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Welcome to the first issue of Commercial e.Speaking for 2006. We hope you find the articles of interest. If you have any specific business or commercial topics that you would like to see covered in future issues, please get in touch with us.

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Due Diligence

- Lessening or eliminating the risk of loss or liability

The expression 'due diligence' can be used in a number of different contexts. However, this article will focus on the concept as it usually applies to property and commercial transactions.

What is due diligence?

Although on a practical level due diligence entails different considerations in different situations, in broad terms it means the process whereby a prospective buyer (whether of a business, a franchise, shares in a company, real estate or other types of property) undertakes inquiries with a view to ensuring that a proper price is paid and to minimise the risk of unpleasant surprises about some aspect of the deal after it is too late. The process of exercising due diligence is therefore essentially a risk management exercise. The objective is to lessen or eliminate the risk of loss or liability.

Some specific examples of due diligence include:

- Checking whether statements made in a prospectus are accurate
- Checking whether companies are complying with their obligations under legislation such as that which applies to trade practices, taxation and occupational health and safety
- A financier investigating whether an asset will give adequate security for a loan
- Resource management and related inquiries
- Checking the status, and terms, and conditions of employees' arrangements
- Investigating the accuracy of statements made in contracts for the sale of assets.

The final example is the main point discussed in this article.

Why undertake due diligence?

Sellers of assets are often under an obligation to disclose certain things about the assets which they are selling, particularly in the case of real estate. However, they will not always be liable to buyers for failing to make disclosure. Buyers are also obliged to conduct some investigations.

The balance between the disclosure obligations of a seller and the onus on a buyer to investigate can be difficult to pin down. The result is that it is generally wise for buyers to conduct their own investigations into assets which they are acquiring, including in some cases the accuracy of statements made to them.

In simple terms, within reason, a prudent buyer will apply the old rule of *caveat emptor* ('buyer beware') and initiate checks.

Undertaking due diligence

Some of the more common checks which buyers may make (or which their advisers may make for them) include the following:

- Checking for any independent record which verifies that the seller actually owns the asset.
- Ascertaining whether the property can be used for the purpose for which it is being acquired, according to the local government zonings.
- Checking whether any part of real property is used as a right of access. If so, checking whether that right is registered on the title.
- Checking whether there are any encroachments over real estate (for example, an overhanging roof from a neighbouring building).
- Investigating whether any relevant government or territorial agencies have any proposals which might have an impact on the property.
- Investigating whether all required services are connected to the property.
- Checking whether there are any debts owed to third parties which constitute a charge or lien over the property.
- Ascertaining whether the property is structurally sound.
- Investigating whether the boundaries are where they are expected to be.



- Checking whether any statements which have been relied on in deciding to enter into the agreement are accurate and have been recorded in the agreement.
- In the case of real property being acquired subject to a lease, checking whether the terms of the lease are adequate or unusual.
- Ascertaining whether there are any unexpected income tax or GST consequences.

A physical inspection should reveal the answer to some of these questions. In other cases, searches of registers maintained by government authorities will be required. In yet other cases, third party experts will need to be engaged to investigate and/or give advice.

Some of these enquiries can be made after a contract is entered into, but others can and should be made beforehand. If a lawyer is engaged before a contract is entered into, searches to be made in advance can be identified. The lawyer can also advise whether any warranties should be sought from the seller and added to the contract before it is signed.

What is required in the exercise of due diligence differs for each different type of transaction and asset. When done properly, the due diligence process can significantly reduce certain risks which are inherent in commercial transactions.

The scope and specific nature of the due diligence inquiries will depend to a large extent on the nature of the assets being acquired. Essentially however, the due diligence efforts will in all cases focus on ensuring that the buyer knows as much as possible about the business, property or other assets being acquired so that the final decision to proceed is made from a fully informed perspective.

Whether Succession or Acquisition – Prepare now

This is the second of a series of articles dealing with succession issues for business owners. The previous article (in Issue 9) focused on the current national business market, pointing out a need to prepare for the sale of a business well before the event. This article explains what business owners and potential buyers can do in preparation to maximise their chances of a smooth and successful sale and purchase.

Careful and early preparation

You never know when a buyer might approach you, so make sure your business is always ready for sale. A surprising amount of time can be required, so start as soon as possible.

Invariably the due diligence process will uncover business weaknesses or problems. Minimise their impact, or preferably, complete your analysis and correct them now!

Decide on your initial sale or acquisition strategies

Which option would suit your business best? A trade sale, management buy-out (MBO), management buy-in (MBI), strategic buyer, or partner/shareholder?

- If you are a buyer think about who, when, and how best to approach this and the funding you are likely to need.
- If you are a seller consider how you/your business must look for the best negotiating situation.

List timeframes, support requirements, resources and changes needed

- Identify any potential areas for concern and change or eliminate them early.
- Identify the professional help you may need:
 - Accountancy and legal for agreements and taxation issues.
 - Valuation and due diligence.



