DUE DILIGENCE: A PRIORITY

WHEN PURCHASING AN EXISTING BUSINESS

For anyone considering the purchase of an existing business, the decision to complete the transaction is often difficult and must never be made without first conducting a thorough due diligence investigation. The term "due diligence" is used in this context to refer to an evaluation of the business, legal and financial affairs of the acquisition target. There are numerous reasons for conducting a thorough due diligence investigation; however, some of the most important reasons include: (i) increasing the purchaser's knowledge regarding the target company's business; (ii) assisting the purchaser in determining a proper valuation for the target company's assets, and (iii) minimizing post-acquisition surprises.

The breadth, scope and content of the due diligence review depends on a variety of factors including the size of the transaction, the type of business involved, as well as its legal structure, be it a sole proprietorship, partnership, corporation or some other form of entity. However, irrespective of these factors, there are certain tasks which should be included on any due diligence list.

The Buyer's Top Ten

1. **Identify the seller's motives.** The business owner's decision to sell may be motivated by any number of factors including, but not limited to, retirement, illness or death, internal disputes, inadequate capital and poor market prospects. By identifying the seller's motives, the buyer obtains valuable information necessary for assessing the risks involved in the transaction, as well as for determining an appropriate valuation for the company.

2. **Review all financial records.** Review of the target companies' financial records is always a key component of any due diligence investigation because it provides the principle basis for the business valuation. The financial review should include, but is not necessarily limited to, a review of the following:

   (a) The target companies' income tax returns for at least five (5) years (if available);

   (b) Balance sheet, income and expense statements, profit and loss statements;

   (c) Current operating budgets and any forecasts of future company operations;

   (d) Schedule of notes and accounts receivable;

   (e) The most recent available schedule of accounts payable, as well as comparable data from the previous year; and

(f) A schedule of all contingent liabilities such as guaranties and product or service warranties.

Often, the financial records of many small private companies are extremely limited and in some egregious situations are totally nonexistent. In such a situation, the due diligence investigation should be expanded in an effort to obtain the financial information necessary for a reasonable valuation. Limited financial data may also impact the terms of the purchase. For example, in a business that has a large number of accounts receivable, without reliable financial statements, the buyer may want to place a substantial discount on the value of these accounts, or even require the seller to guarantee that all or some of the receivables will be collected. At a minimum, the buyer will want to conduct a more thorough investigation regarding the nature of the receivables and the customers owing the debt.

3. **Review of all third party contacts.** The contractual obligations and rights of the target entity must be identified for a proper valuation. Therefore, the due diligence effort at a minimum should include a review of the following:

(a) All franchise and licensing agreements;

(b) All sales contracts.

(c) Any joint venture or partnership agreement to which the company is a party;

(d) All insurance policies;

(e) All agency, distributor and advertising contracts;

(f) All supply contracts;

(g) All government contracts;

(h) All non-competition agreements; and

(i) All other material agreements to which the target company is a party.

4. **Review all employment contracts.** In many companies, the real value lies not in the assets, the product or customer list, but rather in the employees of the company. Therefore, the terms of all employment contracts for key employees, company retirement and benefit plans, as well as employee manuals and union contracts, to name a few, are all crucial to the success of any business venture and should be reviewed as part of the due diligence effort.

5. **Inspect all inventory.** An inspection of company inventory is obviously central to business valuation. Such inspection should also include an inspection of all capital

goods, motor vehicles and other assets needing a recorded conveyance or change of registration.

6. **Review all leases, deeds, mortgages and any other loan agreements.** Included here, the buyer should review the following:

(a) All documents and agreements evidencing borrowings by the target company, including loan and credit agreements, promissory notes, debentures and other evidences of indebtedness;

(b) All documents evidencing mortgages, security interests or loans on assets of the business;

(c) All guaranties, agreements to maintain net worth and similar agreements;

(d) All agreements confirming lines of credit;

(e) All leases of real or personal property to which the company is a party, either as lessor or lessee; and

(f) All documents and agreements evidencing other material financing arrangements including, without limitation, sale and leaseback arrangements, letters of credit and installment purchases.

7. **Review all litigation files.** Information regarding pending or threatened lawsuits involving the target company must be carefully examined. Included here, the buyer should also review any administrative proceedings, governmental investigations or inquiries, as well as any disputes involved in arbitration. All settlement agreements, consent decrees, judgments and other decrees or court orders should also be examined.

8. **Review all required government filings.** Various government permits and licenses are often required before a company may lawfully conduct business such as a sales or tax permit. The buyer should insure that all required permits and licenses have been appropriately maintained.

9. **Review all documents establishing the legal entity for the business.** The buyer should review any assumed name certificate, partnership agreement, shareholder agreement, bylaws, articles of incorporation and any other document establishing the legal structure for the target entity.

10. **Evaluate all intellectual property.** Lastly, the buyer should never forget to evaluate all intellectual property, including any patents, copyrights, trademarks, trade secrets and goodwill.

As you can see from the above list, the due diligence process can be extremely complex and often requires the involvement of several legal, financial and business professionals. Therefore, those interested in purchasing an existing business should take the prudent step of engaging appropriate counsel. There are many risks associated with the purchase of an existing business; however, with proper due diligence, these risks can be effectively minimized.

The foregoing article provides general information about the due diligence process, and is provided with the understanding the publisher and author are not rendering legal advice or other professional services by its publication. Information contained herein should not be acted upon without professional advice.