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When due diligence findings threaten a deal

<u>Overview</u>: In most business acquisitions, a seller's financial and legal representations to a buyer regarding the Seller's business are accurate. But what should business buyers do when they uncover a serious — and previously undisclosed — issue that threatens the value of their deal?

<u>Article</u>

The due diligence stage of a business acquisition is important for various reasons, one being that it gives buyers the opportunity to verify whether they are getting the benefit of their bargain. The following describes four due diligence scenarios and what actions buyers took when they determined that the seller's financial and legal representations regarding the status of the Seller's business were incorrect.

<u>Scenario 1 – The lost customer</u>

When a buyer's representative interviewed the seller's biggest customer — responsible for 25% of the seller's sales — it learned that the customer would be withdrawing its business due to a change in strategic direction. The customer had informed the seller four months previously, yet the seller did not disclose that development, which would significantly adversely affect the future profitability of the business.

Buyers typically protect themselves from this type of scenario by taking two actions. First, buyers require sellers to affirmatively state in the contract whether or not there are any circumstances that are likely to materially and adversely affect the seller's business prospects. Second, buyers require that the closing be contingent on (i) the accuracy of the seller's affirmative statements in the contract and (ii) the business not having suffered any material adverse changes to its future profitability. Such clauses cover events that occur between the signing of the business acquisition contract and the closing. In this case, the buyer was spooked by the seller's failure to disclose the pertinent information and decided to take advantage of those clauses and walked away.

<u>Scenario 2 – Key employees? Not necessarily</u>

The buyer needed an experienced management team that would continue growing the business after the deal closed, so a member of the buyer's due diligence team interviewed the seller's

CFO, its chief operations officer, and its sales and marketing director. Their answers to basic questions seemed tentative and lacking in substance. After additional diligence, the buyer discovered that all three “key employees” had been hired in the past six months to bolster the seller company’s image.

The new management team’s lack of in-depth knowledge of the business represented too much risk for the buyer. Therefore, the buyer decided not to move forward with the deal.

<u>Scenario 3 – Criminal owner</u>

Everything about the business seemed perfect — until the buyer’s attorney performed a litigation search and discovered that the seller’s owner had been convicted of a felony 12 years earlier, before the seller’s owner founded the business. During the preliminary discussions between the buyer and seller, the parties agreed that the seller’s owner would continue to operate the business after the acquisition. After the buyer discovered the felony conviction, however, the buyer believed that having the seller’s owner continue to be involved with the business would be too risky for the buyer’s comfort and the reputation of the business. In addition, the buyer worried about the accuracy of the seller’s financial statements. The buyer hired a forensic accountant to review the seller’s financial statements for signs of fraud.

After determining that the financial statements were clean, the buyer decided to close the deal but only after the seller’s owner agreed that he would have no further association with the business after its sale.

<u>End of the deal</u>?

As these cases illustrate, due diligence can uncover a wide variety of potentially damaging issues. It’s important for buyers to work with their financial and legal advisors to determine whether such problems are reconcilable or whether they signal the end of the deal.