Cherin Law Offices, P.C.

From Start-Up to Exit and Everything in Between

# Selling your Business – Step 2 Preemptive Due Diligence!

Step 1 for Selling your Business was to Assemble the Team (M&A advisors - attorneys, accountants and investment bankers). [link to first article].

Typically, in due diligence, the buyer and its advisors review your business' legal and financial records, contracts, obligations, personnel, intellectual property and information technology, and other issues. Often, after the euphoria of signing a letter of intent or term sheet comes the tedium of responding to the buyer's multiple-page due diligence request. It is part of the process and cannot be avoided. In fact, one CEO observed that the due diligence process is a continuation of the negotiations. If it goes smoothly, fine; but, if it uncovers any issues (or is disorganized), the price may get renegotiated. Remember, NO DEAL GETS BETTER AFTER THE LETTER OF INTENT.

We suggest you get ahead of the process by doing preemptive due diligence even before you offer your business for sale.

Your M&A advisors can provide a typical due diligence request list. By doing preemptive due diligence with your own M&A team, you learn what the buyer's team will see, and you can address problems in advance. We hate it when the buyer's advisors ask the seller's advisors about a particular contract term that the seller's advisors never saw.

- In one instance, the seller's software was poorly documented. Preemptive due diligence would have spotted this issue and solved it before the buyer flagged it. So, rather than scramble to create acceptable documentation during the transaction, the company's CTO could have handled the documentation issue in advance.

An area that requires special focus is "title" to intellectual property:

- Do your licenses cover the current and anticipated business activities?
- Has everyone (employee and contractors) who contributed to the company's intellectual property assigned their rights to the company?
    - If not, this is an important item to track down.

In another situation, certain patented technology formed the core element of the client's extensive business activities. In review, the team saw that the technology license for the patent expired before the patent. So, this company either had to buy the underlying technology or negotiate a license for the remainder of the patent. If the client had failed to do that, a potential buyer would have gained leverage, as it could have negotiated the license extension directly. Or, this item could have killed the deal.

As the accountants and investment advisors review the financials, they can identify items that are out of balance with industry norms, such as slow-moving inventory. With that information, the seller can determine whether to change certain practices or have an explanation in place, such as, "We keep an inventory of all these old parts in case someone needs one, as then they may think of us for their larger orders.

- Are all of the seller's contracts assignable without consent?
- Is consent needed in a merger, a stock sale or an asset sale?
- Understanding what may not be assignable will allow the seller to know where consents will be needed and to prepare for any problems.

One client reported (after we reviewed the consent issues): "We were selling [to a very large multinational company] a $20 million local operation. Steve recommended a merger rather than a sale. He then proceeded to convince us and, then, he was able to convince the multinational that it was the most sensible way to proceed from a risk and tax position for both entities." Where dozens of consents were needed in the proposed asset sale, only two were needed in the merger.

At the very least, after conducting preemptive due diligence, your information will be well-organized. This will allow you to keep the information up-to-date and to respond quickly on a well-informed basis to the buyer's due diligence list, which, in and of itself, will make a good impression.

I'm interested in hearing about your experiences – reply to this post or contact me at steve@cherinlawoffices.com.

If this interests you, stay tuned. Next month, I will share Step 3.

DISCLAIMER: The information presented is not legal advice and does not create an attorney-client relationship.