

Acredula

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Bricker & Eckler LLP's *Acredula* is available to clients and friends of the firm, and highlights information of particular importance to boards and executives. The information contained in this newsletter is not to be construed as legal advice or opinion.

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Acredula is the Latin word for "owl," connoting wisdom. This newsletter is intended as wise counsel for boards and executives.

Every Business Must Plan Its Development and Protect Its Resources

The most practical advice for any business, from emerging to maturing, is to "plan and protect."

An emerging business must both *plan* the development of its business and *protect* its resources. An emerging company should plan the development of its business by preparing financial models and a business plan. At the same time, it should protect its resources by entering into employment agreements and other agreements protecting confidentiality and ownership of ideas and intellectual property.

The same is true for a maturing business. A maturing business must plan its maturation, while continuing to protect its resources.

This issue of *Acredula* focuses on the steps that a maturing business should take as it approaches a liquidity event, such as a merger with or an acquisition by another company. Too often, businesses become so

Editor's Note

involved in the "courting" and negotiations associated with these events that they forget about protecting their resources. Businesses are most vulnerable during the due diligence process preceding a liquidity event. Before a business opens its doors and books, it must protect itself in case the liquidity event does not occur. Otherwise, it will increase its competition and decrease its market position.

Mike Sullivan, the author of this month's feature article, has spent most of his legal career advising businesses regarding mergers and acquisitions. His article provides practical steps for maturing businesses to consider before opening their doors and books for due diligence.



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Practical Advice for Surviving Due Diligence

Michael F. Sullivan, Bricker & Eckler LLP

If a company is seeking to be acquired by or to sell a subsidiary to another company, it must be prepared to disclose material facts about its business and operations to the potential buyer.

During this due diligence process, the potential buyer engages in a thorough inquiry into the business affairs of the company to be acquired, or the target company. Protecting sensitive informa-

tion during this inquiry is important for the security of the target company. From confidentiality agreements to presenting due diligence materials, battle-scarred sellers can offer wise and practical advice to target companies navigating the various stages of this process.

Confidentiality Agreements

At the earliest stages of discussion, the acquirer should be asked to sign a confidentiality agreement, which should emphasize paramount concerns, such as protecting technology, personnel raiding, customer solicitation or some other hot button. The fact that the target company is potentially for sale may itself be sensitive information. Often, target companies use third-party representatives to obtain a preliminary confidentiality agreement before they will even disclose the name of their company.

Staged Disclosures

Complying with a confidentiality agreement is not always easy. For example, if the target company is in the process of choosing a new product line during due diligence, even a well-intentioned buyer would

find it difficult to ignore the knowledge that one product was particularly profitable for the target company, while another product had given rise to product liability lawsuits. In addition to the buyer's agreement that information garnered in the due diligence process will not be used for competitive purposes, the target company should take

other steps to reduce its risks. Knowledgeable companies pursue practical measures beyond the confidentiality contract to minimize the risk of providing a training course to their competition in a failed acquisition.

One major step begins with categorizing company information based on commercial sensitivity. In the first stage of due diligence, there is generally disclosure of non-detailed financial information, publicly available information and non-sensitive information. At the very last stages of the negotiation, after the terms of the definitive agreement have been settled, there is disclosure of highly sensitive information, including:

- Customer names and volumes;
- Pricing; and
- Compensation and production of identified sales personnel.

During the course of the negotiation process, information falling into the middle of the range would be disclosed, such as detailed financial results, terms of major contracts, environmental problems and employee benefit plans.

In addition to protecting information at stages when the acquisition is most likely to fail, the staged release of information serves an additional purpose- it protects both sides from potential violation of anti-trust laws based on coordination of competitive activity. This explanation for withholding information will avoid souring the relationship with the purchaser.

Assembling Due Diligence Materials

Start early. A buyer's first judgment as to the efficiency of the target company and its personnel is often made based on the timeliness and professionalism of their response to due diligence inquiries. While each buyer will have his or her own favorite due diligence questionnaire, a target company can anticipate most inquiries by reviewing a typical due diligence questionnaire, which its corporate counsel should have readily at hand.

Delegate. Management of the target company should identify a team of persons who will be responsible for responding to a broad range of inquiries on topics such as financial data, environmental matters and human resources. That team should begin the process of collecting the documents likely to be requested in a centralized location and finding answers to questions that will likely be asked. The team should be informed that, at the end of the process, they will be asked to certify in writing that the



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information schedules are complete and current.

Be fulsome in schedule disclosures. Target companies will be required to represent and warrant numerous factual circumstances in the acquisition documents and indemnify the acquirer for any breach. These representations will be subject to exceptions for information which is disclosed in schedules. Thus, the ability of the target company to anticipate and collect information that will be an exception to a representation serves an important function- it protects the purchase price from the erosion that will occur if the seller makes post-closing indemnification payments for breach of representations.

Presentation of Due Diligence Materials

The transfer of information from the seller to the buyer should be tightly controlled by the seller. The buyer would like nothing more than to amble about talking to hordes of employees (who know they will soon be employed by the buyer and may be anxious to curry its favor), collecting loads of data to be reviewed at his or her leisure. Smart target companies structure the due diligence process to make it an orderly and productive one for their companies.

A designated manager of the target company should be in charge of the due diligence process. Any contacts between the acquirer's management and the target company's management should be highly structured and arranged only with the concurrence of this "gatekeeper." Every document placed in the possession of the buyer should be copied and retained in a separate file indicating the date of delivery and the recipient. This is the only way to protect against later claims of misstatements or omissions.

The due diligence manager should be particularly careful not to release communications with the company's counsel to the acquirer without prior legal clearance. Such release may effectively waive attorney-client privileges with all kinds of interesting and unpleasant results.

Finally, a cautionary letter should accompany any forward-looking data, such as budgets and projections, which are delivered to the buyer. Counsel should be involved in the drafting of this letter, which will serve as the company's main

protection if the buyer experiences dismal post-acquisition operating results.

Turning the Tables—Due Diligence on the Acquirer

The seller has a natural interest in knowing that appropriate corporate approval mechanisms have been obtained by the acquirer and that appropriate governmental filings, such as Hart-Scott-Rodino, have been made. If any portion of the purchase price is not cash payable at closing, the target company will have an additional interest in the solvency and financial viability of the acquirer. If stock is received in the acquisition, full due diligence as to the financial condition and pros-

pects of the buyer will be necessary. The potential of symmetrical due diligence often has the "Golden Rule" effect of causing the buyer to limit its questions to a level that it will be comfortable answering when it becomes the subject of due diligence.

Conclusion

By following these suggestions, target companies can avoid many of the pitfalls associated with due diligence. Target companies should structure their due diligence programs as if (a) the transaction never closes, and the acquirer moves into their territory next year; and (b) the transaction closes, and their company loses huge sums of money the next year. By protecting themselves in these two next-year scenarios, target companies can survive successfully the due diligence process.

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