WHY PLAN FOR DUE DILIGENCE IN THE SALE OF MY COMPANY?

We'll Just Do Whatever Is Necessary When We Find A Buyer

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WITH KERRI SALLS

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By John A. St. Clair, with the valuable assistance of Kerri Salls

Advance Planning For the Sale of Your Company Adds Value

Owners who wait to plan for the sale of their business until a buyer appears are giving away unnecessarily up to 50% of the value of their business unnecessarily. That's because, by not planning in advance, owners give the buyer important negotiating leverage, which results in a lower price or even missing the sale entirely. Systematic advance planning for an exit or liquidity event (a "Transaction") should be part of running the business far in advance of a Transaction. Advance planning for a Transaction has many advantages, which can include a higher price for the business and a quicker, more efficient sale process.

Kerri Salls has written extensively about why advance planning for the business and its sale is the most valuable thing an owner can do to obtain the maximum price when the time to exit arrives. Kerri's *Fasttrack 20/20* helps owners start planning early, which gives them greater exit options, choices and control, and prepares them for, and guides them through, the Transaction process.[1]

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[1] Kerri Salls, HARVEST YOUR WEALTH, DON'T MURDER YOUR BUSINESS and SELLING YOUR BUSINESS FOR MAXIMUM PROFIT. Refer to: http://www.thiswayoutgroup.com.

Essential to that process, owners should consider advance planning for the buyer's due diligence, which will be a necessary and unavoidable part of any Transaction.[2]

Failing to Plan is Failing

Waiting to plan for the sale until the Transaction begins has significant disadvantages to the owner, including:

Disadvantages of Waiting

- The buyer's proposal, not the owner's best interests, will determine the structure of the Transaction, that is, whether it is to be a sale of assets, sale of shares, merger, cash purchase price or stock and cash, price paid in full at closing or over time, etc.
- Advantageous changes in the company's tax, personnel, operational and other variables, which could significantly increase the owner's return if implemented in advance of the sale of the business, will likely not be possible under the time pressure of the buyer's offer.
- Considerations that are specific to the owner will not have been taken into account in the structure or terms of the sale, and changes in the owner's entity structure (whether the entity should proceed with a sale as a sole proprietorship, limited liability company, S corporation, or C corporation) and whether to involve any minority owners or key employees in the sale, will be prejudiced or impossible because the time necessary to make such changes will be past once the buyer begins driving the transaction.

[2] Due diligence is the Buyer's investigation of all aspects of the owner's company in advance of the definitive purchase and sale agreement, or sometimes in advance of the closing. The process involves the buyer submitting a comprehensive set of requests to the owner, and the owner then providing all information and documents that are called for in the requests. The buyer's requests are designed to extract from the owner all relevant information about the business. It is critical for an enforceable nondisclosure agreement to be in effect before the due diligence process begins.

Why Due Diligence Preparation is a Necessary Part of Planning for a Transaction

Efficient handling of the buyer's due diligence is critical to the owner's ability to negotiate the highest price for the business and to obtain advantageous terms in the final agreement. Since the buyer's due diligence occurs in the earliest stage of the Transaction, an owner's incomplete or delayed due diligence responses can cause the buyer to withdraw or, at least, reduce the offering price to take into account what the buyer will perceive as bigger risks within the company as a result of the owner's unpreparedness to respond to the buyer's due diligence request.

Apart from those direct effects on the Transaction, postponing due diligence work until the Transaction is imminent makes the Transaction more expensive and riskier for the owner. These are some reasons why:

- Virtually without exception, completing a Transaction takes more of the owner's and key executives' time than they anticipate. The more their work is condensed into the time window after a buyer appears, the less efficient, more time-consuming and more incomplete it will be. Even with extensive preparation, responding to the due diligence checklist and accommodating the buyer's due diligence team is very time-intensive and stressful. If this step becomes all consuming, the owner is not able to focus on operational growth and revenue targets, jeopardizing the valuation in the buyer's view.

  The most advantageous deals for the owner will result from the preparatory work for the Transaction being done strategically over a sufficient period of time (1-3 years) according to a plan designed specifically for the owner's business. That is especially true of due diligence because, until an agreement is signed, the owner will wish to keep the Transaction confidential from others within the business and from his suppliers, customers and competitors. As a result, the due diligence work falls on the owner and key executives without their being able to rely on their support teams. This upstream flow to the owner and executives of what is substantially the administrative compilation of documents and information too often results in due diligence materials being supplied to the buyer that are incomplete, delayed and unresponsive to the buyer's request. That can have only negative consequences for the buyer's evaluation of the business.

- Since the sale of the business is usually a "first time/one time" event for the owner, no procedures and processes are in place for handling the buyer's due diligence requests. Thus, the amount of time the owner and key executives spend working on the due diligence and other deal-related matters takes that much more time away from their business jobs, often with negative effects on the business at precisely the time the business needs more rather than less of their attention.to showcase it at its best.

