avoid missing out on the sale.

The purpose of due diligence is therefore to provide information to the prospective purchaser that might change his or her view of the desirability, price, or conditions of purchasing or investing in the business or asset being assessed. Typically, the vendor will have greater or more detailed knowledge of the business than any prospective purchaser. Due diligence on the business reduces the risk for the purchaser of paying a higher price than the purchaser might be prepared to pay if they were more fully informed.

The other principal way a purchaser commonly seeks to reduce his or her risk is by seeking warranties from the vendor. For a discussion of this topic, see Warranties below. For present purposes, the material point is that a vendor who is required to provide extensive warranties in connection with the sale of either a business or shares will commonly conduct its own due diligence on its business. In this way the vendor is able to assess for itself the impact of giving warranties, which will clearly assist the vendor in its sale negotiations.

Checklist for Due Diligence

Due diligence checklists, either in relation to a share purchase or an asset purchase, are common. Often they are modelled to the relevant industry sector and in many cases come to 10 pages or more. Some issues that are common to most such checklists are:

1. **Reasons for selling.** These may include:
   - decline in business;
   - lack of competitive strength;
   - Government policy
   - an urgent need to replace capital assets
   - labour issues
   - the vendor's poor reputation.
2. **Stock.** Is the stock obsolete or aged? What about the saleability of goods? Costing basis? Does the stock have insurance cover? And, importantly; is the stock valuation realistic?
3. **Assets.** Schedule items to be purchased, identify those required to maintain forecast revenue, what is their market value? Age? Obtain confirmation of ownership and pattern of past repair costs. How much has been expended on

maintaining them? Need for significant upgrades? Does the vendor hold all necessary titles to the assets?

4. **Goodwill.** Have there been any product liability claims against the company? Does the vendor/company hold all consents or permits necessary to carry on the business, and are they transferable? What factors might impact on future revenue? Is the vendor aware of any reason why customers of the business would not remain with the business when the acquisition has been completed?

5. **Accounts receivable.** Where possible avoid purchasing these. What about provision for bad debts? What discounts have been given? What is the current economic climate and how does it affect debtors?

6. **Contracts.** What unusual or onerous contracts have been entered into in the course of the business?

7. **Leases.** Are they transferable to purchaser? Are the terms acceptable? What are the rent review provisions? What type of business can be undertaken on the premises (this may affect subsequent sale price)? Is there an option for renewal?

8. **Labour.** Will staff be retained? What is the potential redundancy cost and what other entitlements, such as holiday pay, long service leave, sick leave, superannuation or medical entitlements, apply to them? What employment disputes have there been in connection with the business?

9. **Liabilities.** What liabilities are being assumed by the purchaser? Has the vendor/company met all liabilities of the business as they have fallen due?

10. **Litigation.** Are there outstanding litigation issues? What previous litigation has the vendor/company been involved in?

11. **Taxation**. Has the vendor/company filed all tax returns on a timely basis and has it paid all tax due? What taxation disputes has the vendor/company been involved in?

This list is by no means extensive and is merely intended to give the reader a snapshot of the sorts of questions that arise in the course of conducting a due diligence.

Financing the Acquisition

To determine the working capital requirements of the business it will be necessary to prepare sales, profit and cashflow forecasts for at least the first year.

There must be enough capital for:

- working capital;
- capital upgrades;
- maintenance;
- stock;
- new equipment;
- cash to carry accounts receivable;
- reserve for taxes;
- opening expenses, etc.

The prospective purchaser must make adequate forecasts for all of these. When you have asked these questions, consider; is it now worth the asking price?

Vendors will sometimes offer finance to assist with the purchase of the business. Typically, financial institutions will require some form of security (especially real estate) over the assets of the business.

From the purchaser's point of view, if finance is necessary, the sale and purchase agreement should be conditional on the purchaser obtaining the necessary finance.

Debt or Equity Funding?

Debt funding:

- This involves a loan to the company in the form of shareholder or third party loan.
- Loans, including shareholder loans, carry no features of equity participation and therefore confer no prospect of increased value as a result of the company's increased prosperity.
- It is simpler to repay debt to a shareholder than to return capital to a shareholder (usually done by way of a share repurchase), thus shareholder funding that is intended to be only temporary is more often represented by debt than equity.
- What security, if any, will be provided for loans to the company? A debenture over the company's assets is most common.
- In the case of a shareholder loan, will it be subordinated to any third party financing?
- Will the debt be interest bearing?

