Letter of Intent:

Do’s and Don’ts for entering into Letter of Intents

Source: Massimiliano Maesttetti and
Lorenza Ferro/PSM LAW

Article 405 - Contractual freedom

1 – Within the limits of the law, the parties have the faculty of freely fixing the content of contracts, celebrate different contracts from those provided for in this code or include any clauses they approve of.

2 – (…)

Article 227 - Fault in the formation of contracts

1 – Whoever negotiates with another for the conclusion of a contract must, both in the preliminary stages and in the formation of the contract, proceed according to the rules of good faith, under penalty of liability for the damages caused, with own fault, to the other party.

2 – (…)

Article 232 - Scope of the voluntary agreement

The contract shall not be concluded whilst the parties have not agreed to all the clauses on which any of them has deemed an agreement to be necessary.

OVERVIEW:

- **Purpose**: to establish a framework to govern the relationship between the parties during the due diligence process and the contractual negotiations;
- **Notion and legal qualification**: delimitations and distinctions;
- **Strategy**: simple letter vs. systematic presentation of the transaction and its key parameters;
- **Perspective**: Buyer vs. Seller;
- **Main clauses**: amongst others object, price, exclusivity, confidenciality, cost coverage, way-out, break up fees;
- **Content**: binding/non-binding terms;

Timeline

Time-line of M&A transaction

LOI	DD	Signing	Closing	Post-Closing/ Integration/ Litigation
defines conduct of businesses and contains undertakings between the parties	addresses all issues arising from the DD	enshrines the result of negotiation	contains the complete actions to consummate the deal	sets the rules for dispute

Entered into between a buyer and a seller following the successfull completion of the first phase of negotiations of an acquisition transaction

Purpose

Why enter into a Letter of Intent?

- To *"test the waters"* before incurring the costs of negotiating a definitive agreement and performing due diligence
- Feel morally, if not legally, obligated to key terms once they are set down in writting
- If the deal terms are sufficiently complicated, it is helpful to put them down in writting to ensure that the buyer and seller have consistent expectations
- Assist the buyer in convincing prospective lenders or investors to evaluate the transaction for the purposes of providing financing
- Facilitate complicance with regulatory requirements (eg a premerger notification form)

Notion

- *Unrelated instruments*: comfort letter (lettre de confort, lettre de patronage, Patronatserklärung)
- *Related instruments*: Confidentiality Agreements
- *Variations in terminology*: Memorandum of Understanding, Memorandum of Agreement, Heads of Agreement, Term Sheet
- PreContractual Agreements and Promises to Contract
- Unilateral, Bilateral and Multilateral Letters of Intent

This institution enjoys or suffers an almost total absence of specific regulation in Portuguese Law, whilst its purpose, nature and effects are often uncertain and misunderstood.

Legal Qualification

- *"Full"* Contract
- *Synallagmatic* Relationship
- Promise to Contract
- Offer

Strategy

Short letter with basic protections (“*get the parties to the table*”) or systematic presentation of the transaction and its key parameters (“*identify and discuss key negotiation points immediatelly*”)?

SHORT LETTER	Much shorter, less formal, and less legalistic form that might be used when one or both of the parties are very anxious to sign a letter of intent, whilst preserving protections against later litigation if negotiations break off.	US APPROACH BUYERS BEST OPTION
LONG LETTER	More comprehensive and legally precise form, designed to flush out many of the pertinent issues and to make very clear which elements of the letter are binding and which are not.	US APPROACH SELLER BEST OPTION

… Short Letter

Advantages

- Can be prepared and negotiated upon very short notice
- Can easily be expanded to include more details on non-binding provisions or to add binding provisions such as exclusivity
- Is more user-friendly and less intimidating in the early stages of the acquisition process.

Disadvantages

- Leaves open many important issues to be resolved later on.

… Long Letter

Advantages

- Issues that are deal-breakers can be identified early in the negotiation process before substantial expenses are incurred in due diligence and the drafting of a definitive agreement.
- Resolution of difficult issues at letter of intent stage facilitates the negotiation of a definitive agreement, permitting the buyer more time and energy to prepare for the transition to its ownership of the target.

Disadvantages

- It may burden the negotiation with too many difficult issues too early in the process and may impede the deal's momentum or even cause a breakdown in the negotiations that may have been avoided if certain issues had been deferred.

Perspective

There is often na inherent conflict between the goals of the parties in negotiating a letter of intent.

BUYER

generally is most interested in securing exclusivity or other standstill types of provisions from the seller while seeking to maintain great flexibility regarding the purchase price and other key provisions that may be impacted by the results of the buyer’s due diligence of the target

SELLER

generally will attempt to define more clearly the purchase price, limitations on its exposure with respect to the representations that will be part of the definitive agreement, non-compete covenants, and other ancillary arrangements, and, most of all, will prefer to avoid, or to limit the scope of, any exclusivity commitment.

negotiation can sometimes became bogged down in detailed discussions that are generally reserved to the negotiation of the definitive agreement.

