When you buy a business, the law presumes that you will conduct whatever investigations you think are necessary to determine whether the purchase is right for you, whether the items purchased are as represented and whether the price offered is reasonable. This investigation process is called due diligence. Because buying a business may be the single most expensive purchase you make, you should conduct a thorough due diligence review.

A good purchase contract will contain a period for due diligence. It will have contingencies allowing you to cancel the purchase if you are unable to get financing, if your due diligence turns up negative information, or for other general or specific reasons. You can use the due diligence process to help you calculate the actual value of the business, disclose potential negatives, and determine whether it really presents a good fit for you. Be wary of a Seller who resists a thorough due diligence review.

The following notes will help you focus your due diligence review. This list is neither exclusive nor complete. Every business has its own quirks and legal requirements that you must consider in determining the appropriate scope of review. Should you need to conduct a due diligence review of a business, I would be glad to provide you with specific assistance and consultation.

Why is the Seller Selling? If the Seller can’t make a go of it, or doesn’t like the business, will you suffer the same problems?

Minutes and Resolutions of Seller: Review all company minutes. In particular, make sure the Company has valid resolutions agreeing to the transaction you are contemplating. Review Articles of Incorporation or Organization and stock ledgers. Make sure the person you are negotiating with has actual authority to sell the business. Take note of anything that seems out of the ordinary, or that might indicate financial or other problems, and ask hard questions.

Accounts Payable and Receivable: Do not simply accept as accurate the lists the Seller gives you. Double check against invoices and other documents. Call some of the customers, creditors and debtors and check the accuracy of the company’s information. How old are the outstanding debts and credits? The state of the accounts payable and accounts receivable will give you clues about the real profitability of the business and potential problem areas.

Work-in-progress: Is it good work? Is it profitable? Can you complete it on time and at a profit? Who gets deposits? What expenses have been charged to the jobs compared to percentage of completion? Do costs appear to be appropriately allocated? Do costs seem to be in line for that type of job? A company with lots of work in progress may look great on paper, but if you can’t turn a profit from that WIP, it can do more harm than good.

Inventories: Inventory the furnishings, fixtures and equipment; the inventory the company holds for sale; the inventory held for use in jobs; the A/R; other assets. Make sure you are getting what you are paying for, and that it has actual value.
**Condition of Equipment.** How old is the equipment, and how well has Seller maintained it? It is easy to make money through depreciation. If the Seller has not replaced tools and equipment recently, perhaps the profit margins are over-stated. Once you start upgrading, you may find that you cannot make ends meet.

**Liabilities.** In a stock purchase, you buy whatever liabilities the company has. In an asset purchase, you can choose which, if any, liabilities you will assume. However, knowing what liabilities exist in an asset purchase, as well as a stock purchase. First, high levels of liabilities may indicate financial problems. Second, some liabilities can become the Buyer's responsibility by operation of law, even in an asset purchase (see, “Avoiding Unwanted Liabilities” below). Thus, you need to determine the actual status of the company’s liabilities for yourself. Double check everything Seller tells you. Call customers, vendors, check with taxing authorities, Better Business Bureau, etc. Check with local courts to see if the Seller has any outstanding judgements.

**Deeds of Trust, Mortgages, Security Interests and Other Liens:** You need to know whether any liens encumber the Seller's real estate or personal property. If so, make sure you obtain lien releases prior to closing. This takes time, so start early.

**Personal Property Leases:** Often, a company will lease equipment such as copiers, telephones, and large equipment. You may not want the same equipment or the same terms. However, equipment leases frequently have onerous assumption and buy out clauses. Check the terms.

**Licenses:** You will need a business license from the city or county where you will operate the business. You may also need other licenses or permits, depending on the type of business. Many licenses are not transferrable. Obtaining new licenses may take 30 days or more, and may require certain experience or other prerequisites. Also note that if the Seller does not have the required licenses and permits, this could indicate deeper problems.

**Intangibles.** Good will is often the most expensive asset in an asset purchase. Make sure you get something for your money. Insist on exclusive rights to all customer lists, contact lists, marketing brochures, etc. Know what trademarks, copyrights, patents and other intellectual property rights Seller has. Make sure you buy telephone and fax numbers, websites and email addresses, business names, etc.

**Environmental issues:** If the business owns or leases real property, you need a clean environmental report, because all property owners (and in many cases, those who merely lease the property) are “potentially responsible parties” who may or will be liable for all environmental clean up costs (even if you had nothing to do with the pollution). Recent changes to EPA rules in effect for any purchase closing after November 1, 2006 make this a must-do.

