

BUYER BEWARE!

Caveat Emptor is one of those Latin phrases we lawyers learn in law school. It means “buyer beware”, and is a fundamental principle of English common law that governs business transactions. It means that the buyer of goods or services must exercise caution and diligence in investigating the purchase, and the seller is not responsible for ensuring the buyer’s satisfaction. Of course there are many circumstances in which *caveat emptor* is not the only rule at play. For example, professionals are held to certain standards of performance within their professions. Real estate agents are required to discover and disclose to buyers material defects in a property they are representing. In transactions involving securities or franchises, the buyer is entitled to receive certain disclosures and information prior to making an investment. However, in the commercial context, it is generally the buyer’s responsibility to ask questions, obtain information, and protect himself contractually.

It is simply impossible to discover every potential problem with a business through inspections and due diligence. A motivated seller will always be able to hide a problem, and it is our professional responsibility as brokers not to participate in seller duplicity. At times we rely on our instincts and advise caution when a seller or buyer just does not seem trustworthy. Also, we provide valuable advice to our clients based on our experiences. Described below are three such transaction experiences that have instructed me, and should prove valuable to other brokers as well.

It’s Called Loan Fraud

One of the worst business acquisition disasters I have seen involved a client’s purchase of a transportation business. “Bill” came to me several months after the closing to tell me there was a problem. He felt that the seller had misrepresented the revenues and expenses of the business (unfortunately, that’s not the shocking part), and he was already having a hard time making payments to the bank on the \$800,000 or so he had borrowed. What made the situation worse – and worth mentioning here – was that the actual purchase price was not the \$1,000,000 reflected in all the purchase documentation over which I had labored. The actual purchase price was \$2,000,000, and there was a “side note” (i.e., unknown to the lawyers and the banker) to the seller for another \$1,000,000. The client told me that the broker had come up with this creative structure in order to get the financing closed. A word of caution: anytime there are “side” documents to be signed by the parties, tread carefully. The business that Bill purchased failed and he lost his investment. Still, Bill was fortunate that he was able to resolve the matter without jail time for loan fraud!

Know Your Seller

The reputation and personal integrity of sellers and buyers are important. I still recall studying the Maghribi Traders in law school. These Jewish merchants who traded in the tenth and eleventh centuries A.D. valued their reputation above any other business asset. They knew that they would be shunned from the business community if it was thought that they could not be trusted completely. For most business owners, their reputation in business and the community is just as important as it was to the

Maghribi Traders. Unfortunately, that is not true for all business owners, and buyers should be advised to take time to study sellers.

The most disappointing post-closing business failure I have seen involved a seller who had a reputation in his small-town community for taking advantage of people. Picture John Gotti living in Appalachia. The buyer who I represented had a diminutive persona, and soon after closing things began to unravel. The seller insisted that all trucks would remain on his land (which the buyer was leasing from him), and that he would continue to perform all maintenance on the trucks. It seemed that shortly after closing truck engines needed replaced weekly. Employees of the business were intimidated to quit. The seller was overheard telling his lawyer a few months after closing that he intended to take the business back from the buyer. Before long, the business failed and the buyer had lost a substantial deposit. A little investigation into the seller's reputation in the community would have suggested caution.

The Accidental Franchise

Sometimes franchises appear where they are not welcome. A business owner may intend to structure a simple distributorship arrangement or licensing of business methods. They may be disappointed to learn that their business model will require compliance with franchise or business opportunity registration and disclosure laws in each state where they intend to do business, at significant expense and effort. Brokers and buyers should be aware if a seller is trying to sell an unregistered franchise business, as it is a source of potential future legal liability. Two initial inquiries are recommended, followed by the advice of an experienced franchise lawyer. First, are the "customers" of the business (those down one link in the vertical chain of distribution) relying on the continuing efforts and success of the business model? For example, are proprietary equipment or methods required, or is significant advertising and promotion at the national level promised? Second, are those customers required to purchase from the business or make an initial investment to secure a territory or opportunity? If so, it may be a franchise.

If the seller is a franchisee or distributor, the buyer's lawyer must review the franchise or distribution agreements thoroughly to ensure that the seller's business has the bundle of distribution rights that are advertised and expected. Are there any exclusive territories promised, and if so, are they well protected? Many "accidental franchises" have been established with poorly-drafted distribution contracts. A seller may legitimately think that he has a bundle of rights that are not supported by his contracts.

Lessons Learned

We all learn from our failures, and these learning experiences can be extremely valuable. Hopefully we can also learn from observing others' failures, and these observations can help us, and our clients, to avoid making similar costly mistakes. Keep sharing those war stories at association conferences – they are more than worth the price of admission!