By David M. Shanberg

Due Diligence in Reverse

Companies in the midst of being acquired expect the potential acquirer to perform a thorough due diligence review. But what level of due diligence on the acquirer, or “reverse due diligence,” should they demand?

There are several aspects this question.

Cash as consideration

First, for the investors / shareholders, does the health of the acquirer affect the consideration received? In the case of an all-cash deal, it’s pretty clear that it doesn’t matter. As long as the acquirer has access to the cash and provides adequate comfort that the transaction will close, not much further is necessary or can be demanded. But if the consideration is the stock of the acquirer, some level of investigation of the acquirer is called for.

Stock as consideration, large public company as acquirer

If the acquirer is a large public company, a request for reverse due diligence may be met with a curt, “Please refer to our website and to www.sec.gov for everything you need to know.” In fact, the stock of large or heavily traded public company can be treated much like cash, as it has a more concrete value and can be readily sold. Thus, the same public information available to institutional and individual investors should suffice.

Stock as consideration, smaller public company or private company acquirer

If the acquirer is a public company with a low trading volume or is a private company, the issue of reverse due diligence certainly comes into play. Investors in the target company expect to understand the value of the new combined company. However, the acquirer, feeling like they are the party that is “paying,” will expect the review to be limited. To me, a reasonable middle ground is for the acquirer to provide information consistent with what it would provide a similar size cash investor in the company.

Additional considerations for the executive team

For the executive team, there are additional concerns regarding the health, future, and vision of the acquiring company. For some of the team, they will have a moral expectation and financial incentive to stay with the combined company for a period of time, so they are betting personal opportunity cost over and above the risk incurred by the other shareholders. The team should understand and be comfortable with the future direction of the combined company, much as if they were interviewing for their future positions.

Overall, the issue of reverse due diligence is highly situational, ranging from cases when it is completely inappropriate to cases when it absolutely should occur. It's important to identify which of the above instances is relevant in order to take a responsible yet reasonable position.

David Shanberg has led communications, Internet, software, and other technology mergers, acquisitions, strategic alliances, venture investments, business development, and finance activities for the past 16 years, completing transactions totaling over $90 billion. He also has a previous 4 years of experience in technology consulting.

Baker Pacific specializes in corporate development strategy and M&A transactions for technology companies. Baker Pacific is especially well-suited for situations where a company finds itself contemplating or facing a significant transaction (such as a sale of the company or an acquisition) and needs additional expertise and bandwidth to be successful.

Baker Pacific's philosophy is not to just do deals, but to do the right deals. Its orientation reflects the impartiality and deeper industry understanding of an internal strategy and corporate development executive, as opposed to a transaction-oriented outside advisor. Baker Pacific is not afraid to advise against doing a deal.

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