Main Clauses

Non-Binding

The letter of intent will typically state that it is non-binding, except for certain designated provisions. Usually at this stage in the acquisition process, neither the buyer nor the seller are willing to be bound to conclude a transaction. Further, the letter of intent does not contain all the terms that should be agreed upon in na acquisition. Amongst the non-binding provisions:

- **Object of the transaction**: in the first non-binding provision of the letter of intent, the parties confirm their intent to carry out the planned transaction and define the essential business points of the transaction.

- **Nature of the transaction**: share deal, asset deal, capital increase, etc.

- **Outline of the next steps** – timetable: in addition to defining the major business points, the letter of intent should lay down the next steps of the transaction. To avoid a misunderstanding between the parties on the stages or duration of the procedure, it is further advisable to include a timetable for the due diligence, the contract negotiations and the closing of the transaction.

Main Clauses

- **Description of the Due Diligence**: for the purpose of clarity, it is advisable that the parties define the extent and the duration of the due diligence.

  Further, a letter of intent should clearly describe the documents and information the buyer is to receive as part of the due diligence, whether a thorough environmental analysis will be conducted, and the period of time available to the buyer to analyze the documents and information received and to complete the due diligence.

- **Price/Consideration**:will it be all cash, earn-out? Any escrow to secure the seller's indemnification obligations? If the purchase depends on the results of the due diligence, the parties sometimes do not fix a purchase price, but rather provide for a price range or a valuation method whereby the purchase price will be calculated.

- **Adjustments to the purchase price:** will it be a cash-free/debt free deal? Treatment of transaction fees and expenses.

… Main Clauses

Binding

- **Confidentiality-non solicitation**: the letter of intent and its terms should be agreed to be confidential and typically subject to the non-disclosure agreement between the parties.

  In the due diligence phase of the transaction, the Seller will want to prevent the Buyer from disclosing or making use of sensitive business information that is disclosed to it, or from poaching the employees of the target business.

- **Exclusivity:** the scope and terms for exclusivity granted to the buyer.

  Exclusivity provisions are generally sought by buyers who do not wish to compete or continue competing with third parties for a deal. As one might expect, sellers agree to exclusivity reluctantly, as doing so may reduce their ability to maximize value from the transaction by inducing competing bids. However, without exclusivity, many buyers will refuse to invest the time and resources in conducting fulsome due diligence and negotiating definitive transaction agreements.

- **Expenses**: statement that the parties each bear their own expenses or, in some instances, whether one party (usually the buyer) will cover some of the other party's expenses.

… Main Clauses

Binding

- **Way-out**: Exclusion of liability resulting from "Culpa in Contrahendo", excluding a legal obligation.

  To avoid that a party, in the event of a break down of the negotiations, raises claims under the theory of "culpa in contrahendo", it is advisable, to state in the letter of intent that each party has the right to terminate the negotiations at any time and that the termination does not give raise to any claims of the other party. This helps to avoid unnecessary and usually fuitless discussions on damage claims.

  To avoid any ambiguities, the letter of intent should clearly state which of its provisions are binding on the parties and which are non-binding. In particular, it should clarify that an obligation to carry out the transaction exists only once the parties have validly executed a written purchase agreement. A clear statement on the binding and non-binding provisions is the most crucial point of the document on one hand, it prevents the parties from interpreting the document as an executed purchase agreement and, on the other hand, from claiming in their later negotiations that a binding oral agreement on the major points had been reached during their discussions.

… Main Clauses

- **Break-up fees**: sometimes na aggressive counterpart will insist for inserting in the agreement the so called "exit fees".

  A breakup fee (sometimes called a termination fee) is a penalty to be paid if the Seller backs out of a deal (usually because it has decided instead to accept a more attractive offer). The breakup fee is ostensibly to compensate the original Buyer for the cost of the time and resources expended in negotiating the original agreement.

  A reverse breakup fee is a penalty to be paid to the Seller if the Buyer backs out of the deal, usually because it can't obtain financing. Reasons for such fees include loss of key personnel during the period when the Buyer was "in play".

- **Conduct of the Business**: buyers sometimes insist that sellers agree to operate the selling company's business only in the ordinary course of business and refrain from certain material actions.

  Buyer will want to restrict Seller from shifting assets or otherwise affecting the operations of the Acquired Companies in a way that may reduce Acquired Companies' value before specific provisions are put in place in a definitive agreement. Sellers may object to these levels of restraint on the operation of the Acquired Companie's business in the absence of any binding agreement on the terms of a sale or earnest money payments to Buyer.

Content

<u>Binding / non-binding terms?</u>

- Although the seller and the buyer will generally desire the substantive deal terms outlined in a letter of intent to be non binding expressions of their then current understanding of the shape of the prospective transaction, letters of intent frequently contain some provisions that the parties intend to be binding.

- What portions of the letter of intent should be binding or non-binding and the risks of entering into a letter of intent at all are important issues with a heavy legal overlay.

