WEDNESDAY, NOVEMBER 17, 1993 VOL. P. 3070

The Legal Intelligencer

BUSINESS LAW

Ounce of Due Diligence Worth Pound of Cure

Investigations of Business Deals Should not be Superficial

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Special to the Legal

Although everyone in the business world is likely to agree that an ounce of prevention–otherwise known as due diligence–is well worth a pound of cure, many due diligence investigations are no more than a superficial examination of existing data.

Few actually consider the impact that effective due diligence can have on a purchase decision. That is because it is human nature to assume that bad things only happen to other people, never to you. Consequently, many companies painfully discover information after the fact that–had they known in advance–would have significantly altered the terms of a deal or caused them to walk away from it. The following compendium case study is the story of one major company that learned just how valuable a due diligence investigation can be. (Names and companies are hypothetical.)

Awesome Machinery Corp. conducted a due diligence investigation several months after it acquired majority ownership of a medium-sized company. Awesome had begun to suspect the inventory listed in the acquired company's assets was substantially overstated. The investigation proved that concern to be all too real. The vice president of finance was discovered to be stealing inventory, selling it to one of Awesome's competitors, and covering it up by falsifying Awesome's inventory figures.

Although Awesome, which valued the acquisition based on assets and earnings, greatly benefited by now having a true picture of their new acquisition's financial worth, it was not gained without a significant loss of time and energy. "Next time we consider a major acquisition," vowed Thomas Stasos, Awesome's CEO, "we'll call before the barn door closes."

True to his word, Stasos retained the same forensic financial investigators a few weeks later to perform a due diligence investigation on a supplier that Awesome was eager to purchase.

Vital Parts Co. manufactured a specialized component for one of Awesome's most profitable products. Stasos wanted to purchase Vital both to earn a return and to ensure its component would always be available at a reasonable price.

Awesome had tried to acquire Vital for many years but its sole owner, Harry Jackson, had always declined. However, following a recent round of golf, Jackson confided to Stasos that due to sudden health problems in his family, he was now willing to sell. Preliminary negotiations ensued and an agreement was worked out that would give Awesome complete ownership of Vital in return for 25 percent of

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the purchase price in cash and the other 75 percent in Awesome shares, which would be determined by their stock market value at the time of closing.

The purchase price was based on a five times multiple of Vital's pre-tax earnings as reported in its audited financial statements for the most recent year end. According to the audited financial statements, Vital's pre-tax earnings were $5 million, which meant a purchase price of $25 million. The deal, as always, would be subject to due diligence, in this case by Awesome's forensic investigators.

The forensic team recommended–and Stasos agreed–that its overall mandate would be to determine key business, financial and accounting risks associated with the proposed purchase of Vital. Applying a "bloodhound" approach, the forensic team set out to find the "soft under-belly" of the business.

That meant not only analyzing key financial and accounting information relevant to Vital's operations, but also investigating the marketplace, Vital's present and future position within it, and any unforeseen factors that could weaken or endanger Vital's profitability and viability.

Three Findings

As a result of the investigation, three major findings were presented to Awesome.

The first centered on Vital's customer list, which identified that eight main customers plus Awesome accounted for 80 percent of Vital's annual sales of $30 million. Detailed background searches of the eight companies revealed that three were owned either directly or indirectly by the same international parent.

Further investigation, including obtaining and analyzing public documentation and conducting interviews with sources familiar with the parent, revealed that although the customers were financially healthy, their parent was undergoing major restructuring of its debts, including real estate and plant financing. The restructuring was significant enough to put into question the stability of the parent and, consequently, the future of certain of Vital's customer base.

The second assessed the overall business risk involved in the acquisition, with specific exploration of all the ways Vital might be vulnerable to a loss or decline in its existing dominant position in the marketplace.

It was discovered that Vital had succeeded over the years because it manufactured the part that Awesome required ("Part A") in conjunction with two other products. Part A was primarily manufactured from the by-product of materials from the two others, which kept Part A's cost low.

This meant that any change in the marketplace affecting the quantity of the other two products being manufactured and sold by Vital would impact on the cost of producing Part A.

From further investigation, it was found that Vital's patent on one of the two products was expiring in the near future. That meant, in all likelihood, Vital's market share for the product was going to decrease as the loss of patent rights would open the market up to greater competition.

The lower market share could result in higher costs to produce Part A because of insufficient by-product, thus requiring Vital to purchase raw material at a substantially higher cost.

Officer Investigation

The third finding resulted from background investigations of Vital's key officers. It was discovered that Vital's Controller, Jasper Robkins, had recently acquired a second mortgage on his home, which brought the total financing on his home to more than 90 percent of its current value.

The mortgage was arranged through a mortgage broker at close to double the going interest rates. As a result, Robkins now had mortgage payments that accounted for approximately 80 percent of his annual salary. Since it appeared impossible for him to make ends meet on his salary at Vital, this raised a red flag that demanded further investigation.

A lifestyle review of Robkins revealed a person who spent lavishly on clothing, entertainment, travel and material possessions to a degree far in excess of his apparent income. Stasos and Jackson requested further investigation.

Jackson recommended starting with inventory, for in his view, Robkins spent more time on that area of the business than anywhere else. Selected purchase transactions were investigated and analyzed. That process identified a scam Robkins had been running for almost two years.

Unknown to his superiors, Robkins had been re-routing raw materials (before they were delivered to Vital) to another company registered to his wife with the address being a group of industrial warehouses in a nearby municipality. Robkins had changed Vital's books, including bills of lading, to show that Vital received the goods.

Although the inventory had been audited twice during the relevant period, on both occasions, Robkins was able to direct the young audit staff to test check inventory that he knew existed in accurate amounts. In this way, their test checks of book-to-physical inventory would agree.

He could then easily falsify the physical count sheets to agree to the inventory recorded in the books. It was estimated that Vital had lost approximately $750,000 of inventory. This information was turned over to Vital and Robkins was immediately dismissed.

Following the presentation of the findings, Awesome had to assess whether these were "deal-breaker" or "pricing" issues. From its research, Awesome concluded that the off-shore parent of the three customers would survive its restructuring, but that Awesome would maintain a vigilant watch on the parent's progress.

Awesome also determined that Vital would remain viable despite the loss of patent rights on one of its products but that its profitability would definitely decline. Another factor under consideration was the $750,000 in lost inventory. Although a bad apple had been removed, Robkins had virtually no assets, making any meaningful recovery from his impossible. Further, the fidelity coverage was uncertain.

Awesome decided that it was still a good business decision to purchase Vital but that the deal had to be re-priced to reflect the new information. As a result of the $750,000 in overstated inventory, the pre-tax earnings in Awesome's view had to be reduced from $5 million to $4.25 million.

Due to the impact caused by the loss of patent rights, the purchase price, in Awesome's view, had to be reduced from a five times multiple of earnings to a four times multiple of earnings. Consequently, the purchase price would be lowered from $25 million ($5 million x 5) to $17 million ($4.25 million x 4). Vital accepted the offer and the purchase was completed.

"If we hadn't been burned on the previous deal," Statos said afterward, "I'm sure we would never have conducted such an extensive due diligence review–and we might not have saved $8 million." It is unfortunate that it usually takes a bad experience to convince us that common wisdom we agree with in theory–such as the benefit of preventive medicine–should also be followed in practice.

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