Seller's Side Financial Due Diligence Investigation Checklist

Explanation: Unlike the buyer in a proposed purchase/sale transaction, the seller has relatively few concerns. If the purchase price is paid in installments, the primary focus of the seller's due diligence investigation will be on the buyer's ability to pay the remaining purchase price. The seller's second major concern is usually the tax consequences of the sale.

<u>Buyer's Ability to Make Deferred Payments</u>

1. Structure Deal to Minimize Seller's Risk:
   a. When deferred installment payments will cover part of the purchase price, advise seller to obtain as large a down payment as possible.
   b. Seller's willingness to accept deferred installment payments should be reflected in a more generous purchase price.
   c. Adequate interest should be charged on deferred payments.
   d. If the buyer is an individual or a closely held business controlled by a few key individuals, consider having the seller acquire term life insurance on the buyer(s) (naming the seller as beneficiary) for the period over which deferred payments are to be collected. (The seller may attempt to negotiate that the buyer pays the premiums for such insurance.)
2. Evaluate Financial Status and Character of Buyer:
   a. Obtain buyer's financial statements and understand the source of funds that will be used to make both the down payment and the deferred installments. (Typically, cash flow from the purchased business will be a major source of funds to make the deferred payments.)
   b. Note that a buyer's reluctance to disclose the source of funds that will be used to make deferred payments should be a warning to the seller of potential problems.
   c. Obtain and evaluate buyer's credit history. Sources include Dun & Bradstreet reports and references supplied by the buyer (especially the buyer's banking relationships).
   d. Obtain buyer's representation that all information regarding prior and current loan defaults and bankruptcies has been disclosed.
   e. Check public records to see if the buyer has been named as the defendant or plaintiff in litigation. Evidence of multiple business-related suits brought by the buyer (especially in connection with other business purchase transactions) is an obvious warning that it may be difficult to collect money after the sale.
   f. Thoroughly investigate any suits naming the buyer as defendant in attempts to force payment.
   g. Gather and consider other evidence regarding the buyer's general and business reputation. This may be available from local newspaper stories if the buyer (or a buyer's key employee, in the case of a corporate buyer) is a prominent person. Off-the-record discussions with bankers, attorneys, and business leaders in the buyer's area may also disclose additional information.

3. Evaluate Buyer’s Collateral for Deferred Payments:

a. Generally, the buyer’s stock in the purchased business or the purchased assets are used as collateral (by so indicating in the promissory note issued by the buyer and in an accompanying security or pledge agreement) for the remaining installment payments. Any other assets of the buyer should also be considered as possible sources of collateral.

b. If a personal guarantee is to be obtained from the buyer (or shareholders of the buyer), it also must have collateral standing behind it to have any real value. The collateral must be identified and evaluated.

c. If third-party guarantees are to be obtained (for example, from a related entity to the buyer), verify the party has adequate collateral (which should be specifically identified in the guarantee document).

Evaluate Buyer’s Business Plans

Note: The existence of a reasonable business plan is also a seller concern when deferred payments are involved because the seller has a stake in the ongoing success of the business until the deferred payments are collected in full.

1. Adequacy of Initial Working Capital—Determine whether buyer will have adequate initial working capital (excess of short-term assets including cash over short-term liabilities) to operate the business immediately after the purchase.
2. Longer-range Business Plans—Determine whether buyer has a well-thought-out and “doable” general business plan over the term of the deferred payments owed to the seller.
3. Consider whether it is advisable for seller to negotiate a consulting agreement or employment contract to help assure that the business will be operated successfully so the deferred payments can be made.

Liability for Broker’s and Finder’s Fees and Transaction Costs

Note: It may be somewhat unclear whether the buyer or seller (or both) are responsible for the payment of broker’s and finder’s fees and other transaction costs. Commonly encountered transaction costs include (but are not limited to) legal and accounting fees and the expenses of conducting the due diligence investigation.

1. Nature and Amount of Seller’s Costs:

a. Identify the nature and estimated amounts of transaction costs for which the seller is responsible.

b. Verify that seller has taken transaction costs into account in assessing the financial attractiveness of the deal and that seller has sufficient funds to pay these costs.

2. Specifying Who Pays Which Costs:

a. Verify that the issue of who pays fees and transaction costs is (or will be) specified in the final purchase/sale document.

b. If the buyer and seller believe no party is entitled to a broker's or finder's fee, the purchase/sale agreement should so stipulate.

c. Generally, the understanding between the buyer and seller is that each side will pay its own costs of conducting the transaction.

Warning: In Type B (stock for stock) and Type C (stock for assets) tax-free reorganizations, acquisitions must generally be accomplished by using only stock as consideration. This means that buyer payments of transaction costs for or on behalf of the target or target shareholders can cause problems with the ability of the transaction to qualify for tax-free status. In Type A reorganizations (statutory mergers and consolidations), such payments can be made but may be treated as taxable boot received by the selling shareholders.