

Getting it right

Conducting the proper due diligence to ensure a successful acquisition Interviewed by Sue Ostrowski

When you're considering buying a company, it's not just a matter of locating a target and writing a check. There's a lot that goes into doing proper due diligence, and if you fail to do it right, the transaction could be disastrous, says Thomas Vaughn, member, Dykema Gossett PLLC.

"From the purchaser's perspective, conducting an effective due diligence process is critical to maximizing value from your acquisitions," says Vaughn.

Smart Business spoke with Vaughn about why due diligence is critical to ensure a successful acquisition.

When considering purchasing a business, what is the first step?

Start by assembling a team of in-house and outside lawyers, inside and outside financial professionals, and possibly experts in various areas impacting the target. In the due diligence process, it is the job of the buyer to learn and understand everything it possibly can about the prospective target, and that requires a very deep dive by the due diligence team.

What is the next step?

The team should develop a due diligence strategy, and one of the most important components of that is to agree on the purpose of the due diligence effort.

From a buyer's perspective, due diligence can be a very expensive process, so it is typically done in stages to keep costs down until the buyer is certain it is going to complete the transaction. As a result, in the preliminary due diligence, you are trying to determine the target company meets your investment parameters. You're looking for 'go, no go factors.'

The early stages of due diligence are very financial and operations oriented. For instance, making sure the financial statements and projections accurately represent the company's business prospects and that there aren't any major customer problems or potential defections are critical elements of due diligence.

From a legal standpoint, you look for high-dollar legal issues, like pending litigation or claims, or legal impediments to completing a deal, such as regulatory issues.

Also determine that the value you see in the company is an accurate perception of its true value. As part of that, identify and confirm synergies. All of these efforts will help you negotiate the purchase price and other deal terms.

Once you are satisfied with value and have



Thomas Vaughn
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signed a letter of intent, you can conduct the detailed part of the due diligence process.

How do you proceed with the detailed due diligence?

This is when the process starts in earnest. Have your team divide up responsibilities so that you're not duplicating efforts and you are conducting the process as efficiently as possible. You want to make the process as smooth as possible for the seller. Due diligence is burdensome and time consuming for the seller. Don't have multiple people asking the same questions or asking for the same documents.

One of the best ways to help this run smoothly is to present the seller with a detailed checklist. Often there is information listed on there that the company doesn't have, but you can use the list to trigger the seller to think through the information documents the seller has and should be providing to you. Then keep the list updated to reflect documents received and make the list available to all team members.

How is the due diligence information delivered?

Determine up front the deliverable to come out of the due diligence process. Is the expectation a written report from the accounting and legal staff? That is the most typical result, but there is an expense involved, so you have to determine if you want to incur that. You can

also start with an oral report or short written report that notes red flags and items that are potentially problematic as a precursor to the full report.

That report should come with recommendations as to which problems can be potentially fixed and how to fix them, or whether the problem is so significant that it should have an impact on the purchase price or the decision to move ahead. Another outcome when due diligence identifies problems or uncertainties might be to have part of the purchase price paid as an earn-out. If certain things represented by the seller happen, you'll pay the full price, but if they don't, you won't have to.

What are some red flags?

The biggest one is a very disorganized seller. In this case, the buyer needs to do very thorough due diligence. Lack of documents where you expect to see them, or poorly drafted documents or contracts, are also an issue.

Another red flag is a seller who provides you with certain due diligence but is slow providing other information. This may be an indication the seller is holding back bad news.

How does due diligence help in preparing schedules used in the typical acquisition agreement?

The seller makes representations and warranties in the acquisition agreement and puts exceptions in the schedules. Then the buyer reviews them to get comfortable that nothing new has appeared in the schedules that was not disclosed in the due diligence process. It's not unusual for new information to appear in the schedules, which can be a big problem.

If the buyer feels the seller intentionally didn't disclose information until the last minute, it can have a very negative impact on completing the transaction and the ongoing relationship between the retained members of the management team and the buyer.

What kinds of things can show up at the last minute?

Usually it is a problem the seller was trying to solve before he or she has to disclose it, but can't. The seller discloses it in the schedules just before the acquisition agreement is signed to avoid later indemnity claims. But doing so at the last minute is a problem in itself. <<

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