- Because due diligence requests are directed to the company's business, legal, financial and accounting areas, the owner will have to work closely with his advisors in all those fields to respond to the requests. Under time pressure of the Transaction, the owner will be unable to organize complete information and materials in the most usable fashion for the advisors. The advisors will delegate the work of responding to the due diligence requests to associates who may have incomplete information. As a result, when the buyer and its advisors review the owner's response to the due diligence requests, they will discover that corporate administrative and other items are missing. Advisors' fees will spiral upward as "catch-up" work is done under a tight deadline.
- If an owner's response to a due diligence request is incomplete or inaccurate, it can put the entire deal at risk. At a minimum, it can result in a term of the purchase and sale agreement that will have to be corrected through negotiation, with the increased fees and delays that result from such additional negotiation. Depending on the materiality of the due diligence omission or inaccuracy, the buyer may insist on a reduction in the offer price as a result. If the omission or inaccuracy is not discovered until after the purchase agreement is signed, it can lead to a provision in the final agreement that will be breached by the owner, with even greater costs of correcting the inaccuracy (if possible) or paying damages for the breached provision.

The lack of planning …
increases the owner's costs and diminishes valuation

These results, from the lack of planning for due diligence in advance of a Transaction, can and do materially increase the owner's cost of the due diligence work. They often diminish the valuation on which the buyer's offer will be based. Rushed, disorganized due diligence work also increases the risk of suppliers, customers and competitors becoming aware of a deal in the making.

Advance Planning has Major Benefits

In contrast to the above negative consequences of not planning for the due diligence work in advance of a Transaction; a systematic long-range planning process of preparing for due diligence has positive results, including the opportunity to:

A systematic long-range planning process of preparing for due diligence has positive results

- Discover and resolve issues years in advance of a Transaction opportunity, saving the cost and confusion of last-minute work and enabling the owner's advisors to review the materials and prepare the responses to a due diligence request quickly and efficiently.
- Enable efficient and prompt preparation of responses to the buyer's due diligence requests.
- Implement processes and procedures that facilitate not only the owner's response to the due diligence requests but also speed up the preparation and negotiation of the definitive agreement.
- Minimize the distraction of the owner and key executives from running the business, thereby avoiding any negative impact on forecasted revenue or expenses.
- Reduce the risk that the pending Transaction will become known to employees, customers, suppliers and competitors – because the due diligence process has been part of the company's standard operating procedures far in advance of the Transaction.
- Be ready if a liquidity event appears with due diligence materials prepared, thereby minimizing concerns from buyer's advisors and reducing the time and cost of their having to dig deeper for problems or inconsistencies.
- Eliminate the buyer's leverage to reduce the offering price as a result of risks perceived from an incomplete or inaccurate response to the buyer's due diligence requests.
- Improve the accounting, legal and administrative operation of the business, with cost savings from all of the company's advisors.

The Positive Role of Advisors

Don't worry unnecessarily if you, as an owner or key executive, have little or no time available to manage advance planning for a Transaction. That's the expertise your team of advisors provide. In a subsequent article I plan to address ways to use your company's advisors efficiently to make planning, including due diligence preparation, an integral, cost-effective part of running your business. Effectively using advisors in advance of a Transaction enables the owner and key executives to direct and supervise the process with a minimum use of their time, which will position them to achieve a better outcome.[3] Subsequent articles will discuss some specific actions to take to prepare for a buyer's due diligence, and the critical role your nondisclosure agreement plays in protecting your business from the real risks you will face in going through a due diligence process.

John A. St. Clair

An attorney with over 30 years of experience practicing in international law firms, advising corporations and investors in cross-border transactions and advising early-stage growth corporations about securities and corporate law matters, John now practices independently through the Law Office of John A. St.Clair in order to develop closer long-term relationships with clients and to bill on the basis of value added instead of time spent. Having represented technology companies from start-up through private and public offerings and contractual "exits" by mergers and sales of assets, John provides strategic corporate advice to early-stage companies, advising their boards of directors and management how to avoid problems, where possible, and how to handle those that can't be avoided through strategic legal foresight and planning. Please reach out to John if this whitepaper has been useful to you or your business owner clients.

Kerri Salls

Kerri Salls, Managing Director at This Way Out Group LLC is entrusted by owners of private and family run companies to reduce risk and maximize value transforming an income generating business into a wealth producing asset, to make each business buyer ready and buyer attractive. She orchestrates and integrates business value enhancement with early exit planning to ensure the right transaction, and transition to reinvention. A pioneering exit strategist and mentor, Kerri's approach to owner early exit planning is based on collaboration, cooperation and the coordination of advisors, focused on the owner's best interest. Kerri is the prolific author of **HARVEST Your Wealth,** *(available on Amazon).* **Multiply Your Business Value in 3 Steps** *(Amazon Best Seller)***,** numerous white papers and the first online value growth program for small and mid-size companies, **Fasttrack 20/20.** Please reach out to Kerri if this whitepaper has been helpful to you or your business owner clients.

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[3] For an introduction to this subject, refer to Kerri Salls' whitepaper *How To Manage A Gaggle Of Advisors To Build Your All-Start Exit Team.*

