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Materials for a Presentation by
Sandra Sbrocchi, McMillan LLP
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Written by Sandra Sbrocchi and Timothy Cullen, Student-at-law

Preparing Your Company for a Due Diligence Exercise

Due diligence is a key step in any purchase and sale of a business. For the purchaser, the due diligence process is a way to identify potential "deal-killers" or "red flag" issues and assure the purchaser that the purchase of the target's shares or assets is the right decision at the purchase price being offered. In particular, if done properly, due diligence provides the necessary information to evaluate financial, legal and regulatory exposures, assess risks and opportunities, and gain valuable insight into market position, the strength of customer relationships, long-term sustainability and future outlook. In addition, the due diligence process is a unique opportunity for the purchaser to gain a deep understanding of the target's management, key employees and business practices, which can ease the integration of the target entity into the purchaser's operations after acquisition.

Due diligence is an in-depth investigation that requires planning. Being prepared could be the difference between the deal closing or falling apart. At the very least, proper preparation keeps the transaction process moving forward in a timely and organized manner. Due diligence can create and protect value. Both the seller and the purchaser benefit when transaction costs are reduced, the purchaser pays a fair price, and the entire process is manageable.

Whether you are buying or selling a business, or representing a company in an acquisition, here are some things to keep in mind as you prepare your company or client for a due diligence exercise:

Preparing the Seller for a Due Diligence Exercise

Put Yourself in the Purchaser's Shoes

The seller should put itself in the purchaser's shoes. Knowing what information the purchaser is going to want to review as part of the due diligence process will help avoid preventable delays from cropping up during the due diligence process because: (i) books and records are not up to date; (ii) requested documents cannot be located; (iii) adequate or market disclosure is not made; or (iv) other surprises are discovered by the purchaser that the seller should have noticed.

How Should the Information be Disclosed?

In preparing for a due diligence exercise, the seller should consider how it would like to disclose the information that the purchaser will request for review. Depending on the level of confidentiality the seller intends to maintain regarding the transaction, it may be appropriate to limit disclosure to a physical data room on the seller's premises. A more convenient and cost-effective method of disclosure is an online secure data room. Using an electronic space helps keep disclosed documents organized and allows the subsequent disclosure of documents to be tracked and reviewed with ease. The method of preferred disclosure should be incorporated into a confidentiality agreement that is executed by both parties before the due diligence process begins.

Execute a Confidentiality Agreement

Negotiating and signing a confidentiality agreement is an important preparatory step for a due diligence exercise. The financial, customer and technical information the purchaser is seeking to review is confidential and proprietary, and the seller is usually reluctant to disclose this type of information to the purchaser, especially when the purchaser is a business competitor. The reluctance is understandable when one considers that the deal, for one reason or another, may fall through and the prospective purchaser could then use the seller's information to its advantage and to the disadvantage of the seller. Since the exchange of such sensitive information is necessary to complete the transaction, a confidentiality agreement provides a mechanism for the release of the seller's confidential and proprietary information to the purchaser while minimizing the risk that the purchaser will misuse the information. Other ways to reduce any risks associated with the disclosure of sensitive information is to provide disclosure thereof in stages. For example, a seller may want to disclose redacted documents which show top customers in value terms but do not disclose names of such customers. In addition, the seller can help protect the confidentiality of its business information by using controls in an online data room such as read-only versus download or print rights.

Due Diligence is Time-Intensive but Necessary

It is important for the seller to realize that due diligence is a necessary process and that the purchaser needs time to review the disclosure in order for the deal to close. The seller can make the exercise more manageable and expedient by being prepared and up front with the purchaser. Shielding information, providing inaccurate information, or being unable to provide certain information altogether prolongs the process and could jeopardize the deal. If the seller works with the buyer to provide timely access to requested information, the due diligence exercise will merely be a time-intensive administrative hurdle to clear in order to move forward with the transaction.

How Long will it Take

A due diligence exercise can vary in length. As a starting point, a seller should expect to spend a a minimum of 4-8 weeks to ready a company for sale and in some cases, the process can take up to 1 year.

Preparing the Purchaser for a Due Diligence Exercise

Due Diligence is a Fact-Finding Mission

A sophisticated purchaser may have the necessary human resources to complete this task in-house; however, more often than not, the purchaser will need to engage a team of lawyers, accountants, consultants, investment bankers or financial advisors who can assist with the due diligence process.

For the purchaser, the due diligence process is an in-depth investigation designed to gain a comprehensive understanding of the target’s operations, assets, liabilities and risks (including regulatory and governance risks) associated with the purchase. The purchaser should seek to identify any information about the seller that would cause the purchaser to walk away from the deal, regardless of the sale price. Moreover, the purchaser should determine whether there is any information about the seller that could lead the purchaser to restructure the deal (i.e. for tax reasons) or renegotiate the purchase price.

