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Buyer Beware

Why you should purchase a private company with your eyes wide open.

BY SEAN BROWN AND LADD HIRSCH

In business, an eyes wide open approach is essential to the successful purchase of a private company. When the purchaser of a private company enters into a letter of intent, or LOI, or reaches a handshake deal to buy a private business, the little things often have not yet been fully disclosed and it therefore remains to be seen whether the transaction will fail or succeed. This article focuses on the little things a private company buyer should make sure to address to achieve an optimal outcome, including steps to be taken after the parties have signed the LOI.

Little Thing No. 1: Conduct Adequate Due Diligence

Due diligence, in the context of mergers and acquisitions, is commonly referred to as the process by which the buyer gathers information about the business or the assets for sale. It is crucial for a buyer to conduct sufficient due diligence to establish the following information, at the minimum, before closing on the purchase:

- Confirm the seller has the authority to sell the stock or assets of the target company;
- Identify and investigate potential liabilities or risks;
- Identify necessary steps to integrate the target business into existing business; and
- Identify any obstacles to closing the transaction, such as shareholder consents, third-party consents, or prohibitions on transfer.

Establishing this information requires the buyer to review the seller's organizational documents, such as formation documents, bylaws or operating agreements, benefit plans, vendor contracts, supply contracts, and customer contracts. Some of the common issues the buyer will need to focus on are: (i) ownership of the target company, (ii) existing management of the company, and (iii) necessary consents from third parties in connection with key contracts.

The findings from a detailed investigation of the company can impact the transaction documents in the following ways to address the issues that are discovered: (i) adjustments in the purchase price, (ii) clarifying representations and warranties, (iii) adding new indemnification provisions, (iv) supplementing disclosure schedules, and (v) added pre-closing covenants.

Key Point: The due diligence process does not stop after the LOI is signed. Instead, after the LOI is signed, due diligence should intensify to make sure things like inventory counts, accounts receivable status, outstanding claims or litigation, and internal personnel issues are studied closely to avoid any surprises after closing. Further, if there are contracts in place with key customers, counsel needs to review the terms of all existing contracts.

Little Thing No. 2: Structure the Purchase Price Based on Future Performance

In most cases, a private company buyer should seek to structure the transaction so that a significant portion of the purchase price is contingent, and the final amount paid is determined by the target company's future performance after the sale closes. Generally, the purchase price for a target business is based on a multiple of gross revenue or earnings before interest, taxes, depreciation, and amortization for the preceding 12 months. A portion of the purchase price can be based on the acquired company's future performance by awarding the seller equity in the combined equity, utilizing seller financing, or making a portion of the price based on achieving certain financial targets or milestones.

When the purchase price includes one or more contingent payments based on future performance, it is critical to clearly define the targets that will trigger future payment or future transfer of equity in the combined entity. Using ambiguous terms can lead to post-closing disputes, as the parties will disagree on whether these targets were met. But, adopting carefully worded provisions related to post-closing payments will achieve a win-win as these terms will incentivize the seller to achieve outstanding financial results after closing.

Key Point: The seller may resist deferring payment of any portion of the purchase price until after closing, and this may be seen as a red flag when the seller is demanding an all cash deal with no further commitment to the success of the business after the sale closes.

Little Thing No. 3: Retain Sufficient Capital (Cash) After Closing

The due diligence process includes determining the steps necessary to integrate the target company successfully into the buyer's own business. This includes a working capital analysis to calculate how much working capital the target business needs to

operate consistently with past practices. Working capital is commonly calculated as the total of the current assets minus the current liabilities, but it can be difficult to determine current assets and liabilities, because sellers often change how the business is being run in anticipation of a sale.

Buyers therefore need to include a provision providing for a post-closing adjustment to be made to the purchase price if after a short period, usually 60 to 90 days, there is a deficiency in working capital. This requires the buyer to need a holdback of some amount of the purchase price and the use of clear, specific language defining working capital, including how accounts receivable, accounts payable, bad debt, deferred revenue, and prepaid expenses are handled. If the working capital adjustment is not carefully handled, the buyer may quickly be dealing with a shortfall in the cash needs of the new business after the purchase is made.

Key Point: Working capital is not easy to determine and may not be apparent from the target company's financial records. Thus, the buyer should insist on interviewing the target company's top financial executives as they may be of great help in assessing the company's actual cash needs.

Conclusion

In both life and business, it is the little things that often make all the difference. When a private company purchaser evaluates a target company for an acquisition, these small details may determine the success or failure of the transaction. Managing these details requires the buyer to conduct thorough due diligence, review the terms of all key contracts, interview top financial executives, and structure the payment of the purchase price in a favorable manner. These small steps—an eyes wide open approach—provide the private company buyer with a much better prospect for a successful purchase. **TBJ**

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