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CORPORATE FINANCE

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Examples of Due Diligence issues causing deals to fail

During the presentation given at the Business Show at ExCel in November 2018 we had provided examples of where business sales had fallen through because of issues identified at DD and here are some examples of where the DD process has found problems:

1. Stat books not written up; everyone knows this is just a boring seemingly irrelevant part of running a business but you can be sure that the Buyer will want all the stat books written up properly and fully up to date – that includes all the AGM's!! - these are not difficult to do or to get done and may cost a few hundreds of pounds BUT get them done ahead of DD starting so that you don't have to worry about them; the deal will not happen without them.

2. Previous share transfer not processed; on a similar basis to the above maintaining the stat books is imperative, but when they may not reflect a previous share transfer all sorts of problems may occur. A previous shareholder (minority or otherwise) who has exited but still remains on the share register can cause problems for a deal – they may suddenly see that there is value on the table from the Buyer and seek to get a share of it in return for signing the share transfers when the deal is getting near completion. Get your house in order well before this and at a time when there's no such risk for you.… and yes deals have failed with "supposed" ex-shareholders digging their heels in – don't forget there's no risk to them!

3. Existing minority shareholders not prepared to sell …but "don't worry they'll be fine" message from the majority owners about them; there may be an existing minority shareholder who could be part of the management team (and so crucial to the transition after any sale) who you think will play ball … but as soon as they realise there may be some financial benefit to them they may have different views. This has occurred and the route out has had to be an agreement for a post-sale "bonus" for the person concerned … but that has come off the sale price!

4. Partial exemption VAT issue (in this case zero rated vs. exempt supplies misanalysis); during the DD process it was found that there had been a mis-analysis of the VAT status of certain supplies which meant that some of the VAT reclaimed has been wrong – this has killed the deal as the amounts concerned were quite large and the penalties etc. would have been quite significant.

5. Use of an inexperienced sole practitioner solicitor; a client had used a very inexperienced (for M&A that is) solicitor. The Buyers lawyers ran rings around this person who actually missed some pretty significant issues in the SPA. The Sellers signed up and then found they had given warranties on all sorts of commercial matters and were subject to substantial claims that they had never anticipated. The claims eat into a large part of their sale proceeds so the deal of a lifetime turned into a major disaster for them.

6. Unrecognised change of control clauses with Customers; in the detail of some of the Customer agreements (drawn up by the Customers concerned), for this SME business, were clauses that said the agreements would terminate on change of control. The Seller had not thought twice about these and just expected the Customer relationships to continue. The Buyers found these in the DD and insisted that the Seller receive confirmation from the Customers that the contracts would continue; the Customers refused as the Buyers were not in the same industry and had no relevant experience. Even worse, having effectively put the Customers concerned on notice that they were going to sell, the Sellers found that their work suddenly dried up and the business suffered badly.

7. Long outstanding debtors; it can be quite easy during the sale process to overlook some of the regular day-to-day activities that are the life-blood of any organisation, collecting your debts is certainly one of them. You may even feel that you don't want to chase your customers during the sale process for fear of upsetting them and undermining your business relationship at such a crucial time. We've seen this several times with a knock-on consequence that the Buyer questions the validity of the debts themselves and may well ask you for some more detailed confirmation from the customers that the debts are valid. Even assuming this confirmation is received we've seen cases where the older outstanding debt value is deducted from the sale price being paid at completion and only paid once the customers have paid. Bearing in mind you are no longer in control of the business this may at the very least delay some of the initial payment to you.

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