Simplifying Due Diligence With Thoughtful Planning

Due diligence can be an arduous process for business owners, potential buyers and their respective advisors. Nonetheless, conducting thorough and detailed due diligence is a critical step in the sale process in order to:

- Determine a value for the company, including potential synergies
- Understand the pre- and post-closing operational steps that will be needed to integrate the company into the buyer's business operations
- Identify any "red flags" in the business that may impact the purchase price, contract terms or the buyer's willingness to move forward with the transaction

Thoughtful planning and preparation by both buyer and seller prior to beginning the sale process will go a long way to ensure an efficient due diligence review, maintain an open exchange of information among buyer and seller, and avoid last-minute surprises that may threaten to derail the transaction.

Be Forthcoming, Be Reasonable

In a typical due diligence process, the seller shares a substantial amount of information about his or her business with one or more potential buyers, some of whom may be the seller's competitors. Buyers, understandably, would like sellers to provide them with as much information as possible. Sellers, on the other hand, may be reluctant to respond to each and every diligence request from a potential buyer for several reasons:

- Certain information may cast the seller's business in a negative light
- Sharing highly confidential information with competitors may give them a competitive advantage in the market if the deal ultimately falls through
- Information shared with potential buyers may leak out into the public domain
- Compiling the information will distract the seller's management team from performing day-to-day business operations

A well-run due diligence process strikes a balance that provides potential buyers with the information they need to properly evaluate the business while addressing the seller's concerns about sharing too much.

Sellers should be as cooperative as possible and recognize that any problems with their business will eventually come out in due diligence. Few things are more devastating to a transaction than a buyer discovering an unexpected issue late in the sale process. In addition to the challenge presented by the problem itself, buyers may feel put off by what is, at best, a crucial oversight by the seller and, at worst, a lack of candor. Buyers may begin to wonder what other issues have yet to be uncovered and either lower their bid price accordingly or walk away from the deal altogether.

Buyers, on the other hand, should be respectful and reasonable in their diligence requests and the time they require from management, recognizing that managing a due diligence process places a significant burden on the seller's employees. The buyer's diligence request list should be organized, prioritize items that are critical to the buyer moving forward and indicate which items may require time with the seller's management team. To assuage the seller's concerns about divulging highly confidential information about the business (e.g., customer lists, pricing details or employee compensation) early in the sale process, buyers may consider agreeing to a specific timeline where the seller provides certain information to the buyer only after specific transaction milestones are achieved (e.g., letter of intent signed or first phase of diligence completed).

Due Diligence Documentation:

- Financial statements for the past three fiscal years and year to date
- Current strategic plan and five-year forecast
- Budget for the current year and next year
- Summary of terms and covenant of existing indebtedness
- Copies of material contracts
- Copies of employment agreements
- Description of employee benefits and compensation
- Description of major capital projects for the last three years
- Commitments for pending and proposed major capital projects
- Description of owned and leased real estate and any past or current environmental issues
- Description of any pending or threatened litigation or regulatory proceedings

Sellers Must Be Prepared

In order to be as prepared as possible for the diligence phase of a sale process, sellers should conduct their own "business preparedness assessment" aimed at identifying and addressing potential issues in the business and assembling and reviewing the documentation and information that potential buyers may request during the due diligence process. To conduct a thorough business preparedness assessment, sellers should:

- Develop a detailed due diligence request list that anticipates documents in key business categories (e.g., finance, employees, real estate, intellectual property) that potential buyers may request during the sale process
- Annotate the due diligence request list to identify documents that can stand on their own versus documents that may require conversations with the seller's management team to explain them
- Assemble an internal diligence team made up of key members of management who have access to documents on the due diligence request list (or know who to ask), possess a thorough understanding of those documents, and can articulate their purpose to a buyer
- Identify any potential red flags that a buyer may encounter as part of the diligence process and ensure that by the time the sale process commences, the seller has either eliminated the red flag, mitigated its impact on the business or has a detailed explanation for why the red flag exists and how the seller is addressing it
- Compile diligence materials into a well-organized packet that can be provided to potential buyers (ideally electronically)

Buyers Need the Right Team of Advisors

Buyers must ensure they have the right team of advisors to help their internal team conduct a thorough due diligence review. The buyer's team of advisors should consist of experts capable of evaluating each of the key strategic, financial and operational facets of the seller's business. The team may include:

- One or more CPA firms for accounting and tax review
- An investment bank to help review the company's financial forecast as well as historical and projected financial performance
- Industry consultants to review the company's business model in light of anticipated industry trends and growth
- Legal counsel (M&A, local counsel, tax, environmental, etc.)
- Environmental consultants (for businesses that own or lease real property)
- Consultants for employee-specific issues (employment contracts, employee compensation and benefits, labor unions, etc.)

Establish Ground Rules for the Due Diligence Process

Too often, transactions are delayed or even terminated as a result of a poorly run diligence process. Confidential information is leaked, the seller's management team is overburdened, the buyer is frustrated at the lack of information from the seller or the process simply drags on too long.

Establishing and communicating a few basic ground rules at the onset of the diligence process can go a long way toward making due diligence as productive and efficient as possible for both parties. Key features of a well-run diligence process include:

- Clear rules for who is part of the buyer's and the seller's diligence team, who receives and sends information among team members, and how the confidentiality of the information exchanged will be preserved
- An understanding among deal-team members that the buyer and his or her advisors are not to contact members of the seller's management team without the seller's prior knowledge and consent
- A due diligence point person, selected by the seller from among his or her management team, who has access to key decision-makers and can oversee the diligence process for the seller
- A detailed log that records responses to each due diligence request and any follow-up requests
- Periodic status update calls among key members from both the buyer and the seller's teams

Thoughtful Planning Benefits Both Buyer and Seller

Planning in advance for the diligence process will pay dividends to both the buyer and the seller over the long run, including a smoother process with less distraction for the seller's management team, increased likelihood that the transaction is successful at the right value and on the right terms for both parties, and a good working relationship established between the seller's and the buyer's management teams going forward.

Twenty Red Flags That Could Derail the Sale of a Business:

- Financial projections not substantiated by reasonable assumptions
- Revenue dependent on one or a few key customers
- Incomplete or unorganized books and records
- Commingled personal and business expenses
- Description of any pending or threatened litigation or regulatory proceedings
- Pending or threatened litigation
- Environmental issues with company property
- Numerous financial irregularities (e.g., one-time charges or gains)
- Excessive inventory on balance sheet
- Significant capital expenditures required to achieve financial projections
- High debt burden relative to cash flow
- No formal corporate governance decision-making framework
- Employee flight risk/No succession plan
- Unfavorable contract terms with key suppliers
- Outdated technology systems
- Unfavorable industry trends
- Insufficiently protected intellectual property
- Pending or ongoing regulatory issues or proceedings
- Inadequate insurance coverage
- No long-term business strategy
- Rising or volatile raw material costs

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