- The level of detail in the letter of intent and which issues should be addressed or deferred are key strategic questions and their likely impact on the negotiation of the transaction should be fully explored.

… Content

Did the parties intend to be bound?

In determining whether the parties intend to be bound, one should examine the following factors (expression of the general principle of good faith):

- the actual wording of the document
- the context of the negotiations
- whether either or both parties have partially performed their obligations
- Whether there are any issues left to negotiate (presence of the *essentialia negotti*)
- Whether the subject matter of the discussions concerns complex business matters that customarily involve definitive written agreements.

… Content

The most important factor in determining whether provisions in a letter of intent are binding is the language used by the parties in the document. A detailed wording is an attempt to remove the possibility that oral communications or other actions can give rise to a binding obligation.

The language of the letter of intent should, therefore, be

DEFINITIVE AND PRECISE

In order to avoid factual situations and subsequent communications that have led to find provisions of a letter of intent to be binding despite language seemingly to the contrary in the document.

… Content

<u>Strong wording</u>

- “*no past or future action, course of conduct, or failure to act relating to the Possible Acquisition … will give rise to or serve as a basis for any obligation or other liability on the part of any of the parties or any of the Acquired Companies*”

<u>Weak wording</u>

- *“subject to a definitive agreement”* (in some cases such language has been interpreted as a mere condition subsequent rather than the requisite intent not to be bound).

<u>Advisable to avoid</u>

- Oral statements such as “*Looks like we have a deal!*”
- Phrases like “*must*”, “*shall*”, “*is obliged to*”, “*has a right to*”

… Content

<u>Sample wording</u>

- Incipit: *"the Buyer confirms **its interest in pursuing**, directly or through one or more of its affiliates that is acceptable to Seller, **the acquisition of** the Target (as more fully described herein)"*

- Price determination*: "Subject to completion of satisfactory due diligence, the total consideration offered by the Buyer for the Transaction **will be up to** …"*

- Definitive agreements to be drafted*: "Concurrent with completion of Buyer's due diligence review, **and provided that such due diligence review is satisfactory to the Buyer**, the parties will finalize the Definitive Agreements for the Transaction, all of which shall reflect the principles set forth in this Letter of Intent and such other matters as the parties may agree"*

- Internal approval*: "The Definitive Agreements and consummation of the Transaction will require **approval from each party's Board of Directors** in accordance with its respective internal regulations, to be granted prior to the signing of the Definitive Agreements. Such approval shall in all cases be **subject to the negotiation of mutually acceptable Definitive Agreements** based on the principles of this Letter of Intent"*

… Content

- Exclusivity: *“The Sellers undertake that until [date] it will not solicit, in any manner whatsoever, directly or indirectly, offer for, or participate in negotiations with, any other person with respect to the disposition of any part of the capital stock or of the assets of the Target”*

- Binding Provisions*: “Section …, Section … etc.* ***hereof are binding and shall survive any expiration or termination of this Letter of Intent*** *… All other provisions of this Letter of Intent are non-binding”*

- Nature*: “This letter of Intent shall not be interpreted and/or construed as, or shall constitute, na obligation of the Buyer to purchase or to enter into any agreement … Unless and until the parties executed and deliver the Definitive Agreements and subject to the foregoing,* ***no party shall have a binding or enforceable obligation with respect to the Transaction****”*

- Termination*:* No liabilities*: “Either party may terminate negotiations with respect to the Transaction at* ***any time for any reason or no reason at all, … without liability to either party hereto****”*

Litigation

<u>Contractual Liabilities and Remedies</u>

To the extent that a letter of intent can be consider a contract, with binding effects, if performance does not occur, the creditor may:

(i) Demand that the obligation be carried out (specific performance) and claim damages for late performance;

(ii) Waive his right to require performance and either (a) claim damages for non-performance ("*positive interest*"), and (b) claim the damage it would not have incurred if the negotiations had never taken place ("*negative interest*")

Occasionally, the parties may expressly provide for liability in the event of breach and for the consequences thereof, for example in the form of conventional penalties. Where they have not, the practical consequences of contractual liability might vary considerably and will therefore be assessed on a case by case basis, which might prove to be extremely difficult.

Litigation

Pre-Contractual Liabilities and Remedies

A Letter of Intent can have legal effects even if does not qualify as a contract.

Obligations derive from the rules of good faith on the basis of the *culpa in contrahendo* principles: as soon as the parties start to negotiate they must observe pre-contractual duties.

Pre-contractual duties include: (i) a duty to act honestly (with the intent to conclude na agreement); (ii) a prohibition to deceive (fake auction process); and (iii) a duty to inform (facts which have an impact on the decision to enter into the deal, particular knowledge of a party, parallel negotiations); and (iv) a duty to advise.

