PITFALLS WHEN BUYING A BUSINESS

Buying a business is a risky business in itself. There are many pitfalls that a prospective buyer must look out for. It is therefore imperative that the buyer performs a proper due diligence on the business. The scope and extent of the due diligence will depend on the price for the business, its size and the industry in which it trades.

A due diligence investigation will typically cover the following aspects:

- Corporate structure, governance and ownership
- Assets
- Suppliers and customers
- Licences and other regulatory matters
- Material contracts
- Litigation
- Insurances
- Labour/employment (including pensions and benefits)
- Intellectual property and IT
- Finance and Tax.

The main aim of the due diligence investigation is to identify the risks associated with the buying of the business, as the nature and extent of these risks could have a substantial influence on the price payable for the business and the buyer's decision as to whether to proceed with the acquisition or not.

As part of the investigation of the corporate structure the buyer must ensure that the founding documents of the enterprise that conducts the business, allows for the sale of shares to the buyer or such documents may prescribe certain procedures which must be followed for the sale and transfer of shares, failing which, the transaction may be unenforceable.

By investigating the assets of the business, the buyer can establish if the assets belong to the business or are rented, and if rented, what the terms and conditions of the rental agreements are.

It is important for a buyer to know how many main suppliers there are, and what the exposure of the business is if any one of these suppliers fall away. The terms and conditions of the supplier contracts are therefore important and particularly the provisions dealing with the cession and assignment of these contracts. A supplier contract may for instance contain a provision that the contract may be cancelled by the supplier if the supplier's prior consent for the sale of the business had not been obtained.

It furthermore goes without saying that the business must be compliant with relevant legislation and possess the necessary trading licences, as any contravention in this regard can be the death knell of the business.

All material contracts must also be investigated to establish the terms and conditions thereof and the termination dates of the contracts to ensure continuity of services. Likewise the necessary insurances must be in place, alternatively arrangements should be made for the correct insurance covers to ensure that no gaps in cover exists during the transfer of business from the seller to buyer.

Knowledge of any and all litigation which involves the business must be considered. If for instance the business had been sued for millions of Rands by a third party, a buyer would want to know about this. Judgement for such an amount in due course could mean the end of the business. A record of litigation which involves the business, may furthermore be a reliable barometer of the risks lurking within the business, even if the quantums of such litigation is of a minor concern.

Labour/employment issues may hold many risks for the unwary buyer. The remuneration package of particularly the key personnel must be thoroughly investigated and the obligations of the business with respect to aspects such as fringe benefits and retirement benefits/pensions should be established.

Clarity must be obtained in respect of the intellectual property of the business and the rights of others thereto – particularly if these aspects are material in relation to the products or services sold by the business. The IT infrastructure and IT security must be checked as these aspects hold substantial risks (for instance downtime or security risks) and may be costly to rectify.

Probably one of the most important aspects of a business to investigate thoroughly is its finances and tax. It is imperative that the business must be up to date with tax returns and all tax payments, whatever the nature of the taxes.

Once the buyer has a good understanding of the above issues, he/she can proceed to mitigate such risks by for instance incorporating warranties in the sale agreement and providing for part of the purchase price to be paid some time after the transfer of the business, subject to the profitability of the business and/or the deduction of warranty claims.

It should be noted that, the outcome of the due diligence investigation may determine the entire structure of the sale. The business, if conducted by a company, may be acquired by the buyer by purchasing the assets of the business, which also entails taking over the supplier contracts and other material contracts. The buyer then continues with the business in his/her/it's own name. Alternatively the buyer can purchase the shares and loan accounts in the company. The same entity then continues to conduct the business after the sale of shares, but with a new shareholder (the buyer), who ultimately then owns the business.

Considering the many pitfalls when buying a business, it is recommended that a prospective buyer obtain legal advice and use the services of an experienced attorney to assist him/her with the due diligence process and drafting of the necessary agreements.

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