SALE OF BUSINESS

A practical guide to the sale and purchase of business in New South Wales.

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The author Eric Kalde is the author of over 30 practice guides published through the leading Australian legal publishers Documents Online and Precedents Online. The practice guides contain detailed commentary explaining the relevant area of law and documents ready to download and use immediately. They are available by annual subscription and are kept up to date with the law. They have been written for the legal profession and assume the reader has had legal training.

Contents

1 Overview

This book is for anyone who wants to know how to buy or sell a business. It is not legal advice. It is a general overview of the legal process of buying and selling businesses and explains what's involved.

In this book I make reference to a practice guide. This is a reference to the Practice Guide for Sale of Business in New South Wales, which I have also written and continue to keep up to date. It is published by legal publisher, Smokeball. This book follows the basic structure of the guide. The practice guide goes into each topic in more detail and includes documents ready to download and use. It is written for practising lawyers to use in their work with clients. As well as more detailed coverage, it includes links to legislation and documents. The documents are a collection of legal documents and letters ready to download and use in Microsoft Word format. The practice guide has proven to be a bestseller and very popular among lawyers in New South Wales and across Australia. Checklists in printable form are provided as well as precedent documents.

This book is intended as a more condensed guide that distils the essential parts of the practice guide, but without all the links which end up being distracting when trying to read in Kindle format. This book explains the procedure for sale of a business, and gives you the information to enable you to run the transaction. We look at the process both from the seller's and purchaser's perspective. There is a chapter devoted to each depending on which party you act for. We also go into detail with respect to several important aspects of sale of business such as the contract itself, issues specific to franchises, leasing issues and some others.

There is no legal requirement for a Contract for Sale of Business to be in writing. There is no register of title to a business as there is with the Torrens system of land ownership in Australia. Equipment, stock, leases and licences are listed in the for Sale of Business and define what is being sold.

Although the details of each sale of business are unique, there are issues and procedures common to each. To ensure that all important matters are covered, it us useful to use checklists in printable form. The relevant law is contained in 14 different acts of Parliament. They are too numerous to list here and links to each can be found in the practice guide. The point I am trying to make is that this area of law is heavily regulated and you need to get your head around it.

There is more than one way to sell a business. Selling a business may be effected by selling the shares of the company that owns the business or selling the assets of the business. A sale of the assets of the business is the most common practice. The new owner does not need to concern themselves with the past history of a company and whether it has complied with statutory obligations or paid the right amount of tax.

The process of a Sale of Business is conducted in a similar way to a sale of land: exchange of contracts, followed by a period in which the purchaser makes inquiries and the seller prepares for settlement, and ending in settlement.

The Law Society of NSW has produced a Contract for Sale of Business which has proved to be a popular choice by Australian Legal Practitioners in the past. For those that wish to use the Law Society contract, a set of special conditions is recommended. I have published a set of special conditions in the practice guide to improve on that contract and remove some of the unexpected adverse effects. The procedure for each type of sale is also explained.

Chapter 3 covers the transaction from the seller's point of view, beginning with pre-contract negotiations, confidentiality and disclosure. Pre-contract documents such as heads of agreement and non-disclosure agreements are discussed and their use is explained. I then explain the all important aspect of compiling the contract. Disclosure is covered, and legislation that may be relevant to the sale, including parts of the *Conveyancing Act 1919*. The rest of the chapter provides guidance on drafting the contract of sale, including tips on what it includes. It explains why a good written contract is prudent and necessary to effect the sale both for practical and tax reasons. Taxation considerations for the seller are covered in terms of the various parts that normally make up a business. Duty (formerly called stamp duty) is covered both in terms of the Sale of Business and in respect of any associated Lease or interest in land. Intellectual property is an increasingly important aspect in sale of business, in particular internet based businesses. This is covered in detail. We also look at the transfer of employees - how to keep some and terminate others as part of the sale process.

There are no statutory disclosure requirements for the sale of a business, so purchasers need to be careful about what they are buying. The purchaser's lawyer needs to make sure that their clients are getting good title to the various components of the business they are buying. This means carrying out due diligence either before or after a contract for sale is entered into. Chapter 4 covers points for the purchaser's lawyer to check the contract and to be able to provide meaningful advice in respect of due diligence.

Franchises are governed by a mandatory Franchising Code of Conduct. This makes the sale of franchised business different to non-franchised business. The documentation and procedure are both affected by requirements of the Code. Chapter 5 is devoted to franchising, and covers the relevant aspects for transferring a franchised business.

Agents (or 'brokers') and real estate agents are often involved in a sale of business. A description of their roles in the transaction are included in Chapter 6, along with some useful guidance on engagement. Common issues with selling agents, managing agents and business brokers.

A transfer of lease often forms part of a sale of business. Chapter 7 covers Leases under *Real Property Act 1900* (NSW), the *Retail Leases Act 1994*, the procedures for each, and how to tell the difference. A discussion on the correct procedure for assignment of lease is included.

