Due Diligence

By Stuart M. Bordman

One definition of due diligence is “reasonable steps taken by a person in order to satisfy any legal requirement, especially in buying or selling something… a comprehensive appraisal of a business undertaken by a prospective buyer, especially to establish assets and liabilities and evaluate its commercial potential.”

I view due diligence as having three components: financial, legal and business. A sophisticated buyer will request his accountant and attorney to handle financial and legal due diligence, respectively, while the client himself may undertake the business portion of the due diligence inquiry.

The accountant has the burden of making certain financial information presented by the seller, is materially correct in all respects; all tax returns have been filed and there are no undisclosed liabilities. The buyer may ask the accountant to expand the scope of his due diligence and evaluate, for example, the seller’s accounting personnel and procedures; payroll system and computer system.

The attorney also attempts to determine if there are undisclosed liabilities by conducting a uniform commercial code search; litigation search and a tax lien search. The attorney’s due diligence also includes reviewing any contracts to which the seller is a party. If the buyer is acquiring stock the attorney must review leases and other agreements to see if they contain a “change in control provision”. A change in control is tantamount to an assignment and if a lease, for example, contains a change in control provision consent of the landlord must be obtained even if the buyer is purchasing stock.

In some business settings post termination agreements not to compete with key employees of seller are essential. The attorney must review the same to see if they are enforceable.

The business component of the due diligence process is dependent upon the nature of the business. In a manufacturing business the buyer will review purchase orders; inspect equipment; meet the seller’s key employees and examine numerous other aspects of business.

Regardless of the steps taken in connection with the due diligence process goal is the same: no surprises. The last telephone call an attorney or accountant wants to receive from his client is one in which the client asks “why didn’t you tell me?”