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The Importance of Due Diligence

Written by Frank L. Pohl, Esq.
of Pohl & Short, P.A.

When making a large purchase, such as a home or a car, it is important to find out as much as you can about the item you are purchasing. The same is true when purchasing a business, notably when the purchase will be



structured as a stock acquisition. Unlike an asset acquisition, where a purchaser may choose which business liabilities, if any, he is willing to assume, a purchaser in a stock acquisition generally inherits all of the liabilities of the purchased business. Therefore, completing a thorough legal "due diligence" review to uncover such liabilities is an essential part of the acquisition process.

Legal "due diligence" is the process by which the business' records (as well as public filings pertaining to the business, such as trademark registrations or lien filings) are systematically examined by the potential purchaser or the purchaser's legal representatives.

Documents examined may include the business' promissory notes and other loan documents, leases, organizational documents (e.g., articles of incorporation, bylaws, and shareholders agreements if the business is a corporation), or documents pertaining to previous or pending litigation or regulatory enforcement proceedings.

The records examined and the scope of review will vary depending on the type of business that will be acquired. For example, if the business is engaged in manufacturing, emphasis may be placed on examining the business' warranty obligations and previous or pending product liability claims. If the business provides services, particular attention should be given to the business' employee and independent contractor agreements. Also, if a business needs a particular license to operate, the due diligence review would uncover whether such license is in good standing or if any adverse action has been taken against the license holder.

Another important function of the due diligence review is to uncover whether the sale and purchase of the business itself will constitute a default under

an existing contract. For example, sale of a business may trigger the default provisions of a loan, which could allow the lender to accelerate all payments due under the loan or repossess property that collateralizes the loan. If the repossessed property is a key piece of equipment needed for the operation of the business, the purchaser may find himself in a precarious position.

A thorough legal due diligence review of a prospective business protects the would-be purchaser by affording him or (her) the opportunity to assess the business' liabilities before closing the sale, instead of having to confront the liabilities after closing. Armed with such information, the purchaser may be able to negotiate a more favorable purchase price or sale terms or could simply "walk away" from the deal.