

# A LEGAL GUIDE TO PURCHASING A BUSINESS

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The purchase of a business is usually a major financial and legal decision for a buyer. The purpose of this guide is to highlight some of the major issues and key considerations that apply when purchasing a business in Victoria.

## **1. DUE DILIGENCE**

The satisfaction of buying a new business can easily turn to frustration if it becomes apparent – after settlement has occurred – that the business is not trading as expected, or there is some legal issue which adversely affects its viability.

Whilst risk can never be eliminated in these situations, a thorough due diligence will help to ‘flush out’ any relevant issues before you become fully committed. A purchaser will then be in a better position to either eliminate or manage those risks.

### **1.1. Financial due diligence**

One of the most important considerations when purchasing a business is determining whether, having regard to the purchase price and the level of investment required, the business is profitable, or has a reasonable prospect of becoming so.

A thorough financial due diligence should be undertaken in conjunction with your business advisor and/or accountant to determine if the purchase price is justified, and to provide some analysis of the business’ financial records.

There also needs to be an evaluation as to whether you have the necessary skills, experience and capital to carry on the business. You might also wish to engage an industry specific advisor to assist you in this process.

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*“The sale contract should be carefully negotiated by your lawyer. A lawyer’s role is to ensure that the document accurately reflects the agreement reached by the parties, and protects your legal interests”*

## 1.2. Legal Due Diligence

A legal due diligence is important to ensure that you are actually buying what you *think* you are buying.

At this preliminary stage, if you are being properly advised, your lawyer should be able to:-

- For small business sales, confirm whether the vendor has complied with its obligation in relation to the provision of a Section 52 trading statement
- help to conduct relevant searches to check the ownership of all major assets and identify any encumbrances over such assets
- review and advise you on all key contracts (e.g. supplier agreements, franchise agreements, management agreements, leases, licences etc.)

## 1.3. Asset versus Share Sale

It is important to determine whether or not the business is to be sold by way of a sale of the business’ assets (**Asset Sale**) or a sale of the shares in the company that owns the assets (**Share Sale**). The answer can have important implications for both parties.

- **“Asset Sale”** - If you are buying the assets of a business, the sale agreement will stipulate which specific assets are to be sold. A purchaser will want to ensure that the definition of assets is broad enough to capture all the assets

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which are necessary to conduct the business. This is how the majority of small business sales are conducted.

- **“Share Sale”** - By acquiring the shares in a company, the purchaser indirectly becomes the owner of everything that the company owns but it also inherits the company’s historical liabilities. For this reason, it is usually necessary to undertake a more extensive due diligence process, and obtain comprehensive warranties and tax indemnities.

Whether the sale is conducted by way of a Share Sale or an Asset Sale will have a significant bearing on how the sale is conducted. As such, you should discuss this with your lawyer from the outset of the transaction.

#### **1.4. Assets to be Transferred**

It is important to determine what assets are to be transferred with the business. Whilst each business is different, most business sales would include a transfer of the:-

- business name
- plant and equipment
- licences and registrations required to operate the business
- rights attaching to the Lease
- goodwill
- work-in-progress and/or stock-in-trade
- customer/supplier lists
- intellectual property (e.g. trademarks, patents, copyright etc.)

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## 1.5. Stock-in-Trade and/or Work-in-Progress

There are two main ways that stock-in-trade and work-in-progress (**WIP**) are dealt with in the context of a business sale:-

- **“Walk-in, walk-out”** – this means that the business is purchased inclusive of any WIP; or
- **“Plus WIP/Stock-in-trade”** – this means that the business is purchased without the WIP or stock included in the purchase price. In a retail business, it is usually the case that stock will be payable in addition to the purchase price and capped at a specified value.

## 1.6. Searches

The searches to be undertaken will vary depending upon the particular business in question. Your lawyer can advise you in this regard. However, the following are often sought:-

### (a) Title Search

A title search will disclose if the entity offering the lease actually owns the premises. It will also disclose if there are any registered encumbrances on title which may affect the leasehold (e.g. mortgages or caveats claiming prior interests).

### (b) Planning Search

A planning search should be undertaken to ensure that the underlying zoning supports the use of the premises for the operation of the business. If a planning permit has been issued, it is important to also determine if the business is being conducted in accordance with the permit.

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**(c) Food Act Registration**

All retail food premises must be registered with the local council under the Food Act (Vic). In food businesses, it is always recommended that a transfer inspection be arranged to determine if there are any orders or notifications which affect the business.

**(d) Liquor Licence**

If applicable, a search should be made through the liquor licensing authority to obtain copies of any licence, the red-line plan, and details of any notices or orders which might affect the licence.

