

Business Purchase and Sale

Due Diligence Checklist

Introduction

Transferring ownership of a business—whether you are the buyer or the seller—can be a complex, time-consuming process involving many different legal requirements, forms, and documents. Unless you’re an expert, it’s all too easy to miss something important and potentially delay, or even jeopardize, the transaction. That’s why we’ve put together this general guide. It summarizes the issues inherent in a business sale and lists many of the documents both parties will employ to ensure due diligence is performed—no matter what the industry is or how the sale is structured. Where appropriate, we also provide more specific questions that apply to transactions involving different types of sellers, buyers, or purchase types. Unless otherwise noted, “the company” refers to the business being sold.

Basic Business Information

The first step in any transfer of business ownership is gathering basic facts about the company. Make sure both parties have access to the following information:

- Full legal business name of entity and/or owners.
- Full mailing and physical address(es) of the business.
- Land line, cell, and facsimile numbers.
- Legal status of the seller.
- Sales tax permit number (if applicable).
- Employer number issued by the EDD.
- Federal employer identification number (EIN) issued by the Internal Revenue Service.

Basic Entity Documents

Next, we recommend assembling the appropriate set of basic entity documents:

Corporations

- *Articles of Incorporation* and any subsequent amendments.
- Bylaws and any subsequent amendments.
- Meeting minutes and any consents to action.
- Copies of stock certificates and stock ledger.

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Limited Liability Companies or Partnership

- *Articles of Formation* (for an LLC), *Statement of General Partnership* (for a partnership), or *Certificate of Limited Partnership* (for a limited partnership), and any subsequent amendments.
- Operating or partnership agreement and any subsequent amendments.
- All minutes to member or partner meetings, and any consents to action.

Additional Due Diligence Documents

Depending on exactly how the sale is structured, buyers and sellers can expect to assemble many additional document types and other relevant information. Please review the selections below and select those that apply to your situation:

Debt/Equity Interest (stock, units, partnership interests, etc.)

- For each class of equity, the number of shares, units, or interests outstanding; the names and addresses of the holders; and their cost basis in the equity ownership.
- Any voting trusts; irrevocable proxies; preemptive rights; shareholders', members', or partners' agreements; redemption agreements; buy-sell agreements; or other agreements restricting transfer of, or otherwise affecting rights pertaining to, the company's equity interests.
- All permits and other qualifications issued by, or notices filed with, the California Commissioner of Corporations or other government agencies relating to the company's equity.
- Any options, warrants, calls, or commitments relating to the company's equity, including stock option or similar plans, as well as a list of the option and warrant right holders.
- Any outstanding registration or voting rights agreements.
- Any disputes among owners concerning ownership of the business or its assets.

Business Activities

- The nature of the company's business, including any business conducted outside of California or the United States.
- The address of the company's principal office and all business addresses used by the company within the last five years.
- The counties in California and other states in which the company conducts business, and the states in which it is legally qualified to do business.

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- Any assumed fictitious or other business names under which the company has conducted business within the past five years, and the places and times in which those names were registered, recorded, filed, or otherwise protected.
- The names, dates of formation, and equity ownership of all subsidiaries, joint ventures, or any other entity in which the company has an equity or debt interest of any kind.
- Any private placement memorandum, business plan, or management or investment report on the company prepared in the past five years.
- Any toxic waste disposals made, environmental permits held, or environmental audits conducted by the company at any time.
- Any press releases or clippings files for the past few years.

Material Documents, Contracts, and Permits

- Any contracts, agreements, or instruments, including business licenses, franchises, government approvals, customer agreements, distributor agreements, and sales representative agreements that:
 - Are material to the conduct of the company's business.
 - Call for payments based on the profits or sales of the company.
 - Were entered into outside the ordinary course of business.
 - Are with any material member, shareholder, manager, officer, or director of the company.
 - Have a term exceeding six months.
 - Restrict dividend payments or distributions.
 - Restrict the company's ability to compete in any line of business.
 - Are with government agencies (include all related agreements concerning the treatment of any items for accounting purposes).
- Any installment purchase contracts or other instruments executed by Seller granting any third party a security interest in any business assets.
- All licenses or permits issued to the business or its owners.
- Copies of all contracts or other documents regarding customer commitments to purchase products of the business.
- To the extent applicable, copies of all registrations under, and other evidences of compliance with, state and federal franchise laws.
- The nature and amount of the company's backlog of unfilled purchase orders, the names and addresses of the major purchasers under those orders, and the extent to which that backlog is firmly committed (i.e., orders that the customer must pay a penalty to cancel). These should be verified in writing.
- Standard forms used recently by the company, including purchase orders, invoices, and any material related to extensions of credit to customers.

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- Any government security clearances under which the company is operating.

Assets

- The nature and location of the company's tangible and intangible assets.
- Any pledges, conditional sales, mortgages, consignments, assignments, or other security agreements for assets that the company has purchased, owns, or uses in its business, and any material assets that it has recently sold.
- A list of all:
 - Banks in which the company maintains accounts, credit arrangements, or safe deposit boxes.
 - Persons authorized to withdraw from these accounts and safe deposit boxes or to borrow under those credit arrangements.
 - Motor vehicles and the states in which they are registered, along with the associated vehicle identification numbers.
- Any leases, sub-leases, deeds, options, subordination agreements, and other material instruments relating to the company's interests in real property, or any improvements, leases, and other bailments relating to any real or personal property interests owned or used by the business.