Conclusion

A well-drafted letter of intent can increase the likelihood of an acquisition successfully closing, on optimal terms

To avoid any ambiguities, the letter of intent should clearly:

(i) state which of its provisions are binding on the parties and which are non-binding

(ii) Clarify that an obligation to carry out the transaction exists only once the parties have validly executed a written purchase agreement.

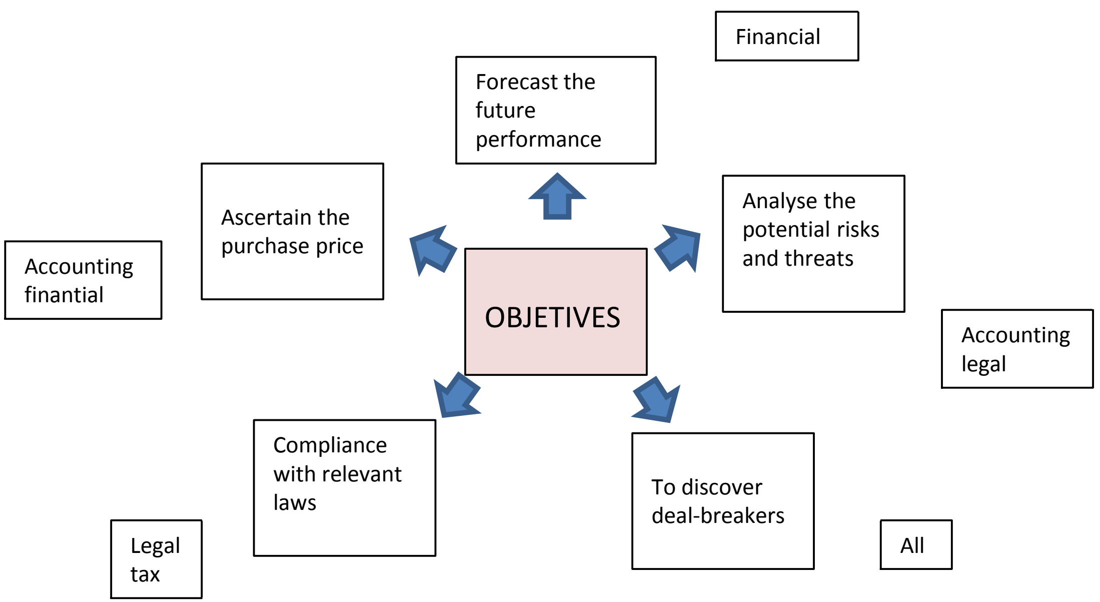
THIS IS THE MOST CRUCIAL POINT OF THE DOCUMENT AS, ON THE ONE HAND, IT PREVENTS THE PARTIES FROM INTERPRETING THE DOCUMENT AS AN EXECUTED PURCHASE AGREEMENT

DUE DILIGENCE

Source: KNAV

Due Diligence and its objectives

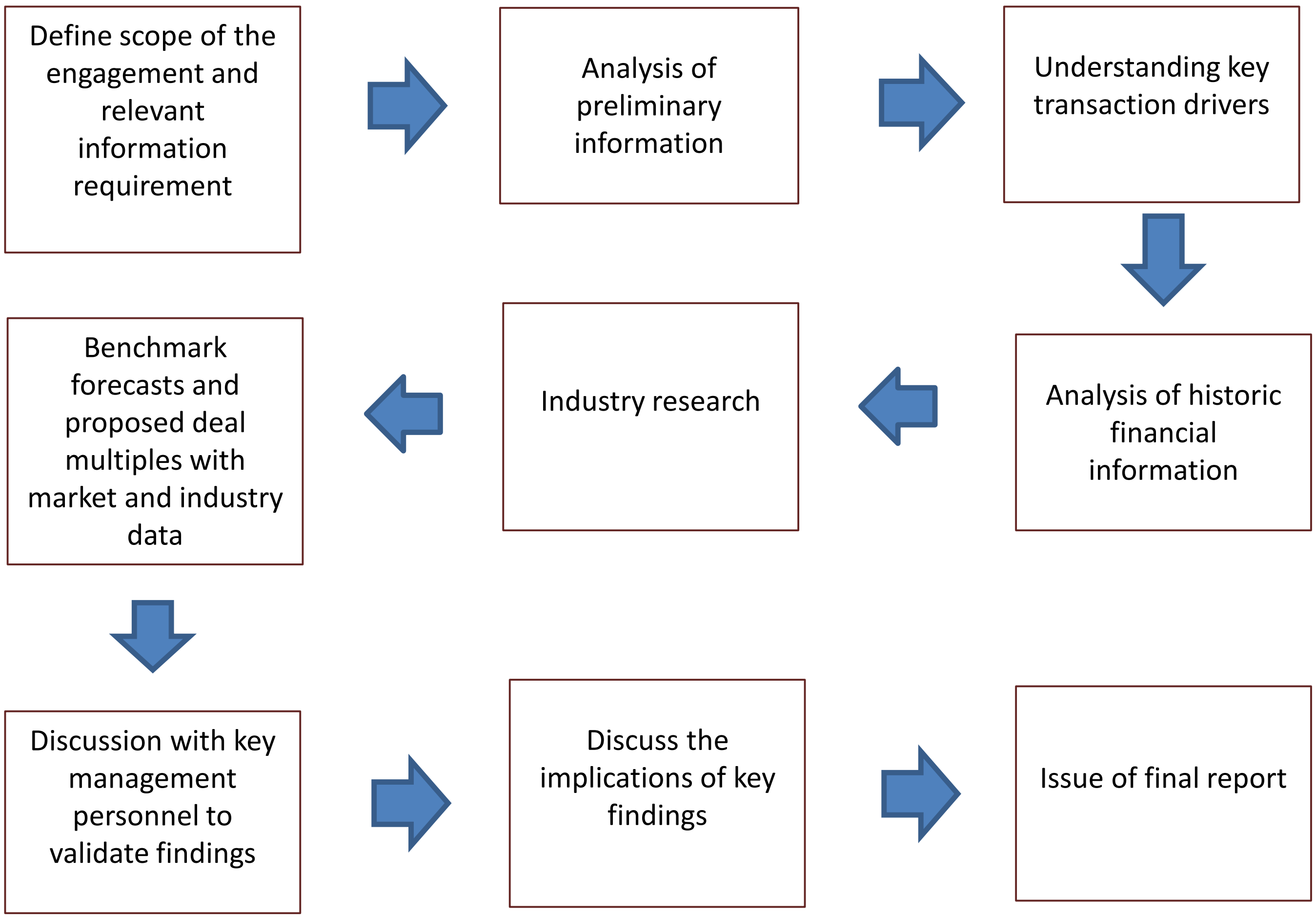
Due diligence is a process by which all the **relevant information to making a decision** on a particular transaction comes to light!