**(e) Vendor company search**

A company search should be undertaken to confirm if the vendor entity is registered with ASIC, and to correctly identify the officers of the company.

**(f) Personal Property Securities Act (Cth) (PPSA)**

A PPSA search will show any registered security interests against the assets of the vendor. If so, any encumbrances need to be discharged at settlement.

**(g) Trade Waste Agreement**

For businesses that discharge wastewater into the sewer system, it is necessary to have a trade waste agreement in place with the local water authority, and a grease trap installed.

Although there is provision in some contracts for enquiries to be made after the contract is entered into, most searches should be undertaken prior to entering into a binding contract of sale.

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## 2. LEGAL DOCUMENTS

### (a) Confidentiality Agreement

The business broker will usually require a potential purchaser to enter into a confidentiality agreement before disclosing confidential information in relation to the business. This is designed to protect the vendor from the purchaser improperly disclosing such confidential information to third parties.

### (b) Heads of Agreement

The business broker may require you to enter into a heads of agreement which sets out the principal terms of the proposed sale. This is sometimes prepared as a **non-binding agreement** which is subject to the parties entering into a formal contract of sale. However, it can sometimes be a **binding agreement** that creates immediate and binding obligations on the parties.

### (c) Contract

The contract formalizes the deal and can address any issues identified in the due diligence process.

## 3. THE CONTRACT

In Victoria, most contracts for the sale of a small business are based on the standard form contract approved by the REIV (Real Estate Institute of Victoria) and the LIV (Law Institute of Victoria).

The standard form contract should only be modified by a lawyer to meet the requirements of an individual transaction. However, it should only be used in circumstances where the vendor is selling a Victorian business as a going concern.

It is important to ensure that you have either completed your financial due diligence before entering into the contract, or that a due diligence period is specifically negotiated in the heads of agreement.



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If you intend to obtain finance to fund the purchase, you should ensure that any offer is made subject to finance being approved on conditions which are satisfactory to you. This protects you in circumstances where finance may be approved subject to onerous and unreasonable conditions.

The sale contract should be carefully negotiated by your lawyer. A lawyer's role is to ensure that the sale document accurately reflects the agreement reached by the parties, and protects your legal interests.

Your lawyer will need to carefully consider the following issues:

- If applicable, has the vendor complied with its obligations in relation to the provision of a Section 52 trading statement?
- are the assets of the business accurately defined in the sale agreement?
- are the proposed warranties and indemnities to be provided by the vendor adequate?
- are the vendor's and the vendor's guarantor's post completion restraints adequate to protect the goodwill of the business?
- can the lease and any key contracts (e.g. management agreements, franchise agreements, supply agreements etc.) be validly assigned?
- are the purchaser's interests sufficiently protected having regard to the contract conditions?
- Does the sale qualify under the GST 'going concern' provisions?

A purchaser should also ensure that they have discussed the ownership structure of the business with their accountant. In particular, will the business be owned by an individual, company, trust or partnership? The decision in this regard can have important implications from an asset protection and taxation point of view.



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## 4. THE LEASE

The lease is usually a key agreement which is critical to the outgoing viability of the business. As such, you need to ensure that you understand all of the key terms before signing any documentation.

There is often a rather optimistic expectation on behalf of purchasers that, once a heads of agreement is signed, settlement of the business should be able to occur within a couple of weeks. Unfortunately, that's rarely the case.

One of the main obstacles to a quick settlement is the transfer of the lease. In short, the transfer and approval process can be lengthy, and the process needs to be complied with strictly to avoid delays.

The classic obligation set out in most leases is for the current tenant to demonstrate that the purchaser (or the proposed assignee) is solvent, responsible, and able to meet the lease obligations.

Whilst the requirements of each landlord (or their managing agent) can be slightly different, the following reference material is often requested:-

- At least two (2) trade references
- An Assets and Liabilities Statement certified by the purchaser's accountant
- If the purchaser is a company, then:-
  - a current ASIC Company Search
  - an Assets and Liabilities Statement from all directors of the company certified by its accountant
- If the purchaser or its directors own property, a copy of an updated Council rates notice which shows the capital improved value

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- A Business Plan which details the type of business the purchaser intends to operate, as well as details of all relevant experience
  - Details of any planned changes/upgrade to the fit out

## **5. CONCLUSION**

There are a significant number of legal issues that need to be addressed in the context of purchasing a business. An experienced business lawyer should always be engaged to assist you to navigate the complexities of the transaction.

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The information contained in this article is intended to provide general information only and is not legal advice or a substitute for it. You should always consult your own legal advisors to discuss your particular circumstances.