

ROBERT G. HUTCHINS – LEGAL ESSAYS

Buying Private Companies, Subsidiaries and Divisions - Part II - Identifying, Investigating and Analyzing the Target.

Preliminary Note

Public companies report a continuous stream of detailed information about their financial position, operating results, material successes or reversals and future prospects. The information is assessed and discounted within minutes by the securities markets. The resulting data base permits informed valuations to be made of these companies, without obligation, by persons interested in acquiring them. When public companies are "put in play," whether by their own directors or through a hostile tender offer, the ensuing bidding is conducted under rules of engagement that are widely accepted as fair and in any case are settled and therefore predictable. Bidders have access to relevant information, and an opportunity to submit purchase offers, on an equal basis.

Private companies, subsidiaries and divisions, by contrast, are operated in secrecy. Potential buyers may pursue opportunities to acquire them only through direct contact with their owners, or with intermediaries the owners have engaged. There is little opportunity prior to that contact for a buyer to initiate a transaction. When the owners are able to control the bidding process, which often is the case, there are no reliable means for a buyer to assess competing bids, or determine whether all bidders are being treated equally. The buyer must conduct as thorough an analysis of the target as the circumstances will permit, make its offer and hope for success.

The buyer's analysis requires access to non-public information about the target, much of which will be viewed by the owners as confidential. Yet, unless all such information is provided, a buyer is in no position to frame more than a hypothetical acquisition proposal. The resulting impasse is bridged by preliminary documents setting out the ground rules for the buyer's investigation. As a minimum, the buyer is pledged to secrecy respecting sensitive data. There are usually additional protective undertakings the buyer may purchase before conducting the investigation, but they all involve varying degrees of risk. If the buyer purchases an option to acquire the target, for example, it can exit the transaction without stating cause, but the option price will be forfeited. If the investigation shows the exercise price is too high, the option is useless anyway. Buyers rarely know enough when negotiating an option to establish an exercise price with much confidence.

If the buyer forgoes an option in favor of a "non binding" Letter Of Intent that outlines proposed terms but disclaims an obligation to purchase, the buyer will avoid the cost of an option but the owners will disclaim an obligation to sell. In any case, the cost of the buyer's investigation may be substantial and it will be lost if the transaction does not close.¹

This Essay summarizes the methods used, and the problems typically encountered, in the buyer's effort to identify, investigate and analyze a privately held target.

The Identification Process - Establishing A Profile For the Target

Buyers of private entities must be aggressive when searching for targets, efficient when pursuing a closing and quick to abandon unpromising negotiations in favor of other opportunities. To acquire the necessary agility, buyers must first establish the desired and *attainable* attributes of the target. That process involves much more than deriving a profile from an acquisition wish list, compiling general information about relevant business segments or analyzing existing relationships with comparable firms. Here are examples of fundamental questions that should be considered carefully by any buyer before it enters the marketplace:

- **Financing Questions:** How large an acquisition can the buyer actually finance? The failure to obtain a clear answer to that question has frustrated many transactions in mid stream. The acquisition price negotiated by the parties is often based upon assumptions about post-closing business synergies and cash flow that are not shared by the buyer's lender. What is worse, the lender's seemingly arbitrary rejection of the assumptions may actually reflect its lack of confidence in the ability of the buyer to absorb the acquisition and operate the target successfully after the closing. That is something loan officers are understandably reluctant to mention directly. I recommend an early and frank discussion with lenders about this subject during which, if necessary, the buyer itself can raise the difficult issues. The resulting financial guidelines will provide an invaluable reality check later when actual negotiations are in progress.

- **Structural Questions:** The acquisition of a private target can be structured as a purchase of assets, a purchase of stock, a merger or a consolidation. The acquiring entity can be the buyer, an existing subsidiary or affiliate, or a new

¹ Buyers and sellers alike are often confused about the consequences of purportedly "non binding" Letters of Intent. See this Website, Publications, Essays, *Letters of Intent in Business Acquisitions. Problems, Risks, and a Mechanical Solution.*

entity specially formed for the transaction. The variations are endless. The structural objectives of buyer and seller will often collide. From the perspective of the buyer, what structural elements are either indispensable (e.g. those necessary for risk management or regulatory compliance), or important determinants of the price (e.g. tax treatment)? Are there special structural issues that are apt to be important to some owners but not to others (e.g. "ego" issues such as post-closing executive titles and business names)? How, in light of all relevant factors, should the buyer's structural goals be prioritized?

