What to expect from due diligence

By Anja Bernier
Managing Director Efficient Evolutions LLC, Certified Business Appraiser (CBA), Certified Valuation Analyst (CVA)
Contact: abernier@efficientevolutions.com, (781) 806 0880

Many entrepreneurs who have not been through the company sale or acquisition process, expect that getting offers on the table, and subsequently signing a Letter of Intent (LOI), is the key step during the sale process. I certainly don't claim that negotiating a detailed LOI is not an important step in the process, but based on my experience, it is typically the next phase of the deal, the buyer's due diligence period, that makes or breaks the deal. Let me start with some basic facts about due diligence:

For the acquisition of an owner operated small business with $1 million – $10 million in revenues, agreeing on 45-60 days to complete due diligence and negotiate the Purchase & Sale Agreement, is considered pretty standard. As a seller, you probably want to keep it at 45 days, while as the buyer, you will likely be pushing for 60.

Due Diligence often incurs cost in the form of bills from Accountants/CPAs or attorneys that need to get involved. Typically, buyer and seller agree in an LOI that each party will cover their own due diligence related costs. Due diligence also takes up an enormous amount of time for both sides, so buyer and seller should have a fair amount of confidence that the deal will close, before they agree to enter the due diligence period.

Due Diligence is essentially a complete audit of your business and thus often a time of anxiety for both sides. The buyer is anxious about uncovering any skeletons in the closet before the transaction closes, while the seller frequently feels like he/she is being cross-examined on a witness stand. Oftentimes, this leads to tension between the two parties. The first thing I thus always tell all of my seller clients is this: "Don't take it personal!" According to the Merriam Webster Dictionary, due diligence can be defined as "The care that a prudent person might be expected to exercise in the examination and evaluation of risks affecting a business transaction". As far as the representatives of the buyer are concerned, just taking a seller's word on everything, would not be considered being prudent. When I tell my seller clients to not take things personal during due diligence, I mean exactly that: the buyer's representatives are being paid to ask critical questions, to challenge your past decisions. They would do that to any seller, not just you, so being asked critical questions does not mean that the buyer, or the buyer's representatives, do not trust you personally, or think you are incompetent. It simply means that they are being prudent in their information gathering.

A seller should also keep in mind that due diligence lists are pretty standardized, and are also VERY detailed, often including information requests that are fairly irrelevant to the deal at hand. A typical due diligence checklist has 14 major categories, with each category having several sub-categories, so most due diligence checklists I have seen, are 10-15 pages long. This is a litigious society, so a good lawyer and investment banker will rather ask too many question, than too few. I do a lot of buy side representation and my due diligence checklist is largely identical from deal to deal. Because when it comes to protecting the best interests of my client, the buyer, there is a difference between me omitting a question because I think it is irrelevant, and me asking the question anyway but being told by the seller that it is irrelevant. So if you are a seller, don't panic when you get a due diligence checklist that goes on and on, page after page, subject after subject. Keep in mind that for many of the questions/requests, a simple "not applicable" is a sufficient answer.

Time is the enemy of every deal, and I therefore highly recommend to all sellers to be truly ready for due diligence. As mentioned before, due diligence checklists are fairly standardized, so an experienced transactional attorney or investment banker should be able to anticipate about 90% of the questions and document requests. When I'm representing a seller, I get ready for due diligence before an LOI is even on the table which means that once the buyer submits their due diligence checklist, I can typically provide the overwhelming majority of answers and documents within 48 hours. Preparing the documents and answers ahead of time also provides the opportunity to clean up any pending issues without getting the buyer involved. For example, every due diligence checklist will ask for copies of all material contracts the company has. Knowing that, as part of getting a company ready for sale, I ask my clients to provide me with copies of all material contracts and I review them for any business issues. Several years ago, while doing that, I found a 5 year old contract in one of my client's files, in which he had signed away a substantial portion of his IP to another company. When I asked my client about it, he said that this was not a big issue since this other company was owned by a friend and that they had a verbal agreement that the friend would not enforce the contract terms. Well, as you can imagine, that would not have been a satisfactory response to any unrelated buyer asking about this issue. However, given that this issue was uncovered well before a buyer started doing due diligence, we had plenty of time to have my client's lawyer draw up a contract between the parties that officially voided the original contract. His friend did indeed sign it and all was well. However, the process of voiding the contract still took about 6 weeks. Not taking care of this issue ahead of time, at minimum, would have delayed the closing of the deal.

Another issue I often see, is that smaller businesses have errors in their QuickBooks entries. Expenses that are Cost of Goods Sold show up under General and Administrative Expenses, or vice versa, inventory is not tracked properly (a common issue with QuickBooks), etc. A seller should expect that a buyer will request access to the QuickBooks file during due diligence, so the best time to correct any potential errors is before due diligence, not during due diligence.

A buyer will also check for compliance with Department of Labor Laws, OSHA, etc. So a seller should make sure that all required postings are on the bulletin board, required documentation properly filed, etc. A few years ago, I was representing buyers during an acquisition and during due diligence we uncovered that the seller's compensation policies for overtime were not compliant with MA labor laws. This made us suspicious that there might be additional issues with the target company's HR policies, so we insisted on an HR audit before the transaction could close. It also meant that we insisted on putting provisions in the Purchase & Sale Agreement that offered additional protection to the buyer and were quite disadvantageous to the seller. The HR audit did not find any additional issues, but had the seller taken care of this fairly obvious issue ahead of the due diligence, a lot of time and money could have been saved. And since we are talking about HR policies: a seller should keep in mind that a buyer will most likely interpret a lax enforcement of labor laws as a sign that he or she is in general not running a tight ship. A very obvious example of this are screen savers or calendars showing (half) nude women. You would not believe how many of those I have seen during site visits and yes, they do fall under the definition of a "hostile work environment", and are thus not supposed to be there.

An issue that often comes up during due diligence is the question of whether the buyer will have any access to employees, vendor, or customers. This can be a tricky issue as this means that those people contacted, will find out about the pending sale of the business at a time when the transaction might still get derailed. Allowing access, and thus disclosure of the pending transaction, should be a case by case decision during which a buyer’s potentially legitimate need to talk to some of those people needs to be carefully weighed with the potential harm a premature disclosure of the pending sale may do to the seller. I have seen plenty of transactions where no such access was granted by the seller, but also had some in which it was agreed that allowing the buyer to talk to certain people was a prerequisite for closing the deal. As with many other due diligence related questions and concerns, an experienced business intermediary or transactional attorney will be able to advise you on what the right decision might be, in your specific case.