- Funding and equity. Have your cash contribution arranged and pre-approvals for finance or equity as advanced as possible before beginning the sale and purchase, or MBO/MBI process. There are some institutions that provide a one-stop shop for both traditional debt finance and private equity.
- A successful and highly professional business broker.

Write down your value for the business you are selling or wish to acquire

Establish your rationale for the value you determine, and then perhaps get professional advice on your business valuation.

Plan your 'After Acquisition or Sale' strategies

- A seller may need to confirm their rationale for selling, and prepare emotionally for the event
- A buyer will need to have thought about the management structure and skilled people already in the business or to be employed.
- Identify how you are going to improve company performance and profitability and the timeframe and resources needed.

Seller – Optimise the value of your business

- Produce accounts for sale purposes with the help of your accountant. Leave out costs such as interest, depreciation and tax. Then, identify shareholder remuneration and list the expenses not included.
- Minimise expenses and improve gross profit. Every \$1 profit could produce \$4 or more tax-free on sale. Do this exercise: Change each of these by 2% and note the % increase in net profit/business value.
- Evaluate all leased and financial assets for conversion to owned assets to increase profitability.
- Develop documented legal and contractual agreements such as supply/distribution and patent/copyright agreements, partnerships/JVs, leases and assignments, contracts, etc. Document long-standing verbal agreements.
- Ensure management systems that control business operations and systems are documented.
- Ensure the premises are well maintained and presented.
- Do a full stock take and lists, clean up the items held and understand market values.

Business plan and the due diligence checklist

A potential seller would need to be cautious about providing some of the data to a competitor in case the sale did not eventuate. However, the following material should be prepared:

- Business background, special events, and photos.
- Products, services, primary markets, industry growth/growth opportunities within the business, industry changes/emerging technology.
- Details of primary customers and suppliers, testimonials, terms of trade, pricing, etc.
- Details of assets, plant, furniture, inventory.
- Strengths weaknesses and threats (whether a seller or buyer).
- Financial history: Recast P&L for three years, current year monthly P&L, business service contracts, GST returns, and aged debtor and creditor lists.
- Forecasts: Remainder of current year and the next two/three years, with commentary and explanations where needed. Sales forecast by 'customer', WIP, planned new products or services with relevant sales, margins, and development costs identified separately in the forecasts.
- Staffing: Organisation chart, key personnel and remuneration details, employment contracts, and staff and leave records.
- Miscellaneous: Insurance details, professional indemnity cover, and contingent liabilities.

Now you are ready to optimise your chances of success.

The third article in the series will discuss management buy-outs (MBOs).



Adopting a New Trade Mark? - Searching beforehand is essential

The way certain products smell, the colour of a chocolate wrapper, or a catchy tune that over time has become imbedded in the minds of the nation. These are some of the new breed of trade marks which are being adopted and protected by more and more New Zealand businesses.

Why register?

The purpose of a trade mark is to indicate the source or origin of the goods or services in question, to show a connection between the goods and services and the trade mark owner. Registerable trade marks include distinctive words, phrases, symbols, pictures, colours, labels, three-dimensional shapes, or even sound and smell if they can be represented graphically. Non-distinctive matter, such as words that praise or directly describe the goods, common surnames or geographical names are not eligible for registration.

Registration of a trade mark gives the owner the exclusive right throughout New Zealand to use that mark in relation to goods or services specified in the registration. The registration is also infringed by any person using a confusingly similar mark in relation to similar goods or services.

However, as Carrick Robinson of James & Wells Intellectual Property warns, "Trade marks can be registered or unregistered. Unregistered trade marks can only be enforced under the tort of passing off, or pursuant to the Fair Trading Act 1986. Such actions rely on proving significant goodwill and reputation in the trade mark, which can be an expensive exercise."

Conducting a clearance search before a new trade mark is used is essential. "Starting to use a mark without first making sure you're not stepping on anyone else's toes can be commercial suicide, given you may be forced to change your branding, which will be costly," says Mr Robinson. "If you have successfully registered a company name and a domain name which includes your new trade mark, you should not automatically assume the mark is free for you to use." A search of the trade marks register should be made, as well as 'in-use' searches of the internet, telephone books, and business and trade directories, to determine whether the mark is already being used by someone else.

Professional advice is also a must. The search results need to be interpreted by an IP specialist, so that a commercial assessment of the availability of the mark can be made. Even then it can be hard to foresee challenges from third parties.

Trelise vs Tamsin Cooper

"The Trelise Cooper/Tamsin Cooper trade mark dispute is perhaps a good example of this," says Mr Robinson. Trelise Cooper opposed Tamsin Cooper's applications to register the trade mark TAMSIN COOPER for bags and clothing. "Although Tamsin Cooper cannot be stopped from using her name to promote her business, Trelise Cooper appears to consider the way Tamsin is using her name is too close. It will be interesting to see how this one plays out. Tamsin will have grounds to defend the opposition, but assuming the dispute goes to the wire, she will have to endure the cost of the proceedings in the interim."

Searching and planning is essential before a new trade mark is adopted for use and registration. An IP specialist can sift through the search results and provide valuable advice regarding the availability of the mark, thus avoiding costly disputes at a later date.