How to Buy a Business

NORTH DAKOTA SMALL BUSINESS DEVELOPMENT CENTERS

Your Ideas - Our Expertise - Your Success

NDSBDC.org

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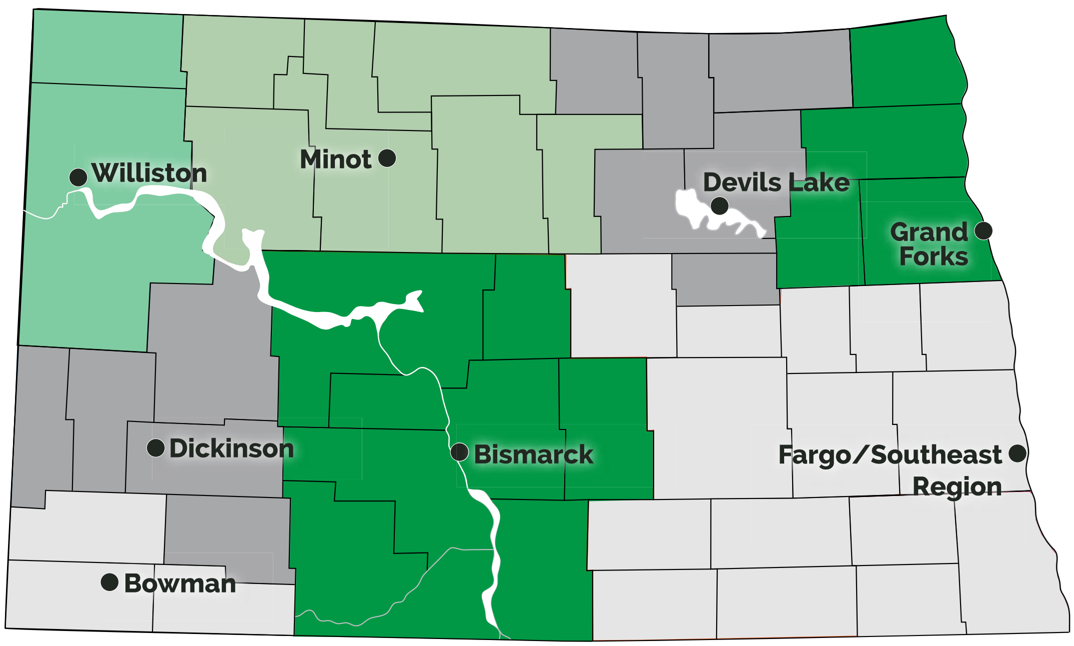
ABOUT THE ND SBDC

POWERING the creation, growth, and success of small business in North Dakota.

The ND SBDC network of credentialed business advisors empower North Dakota small businesses and entrepreneurs to thrive. We accelerate business growth in communities across North Dakota by providing customized guidance and resources that help owners and entrepreneurs achieve their goals at every stage of their business life cycle. For over 35 years, our network has supported small business owners and entrepreneurs across the state. When small businesses thrive, communities thrive, North Dakota thrives.



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POWERED BY SBA U.S. Small Business Administration

UND UNIVERSITY OF NORTH DAKOTA CENTER FOR BUSINESS ENGAGEMENT & DEVELOPMENT

BND Bank of North Dakota

AMERICA'S SBDC ACCREDITED MEMBER

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INTRODUCTION

Your interest in becoming a business owner is what drives the American economy. America's 22 million small business owners are the backbone of our country's free enterprise system. Some economists have said that America as a nation would not have endured without the firm foundation of leadership provided by the business owners in each community, city, and state. As a business broker, I have the privilege - and the fun - of helping my clients attain business ownership. It's a great way to make a living!

However, I have found that a great many people think that having a business of their own is an unattainable goal. They think that it takes too much money or that buying and running a business is too complicated. One of the reasons I'm writing this booklet is to try to dispel these notions.

The other reason I've undertaken this booklet is that even the people who have decided to buy a business have told me that they don't really know how to go about the project. There is a logical step-by-step process that the pros use to buy a business in a safe and organized way. In this booklet, I will try to explain each step in detail and in a user-friendly manner.

As you read through the various chapters, the process of purchasing a business may seem complicated - but it's really not. It will all make more sense as you move through the plan of action. Remember, take your time and stay with the program step-by-step. Ask if you don't understand and most of all, enjoy the trip. You'll learn some new things, and I guarantee you that you will not be bored!

But first, a couple of disclaimers: I have used the words he, his, and him throughout this writing just as a convenience and without any slight intended whatever of the feminine gender. The ranks of women among small business owners is increasing - and rightly so. Also, the opinions expressed and advice given herein are mine alone and not necessarily those of my brokerage office.

"There is a logical step-by-step process that the pros use to buy a business in a safe and organized way."

William Bruce

CHAPTER 1:
AN OVERVIEW

America is a nation of small business owners. Most people are surprised to learn that the country's more than 30 million small business owners create about two thirds of America's new jobs each year.

General Electric, General Motors and Microsoft get most of the press, but you and I are "where the action is" - out there in the exciting, dynamic and profitable world of small business ownership.

You are reading this booklet because of your interest in joining that group of adventuresome individuals who have chosen to become masters of their own destiny. Welcome to the arena!

Why Go Into Business for Yourself

There are several good reasons why people want to become independent businesspersons.

In today's environment, we get a lot of clients in our business brokerage office who have been "downsized" by one of the major corporations in the area. Or they are in a dead-end job with little future. Certainly, if you're unemployed or being transferred to a place you don't want to go, buying your own business can be a viable solution. It puts you in control.

In addition, there is an undeniable status that America attaches to a person who owns their own business.

Interestingly, on surveys done as to why people want their own business, income is not the first consideration. The reasons in order of how often each was mentioned in a recent survey were:

- Control of one's own destiny
- Flexibility
- Status /Recognition
- Income
- Security
- Privacy

For whatever reasons, millions of Americans are finding anew each year that owning their own business can be a rewarding experience, both personally and financially.

Is Buying and Running a Business Complicated?

Going into business for yourself is not as difficult, complicated, or as expensive as most people seem to think.

First, when you buy an on-going business, you don't have to reinvent the wheel. It's all been done for you. The policies and procedures are already in place. The location of the business has proven advantageous. The employees have already been hired and trained. Adequate inventory levels have been established. The product or service that the business offers has been market tested.

Probably the most important advantage in buying an operating business is that an established customer base is already spending money with the company. You have cash flow from the first day that you own the business. Your job is to improve what's already working without doing anything to mess up things.

These advantages are not available in a start-up situation. Starting a business from scratch is certainly a more risky proposition than buying an operating entity.

Why Would a Good Business Be For Sale?

Some of my clients in the past have expressed the thought that if a business is for sale, there must be something wrong with it. This is sometimes true and if it is, the reason can usually be ascertained with a little digging.

However, there are valid reasons that some very good privately held businesses become available. The first reason most people would think of is retirement. Another is the fact that the owner may be experiencing health problems which prevent him from managing the business as usual.

Other reasons may involve estate planning situations in which the owner would rather leave liquid assets that can be split more easily among several heirs than a business entity.

Still other legitimate reasons could involve friction among the owners. This kind of situation can become particularly serious if the friction is among family members who jointly own the business. recently handled the sale of a business in which the real motivation to sell was to prevent further deterioration of the family relationships. The differences among the partners were serious enough that they would surely have led eventually, if they stayed in business together, to an ugly family split-up. The partners correctly decided that it was better to sell the business and preserve the family. Each partner took their portion of the cash from the sale and went their separate ways. And now they are still congenial when they get together at Thanksgiving and Christmas!

