**Business Law Seminar – 2 November 2015**

**The legal pitfalls of purchasing a business**

The Importance of Due Diligence

There are necessary costs associated with conducting due diligence, however, the benefits always outweigh these costs.

The information below is relevant to;

* Liquidators selling business – these are matters which the solicitor and accountant for buyers will address
* Liquidators involved with Pre-packs – these matters need to be addressed
* Liquidators setting aside uncommercial transactions – these are the matters which should be addressed and their absence will be indicative of an uncommercial transaction
* Accountants who assist clients in the sale (or purchase) of a business

Accountant’s role in Due Diligence for Purchaser

* Analyse financials, P&L, Balance Sheet, Tax Returns, Information Memorandum etc
* Advice on current and future profitability of the business’
* Advice on value of business - suitability of purchase price
* Tax and business structure advice
* Negotiations

Lawyer’s role in Due Diligence for Purchaser

* Purchaser’s business structure (individual, partnership, existing/new company, trust)
* Identify the purchase – shares, partnership interest, business name and assets, just physical assets
* Identify the assets – including employees, customer contracts, supplier contacts, IP
* Restraints of trade – against outgoing Vendor and non-retained employees
* Premises – owned or leased, rights of occupation, length of guaranteed occupation
* Advice on Contract for Sale of Business and Lease/Contract for Purchase of Land
* Searches – ASIC, ABN, PPSR, ATMOSS (IP), domain/website

**Case Study – The Thrifty Purchaser of a Small Business**

Summary of Facts

* Client buying business for 18 year old daughter
* The business - small Beautician and Day Spa in Ballina
* Minimal due diligence – limited tax/finance advice; no legal advice
* Vendor had lawyer draft contract and advise
* Vendor provided large volume of documents – “That’s all”
* Sale of business name and assets occurs
* Client opens new Beautician and Day Spa (new name)
* Inundated with gift vouchers
* Purchaser’s choice: Honour vouchers OR reject and damage brand

What went wrong?

When our client opened their business, they were inundated with customers of the previous business seeking to redeem gift certificates. Our client was compelled to honour the previous Spa’s gift certificates or face significant irreparable loss and damage to their business and reputation (small town).

Unbeknownst to our client, the Vendor sold and/or gifted a large number of gift certificates for products and services to be supplied by the business up to and immediately prior to the sale of the business to our client.

The large number of gift certificates issued created a significant liability for our client and their new business. None of the documents provided contained any information regarding the gift certificates.

Prior to purchase, our client had requested the Vendor provide a list of all outstanding liabilities of the business. In response, the Vendor said that “*There are no monies owing to anyone or outstandings*”. However, this was not in the Contract for Sale of Business.

Importantly, the client was too trustworthy and inexperienced at purchasing a business, the business had a low purchase price, client did not want to spend money on professional advice, nobody reviewed the Vendor’s computer software and electronic records.

Lessons to be Learnt – Due Diligence

Like the purchase of residential property, people often ‘fall in love’ with a business they are interested in purchasing. As the client can be blinded by this, it is important to slow down, conduct a proper due diligence, ensure it is a “good buy” and obtain professional assistance from accountants and legal practitioners.

Even if the purchase price is relatively low – obtain financial/tax and legal advice.

The Purchaser needs to make sure it knows what it is purchasing – identify all assets and liabilities, free title?, unencumbered goods?, value of goodwill? Etc

**Case Studies – Uncommercial Sale of Business**

*McDonald and Anor v Hanselmann Matter No 3480/97 [1998] NSWSC 171 (28 April 1998)*

… so that one sees that the agreement was to sell the whole two pages worth of plant and equipment plus goodwill, and what I might call customer base, for a package price of $46,000

It seems to me that in the instant case one can take neither the going concern value nor the auction value as being the true value. The truth is that the controller of the company knew that his son was interested and that his son was willing to take virtually the whole of the plant and equipment for his new business.