Restraint of Trade clauses are important to the viability of a recently purchased business to ensure the seller does not reappear as a competitor of the purchaser. Warranties are useful in covering aspects of the business that cannot be fully investigated in due diligence or potential problems uncovered during due diligence. Both parties require indemnities so that the seller may walk away from the burdens of the business and the purchaser is not saddled with obligations that were not disclosed. Warranties, Indemnities & Restraint of Trade are all covered in Chapter 8.

Different business activities each may attract a separate set of licensing requirements. The main licensing requirements will flow from specific legislation (federal or state) that governs the operation of a particular business. Chapter 9 tells you how to find out what licenses are required, if any, and what to do about transferring them.

Chapter 10 contains a handy alphabetical list of precedents grouped under headings. So that you can quickly find what you need, when you know exactly what you want. Precedents are grouped under headings: 'checklists', 'letters', 'contract documents' to make them easy to find.

2 The Sale of Business Contract

No particular form of contract is prescribed by law in New South Wales. The type of contract used will be determined by the type of sale. The main difference in types of sale is an asset sale or sale of shares in a company. Selling a business may be effected by selling the shares of the company that owns the business or selling the assets of the business. A sale of assets occurs when all the things required to run the business are sold by the current owners to new owners. A sale of the assets of the business is the most common practice. The new owner does not need to concern themselves with the past history of the company and whether it has complied with statutory obligations or paid the right amount of tax. In the case of a sale of shares, the ownership of the company that owns the business assets is sold, thereby transferring ownership of the business owned by the company.

A business can be sold by way of a transfer of shares in the company that owns the business. Shares in a company are purchased as a means of acquiring control of a company. The ownership of shares in a company does not give the shareholder any ownership rights in the assets owned by the company. Shareholders have the power to influence the management of the company via the voting rights in their shares. This is a popular method in the case of one business partner selling out to another. One of the shareholder/ directors in a company decides to leave the business and sells their shares to the remaining shareholder/ director.

In addition to selling the shares in the company, the exiting director usually also wishes to get out of collateral contracts such as the lease of the premises from which the business is conducted and directors guarantees. A well drafted share sale agreement will not only effectively transfer title in the shares but also protect the rights of the party leaving the business from ongoing liabilities, and leave the remaining parties with ownership of the business assets. These principals also apply if the purchaser is not an existing director of the company. That is, if someone outside the company buys the shares in the company as a means of acquiring the business owned by that company.

Share sales are characteristically evidenced by:

(a) **A Share Transfer** – a simple one page document evidencing the transferor, transferee, date of transfer and consideration. It usually refers to a more complex document called an Agreement for Sale of Shares. This more complex document usually contains all the detailed terms and conditions of the sale.

(b) **An Agreement for Sale of Shares** – a detailed agreement containing all the terms and conditions of sale. As in a sale of business assets or property, the agreement contemplates a three step process in the sale of shares:

   (i) Signing and exchange of contracts (in this case the Agreement for Sale of Shares);

   (ii) A period in which adjustments are made and accounts prepared in readiness for settlement; and

   (iii) Settlement, where a final payment is made in exchange for signed Share Transfer, Share Certificate and any other documents evidencing title to the shares and ownership of the business.

Proprietary companies must advise ASIC of any changes to member (shareholder) details using a Form 484. That is, a Form 484 must be lodged with ASIC within 28 days of a sale of shares or fine will be incurred. The form can be downloaded or filled in online on the ASIC website. Public companies do not need to supply this information.

Sometimes the company that runs the business does not own all the assets of the business. In this situation the sale of business will involve both aspects of a sale of shares and a sale of business assets. Sometimes the intellectual property of a business such as trademarks and patents are owned by a separate legal entity as a risk minimisation strategy. The valuable intellectual property is owned by a low-risk asset holding company that does not trade. A licence is granted to a high risk taking trading company that uses the intellectual property and runs the business.

In a sale of assets many firms use their own form of contract. The other alternative is to use the form published by the Law Society of New South Wales and the Real Estate Institute of NSW, commonly referred to as 'The Law Society Contract'. This popular form of contract largely because it is familiar to many practitioners in NSW. The form is not always the best fit depending on the type of business being sold. The most recent update to the form is the 2004 version, which is now becoming somewhat dated.

The Law Society Contract contains standard terms and conditions which are copyright protected. The first two pages may be produced as a Word document with pages 3-10 purchased in hard copy from the Law Society. The Law Society Contract is not available in soft or electronic format. The copyright pages 3-10 contain the basic terms and conditions used for most purposes, and these are then amended by way of special conditions to adapt it to a specific business.

The accepted practice is to add the pages 3-10 unmarked to the contract and then add and delete terms and conditions by way of special conditions. This enables the standard terms to be suited to the individual transaction and avoids some of the unexpected outcomes in the standard wording.