Due Diligence and its objectives

Objective of Due diligence	To **investigate** into the **affairs of business** as a prudent business person
	To confirm all material facts related to the business
	To assess the **risks and opportunities** of a proposed transaction
	To reduce the **risks of post-transaction** unpleasant surprises
	To confirm that the business is **what it appears**
	To create a trust between two unrelated parties
	To **identify potential deal killers** defects in the target and avoid a bad business transaction
	To verify that the transaction complies with **investment or acquisition criteria**

Due Diligence process



Types of due diligence

Accounting due diligence

- Review of finantial statements and management accounts
- Review of significant accounting policies and compliance with relevant Generally Accepted Accounting Principles (GAAP)
- Historical revenue and cost trends
- Consistency between historical results, versus budget and forecast.
- Review of debt covenants and terms of other debt-like instruments

Financial due diligence

- Basis for future business plan
- Valuation
- Deal financing
- Market dynamics and customer attractiveness
- Industry structure and dynamics
- Distribution channel dynamics
- Business plan review
- Quality of assets

Tax due diligence

- Assessment of tax impact arising from "change in control"
- Assessment of historical tax exposures
- Identifying tax saving opportunities
- Assessment of various modes of tax neutral deal structuring

Legal due diligence

- Liabilities and potential risks
- Competition authority implications
- Transaction mechanics, execution and closing

Buy side v/s sell side due diligence

Buy side due diligence → **Assist the buyer maximize his return on the deal**

Sell side due diligence → **Assist the Vendor /Seller get the best value on the deal**

Due Diligence enables negotiating team in a transaction to take on critical decisions pertaining to the transaction. The process allows negotiating team to strategize the course of action and terms of negotiations going forward

Due diligence findings

Deal breakers-Issues which would impede the consummation of the proposed transaction

Negotiation points - Issues which would be necessary to consider in the valuation of business/negotiation of bid price

Commercial override- Risks and issues which are knowingly taken over as a calculated commercial decision

Issues for agreements- Issues which would warrant indemnities and identify conditions precedent for hapening of the transaction

Key discussion points

ONLINE DATA ROOM

It is critically important to the success of a due diligence investigation that the **target company establish, maintain and update as appropriate a well-organized online data room** to enable the buyer to conduct due diligence in na orderly fashion.

- The target company **makes it available to the buyer as early in the process as possible**
- The data room has a **logical table of contents or directory and full text search capabilities**
- Subject to confidentiality concerns, the buyer is **permitted to print documents for offline review.**
- The data room is **indexed to any due diligence checklist** provided by the buyer to facilitate cross-referencing and review
- **Updates** to the data room are clearly marked or **trigger email notifications** to the buyer's counsel, to help ensure that nothing is missed as supplemental materials are added during the process

Due diligence report

The due diligence report would typically consist of the following three sections:

Executive Summary:

- This draws to the attention of the Acquirer, any items of concern or otherwise requiring attention and could usually start with the most critical points or deal breakers

Long Report:

- This would ideally follow the order and headings of the terms of reference or the checklist

Appendices:

- This section includes data sheets and/or documentation which are relevant to a critical issue

The Purchase or Sale of a Business

- The *Merger & Acquisition* activity begins at the time a business is offered for sale or a buyer decides to acquire a business.
- The early stages of these activities may involve the use of a business broker, investment banker, or some other party introducing a potential buyer and seller.
- At some point in the M&A process, the buyer and seller will conduct some form of *due diligence* activities.

