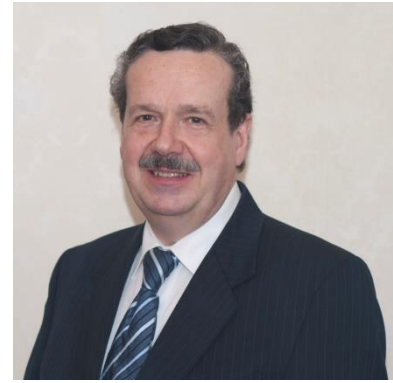


SO YOU HAVE DECIDED TO SELL YOUR BUSINESS...

By Piers Warner, LLB, BSc (H)

Once the decision to sell has been made it's tempting to think that the difficult part is over but that's just the start. There are the more obvious steps to be attended to. These include ensuring all financial information is up-to-date and preparing current financial statements going back several years. A business valuation needs to be obtained and a business broker or selling agent has to be selected. Next come the less obvious questions such as what exactly are you selling? Are you selling a company, units in a trust or individual assets? More often than not buyers prefer to acquire assets but a seller may prefer to sell the legal structure holding the business. The choice can be difficult. How the transfer of customer and supplier contracts is managed is a relevant consideration.



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One of the legal areas that can raise difficulties in the sale of a business is managing contracts where the business depends on ongoing working relationships with customers and suppliers. This is especially the case in a service business with a limited number of long-term customers and suppliers. Often the applicable contractual law is not well understood by those involved, so it may not be managed well in the sale process. As a result problems can sometimes arise long after the sale is completed.

Customers

The transfer of business contracts is not as straight forward as one may expect. In general where customer contracts need to be transferred from the business vendor to a purchaser of the business, the rights of the vendor under a customer contract (e.g. payment) can be assigned to the purchaser unless the customer contract prevents it or some limited exceptions apply (see below for an example involving a supplier). However, the obligations of the vendor to provide goods or services to a customer under a contract with the customer cannot be assigned. The vendor has to be released from its obligations under the customer contract by the customer and those obligations must be assumed or accepted by the purchaser of the business.

If this potential problem is to be avoided the cooperation and consent of the customer has to be obtained. A simple example illustrates the point: a lender can in general assign the right to receive interest and the repayment of a loan but the borrower cannot transfer the obligation to repay the loan to another party. If that were possible, borrowers would transfer their loan obligations to people who cannot repay the loan and avoid their liability to repay the lender.

Ideally when a business with material ongoing contracts is sold agreements are executed with each customer of the business to allow the vendor's obligations to be transferred. Often this doesn't happen or is considered too hard or just neglected. The contractual consequences are illustrated in the diagram below. So long as the purchaser of the business performs well there are unlikely to be problems. Contracts can be renewed in due course with the new business owner in place of the vendor. Unfortunately where problems occur after the sale of the business is completed the customer can seek redress against the vendor, unless the vendor has been released from its contractual obligations to customers of the business. In these circumstances the purchaser of the business is in some respects in a position similar to that of a subcontractor to the vendor of the business.

Suppliers

In general the vendor of the business transfers their contractual rights in respect of supply contracts to the purchaser of the business. The obligations to suppliers are generally straight forward (e.g. payment) so are usually less problematic, although failure to pay by the business purchaser would create problems. Suppliers' obligations to supply goods and services do not need to be transferred but some contractual rights are not assignable. Contractual rights cannot be assigned if it is clear that the supplier is only willing to perform in favour of the business vendor and if it would be unjust to force the supplier to perform in favour of another (a purchaser of the business). This is justified on the basis of the personal nature of the supply contract preventing assignment.