The authorities show that where one has such a situation even if there are no other potential buyers, the value of the property is the amount which the only purchaser would be prepared to pay for it rather than to lose the property.

…I would think that had the difference between what was paid and the value of the property been less than 15% of the value of the property, I would have been justified in holding that there was not such a magnitude of discrepancy in value as would make the transaction uncommercial.

*Welcome Homes Real Estate Pty. Limited & Ors. v. Ziade Investments Pty. Limited & Anor. [2007] NSWCA 167 (13 July 2007)*

56 However, the circumstance that there is a family relationship is also a reason for scrutinising a transaction closely: McDonald v. Hanselmann [1998] NSWSC 171 ; (1998) 144 FLR 463 at 470. The circumstance that a transaction does not define or require benefits that are said to be expected from it, and to justify it, is a factor strongly suggesting that the transaction is not one that a reasonable person in the company’s circumstances would enter into.

*Skouloudis Group Pty Limited v Planet Enterprizes Pty Limited [2002] NSWSC 239 (28 March 2002)*

1 An order for the winding up of Skouloudis Group Pty Limited (the company) was made on 9 November 2001. Mr Lord, the second plaintiff, was appointed liquidator of the company. Some time after 30 June 2001 the company sold one of its assets, namely the newspaper O Kosmos. At the time of sale, the company was insolvent.

16… (a) Assuming that the purchaser would comply with her obligation to discharge the business liabilities, the benefits to the company of entering into the transaction were to have those liabilities discharged. On the evidence it was not able to discharge those liabilities itself.

(b) There would only be a detriment to the company in entering into the transaction if at the date it took place it could have obtained a higher price for the business or, if it were able to continue running the business in the future, some profits would eventually be obtained as a result of it doing so.

(c) The respective benefits to vendor and purchaser can only be looked at in the light of the foregoing two comments. The only evidence as to a proper price for the business at the time the transaction took place is the evidence that other potential purchasers were around who might have paid about the same price. If a transaction to that effect had in fact been entered into, then the benefits to the company would have obtained a sum of money which might have paid out most of the creditors of the newspaper business. On the other hand, assuming that Mrs Skouloudis or Planet was able from a financial point of view to comply with the obligations to discharge the creditors then on the evidence as it stands the company would be in no worse a situation and perhaps a slightly better situation because the obligation was to pay out all creditors rather than to pay a particular price.

17 Various matters are put forward by counsel for the plaintiffs as indicia of uncommerciality. These may be summarized as follows:

(a) That there was no written agreement for transfer of business and no resolution of the directors of the company to sell the business.

(b) That there was no ascertainable purchase price.

(c) That there were no listings of creditors, liabilities to employees, plant and equipment and stock to be assigned. That there were no arrangements for a lease of the premises, or new bank accounts to be opened for indemnification of the company against creditors’ claims.

(d) That there was a continued use of the bank accounts of the company and therefore and intermingling of funds.

(e) That it was not an arm’s length transaction.

It was the plaintiff who insisted on rushing this matter on to hearing in the duty judge list against the opposition of the defendant on the basis that the hearing would take about two hours, whereas in fact it took about two days. It is for the plaintiff to establish that the transaction was uncommercial. In my view it has **not done so.**

**Purchaser’s checklist**

This is a brief summary of our Checklist handed out at the seminar:

* Preliminary Questions
* Due Diligence
* Assets and Profit
* Liabilities
* Tax
* Contractual Relations
* Questions for the Purchaser
* Review draft purchase agreement/contract for sale of business
* Pre-Settlement
* Post-Settlement

**Disclosure requirements affecting Accountants and Liquidators**

LAND AND BUSINESS (SALE AND CONVEYANCING) ACT 1994 - SECT 8 (South Australia)

8—Particulars to be supplied to purchaser of small business before settlement

(1) A vendor of a small business must, at least five clear business days before the date of settlement, serve, or cause to be served, on the purchaser a statement in the form required by regulation (signed by the vendor) setting out—

(a) the rights of a purchaser under section 5; and

(b) the prescribed particulars in relation to the business; and

(c) where land is sold under the contract for sale of the business—the particulars that would be required in a vendor's statement under section 7 if the land were sold separately.

