

THE SELLER CONFRONTS DUE DILIGENCE

By: *Terence P. Kennedy, Founder, Kennedy Law Group*

Let me paint the scene for you. You have decided to sell your business. You and your advisors circulated nondisclosure agreements to potential suitors. The suitors prepared letters of intent. You chose the one you thought was the best and have negotiated it. The purchase price might not be what you first expected, but you believe the deal is basically fair. The letter of intent says that the deal is expected to be signed and closed within 120 days during which time you and the buyer will negotiate the definitive purchase agreement. The letter of intent also provides that during that 120 day period the buyer is entitled to perform due diligence on your business. The obvious question is “what’s that?”

I cannot tell you with any degree of certitude that the term “due diligence” was invented by lawyers, but lawyers, among other things, are sticklers for precision, and one of the methods they use for getting things right is the “definition.” So when you get a legal contract from a lawyer, it is not unusual for it to be filled with definitions. It is the same with “due diligence.” Lawyers even have their own dictionary, the hallowed Black’s Law Dictionary. Black’s Law Dictionary contains a description of due diligence. It is as follows:

Such a measure of prudence, activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent man under the particular circumstances; not measured by any absolute standard, but depending on the relative facts of the special case.

This sounds erudite. We, however, being practical men and women, prefer something a little more succinct. So, for our purposes, due diligence is a thorough investigation by the buyer of the business being purchased and of its owners and managers so that the buyer can rest assured he or she is not getting snookered. Asking the right questions and drilling down until you get the right answers. This is fair as things go, but as a seller, you have some follow up questions. When does due diligence start? How long does it last? What is the purpose of due diligence? How will it affect the deal? And the all important question, is the due diligence process going to disrupt my business? Let’s look at each of these.

Timing of Due Diligence

As a practical matter, due diligence begins upon signing of the letter of intent. Prior to that time, you have provided the potential buyer with a term sheet containing bullet information on your business, together with summary financial information. If you have an investment banker or a broker/intermediary working with you, the buyer has also seen a selling book prepared by you and your advisor which contains the story of the company. However, as of yet, buyer has not been able to verify any of the information in the selling book. For example, the selling book says you own a piece of property, now buyer wants to see the deed. The selling book says you are fully insured; now buyer wants to see the insurance policies. The selling book says all your employees have signed nondisclosure agreements and covenant not-to-compete agreements, now buyer wants to see copies of all the signed agreements. Buyer will also check these agreements against a list of employees buyer requested from you. You get the picture.

Generally, the due diligence investigation can continue right through the signing and closing of the definitive purchase agreement. It should be noted that in the lower middle market, many definitive purchase agreements are signed and closed on the same day. The richer deals tend to sign on one day with a closing occurring a month or more later. In these deals there is sometimes a definitive date upon which due diligence must stop; hence, buyer wants to close soon thereafter.

The Purpose of Due Diligence

Although by no means are these the only reasons, there are three main reasons the buyer performs due diligence. First, buyer wants to verify any information that has been put into the selling book prepared by you and your advisors. If there are discrepancies, buyer will confront you with the same. Needless to say, discrepancies should be avoided. Make certain the selling book is accurate. Second, buyer wants to determine if there are any problems or risks associated with the business. For example, if you own real estate as part of the business, buyer might want to do a Phase I Environmental to make certain there are no contamination problems. If you are in the high risk construction industry, buyer will want to make sure that there has not been any serious injury to your employees on the job within the last 10 years. As a third purpose, buyer wants to determine if there are any road blocks to doing the transaction. For example, you might lease a building in your business. Typically, the lease will require the consent of the landlord before you can assign your interest in that lease to a successor, like buyer. Buyer wants to know about this in advance so he can negotiate an assignment and consent form with the landlord and you as seller in advance of the closing. That's pretty much it in a nutshell.

Effect of Due Diligence

Due diligence gives the buyer several options. If no surprises are revealed by the due diligence process, buyer can go forward with the transaction on the basis of the letter of intent. This is the best case scenario for seller. If the due diligence reveals unsolved problems or unexpected risks, buyer will re-open negotiations on the purchase price to drive down the price or to change it in some way. For example, buyer might want to convert part of a cash purchase price into an earnout that seller has to earn after the closing based upon the future earnings of the purchased business. This is not good for the seller for two reasons. First, you want all our cash at closing, second, seller no longer has influence over company's performance. Finally, if the risks are too great, buyer can bite the bullet and walk away from the deal. Examples of these risks include significant environmental contamination or one customer accounting for 80% of seller's revenues. Another example might be if the seller has an exclusive license to manufacture or sell a profitable patented product, but that patent is about to expire. Of course, when buyer walks away it is a seller's nightmare. To avoid the second and third options above, seller needs to make certain that he has addressed or is attempting to address any and all problems of the company. For guidance on doing this, see my article "Preparing Your Business For Sale" on the website. In addition, be certain to describe any significant problems in the selling book, providing proposed solutions thereto. It is important for seller to control his destiny and that is done by eliminating all reasons buyer can conjure to reduce the purchase price or walk away from the deal.

