Fundamentals of Due Diligence

By James A. Russell and Thomas J. Williams

The fact-finding exercise known as due diligence is a deeper dive than many business owners are used to taking. But, cooperating fully in it is the key to completing a successful M&A transaction.

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If there are "moments of truth" in the acquisition of one printing or packaging company by another, they tend to occur during due diligence. In this phase of the transaction, the buyer documents and confirms everything he or she has learned up to this point about the company being purchased. It's the final fact-checking exercise that verifies all of the remaining details and lets both parties proceed with confidence to closing the sale.

Due diligence usually begins once the seller has reviewed and accepted the buyer's letter of intent (LOI) to purchase. Now, most of the responsibility for carrying out the due diligence process belongs to the buyer, although as we'll see, the seller also has a significant part to play in making the process work.

The task isn't monolithic. It consists of financial due diligence, legal due diligence, customer due diligence, and due diligence applied to whatever other aspects of the seller's business that the buyer needs to verify. We advise our buying clients to draw up a list of these objectives by category. For buyers representing smaller, closely held companies, the list might run to one or two pages. But, in cases where the buyer is publicly traded, the list probably will be a good deal longer.

Assuming that the seller provides the information the buyer wants without delay, 30 to 60 days ought to be enough to complete due diligence and proceed to closing. The buyer will spend most of that time amassing and examining documents: financial records, contracts, insurance policies, payroll records, leases for property and vehicles, employee manuals, and whatever else pertains to the management of the seller's business.

Sometimes overlooked is the fact that due diligence also should identify what is to be excluded from the deal – assets that the selling owner does not intend to convey to the buyer. A company-owned car used by the seller is one example; office artwork and decorative heirlooms are others.

Neglecting this part of due diligence can lead to serious problems. We once saw a deal almost collapse on the day before closing when the buyer learned that the seller did not want to part with a vintage pickup truck that the company would routinely lend to a large retail customer as a prop for store openings. The buyer wanted to continue doing that for the customer, but the seller balked at handing over the vehicle. Only after the buyer had increased the offer by the value of the truck could closing finally take place.

Fortunately, misunderstandings like this one are rare. In the normal course of due diligence, the buyer avoids surprises by engaging accountants, lawyers, and other professionals to assist in the review.

Since multiple people will be scrutinizing the material, it's best to have as many of the documents as possible in electronic form. That way, the seller can set up a "virtual data room" where authorized personnel can readily access the information they need to conduct their portions of the due diligence process.

Apart from, say, a meeting with the controller, due diligence typically doesn't involve contact with the seller's staff. At this stage, only a handful of people on the seller's side will know that a transaction is in progress, and it's essential to maintain that confidentiality until the process is complete. Leaks can scuttle deals, and due diligence is the worst possible place for them to spring.

The time for disclosure comes when the buyer is satisfied with the information gathered and both parties are ready to sign a contract of sale to consummate the deal. Now the buyer can meet with customers and suppliers to keep relationships intact, and with employees to offer the reassurance that these stakeholders will expect.

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It should be obvious that due diligence must be organized and methodical if it is to achieve its intended result: revealing to the buyer everything that's crucial to know about the company he or she proposes to buy. Quarterbacking the process to keep it moving is the buyer's primary task as the documents come to hand and a fully articulated picture of the seller's company begins to emerge.

It's up to the buyer to identify, request, and review the source materials. The seller's job is to furnish them promptly and to answer any and all questions that arise in connection with them.

The experience won't always be comfortable as the buyer probes for answers that the seller may not have thought about for a long time, and may have difficulty coming up with. It's a deeper dive than many business owners are used to taking, but cooperating in it is vital to both sides.

Since the final value of the deal will be tied to the quantity and quality of the information provided by the seller to the buyer, there are no substitutes for candor and transparency in the due diligence phase. We frequently have to remind sellers that they likely are making the largest sales of their entire lives and that they shouldn't get annoyed or upset by questions from the buyer that might seem superfluous.

Advisement by M&A professionals goes a long way toward maximizing the efficiency of due diligence. An adviser can help the buyer strategize the process by pinpointing the documents to gather and the questions to ask. The adviser also can set up the "virtual data room" and keep the fact-finding moving ahead within the time frame set for it. Sellers as well as buyers can ask advisers to steer them through due diligence: the objectives, after all, are the same.

It's interesting to note that many people use the expression "due diligence" informally to describe any activity where it makes sense to cross t's, dot i's, read the fine print, and just plain get the facts straight. For buyers and sellers of printing and packaging companies, they're words to live by – and to seal mutually rewarding deals with

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