Some unexpected effects of the Law Society Contract to be aware of are:

- Seller to pay costs of the landlord in transferring the lease (Clause 27.3). This is contrary to the expectations of most sellers who reasonably expect the purchaser of the business to pay for all costs of transferring the lease.
- Requistions; Clause 14 is unclear about whether a right to request requisitions exists. If making requisitions is important to the purchaser, this right should be conferred unequivocally by special conditions.

Although there is no statutory requirement for a Contract for Sale of Business to be in writing. Having a written contract is advisable. A business often includes an interest in land, usually in the form of a lease. Section *s54A of the Conveyancing Act 1919* requires dealings in land to be in writing. There are other advantages to having a written contract which are explained below.

There are no statutory disclosure requirements for the sale of a business, as there are with real property. The exception is in the sale of a franchise. It is a good idea to disclose as much as possible. This eliminates any doubt as to what is being sold and acts as an inducement to the purchaser to sign the contract. Consider the following as list of common annexures to disclose in a contract for sale:

- profit and loss statement
- balance sheet,
- inventory of equipment
- stock-in-trade
- a list of work in progress
- licences affecting the business
- list of continuing agreements (for example, equipment and service agreements)
- franchise documents (if relevant)

- local council development approval
- lease
- business name registration certificate
- certificate of registration of trade mark
- certificate of registration of patent
- certificate of registration of design
- list of internet domain names
- schedule of employees, length of service and entitlements
- Collective Agreements (if any)
- service agreements with independent contractors

3 Procedure

A typical sale of business starts with some Pre Contract Negotiation. Normally things like price are agreed first, and this may sometimes also result in a Heads of Agreement or Memorandum of Understanding being drawn up. A seller may wish to have a prospective purchaser enter into a non-disclosure agreement (NDA) for any number of reasons. Giving a purchaser a contract for sale entails attaching important business records to the contract. If the sale does not proceed, the seller would usually prefer to have this kept confidential.

'Heads of agreement' and 'memorandum of understanding' are terms used interchangeably to cover any agreement prior to entering into a contract for sale of business. This may be desirable in certain instances where the seller has been approached by a prospective purchaser when the business has not been officially on the market and no contract for sale is in existence. It also allows the seller to take a deposit to cover the legal expense of compiling a contract.

A Non-Disclosure Agreement (NDA) may be a good idea as often important business information is disclosed to a prospective purchaser. The Seller wants to protect themselves in the event that the sale does not proceed. The purchaser may be tempted to go into competition with the seller, using some of the sensitive business information that has been disclosed. Each party, the buyer and the seller then normally go to their lawyers, if they have not done so already.

Once a buyer is found and a price is agreed, the seller's lawyer normally creates a Contract for Sale. There is usually already a Contract in existence for marketing purposes. The marketing contract is seldom complete and may not have all the annexures that the seller may wish to disclose. It will also not have the purchaser's name or the purchase price. The seller's lawyer sends the Contract to the buyer's lawyer and normally some negotiation over terms ensues. This usually concerns things such as training, responsibility for trade debts and restraint of trade timeframes and territories.

Once Contact terms have been agreed they are signed and exchanged. The seller ends up with a contract signed by the buyer and the buyer ends up with a copy signed by the seller. A deposit ids paid at the time of exchange, and this is the date of the contract. The deposit can be held by the seller's lawyer or the selling agent, if there is one.

Once contracts are exchanged the seller normally asks their landlord for consent to assignment of the lease. In seeking the landlord's approval to assign the lease, the purchasers will need to provide details of their relevant experience in running the type of business they are purchasing and their financial resources. The landlord will want to be convinced that the new tenant will be as lease as good as their current tenant both in terms of business acumen and their ability to pay the rent. In seeking approval it is preferable that the seller's lawyer review the material being put forward in support of their application. I have seen many requests for consent declined because the purchaser did not appreciate the importance of obtaining consent and consequently did not put enough effort and care into their supporting material. They were declined and unable to purchaser the business. The seller needed to find another purchaser.

After exchange of contract there is normally a period of about 28 days in which the purchaser learns the business, is introduced to staff and customers and various checks are carried out by the purchaser's lawyer. The purchaser's lawyer will check that there is not money owing on plant and equipment, the rent and wages are up to date and other such matters. Between exchange and settlement the purchaser and seller will also do a stocktake. As a result of these inquiries and adjustments there may be an adjustment to the purchase price.

At settlement The Seller hands over all the documents giving ownership of the business to the purchaser including a transfer of lease, transfer of business name and original certificates of registration. The purchaser's lawyer will check to see that they have been given all other transferable permits and licences, all forms of transfer and the original lease of the premises. The Purchaser hands over bank cheques for the balance of the purchaser price and an order on the agent authorising release of the deposit.

After settlement there may be a further period of training by the seller, and introduction to customers by seller. It depends on what was originally agreed in the contract. It’s a good idea to get your lawyer involved early, so that they can ask for all the things you will want to be included in the contract. This will affect the way the rest of the transaction goes. One the contract is signed, it is too late to make changes.