Perhaps the most common reason that a business is for sale is one that might not immediately come to mind. But as a business broker, I see it frequently. And I'll simply label it as "burn out." After an owner has operated the same business for a number of years, some just plain get "burned out."

Some people are more prone to burn out than others. It's highly subjective but certainly understandable. On a personal note, I experienced it in a previous business that I owned. After twelve years, when it got to the point that I hated seeing customers come in the front door because I knew I'd have to spend time with them, I knew it was time to get out! Burn out is real and I see a lot of it.

So keep this in mind: The mere fact that a business is for sale doesn't automatically make it a bad business. Find out the real reason it's for sale and plan from there.

But There Is No Perfect Business

Any business from Bob's Hot Dog Stand to Microsoft will have areas of concern. Even the best run businesses will encounter some problems. It's the dynamic nature of business.

And actually one of the attractions of entering the business world is that the rewards of problem solving in this field of endeavor are so profitable. Business owners get paid - sometimes handsomely - for solving problems.

As one of my clients told me recently on his first visit to my office, "I'm looking for a business with problems I can fix."

What Are the Steps Involved in Buying a Business?

The steps in buying a business follow a logical sequence. Each step in the process is explained in detail in the following chapters. In summary they are:

- ***How do I decide on the type and the size of a business to be considered?*** Your personality, likes, dislikes, and the amount of money you have to invest are some of the determinants.
- ***How do I find a business for sale?*** You have four sources from which businesses for sale can be found. We'll show you where to look.

- ***Where do I find the money to buy the business?*** There are four sources. We'll discuss the pros and cons of each.
- ***How do I analyze the business?*** What do I look for? There are key numbers to look for. We explain them in detail and show you how to make the decisive calculations.
- ***What is the business really worth and how much should I offer?*** We'll show you how to appraise the business.
- ***How do I make the seller of the business an actual offer to purchase?*** And what about the negotiations? This important phase of buying a business is spelled out in detail.
- ***What is the Due Diligence phase and how important is it?*** It's very important and we walk you through it step by step with advice and checklists.
- ***What's the best form of business ownership?*** There are six options and we'll discuss each.
- ***How do we close the transaction after everything has been agreed upon?*** It's not nearly as complicated as you might think. We show you how it's done.

Don't let this list intimidate you. It's really pretty simple. As I said before, the process of buying a business follows a logical process. In subsequent chapters, we take you through each step with advice and recommendations that have been distilled from years of experience in the sale and transfer of many businesses.

Now, a few words of advice to begin with: Stick with the process. Don't get the cart before the horse. And enjoy the ride. After all, you're beginning a process that will land you "the American Dream" - a business of your own.

CHAPTER 2:

WHAT TYPE & SIZE OF BUSINESS IS RIGHT FOR ME?

Let's assume that you've already done the soul searching about your future, considered the advantages of business ownership, and decided that you definitely want your own business. You're ready to proceed with all deliberate speed. You're probably asking yourself, "What's next?"

What Type of Business Should I Buy?

You may already have a pretty good idea. If your family or some of your friends own a business, you probably have some familiarity with that type of business. Is it the kind of business that you can see yourself operating?

What are your preferences on hours worked, management of employees, physical labor, and interaction with customers? Do you prefer to stay in one place or would you rather be on the road in your new business? Do you prefer to stay indoors or are you the outdoor type? Are you a people person? Are you service oriented? Your preferences in these and other matters will give you some direction as to the category of business.

However, the decision really boils down to this question that you should ask yourself as you consider any type of business: Can I see myself happily and successfully operating this particular business? If the answer is "yes" then that may the business for you - assuming, of course, that the company checks out as you take a closer look in the steps that are explained in subsequent chapters.

Some more words of advice: Keep an open mind as you look at different businesses. Don't become so inflexible as to type of the business that you would automatically rule out an excellent business for sale in your price range producing the income that you desire.

An interesting statistic from my business brokerage practice is that over half of my clients wind up buying a business in a category different from the one that they initially contacted me about. So, stay flexible as to type with your eyes wide open for a jewel of a business of a type that you may not have considered.

What Size Business Can I Buy?

The answer to this question is dependent on the amount you have to invest. Down payment requirements for buying a business range from approximately 20% to 50% the purchase price of the business -- with the average being about one-third.

Let's say you have $40,000 to invest in the purchase of a business. I don't advise my clients to use their total available investment as a down payment because they are going to need some of it as working capital in the new business.

The amount of working capital needed depends on the necessary monthly operating expenses of the business. Let's say the business you are buying has operating expenses of $5,000 per month which includes rent, insurance, utilities, payroll and the

other items needed to keep the doors of the business open. If you have determined that the business has good cash flow and there are no major problems, you could probably get by with one month's expenses figured in as working capital. However, to be safe, I usually recommend two months expenses held back for working capital. In this example that would be, of course, $10,000.

After deducting the two months business operating expenses (working capital) from the available $40,000, we have $30,000 to offer as a down payment on a business.

Which brings us back to the question: What size business can I buy?

The answer is a matter of simple arithmetic. With the $30,000 and the fact that some businesses can be bought with a 2A% down payment, this would project a maximum price for a business of $150,000. With the more likely one-third down payment, the maximum purchase would be $90,000. So somewhere in this range of $90,000 to $150,000 is the size business you can afford.

And from my experience as a business broker, there are lots of attractive businesses out there of this size that produce a very nice profit for their owners.

Your job is to find them!

CHAPTER 3:
HOW DO I FIND A BUSINESS I CAN BUY?

Now that you know about what size business you can afford and have identified some preferences as to type, you're ready to begin your search. There are four places to find businesses for sale.

The First Place to Look

The first place I'm going to suggest may surprise you. You may never have thought about it, but probably the first place you ought to look is within your own family. Do you have a family member, close or extended, who owns a business? Do you think they might, for one reason or another, consider selling it to you? Are they approaching retirement age? Do they appear "burned out'?" Are health problems limiting the amount of time they can devote to the business? Do they want to travel? You never know until you ask.

Let's say your Uncle Ben has a convenience store that you might consider operating as your own if it was for sale. Call Uncle Ben and make an appointment. Tell him over the phone that you want to "come by and talk about something important when he has a few minutes." This puts Uncle Ben on notice that this is not just a casual visit. When you visit your uncle, be completely "up front" by telling him you have decided to go into business for yourself and you were wondering if he "had ever considered selling his business." Then be quiet and listen. If he has been considering getting out, you may have hit pay dirt. If he is not interested, he may know of other businesses for sale. Or he may actually offer to help finance the purchase of a business when you find one! Stranger things have happened. You can't lose by talking with him.

However, some words of caution are in order when dealing with family members. Don't take any short cuts just because you're dealing with family. Go through all the remaining steps described in this book. Of particular importance when family is involved, is the "due diligence" phase. Take a hard, critical look at the business just as you would if a complete stranger owned it. Make sure it is the right business for you.

The Sunday Newspaper

Another place to look for businesses in the Sunday newspaper. Sunday is traditionally the day that businesses for sale are advertised. Look under the classifications of "Business Opportunities" or "Businesses for Sale." Some newspapers have both classifications. In my hometown newspaper, "Businesses for Sale" is in the real estate section separated from the rest of the classifieds. The "Business Opportunities" is in the main classified section just after the employment ads. There are local businesses for sale listed in both sections.

