Chapter 13: Buyer/Seller Due Diligence

Due diligence is conducting an investigation in order to support the purchase price of the business. From the standpoint of the buyer, he wants to be assured that he is not paying too much and that there are no surprises. The seller wants to know whether the buyer will perform and repay debt and understands the tax consequences of the transaction.

Introduction

Due diligence can vary depending upon whether the target company keeps records based upon a cash or accrual basis. In cash basis accounting, all transactions and taxes paid are according to one's real-time cash flow. Cash income begins when you receive it, and expenses are paid as they occur. The accrual accounting method charges income and expenses to the period to which they apply, regardless of whether the cash has been received. Accrual accounting must always be used if the business involves nonperishable inventory.

Buyer Due Diligence

Buyers want to accomplish the following during due diligence:

- understanding how the business works
- whether the seller is accurately representing the assets, liabilities and financial statements
- whether there are any surprises in the near future such as a downturn in the industry, major customers going bankrupt, top sales persons leaving, etc.

Obviously, if due diligence does not support the valuation, then there would be a disconnect between the buyer and seller and there needs to be a reduction in the price of the business.

This section will discuss the business operations and financial impact of these operations through a review of the balance sheet and income statements (profit/loss statement). Many of the financial ratios have already been discussed in Chapter 2 and will be referred to throughout this chapter. This review is not intended to be comprehensive. As always, one would be better served by retaining a great CPA who has previously done due diligence of small companies and is possibly a forensics expert.

Due Diligence Stages

There are generally three different stages to performing due diligence:

- an initial walk-through and interview with key personnel
- gathering data
- a final walk-through and review of things that have changed since the initial walk through.

Obviously these stages depend upon the size and complexity of the business.

Like most things in life, intuition can be valuable in gathering information. Buying a business is no different. Data revealed during one of three stages may terminate any further investigation.

During the first stage, the owner would release some financial information and give an overview of the operation. Obviously the buyer wants to receive all of the information upfront. However, many business owners may not relinquish certain information, believing that such guarded information would give them an edge over their competition.

When walking through the plant or office, a close eye should be kept on the employees and the real estate facility. Do the number of employees stated show up on the floor? Are they busy at work or are idle? Is there a sense of productivity? Do a mental headcount on employees. Is garbage being piled up. Sometimes a large number of the work force will get terminated prior to a sale, in order to reduce expenses and thereby show increased earnings. Sometimes, a walk-through can be more informative than weeks of reviewing financial statements. Many business owners are reticent to allow an interview with their key employees. The buyer should suggest that the owner be present in order to reduce any apprehension by the seller.

The second stage is a hard review of the financial statements and some of the information described in the business checklist seen earlier in Chapter 2. The last stage is simply tying up the loose ends. Finally, personnel and management should be interviewed.

Operations

Line of Business

In many cases it is difficult for the buyer to figure out exactly what the company does, who are its customers, and why this company is different from other competitors in the same industry. The seller typically speaks about the company business in an industry in a broad way rather than in a more exact manner. It is important to have the seller break out both the specific service or product provided, and also the area of specialty and any related areas in which the company competes. Identifying where the company fits into the business food chain is important to understand.

Real Estate and Leases

Leases are generally looked upon lightly by buyers, but for small businesses, leases are very important. For retail operations, an increase in the rent can reduce the cash flow and make a profitable business unprofitable, much less desirable or impossible for resale. If the lease terms are unfavorable, the buyer should search for another business opportunity with more favorable lease terms. The lease agreement should be read first before the buyer expends any time and energy on walk-throughs and reviews of financial statements. Is there percentage rent? How long is the term? Are there options? The buyer should not rely on the seller's verbal representations regarding the lease terms of the lease agreement since the seller may not be fully aware of all of the terms.

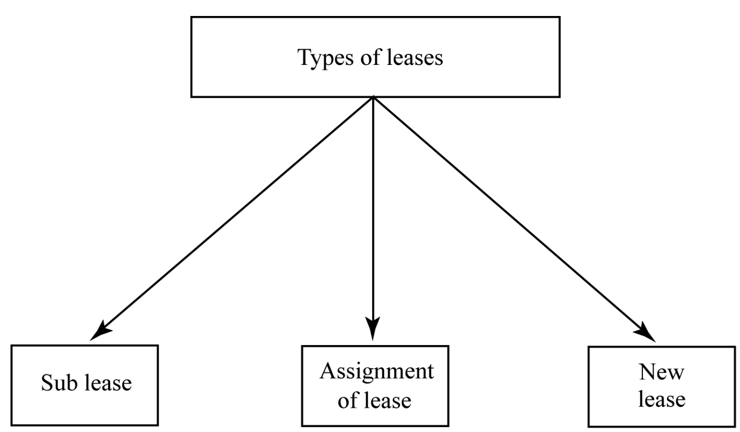
When a business sells, there are three different lease structures that a buyer and seller can work out:

(1) a sublease

(2) an assignment of lease

(3) a new lease with the landlord (lessor)

Figure 13-1: Different Types of Real Estate Lease Structures



These three methods of transferring lease rights are critical and should be reviewed with an attorney. Regardless of the method of transfer of the lease, the buyer should obtain an *estoppel certificate* from the landlord. This would certify that the seller does not owe any back rent, and that the landlord has no claims against the seller.