In order to ascertain this, the purchaser should consider, among other things, whether: (i) the seller's financial information is truly representative of the target's financial health; (ii) the acquisition target is a good fit for the purchaser's business; (iii) the target's future outlook is realistic and future liabilities have been accounted for; (iv) the target's current customers, employees and management provide value and can be retained as part of the acquisition; (v) there are any unanticipated material risks and liabilities; and (vi) the target's structure should be changed post-closing.

Develop a Due Diligence Request List

The purchaser should develop and provide to the seller a due diligence request list, which sets out all of the information regarding the target that the purchaser would like to review before the conclusion of the due diligence exercise. Although the due diligence request list should be tailored to the particular deal, common requests include information regarding the target's corporate and financial records, material agreements (including supply agreements, service contracts and customer contracts), owned real property and real property leases, human resources (including employment agreements, personnel information, non-compete and non-solicitation agreements), pension and benefit plans, intellectual property, regulatory information (including copies of permits and licences) and information regarding tax, insurance, environmental, indebtedness and intercompany matters.

The answers to a purchaser's questions may not be found in documentation alone. It may be necessary to request permission to complete a facility walk-through or inspect assets that are central to the transaction. Interviewing key personnel may be vital in order for the purchaser to properly assess the target before acquisition. The purchaser should not limit its due diligence to merely that which can be put on paper.

Put Yourself in the Seller's Shoes

The purchaser should recognize that the seller is reluctant to share confidential information about its business and may not want the transaction to become public until the deal has closed. The purchaser should be prepared to negotiate a confidentiality agreement and should consider whether a physical or online data room makes the most sense for the transaction. Finally, the purchaser should not forget that the seller is likely still running its business while the purchaser is in the process of potentially acquiring it. This may cause delays in receiving requested information or limit the amount of contact that the purchaser is able to have with the seller's personnel.

Preparing as Legal Counsel for a Due Diligence Exercise

Understand the Deal and Know Your Client

Legal counsel to either the seller or purchaser in a transaction plays a key role in preparing their client for the due diligence exercise and overseeing its execution. This requires more than simply a basic understanding of the transaction at hand. The scope of a due diligence exercise is informed by a number of transaction-specific factors, so it is paramount that counsel understands the deal.

A due diligence exercise will be more rigorous when the seller refuses to provide certain representations, warranties or indemnities, or its representations, warranties and indemnities will not survive closing. Similarly, more thorough due diligence is required to protect the purchaser in circumstances where there will be no surviving entity or appropriate shareholder to stand behind the representations and warranties after closing; there are successor liabilities or the purchaser is assuming extensive liabilities.

The purchaser's legal counsel in the due diligence process will aim to identify any material issues that would be a significant impediment to completing the proposed transaction or materially impact pricing of the offer. In addition, the information provided in the due diligence process will be used to confirm the representations and warranties made by the seller in the transaction. Legal counsel will also need to identify which material agreements, such as real property leases or key customer agreements, require consent to a change of control of the target or an assignment of such agreement. Special attention must also be paid to challenges that arise in cross-border transactions, such as regulatory (including *Competition Act* and *Investment Canada Act* compliance), tax, or employment considerations.

Due diligence will also assist the seller's counsel in drafting key documents and identifying which documents will be required for the deal and which agreements will need to be terminated upon closing of the transaction.

Tips for Avoiding Common Errors in Due Diligence

Lack of preparation can lead to a number of errors during the due diligence process, including: (i) the purchaser's due diligence team fails to properly identify all of the risks to be evaluated for a proposed transaction; (ii) the due diligence team may be so focused on the seller's financial numbers and other technical data that it overlooks equally important aspects of the target; (iii) the purchaser fails to consider alternative means of conducting due diligence, such as performing a facility walkthrough or interviewing personnel; (iv) team members are so focused on their individual tasks that they do not work together to identify overlapping risks; and (iv) the purchaser may be so determined to close the deal that it may ignore the risks that warrant walking away from it.

The purchaser is more likely to avoid these mistakes when they have assembled the right team to assess the target. The team should meet regularly throughout the due diligence exercise to share their findings, reassess risks and remind themselves of the big picture. The purchaser needs to accept that uncovering certain information about the target is a deal-breaker.

If successful, due diligence will provide in-depth insight into the business of the target, confirm or contradict the purchaser's valuation of the target, identify any deal breakers or deal changers, enable the purchaser to analyze risks and opportunities, and assist the purchaser with integration planning.