If you haven't looked at these ads before, you'll be amazed at the variety. Some are pretty "scammy." There will be many ads for vending routes (with grossly overpriced vending machines) and home based businesses including medical billing (with grossly overpriced computer software and no clients). But don't despair. With just normal smarts, you'll be able to tell the difference between the "scammy" and the legitimate local businesses that are for sale. One quick way: local businessmen use local telephone numbers, not toll-free ones that are answered halfway across the continent.

The Internet

A third place to look for businesses for sale is on the internet. With a computer, you're sitting right in the middle of the world's largest library. Just search "Businesses for Sale" or "Business Brokers." You'll get hundreds of sites. To narrow down the sites to ones you can use, you might want to enter: "Business for Sale in North Dakota" or "Business Brokers in North Dakota" (or whatever state you want). One of the largest and best sites on the web is bizbuysell.com. And for businesses in the Central Gulf Coast area, my website lists dozens of businesses for sale in the sunbeltbroker.com. (Hey, you don't mind an occasional commercial, do you?)

A Business Broker

And speaking of commercials, the fourth way to find an array of businesses for sale -- advertised and unadvertised -- is my favorite. It is through the use of a qualified, knowledgeable business broker. (It's my favorite because that's the way I make my living. I'm a business broker!)

An experienced business broker is familiar with the local market and he usually has a considerable number of businesses listed for sale at any one time. He can assist you with everything from focusing your search, preliminary screening of several offerings, visiting the businesses, buyer-seller meetings, cash flow calculations, pricing rationales and strategies, offers to purchase, negotiations, contingencies, and closings.

If you choose to use a business broker, plan on spending some time with him. He needs to get to know you and your requirements. And you need to get to know and trust him. To ensure that you receive the maximum benefit from his experience, be honest with your broker about your needs. Let him know what kind of income you need and what you have in investment capital. Give him any limiting conditions that will influence your decisions.

The assistance of a knowledgeable, trustworthy business broker can be invaluable. He can save you time and money. He can steer you clear of the common pitfalls in the business buying process. And he can make sure you get what you paid for.

But as I've already said, I'm prejudiced. I'm a business broker

CHAPTER 4:

WHERE DO I FIND THE MONEY TO BUY A BUSINESS?

There are four places to obtain financing for the purchase of a business. Let's take a look at each.

Family

Many times the older generation in a family will lend the down payment or the entire amount needed to a promising member of the family's younger generation. If your family is willing to lend you the money, one word of advice is in order. Have a very clear understanding as to how the debt is to be handled and put it in writing in the form of a legal note. And even though it is family, I also suggest that the note carry a reasonable rate of interest. The written note with a reasonable rate of interest will not attract the attention of the IRS who otherwise might try to reclassify the loan as a taxable gift or income. Also, a note that earns interest can keep peace in the family, particularly among members who might be somewhat jealous.

Banks

Although most people seeking a loan to buy a business will think first of banks, I can tell you from years of business brokerage experience that banks generally do not make business acquisition loans.

That statement will surprise most people. Once you're in business, banks will compete for your patronage, but most will not stick their necks out in the beginning to make you a business acquisition loan. Bank advertising would lead you to believe they would do so, but in more than 90% of the cases, they will find some reason to decline the business acquisition loan application.

The exception might be if you have a strong, years-long relationship with a bank and you can offer some other collateral such as Certificates of Deposits. Or if the bank participates in the SBA loan program, they might be able to approve a SBA guaranteed loan (see SBA below).

So if a bank turns you down, don't take it personally. And don't take it as a reflection on the business. It's just the way things are.

Now this is the humorous part of the situation. It's ironic but it has happened more than just a few times. After you've been in business for a number of months or a year or so, the same bank that turned you down for a loan to buy the business may come calling on you soliciting your banking business! One of my clients in this situation responded to the banker by assuming a serious air and in a somber tone, said, "Well now Mr. Banker, we'll be happy to consider your application for our business. Let's see, we'll need your financial statement and a list of references and your business plan for five years into the future. Once we have your completed application, I'll be glad to take it before my committee and let you know of our decision."

The banker was taken aback.

SBA

The Small Business Administration (SBA), an agency of the federal government, provides for business acquisition loans through its approved lenders. The SBA generally does not make direct loans, but rather the agency guarantees the loan that is made by the approved lender. It's known as the SBA 7(a) program.

The SBA list of approved lenders includes some banks and many non-bank lenders such as CIT, GE Small Business Lending, and AT&T Finance. Some of these lenders will include in the loan total an amount for working capital in addition to the price of the business. Down payment requirements range from 2% to 35% plus there are usually up-front fees involved for various requirements. Interest rates are competitive with the marketplace.

The SBA guaranteed loan requires a lot of detail and documentation. If you go this route, be patient. And stay on top of the SBA requests for information. The quicker you can get the information and documentation to the SBA underwriter, the quicker your loan will close.

The SBA route for a business acquisition loan is sometimes frustrating because of the time and detail that is involved. However, keep in mind that the SBA will approve loans that others have turned down and will usually approve them with a smaller down payment. In most cases, it's worth the wait.

The Seller

In about half of the business transfers that I handle, the owner of the business finances a portion of the purchase price for the buyer. Some sellers cannot offer owner financing for a variety of reasons, but when they can, it conveniently solves the problem of financing.

The fact that the business owner is willing to finance the sale of his company provides more than a convenient finance plan. More importantly, it provides a strong validation of the present owner's belief that the business will support the new owner and earn enough cash to pay back the loan. You can't get any better recommendation on the business than this.

Owner financing also keeps the owner "in the boat" for the duration of the loan. If the new owner experiences any problems, the seller has a vested interest in assisting.

The normal down payment for owner financing ranges generally from around 25% to 50% of the purchase price of the business. Interest rates are generally market driven but there is more flexibility here than in other forms of financing.

Of course, the owner is going to want to know a little about you before making a commitment to finance. If you're going to ask him to finance the business for you, be prepared when you meet him to give him some background information on yourself and your business or work experience. Remember, you need to sell him on your qualifications as much as you need to be sold on his business. In subsequent meetings with him, assuming you are seriously interested in buying the business, it would be an act of good faith on your part to give him your personal financial statement, a list of references and a copy of your credit bureau report (if it's good). That shows professionalism.

Most owner financing - though not all - is in the form of a balloon note. The balloon note solves two opposing desires. The buyer of the business wants to keep his payments low; however, the seller usually wants his money as soon as possible. By amortizing the note (calculating the payments) on, say, a l2-year payback schedule, the payments are kept low. But the inclusion of a 5-year balloon, for example, requires that the balance be paid off at the end of five years. After the new owner has been in business for five years and has built a track record for himself at his bank, he should have no trouble going to his bank and refinancing the balloon. In the low interest rate environment of recent years,I've seen new owners refinancing the balloon even before it came due to save money. The balloon note has been a win-win vehicle for both buyers and sellers.

A Trifecta

The above four sources of financing are not mutually exclusive. I recently handled a transaction in which three of the four sources were used to buy the business.

It's called *creativity*!

CHAPTER 5:

HOW DO I ANALYZE A BUSINESS?