Will the Due Diligence Process Disrupt My Business

If there is one thing that keeps a seller up at night when he is selling the business, it is the fear that a potential buyer is going to come into his business and tear it apart looking for issues,

alienate the employees, spook the vendors and customers, then walk away from the business leaving it in shambles. Many, but not all, buyers are sensitive to this. In order to avoid this outcome, you need to be prepared to sell your business. Again, see my accompanying article on this website, "Preparing Your Business For Sale." Briefly, to avoid this result, you need to be systematic and organized and anticipate the due diligence request.

In any purchase and sale of a company, the buyer's attorney and the buyer's accountants will each prepare a due diligence checklist. Needless to say the attorney's due diligence checklist deals with legal issues. See the sample pages from a legal due diligence checklist below.

KENNEDY LAW GROUP
311 Keystone Avenue
River Forest, Illinois 60305

PRELIMINARY LIST OF LEGAL DUE DILIGENCE MATERIALS REGARDING
THE PROPOSED TRANSACTION INVOLVING
XYZ

ADD HERE THE NAME OF ANY SUBSIDIARY OR WRITE "N/A"

(EACH OF THE AFORESAID COLLECTIVELY REFERRED TO HEREIN
AS THE "COMPANIES" AND INDIVIDUALLY AS THE "COMPANY")

NOTE "N/A" OR DATE PROVIDED

1. CORPORATE DATA ON ANY OF THE COMPANIES OR ANY RELATED ENTITIES
- 1
- ___ 1.1 Legal name of each of the Companies, and a list of each Company's organizational documents, Certificate or Articles of Incorporation or Organization as amended, and any By-Laws, any limited liability company operating agreements or partnership agreements, as amended, or comparable charter documents, for each Company. A chart showing the ownership of each Company.
- ___ 1.2 Documentation (including acquisition and/or divestiture agreements, together with exhibits, schedules and closing materials) relating to any purchase and sale, or reorganization of any of the Companies, or significant acquisitions within the last five years.
- ___ 1.3 A list of the provinces, states, territories, foreign countries, etc., other than the state of incorporation, in which any of the Companies.
- (a) have (a) an office, plant, warehouse or consigned stock of goods; (b) any other property; or (c) employees;
- (b) is qualified, formally, to do business as a foreign corporation; or
- (c) pays taxes of any kind.
- ___ 1.4 A list of any names, other than current names, under which any of the Companies, or their respective predecessors, have done business in the past.
- ___ 1.5 Complete list of stockholders (showing their respective holdings), officers and directors of

the Company and each subsidiary. If any shares are registered other than solely in individual names, we will need to have details such as the terms of any trust under which shares are held, restrictions on transfer of shares held by corporations or partnerships, and other similar situations.

2. PROPERTIES

- ___ 2.1 Legal descriptions and copies of the most recent deeds, title insurance policies, and opinions on title for all leased, owned or optioned real estate.
- ___ 2.2 Copies of all available surveys of real property owned, leased or under option, showing the location of all buildings and improvements.
- ___ 2.3 Copies of all leases, easements and licenses (pertaining to land) to which any of the Companies is a party, either as lessor, lessee or otherwise.
- ___ 2.4 The zoning classification of each parcel of owned or leased property and details on any formal zoning variances or exceptions pertaining to any of those properties and any nonconforming uses.
- ___ 2.5 Copies of any mortgages affecting any real properties.
- ___ 2.6 Listing of equipment showing date purchased, original cost and amount depreciated for each of the Companies.
- ___ 2.7 Copies of any leases whereby any machinery, equipment, vehicles, etc., are leased to or from any of Companies and treatment thereof (i.e. operating vs. capital).
- ___ 2.8 Copies of any outstanding purchase contracts (or series of related contracts) whereby (i) vehicles are being purchased or have been ordered for future delivery, or (ii) other machinery, equipment, or the like are being purchased or have been ordered for future delivery (excluding for (ii) routine non-repetitive contracts or series of related contracts involving less than \$2,000).

3. CONTRACTS

- ___ 3.1 Copies (or descriptions, if oral) of any 3 months contracts or series of related contracts or arrangements (including purchase or sales orders and personal property leases) involving an aggregate amount in excess of \$2,500; and any contracts or series of related contracts (regardless of length of time) involving an aggregate amount of more than \$5,000 annually, for:
 - ___ 3.2 Copies of all customer contracts regardless of length of time involving an aggregate amount of more than \$2,500 annually.
 - (a) purchase of equipment, materials or services; or
 - (b) purchase of utilities (electricity, steam, heat, water, gas, etc.).
 - ___ 3.3 A statement of any arrangement whereby the cost of plant services (steam, electricity, heat, water, watchmen, etc.) are shared with any third party.
 - ___ 3.4 Copies of all agreements with sales representatives or, if appropriate, a copy of the form of sales representative agreement together with a list of all sales representatives and their respective territories and variations on the form agreement.
 - ___ 3.5 Copies of all distribution agreements with suppliers and dealers.
 - ___ 3.6 Copies of any other agreements which may be of significant consequence to the corporate

affairs or business of any of the Companies which are not more specifically covered in this list (for example, powers of attorney, shareholder agreements, option agreements).

- ___ 3.7 Copies of all loan or financing agreements, together with any related security or collateral agreements relating to the business or assets of any of the Companies.
- ___ 3.8 Copies of written product warranties or other guarantees by which any of the Companies is bound.

Each lawyer has his or her own due diligence checklist (nobody can do it as well as he can), but, in general, they all ask for the same information. The trick is to make certain that you have all this information categorized and filed before you get the buyer's checklist. The best way is to ask your friendly neighbor who happens to be an M & A lawyer if he can provide you with a checklist so you can get your company organized. If at that point he proves to be less friendly than you thought "Google" it. You will find something. Use your judgment. The more comprehensive the list is, the better. Or better yet, call me. I'll be happy to provide my due diligence checklist to any prospective seller. It should be clear and understandable like the sample above. The due diligence checklist will be indexed. When you create folders of the information, label the files so they correspond to the index on the due diligence checklist.

In the "good old days," before Microsoft, Google, the internet, discs and so forth, we would actually photocopy all the documents and provide them in boxes for the buyer to review. Indeed this is still done in many deals. But the wonders of science have made life simpler. Now, once you have everything organized and indexed, you can just scan it into your hard drive ready to be transferred to a disc. For deals that can bear the price, there are even companies today (for a price, as I said) that will prepare a virtual data room with all your indexed documents. Whenever a person on a buyer's team wants to review a document, he signs into the provider's site, signs out the document, and reviews it. This procedure is clean and simple. The idea here is to do as much in advance as you can, knowing what the buyer will want to see. This minimizes the intrusion into your business.

I want to add a word about interviews. 90% of the due diligence process includes the buyer going through seller's financial statements, tax records, organizational documents, contracts, insurance documents and so forth with a fine tooth comb to learn more about the business followed by additional questions to the seller to clear up any issues. The other 10%, if that high, involves hands on investigation, including interviews. Who does the buyer want to interview? First, he wants to interview seller's customers. Next he wants to interview seller's key employees including salesmen. Finally, he wants to interview seller's vendors. Buyer has legitimate concerns. He wants to know the customers are happy. He wants to make certain key employees will stay in the business and that prospective sales won't vanish. He wants to know that vendors can handle expansion and he wants to get some comfort that prices are stable. On the other hand, seller has legitimate concerns. Most importantly, he doesn't want buyer to crash into these relationships like a bull in a china shop. This is especially true because a buyer generally retains the right to walk away from a deal if he is not happy with what he discovers in due diligence. The last thing a seller needs is for buyer to walk away having left the seller's business in shambles. I don't want to go into too much detail on this, but I want to assure you that a good deal lawyer will get written assurances from the buyer on how to proceed with these interviews. For example, your lawyer should control the timing of these interviews. Generally, these don't occur until well into the due diligence process. Next, your lawyer can get assurances on the procedure to be used. For example, with customers, the lawyer will want to limit it to a

couple of key customers. He will also want to disguise the interviews. Typically, a phone interview will be had with the customer under the guise of a customer satisfaction interview. Customer will not know that an actual sale of the business is contemplated. With respect to key employees, the lawyer will want to know what questions will be asked. Again, if these interviews occur, it should be limited to key employees only.

You should know that in many cases I have handled, seller insisted that these interviews not take place. This position is especially successful when the business is growing both the top line and the bottom line. The argument here is that the numbers speak for themselves.

Conclusion

Due diligence is the investigation of seller's business by buyer that commences roughly after the letter of intent is signed and continues until the deal is closed. Buyer does due diligence to verify the accuracy of your selling book, to look for problems in your business, and to determine if there are any road blocks to closing the deal. If the buyer is satisfied that your business is clean after due diligence, he will go forward with the deal on the basis of your original negotiations in the letter of intent. If he is not satisfied that your business is clean, he will try to drive down the purchase price or convert some portion of the purchase price into a conditional earnout. If buyer perceives the problems of the business to be insurmountable, he can walk away. That is why it is best to do your own due diligence on your company no later than as soon as you decide you might want to sell your company. If you address the problems of your company before you try to sell it, you have a far better chance of completing the transaction. In addition, if everything is organized in good fashion and all your business documents are collated and scanned onto discs, you have a far better chance of keeping the buyer out of your hair as you try to run your business. The idea is to sell your business with the least amount of disruption. To limit the disruption you need to plan ahead. There will always be hiccups in any deal. However, if you plan ahead, I promise you due diligence is going to go a lot smoother than if you don't. Get started and good luck.



Terence P. Kennedy is the founder of the law firm KENNEDY LAW GROUP in River Forest, Illinois. He concentrates his practice on mergers and acquisitions, capital-raising for the middle market and providing general counsel services to entrepreneurs and family-owned businesses.

311 Keystone Avenue
River Forest, Illinois 60305
708-657-4153
tpkennedy@tpklawgroup.com