- **Negotiating Questions:** Who are the owners of the known potential targets? Their circumstances and probable level of sophistication should be taken into account when the buyer assembles its negotiating team. Sometimes the target is a division or subsidiary of a large corporate parent. The "owner," accordingly, will be represented by executives and advisers who have substantial merger and acquisition experience. For the obvious reasons, that environment tends to reward buyers who staff their teams with experts having a sound grasp of technical issues who can hold their own through each thrust and parry of the bargaining.

If the target is an independent company, on the other hand, the owner may be both inexperienced in acquisition practice and burdened by a great deal of stress. The sale may have been prompted by the imminent retirement of an owner who was also the company's founder, with all of the mixed emotions that circumstance entails. The sale may also have been prompted by a catastrophic illness of the founder, or by an overwhelming financial reversal at the personal level. Multiple owners may disagree among themselves about the minimum selling price and terms, or about whether any sale at all is appropriate. The owner's representatives can hardly be expected to disclose these internal pressures or conflicts voluntarily. Buyers whose own representatives can discern them, and empathize with the owners afflicted by them, have a significant negotiating advantage over their less sensitive competitors. In this environment, the buyer's representatives must be willing to put aside their Harvard MBAs and financial models long enough to establish personal relationships with the owners and gain their confidence.

Operating Questions: Are there products, distribution channels or facilities of the target that overlap or conflict with those of the buyer? Is the operation of the target after the closing likely to be impeded by cultural issues? Can the buyer really duplicate the widget that has been manufactured successfully by the target for many years? I am convinced that the ability of the buyer to operate the target after the closing is often the most important factor in the success of an acquisition. From what I have been able to observe, the most dangerous enemy of an otherwise sophisticated buyer is its own hubris. The most valuable attribute is a healthy respect for the unique and often subtle challenges presented by the target's business.

Conducting the Due Diligence Investigation -Analyzing The Target

The buyer's preliminary information about the target will be derived from sales brochures prepared by the target's brokers or other representatives. Brochures vary widely in quality. Some of them are too cursory to provide a meaningful summary of the target. Buyers wishing to inquire further must resort to supplementary questioning to determine whether the target's overall size, product and geographic markets, financial performance and proposed sale structure fit the buyer's acquisition criteria and justify the opening of formal negotiations. When such questioning is necessary, it should be designed to elicit only the basic information that has been omitted. The buyer should not attempt, at this stage, to obtain premature and unprotected disclosure of confidential or otherwise sensitive information. The buyer should also avoid phrasing questions in a way that disparages the brochure or its authors. These seemingly obvious precautions can be difficult to execute, but if the questions are asked tactfully, the owners will usually be willing to answer them promptly and informally. If not, the buyer can find itself out of the running very quickly.

If the parties enter negotiations, the importance to the buyer of its ensuing "due diligence" investigation cannot be stressed too much. When the target is a private enterprise buyers must be particularly sensitive to the perils of a superficial review. Though they may be stunningly successful, most private companies are managed informally. Their journal entries, employee and general business records, forecasts and other planning documents are often cryptic, their financial reports unaudited, their "know how" largely unwritten. That does not mean there is little to investigate. It means that buyers cannot rely upon the *documentary* history of these companies. The history exists. The fact that it is not recorded increases the analytical burden.

Furthermore, buyers should not accept at face value the verbal reports and explanations of events provided by company owners and executives. I do not suggest those persons mean to deceive, but they do have a stake in the outcome of the transaction. They also tend to assume the buyer possesses much more information and relevant knowledge than is actually the case and they often neglect to disclose risks they have long accepted as a fact of life apparent to anyone.

Even when the target is owned by a publicly held corporation information gaps persist. The consolidated financial statements of such corporations do not normally treat their subsidiaries as stand alone entities. The assets, liabilities, contingency reserves, general overhead and capital expenditures affecting a subsidiary are usually reported at the parent level. The impact of those entries upon the subsidiary itself must be gleaned from footnotes and supplementary schedules.

The basic task of identifying the employees, assets, liabilities and operating results properly attributable to a subsidiary can be extremely difficult.