The Need for Confidentiality

Confidentiality is critical to successful transfer of a business. If word gets out that a business is for sale, several things start happening and none of them are beneficial to a prospective buyer. First, key employees start looking for other jobs, fearing that a new owner may not retain them. In the uncertainty, customers start looking around and begin shopping elsewhere. Suppliers get nervous.

This is why a business broker will ask you to sign a non-disclosure agreement. It's sometimes called a confidentiality agreement. In this agreement, you confirm that you will not disclose the fact that the business is for sale -- except to your professional advisors. And yes, your spouse is considered a professional advisor. After all, he/she consults with you often on a professional basis, right? Just caution them on the need for extreme confidentiality.

If you show that you take the need for confidentiality seriously, you will be regarded as the professional that you are.

Now, let's say you have identified a business that is for sale and you think you might be interested in it. What next?

The Anonymous Customer

If you're working with a business broker, he will have furnished you with a one-page fact sheet (profile) on several different businesses. The profile will summarize all the salient points of the business including gross revenue and owner's cash flow.

From the several profiles that your broker has given you, pick the ones that you would like to pursue. The first step for each business that you would like to investigate is an anonymous visit, when possible, posing as a customer. We call this a reconnaissance run.

As you visit, first, note the location. Is it appropriately located for the type business? As you're driving into the parking lot, what does the business look like from the street? What about signage and street identification? Then as you walk to the entrance, what kind of an impression do you receive?

Once you're inside, take a close look around. If it's a retail establishment, are the shelves full? Is it clean and neat? Are there customers there? Are the employees helpful?

What is the general feeling you received from your visit? If you decide this is a business you want to follow up on, make a list of questions for the owner. Make this list while the visit is fresh on your mind. Include anything and everything you're curious about.

It's great if the image is good, but don't despair if it's not. As one of my astute clients reminded me recently as I was lamenting the poor street image of one of my business listings, "It's an opportunity for a new owner to make a difference."

A word of caution: While on this visit, don't talk to anyone in the business about the fact that the company is for sale. Chances are the employees don't know it's for sale. And even the owner would not be free to talk about it at this point within earshot of customers and employees. Chat pleasantly about the weather ... or sports!

The Meeting With the Owner

The next step in this logical sequence will be a meeting with the owner. If you're working with a business broker, he will set up the meeting at a time convenient with both parties. He will go with you to the meeting and facilitate the exchange of information.

Be sure to bring your list of questions. Ask anything you want to. However it's usually best, at this point, not to discuss the selling price of the business or the possibility of owner financing. That comes later. But ask anything else that comes to mind. Nobody knows the business better than the owner. If you're meeting at the business, ask for a tour of the facility.

It's important that this meeting remain informal and cordial. Remember, you are both checking each other out. If the owner is going to finance a portion of the selling price, he's looking at you as much as you're looking at the business. It's a two-way street. At the end of the meeting, you don't have to express any commitment.

Simply say something like, "Well this has been very informative. Thanks for your time. Let me consider this new information." It might also be a good idea to convey to the owner that the information will be kept in the strictest of confidence. He'll appreciate your sensitivity to that issue.

Computing Cash Flow

The next step, assuming you are interested in the business, is to determine the operation's annual cash flow. After all is said and done, what you will be buying is the ability of the business to produce cash. So first let's define cash flow. Some brokers refer to it as owner's discretionary cash flow or ODCF. Owner's discretionary cash flow is defined as that amount of cash that the business produces in a year's time that is available (1) to pay back any debt that the owner of the business incurred to buy the business, and (2) for the owner's personal living expenses.

Another way to express it is that ODCF is the amount of cash the business produces after all necessary cash operating expenses - and only the necessary cash expenses have been deducted.

ODCF is not the same as net profit shown on the profit and loss statement. It's not the same because of the bookkeeping practices of the large majority of business owners. Simply stated, business owners do not keep books to pay income taxes. Most business owners make strenuous efforts to reduce any taxable income.

ODCF:

Owner's discretionary cash flow is defined as the amount of cash that the business produces in a year's time that is available (1) to pay back any debt that the owner of the business incurred to buy the business and (2) for the owner's personal living expenses.

For this reason, most business owners, in an effort to reduce their taxable income, run some expenses through the business that are not purely business expenses. This practice reduces tax liability but it also oftentimes masks the true earnings record of a business.

As an example, take the sale of a restaurant that I recently handled. The profit and loss statement from the business was actually showing a small loss. However, the owner's wife drove a Lincoln Navigator which was listed on the books of the business as a company vehicle. The company also paid for all her gas and maintenance on the Navigator although she has no role in the operation of the restaurant. Same for the daughter's Honda which she drove back and forth to college. The daughter was also on the payroll as an employee of the restaurant which furnished her with spending money at college, although she never actually worked at the restaurant. The family ski vacation to Colorado was charged to the business because the owner attended a business meeting for a few hours while in Aspen. You see where I'm heading here, don't you? By the time all these items plus any non-cash deductions were accounted for, the restaurant was actually producing a nice yearly cash flow for the family.

In considering a business, your challenge is to determine its true cash flow. This process is referred to as the recasting of income. Some CPAs refer to the procedure as the normalizing of income. If you are using a business broker, he has probably already prepared a recasting worksheet on each business he presents to you.

Remember our definition of owner's discretionary cash flow (ODCF). It is that amount of cash a business produces that is available for debt repayment and owner's living expenses. In recasting a profit and loss statement, his is the procedure that is used to compute ODCF:

- Start with the company net profit (or loss) as shown on the profit and loss statement or tax return.
- Add any non-cash deductions that have been taken such as depreciation and amortization. (These are "paper deductions" allowed by the IRS for which no check is written.)
- Add any interest expense (because you will be buying the assets free and clear so you will not incur this expense. It will be available to you for your debt service).
- Add the owner's salary and perks (because this amount will be available to the new owner for his own living expenses).
- Add any family perks (cars, vacations, non-working employees, etc.) that have been run through the business as a business expense.
- Add any one-time, extraordinary expense items that will not be routinely incurred again (such as a major repair bill).

The total of these items will give you a more accurate assessment of the cash producing ability of the business and is referred to as owner's discretionary cash flow (ODCF).

To Pursue or Not to Pursue

After computing the ODCF of the business, the next step is to determine if the cash flow is enough for you.

To do this, you need a fairly close approximation of what your debt service will be on the amount borrowed to buy the business. After all, it's the amount left over after debt service that will be available for you and your family to live on.

Your broker will have amortization tables available for debt calculation. Business loans without real estate generally run five to ten years. With real estate, the term of the loan can be up to 20 years.

As we've already discussed, an increasingly popular type of loan for owner financing is called the balloon loan (see page 12). It lowers your payments significantly. If it's available it's a win-win situation for both parties.

Your worksheet should show:

Annual Owner's Discretionary Cash Flow $ ____________

Less Annual Debt Service $ ____________

Cash Left Over to for Owner's Living Expenses $ ____________

It probably should be mentioned that the above calculations do not consider any increases in revenue and cash flow resulting from new ownership. Historically, a business will experience a revenue increase of between ten and fifteen percent due solely to a change in ownership. Nor does this calculation account for any new products and services or other changes that a new owner may plan to introduce.

Now it's decision time. If the business is of interest to you, and if it returns the amount of cash flow you need (or can be made to do so), and if you can envision yourself successfully running the business, then you may be ready to move on to next logical step.

To seriously consider the business, you've first got to figure out what it's worth. You already know what the owner is asking; however, it's now time for you to determine what it's worth to you.