Source:
Jim Cochran, Mike Craft

Primary Components of an Acquisition

- Identify the targeted business
- Negotiation of price and terms
- Execution of various documents
- Conduct Due Diligence
- Financial, tax, operating, capital, legal and other aspects
- Closing of the purchase

Common Documents Used in the Purchase of a Business

- Letter of Intent
- Purchase and Sale Agreement

Letter of Intent

- Agreement to negotiate
- Generally non-bonding on either party
- Sets forth basic principles of the soon-to-be Purchase and Sale Agreement
- Minimal details of the upcoming transaction
- Anticipated purchase price
- Basic terms

Purchase and Sale Agreement

- This is THE agreement.
- Very detailed and usually lengthy
- Specific price and method of payment
- Terms of closing
- Provides for *due diligence* process.
- May not be finalized until some point during or near the end of the due diligence process
- Even if executed before due diligence, either party may seek to modify it based upon findings from due diligence activities.

What is this thing called *due diligence*?

- Due diligence is a *process* during which a potential buyer of a company investigates that company to gain information to allow it to decide whether to go through with the acquisition.
- Due Diligence is the act of gathering and evaluating information about a target business.

Parties with an interest in due diligence

- All parties involved usually benefit.
- The buyer for sure
- The seller in some ways, though the buyer's due diligence could result in the deal falling apart
- Other Stakeholders
- Investors, lenders, employees, customers, vendors, attorneys (lots of fees!) and accountants (more big fees!)

How the buyer benefits

- Buyer gains information to help decide whether to go through with the acquisition.
- Buyer should have fewer surprises after taking over the business.
- Buyer readies itself to operate the business.
- After the purchase, buyer can “hit the ground running.”
- Buyer is able to develop a business plan, determine staffing needs and identify areas needing improvement in advance of taking control of the company.

How the seller benefits

- May allow the closing of the sale to go more smoothly.
- Reduces the likelihood of post-closing disagreements, which could turn into lawsuits, since buyer identified and got comfortable with issues prior to closing.
- Allows the seller to identify tax issues and deal with those before it is too late.

What about a business is important to the buyer?

- Its operations, of course
- The financial strength of the business
- The value of assets to be acquired and liabilities that will be assumed
- Its management and other key personnel
- Will they stay or go? Do you even want them to stay?
- Tax issues and their effect on the acquisition
- Contracts, litigation and other legal matters
- What will the buyer have to live with going forward?
- Technology issues
- Environmental issues and regulatory constraints
- Other, especially depending on the industry involved

What else does the buyer need to know?

- All sorts of financial information about the target company
- Financial statements
- As many as you can handle – Annual and monthly
- Audited financial statements are preferable
- Accounts receivable aging, accounts payable detail, inventory details
- The buyer needs to identify, among other things:
  - what it wants to include and exclude from the purchase
  - what it will cost to buy the company and ow it will pay for it
  - the sources of revenues and the uses of the company's cash
  - potential risks from acquiring the business
  - the upside of the acquisition

What should the buyer do with all this information?

- Identify and evaluate what it will be getting.
- Identify risks and opportunities of buying the business.
- Develop a prospective financial model of the newly acquired business.
- Project cash flow from the business with the planned equity and debt structure.
- Use it to assist in final negotiation of price and terms of the deal.
- Use it in the final decision as to whether to go through with the acquisition.

The Plan for the Due Diligence Project

- Designed to address the ultimate objective of making an informed decision as to whether to go through with the transaction
- Prepared with the involvement of all key players, including seller to some extent
- Written is better, to help ensure that everything gets done and is documented and communicated to all parties.

(…)

- Must balance risks and rewards with the practical aspects of the investigation.
- The objective is to conduct a reasonable investigation under the circumstances.

The Design of the Due Diligence Plan

- Each plan should be designed to fit the transaction.
- It should address the specific concerns likely to be associated with the target company.
- The plan should identify how the plan will be executed.
  - What will be done?
  - Who will do what?
  - Where will they do it?
  - When will they do it?

The Bottom Line

- Due diligence addresses the need to evaluate the likelihood and amount of future earnings and cash flow.
- Strategic advantage and other reasons for the acquisition should also be considered, but even those ultimately translate to cash.

What should be done?

The plan is intended to:

- Identify and evaluate what makes the business run
- Obtain and confirm data
- Identify and evaluate business-related issues
- Identify and assess risks

Who will do it?

- In short, the best person for the task
- The team should include the buyer’s management team, its attorneys and its accountants, auditors and tax advisors.
- Other experts should be used as needed for issues related to environmental, regulatory or other issues
- All participants must be able to maintain confidentiality

Where to do it?

