Buying A Restaurant?

Prior Due Diligence Will Facilitate the Deal

By MARK A. TANNER

Purchasing an existing restaurant is an exciting undertaking. However, with failure rates for independent restaurants as high as 26% in the first year of operation and 59% after three years, it is critical that restaurateurs treat the time leading up to the purchase as carefully as day-to-day operations.

Initial Due Diligence

Once a target for acquisition is located, it is important to obtain and review the restaurant's financial documents. In most instances, these documents are provided by the owner, or by the broker listing the restaurant. At minimum, financial statements, tax returns, and profit-and-loss statements for the past several years' operations should be reviewed.

Purchasers should be skeptical when it is intimated that financial documents do not represent the 'actual' cash flow or profitability of the restaurant. Financial information should also be reviewed by an accounting or business acquisition professional, who, after review, should be able to discuss the financial viability of the restaurant, especially as it relates to the asking price.

Prospective restaurateurs should also review the target's inventory and ordering records, food and labor cost logs, recipe manuals, non-confidential employee records, and equipment leases, as well as sales, management, and maintenance logs. The presence and completeness, or the lack of, these control mechanisms provides insight into management and operational efficiencies and can be used to double check the veracity of financial documents.

In addition to completing a thorough paper review, purchasers must visit the restaurant on several occasions and at different times of day. During these site visits, pay particular attention to staff/guest and staff/staff interaction, the number of turns, and the general manner in which business is conducted. If possible, speak with guests and employees, because they are likely to remain once the purchase is completed.

Asset or 'Entity' Sale

Many restaurants are owned and operated by entities, such as corporations or limited liability companies. If the target restaurant is a corporate entity, the decision will have to be made whether to purchase the operating entity itself, or to purchase only the entity's assets. In an entity sale, the seller transfers the stock or other indicia of ownership to the buyer. The new owner continues the depreciation and amortization the target has on its books, keeps the same tax identification number, and usually takes on any outstanding liabilities or obligations of the corporation.

This continued liability, coupled with what many consider to be less favorable tax treatment, makes 'entity' sales relatively uncommon with small businesses. The more common structure for the purchase of independent restaurants is the 'asset sale' wherein the buyer purchases the restaurant's assets, such as equipment and good will, but does not purchase the entity's stock. This minimizes the risk of inheriting unknown liabilities and generally provides more favorable tax treatment for the buyer.

Real Property

If real property is included in the sale, all due diligence associated with the purchase of real property must be included in the buyer's due diligence. If the location is leased, it may be necessary to negotiate a new lease with the landlord, or enter into an assignment of the current lease, which may require the landlord's written consent. Because many landlords require that new restaurateurs individually guarantee lease obligations, it is usually a good strategy to attempt to negotiate a short initial lease of one to three years, with numerous long-term extensions.

This lease structure provides some protection for the restaurateur's individual assets during the restaurant's formative years, while providing the long-term leasehold required by most lending institutions. Other lease terms that must be particularly scrutinized in the purchase of a restaurant include clauses which limit operations, insurance provisions, treatment of fixtures, parking, taxes, utilities, rubbish disposal and water/sewer charges.

Operating Entity

Early in the due diligence period, it is important to consider forming the entity through which operations will be conducted. Business forms used by restaurants include sole proprietorships, partnerships, limited liability companies (LLCs), and corporations. Sole proprietors and partners are generally individually liable for the debts of the restaurant. LLCs and corporations, when coupled with a homestead on the restaurateur's principal residence offer greater protection for individual assets.

However, because many creditors require that new restaurateurs personally guarantee the restaurant's debt and because of additional filing fees or taxes, some benefits of the corporate form are lost on start-up businesses. Further, if alcohol service is key to the restaurant's concept, be aware that the choice of operating entity can directly affect the ability to obtain and retain a liquor license in Massachusetts.

Permitting

• **Zoning:** In turn-key situations, it is likely that the current operator has obtained the permits necessary to operate the restaurant. Do not assume that because the premises are currently used as a restaurant that a new owner will be able to continue the current use. Many municipalities limit locations where restaurants may be operated and require special permits from a planning or zoning board that can limit hours of operation, outside dining, noise, parking and live entertainment. Because there are notice requirements, and public hearings associated with these permits, it is imperative that permit applications, if necessary, be completed months in advance of the closing to ensure approval is received in a timely manner.

• **Liquor License**. Alcoholic beverages generate higher profit margins than food sales, and represent an attractive source of revenue for many restaurateurs. Restaurants serving alcohol usually carry an on-premise or 'pouring' license which allows for the service of 'all alcohol,' 'wine only,' 'malt only' or 'wine and malt,' with 'all alcohol' licenses generally being the most valuable and most difficult to obtain.

