BUYING AND SELLING MUSIC STUDIOS

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The sale of a music teaching studio may range from the simple purchase of the student list to the full blown sale of the entire business, including real estate, equipment, inventory and goodwill. While every transaction is different and will pose its own unique issues, there are certain common elements that customarily arise in these transactions. Below we have discussed those elements from the perspective of both potential sellers and buyers.

1. **Overall Form of Transactions**. If the seller has previously incorporated the business, the parties will first have to address whether the transaction will be a sale of the stock of the corporation or a sale of the assets owned by the corporation. From the seller's perspective, the stock sale is usually more attractive since the seller will pay lower capital gains taxes on the appreciation of the stock. Additionally, when purchasing stock, the buyer will be assuming all existing liabilities of the business such as past claims or unknown debts. In most cases, the buyer will benefit more from an asset transaction, while the seller will desire the stock sale.

In the case that the business that was not incorporated or organized as a limited liability company, or if only certain assets of the business will be sold (*e.g.,* the student list), the transaction should be structured as an asset sale. Asset sales will limit the transfer of liability between the seller and the buyer, such as past claims, bills, and lawsuits. They will also allow the buyer to purchase only those items it really wants.

2. **Student Lists**. With many professions, the most valuable asset owned by the business is the loyalty of its clientele. However, that loyalty may, in many cases, be a difficult asset to sell. Because the client is free to select another professional, a transfer of the client list

from the seller to the buyer is no guarantee to the buyer that it will ultimately receive the business of the client.

What steps can a buyer take to protect itself? Certainly, a transitional move over several months versus a sudden transfer provides a better opportunity to retain students. If the seller agrees to stay on for a few months after the purchase so that the students can make the transition to the buyer, it may go a long way toward an effective transfer.

Another method to protect the buyer is to structure the purchase of the student list as an earn-out rather than a lump-sum purchase. Under an earn-out formula, the buyer pays the seller a decreasing percentage of the revenue generated by the transferred students. For example, the purchase agreement may provide for an 18-month earn-out payment schedule with the seller receiving from the buyer 40% of the fees paid by the transfer of students in the first six-month period, 20% for the next six months, and 10% in the final six-month period.

While the earn-out payment structure lessens the risk for the buyer, it obviously increases those risks for the seller. If the buyer turns out to be a poor teacher, students may rapidly defect to other music instructors and the seller's percentage fees will fall off quickly. Probably some type of middle-of-the-road approach, with the seller receiving a portion of the purchase price in a lump-sum down payment with the remaining portion paid in a percentage earn-out, is the most equitable way to apportion risk between the buyer and seller.

3. **Non-Competition Covenants**. One critical element to the buyer in most transactions is to obtain a non-competition covenant as part of the transaction. In a business with high loyalty such as music instruction, if the seller is allowed to re-open a new studio after selling the old one, former students will follow the seller. The buyer has purchased very little of

value if the seller can hang out a new sign and reacquire the same students he or she just “sold” to the buyer.

To protect the buyer, the purchase agreement should prohibit the seller from competing with the buyer. Typically, these non-competition covenants contain a prohibition against the seller engaging in music instruction services within a certain radius from the buyer’s business. The covenants will usually last for several years from the date of sale.

While courts generally do not permit employers to impose expansive non-competition covenants against employees, courts are more lenient when the covenant is part of the purchase of a business. A buyer should seek to restrict the seller from offering music instructions, whether as an owner or an employee of another business, over a broad area such as one or more counties surrounding the location of the studio. The restrictions should last a minimum of one year and probably should be in the three to five year time range to adequately protect the buyer.

In addition to prohibiting the seller from competing, the buyer may also seek the seller’s affirmative support in retaining clientele. Contract provisions can include covenants by the seller to encourage students to transfer to the buyer and to support and promote the buyer as the successor to the seller’s business. At the very least, the buyer should seek a contractual warranty that the seller will not disparage the buyer nor support in any manner a competitor to the buyer’s business.

4. **Inventory and Equipment**. Assuming the seller is looking to retire from music instruction, he or she is probably interested in selling inventory and equipment which will no longer be used. Sheet music, music instruction books, instruments, recording equipment and furniture may become part of the sale of the studio.

Typically, inventory is priced at wholesale cost. However, since some of the inventory may not be marketable, the buyer will want to sift through the inventory to determine how much of it can be sold. If inventory is out-of-date or not marketable, there is very little value in purchasing it.

The same is true for equipment, the buyer would be well advised to inspect it with a critical eye to see how much use it will provide. Obviously, if the buyer can use the equipment, it will be less expensive than purchasing new equipment.

As far as addressing the purchase of inventory and equipment in the contract, the buyer should insist that detailed lists of inventory and equipment be attached as schedules to the contract. To avoid disputes on what is and what is not being purchased, the use of itemized schedules and exhibits are necessary. The contract should also spell out if the equipment is being purchased "AS IS" or if the seller is making any warranties to the buyer regarding the operational condition of the equipment.

5. **Goodwill**. Part of the value of a music studio will be its name and reputation in the community. This is generally regarded as "goodwill." The purchase agreement should customarily include goodwill as an asset being obtained. Included as goodwill would be the trade name of the music studio, any copyrighted materials it owns, its phone number, fax number and website, customer lists and records, and the right to hold the new business out as the successor of the seller's business.

6. **Real Estate**. While most music studio sales do not involve the sale of real estate, there are instances when the seller owns the real estate where the business is situated. The seller may look to sell the studio building as part of the business or lease it to the buyer as a tenant.

From the buyer's standpoint, the purchase or lease of real estate is beneficial on several fronts. First, it will greatly facilitate the transition of the clientele from the seller to the buyer. Simply because of familiarity with the location, students are more likely to stay with the buyer. Additionally, since the building is already serving as a music studio, presumably, the buyer will not have the expense of converting a building to a studio. Owning the real estate will also give the buyer collateral on which to obtain financing necessary to purchase the business.

Before purchasing or leasing the real estate, the buyer should have it inspected for physical defects. Due diligence would also require a title commitment, zoning check, and an evaluation of whether access to and from the studio complies with the requirements of the Americans with Disabilities Act (ADA). All of these items should be addressed in the purchase agreement with the seller providing warranties that the real estate has no known physical or environmental problems, is zoned to allow the music instruction business, and has accessible entryways, hallways, music instruction rooms and rest rooms that comply with the ADA.

If the buyer leases the building instead of purchasing it, the buyer may want to negotiate an option to purchase the building as part of the lease. The option provides that after a certain period of time, the tenant may elect to purchase the building either at a set price or a price to be established by a jointly appointed appraiser. If the seller is unwilling to grant an option, the buyer may want to negotiate a right of first refusal clause. This provision states that if the landlord does negotiate the sale of the real estate to a third party, the tenant has the option to match the purchase price offered by the third party and purchase the building.

In addition to negotiating options in the lease, the buyer and seller will need to address rental rates, responsibility for utilities, taxes and insurance costs, the term of the lease and options to extend the term, and obligations for interior and exterior maintenance. Oftentimes, in

commercial leases, the landlord looks to have a "triple net" lease which places all of these costs on the tenant.

While the purchase and sale of a music studio can certainly be negotiated and finalized directly between the parties, it is highly recommended that each party use an experienced transactional attorney. The temptation to save the cost of legal fees may come back to haunt a seller or buyer after the sale if they have not negotiated adequate protections in the contract documents.

If MTNA members have questions regarding this article, please contact the MTNA offices directly at 888-512-5278.