4 Taxation Issues

An important aspect of business structures is to remember that each component of the business may have different legal or taxation consequences associated with them. Accordingly, taxation issues need to be considered for each component of the business. The seller usually has a preference to apportion the bulk of the purchase price to goodwill. This is normally because consideration for goodwill can be reduced by the capital gains tax concessions for small business.

Conversely the purchaser will usually want the highest amount apportioned to plant and equipment. The reason is that the purchaser is able to claim depreciation and obtains a tax deduction for these items. The purchaser usually has a preference to apportion the purchase price to items that are entitled to an immediate or faster deduction. The purchaser will usually want the highest amount apportioned to plant and equipment for this reason (this is contrary to what the seller usually wants). The reason is that the purchaser is able to claim depreciation and obtains a tax deduction for the capital cost. The ATO will generally adopt the apportionment in the contract, even though there are provisions in the tax legislation which allows the ATO to make their own apportionments.

In practice the ATO will generally go with what is shown in the contract, even though they can make their own apportionments. Where an apportionment is not made in the contract, each party can determine how to apportion the price amongst the assets. It is likely that the apportionment made by the seller will be different to the apportionment made by the purchaser. There will therefore be two counterparts with different apportionments. They cannot both be true. The risk in these circumstances is that the Commissioner of Taxation may review the transaction and impose its own apportionment. This could lead to tax adjustments and penalties for both the seller and the purchaser.

Any consideration for goodwill can be reduced by the capital gains tax concessions for small business. Goodwill does not attach to the assets of a business. The sale of a particular asset of a business (separate from the business itself) does not involve a disposition of goodwill. A partial sale of a business does not involve any goodwill unless that part can stand alone as a separate business.

Any part of the purchase price apportioned to land will not be tax deductible to the purchaser until the land is sold. Any repairs that are needed to be carried out immediately may not be tax deductible by the purchaser. Therefore it is preferable to require the seller to undertake immediate repairs prior to sale. Usually no tax consequences arise where the business premises are leased. With leased premises, either the seller will assign the lease or, the purchaser will enter into a new lease with the landlord.

The purchaser will usually want the highest price apportionment to plant and equipment as opposed to goodwill. The purchaser is entitled to claim depreciation and, accordingly, obtains a tax deduction for the capital cost. The seller usually wishes to apportion less to plant and equipment and more to goodwill.

The purchaser will usually wish to in apportion the highest possible value to trading stock. There will be an immediate tax deduction on the sale of the stock. Stock should not be acquired by the purchaser for higher than market value, as that value will be reduced to market value by the ATO for tax purposes and no deduction will be allowed.

The purchaser is unable to claim a deduction for any bad debts assumed from the seller. Usually the purchaser will agree to receive debts on behalf of the seller for a commission or fee. If debts are transferred, the purchaser should require an indemnity from the seller. The purchaser is entitled to a deduction for the amount paid to acquire work in progress. When the work in progress is actually billed and recovered the purchaser would be assessed on it at that time.

The Capital Gains Tax (CGT) system taxes capital receipts of a taxpayer, which often accrue from increases in the value of a taxpayer's asset. These are receipts which are not income according to ordinary concepts. CGT is not a separate tax. The CGT provisions are included in the *Income Tax Assessment Act 1997*.

Capital gains may be reduced by the CGT 50% discount concession in Division 115 of the *Income Tax Assessment Act 1997* and the small business CGT concessions in Division 152 of the *Income Tax Assessment Act 1997*. Taxpayers with a capital gain from an asset held for more than 12 months may include only part of the nominal capital gain (the amount of the gain excluding any indexation) in their assessable income.

The two criteria that must satisfied are: the gain must be made by an eligible taxpayer; and the gain must arise from a CGT event regard an asset held for more than 12 months.

To be eligible for a discount capital gain the capital gain must be made by an individual, or a complying superannuation entity, or a trust. These concessions are not available to companies. We recommend a two-step approach: First, determine eligibility, then see what concessions apply.

There are four ‘small business’ CGT concessions in Division 152 of the *Income Tax Assessment Act 1997*

(a) 15-year concession; subdivision 152-B *Income Tax Assessment Act 1997*

(b) 50% reduction; subdivision 152-C *Income Tax Assessment Act 1997*

(c) retirement exemption; subdivision 152-D *Income Tax Assessment Act 1997*

(d) rollover relief. subdivision 152-E *Income Tax Assessment Act 1997*

The eligibility criteria are located in subdivision 152-A *Income Tax Assessment Act 1997.* Further detailed treatment of this topic can be found in the practice guide.

Do not forget the sale of a business will attract GST. In order to get the going concern exemption from GST the parties must have agreed in writing that the supply is a going concern. This is another good reason to have a written contract.

(Stamp) Duty must be paid on agreements for the sale of business. Duty is normally payable by the purchaser. There will be a Duty liability where there is a written or unwritten transfer of dutiable property. Plant and equipment on its own is not treated as dutiable property unless that plant and equipment is transferred as part of a sale of a business. Attempting to separate the sale of business from the sale of the plant and equipment will usually not result in any stamp duty saving for the purchaser because of an aggregation provision in s25 of the *Duties Act 1997*. Stamp duty is paid at ad valorem rates set out in s32 of the Duties Act 1997. A quick way to calculate stamp duty is by using the Office of State Revenue’s Duty Calculator for Transfer of Land or Business.