- At the primary business location, to the extent possible
- At offices of accounting, law and other consulting firms
- Site visits to other locations, for multi-location businesses

When to do it?

- In a timeframe agreeable to the seller
- Should be specified in letter of intent or purchase & sale agreement
  - Beginning and ending dates, acceptable business hours, etc.

The Due Diligence Plan

- Should be agreed upon with the seller and other parties
  - All parties must understand the process.
  - Know what is allowed .
  - Know what is off-limits.
- A written work plan is best.
- It is usually time-consuming and may be expensive, depending on the size and scope of the acquisition.
- Strong representations and warranties in the purchase and sale agreement can help balance the risk, but does not replace the need for investigative work.

The Plan should address all areas of the business

- Operations
- Sales & Marketing
- Financial
- Human Resources
- Legal
- Tax and regulatory compliance
- Information technology
- Issues specific to the target company and the industry

A Typical Due Diligence Checklist

- A look at some of the items on a typical checklist used in the due diligence process.

Due Diligence Checklist: “Failing to Plan, is Planning to Fail”

1. Identify the overall objectives of the buyer and seller.
2. Understand the financial needs of buyer and seller.
3. Obtain approval from seller for lines of communication with seller’s staff and for conducting discussions with employees and third parties.
   - Sellers are particularly sensitive to the buyer talking with employees and customers.
4. Assign responsibilities for all areas of the work.
5. Line up attorneys, outside accountants and other specialists, and reach an understanding of assistance they will provide.

Due Diligence Checklist: Basic Information

1. Understand the business and its history.
2. Obtain an organizational chart or listing of employees.
3. Obtain resumes of management and key employees.
4. Obtain data of outstanding stock and its ownership, if the transaction will be structured as a stock purchase.
5. Prepare a roster of team members, both inside and third party consultants, to include addresses, phone numbers, email addresses, etc.
6. Obtain industry statistics to serve as a benchmark for the target company's operations.
7. Understand the company's economic prospects, its products and the industry.
8. Determine the countries/states in which company is licensed to operate.

Due Diligence Checklist: Operations

1. Evaluate quality of products and services and determine the effort required to rectify any deficiencies.
2. Evaluate the plant, facilities, warehouses, equipment, offices, etc. to be acquired.
3. Review production, materials-handling, warehousing, shipping, etc. procedures and controls.
4. Determine that the present and potential operating capacity is adequate to support the market forecast.
5. Determine availability and supply chain of raw materials, parts, components, etc. required for the company’s business.
6. Evaluate the quantity and condition of inventory, as well as the market for the inventory.
7. Consider the investment needed to support any plans for expansion.
8. Obtain copies of the Company’s licenses and permits.
9. Determine safety, productivity and efficiency standards and performance.
10. Obtain summary of OSHA matters for the last several years.
11. Obtain summary of federal and state EPA issues for the last several years.
    - Evaluate the need for and cost of any required clean-up of contaminants.
    - Strongly consider the need for an environmental study.

Due Diligence Checklist: Sales & Marketing

1. Identify major customers to evaluate likelihood of their continuing with the company.
   - Obtain sales volume by year for the last several years.
2. Determine whether the company is overly dependent on any single customer.
3. Identify major competitors and evaluate the company's competitive position (possible SWOT analysis).
   - Identify and understand barriers to entry into the market, as well as the company's competitive advantages and disadvantages vs. its competitors.
4. Determine the company's market share and evaluate whether the company has potential for growth or has reached market saturation.
5. Document the company's advertising and sales policies, as well as the cost of those activities.
6. Explore the company's advertising agency and review its budget and historical spending.
7. Understand the methods of distributing the company's products or services.

Due Diligence Checklist: Sales & Marketing (Cont'd)

8. Map out the distribution of sales/customers and ensure proper deployment of sales people.
9. Obtain reports on any market surveys and studies completed over the last several years.
10. Evaluate the extent of governmental regulation of the company's products, including product safety and recall records.
11. Determine the order backlog is reasonable and believable.
12. Identify any strategic alliances and evaluate their effectiveness.
13. Understand the company's sales cycle, including seasonality.
14. Obtain a list of patents, trademarks and trade names. Ensure all filings are adequate.
15. Meet and talk with customers, if seller gives consent.

Due Diligence Checklist: Procurement

1. Understand the procurement function.
2. Evaluate policies & procedures applicable to the procurement function.
3. Understand the types of materials and inventories purchased, as well as their availability in the market.
4. List major vendors and volume of materials and inventories purchased each year.
5. Quantify outstanding purchase commitments and ensure they are reasonable for future anticipated volume.
6. Determine whether more than one vendor is available for critical items.