Equity funding:

- This involves owning shares in the company which carry with them the benefits of ownership of the company (eg, voting rights and rights to dividends).
- Where shares are issued, consider the effects on control of the company. If control is not intended to change upon an issue of shares, the voting rights attaching to those shares will need to be limited appropriately.

Goodwill

Valuations are inherently subjective and the valuation of goodwill gives testimony to this fact. Goodwill is an unidentifiable, intangible asset. It cannot be individually identified and is an intrinsic part of the business. Goodwill represents the future economic benefits associated with an existing customer base, efficient management, reliable suppliers, and so on. It is not something that is separately transferable with the business.

Goodwill is generated externally (ie, purchased goodwill can be measured more objectively on the basis of the amount paid for it than internally generated goodwill; which is not brought to account). Purchased goodwill is measured as the excess of the cost of acquisition (purchase consideration plus incidental expenses) incurred by the purchaser, over the fair value of the identifiable net assets acquired.

Other than in relation to a property lease, goodwill is generally capital for tax purposes and non-assessable for the vendor and non-deductible for the purchaser.

Intellectual Property

The intellectual property of a business can be described as a non-monetary asset without physical substance that includes trademarks and patents. Invariably it has value of its own.

The prospective purchaser should obtain details of all patents, trademarks, know-how, copyright or registered designs, and any other intellectual property rights owned, licensed, used or enjoyed to or by the company or business.

In the case of the intellectual property listed above the prospective purchaser is to ask for details of the author/inventor, registered owner, descriptions and numbers, dates of expiration, chain of title from inventor to company, copies of all relevant registration, licences, sub-licences, or agreements. It will also be prudent to obtain details of any infringement of property rights by the company or business, or of intellectual property owned by the company or business.

The prospective purchaser should also undertake a review of domain names registered by and against the company. It has been recognised by New Zealand courts that domain names attract goodwill; it may be prudent to review what is on the internet.

Employees

Any prospective purchaser will wish to secure the ongoing services of key employees, while retaining employees who are not transferring to the new owner. Any contract would need to be subject to these conditions and on terms that are satisfactory to the prospective purchaser.

A purchaser should seek from the vendor a warranty to pay all wages to those employees to the date of settlement, including all holiday pay, and other leave so that the prospective purchaser starts on a clean slate. In the absence of a warranty, or if there is risk to a purchaser relying on the warranty (e.g., the vendor is an offshore party or in financial distress), a purchaser should investigate thoroughly all employee issues, disputes or entitlements.

Contracts and Agreements

It is important to verify and validate all contracts and agreements that are material to the business or company. These contracts must be enforceable and assignable. It is important to consider the term of the agreements, termination rights and the ability to assign the agreement at a later stage. Generally, a purchaser would be unwise to assume liability under a long-term contract that does not entitle it to terminate within a reasonable period, or if a change of circumstances makes it undesirable for the purchaser, or less desirable than was the case when the purchaser entered into or assumed liability under the contract.

Warranties

An area of warranties is usually enthusiastically negotiated. Clearly it is in the vendor’s interests to keep these to a minimum and, if possible, to limit both the maximum liability they provide for and the time period within which a warranty claim can be brought. Conversely, it is in the purchaser’s interests to avoid any limitations. Warranties are all about risk assessment and the willingness of the parties to accept risk. A vendor who is confident that no liabilities are likely to flow from a warranty may be prepared to accommodate a purchaser’s demands and to provide extensive warranties.

Often a vendor’s position will be governed by the size of the business. Obviously, the smaller the business, the more room there is for a vendor to have a high degree of confidence about any liabilities. The larger the business, the more the vendor has cause for concern, and the more the purchaser will wish to receive extensive warranties.

Usually the parties are able to find some middle ground. If not, the purchaser will need to either extend its due diligence accordingly or decide upon the level of risk it might accept. The issue is of greater importance where the purchase is one of shares in a company, rather than the assets and undertaking of the company. In the case of a share purchase the purchaser effectively inherits all liabilities touching the business. That is not so with an asset purchase.

What is the Difference Between the Sale and Purchase of Assets and Shares?