**OSHA compliance disclosure:** Has the company ever been the subject of an OSHA investigation or compliance review? (Note: Utah will conduct a non-penalty safety inspection for free; the company does have to rectify any serious violations found). Ask the
Seller for any compliance manuals. Ask the Seller what they do to meet OSHA requirements specific to their business. OSHA violations are very expensive, and they have rules for things you can’t imagine.

**Claims and Litigation:** Ask sellers about existing or threatened litigation, regulatory actions, violations, disgruntled customers or employees. You need to see all complaint letters and letters threatening suit or legal action. Check local courts for legal actions involving Seller.

**Real Estate Lease:** Get a copy of any real estate lease. Most leases give the property owner the final say in whether to allow an assignment or sublease. Will the property owner agree to allow the Seller to assign the lease? Will the owner try to raise the rent or change the terms of the lease?

**Use of trade name:** In an asset sale rather than a stock sale, you may or may not choose to buy the trade name. If the Seller has had problems (poor business decisions, legal claims outstanding, etc.), you may want to distance yourself from being considered a “continuation” of the Seller's business, by taking a new business name. On the other hand, if the name has significant good will value, you may want to buy the right to use the name as part of the purchase agreement.

**Allocation of purchase price:** Buyer and Seller must agree on and use the same allocation of the purchase price. The allocation must make sense, but otherwise, you have a lot of flexibility. Review the allocation with your accountant; every allocation has income tax consequences, and these often differ for Seller and Buyer.

**Employee issues:** In an asset sale, the Seller will terminate all employees as of the date of sale, and you can then rehire those you want to retain, on whatever terms you want. You have no legal obligation to rehire anyone, or provide the same pay and benefits to the employees you do choose to rehire; however, smooth operation of the business will probably require that you keep many of the employees and pay them at least what the Seller paid them. If you are not going to retain the employees, make that clear early in your negotiations.

You need to know if any employees have pending or potential claims against the Seller, as those claims may reveal important problems in the business, and can affect you directly. Does the company have a written employment handbook, or written policies? Tax and other considerations abound when you have significant numbers of employees, or have 401(k) plan or other federally controlled benefits. In these cases, you will probably need to retain a tax specialist.

**Tax issues:** Make sure the Seller is up to date on all tax filings, especially employee and sales taxes (horrendous penalties if not). As a matter of law, you need to get a letter from the Utah Tax Commission stating that all taxes have been paid, and one from the WFS regarding unemployment insurance, or you will need to escrow a portion of the purchase money.
Avoiding Unwanted Liabilities: Even in an asset purchase, where you expressly do not assume any liabilities, you may be considered a “continuation” or “successor” business to whom liability flows under certain circumstances. The best way to avoid such a finding is to (a) buy less than “substantially all” the assets of Seller (Utah courts generally consider 75% of the assets of a company to be less than substantially all its assets, but this is no guarantee) and make Seller give you a representation that it will remain in business; (b) close the doors for a period of time – 3 to 4 weeks is usually sufficient; (c) fire all employees of Seller (though you can rehire a few of the employees); (d) make sure there is no common ownership between Seller and your company; (e) use a different business name, and make sure to hold yourself out to the public as a new and separate business, not a continuation.

To the extent the above ideas are not practical for you, make sure you get tax letters, and spend a bit of extra effort on due diligence.

Special Concerns in a Stock Purchase. In a stock purchase, you are buying all the business's liabilities as well as its assets. Any problems in the past will become your problems, so it is even more important to do a thorough job of investigating the company before you close the deal.

You need to know that you have bought all the stock (unless you intend otherwise). Ask to see all stock subscription agreements, shareholder agreements, voting agreements, stock ledger book and the certificates themselves (if any). You also need to make sure the stock has not been pledged as security for anything, and that no other contracts of sale encumber the stock. Stock that isn’t registered with the SEC and/or the state will have sales restrictions, and should have a legend on the face of the stock certificates. (If stock is non-certificated, you must look at the stock transfer ledgers.) Make sure your purchase does not violate those restrictions.

Seek the Truth: Ask hard questions, check everything, take good notes and be skeptical. Remember what Winston Churchill said:

“All men stumble over the truth sometimes, but most pick themselves up and hurry off as though nothing had happened.”

Don't hurry off. Take your time and make sure you know what you are buying.