When a transfer of lease is associated with the sale of the business, duty on the transfer of the lease is assessed as a nominal $10.00 in addition to the duty paid on the transfer of business. The duty is on the transfer. There is no duty on the lease itself. The stamped contract of sale is an important piece of evidence should the purchaser require these for a tax audit or similar purpose at some time in the future.

Where the seller is the owner or licensee of an Australian patent, registered design, or copyright, then the seller may claim tax deductions in respect of the cost of such assets. If so any consideration received on disposal of these assets will be subject to tax to the extent that the consideration received exceeds the tax written down value of the asset (the 'residual value').

The application of capital gains tax to Intellectual Property is expressly excluded by section 118.24 of Income Tax Assessment Act 1997. The seller will benefit most by apportioning a value to intellectual property items equal to the tax written down value, leaving any balance to be classified as goodwill or some other asset subject to the operation of the CGT provisions. However, the purchaser would seek to apportion a greater value to intellectual property, as a tax deduction can be claimed pursuant to Division 40 of Income Tax Assessment Act 1997.

5 Intellectual Property

Intellectual property (IP) can be an important business asset. It may take the form of a strong brand name or logo, copyright, or valuable patents or designs. Check and list all IP being sold in the contract. Consider whether any IP is dependent on a statutory registration (e.g.: trademarks, patents) or is based on a common law right or usage (copyright). Include any contracts on which IP ownership or usage depends. Check that all IP registrations are current *and* check their expiry dates. If any IP registration has expired, or about to, require the seller to renew it. Any assignment documents will need to be prepared by the purchaser and sent to seller to be signed and then handed over on settlement.

Consider under what names the seller carries on business. These are the trading names in which the "goodwill" resides. Then check to see whether those names are registered business names. Arrange to transfer ownership of the business names prior to settlement. The certificates of registration of each business name should be handed over on settlement. Check to see whether the business names are trademarked. If not, check to see if you can trademark them after settlement.

The seller may use IP rights under a licence. This could apply to trading names or product brand names; statutory IP such as patent rights, trademarks and copyrights; or proprietary software used in its business. Locate a copy of each licence to be included in the sale. Determine whether there is any registered encumbrance over the IP. IP rights can be encumbered (mortgaged) just like any other asset. Also, identify ownership of IP that is not required to be registered. That is, check IP protected by copyright, such as software programs. Such rights do not require registration in Australia.

The seller's domain name and website whilst not strictly speaking ‘IP’ are important marketing tools. Check registration of domain name and that the seller is in fact the owner. Check terms of the registration and determine if expiry is imminent. Check also the website itself: you want to make sure there is privacy statement that complies with the Privacy Act. There should also be displayed a claim for copyright of all materials of the seller. If the seller is engaged in sending email marketing campaigns, check to see that there a functional "unsubscribe" mechanism to comply with the Spam Act 2003 (Cth). It is worthwhile signing up to the seller’s mailing list to see the frequency of marking emails and their quality.

6 Employees

Any accrued benefits of employees over and above annual and long service leave (such as bonuses) should be paid to the employees by the seller and not assumed by the purchaser. The seller should terminate any employees the purchaser does not wish to keep prior to settlement. The amounts are paid by the seller to the employees on termination of employment. The amounts are 'employment termination payments' for which concessional rates of tax may be available to the employees.

Payments received by employees on termination of employment with the seller will be treated more beneficially than if received by the employee during an employment period, say with the purchaser. The tax position of the seller or purchaser paying the amounts should be neutral because it should be seen as employment expenses in both circumstances. Identify the "core" employees of the business who are essential to its operation. Put in place formal employee contracts, if these do not exist. Identify the extent of the seller's legal commitments to all employees.

Determine what legislative jurisdiction governs the employment relationship. Employee entitlements may vary significantly depending upon the employee's industrial coverage. Check the documents that record the employee arrangements. These may take the form of letters of employment and contracts. Also less common are employee collective agreements, union collective agreements, enterprise agreements made under the *Fair Work Act 2009* awards.

Confirm the seller has paid or made provision for its current employee liabilities. The seller should produce or attach to the contract a schedule of employee liabilities, which should indicate the liabilities for wages, holiday pay, sick pay, long service leave. Check that retrenchment entitlements have been paid for those employees whose employment may be terminated following the sale. In the sale contract, the seller should warrant the accuracy of information disclosed and indemnify the purchaser against any additional or undisclosed employee liabilities.

Confirm the seller has workers' compensation insurance. If there are actual or anticipated claims for workers' compensation, ask the seller to confirm that the workers' compensation insurer will cover these claims. Any claims that are not covered should be dealt with by specific indemnities in the sale contract.