(2) The statement must have endorsed on, or attached to, it a certificate in the form required by regulation (signed by or on behalf of a qualified accountant, not being the vendor) certifying—

(a) that the accountant or a person acting on behalf of the accountant has examined the accounts of the business; and

(b) that the financial particulars disclosed under subsection (1)(b) appear to be in conformity with the accounts.

Property, Stock and Business Agents Act 2002 (NSW)

Section 3

**business agent** means any person (whether or not the person carries on any other business) who for reward (whether monetary or otherwise) carries on business as an agent for exercising any of the following functions:

(a) selling, buying or exchanging or otherwise dealing with or disposing of businesses or professional practices or any share or interest in or concerning or the goodwill of or any stocks connected with businesses or professional practices,

(b) negotiating for the sale, purchase or exchange or any other dealing with or disposition of businesses or professional practices or any share or interest in or concerning or the goodwill of or any stocks connected with businesses or professional practices,

(c) any other function that is prescribed by the regulations for the purposes of this definition.

8 Agents required to be licensed

(1) A natural person must not act as or carry on the business of (or advertise, notify or state that the person acts as or carries on the business of or is willing to act as or carry on the business of): …

(c) a business agent, unless the person is the holder of a business agent’s licence, or

Maximum penalty: 100 penalty units.

(2) A natural person is not entitled to bring any proceeding in any court or tribunal to recover any commission, fee, gain or reward for any service performed by the person: …

(c) as a business agent, unless the person was the holder of a business agent’s licence, or employed the holder of such a licence, at the time of performing the service,

55 No entitlement to commission or expenses without agency agreement

(1) A licensee is not entitled to any commission or expenses from a person for or in connection with services performed by the licensee unless …

(a) the services were performed pursuant to an agreement in writing (an agency agreement)

Limits on Warranties

22.1 The Warranties are given subject to the disclosures in:

22.1.1 this contract; and

22.1.2 the Records; and

22.1.3 any other document which, or a copy of which, has been given to the Purchaser before the Completion Date; and

22.1.4 any other disclosure made by the Vendor to the Purchaser prior to the Completion Date.

22.2 The Purchaser must not claim that any facts disclosed in any of the documents specified in this clause renders any of the Warranties untrue or misleading or causes them to be breached.

**Liability of Accountants and Liquidators**

**BARTLEY & ANOR v MYERS & ORS No. SCCIV-00-978 [2002] SASC 24 (6 February 2002)**

62. The Trial Judge has found that at or about 10 April 1997, there was some discussion between the Buyer and the Seller about the transactional costs. They agreed that they would endeavour to keep the transactional costs at a minimum by both employing the same accountant (the Second Defendant) and the same solicitor. The Buyer therefore withdrew her instructions to her accountant with the intention of instructing the second defendant.

255. The Accountant had been the Seller’s accountant for a number of years. He visited her at her premises at 301 North Terrace, Adelaide on a regular basis and developed a close relationship of accountant and client with her over the period in which she had been in business.

64. The Seller wanted to put in place a franchise agreement. The Franchise consultant Mr Wheeler advised the parties that he would need a copy of the previous financial statements. The Seller again telephoned the Accountant and instructed him to provide Mr Wheeler with those financial statements.

65. Mr Wheeler was unable to obtain those statements from the second defendant Accountant. In due course the second defendant refused to supply them because they were unavailable.

66. The Trial Judge has found that the financial statements were not produced by the second defendant because the second defendant realised they were not likely to be acceptable. It is not entirely clear what His Honour meant by that. I think he meant that the financial statements were unlikely to disclose a viable business.

139. There is no doubt, in my opinion, that the second and third defendants owed the first plaintiff a duty of care. Such a duty of care arose by reason of the relationship between the first plaintiff and the second and third defendants. The second and third defendants undertook to act as the first plaintiff's accountants. Thereby a duty of care was erected.

