

Mergers and acquisitions

Due diligence identifies risks, opportunities. **Interviewed by Dale W. Hlaves**

When a company begins the process to hire new talent, due diligence concerning the candidate is very important to make sure the right person is hired. It is equally important for a company to conduct due diligence during the merger-and-acquisition process.

"The primary function of due diligence is to identify the assets, liabilities, risks and opportunities of a particular transaction," says Dan Lampert, partner at Berger Singerman. "Any business acquisition creates some risk and exposure to the undisclosed liabilities of the acquired business. Due diligence seeks to identify those undisclosed liabilities and assess the other risks and opportunities of each proposed transaction."

Smart Business talked with Lampert about the importance of due diligence.

Whose responsibility is it to conduct due diligence?

The seller needs to complete its due diligence to prepare disclosure schedules for the acquisition agreements, and these disclosure schedules frequently control the pacing of the transaction documents. The seller prefers not to sign the document until it can complete the disclosure schedules, and therefore the seller's principals give priority to this effort.

On the other side, the buyer's and lender's principals will not commit to the transaction until completion of due diligence, so they provide the impetus to their professional's due diligence efforts.

Is there a standard format for due diligence?

We use various formats and checklists for each due diligence process. But like all corporate law forms, these only provide a convenient starting place for the process. Each acquisition has unique risks and other characteristics, and a particular size and level of complexity. We have to adapt the due diligence processes, checklists and forms to suit the particular needs of each transaction.

What principal areas require the most time for due diligence?



Dan Lampert
Partner
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Generally, the most time-consuming areas of concern are environmental due diligence and review of contracts, including leases.

For various reasons under environmental law, an asset buyer must perform due diligence to attain a defense to potential environmental liabilities. Acquisitions that involve real estate therefore generally require Phase I or Phase II environmental audits.

Review of contracts also takes a lot of time because the buyer in an asset deal or a stock purchase deal either takes an assignment or assumes most of the contracts of the acquired business, and also needs to understand the liabilities created by the contracts that the buyer does not purchase. These contracts include leases, purchase and supply agreements, employment and other labor contracts, computer agreements, intellectual property licenses — and this all amounts to a mountain of paper or computer pixels. The due diligence teams must sort through all that material not only to understand the terms of the contracts but also to discover potential problems.

What are the other areas of concern for due diligence?

Due diligence commonly focuses on the

downside, on undisclosed liabilities and assessments of various risks raised by an acquisition. However, due diligence can also assume importance in assessing a transaction's upside and chances for future growth and profits.

The seller of a business commonly touts the upside growth potential of that business. Due diligence can flesh out, validate or disprove those points. For example, a business that relies on intellectual property values (patents, trademarks, etc.) requires due diligence (for example, obtaining a patent search or opinion) to determine the strength of those assets.

In the public company arena, Sarbanes-Oxley greatly affects due diligence. If the buyer is or plans to become a public company, it must ascertain the difficulty and cost of bringing any acquired business into compliance with Sarbanes.

A public company making a material acquisition must report the acquired business's audited financial statements in an 8-K report, which can also form an obstacle to acquisitions of businesses that have not obtained audits.

For how long are the results of due diligence valid?

Due diligence has a shelf life that varies from enterprise to enterprise. A computer software company's technology might turn over twice in one year; a widget manufacturer's twice in a lifetime.

Transactions that take time, such as public transactions that require a proxy statement, can put a wrinkle in that shelf life. A merger proxy requires an SEC review process. A public-company buyer may also seek to register stock issued in the deal as part of the proxy process. These processes can take several months, and holding the shareholder meeting after SEC clearance can take another month. In that context, the buyer stages its due diligence so that its results will be current at the time of the shareholder meeting, which is generally a few days before the close of the deal.

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