

Sale of Business Doing the Heads of Agreement



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1. Why invest in the Heads of Agreement? - SELLER & BUYER

We recommend that the parties to a business sale/purchase transaction consider the issues set out in this document before they agree to the terms and conditions of the transaction.

By clearly identifying the hip pocket considerations and other general commercial issues before the instructions get to the lawyer means that:

- Party expectations have already been addressed and managed.
- Important issues do not either have to be dealt with from scratch or reworked.
- If they do, it can create a sense in a party that the goal posts are being moved and that the wheel is being reinvented.
- Simply helps to get the deal done
- The overall time between exchange and settlement is quicker and the job can be done more cost effectively.

2. Binding or Non Binding Heads of Agreement - SELLER & BUYER

If a written Heads of Agreement is to be entered before engaging lawyers, make sure that the transaction Heads of Agreement not only represent the deal but:

- if the Heads of Agreement are meant to be binding, that there is no uncertainty about that [eg “These Heads of Agreement create a binding contract between the parties.”] ***Despite this, formal written contracts may/will be entered if either party requires a formal written contract, in which case, it will be prepared by that party at its cost on all of the normal terms for that sort of document but which are not different to these heads of agreement. Use the extra italicized words with caution;*** and
- if the Heads of Agreement are not meant to be enforceable, that they clearly state that intention [eg “No binding contract will be entered into by these Heads of Agreement.”] ***Binding contracts will only be entered when formal written contracts are exchanged. The contract will be prepared by ### and contain all of the normal terms for that sort of document. Use the extra italicized words with caution.***

(see Masters v Cameron for an analysis of this issue)

3. Confidentiality Agreement - SELLER

If a seller is going to let a prospective buyer into the business before exchange of contracts, consideration should be given to a pre contract/due diligence confidentiality agreement, particularly if the seller’s intellectual property is going to be made available to the buyer.

The only magic in this document is that it gives the seller a basis on which to claim damages and restrain conduct of the buyer.

It also demonstrates to the buyer the manner in which the seller conducts its business. Perception is reality.

4. Identify the costs of sale - SELLER

Agent's commission

Accountant's fees

Lawyer's fees

Landlord's costs

Redundancies

Tax on the sale

Costs of any consent to the sale

Obsolete stock

Non recoverable WIP

Bad debts

5. Due Diligence - SELLER & BUYER

Does it happen before or after exchange?

Are there to be thresholds/conditions before the buyer can walk away or can the buyer walk no matter what?

6. Identify the Seller - BUYER

There is no title deed like there is for land to reconcile ownership against.

7. Get the buyer structure right - BUYER

What is the structure that will be used?

Start with a discretionary trust and work out reasons why you would not use it.

Use a corporate trustee.

Have a sacrificial lamb - don't all act as directors.

8. Is the finance right to go - BUYER

Is required finance available and can conditions be met?

9. Sort out the co-ownership / Buy Sell agreements - BUYER

What co-ownership agreements will be required, for example for involuntary buy outs or day to day administration of the structure/business.

10. Warranties - BUYER

Should the transaction documents include any conditions to cover post settlement financial performance or other warranties that may have been made or should be given by the seller?

Time period for making a claim?

Cap on the amount that can be claimed?

Don't allow consequential damages to be excluded?

Absolute or simply as far as seller is aware?

Topics to be covered:

Disclosure

Capacity

The Seller

Conduct of the Business

Financial matters

Assets generally

Trading Stock

Products

Plant and Equipment

Intellectual Property

Permits

Statutory permits and compliance

Real Property

Employees

Contracts

Litigation and compliance with legislation

Environment

Insurance

11. Personal guarantees - SELLER & BUYER

Where the buyer is not a person, are personal guarantees required?

12. Apportionment of the Price - SELLER & BUYER

Settle on an apportionment of the price now, not later.

13. Contingent Price / Earn Outs - SELLER & BUYER

As a buyer, why pay full freight up front when you have not had a chance to test the product.

Beware of earn outs based on profit.

Will the earn out thresholds be achievable when the seller is no longer in control.

If part of the price is contingent and unascertainable at the time of settlement because, for example it is tied to post settlement financial performance of the business, the right to receive that money used to be a separate asset to those assets sold under the contract.

I don't think that we yet have the legislation but see TR 2007/D10. The look through approach will apply to transaction on and from 17 October 2007.

14. GST

Will it be a going concern and free from GST? See GSTR 2002/5.

