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Due Diligence at Warp Speed

By Sharleen Johnson McCooey
for Office.com

April 3, 2001 — In a fast-changing economy, mergers and acquisitions are fast, too. But closing quickly doesn't have to mean that due diligence takes a back seat. There are some details that you can't afford to skip.

Attorney Neal Millard, a senior partner in the Los Angeles office of White & Case, tells of a bank asked to lend money on the basis of hundreds of thousands of cattle as collateral. It sent a banker unfamiliar with livestock to count the animals. "The borrowers sat the banker on a hill and told him to count the cows as they ran them by. Since he was inexperienced, he couldn't tell one cow from another. What they did was run the cows around the hill so he was counting the same cows over and over till they got up to the number they wanted."

Beware of anyone trying to lead you to believe you're buying more cows than you actually are. Not making sure assets actually exist, Millard says, is a common example of inadequate due diligence in mergers and acquisitions.

Show Me the Research

"Due diligence" is a legal term that refers to the meticulous legal and financial research usually performed by lawyers and accountants that is part of business negotiating and the centerpiece of a planned merger or acquisition. It's time-consuming — and expensive.

Christina Sultan, president of Sultan & Co., a Los Angeles company that provides corporate and private investigations and business intelligence, says fees for the investigative part of due diligence on a $1 million company will typically be around $5,000; on a $500 million company the figure is more like $50,000. Legal and accounting fees will be $10,000 to $20,000 and $100,000 to $250,000, respectively. Attorney Millard, who also teaches international finance at University of Southern California Law School, says that international investigations, in particular, can be very expensive. Are businesses doing as much due diligence today as they once did? "Probably not," says Millard. "But you can attribute that to the fact that there's information available on the Internet. You can do a lot before lawyers get involved."
"I think (dealmakers) feel they have more control over the due-diligence process when they do it in-house," Sultan says.

How Much Due Diligence Is Enough?

"Due diligence is just a shorthand way of saying you do an investigation of the other side," Millard says. "How much of an investigation you do is your choice." If you're acquiring a company you have a relationship with and know well, you'll probably do less checking.

Millard points out that the process of due diligence could potentially go on forever. Therefore, putting a time limit on the process is, in many ways, a good thing. Given the example of a company with $50 million in annual revenue wanting to acquire a single-location, $20 million company, Millard suggests three weeks as a reasonable length of time to spend on due diligence. "You don't want to go overboard," he says.

According to Millard, minimum due diligence should consist of:

- making sure the legal structure of a company is properly set up
- looking for business liabilities
- examining the business assets to make sure they are what they say they are
- examining the company's labor situation (with regard to its employee contracts, union problems or other potential problems)
- checking for environmental liabilities

What tend to fall by the wayside in the making of faster deals are the traditional methods of due diligence. Today, in some cases, it may consist only of searching for the obvious, such as federal indictments and bankruptcies.

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But due diligence can do more than safeguard against fraudulent deals. It helps ensure that the deal is what you want. At the very least, Millard says, ask yourself: What are the basics we expect to get out of this transaction? "For example, in an acquisition you may be buying the company because you want a supplier of a certain amount of inventory in the southeastern United States," he says. "You should do the minimum amount of due diligence necessary to ensure this company can meet your requirements for supply."

As another example, if you are a company with a policy of strict product testing and you want to acquire another company with a product that complements your own, check their testing history. If the company hasn't been performing the same level of testing, and if you don't discover this fact through due diligence, you are buying a liability. "And if that liability is larger than your company, you can lose all you've built up," Millard cautions.

One area has outlived today's warp-speed dealmaking climate: environmental matters. Most businesspeople are reluctant to take shortcuts when it comes to environmental issues, say the experts. "In any kind of transaction that involves real property, the risk of inheriting an environmental problem usually outweighs concerns about saving time and money," Millard says.

Do-It-Yourself Tips
As fast as deals are consummated, they generally don't get done in a day's time. "It doesn't take much time to go on a computer and go through search engines," Millard says. "It may take a night, but no transaction takes place within 24 hours. There's always enough time to do minimal due diligence." Go through government information available on the Internet, he advises. "Is the company duly incorporated? Has it paid its taxes? Run the names of the company's principals through the search engines."

When it comes to talking to people within the company, don't stop with the CEO and CFO, Sultan says. "Talk to some of the middle-line managers. Talk to somebody who left the company six months ago." Contact suppliers, those who might be on the other side of a business dispute and people who used to work at the company — or, if you're an accountant, do an on-site audit to check that revenue is what the company says it is. Rather than relying on an expert's report, send someone from your own company out to ask basic questions. "Lawyers and accountants aren't stakeholders in the deal — you are," she says.

If the transaction is in your own area of business, it shouldn't be too hard to find people who know the reputation of the people and the company you're negotiating with. "Just about every business has its own trade magazine," Millard says. "Even a small business that's headed by someone fairly successful will be mentioned in these publications."

Bring on the Experts and the Customers.
Allan Weinstein, VP of the private New York-based equity firm Lincolnshire Management Inc., suggests developing a hypothesis and then trying to validate it. Perhaps you're interested in buying a company that sells products used for extracurricular activities in schools. An obvious question is: What is likely to happen to budgets for these activities in a recession? You might hypothesize that budgets would be cut. To find out if this is true, he says, call the principals of a couple of schools per state, explain you're doing homework on a deal, and ask how their budgets are determined.

"Until you're in the shoes of a customer," says Weinstein, "you're going to miss things." If you want to merge with or acquire a company, use its product or service. Buy it in every way that it's available. "If they sell a product through a catalog, buy it through a catalog," he says. "See how long it takes to arrive. Examine the packaging. Open it up."

Recognize, however, that in many cases, someone who specializes in what you need to know can save you time. "There are attorneys we work with who specialize in venture capital funding for high-technology companies located in northern California," Sultan says. "That's all they do; you know they have their own network of contacts and you can put out your needs to their resource web."