From the seller's standpoint, a new lease between the landlord and buyer generally gets the seller off the hook. If a new lease cannot be obtained, then the seller has to decide whether he or she should sublease to the buyer or assign the lease. The pros and cons of all three methods can be seen in Table 13-1.

Table 13-1: Pros and Cons of Different Real Estate Lease Structures

	Advantages	**Disadvantages**
Sublease	Gives seller control of the lease since buyer will be leasing from seller. The seller is in a "sandwich" position between the buyer and landlord.	Seller is tied to the lease and is still obligated to pay the landlord; seller must collect rent from buyer.
Assignment of Lease	Most common way of transferring a lease; can be used for seller protection against liability.	Same as sublease in that seller is still on the hook if buyer defaults on rental payments; Seller assigns all rights in the lease to the buyer. Therefore, if buyer defaults, seller can take back business but cannot enter the premises or building. This would make it difficult for the seller to take back the business if the buyer blocks the seller entering the premises; some states do not recognize assignments as an interest in real estate.
New Lease	Releases seller from being responsible for lease; allows buyer and landlord to draft a new lease; sometimes allows for longer terms than the existing lease.	Takes longer to draft lease; complicates the sale of the business; buyer may renegotiate lease which may be unfavorable to seller, due to cash flow issues, collateral, or other agreements between seller and buyer; makes repossession of the business by seller difficult if buyer defaults to seller.

Aside from the lease sellers may also sell their real estate which houses the business. However, most buyers want to buy the business and not tie up their working capital with buying the building from the seller. If the seller wants to sell the building, he or she should try to sell the real property separately from the business, assuming that the buyer does not want the property.

Restrictions on Transferring Existing Financing

Restrictions on transferring existing financing can be just as problematic as transferring leaseholds. In many banking and financial contracts there are restrictions on asset sales. As a result, any transfer would be difficult. The buyer should not accept the seller's representations regarding financing and should personally read the loan documents.

Sellers oftentimes have notes due with a bank for machinery and equipment, which have not been paid back. In addition, there is usually a personal guarantee by the seller to the bank. Sometimes accounts receivable, inventory, or patents may also be pledged as security.

UCC- Filings

The buyer should determine the nature and extent of any debts, incurred by the seller's business. Pursuant to the Uniform Commercial Code (UCC), many states and counties record filings by creditors who claim an interest in a given business. The UCC filings are similar to recording title in real estate. The county recorder's office and secretary of state keep these filings as public records. By reviewing these filings a buyer may gain insight into the debt history of the business. The buyer should review all filings under the name of the business owners and "dba"s (doing business as). The filing will describe each asset in which the creditor is claiming an interest.

UCC filings are designed to give notice to anyone thinking of loaning money to the company or individual. In essence, the filing establishes a priority of claims, and says to other individuals that, "We get paid first if anything goes wrong." It is similar to recording title for real estate. Generally, the first to record is the first in line. *It must be remembered that all UCC filings are for secured borrowings and do not represent unsecured borrowings.* The term "secured" refers to an obligation which is secured by a given asset.

Remember that these filings are not full proof. I have a friend who bought some copying equipment after checking for all filings. Everything seemed clear until he got a knock on the door from Xerox who wanted their machines back.

Sometimes a seller may suggest that the buyer and seller not notify the bank of the pending sale of the business. This is unwise. A seller may suggest that the buyer pay the seller, so the seller can route the check to the banker. This arrangement may work until the lender finds out, and lenders always do. The lender will then ask for repayment of all loans. This is like a huge balloon payment. It may bankrupt the buyer. Once again, read the documents. Sometimes a bank will approve a loan assumption for a fee, but this can be a hassle.

Customer Relations and Vendors

Reading documents is simple compared to the task of sifting through the seller's relationships with vendors and customers.

With respect to vendors, the buyer should examine the existing terms which are offered by the vendor to the selling company. Is the seller on COD (cash on delivery)? Pulling the credit report on the target business will confirm this. The bad credit rating may be a good bargaining chip for the buyer if he can re-negotiate better terms with the seller. A pivotal supplier may indicate that he would never give credit terms as long as the seller is the owner. This is an example of bad will.

How diversified are the vendors? Are there other vendors which have relationships with the business. In addition to having a diversified customer base it is important to have backups in case a vendor files for bankruptcy or sacrifices quality. The buyer may have to visit the key vendors to guarantee a continuation of favorable terms.

Much can be written on maintaining customers. However, three items are important to note: