ima® The Association of Accountants and Financial Professionals in Business

LONG ISLAND CHAPTER

October 2015

Due Diligence – Why it is Important and Understanding the Process

By Gregg B. Schor, CEO, Protegrity Advisors

The words "due diligence" often carry negative connotations in the minds of owners thinking of selling their company (Seller), conjuring up images of a group of sullen lawyers and accountants paid by the buying company (Buyer) whose raison d'être is uncovering potential red flags that will at best be used to try to lower the purchase price negotiated in the letter of intent (LOI) or to increase the escrow amount, and at worst to kill the deal altogether. Additional legitimate concerns related to due diligence activities include rumors of a possible sale leaking out to employees, customers and competitors, and the adverse impact on the Seller whether or not a transaction actually occurs.

However, due diligence, if properly prepared for and conducted, can greatly benefit both the Buyer and Seller and will increase the chances that the post-transaction integration will be successful, which is in everyone's interest. Future performance becomes especially meaningful to a Seller if they remain part of the company after the sale or if there is an earn-out component to the deal.

One suggested approach which puts the due diligence process in a significantly more positive and constructive context is not to call the requests for information a "Due Diligence Checklist", but for the Buyer to provide the Seller with an "Integration Checklist" instead and to approach the process with that purpose in mind. While certainly the main objectives of diligence are to validate representations made by the Seller, to be able to evaluate risk levels, and to identify known and unknown liabilities, a major focus should be fact-finding in order to be able to intelligently develop practical plans for leveraging the underlying synergies between the companies (i.e., the reasons for the transaction in the first place) in the post-transaction entity. This aspect is far too often overlooked, and consequently, the results of the majority of acquisitions fall far short of what was envisioned in the eyes of all parties.

Formal due diligence usually begins once the LOI is signed. The purpose of the LOI is to make sure that there is a meeting of the minds on the most important business and financial terms before the Seller opens the kimono and the Buyer commits to spending further time, attention and capital. In most cases it is non-binding, with the exception of a "no-shop" clause which will give the Buyer exclusivity for a defined period of time to conduct diligence without fear that the Seller is negotiating in parallel with other prospective purchasers in an effort to secure more favorable deal. If a nondisclosure agreement has not been previously signed, those terms will be part of the LOI and will also be binding.

The information request list will ordinarily be populated with broadly worded and overlapping categories and subcategories, such as financial statements, legal, human resources, intellectual and real property, threatened or pending litigation, products or services, customers, suppliers, partners, etc. Most likely this will be a standard list used for investigating other types of companies. The Seller should designate a point person for this process, generally the Chief Financial Officer, General Counsel, or M&A Advisor, who, prior to breaking down and disseminating the request list to appropriate internal stakeholders, should work with the Buyer's point of contact (who may be an executive of the Buyer or their investment bank) to filter, narrow and organize the list so that it makes sense relative to the Seller's business and the transaction type.

If the Seller has had the foresight to already be prepared for planned or unplanned due diligence events, the benefits are enormous. Such advance planning is critical to being able to address any real or perceived red flags ahead of time and prior to the Seller being under the magnifying glass, maximizing valuation, minimizing escrows or payment hold backs, shortening the diligence period, reducing the distraction to management, decreasing the chances of inadvertent disclosure, enhancing Seller credibility in the eyes of the Buyer and its advisors, and being able to present information in such a way as to accelerate and improve the post-transaction integration process.

Once internal documents and materials have been obtained and organized, whether complied as an advance exercise or during an actual due diligence, they should be stored in a virtual deal room (VDR). VDRs have many benefits, including providing remote access to multiple people simultaneously, avoiding causing a disruption at the Seller's offices, knowing what documents have been viewed by who, when, and for how long, and being able to give or terminate access immediately.

Requests in this scenario will invariably lead to supplemental requests, but a timetable for new requests and provisions of responses should be enforced and adhered to as much as reasonably possible to avoid the diligence process exceeding the agreed upon period and for both sides to be able to make a decision about whether to proceed to definitive agreements as efficiently as possible.

Due diligence is obviously necessary and important for a Buyer to understand as complete a picture as it can in a reasonable time period about the target company or assets being acquired, what a fair purchase price is, and as a foundation for knowing what contractual protections, representations, warranties and other terms are appropriate to include in the definitive transaction agreements. Due diligence can also be a tremendously valuable business planning tool for integrating the Seller into the Buyer post-transaction, and if thought of and conducted in that regard, it could be a much more rewarding and less adversarial experience for all concerned.