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MITIGATING DUE DILIGENCE ISSUES WITHIN A BUSINESS TRANSACTION

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Due diligence allows a potential buyer or investor to evaluate, investigate and analyze a business to determine whether it is a worthy investment. This enables a buyer to identify governmental or third party consents required to proceed, and reveals issues and concerns, early in the process. Obtaining third party consents may be challenging since most third parties do not have a vested interest in the transaction proceeding quickly. If they are advised later, they could delay the closing of the transaction. For example, if a business has numerous locations, various landlords may need to conduct their own financial due diligence on the buyer before providing consents.

When does due diligence result in a deal not proceeding?

When issues are identified, whether or not a deal still proceeds depends largely on the appetite of the buyer and the significance of such issues. If the problems could be characterized as materially adverse to the target business and its financial condition, the parties may be unable or unwilling to recover the deal unless they are prepared to renegotiate different business terms. For instance, if a buyer discovers that certain key employees will resign after closing and are not bound by written non-competition or non-solicitation obligations, this could be devastating to a service-oriented business that largely depends on the goodwill of the customer base with such employees.

How can parties compromise to move a transaction forward?

If issues are less significant and the parties are still motivated to continue, there are ways that the parties can bridge gaps to move forward. A common risk management option for buyers is a holdback or post-closing escrow, which defers payment of a portion of the purchase price for some period of time after closing. This ensures that funds are set aside to set off against indemnity claims or other specific concerns. If there are issues identified by the buyer during due diligence (such as existing litigation or audits by governmental authorities), these could be addressed by strong indemnities provided by the seller, in conjunction with a sufficient holdback to protect the buyer against such risks.

Another option to consider is for the buyer to purchase only a portion (and not all) of the business. This

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could be an effective strategy if the seller is willing to stay on and actively transition the goodwill and customer relationships to new management over time. The buyer would still require a robust shareholders agreement to ensure that there is a mechanism to buy out the remaining interests of the seller.

If the buyer is an acquisition vehicle strategically purchasing other target businesses in complementary industries, there may be value and long-term growth potential for the seller to take equity in the buyer, as part of the sale consideration. Under such circumstances, the seller should consider conducting due diligence on the buyer.

It is important not to underestimate the human side of a business transaction, and the importance of building trust between the parties during the course of negotiations. An aggressive negotiating stance may sour the discussions and cause a party to walk away. If the parties are motivated to work towards the common goal of closing the transaction, they may need to make concessions on less critical issues. Securing a good relationship with the seller may also aid a buyer when transitioning customers and employees post-closing.

Our M&A team have authored "*Make Your Move*"; a tool to support entrepreneurs who are considering buying or selling a business in British Columbia. Please email rbs@rbs.ca if you are interested in obtaining a copy of this guide.

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