CHAPTER 6:

HOW DO I DETERMINE WHAT THE BUSINESS IS WORTH?

(OR HOW DO I MAKE SURE I DON'T PAY TOO MUCH?)

Nothing causes the buyers and sellers of businesses more anxiety than the question of valuation. The question of selling price haunts both parties. The seller doesn't want to price his business too cheap and "leave money on the table." On the other hand, the buyer of the business is afraid he'll pay too much and not get the best possible deal.

The appraisal of privately held businesses is not an exact science but there are guidelines and rules-of-thumb that can be used for a quick approximation. And formal business appraisals are now readily available. The professional firm that my office uses for business appraisals produces a quality 40-page report on the business with the conclusions of value thoroughly supported and documented, all done for a fee of only $1,500.

Certain situations require a formal business appraisal such as the larger merger-acquisition situations, large loan applications, management performance tracking, estate planning, divorce or the most dreaded of all -- IRS issues. And you might want or order a formal appraisal of the company you are considering. After all, it certainly takes the guesswork out of the situation.

However, what we will discuss here is not a formal appraisal but rather the informal methods of quickly approximating the value of a business entity. All of the guidelines we'll quote are averages derived from thousands of completed transactions reported to national and regional databases.

Let's First Define What You're Buying

Most small business transfers are asset sales. This means that the buyer of the business buys certain assets of the business - usually the furniture, fixtures, equipment, inventory, the business name, and goodwill. These assets are transferred to the buyer at closing free and clear of any financial encumbrances. Generally not included in an asset sale are the cash on hand and the accounts receivable. These two items are usually retained by the seller.

The opposite of an asset sale is a corporate stock sale. In this case the purchaser buys the outstanding shares of stock in the corporation, thereby taking control of all the assets and debts of the business.
And a basic word on business value might be in order here. An on-going business entity that is earning a profit is worth more than the sum of its tangible assets. What is really being transferred in the sale of a business is an income stream. Business appraisers seek to put a value on that income stream.

There are two kinds of business appraisal rules-of-thumb. The first one - and the easiest to use - says that a business should sell for a certain percentage of annual revenue. The other formula works off of the cash flow of the business. These guidelines include all furniture, fixtures, equipment and inventory needed to do business. However as stated above, the sellers of most small-to-medium size businesses do not include in the sale any cash or accounts receivable. Hence, the guidelines do not include these items.

Nor do the guidelines include any allowance for real estate. The guidelines assume that the business is in a leased location at a competitive lease rate. If real estate, cash or accounts receivable are to be included in the sale of a business, their value should be added to the guideline results.

And these guidelines assume that the business is making a net profit percentage that is average for the type of business. If the business is above or below average in profit percentage for its category, the resulting values would need to be adjusted accordingly.

Value as a Percentage of Annual Revenue

First, almost all privately held businesses with annual sales under $5 million will sell for somewhere in the range of 20% to 80% of annual revenue. In one large database, the average price in the year 2000 of 38,000 transactions was 44% of revenue.

Exactly where in this range of 20% to 80% of revenue the selling price of a specific business falls depends on the kind of business. Convenience stores, for example, are at the low end of the range and dry cleaners are at the high end. The range of difference is due to the fact some businesses require much more inventory or equipment than others. Also, some businesses traditionally take more profit percentage to the bottom versus total revenue than others.

If you're looking for an auto parts retail store, as another example, you should expect to pay about 45% of revenue to purchase the business. Let's say you are looking at a tire store with auto service. You should be able to buy it for somewhere around 40% of sales. Other examples: dress shops sell at around 20% of sales, coin laundries at 75%, franchised fast food outlets at 50%, print shops at 50%, vending routes at 65%, video stores at 55%, and restaurants at somewhere between 30 to 40% of sales depending on type. Manufacturing operations sell for somewhere in the neighborhood of 65% of revenue depending on the product and other factors.

Value as a Multiple of Cash Flow

The other set of guidelines seeks to approximate the value of a business by applying a multiple to the cash that a business generates. This second guideline states that most businesses will sell for between one to six times owner's discretionary cash flow (ODCF). Exactly where in this range that a specific business falls, again, depends on the type of business.

From the database of completed transactions, we know that an air conditioning/heating contractor would sell for somewhere around 1.5 times ODCF. Beauty salons go for about 1 times ODCF. Day care centers that are licensed for 100+ children sell for around 4 times ODCF. A hardware store is worth approximately 1.2 times ODCF. Other examples: Home health care is 3 to 5 times, janitorial services are 1.5 times, jewelry stores are 4 to 6 times. Manufacturing operations will sell for between 3 to 5 times ODCF, depending on size and quality. Wholesale distributors in general can be bought for 1.5 to 2 times ODCF.

But You Are the Ultimate Judge of Value

You are the final arbiter of what the business is worth to you. Remember, these guidelines are only averages. And the guidelines certainly don't take into account any special considerations or any future plans that a new owner might have for the business. What a particular business might be worth to you may be more or less than it is worth to the next person who looks at it.

So a word of advice: In buying a business, don't loose a company that you really want by trying to squeeze the very last dollar out of the transaction. Look at the big picture.

One interesting observation: There is little geographic deviation in the value of businesses. A gift shop in Alabama is worth about the same as a similar one in California.

And finally, work with your business broker. If the type of business you're looking for was not covered in this chapter, ask him for the appraisal guidelines. He has access to myriad resources for all types of businesses. And as mentioned above, your broker can assist you in obtaining, if you desire one, a professional and fully documented written appraisal of the company in question.

Now that you have an idea of what the business is worth, you're ready to move to the next logical step: Making the contingent offer.

CHAPTER 7:

MAKING THE *CONTINGENT* OFFER

Congratulations on making it to this stage in the process. Let's say you have looked at several businesses and narrowed it down to the one that you want to pursue. You think you might want to make an offer on this business, but you're not quite sure. You have a little anxiety about the unknowns. You wish you had more in-depth details on the business.

The Problem

The problem, bluntly stated, is that the seller of the business does not want every Tom, Dick and Harry going through his private books and records, some of which might be very sensitive for one reason or another.

Let me ask you at this point to stand in the seller's shoes for a moment. He has taken the big step of putting his business up for sale. This may have been a tough emotional decision for him. And he probably has the same heightened level of anxiety as you about the future transaction.

Now his business is up for sale and before long, he's got all sorts of strangers asking him to let them look through his most private records. As a business broker, I can verify that this is a real problem. Some people who look at businesses have no real intention of ever buying a business. They are what we call "tire kickers." They will look forever and never make a purchase. Looking is a form of recreation for them. Others may have a real interest in buying, but when push comes to shove, they lack the financial capacity to make the purchase. Still others may have the financial capacity, but are unwilling to pay the owner anywhere near an acceptable price for his business. There have also been instances in which a competitor sent in a stranger to check out the business.

And all of these people will demand to paw through the seller's private books and records.

Now you may step back into your own shoes. I hope the brief visit to the seller's side of the desk gives you an appreciation of the problem.

The Solution

The solution is the contingent offer to purchase.