Liabilities

- Any outstanding bonds; notes; debentures; trust indentures; loan agreements; bank credit agreements; guarantees or other indebtedness; convertibility into equity; nature of acceleration triggers; as well as a list of the lenders or holders and any recent correspondence with, or certificates to, the lenders or the holders.
- Any lawsuits, claims, or demands, including government agency or administrative proceedings and tax deficiencies, pending or threatened against the company. Audit letters from the company's lawyers to its auditors for the last three years (or other periods deemed appropriate) should be reviewed.
- Any bad debts and any agreements that might reasonably be expected to result in a loss.
- All warranties, guaranties, and other obligations given or incurred by the company (or any disclaimers of them) with respect to its product(s) or services.
- The names and addresses of any finders or brokers used in connection with the proposed transaction, the fees payable to each, and any written contracts involved.

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Employees and Contractors

- The names and a brief biography of the company's directors, officers, and key employees (including persons with compensation exceeding a material amount) and approximate dates of appointment to positions held.
- The number and types of non-key persons employed by the company and any employment contracts, labor unions agreements, or similar documents associated with them.
- The number and types of non-employees engaged by the company, whether independent contractor agreements have been entered into, and the specific nature the relationships.
- A description and documentation of the following:
 - The company's pension, retirement, or profit-sharing plan.
 - Medical, health, or dental plans or policies.
 - Non-qualified bonus, deferred compensation, or other compensation plans or arrangements.
 - Other incentive and fringe benefit plans (including copies of any agreements and insurance policies relevant to these plans).
 - The company's written general employee and independent contractor policies (in the form of a policy manual, employee handbook, or otherwise), including those governing travel, entertainment, expenses and reimbursement, vacations, sick leave, hiring, promotion, and termination.
 - Summaries of unwritten policies and procedures.
 - Any investigations or complaints regarding employees or consultants.
- Written employment and consulting agreements, including any separately negotiated or existing non-compete or non-solicitation agreements.

Insurance

- Any insurance policies held by the company or relating to its assets or business and the name of the company's broker or agent.

Intangible Assets

- The company's inventions, patent applications (including serial numbers and dates filed), patents (including numbers and dates issued), copyrights, trademarks, trade names, and similar rights, and any filings made or other protective measures taken with respect to them.
- Any agreements or licenses between the company and employees, or others relating to inventions, patents, patent applications, trade secrets, confidential information (including customer lists), trademarks, trade names, and noncompetition covenants.

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- Any infringement claims or actions involving any of the company's proprietary rights (e.g., inventions, patents, trade secrets, copyrights, trademarks, and trade names).

Tax Matters

- The most recent returns (preferably for the last three years) for state income, sales taxes, and federal income tax, including any elections filed by the company. If the company is taxed as a sole proprietorship, include individual returns and schedules; if taxed as a partnership, include partnership returns.
- The last year for which the company's federal tax returns (or individual returns if taxed as a sole proprietorship; or, information returns if taxed as a partnership) were audited by the Internal Revenue Service or Franchise Tax Board, and the determination of liability resulting from audits.
- If a corporation, a description of any corporate net operating or capital losses or credits that may be carried forward.
- The names of any persons holding tax or other powers of attorney executed by the company and the purposes for which those powers were given.
- The name, address and phone number of the tax matters member in the case of a limited liability company taxed as a partnership, or as a general or limited partnership.

Financial Matters

- All available financial statements (profit & loss, balance sheet, etc...) for the preceding year; any interim statements for subsequent periods; and annual, quarterly, and monthly statements, if available, from prior years.
- Any pro-forma financial statements or projections.
- Copies of any management reports prepared by the company's accountants or auditors.

Items Often Addressed in the Purchase & Sale Agreement

The Purchase and Sale Agreement is the central document involved in the sale of a business. This agreement clearly defines everything included in the sale, including:

- Description of business or assets to be sold.
- Assets to be included in, and excluded from, sale.
- Total purchase price of business.
- Manner in which payment is to be made.
- Seller and Buyer representations and warranties.
- The liabilities which will be assumed, if any.
- Effective date of the transaction, and the closing date and location of sale.
- Whether or not an escrow will be necessary or desirable.

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- Basis of security for payment (security interest in inventory, accounts receivable, personal property of Buyer, personal liabilities of Buyer members or shareholders).
- Assignment of assets or transfer of equity.
- Conduct of business after closing.
- Indemnification of Buyer for breach.
- How disputes will be resolved (mediation, arbitration, litigation).
- Transfer or renewal of insurance policies.
- Manner in which Buyer and Seller will share or pay the costs of the sales transaction and documentation (attorney fees, recording and publication costs, inventory or other costs).

Additional Items/Questions to Consider

- Applicability of sales and use tax to the transaction.
- Applicability of federal, state, and local environmental laws and regulations.
- Satisfaction of Seller's tax obligations (sales tax return, unemployment insurance contributions, tax clearance certificate).
- Assistance and/or training during transitional period.
- Reporting of income tax consequences of sale.

Documenting the Sale & Post-Sale

To ensure that all aspects of the business sale process are fully documented and complete, we recommend that each transfer of business ownership include the following documents and information:

- Conflict waiver, if appropriate.
- Entity formation documents, if relevant (articles of incorporation or formation, bylaws, operating agreement, etc...).
- Buy-Sell Agreement.
- Purchase price allocation schedule.
- Bill of Sale and/or Assignment of Assets.
- Lease or sub-lease agreement.
- Licensing agreement.
- Modification to corporate or limited liability company governing documents.
- Meeting minutes or written consents approving transaction.
- Stock certificates or limited liability company unit certificates.
- Bulk Sale notices/compliance.

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- Promissory note.
- Escrow instructions.
- Security agreements.
- Financing statements.
- Personal guaranty.
- Post-close employment or independent contractor agreements.
- Employee manual.

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