In relation to superannuation, check that the seller has made all compulsory contributions for its employees to its own approved superannuation fund or to funds nominated by each employee. Confirm that any superannuation fund being administered by the seller complies with the current regime.

Determine whether some "staff" are in fact independent contractors. In relation to contractors, identify the terms of the contracts under which they are engaged. Obtain signed copies of the contracts or letters of appointment The originals should be handed over on settlement. Ensure that any verbal arrangements with key contractors (or changes to written arrangements) are documented. Confirm that all payments due to those contractors have been made and determine whether any outstanding claims exist by such contractors.

7 Due diligence

"Due diligence" is a term used in a number of situations involving either an investigation of a business or person prior to signing a contract. We will refer to due diligence as a process by which a purchaser evaluates a seller company or its assets prior to acquisition. The process of due diligence involves a potential purchaser having a close look at a business being sold before committing to the sale. The alternative is to enter a sale contract in reliance on untested assertions, statements, figures and warranties by a seller or selling agent.

The purchaser's legal and financial advisors usually handle the due diligence. As part of the due diligence process, the purchaser's lawyers may negotiate warranties into the contract of sale with the seller's lawyers. Such warranties will normally address adverse findings of due diligence. Due diligence may take place after the exchange of contracts and prior to settlement. In that situation, the focus of the due diligence will be seller warranties.

If time allows the due diligence is best done before exchange of contracts. This is preferable because the purchaser has the opportunity to avoid the contract completely. If serious issues cannot be resolved, the purchaser can withdraw from the transaction at an early stage and save legal and other costs. A purchaser will often have limited time for due diligence. Consider using an option to allow time for due diligence.

Due diligence is usually undertaken by a team of professionals according to their particular expertise. Often this involves lawyers and accountants. Architects, builders, engineers and valuers are also often called upon for their expertise. A due diligence team may include executives from the purchaser company as well as external experts. The external experts might include scientific or engineering experts in that industry. If the purchaser plans to list the seller on the Stock Exchange in the near future the external experts might include representatives from a sponsoring stockbroker or the proposed underwriter for the float.

A lessee of business premises has all the privileges and responsibilities of an owner. The client, whether lessee or purchaser of the property should be advised to make inquiries of the property. and of the lessor. The enquiries should be similar to what they would do if purchasing the property. The longer the lease the more extensive the searches should be. You will need to consider the context. For example, when leasing retail shop in a shopping complex, structural issues may not be as relevant as when leasing a free standing building or warehouse for the purpose of installing heavy manufacturing machinery.

Obtain a current extract from ASIC to determine the directors of a company. The lease should be signed by two directors of the company pursuant to section 127 of the Corporations Act 2001. If it is not signed by directors, you will need to know that the person signing has authority to bind the lessor to the lease. You do not want the lessor to later argue that an unauthorised employee of the company purported to enter into a lease when they in fact had no authority to do so.

A bankruptcy search is a prudent measure where the lessor is a natural person. It will tell you if the other party an undischarged bankrupt or a petition for bankruptcy been served.

Make appropriate searches on the property from which the business is conducted. Consider at a minimum obtaining a title search, and a S149 Certificate (zoning and planning). Confirm the current planning environment allows the business to be conducted under local planning laws. Determine whether Development Consent is required, and if so, whether it has been obtained. If there is Development consent find out what conditions are attached to it. Check that the building is sound. Consider a building & pest inspection. If there are major works required, these are likely to be disruptive to business.

If you are a lawyer you will need to obtain your client's instructions regarding the specific use of the property. Usually the client will volunteer any special features they require, but it is worthwhile getting into some detail about how the client intends to use the property, what hours they intend to keep and what issues may arise in terms of what the terms of the lease allow.

8 Franchises

The term "franchising" is normally used in connection with either a business format or a trade mark. Under a business format franchise, the Franchisor grants to the Franchisee not only the right to use the Franchisor's trademarks but also the right to use an entire business system. The Franchisee must carry on their business according to the system.

Franchising in Australia is governed by the Franchising Code of Conduct. The Franchising Code of Conduct is a mandatory industry code of conduct that has the force of law under the *Competition and Consumer Act 2010* (Cth). The Code is contained in a Schedule to the Trade Practices (Industry Codes — Franchising) Regulations 1998 ('The Code').

Under the code, franchisors must give a franchisee certain documents at least 14 days before the franchisee enters into, renews or extends a franchise agreement or pays a non-refundable deposit in relation to a franchise agreement. The code also requires that a franchisor inform the franchisee of any materially relevant facts about the franchise (for example, certain court proceedings) within 14 days after the franchisor becomes aware of them.

The code gives franchisees certain rights. Among them are cooling off period. A franchisee may terminate a franchise agreement within 7 days after entering the agreement, or paying any non-refundable money, whichever is earlier. If the franchisee exercises their cooling-off period, they must be given a refund minus any reasonable expenses incurred by the franchisor within 14 days.

