CENTERPOINT M&A ADVISORS

Truth or Consequences in M&A Due Diligence

Due Diligence Basics

Simply put, due diligence is a buyer's examination of legal, financial, operational, tax, marketing, insurance and environmental issues conducted prior to the acquisition of a business.

We need to start with the premise that buyers are smart, sophisticated business people. Before committing millions of dollars to acquire a business, buyers will spend a tremendous amount of time, money and effort to make sure that they know what they are buying. The purpose of this article is to emphasize the importance of being forthcoming with information about your business during the sales process. Not only because it is the right thing to do, but because doing otherwise will inevitably cause problems with your transaction and can possibly derail the transaction completely. Those who hide problems during due diligence typically find the consequences to be severe, sometimes causing the buyer to pull out of the deal.

The Due Diligence Process

The due diligence process starts after the buyer and seller have signed an offer letter, called a Letter of Intent or LOI. The LOI sets forth the general terms of the deal that both parties have agreed upon, including the purchase price, structure (purchase of assets or stock), employment agreements, etc. Due diligence must be completed before a final purchase agreement is signed and the transaction is closed. A typical due diligence request list contains hundreds of items and takes a tremendous amount of planning, organization and time to complete. The buyer will hire teams of professionals including accountants, lawyers, insurance consultants, human resources firms, etc. to scour through every aspect of your business before closing the transaction. By the time due diligence is completed, the buyer will know every intimate detail about your business.

Your ultimate objective after signing the LOI is to get through the due diligence process as quickly as possible to get your deal closed at the terms that were agreed upon in the LOI.

Disclose Everything

Through the process of due diligence, a buyer will eventually find out everything there is to know about your business, the good and the bad. It is important to provide everything that is requested in a timely manner, even if a particular piece of information reflects negatively on your business. Attempting to "hide" information that is material to the transaction will only lead to problems later when it is discovered (and it *will* be discovered). It can even put the entire transaction in jeopardy. Your interests will be much better served by fully disclosing all information (positive and negative) as quickly as possible, and then having an open discussion with the buyer about how to remedy any problems with the business.

> ***By the time due diligence is completed, the buyer will know every intimate detail about your business.***

Also, be up-front and disclose everything regardless of whether or not you think the information is material to the transaction. Let the buyer make the determination of materiality. If you find yourself wondering, "Do they really need this piece of information?" send it anyway. As long as you have properly disclosed everything that has been requested, you have fulfilled your obligation to the buyer. When in doubt, provide more information, rather than less. The disclosure of very sensitive information such as customer lists can be delayed until later in the due diligence process in order to minimize the seller's risk in case the deal does not close.

(continued on reverse)

CenterPoint M&A Advisors

(continued from page 1)

Maintain Your Credibility

Maintaining credibility with the buyer throughout the closing process is crucial to getting your deal closed. During the due diligence process, the buyer will rely on your personal knowledge of the business in addition to the documents that you will provide. There is a certain level of trust that both sides need to have with each other to move a transaction forward. If the buyer at some point discovers that you are hiding something considered to be material to the transaction, you will have lost your credibility and will have put your deal at risk. From that point forward, the buyer will place a higher level of scrutiny on ***all*** information that is provided to them, which will ultimately slow down the process. Do not put yourself in a position of having to explain why a certain piece of information was not provided. It will only reduce your chances of getting your deal closed.

When to Disclose Problems

Many sellers choose to hold off telling the buyer about material problems in the business until after the LOI is signed, because they are afraid to tell the buyer something that may affect the value of the business. But as discussed above, the buyer is going to discover it anyway. If a material problem is hidden and not disclosed until after the offer is made, it is likely that the buyer will later demand a purchase price reduction when it is discovered in due diligence, and they would be justified in doing so.

A seller has the most leverage in the transaction before the LOI is signed, while several interested buyers are bidding on the company. Often, a problem that is discussed while the LOI is being negotiated, will not affect the price that the buyer is willing to pay, and it avoids the danger of it being discovered later in due diligence.

You Have Continuing Obligations

Your liability does not end once the purchase agreement is signed and the money is wired to your account. As the seller, you will sign a detailed purchase agreement which, among other things, states that you have fully disclosed the information that was requested by the buyer. If the seller did not disclose material information about the business, and the lack of disclosure had a negative affect on the business, the buyer may have recourse on the seller for a period of time after the closing. By fully disclosing all information, you reduce your risk of litigation after the transaction is closed. Remember, if you are selling your company to a sophisticated buyer such as a larger strategic buyer or a private equity group, they have most likely been through many transactions before yours and they know how to protect themselves.

Conclusion

Correcting your company's deficiencies prior to offering it for sale may be your best option, but if you choose to move forward, then make sure you disclose everything. Believing that you will be able to sell your company while hiding material problems is not a realistic scenario. If you have to hide details about your company to get the valuation that you are seeking, then your business probably is not worth that purchase price in the first place. If you don't tell the truth up front, the buyer will ultimately discover the problem, and you may suffer the consequences of a reduced purchase price or even the buyer's withdrawal from the transaction. When it comes to selling your business, honesty really is the best policy.

About CenterPoint

CenterPoint M&A Advisors helps middle market business owners sell their companies. The principals of CenterPoint use their 30 years of combined experience to aggressively negotiate the most favorable price and terms for our clients.

Please call Scott Berejikian or Chris Bandouveris at (818) 593-7907 to discuss your situation on a confidential, no-obligation basis.

www.centerpnt.com

© 2011 CenterPoint M&A Advisors, Inc.