Due diligence

How to review company information in the M&A process

INTERVIEWED BY ROGER VOZAR

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When acquiring a company, it's important that there are no surprises after an agreement has been signed. That's why it's critical to do your due diligence to ensure that there are no unknown problems that might arise after the closing.

"Companies that conduct a volume of transactional work — a lot of acquiring of businesses — understand the importance of getting information on the target company and assembling the proper team to review it," says Patricia A. Gajda, partner and chair of the Corporate Group at Brouse McDowell.

Smart Business spoke with Gajda and Rachael Mauk, an associate at Brouse McDowell, about what areas to look at and the potential pitfalls in the due diligence phase of an M&A transaction.

What is involved in the due diligence process?

From a business, legal and financial perspective, you look at everything in the company that could have a risk or liability associated with it.

Usually the buyer will provide a list of documents for the seller to gather, including:

- Organizational documents.
- Financial documents, including three or four years of audited and unaudited financial statements, monthly statements, any audit reports, receivables, etc.
- Contracts with vendors, customers, etc.
- Real property information such as title documents, deeds, title insurance, zoning variances and leases.
- Permits and certifications.
- Environmental testing reports, remediation records, audit information.
- Intellectual property (IP) including patents, copyrights, trademarks, trade secrets, confidentially agreements, and licenses and software agreements.
- Employee information.

You also want to investigate the company to examine past and pending lawsuits, insurance claims, product liability questions, warranty information — how often there were product warranty claims — and delve into the history.

Due diligence can play an important role in determining the final transaction price. For example, if you find out the target company you intend to buy has a $5 million lawsuit pending against it, you will want to determine if and how that will negatively affect the company, even if you're not going to take the liability for the lawsuit.

Are there things you find that might cause you to back out of a deal?

It will depend largely on your motivation for acquiring the target company. You may be buying a company because they have the latest product, which you want to incorporate into your product line, only to discover that the target company doesn't own the IP or the IP associated with the product was not protected. Alternatively, you might uncover product warranty issues that bring into question whether the product works, or review the financial records and find out it's not a profitable line of business.

It's not just attorneys who do the due diligence. A company will put a team together to look at the various segments of the business. Accountants will look at the financial statements and tax returns. If there are environmental issues, you might have an environmental consultant do additional testing.

What pitfalls do companies experience in doing due diligence?

They do not allow for adequate time for due diligence. A strategic buyer is generally familiar with the business, so it may think it already knows everything. Things can fall through the cracks, so leave enough time for adequate review, testing and follow up. The process can take from a few weeks to 30 days or more if it's a complicated business.

Typically, due diligence is done simultaneously with negotiating the purchase agreement. It might result in a purchase price reduction because something discovered doesn't add up to the price that was originally discussed. You might find there's the potential for environmental liability and seek an indemnification for that specific item — due diligence can lead to specific requests in the purchase agreement.

Once you've completed the due diligence, you're close to signing the transaction agreement and the purchase can go as planned. ●