"Due Diligence" investigations, sometimes called "acquisition reviews," are usually conducted in two phases. The first phase deals with the financial and business aspects of the transaction. It is conducted by the Buyer's accountants and executives and is designed to ensure that the Buyer does not overpay for the target. Phase one usually follows an exchange of preliminary information authorized by a Memorandum of Understanding or Letter of Intent and it is completed prior to the signing of a formal Acquisition Agreement.

Phase two consists primarily of a legal rather than a financial or business audit. It is launched with the signing of the Acquisition Agreement and continues to the Closing. Obviously there can be considerable overlap between these phases in a given transaction. Here are observations applicable to both of them:

- **Financial Statements and Related Warranties:** Financial statements are prepared for *general-purpose* users. Generally accepted accounting principles ("GAAP") require only that the statements for a given company present fairly, in all *material* respects, the financial position and results of operations of the company *considered as a whole*. Auditors make assessments of materiality both to determine fair presentation and to consider the scope of the audit in the first instance. They balance the cost of investigating a potential adjustment against the benefit of a thorough analysis of the relevant line item and any added disclosure, *to a general-purpose user*. In the absence of an express contrary acknowledgment, their duty to exercise professional judgment, ensure fair presentation and provide adequate disclosure is owed to the *company*, not to its buyer.

Auditor's judgments about materiality can produce unsettling results for a buyer whose interest in the financial statements of a target is *specific* rather than general. For example, the auditors may have concluded that a variation of \$100,000 in the net earnings of the target is not material to a general purpose user of the target's financial statements because average net earnings for the past 5 years have been high enough that a variance of \$100,000 in any one year would not change the general financial impression of the target considered as a whole.

Suppose, however, that a Buyer offers a purchase price for the target calculated at 15 times net earnings for the most recent fiscal year. A materiality threshold of \$100,000, which the auditors have concluded is appropriate under GAAP, would permit the auditors to "pass" (not make) a potential adjustment that would have reduced net income by \$100,000 for that year. If in the interests of complete accuracy the adjustment should have been made, the unwitting Buyer will pay \$1.5 million more for the target than planned. If in the Acquisition Agreement the owners have represented only that the target's financial statements conform to

GAAP (which is often the case), the buyer will have no recourse when it discovers its error. The related warranty will not have been breached.

- **Recognizing Signs of Trouble:** A primary symptom of a troubled acquisition is the emergence after the closing of adverse facts about the target that the buyer did not anticipate. The target may be threatened suddenly by claims, equitable liens, or contractual commitments that were neither disclosed nor discovered. The target's customer or supplier relationships, credit lines, insurance policies or leasehold interests in facilities, on all of which the buyer relied, may be terminated, or must be re-negotiated at increased cost because of a failure to obtain advance approval of the acquisition. The post-closing operations of the target may be hamstrung by the unanticipated departure of its key executives, or by an intractable culture clash between the employees of target and buyer. Although no system is fail safe, there are two steps that should be taken during the investigation to plug gaps in the documentary record and minimize the risk of post-closing surprises. *First*, the buyer should identify any pre-closing *events* that might give rise to claims. To frame the search, the buyer should consult with counsel about the statutory limitations periods for the assertion of relevant *classes* of claims. *Second*, the buyer should obtain third party verification of questionable or unconfirmed facts or assumptions whenever possible. With those steps firmly in mind the buyer can ask appropriate questions. For example:

- Has there *ever* been any hazardous or toxic substance stored, used, or spilled *by anyone* on real estate owned or leased by the target? Has there been any correspondence concerning the real estate with any environmental, zoning, or permitting authority? Has the real estate been surveyed recently? Can the target find the permanent boundary markers? Can the target provide the buyer with title insurance for the real estate with "extended coverage" insuring against claims for encroachment and against liens for improvements on the property, or easements for its use, allegedly acquired on equitable grounds or by adverse possession? Has there been construction completed upon the property recently as to which statutory liens for labor or materials might still be filed?

- Which employees have been terminated by the target over the past several years? What was the cause of the termination? Was there an exit interview? Is there a personnel or correspondence file for the terminated employee?

- Has the target received complaints from important customers or suppliers? Are there other complaints that, though not significant in themselves, suggest a general fall off in product quality or customer service? Do the financial statement schedules or underlying journal entries show significant reductions in or alterations of buying or selling patterns?