An agreement for the sale and purchase of assets:

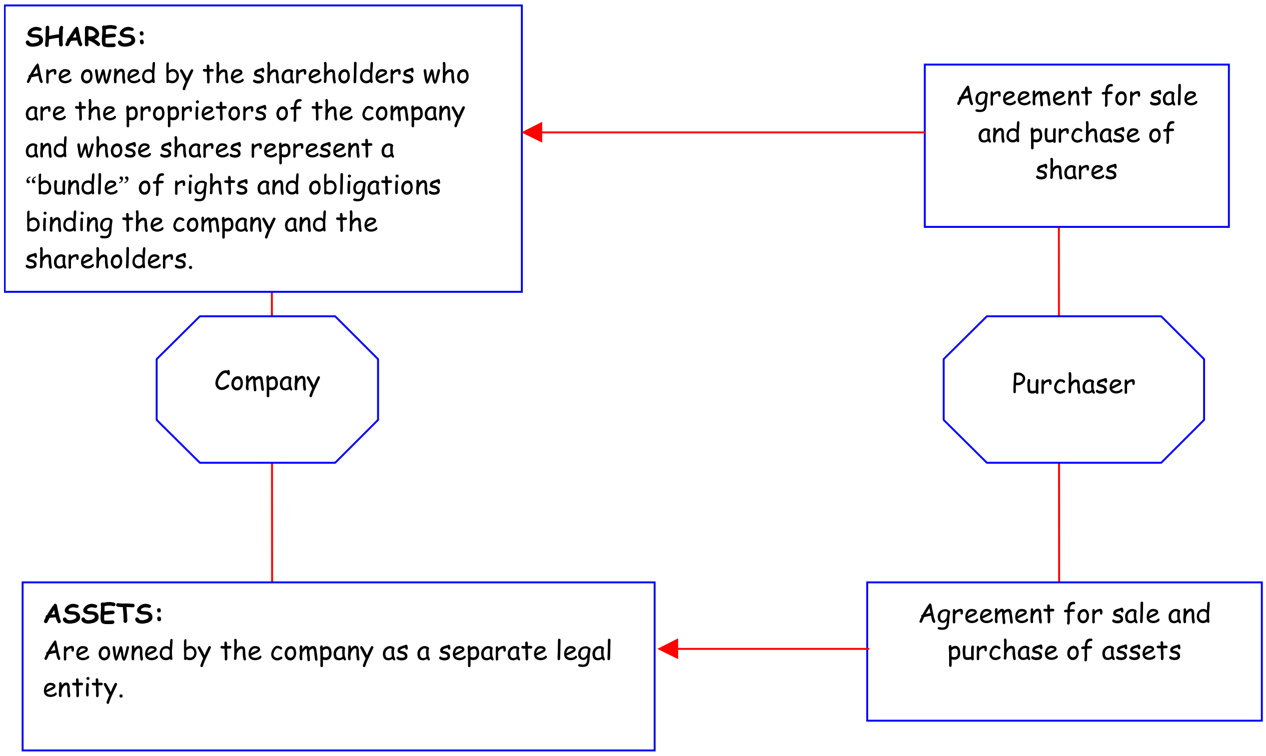
- involves the purchase of specific assets owned by the company, in which case:
    - the agreement for sale and purchase must identify, with as much specificity as possible, which assets are being purchased;
    - if the assets are purchased as a "going concern", the purchase of those assets will be zero-rated for GST purposes (although to qualify for zero rating the parties must expressly state in the agreement that the assets are being transferred as a going concern). If only part of an existing business is being purchased, the purchaser will need to be able to show that the assets being purchased include all the elements necessary for the business to continue as a "going concern", otherwise the transaction will attract GST;
- may involve the transfer of liabilities associated with the business assets from the vendor to the purchaser. Any liabilities that are intended to be transferred must be identified in the agreement for sale and purchase.

An agreement for the sale and purchase of shares:

- involves the purchase of some or all of the shares in a company.

The ownership of the company's assets and liabilities remains unchanged (i.e., remains with the company). If the company, the shares in which are being purchased, has assets or liabilities that the purchaser does not wish to acquire indirectly when it acquires the shares in the company, the vendor will need to agree with the purchaser the basis upon which the company is to dispose of the unwanted assets/liabilities before the shares in the company change hands.

Unless and to the extent that the agreement contains provisions specifically addressing company liabilities, in effect the purchaser of shares inherits the entire trading history of the company, including the risk of claims arising from it.


SHARES:
Are owned by the shareholders who are the proprietors of the company and whose shares represent a "bundle" of rights and obligations binding the company and the shareholders.
Agreement for sale and purchase of shares
Company
Purchaser
ASSETS:
Are owned by the company as a separate legal entity.
Agreement for sale and purchase of assets