140. The defendants were under a duty to take reasonable care and skill in the advice which they tendered to the plaintiffs. They were under a duty to advise the first plaintiff of the risks associated with the transaction. They were under a duty to advise the first plaintiff of the financial viability of the business.

310. The learned trial Judge found that the Accountant deliberately gave false evidence to bolster his own case and was not worthy of any credit on matters which were in dispute. The learned trial Judge found that many of the Accountant's assertions were unconvincing, self-serving attempts to bolster his defence and to deny that he had acted unethically.

330. The Buyer suffered loss or damage by the conduct of the Accountant in breach of Part 10 of the Fair Trading Act. The conduct in question was the inducement by the Accountant, of the ANZ Bank, to make a loan of $140,000 to the Buyer, a loan which would not have been made if the bank had been fully informed of the true position as to the turnover and profitability of the business which the Buyer was about to purchase. If the bank were to refuse to make the loan, the Buyer would have had no option but to refuse to complete the purchase of the business concerned.

**Accountant Liable for $152,629**

**"Phoenix Activity and the Liability of the Advisor"**

Anderson, Helen; Haller, Linda [2014] SydLawRw 21 at 471

The difficulties of fixing advisors with civil liability for involvement in fraudulent phoenix activity are demonstrated well by the only apparent case in which this has been attempted: *Dae Boong International Pty Ltd*. In that case, Oldco, through its liquidator, sued its barrister for negligent advice. The insolvent company was facing certain winding up on the basis of an unsatisfied statutory demand. Advice was sought from a barrister, Mr Gray, who faxed a document including the following statements to the company’s solicitors:

*To avoid the control of the company and its assets passing into the hands of a liquidator on 8 March 2005, I believe the company has available to it the following options only ….*

*No later than 10 am on 8 March, the company must transfer by way of sale the whole of the company’s undertaking and assets to a new company.*

*If the new company assumes liability for all the existing company’s debts (except the judgment debt on which the winding up summons is based) then there would be no need for any significant sum of money to change hands, but the transaction must be completed (ie transfer of title of assets be actually completed) by 10 am Tuesday 8 March;[36]*

Windeyer J denied the negligence claim on a number of factual bases, including that Oldco had suffered no loss. He held that there was insufficient evidence to show the transaction was fraudulent, and if it was fraudulent, he found that it could have been set aside by the liquidator. He also found that the plaintiff had not shown that it was the responsibility of the barrister to advise that the contract price be market value and that money actually change hands, and to warn that the transactions had to be bona fide and for value and ‘otherwise might be set aside as preference or as uncommercial transactions’… His Honour went on to say ‘[the barrister] had not advised that security should be taken for the indemnity ... [but] I do not consider that it was part of his responsibility [to do so]’.

*Dae Boong International Pty limited v Dae Boong Australia Pty Limited [2008] NSWSC 357 (15 April 2008)*

**Sale by Trustee/Liquidator**

The Vendor makes no warranties in respect of the business as he is not in a position to do so, as the Vendor was only appointed Trustee of the bankrupt estate on … and has no prior knowledge of the business.

The Purchaser acknowledges that the sale is being effected through the liquidation of the Vendor and therefore the Vendor provides no warranty whatsoever regarding the performance or working order whatsoever of the Business or the Business Assets.

The Vendor gives no warranties that the financiers which are the other party to the Finance Agreements shall consent to the transfer or assignment of the right title and interest of the Vendor in the assets which are subject to the Finance Agreements or the assignment of the Vendor’s rights under the Finance Agreements or any novation of the Finance Agreements.

The Purchaser acknowledges that any advice, recommendation, information, assistance or service given by the Vendors in relation to this Business Sale Agreement is given in good faith and is believed to be accurate, appropriate and reliable at the time it is given, but is provided without any warranty or accuracy, appropriateness or reliability and the Vendor does not accept any liability or responsibility for any loss suffered from the Purchaser’s reliance on such advice, recommendation, information, assistance or service.