Applying to the local licensing authority for a new license or transfer of an existing license does not guarantee a license will be issued. Applicants may be barred from holding an interest in a liquor license if they are not a

U.S. resident, have been convicted of a crime or are under the age of 21. Further, local licensing authorities may reject a license application if an applicant fails to comply with state law, ABCC regulations, or any other reasonable requirement imposed by the licensing authority.

Purchase-and-Sale Agreement

The purchase and sale agreement is the document that pulls the transaction together. When drafted properly, this agreement is a binding, legal document between the buyer and seller. There are several provisions which should be included in this important agreement.

- **Assets to Be Sold**: These provisions should include a detailed description of the assets being sold. If there are proprietary items such as food or beverage recipes, trade secrets, or copyrighted materials being transferred, the provisions must carefully detail each party's right to the use of the property. Less glamorous items that must also be accounted for include equipment, good will, inventory, and food in production, which must be accounted for just prior to closing through a hands-on inventory.
- **Allocation of Sales Price**: Allocation provisions in the agreement attribute the sales price among the assets being purchased. Since the purchase or sale of a restaurant is reported on both parties' tax returns (which may be compared by the IRS), it is in everyone's interest to report the same allocations. Generally speaking, the buyer wants the purchase price allocated to assets such as equipment, which can be rapidly depreciated. Prior to agreeing to an allocation schedule, a tax or accounting professional should be consulted, as the allocation dictates amortization and depreciation, which in turn impacts cash flow and financial viability.

Additional items for inclusion in the agreement for which the sales price must be allocated include:

- **Non-Compete Agreements**: Such agreements entered into during the sale of a business are generally enforceable, are an asset of the business and can be depreciated over time.
- **Consulting Agreements**. For turn-key operations, consulting agreements provide the buyer the comfort of knowing someone will be available to provide advice and guidance for a limited period of time. Buyers generally expense money paid on consulting agreements as it is paid, rather than over time, and therefore want as much of the sales price as is realistic, attributed to the consulting agreement since the expense is recaptured relatively quickly.
- **Contingencies**. The agreement should contain a number of contingency provisions. These provisions protect the buyer by ensuring that certain milestones are met before the buyer's deposit or 'good-faith' money becomes non-refundable. If possible, contingencies should include an automatic extension of time for the buyer to back out of the sale if conditions precedent to the sale are not met.
- **Inspections**. The agreement should provide for inspections by the purchaser on at least two occasions prior to closing. Early inspections provide the buyer an opportunity to inspect equipment for functionality. Later inspections ensure that material changes in operations have not occurred.
- **Financing**. If the purchase price is to be paid through third-party financing, the Agreement must contain a financing contingency. Generally, this provision provides a date by which the buyer must obtain financing, terminate, or extend the agreement.
- **Licensing**. Obtaining local permits and liquor licenses is not guaranteed or automatic. The agreement should provide realistic dates for each required permit or license to be obtained and also provide for an automatic extension or termination at the buyer's option if the permit is not granted or license is appealed.
- **Lease**. Assuming the sale of assets does not include real property, the Agreement should include a lease contingency. This provision insures the buyer has adequate opportunity to negotiate a satisfactory lease prior to becoming irrevocably obligated to purchase the restaurant.
- **Continuation of Business**. In most restaurants repeat guests are the key to a successful business. In turn-key situations, buyers should negotiate a continuation-of-business contingency to insure that current management continues to operate the restaurant in the manner represented in site visits and offering documents. This contingency provides the buyer with an escape if the seller makes a change to the mode or manner of business that adversely impacts the viability or reputation of the restaurant.

Seller's Warranties and Indemnification

Without warranties and indemnification, the seller's prior representations are virtually worthless. Buyers should expect the seller to warrant and indemnify the buyer on account of 1) all financial documents provided by the seller; 2) outstanding state and federal tax liability including meals taxes; 3) payment of employment- related taxes, contributions and benefits; 4) threatened or pending legal actions; 5) that all food and beverage purveyors have or will be paid (the new restaurateur will likely be doing business with these same companies and any purveyors will not understand that yours is a new business and not a continuation of the old operation); and 6) that the seller's business has been maintained in accordance with all state and federal laws, rules and regulations.

As detailed above, there are innumerable opportunities for mistakes in the purchase of a restaurant. Fortunately, if you involve your professionals early in the process it is generally possible to avoid or resolve pitfalls before they adversely impact operations.

The above article is provided for informational purposes only, does not constitute legal advice and should not supplement independent advice. Individuals involved in the purchase or sale of a restaurant should seek out their own tax and legal advisors.

Mark A. Tanner is an attorney in the Northampton office of the law firm of Bacon & Wilson, P.C./Morse & Sacks. Prior to practicing law, Mark graduated from the Hotel, Restaurant and Travel Administration Program at UMass, Amherst and the MBA program at the University of Colorado. Mark managed, and opened new restaurants for Gilbert Robinson Inc. and Morrison Restaurants in Massachusetts, New Jersey and Colorado; (413) 584-1287.

mtanner@bacon-wilson.com.