

HARRIET B. ALEXSON

A Professional Law Corporation



BUSINESS ALERT

CURRENT LEGAL ISSUES FOR THE BUSINESS COMMUNITY

August, 2007

Vol. 6, No. 3

ACQUISITION OF A COMPANY: LEGAL ISSUES

By: Harriet B. Alexson (949.250-9664)
©2007. All Rights Reserved.

The negotiation and documentation of the acquisition of a company includes many legal issues. When acquiring (or selling) a company, you should consult legal counsel before the contract negotiations begin to determine the structure, price, and any liability issues. Below please find a summary of the legal issues to be addressed in any transaction.

A. **Acquisition Structure.** The acquisition of a company will involve the purchase of all or a controlling interest in the stock, partnership, or membership interests or the acquisition of all or substantially all of the company's business assets. The buyer often prefers to acquire only the company's assets, in an effort to avoid assuming unknown contingent liabilities. In addition, the buyer may obtain fee title to, or a leasehold interest in, the real estate owned or leased by the seller.

B. **Due Diligence.** The buyer should conduct a thorough review of all applicable documents as well as a thorough physical inspection of the property. The buyer's due diligence efforts should include an evaluation of the facility's current compliance with all applicable legal regulations and potential legal liabilities.

1. Classification of Documents and Reports. The buyer and buyer's counsel will review and approve the following documents:

(a) Documents necessary to assess compliance with applicable building and zoning requirements, such as recorded use restrictions, development permits, certificates of completion and occupancy, inspection reports by the fire marshal and any notices of violation from local agencies and "as built" drawings for all buildings.

(b) Documents necessary to assess the seller's ownership interest and the physical condition of the property and improvements thereon, such as a deed or property lease, mortgage financing or other loan documents, schedule of inventory and personal property, real property tax bills, previous surveys, title policy reports pertaining to termite and pest inspections, reports on mold or mold remediation and Phase I and II environmental assessments.

(c) Documents concerning the day-to-day operation of the company, such as business and/or operating licenses and permits, current rent roll, equipment leases and service/vendor contracts, utility bills, insurance policies (or a summary of these policies) and insurance loss history.

(d) Various documents concerning the financial aspects of the business operation, such as audited financial statements, if available, monthly and yearly operating statements, budgets, description of capital expenditures and accounts receivable reports.

2. Physical Inspection. The buyer should conduct a thorough physical inspection of the facilities. Upon entering into the purchase agreement, the buyer should order a Phase I environmental assessment unless the seller is

able to provide a copy of such an assessment that was performed within the past six (6) months. The parties will need to negotiate language in the purchase agreement concerning the circumstances under which the buyer will be allowed to conduct invasive testing in the event a Phase 2 is required. Typically, the buyer must agree to defend and indemnify the seller against any losses arising from the buyer's physical inspection, and the buyer and its consultants and contractors must maintain adequate insurance to cover any such losses; however, the buyer should not be required to defend or indemnify the seller for losses discovered but not caused by the buyer's investigation. Please note that if the buyer and seller agree to environmental testing prior to the execution of the purchase agreement, the parties can enter into a site access agreement.

3. Personal Property/Intangibles. The parties should determine what personal property at the facility, such as equipment, appliances, furniture, furnishings, building materials, replacement parts, office equipment and other tangible property will remain at the facility and if there are any third-party consents necessary to transfer title to such property. In addition, the parties should determine what intangibles such as permits, licenses, approvals, and authorizations from governmental authorities and what trademarks, copyrights, tradenames, service marks, right to the name of the company (including all related good will), and/or logos, websites, and other intellectual property, will be assigned and assumed.

C. **The Purchase Agreement.** There are several issues that need to be negotiated in the purchase agreement by which the buyer acquires the assets or stock of seller, including the following:

1. Purchase Price and Deposit. The seller and the buyer each should rely on advice from a consultant knowledgeable in the industry to determine the fair market value of the assets or stock. The purchase price should take into account the value of the real estate interest (i.e., fee ownership or leasehold interest), the value of the equipment, inventory and intangible property (including goodwill and any intellectual property), the projected net revenues and expenses of the facility, and any known or contingent liabilities. Oftentimes, the real property is owned by a shareholder/member of the seller, so the allocations are important, as the principal shareholder/member may claim the consideration for the real property. The buyer will make an earnest money deposit that (i) become non-refundable upon the buyer's approval of due diligence, except upon the failure of any conditions to closing; or (ii) is retained by the seller as liquidated damages upon any default by the buyer.