The Vendors have disclosed to the Purchaser that not all the items listed in the Equipment and stock schedule are functional and some may require repairs, the Purchaser acknowledges and agrees that the Vendors are not required to attend to any repairs of the Equipment and stock. The Purchasers acknowledges that the Vendor does not warrant the suitability of the Equipment and stock and the Purchaser accepts the Equipment and stock at its own risks at their present conditions. The Purchaser releases the Vendors from all actions, claims, demands, damages, costs and expenses in relation to or arising out of the Equipment and stock.

The purchaser warrants that it has had the opportunity to inspect the equipment and acknowledges that it purchases the equipment on an as is where is basis.

For the avoidance of doubt the purchaser acknowledges that the equipment is subject to an all present and after acquired property security interest registered on the Personal Property Securities Register and agrees to purchase the equipment despite that encumbrance.

**Minimising liability when purchasing a business**

The best way to minimise legal pitfalls and potential exposure to liability is to include well drafted, comprehensive special conditions.

Our Purchaser Checklist suggests some generic special conditions. However, like most contracts the special conditions of a sale of business should be tailored to the specific circumstances of the business and the particular purchase.

The following problematic scenarios could be remedied by special conditions.

**No outstanding liabilities**

Garry’s Guitar Lessons

Garry ran his music teaching business in a way that he invoiced in advance of providing the lessons and took payments before the services were delivered. This practice was not disclosed to George the Purchaser.

Depending on what was actually purchased, George will have inherited a legal liability to provide lessons without receiving payment OR George will be faced with a dilemma regarding whether to provide the lessons for free (despite no legal obligation) or refuse and potentially alienate clientele. A simple clause as seen below would have provided the necessary protection to the Purchaser.

* *The Vendor warrants that all costs, expenses, claims, demands and all other liabilities of the Business whatsoever are paid in full or the Purchaser has been otherwise notified in writing of the particulars of all outstanding liabilities and future obligations of the Business.*

**Access to and Accuracy of documents**

As mentioned earlier, our client purchased a Beautician and Day Spa business and has to honour potentially hundreds of gift certificates or damage her relationship with most of her potential customers. This situation could have been easily avoided.

A Purchaser should always make sure they have had access to all relevant documents of the Vendor’s Business and that those documents, upon which the Purchaser is relying on in deciding to purchase the business, are accurate.

* *The Vendor warrants that prior to the purchase it provided the Purchaser with all of the books, records and other documents of the Business and the Vendor warrants the truth and accuracy of all such books, records and documents provided or made available to the Purchaser (or its agents) in relation to or in connection with the purchase of the Business.*

**Indemnity from the Vendor**

When purchasing a business the last thing the Purchaser wants to do is deal with any unresolved issues of the previous owner. Unresolved issues could arise in a number of scenarios, including underpaying employees, misleading or deceptive advertising of products or not abiding by government regulatory bodies regulations. These issues can result in the new owner of the business being liable for the old owner’s mistakes.

* *The Vendor warrants that it has complied with all applicable laws in regards to and in connection with the business, the premises and employees.*

This style of special condition will either allow the Purchaser to recover damages from the Vendor or, preferably, it will encourage the Vendor to settle these kinds of debts and disputes before the sale is completed so the new owner does not inherit the old owner’s problems.

**Intellectual Property**

When a Vendor is selling its business, more often than not all assets of the business are being sold including the intellectual property. However, if the applicable intellectual property is not listed in the Contract as an asset being purchased the Purchaser may not receive the necessary intellectual property it needs to properly operate the business. Further, it is a common occurrence that intellectual property is owned by a separate related company (not the Vendor). To avoid these problems we suggest a special condition to the following effect:

* *The Vendor warrants that all Intellectual Property relating to, used by or in connection with the Business is owned by Vendor. The Vendor warrants that it assigns all rights, title to and interest in the Intellectual Property to the Purchaser free of any encumbrances and the Vendor is not aware of any dispute, claim or circumstances that may give rise to such relating to the Intellectual Property.*

“Intellectual Property” should be broadly defined in the Contract. This type of clause can also protect the Purchaser where the Vendor has been using some other entity’s intellectual property, including that of an employee, without proper ownership or lawful entitlement.

