

FOR IMMEDIATE RELEASE

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RE: THE ART OF DUE DILIGENCE

Thinking about buying or investing in a business? How can you tell if it is really a viable and safe business with long-range income potential? The answer is in proper due diligence - legalese meaning, *turn over enough rocks to make sure there are no scorpions in the flower garden.*

Many would-be entrepreneurs or investors think that reviewing a company's balance sheets and income statements constitutes due diligence. But that should only be the start of a more elaborate process. Here are some other items that warrant close inspection before you sign the final closing documents.

1. Client List. Find out if most of the company's business is done with a few entities or individuals, or if there is a diversified and extensive customer base. If there is a limited clientele, you may want to meet with some of them as a part of your due diligence process to determine if they will remain loyal after the sale.

Because of the seller's need for confidentiality, any such contacts would occur just prior to closing and under the seller's scrutiny.

2. Key Employees. If you are looking at a company that relies on key people to perform its services and you do not possess the necessary skills to run the company in their absence, protect yourself. A confidential meeting with a key

employee can help you determine his company loyalty. Our experience dictates that most employees will remain after the sale, because the change of ownership is not nearly as traumatic as a change in employment.

3. Books and Records. Tax returns are signed under penalty of perjury and should be used to verify income statements, so try to obtain copies for the last three years. Other records to peruse include: accounts receivable and payable; any property or equipment leases, pertinent contracts, warranties and copies of the gross receipts tax statements for the past year.

4. Equipment and Inventory. Asset-intensive businesses warrant an inspection of the assets to determine if the inventory is marketable and the equipment is in good repair and adequate for the purposes for which it is intended. Buying any business with obsolete equipment or inventory is like buying a car without an engine.

5. Industry Outlook. If you are paying for "goodwill", make sure there is some. Research the industry on the internet to see if it is still a healthy and growing area of commerce. Try to determine where the subject business ranks with respect to its market share and work with the seller to develop a list of the things you can do to improve its position.

6. Chattel and Tax Lien Search. The closing attorney should order these very important searches to uncover any encumbrances that may exist against the assets of the business. Smart buyers run searches on both the business and the owner to make sure all bases are covered.

7. Suitable Lease. If you are buying a business with a seven-year promissory note, a three-year lease isn't very attractive. The seller's leasehold interests can be transferred to the buyer in one of three ways: a lease assignment, a sublease or a new lease. If there is plenty of time remaining on the existing lease (renewal options included), it is sometimes easier for the seller to simply assign the lease to the buyer, subject to the landlord's approval. In some instances (very few) the seller may be able to sublet the property to the buyer. If there is only a little time remaining on the lease, it is often better for the buyer to simply negotiate a new lease with the landlord. Any purchase agreement should reflect the fact that the purchase is contingent upon the buyer's acceptance of a suitable new lease or lease assignment.

8. Professional Assistance. A good CPA is necessary to review financial records, while an experienced business attorney can advise you on legal matters such as those surrounding important contracts, leases and other agreements.

Spending a couple of thousand dollars on professionals prior to a major investment can be a cheap price to pay for peace of mind.

A couple of year's ago, a distraught gentleman (let's call him Reed), visited my office and related a sad tale. He had recently bought a business directly from an owner and was having serious doubts about its future. When I asked him what due diligence he had performed, he said he had looked at profit and loss statements, had reviewed the lease and had inspected the inventory and equipment. He had also researched the industry to satisfy himself that there was remaining growth potential.

Unfortunately, Reed tried to save a buck by using a standard Bill of Sale bought at a stationary store rather than relying on a business attorney to draft the proper closing documents and order a chattel and tax lien search. The rest of his story reads like a Steven King novel. Four major pieces of equipment were actually leased and in arrears; the company had not paid any payroll or gross receipts taxes in two years; and there was \$20,000 in inventory that was about to be confiscated by the vendor for nonpayment.

Essentially, Reed had purchased a lemon and no amount of post-sale lamenting was going to turn it into lemonade. Hopefully, Reed's dismal experience will have a positive effect in motivating future buyers to do their pre-sale homework.

Due diligence is not just a phrase, it is a requisite for peace of mind.