Stop and think - will the seller be supplying to the buyer everything that is necessary for the continued operation of the business? Any number of things can bring us unstuck.

Make sure that the parties agree in writing.

Paragraph 75 of the ruling is a potential sting. Not only does the seller have to supply all of the assets that are essential for the continued operation of the enterprise, but also the "operating structure and process of the enterprise". What it means remains to be seen, but in the mean time, we should not under estimate its reach?

Key employees – see paragraphs 125 and 126, as they may be required.

Look out where the business assets are owned by different vendors, which sometimes happens with the intellectually property when it is owned by an entity other than the trading entity.

Don't let the buyer make its own arrangements for stock and have the seller run the stock out.

The business is owned by A and the land by B. B leases the land to A. If each sell their assets to C with simultaneous settlements, the ATO says each sale will qualify for the concession. (See paragraph 137)

The business and freehold owned by Y is being sold to party X, but party X, unbeknown to the seller takes the business legally and beneficially for X, but the freehold as trustee for the X family trust. When we act on the business and freehold sales, we obtain a warranty from the buyer that the buyer takes both the legal and beneficial title in both assets. (See paragraph 131)

The premises lease is a prime culprit for problems:

- Look out for the situation where the buyer wants a new lease. At least GSTR 2002/5 gives a better outcome on this than its predecessor, GSTR 2001/5. See paragraph 58. If the buyer wants a new lease, the seller can still supply 'all of the things necessary for the continued operation of the enterprise' by surrendering the lease and facilitating a new lease. In this case,

I think you need to ensure that there is a contractual obligation on the seller to facilitate the new lease and that seller actually does it.

- But a tenancy at will is not capable of assignment. Eg where A owns land and B owns the business. B only pays the rates and no other rental and has no formal lease. B can't assign its lease because it is a tenancy at will. (see paragraphs 64 to 70) Possibly look to use the example at paragraph 97+ where there is a tripartite agreement between A, B and the buyer that B will procure a lease of the premises by the day of supply. However, paragraph 97+ relates to a supply of alternate premises and you need to be wary of acting without a private ruling.

You must always keep an eye on the anti avoidance provisions of Div 165.

15. Lease - BUYER

Whether a new lease is to be granted or the existing lease transferred, consider the following and in the case of a new lease, negotiating them with the landlord:

- No make good (make good is often estimated at 80% of the fit out cost)
- If the lease is not a RLA lease, a release on assignment of the tenant and guarantors
- Landlord to maintain and replace air conditioning at landlord cost. If not working, tenant to have set off rights. Possibly even termination rights
- Landlord to keep building weatherproof
- If there is a rent free period, no landlord claw back of the rent free amount
- Amount of security deposit, possibly reducing over time
- Negotiate with the seller/buyer who pays for the landlord's costs on the grant of the new lease or the transfer of the current lease.
- No personal guarantees, or if given, limit to 1 spouse only and look at asset protection issues that surround these decisions.

16. What is being sold / What is not being sold? - SELLER & BUYER

Always clearly identify what is being transferred from the seller to the buyer and what assets are not being transferred.

If the whole of the business is not being transferred, always clearly identify what is being transferred and on what terms.

Where only part of a business is being transferred, do the agreed level of debtors and creditors need to be documented?

17. Inventory of plant and equipment - BUYER

Have the parties agree on an inventory of plant and equipment and any other item that is included in the sale. If so, it should be attached to the Heads of Agreement and the final contract.

It should be checked by the buyer before exchange - making sure that everything which is thought to be included is included.

It should be checked again before settlement - making sure that everything that is supposed to be there, is there.

Be careful of expressions “used by the Seller in the business” as that does not mean “owned”

18. Non Owned Plant & Equipment - SELLER & BUYER

Is all of the plant and equipment owned by the seller or is money owed on the security of or in respect of it.

If money is owed on security or in respect of it, is that debt to be paid out by the seller from the sale proceeds or is the buyer to assume the liability?

19. Stock - BUYER

Is stock being transferred?

If so, at what value?

When is the stock to be paid for - get it on completion not after?

Is only good and saleable stock to be transferred? How do you determine what is obsolete?

Is a cap to be placed on the amount of stock the buyer has to take?

How do you reconcile that to pre completion orders of stock?

If the seller has not paid for all of the stock, it should be paid for by the seller on settlement, otherwise if the buyer proposes to continue to use the supplier and stock is not paid for, continuing relationships may get difficult, even though the supplier does not have a claim against the buyer (other than for registered security interest in respect of a retention of title clauses).