**Purchase of Unencumbered Assets**

The Purchaser should always insist that the Vendor give a warranty that the assets are not subject to any encumbrance. If an asset is subject to an encumbrance, the Purchaser may not obtain good title (or any) to the asset and this can lead to a costly dispute and legal proceedings. A simple yet effective clause as set out below, could save the Purchaser thousands of dollars and make sure that they are getting exactly what they paid for:

* *Vendor warrants that it is not aware of any charge, security interest or other encumbrance over any assets being purchased by the Purchaser other than as expressly disclosed in the Contract.*

**Restraints of Trade**

It is common that the Vendor(s) (and other key employees) will be subject to a restraint of trade clause when selling a business. The purpose of such a clause is to protect the goodwill acquired by a Purchaser.

Restraints of trade must be carefully drafted, or the Purchaser will run the risk that the restraint is void or unenforceable. For example, if a small fruit shop in the suburbs were purchased and the Purchaser wanted to enforce a 15 year, 100km radius of the Vendor premises restraint of trade, the Purchaser would most likely be unable to enforce the restraint even though the Vendor agreed to it. There are a number of factors the Court considers when assessing whether a restraint is legally enforceable but the primary test is: whether the terms of the restraint are reasonably necessary in order to protect the legitimate business interest of the business.

In most parts of Australia, if a restraint is not reasonably necessary in order to protect the legitimate business interest of the business it will be void and unenforceable. However, in NSW the Courts have some power to read down an unreasonable restraint to make it enforceable pursuant to s4(3) of the *Restraints of Trade Act* 1976.

**Employees of the Vendor**

Well before signing the Contract, the Purchaser needs to decide whether they will:

1. Accept the transfer of all existing employees of the business; or
2. Accept the transfer of some of the existing employees of the business; or
3. Accept the transfer of none of the existing employees of the business and engage other employees; or
4. Accept the transfer of none of the existing employees of the business but offer the existing employees employment with the new business.

If the Purchaser fails to choose one of these options and ensure that the Contract properly reflects the particular option then the Purchaser may find that the employees of the old business will be deemed to have been transferred to the Purchaser pursuant to the provisions at Part 2-8 of the Fair Work Act 2009.

Each of these options has its own advantages and disadvantages.

Option 1

The Purchaser obtains all the staff but suffers the burden of all of the employees’ long service, annual leave, sick leave and other entitlements. If the Purchaser decides to terminate any of these employees it is usually difficult and costly as the Purchaser will be deemed to have employed the employee from when they commenced employment with the Vendor and the Purchaser does not have a probation period for these employees (unlike any other new employment relationship). The Purchaser needs to ensure to offset the value of the employee entitlements to reduce the purchase price.

Option 2

Has the advantages and disadvantages of options 1 and 3.

Option 3

The Purchaser may not have experienced staff. Some of the goodwill of the business may have been connected with the employees as the customers like or are familiar with them.

Option 4

There is no guarantee that the employees will take up employment with the Purchaser – the employees may be disgruntled because they lost the benefits of service with the Vendor and could instead choose to work for a competitor. Even if the employees do accept the Purchaser’s offer of employment those employees may still be disgruntled because of this option and this may diminish their productivity and performance.

The Purchaser must ensure that all of the employees are properly made redundant by the Vendor and are fully paid out all entitlements or the Purchaser could be liable to the employees for those entitlements or the Purchase may be come embroiled in a dispute with its new employees and the Vendor. The Purchaser should have the employees sign contracts of employment with the Purchaser which are subject to the Contract for Sale of Business proceeding.