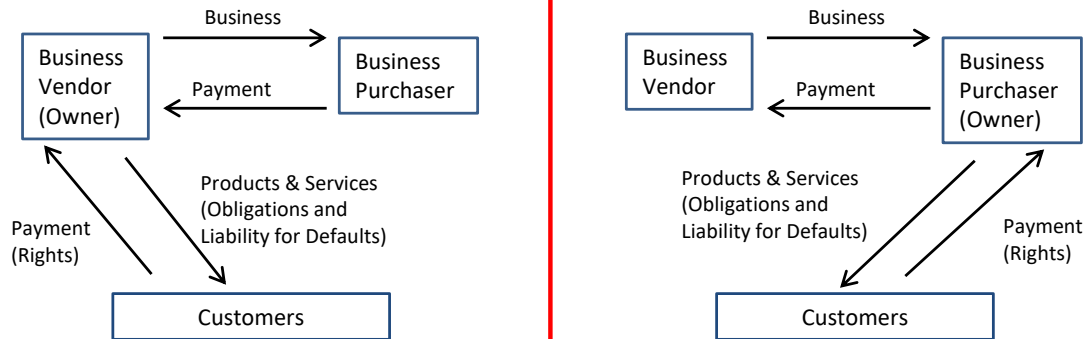
This most commonly arises when a vendor of the business wants to assign the rights associated with employment contracts. The consent of employees to the transfer of employment contracts is needed. The same principle can occasionally apply to contracts for the sale of goods. In one case it was held that the benefit of a contract to supply coal on credit to a retail coal merchant could not be assigned to the successor in the business. In making the contract the seller of coal had relied on the original business owner's commercial experience. Forcing a supplier to give credit to his successor (who had no such experience) would subject the supplier to quite a different business risk.

BUSINESS SALE PROCESS

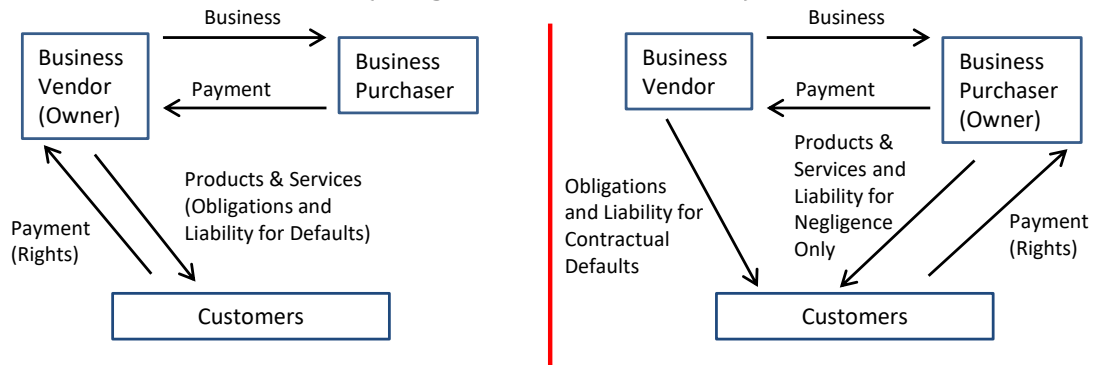
BEFORE SETTLEMENT

AFTER SETTLEMENT

Properly Completed Sale



Incompletely Completed Sale (Obligations Not Transferred)



PLEASE NOTE: In order to produce this diagram to illustrate the accompanying discussion various assumptions about facts and some generalisations have been made. In each particular case there will be factual differences which will affect the above illustration to varying degrees. Consequently it does not constitute legal advice and no reliance should be placed upon it. It is merely intended to illustrate some of the underlying contractual principles involved in a business sale transaction.

Risk Reduction

The sale of business agreement will usually provide the vendor with some protection by requiring the purchaser of the business to indemnify the vendor but if the purchaser of the business is not in a strong enough financial position to compensate the customer or in some cases a supplier, the vendor may be exposed to a claim from the aggrieved customer or supplier. Sometimes vendors are

prepared to accept this risk to procure a sale of the business and sometimes they remain exposed because they don't understand the application of contract law to the sale of the business. It's best if those involved understand the contractual risks in these different approaches to the sale of a business. No one wants to find themselves with an unexpected surprise some time after the sale of the business!

If the business is owned by a company then the sale of the company will avoid these problems in most cases. It may be impractical to transfer the company if it owns other businesses or is the trustee of a family or trading trust. Purchasers are often unwilling to take on the risks involved in acquiring a company. By acquiring the company they inherit all the debts and liabilities of the business that may not have been discovered in the due diligence process and would otherwise remain with the vendor. Often there will be different taxation outcomes depending upon whether the business assets are sold or the company that owns them is sold.

Message

Selling a business is not as simple as it first appears. Professional guidance can help avoid unexpected problems.

Piers Warner, Commercial Lawyer

Piers Warner has over thirty years of experience as a commercial lawyer and during that time he has provided commercial legal services to individuals, small businesses and to some of Australia's largest listed corporations.

Disclaimer:

The information contained in this article is intended to provide general information only and is not legal advice or a substitute for it. Always consult your own legal advisors to procure legal advice that correctly addresses your particular circumstances. Almost every business sale involves facts that are unique to that transaction.