Due Diligence Checklist: Financial

1. Review books and records, financial statements, tax returns, and interim reports for the last five years, as well as current year-to-date.
   - Review monthly financial statements for the current year and possibly the previous year.
   - Evaluate sales and profitability by product line and location.
2. Review any changes in accounting methods during last several years.
   - With seller's consent, meet with the company's auditors and tax advisors and review their audit/tax work papers.
3. Determine financial ratings from D&B and other credit bureaus.
4. Understand accounting policies and practices for all areas, but especially inventory valuation method. Consider conducting a physical inventory.
5. Evaluate the company's system of internal controls.
6. Review credit policies and collection procedures.
7. Evaluate the accounts receivable aging records. Ensure the allowance for doubtful accounts is adequate.
8. Identify real and personal property owned and leased. Consider an appraisal to evaluate its value and condition.

Due Diligence Checklist: Financial (Cont'd)

9. Identify all assets pledged under loan agreements, and consider any issues with their transfer to buyer.
10. Identify obsolete or slow moving inventory, and determine the need for any reserves.
11. Review detail of accounts payable and accrued liabilities. Ensure accruals are adequate. Ensure liabilities are reasonable as compared to historical levels.
12. Be alert for any contingent liabilities which could materialize from lawsuits, labor issues, environmental issues, etc.
13. Identify related party transactions and determine their impact on the company going forward.
14. Identify infrequent or non-recurring transactions and determine their impact on the company's financial position.
15. Review profitability by product line and location.

Due Diligence Checklist: Human Resources

1. List current employees by department and compensation level.
2. Evaluate competence of management and key employees, and evaluate any needed changes in staffing.
3. Review the employee handbook.
4. Inquire as to compliance with DOL and other regulations.
5. Get a feel for employee morale.
6. Obtain benefit plans and determine their adequacy.
   – Ensure company is in compliance with the Affordable Care Act.
7. Understand incentive compensation plans and evaluate whether changes will be needed.
8. Review 401(k), pension and other retirement plans.

Due Diligence Checklist: Human Resources (Cont'd)

9. Identify employee vacancies in critical positions. Ensure the company has not been sacrificing staffing for window dressing.
10. Review turnover statistics.
11. Interview key employees, if seller consents.
12. Review union contracts and determine affected employees. Consider the impact of any upcoming union negotiations for renewed contracts.
13. Review any employment agreements or contracts.
14. Understand any labor disputes in the last few years.

Due Diligence Checklist: Legal Matters

1. Review the corporate and organization documents, especially in connection with a stock purchase.
2. Talk with inside and outside attorneys to identify and evaluate legal issues, ongoing litigation, etc.
3. Identify states in which the company is registered to conduct business and ensure filings are up-to-date.
4. Review patents, trademarks, and service marks to ensure they are adequately registered.
5. List representations and warranties to be requested of the seller.
6. Review a list of licenses, contracts, and leases to determine any impact on the acquisition and needs going forward.
7. For any loans which will be assumed, review applicable agreements.
8. Consider any impact of stock vs. asset purchase in order to structure the acquisition.

Due Diligence Checklist: Information Systems

1. Understand the various information systems and conclude as to their effectiveness.
2. Review the Company's software licenses.
3. Understand the support structure for the IT systems.
4. Determine any future hardware and software requirements.
5. Understand the company's disaster recovery plan and procedures.
6. Determine whether the company's IT systems can interface with those of the buyer.

Due Diligence Checklist: Insurance

1. Review the company’s insurance coverage.
2. Determine the extent to which the company is self-insured, if applicable.
3. Obtain a history of losses and claims for the last several years.
4. Obtain information on any outstanding claims and evaluate the potential for loss.
5. Review the company’s workers compensation claims history and ratings.
6. Interview the company’s insurance brokers and consultants, if seller consents.
7. Evaluate the need for loss reserves and communicate this to those performing the financial due diligence.
8. Investigate need for any special coverages, such as environmental risks, cyber matters, earthquake or other potential catastrophic risks.

Due Diligence Checklist: Pro forma Financial

- Develop prospective financial projections for the new company based on knowledge gained through due diligence, management's plans for the business and the anticipated capital and debt structure.
- Determine projected earnings for the new company.
- Determine projected cash available for anticipated debt service.
- Ensure projected financial results are adequate to support the purchase price.
  - These pro forma financial statements, prepared based on the results of due diligence, can help determine or validate the purchase price

Issues requiring additional work

- Acquisition of only a division or separate line of business
- Acquisition of a business that is under common control with other businesses
- Significant issues or concerns identified during due diligence
- International business

International Issues

- Import/Export Duties, Tariffs and regulations
- Management attitudes
- Legal matters
- International Tax Issues
  - United States tax issues
  - Foreign country tax issues
- Cultural differences
- Language barriers

Summary

- Due diligence is a process of investigation to gain information.
- Due diligence can be used in any type of transaction.
- Due diligence needs to be well planned.
- Due diligence activities should be practical for the acquisition.
- Due diligence benefits all parties involved in the transaction.
- Due diligence helps determine or support the price and other terms of the transaction.
- Due diligence helps ensure a successful acquisition and transition.
- Due diligence puts the buyer in a position to hit the ground running with the new company after acquisition.