Every franchise agreement must have a dispute handling procedure that complies with the code. Any party to a franchise agreement who has a dispute with another party to the agreement may engage the code's dispute resolution procedure. The Office of the Franchising Mediation Adviser provides mediators for resolving disputes using the dispute resolution procedure set out in the code.

The Code imposes certain restrictions and obligations upon a franchisor and a franchisee in connection with the transfer or assignment of a franchise and the sale of a franchised business.

Master franchising is popular with service franchises. Service franchises are those which involve the franchisee selling services rather than goods. Service franchises are common in the home services, cleaning and courier industries. Often there will be no retail premises involved, with the franchisee operating from home. The use of a vehicle will be a critical element of the franchise.

A feature of service franchises is the high number of individual franchisees. To avoid creating a large head office bureaucracy master franchising can be used to delegate the responsibility of growing, developing and monitoring the network in a territory to a master franchisee.

The grant of a master franchise is very similar to the grant of a franchise. However, the terms of the master franchise and the responsibilities of the master franchisee are different from those of a franchisee. .

The master franchise arrangement can be structured in such a way that the master franchisee can be a prime contracting party, an agent of the franchisor, or a joint contracting party. The franchisor will normally wish to protect the business format, systems and image that the franchisor has developed, but otherwise the nature of the master franchising arrangement can be structured to suit the needs of the particular network.

When creating master franchise arrangements consider the prohibition of Pyramid selling schemes in Division 3 of the Australian Consumer Law. This prohibition may well render some methods of master franchising illegal.

Clause 20 of the Code deals with the process of transfer of a franchise. Sometimes transfer of a franchise is referred to as ‘novation’ of a franchise. A franchisee may make a request for the franchisor’s consent to transfer and the franchisor may not unreasonably withhold consent.
The franchisor is deemed to have given consent to the transfer in certain circumstances. Legal advice should be sought on this issue and on all sales of business involving a franchise.

9 Agents

Business selling agents (also referred to as 'brokers') or real estate agents are often involved in a sale of business. A real estate agent may be involved as the property manager of leased property or a selling agent of the underlying freehold. A business agent will often handle the deposit as stakeholder in a similar way to a real estate would during a property conveyance.

Business selling agents or brokers usually charge the seller up to 10% commission to sell a business. Their agreements are similar to real estate selling agents. Read the agency agreement carefully. Most business agents use a standard form contract that provides amongst other things an exclusive agency period. During exclusive agency period the agent is paid their commission if the business sells. The commission is payable regardless of who sells it or whether or not the agent has introduced the sale. The exclusive agency period is usually followd by a continuing agency period. During the continuing agency period the agent is paid their commission if the property is sold to a purchaser whom the agent has introduced.

If you wish to terminate the agency agreement then notify the agent in writing. In your letter notifying, request the agent to provide full list of all introductions to the business, and a copy of the contract for sale (mainly for your information, to know what prospective purchasers have been sent).Take note to terminate in respect of the exclusive agency period and the continuing agency period.

Managing agents are a useful point of contact in contacting the seller’s landlord and their lawyer. They also often handle adjustments of rent and handover of deposit in respect of leased premises that are the subject of sale.

10 Leasing issues

A transfer of lease often forms part of a sale of business. The agreement for sale of business ought to have the current lease attached to it as a disclosure document. and the sale of business is usually conditional upon the lessor granting a transfer or a new lease.

Assignment of a lease usually involves lawyers acting for the seller (lessee/assignor), for the purchaser (transferee of the lease/ assignee), for the lessor, for any mortgagee, and possibly for guarantors also. Guarantors should be represented separately to avoid a conflict of interest. 'Transfer' and 'Assignment' are interchangeable terms.

A lessee can transfer (assign) the lease. However, a transfer of lease without the consent of the lessor may be a breach of the lease. Consent cannot be unreasonably withheld by the lessor unless the lease expressly prohibits assignment, which is relatively rare. Consent to transfer of lease is covered in *s133 B(1) of the Conveyancing Act 1900* (NSW). In a situation where there is a clause expressly prohibiting assignment, then s133B(1) of the *Conveyancing Act* does not operate. The Lessor may subsequently waive the prohibition and impose any condition it desires.

The *Retail Leases Act 1994 (NSW)* contains extra procedures that should be followed when assigning a lease. These act in favour of the seller of the business, provided the procedures in the Act are followed. The main features to be cognisant of in relation to assignment are deemed consent and the assignor's disclosure statement.

The Retail Leases Act 1994 (NSW) contains special protections for the Assignor of a lease provided certain conditions are met. The procedure for obtaining consent is set out in section 41 of the Retail Leases Act 1994 (NSW). That section provides that if the procedure is followed and the lessor has not given a response within 28 days, the consent to assignment is taken to have been given.

The benefit of the assignor giving is that the assignor and guarantors will not be liable to pay the lessor any money payable by the assignee to the lessor after the date of transfer - s 41A(1) *Retail Leases Act 1994*(NSW). This is covered in greater detail in the practice guide.

