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DUE DILIGENCE WHEN BUYING A BUSINESS

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Buying a business is a complex and risky undertaking. A thorough due diligence plan, however, will uncover potential weaknesses of a target business giving a prospective buyer the information it needs to make a fully-informed investment decision. That same information will also be used by the buyer's advisory team to negotiate deal terms which then allocate the business and legal risks among the parties.

How is Due Diligence Conducted?

Due diligence is the process whereby a buyer, together with its financial and legal advisors, investigates the legal, financial, and operational affairs of a target company in order to evaluate a purchase opportunity. A seller often responds to the inquiries directly or through a "virtual" data room that gives buyers electronic access to the seller's important information such as business plans, financial statements, material contracts, and lists of employees and assets to name a few.

Why is Due Diligence Important?

Due diligence is particularly important for the buyer who will inherit certain risks and liabilities associated with the target business, such as its material contracts and employee severance obligations. The buyer has one goal: to learn as much about the target company as possible before committing funds to purchase.

What Types of Inquiries are Made?

The scope of the inquiries depends on the target's industry, the parties' circumstances, the size of the transaction, and the deal structure itself. Due diligence is often divided into two general categories:

(a) *Financial:* A buyer's accountants and financial advisors will lead the investigations into the financial health of the target company. Past performance and future prospects are analyzed to understand the company's revenues, expenses, financing, accounts receivable, and other financial metrics. Financial statements are reviewed, human resources are evaluated, and corporate policies, such as business interruption and cybersecurity plans, are scrutinized.

(b) *Legal:* The buyer's lawyers will review the legal status of the target company and its contractual





relationships with customers, suppliers, lenders, and employees. Legal counsel will typically suggest searching applicable governmental or third party agencies (such as Canada Revenue Agency, provincial taxation authorities, WorkSafe, Employment Standards, and the Courts) to determine whether there are any claims or proceedings against the target business.

When Should Due Diligence Begin?

It is advisable to begin the due diligence process as early as possible in the negotiations. This will allow the buyer more time to determine whether any government or third party consents and approvals are required and to address with the seller any issues which have been discovered. Also, certain government agencies may take several weeks or longer to respond to search inquiries.

What are Benefits of Due Diligence?

Due diligence allows the buyer to discover potential issues early in the acquisition process before significant time, money, and energy are expended on negotiating the purchase agreement and devising a transition plan.

The process will provide information about the organizational and capital structure of the company, determine if any consents or approvals from government, shareholders, or a financier are required, and uncover whether the company is subject to any real, potential or threatened claims and lawsuits. This vital information establishes the basis for the deal fundamentals including the purchase price, structure, representations and warranties, indemnifications and additional covenants to protect the buyer.

What are Potential Consequences of Inadequate Due Diligence?

By failing to conduct thorough due diligence prior to committing to an acquisition, the buyer risks making a poor decision based on an incomplete picture of the financial health and legal status of the target company. It may also limit the ability of the buyer's legal counsel to address such issues and protect the buyer, to the extent possible, through appropriate provisions in the purchase agreement.

The Business Lawyers at Richards Buell Sutton LLP have authored "Make Your Move" which is a tool to support entrepreneurs who are considering buying or selling a business in British Columbia. If you are interested in obtaining a copy, please contact us at rbs@rbs.ca.