20. Restraint - BUYER

Capture all relevant individuals and key employees, not just the party that is the seller.

If the seller is a company/trust etc, make sure that the principals are also restrained.

Define the area and period of restraint and elect to use a cascading restraint clause if there is any suggestion that the restraint is unreasonable. Although, in NSW at least, our Restraints of Trade Act allow the courts to read down the restraint.

Consider a non solicit provision, not just a restraint. Cover the employees too.

Reasonableness of the restraint is the key to enforcement of the restraint. You can't just pluck the figures out of the air.

If the seller has been the beneficiary of an unexpired restraint, make sure that it too is assigned to the buyer and that it is assignable.

21. Employees - SELLER & BUYER

Look out for redundancies that arise from non transfer to the buyer.

If the buyer takes on employees but soon after dismisses them, the buyer may be liable for redundancy payments.

Make sure that you are aware of periods of service and possible redundancy payments if employment is terminated soon after settlement.

If the seller is required to terminate all employees on settlement, make sure that the buyer takes on all employees in positions at least “no less favourable” than in the position of employment with the seller, otherwise redundancy issues may arise.

If the seller is required to make a LSL allowance for employees transferring to the buyer, that allowance may never be payable to the employee. If the allowance is significant, **either** have it held in trust and if the payment is not made to the employee, it is refunded to the seller on the termination of employment **or** have a discount applied against the accruing amount TO provide for the lottery that exists as to whether the allowance will ever in fact be paid to the employee [and for the fact that the buyer will get a tax deduction for the amount if and when it is paid to the employee but the seller will not – see next point].

Also look out for the seller’s taxation implications of employee entitlements not being paid to the employees by the seller. If they are not paid to the employees by the seller but instead they are allowed in favour of the buyer on settlement (effectively reducing the purchase price), the seller will not get a tax deduction for those payments. The 70% rule.

As a buyer, don’t forget that on every employee entitlement of \$1, there is SGC, Payroll tax and workers compensation to pay approximately 18%.

22. Consent for Use of Premises - BUYER

Do the business premises have development consent for their current use?

23. Privacy - SELLER

If acting for the seller, make sure that the due diligence process is handled in such a way that if the sale does not proceed, privacy issues do not arise. [Eg – no copying of data, get all copies back if deal does not proceed, due diligence on site and no removal of data.]

If the sale goes ahead, get a buyer warranty that the information subject to privacy will be used only in the manner for which it was collected and for which the seller uses it.

If acting for the buyer, will the buyer be able to use the information for the buyer’s intended purposes if it has been collected for another purpose?

(Refer to the National Privacy Principles.)

24. Tuition & Assistance - SELLER & BUYER

How is that to be dealt with?

Do you let the buyer in at all before settlement?

What can the buyer do during the tuition? Can the buyer approach employees, customers, suppliers?

Is it paid or unpaid? Unpaid unless stated otherwise.

25. Existing Customer Contracts - BUYER

If existing customer contracts are important to post settlement continuing viability of the business, will customer stay on board after settlement. If under contract, is the contract assignable?

26. Supplier Contracts - SELER & BUYER

Are supplier contracts assignable?

What of liability for mistakes made by the Seller under contracts that will be fulfilled by the Buyer after settlement?

27. IP - BUYER

What IP is included?

Identify all intellectual property owned by the seller or by a third party and which is used in the business.

Are there any:

- Copyright issues
- Moral rights issues
- Trade marks
- Patents
- Designs
- Know how – (if you take any notice of GSTR 2002/5)
- Confidential information being transferred (customer lists and records – see also Privacy issues)
- Business Names
- Email addresses
- Domain Names
- Web Sites

28. IT - SELLER & BUYER

Software licenses normally cannot be sold by the seller.

29. OH&S - BUYER

Does all plant & equipment comply with all occupational health and safety laws?

30. Environmental issues - BUYER

Are there any potential environmental issues that may affect the decision to purchase? (eg contamination of the ground by petrol, continuing compliance with environmental laws). Certainly the contamination issue may impact on a finance application of the buyer.

31. Statutory requirements - BUYER

Does the business comply with all statutory requirements?

If in doubt, ensure the contract has a GST recovery clause.

32. Special Conditions Unique to the Sale

Disclaimer

The information in this paper is general in nature and is not intended as legal advice.

You should not do or fail to do anything in reliance on information in it.

We do not accept any responsibility for any loss that you suffer if you do.

You should seek professional advice before you do anything about the issues set out in this paper.