More often than not, the purchaser will be anxious to have possession of the premises and the seller will be willing to give it. Both parties may regard the signing of lease documents as an afterthought, something that can be attended to after the purchaser moves in and begins paying rent. There is a particular danger to the lessor in granting early possession to the premises, particularly where the Retail Leases Act applies. Section 8 of the Retail Leases Act provides that a retail shop lease is considered to have been entered into when a person enters into possession or begins to pay rent (whichever happens first).

Consider then the effect of *s16 of the Retail Leases Act* which provides for a minimum term of 5 years unless this has been specifically excluded. If there is not yet any signed documentation, the combined effect of giving early possession to a lessee is to effectively grant a 5 year lease over the premises.

It is prudent to make formal inquiries of any proposed lessee. Once occupation has been granted, and a lease has been signed and registered it is a difficult and expensive process to evict a lessee should that become necessary. It is only at the end of this difficult and expensive process that the lessor will give focused consideration to recovering their costs from the lessee.

If the lessee is found at this point to have no financial backing or assets then the lessors chances of recovering their costs are effectively nil. This is bad news for the lessor and the lawyer representing them.

The risk of this adverse scenario can be minimised by making prudent inquiries of the proposed lessee before the lease is entered into. Even if the lessor ultimately decides to proceed on verbal assurances alone, it is important that the issue of due diligence concerning the lessee was raised early on. If the lawyer can produce a copy of a letter to the lessor advising on this point, then so much the better.

If the property is mortgaged, a transfer without the consent of the mortgagee will usually be a breach of the mortgage. The Lessor is required to get the consent of its mortgagee if it has one. The mortgagee will usually require the Lessor and Lessee to enter into a deed. The main purpose of the deed is to give the mortgagee all the rights of the lessor in the event that the mortgagee exercises its power of sale and becomes the possessor of the land. Without such a deed there would be no contractual relationship between the mortgagee and Lessee and therefore no rights between the two.

The mortgagee will require its legal fees and disbursements to be paid by the Mortgagor/Lessor who in turn would expect to pass this cost on to the Lessee. Note that the buck stops here in terms of a Sale of Business – the standard Law Society of New South Wales Contract for Sale of Business terms require the seller to pay the costs of the Lessor in granting consent. If your client requires otherwise, include a special condition modifying this provision. The Lessee is required to pay any costs associated with further negotiation of terms of the lease. This arrangement may be altered by adding appropriate special conditions.

11 Warranties, Indemnities & Restraint of Trade

Consider including seller warranties in the contract if issues arise with important aspects of the contract, the parties or the property. Ensure the signatories have the power and authority to enter into the contract and they are not insolvent, bankrupt or about to become so. Seek warranties that execution or other process has not been levied against the Sellers or in relation to the Assets. Similar warranties should also be sought in relation to appointment of receivers, trustees or administrators. Common warranties state that the Seller Assets are owned both legally and beneficially by Seller free from any third party rights and in its possession. A general warranty that all the information attached to the contract complete and accurate is useful. Consider what if any, specific warranties should be included to deal with aspects specific to the business

The purchaser does not want to see material change in the financial or trading position of the business once it becomes the owner. The same applies to changes in the value of assets or liabilities, turnover, expenses or profitability. Ensure the warranties in the contract reflect this.

Indemnities should be sought from the seller in respect of a breach of specific warranties. Also, consider specific indemnities in relation to product warranties offered to consumers, purchases on finance terms or layby.

Restrictive covenants or restraint of trade clauses may included in the main contract of sale and sometimes also separate agreements binding key persons in the business. A restrictive covenant is regarded as a separate asset for tax purposes. Any consideration allocated to a restrictive covenant in the sale contract will be subject to capital gains tax.

12 Permits and licenses

The type of business being sold will influence the inquiries that will need to make in relation to business licensing. Different business activities each may attract a separate set of licensing requirements. The main licensing requirements will flow from specific legislation (federal or state) that governs the operation of a particular business. Identify all licences needed by the business to lawfully run its business at federal, state and local government level. Inspect the originals of these licences to check that they are current and what conditions they carry. Obtain from the relevant licensing authorities a written confirmation that there is no outstanding breach of the conditions attached to each licence and that all current licence fees are paid. Consider if any new or renewed licences will be needed. Obtain the forms for transfer of licences. The purchaser should obtain these and forward to the seller prior to settlement.

The local council in which the business operates will also have specific zoning and planning requirements. Check to see whether Development Consent is required to run the type of business being sold. If development consent is required, check to see that it has been granted and what if any, conditions attach to it.

13 Also by Eric Kalde on Kindle

- Choosing the Right Lawyer
- Leasing Real Estate

The material in this book is explained in more detail in the practice guides ‘Sale of Business Practice Manual (NSW)’ a ‘Leasing Practice Manual NSW’ and ‘Franchising Agreements’ published for the legal profession in Australia by Documents Online and Precedents Online and is referred to throughout this book as ‘the practice guide’. For full access to the practice guide with links to legislation and precedent documents, contact the publishers directly via the links below.

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14 Legal & copyright

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