- Has the target exhibited a cavalier attitude toward certain aspects of its business? Does the litigation history of the target (easily obtained through reporting services) show a pattern of actionable conduct? Do the pleadings filed in past lawsuits reveal potentially adverse facts about the target's business practices?

- Can the target obtain verification directly from the third parties involved of the good standing and enforceability after the closing of major financing, sales and supply contracts, leases, distribution agreements, licenses, franchise agreements, insurance policies, collective bargaining agreements and executive employment agreements? Can the third party verify that the agreements the buyer has examined constitute *all* of the agreements entered between the target and the third party?

- Can the target obtain current tax clearance, good standing, inspection, or compliance certificates from public authorities having jurisdiction over its business? Has the buyer examined all of the target's audit or correspondence files with those authorities?

- Can the buyer assume that the strategic and operating plans of the target reflect the objective, best judgment of the target's executives? Has senior management of the target set unrealistic sales goals, for example, that might taint the revenue forecasts prepared by compliant junior executives? What is the track record of the target for forecasting accuracy?

- Have there been changes in accounting methods, deferred capital or maintenance expenses, unusual fluctuations in inventory levels or turnover, or disagreements with, resignations or terminations of outside accountants within the last 5 or so years?

- Do the interviews with the target's employees suggest problems with morale? Do the interviewed employees feel they are *permitted* to do their best work in light of the workplace rules, manuals and culture developed by the target? Are they proud of the target and their contributions to it? Do they seem to respond well to the buyer's representatives? Are the representatives the same people who will work with the employees after the closing?

- **Two Common Mistakes:** Comprehensive checklists for investigating a target are easily obtainable and should always be consulted. They are a useful tool for organizing an investigation and making certain that all significant areas of inquiry are covered. Slavish reliance upon them, however, is a common error committed by even the most conscientious of buyers and it can be fatal. In the final analysis the investigation should enable the buyer to identify those conditions

that must continue to exist, or must be established, for the target to be successful. The identification process involves *interpreting* data, not merely collecting it.

The buyer's senior executives should set aside time prior to the closing to remove themselves from the day to day investigative routine and review first hand impressions in an atmosphere of quiet contemplation. It is often desirable to have trusted outside associates, consultants or advisers participate in the review. The personnel who gathered the facts may be too close to the investigation to appreciate its overall significance.

The pressures of time and the desire to control acquisition costs often lead to a second basic error; the exclusion of experienced counsel, accountants and other advisers until late in the investigation. Buyers should realize that the fees of those experts are likely to be *increased* by eleventh hour involvement and by the need, which often is present, to undue or ameliorate an unacceptable contractual obligation, tax position, regulatory posture or price formula affecting the target. *Of all the mistakes a buyer can make in a business acquisition, the skimping of the due diligence investigation is probably the most common and the most easily avoidable.*

- **Dealing With Adverse Facts:** Buyers may discover adverse facts about the target, including facts that were misrepresented or deliberately omitted by its owners, at any stage of the transaction, both prior to and following the closing. If the investigation shows the target simply failed to measure up to agreed criteria and the failure is discovered in time, the buyer can exit without closing citing those provisions of the Letter Of Intent or Acquisition Agreement that, under the circumstances, give the buyer that right. The more difficult questions arise when potential adverse facts are discovered but not confirmed and the buyer's potential recourse is in doubt. To preserve the primary benefits of the acquisition, the buyer may be tempted to remain silent, close the transaction and rely later upon its contract remedies.

The available remedies, however, will vary widely depending upon the language of the documents that have been signed, the buyer's reliance upon the documents, the timing of the discovery of the adverse facts and whether the Buyer was really misled by the owner's failure to disclose them. The salient point here is that a Buyer that remains silent can find itself deprived of any remedy at all. This is no time for gamesmanship. A buyer that discovers something amiss with the target during its Due Diligence investigation should *always* disclose its discovery to the owners promptly and in full. The best opportunity to cure the problem, or re-

negotiate the acquisition to accommodate it, is presented before the target and the purchase price have changed hands.²

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² For an expanded discussion of this phenomenon see this Website, Publications, Essays, *Selling Private Companies – Part III – Representations and Warranties in Acquisition Contracts*.