Simply stated, it works like this. You, as the prospective buyer of the business, assume for the moment that the preliminary information furnished to you on the business is accurate. You should by now have at least the annual revenue and cash flow of the business plus the other important numbers.
You then base the amount of your offer to purchase the business on those numbers, but with the following wording written into the contract as a condition of the offer:

> ***This offer to purchase said business is contingent upon buyer's inspection of all the books and records of the business and the buyer's satisfaction with the information contained therein.***

This verbiage in the contract fully protects you. If you find, during your inspection of all the books and records, including the tax returns, that the numbers furnished you were not correct, then you have the perfect right to terminate the contract and walk away with no further responsibility. Any earnest money deposit held in trust is promptly refunded.
This procedure also protects the seller, as he knows that you are now serious about the transaction. You and the seller have come to an agreement on price and terms - possibly after some counter offers - and you have put up an earnest money deposit. The buyer should now regard you seriously, and accordingly will open up all of his books and records for you to inspect. This inspection phase of the transaction, by the way, is referred to as due diligence and is covered here in a later chapter.

The contingent offer is actually a win-win situation for both parties. It assures the seller that the buyer is serious and it protects the buyer in case the information that has been furnished is not accurate.

The Other Issues

There are other contingencies that you also might want to include in the contract. For example, if you are borrowing the money with which to purchase the business, you would need to include the following language to protect yourself if you don't already have the loan approved:

> ***This offer is contingent upon the buyer obtaining satisfactory financing for the purchase of the business.***

And if the business operates from leased premises, you would want to include the following proviso:

> ***This offer is contingent upon the buyer's assumption of the existing lease for the business premises or otherwise negotiating an acceptable lease with the landlord for said premises.***

The other issues involved in the purchase are covered by the sample "Offer to Purchase" contract included at the end of this chapter. You simply fill in the blanks. For reference, refer to the following numbered paragraphs in the sample contract included on page 20;

- **The Closing Date and Place.** Pick a closing date that will give you enough time to inspect the books and records of the business, get your loan approved and take care of any other issues. If you want a lawyer or title company to close the transaction, it's customary in this area for the buyer and seller to split the closing costs.
- **Inventory Level.** If the business carries inventory for resale, this is where you insert the amount of inventory that must be on hand on the date of closing. This should be the amount of inventory normally carried by the business in the normal course of doing business. Your broker should have this figure. The purpose of this provision is to prevent an unscrupulous seller, between the date of agreement and the date of closing, from selling out the inventory and leaving the buyer with empty shelves. You and the seller jointly take inventory on the day of closing. If the inventory level, at cost, is below the figure specified in this paragraph, the purchase price of the business goes down by the amount of the shortage. Conversely, if the inventory is over the specified level, the price of the business is adjusted upward by the amount of the surplus. This is fair to both parties, and if the inventory discrepancy is small, the difference is usually waived, as both parties understand that it is impossible to quote an exact inventory figure in advance for any given day. But the provision is there for protection if it needs to be invoked.
- **Training.** Insert the number of days training you think you will need from the seller. Normally this ranges anywhere from one week to two months.
- **Non-Compete Agreement.** You don't want to buy Ms. Jones's gift shop and then next month see Ms. Jones open a competing shop right down the block. This paragraph prevents that possibility. Simply insert the distance and time limitation in the blanks.
- **Removal of Contingencies.** Remember all the previous discussion about the contingencies (i.e.: inspection of the books, the lease and loan approval)? At some point, these contingencies are satisfied or waived by the buyer. This is where you decide how much time you're going to need to accomplish any work needed to satisfy yourself as to these contingencies. Ten to 15 days prior to the closing date is customary. After satisfaction of the contingencies, the contract then becomes binding on both parties, and the closing documents can be prepared.
- **Offer Deadline.** This paragraph gives the seller a deadline for response (acceptance or counter-offer) to your offer. If there is no response from the seller by this date and time, your offer is legally null and void and you have no further liability. Two or three business days is long enough here, unless there are unusual circumstances.

Now, take a deep breath. It's really not as complicated as most folks seem to think. And we're just getting to the fun part - the negotiations.

OFFER TO PURCHASE

Date: ________________, 20__

____ (Buyer) hereby offers and agrees to purchase from the Seller, upon the

and Conditions hereinafter set forth, The Business known as ________________________________ (Business) loc

________________________________ (legal description)________________________

and certain assets owned by or used by the Business, including all furniture, fixtures, equipment, inventory, goodwill, trade names, lease real estate (if included), subject to the Terms and Conditions on both sides of this agreement.

The Purchase Price of $__________________ shall be paid as follows:

$__________________ By earnest money deposit, included in total down payment.

$__________________ Additional deposit upon acceptance by Seller, included in down payment. Deposit held by Sunbelt Brokers, Inc. (Sunbelt) as Escrow Agent. The Buyer and acknowledge that any checks accepted by Sunbelt are subject to collection. Es funds will not be distributed until they have been cleared by said bank.

$__________________ Balance of down payment due at closing by cash or In-State Certified Check.

$__________________ Total Down Payment.

$__________________ Assumption of existing obligation payable as follows: $______________ per including __________ % interest rate. (Estimated amounts, to be adjusted at Clc

$__________________ Balance by a duly executed Promissory Note, made in favor of and delivered to Se

Closing amortized for _______ months with a monthly payments of $________

Which includes interest at the rate of __________%, and one final Balloon payn

the end of ________ months. The first payment shall be due and payable _____ days from Closing.

$__________________ Additional terms: SEE AMENDMENT "A"

$__________________ Total Purchase Price. Subject to Terms and Conditions on both sides of this agree

IT IS HEREBY AGREED THAT:

1. The Closing shall take place on or before 4:00 o'clock P.M. on ____________, 20_____ at the office of ______________ Buyer and Seller agree to execute all required documents as reasonably requested by Closing Agent and each shall pay one-half (Closing Agents fees and expenses. Any extension of this Closing date must be in writing and signed by Buyer and Seller.

2. The full Purchase Price shall include on-hand inventory of marketable goods of $ __________________ at Seller's cost. An in physical count of these goods for resale shall be taken and/or agreed upon by both Buyer and Seller prior to Closing, any incr decrease as compared to this cost shall adjust the total Purchase Price; an increase shall be added to the Promissory Note owed to Se paid in cash at Closing or absorbed by Seller as the case may be and agreed upon. Any decrease shall reduce the cash down payment.

3. Seller agrees to spend, at no cost to Buyer, a period of ____________ days, during normal business hours, from the closing c assist Buyer and employees in the familiarization, training and the orderly transfer of the Business.

4. The Seller (and its principal corporate stockholders and officers, if a corporation) agrees not to compete directly, indirectly or in any n or engage in a business similar to the Business within ________ miles of the Business being purchased, nor assist anyone else, Buyer, nor solicit in any manner any past accounts of the Business, nor solicit for employment any active employee of the Busines period of ___________ months from date of Closing. Allowable exceptions will be ______________________

5. All contingencies must be removed in ______________ ( ) working days prior to the Closing date as agreed above. shall execute an assignment and Buyer shall assume the lease(s) on the Business premises and/or equipment with Lessor's written co This contract shall be subject to such consent where consent is required. Seller shall assist the Buyer within the time constraints set out in obtaining new lease(s) to be effective as of the Closing date.

6. Buyer's Offer to Purchase hereby made shall be open for Seller's written response on, or before 5:00 PM on ______________ 20_____, and the Seller shall deliver to Sunbelt the Seller's written response within 24 hours of this date, or the deposit shall be retur the Buyer and Buyer may revoke this Offer. Any extension of this date and time must be in writing and approved by the Buyer.

The undersigned Buyer and Seller expressly accept and acknowledges fully reading, understanding and receiving a true copy of l sides of this agreement. Subject to Terms and Conditions continued on this and the reverse side of this Offer to Purchase agreem

Dated and Accepted this ________________ day of ________________, 20_______. Subject to Terms and Conditions h

Buyer's Name (Please Print) | Address

Buyer's Signature | City, State | Phone

Dated and Accepted on this ________________ day of ________________, 20_______. Subject to Terms and Conditions herei

Seller's Name (Please Print) | Business Name

Seller's Signature | Business Location

Sunbelt Brokers, Inc.

THIS IS A LEGALLY BINDING DOCUMENT, READ IT CAREFULLY
SUBJECT TO TERMS AND CONDITIONS ON REVERSE SIDE.

AMENDMENT "A"
OFFER TO PURCHASE

The following amendments and addenda are hereby made to the attached Offer to Purchase

dated ______________ on the business known as ____:

THIS OFFER IS FULLY CONTINGENT UPON:
1. BUYER'S INSPECTION OF ALL THE BOOKS AND RECORDS OF THE BUSINESS AND BUYER'S SATISFACTION WITH THE INFORMATION CONTAINED THEREIN.

All other terms and conditions of the Offer to Purchase are to remain the same. If the Seller fails to accept these amendments and addenda by 5:00 PM on ________________, then these amendments and addenda and the attached Offer to Purchase may be revoked by the Purchaser and deposit will be returned to the Purchaser.

Date: ______________________________ Date: ______________________________

______________________________ ______________________________
Purchaser Seller

CHAPTER 8:

WHAT ABOUT THE NEGOTIATIONS?

It's really not complicated. Most likely you've already bought a car and/or a home. The negotiations over the price of a business are similar.

You make an initial offer of some amount, usually lower than you actually think you'll wind up paying. But hey, stranger things have happened. The seller might take it! But more than likely, he'll counter the offer at some figure between his original asking price and your initial offer. You can then accept this figure or continue the ping-pong match until a number is reached that is acceptable to both parties.

Some advice on the negotiating process:

- The services of a business broker as an intermediary in this phase are invaluable. If the buyer and seller negotiate face-to-face, chances are high that ill feelings will be aroused. Even some innocent comment by one of the parties is often times taken the wrong way and the whole transaction blows up. It's an extremely sensitive phase of the process.
- If you are a cash buyer, you're in a stronger position to bargain on price. If you're asking the seller to finance a significant portion of the purchase price, you still have some room to negotiate but maybe not quite as much. However, the seller may be willing to carry the note at a somewhat discounted interest rate. That might make up the difference in any price variation.
- If it is not a distress sale, don't expect t0 buy the business at a distressed sale price.
- If you're going through a business broker, use him. He's been involved in similar negotiations dozens of times before. At each step of the negotiations, ask him for his thoughts and feelings. You don't have to take his advice, but asking for his input might be advantageous. Remember, his services are free to the buyer.
- Respect the other party. After all, you're going to need his goodwill in the training and transition phase. Don't make ridiculous demands (i.e.: "This offer is good for one hour only, take it or leave it.")
- Don't be "penny wise and pound foolish." (Is that the right cliche? Well anyway, you know what I mean.) If the business is producing a good profit and has good potential, don't let it get away from you by trying to wring every last dime out of the negotiations. Get the best price you can, but keep in mind that buying a business is usually a series of compromises in the negotiations phase. I've seen too many people lose the opportunity over a few dollars that could have been easily recouped once they were operating the business.
- Relax as much as possible. You're getting pretty close to landing your own business!
- Once you and the buyer have come to an agreement, move on to the next phase with deliberate speed. The next phase is *Due Diligence*.

CHAPTER 9:

WHAT IS DUE DILIGENCE?

Due diligence is a fancy term. In practical use, it can be summarized as that phase in the purchase of a business when (1) you verify the accuracy of the information that you've previously been furnished and (2) you make sure that there are no serious, undisclosed problems with the business.

In this step, you will inspect the books and records of the company, including the tax returns, to verify the financial information. You will also check whatever appropriate sources are necessary to make sure there are no undisclosed problems lurking around the corner that would seriously affect the business in an adverse manner.

The "Books and Records"

You are entitled to all the books and records of the business including the balance sheets, profit and loss statements, and the tax returns. At this point, you can ask the seller any questions you want about information contained in any of these records. In fact, you will probably need his assistance in interpreting some of these financial reports. Don't be shy. Ask for any clarification you need.

You may also want to look at other documents such as the monthly sales tax reports if there is a question about sales revenue or the seasonality of sales during different times of the year. Also the quarterly payroll reports should be available for your inspection if there is any question about wages.

Again, this is the time to satisfy yourself as to the accuracy of the information that you relied upon to make your offer to purchase the business.

The Other Issues

The other points to be covered during due diligence involve questions about key employees; legal, regulatory, environmental issues, and the lease. The following checklists should walk you through each of these.

Be aware that only a few of the legal, regulatory and environmental problems, if any exist, will flow through to the new owner in an asset sale. Remember, in an asset sale, you are buying selected assets of the business and assuming none of the liabilities. In a corporate stock sale, they would all definitely remain for the new owner. Having said that, you still need to be aware of any problems that exist, and make sure they are handled to your satisfaction.

Like an Astronaut

Now if everything checks out all right - and in the majority of cases it does - then you are almost to the finish line. As the astronauts say near the end of the countdown to blastoff, "We're good to go."

You are now "good to go" to the closing table. Congratulations! You've done everything in a methodical fashion and in a logical sequence. You've handled the issues that came up in a rational way. You've earned the respect of all with whom you've dealt in this journey. Because of the way you've done your job, the last step of the process - closing the transaction - should be a breeze.

EMPLOYEES

Who are the key employees, their responsibilities and compensation, and would they be willing to stay with a new owner?

1.

2.

3.

4.

5.

Are any of the employees overpaid or underpaid? ____________________

Are there enough employees or too many? ____________________

Is the payroll done in-house or by an outside firm? ____________________

LEGAL, REGULATORY, & ENVIRONMENTAL

Ask the business owner if the business has any of the following (explain in detail if necessary):

- [ ] Pending litigation
- [ ] Unresolved insurance claims
- [ ] Back wages due
- [ ] Any product liability exposure
- [ ] Unpaid medical or insurance premiums

Are there any violations now pending with or under investigation by the following agencies?

- [ ] Health Department
- [ ] Fire Department
- [ ] Building Inspector
- [ ] Zoning Commission
- [ ] State Alcoholic Beverage Department
- [ ] Environmental Agency
- [ ] Police Department
- [ ] Job Service / Unemployment Insurance
- [ ] Internal Revenue Service
- [ ] State Tax Authorities

Does the business have any problems in areas regulated by the following?

- [ ] Occupation Safety Health Act
- [ ] Clean Air Act
- [ ] Noise Pollution Control
- [ ] Clean Water Act
- [ ] Federal Water Pollution
- [ ] National Environmental Policy Act
- [ ] Resource Conservation and Recovery Act

Does the business include the disposing of any hazardous waste? ____________________________

Is there any other legal, regulatory, or environmental situations involving the business that is not covered here?

THE LEASE

- [ ] Monthly rent amount ______________________
- [ ] Term (with available options) ______________________
- [ ] Lessor (Name, address, phone, contact) ______________________

____

____

____

- [ ] Can the lease be assumed (or is a new lease needed)? ______________________
- [ ] What insurance is required? ______________________
- [ ] What are the maintenance responsibilities? ______________________
- [ ] What are the additional charges for:

  Common area maintenance (CAM) ______________________
  Taxes ______________________
  Insurance ______________________
  Other ______________________

- [ ] Is there a percentage of sales due as additional rent? ______________________

NOTES:

CHAPTER 10:
WHAT'S INVOLVED IN CLOSING?

Closing is the easiest step. You've already done all the work.

Closing agents require a cashier's check, so go by your bank on the way to closing to convert your funds into a cashier's check. The reason for a cashier's check is to allow the closing agent to make immediate disbursement. This is particularly important if there are any secured creditors of the seller who are to be paid out of the proceeds of the sale in order to deliver a "free and clear" title to you, the buyer.

As stated previously, it is customary in my area for the buyer and seller to jointly choose a closing agent and split the costs. However, sometimes one of the parties insists on using his own lawyer to the exclusion of the other party. There is nothing wrong with this, but then that party should be responsible for his own lawyer's fees. In this situation, it would probably be a good idea for the other party to also retain a lawyer to look after his interests at closing.

As an option in my business brokerage practice, my office offers a no-cost closing service to the buyer and seller. Both parties have to agree to use the service and sign a waiver stating that they have done so. We close the transaction in our office on lawyer prepared documents that have stood the test of time. We'll give each party to the transaction a copy of the blank closing documents a week before the closing date so that each can have the papers reviewed by their lawyer if desired.

Closing documents for an asset sale include:

- The Bill of Sale for the non-realty assets.
- The Deed for the real estate (if there is any)
- The Note (for the loan if owner financing is involved)
- The Chattel Mortgage (making the seller a secured creditor if he's financing a part of the sale)
- A Covenant Not to Compete
- Any other documents as called for by agreement between the parties.

Other matters handled at closing are:

- Any prorating of rent and other similar expenses are handled by a separate check between the parties. For example, suppose you close on the 15th of the month. Most lease payments are due in advance, so if the seller paid the rent on the first of the month, you would owe him for the second half of the month.
- The keys to the business premises are exchanged.
- A plan for the next couple of days is formulated including a decision on how and when to tell the employees. In most cases the buyer and seller leave the closing and go straight back to the business to make the announcement and begin the transition.

Congratulations!

You now have a business of your own and it's one you can be proud of. You are your own boss. It's an exhilarating time. Enjoy it.

And welcome aboard!

CHAPTER 11:

WHAT'S THE BEST FORM OF BUSINESS OWNERSHIP?

Actually, the decision as to the best form of business ownership doesn't have to be made prior to buying the business. You can simply take title to the business in your name as a sole proprietorship and then later transfer the business assets to another legal entity, if that is the course that you decide upon.

We're assuming that the purchase of the business is an asset purchase (most are) as opposed to a corporate stock purchase. You are purchasing certain assets of the business (usually everything except the cash and the accounts receivable) and assuming none of the liabilities of the company. The opposite of an asset purchase, as we've already discussed, is a corporate stock transaction in which you buy the outstanding shares of stock in the corporation.

The decision that you need to make, in consultation with your CPA, is to determine the most advantageous form of ownership in which to place the business assets that you have bought. In discussing the different legal forms, we will look at their impact on a number of relevant issues. Method of formation, tax impact, and owner liability are some of the more important issues.

- Some legal forms involve a separate legal entity being established, agreements being entered into and/or documents being filed with the state of formation.
- Some entities suffer from what is referred to as "double taxation". In this situation the entity itself must pay taxes on its income, and then the owners of the entity must pay taxes when the entity's income is distributed to them, hence the term "double taxation." In situations where there is no entity level tax, the profit and loss from the business are generally reported on the owner's personal income tax return.
- If an owner does not form certain types of separate legal entities, the owner will be personally liable for the liabilities and other obligations of the business. In most cases, when separate legal entities are formed, the owner is not liable for the entity's debts. In this situation, the owner is referred to as having "limited liability." Some exceptions to this rule exist, including in the case of the owner not following the requirements as to how the entity should be governed. This latter situation is sometimes referred to as "piercing the corporate veil." Lawyers have become adept at "piercing" which makes it imperative that the owner of a corporation scrupulously maintain the integrity of the corporate entity. Also, to the extent that an owner personally guarantees an obligation of a business, he or she would be personally liable for that obligation. Most banks and large creditors usually require small business owners to personally guarantee corporate debt.

Sole Proprietorship

A Sole Proprietorship is the simplest business form, and does not even involve a separate legal entity. No complex administrative issues are involved and there is no double taxation. It can be the best form for a small business where it is unlikely that the business will incur any significant debt or could be sued for a business related matter. This is an important point because a separate entity is not being formed, and thus the owner is liable for all of the business' actions.

General Partnership

In many ways, a General Partnership is quite similar to a Sole Proprietorship, except that there may be more than one owner. Like the Sole Proprietorship, it is fairly easy to administer and there is no double taxation; however, there is the risk of unlimited liability to the owners. It is also more complicated because the arrangements between the owners (the partners) must be defined, usually in a Partnership Agreement. The Partnership Agreement usually specifies, among other things, how income is allocated, and what happens if one of the partners wants to leave the business or dies.

Limited Partnership

Closely related to a General Partnership is a Limited Partnership. A Limited Partnership is composed of one or more general partners and one or more limited partners. Although the general partners still have unlimited liability, the limited partners do not, so long as they are passive investors and do not have an active role in the operations of the business. Their liability is generally limited to the amount of their original investment. Many times a separate Corporation is formed to act as the general partner to further reduce the unlimited liability risk. As you can see, a Limited Partnership can quickly become more complicated from an administrative standpoint, but has many benefits, including no double taxation, and elimination of the unlimited liability risk for limited partners.

Corporation

Establishing a corporation involves the formation of a separate legal entity under the laws of a particular state. A Certificate or Articles of Incorporation are generally required to be filed with the Secretary of State's office. In addition, annual reports and other technical requirements are generally needed to keep the corporation alive. There are corporate service firms that can help with these filings. Additional corporate formalities include the need for a board of directors, corporate officers and agents, and an annual meeting of stockholders and directors. The corporate form suffers from double taxation; however, all owners have limited liability so long as the appropriate corporate formalities are observed. In addition, it is generally easier to have many owners. A note of caution is in order: Lawyers have become adept at "piercing the corporate veil" and voiding the limited liability offered by corporations. This makes it imperative that the owner of a corporation scrupulously maintain the integrity of the corporate entity.

S Corporation

An S Corporation is very similar to a regular Corporation, except it has elected to be treated under the rules of Subchapter S of the Internal Revenue Code. So long as the technical requirements of the Code are met, an S Corporation is not taxed at the entity level, and thus does not suffer from double taxation. Adhering to all of the requirements of the Code can, among other things, limit the types and number of owners of an S Corporation.

Limited Liability Company (LLC)

Within the past 10 years, a new form of business ownership has come into being which, for the most part, takes the best of all worlds. The Limited Liability Company provides all of its owners with limited liability, and avoids double taxation. In addition, unlike an S Corporation there are few, if any, restrictions by state law on ownership. Usually, a document must be filed with the state of formation, but other administrative formalities are generally less involved than with a Corporation. The biggest reservation some advisors have about an LLC is that since it is a new business form, some states are still in the process of developing their regulations, and the IRS may still have further pronouncements in the area.

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