2. Due Diligence Period. During the due diligence period, the buyer and the buyer's counsel will need to complete the evaluation of the due diligence documents, the physical condition of the real property and all title matters pertaining to the real property. The due diligence period could customarily be thirty (30) to ninety (90) days. If the Buyer needs to obtain a loan, this contingency may be fulfilled during the due diligence period, or may become a condition to closing.

3. Licensing. The seller should be required to cooperate reasonably with the buyer's application for a license, if required to operate the company and the buyer should be required to proceed with diligence in obtain the license, if required. For example, if the buyer will operate a company which currently holds a California finance lender's license, the buyer must obtain the license in its own right.

4. Non-Compete. The buyer will want the seller and its principals to agree not to either compete with the sold company or solicit its employees within a specified period of time after the closing (typically one to two years). California courts will enforce a non-competition agreement, if the agreement is both (i) executed by the owner of a business entity or partnership in connection with the sale of all or substantially all of the assets of such business entity or partnership and (ii) reasonably limited in duration and geographic scope to the area where the sold entity carried on its business before the closing.

5. Title Insurance. Whether the buyer is acquiring fee title or a leasehold interest, the buyer will obtain a title policy (including any appropriate endorsements) which shows only certain permitted encumbrances as exceptions to title. Obtaining a title policy with appropriate endorsements can insure the buyer against the risk of future claims relating to defects in title and unknown encumbrances such as mechanic's liens. During the due diligence period, the buyer will order a preliminary title report and underlying documents for review.

6. Contracts. The buyer will retain the right to notify the seller, before the expiration of the due diligence period, whether the buyer elects to assume or reject contracts pertinent to the operation of the company, such as service or vendor contracts, equipment leases, and leases of space to third parties. The seller should have the obligation to terminate all contracts which the buyer has not elected to assume. The purchase agreement should contain as an exhibit an assignment and assumption agreement, with respect to all such contracts.

7. Consents. If the seller holds a leasehold interest in the company, the transaction will be conditioned upon the landlord consenting to the assignment of the lease. The buyer also may want to insist upon the landlord signing an estoppel certificate confirming, among other things, that there are no known defaults under the lease. The buyer may also wish to negotiate a new lease as a condition to closing. For example, if the buyer is purchasing an auto dealership, the buyer will need the consent of the franchisor (such as Toyota, Ford, etc.) to operate the facility.

8. Buyer's Loan. If the buyer wishes to assume an existing loan upon the closing, the transaction must be conditioned upon the buyer obtaining the lender's consent to the assumption of the loan. Buyer's counsel should also be prepared to review loan documents if buyer needs to obtain a loan to perform under the terms of the purchase agreement.

9. Representations and Warranties. A seller will try to take the position that the sale is "as-is, where-is" with limited representations and warranties relating to the seller's authority to enter into the contract, but not the condition of the property. However, a seller should make representations and warranties to the buyer concerning, at a minimum, the physical condition of the assets, the accuracy and completeness of all financial statements, the existence of any litigation, compliance with applicable laws and the existence of any adverse circumstances such as hazardous materials, notices of violation, or condemnation. Please note that the buyer can obtain a litigation search, certificate of good standing, etc.

10. Covenants. The seller will make covenants regarding his ongoing obligation to operate the business during the escrow period. The buyer may covenant to keep due diligence documents confidential.

11. Indemnification and Escrow Holdback. Each party should defend and indemnify the other party against any claims or losses arising from the inaccuracy of any representation or warranty or the breach of any covenant. In some instances, the buyer will insist upon a portion (e.g. 10% to 20%) of the seller's purchase price proceeds being held in escrow for a specified period of time after the closing to ensure that there are funds available to pay for any post-closing indemnification claim by the buyer.

12. Prorations and Reconciliations. The parties will, through escrow, provide for the proration of items that can be calculated upon the closing (e.g., property taxes or any rent payable to landlord) and post-closing reconciliation of items that cannot be calculated at the closing (e.g., payments received after the closing for accounts receivable in effect at the closing, or late payments of rent received after the closing).

The matters discussed above are only a general summary of the issues to be addressed in the sale or acquisition of a business. Please contact this office if you would like to discuss an acquisition or sale and if you would like a checklist of the due diligence documents to be reviewed in connection with such a transaction.

* * * *

Actual resolution of legal issues depends upon many factors including variations of fact and state laws. This article is not intended to provide legal advice on specific subjects but rather to offer insight into legal developments and issues. Consult with legal counsel before taking action on matters covered in this article. Copyright 2007 Harriet B. Alexson. All rights reserved.