AN AMERICAN IN LONDON: DUE DILIGENCE OBSERVATIONS

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INTRODUCTION

U.S. business owners and professionals performing due diligence on potential merger or acquisition candidates are all too familiar with the trials and tribulations of arriving at a fair valuation for the acquirer. They often stress over the quality of the target's financial information, potential hidden liabilities, financing, and the like. Now, imagine that the due diligence exercise is occurring outside of the U.S. because the target is based abroad. Adding to the stress is a different culture as well as different finance and legal terminology, laws, and accounting principles. How is one to manage?

The silver lining, in my experience, is that when the due diligence involves a non-listed (*i.e.*, privately-held) U.K. company, financial information is much more accessible than it is in the U.S. One can purchase information on a possible target and see the reported operating results, ownership group, and directors. The information is provided in a required government format, as will be discussed. However, this does not guarantee that the information is accurate. Normal due diligence skepticism still applies.

This article will provide information on some sources of information, forms of financing, and director responsibilities that are typical in the U.K. This is not a "how to" on M&A due diligence, but rather an overview of the types of financial information, financing, and other business practices relevant to acquiring a privately-held company. It is based on the author's experience garnered from several due diligence exercises in the U.K. for potential acquirers based in the U.S.

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FINANCIAL INFORMATION

In the U.S., we are accustomed to receiving various forms of financial statements in accordance with Generally Accepted Accounting Principles ("G.A.A.P."). In the U.K., there are also Generally Accepted Accounting Principles. However, they are known as U.K. G.A.A.P. Financial statements are often prepared in accordance with these principles. In addition, financial statements may also be prepared pursuant to International Financial Reporting Standards ("I.F.R.S."). The latter is usually reserved for listed (*i.e.*, publicly-traded) companies.

In the U.K., public and private companies are governed by the Companies Act 2006 (the "Act") as amended. The Act sets forth the requirements for operating public and private corporations and limited companies, including director responsibilities and reporting requirements to Companies House, the keeper of all financial statements. Generally, non-listed companies are required to report their financial information

within nine[1] months after the fiscal year-end, listed companies within six months.[2] Penalties are assessed for lateness and may indicate financial or operating issues to be cognizant of during the due diligence process.

Now that we have context, the financial information must be acquired from Companies House. The information can be accessed by following this link. Here, one can access free information, select documents, or subscribe to the Companies House information service. Personally, I commence my due diligence with a request for the financial statements.

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Contained in the financial statements are statements and exhibits we, in the U.S., are unaccustomed to seeing for non-public companies. One such exhibit is the section on "Company Information." Company Information contains a listing of the company's directors, registered number (the equivalent of an E.I.N. in the U.S.), registered office business address, auditor, and bankers, if any.

I use this information to begin some of my preliminary due diligence. I call business associates and colleagues to see what I may uncover in casual conversation based on knowing the players. I also conduct internet searches to determine lawsuits, sanctions, or other adverse actions taken against the company or its directors, as well as the professionals retained by the company.

While on the topic of financial and accounting data, I want to emphasize the importance of skepticism when evaluating the data. Too often we tend to put more credibility in audited financial statements than other levels of financial statement preparation such as internal management reports or tax returns. On more than one occasion, my due diligence has uncovered questionable accounting principles. These questionable principles were not developed to facilitate the transaction but rather were used and adopted over years.

As one banker friend once said to me, "I don't understand G.A.A.P., but I know if the business cash flows." This tactic is important when conducting due diligence in the U.K. Americans will not know all of the U.K. G.A.A.P. differences, but we can develop cash flow models proving or disproving the operating results. After all, it is all about business.

BANKING

Banking in the U.K. is vastly different from banking in the U.S., both in process and diversity of product – some better and some worse. For this reason, it is useful to understand the more common forms of bank financing one will encounter in the U.K. In my experience, the most common forms are bank sales financing, overdraft facility, trade financing, and bank guarantees.

Bank Sales Financing ("B.S.F.")

B.S.F. is asset-based financing. Similar to the practice in the U.S., B.S.F. can be secured by accounts receivable ("debtor accounts") or inventory ("stock"). The advance rate will be similar to what we are accustomed to seeing in the U.S. – 80% of eligible accounts receivable. Incorporated into the agreement will also be ineligible

[1] "Filing Accounts," GOV.UK, last updated July 25, 2017.

[2] *Id.*

accounts (*e.g.*, cross-aged receivables greater than 90 days old, concentrations, or accounts receivable with right of offset). Accounts receivable with right of offset occurs frequently when the business sells to a vendor. The bank is very concerned with not realizing 100% of its collateral in the event of a bankruptcy ("receivership"). The bank therefore limits its exposure through additional advance rate restrictions, perhaps 50% or less for accounts with rights of offset. The disadvantage of this financing vehicle is that the company is limited to the accounts receivable at a given point in time. This means if the business is seasonal, there will be insufficient working capital for the business, and the business may need Trade Financing, discussed below.

Finally, the reporting is more cumbersome than in the U.S. Monies received from customers are immediately swept against the outstanding balance. From my experience, the finance team of the target company must be competent and on the ball with their reporting or this facility will prove to be problematic.

Overdraft Facility

An overdraft facility is known as a line of credit in the U.S. It operates in much the same manner. However, in my experience, banks in the U.K. do not extend this type of financing to privately-held companies, least of all U.K. companies owned by a U.S. entity or individual. There are ways around it, if one is willing to post a Letter of Credit. However, the bank may still refuse overdraft facility in lieu of lending using a B.S.F. secured by a Letter of Credit.

Trade Financing

Trade financing, commonly referred to as import/export financing, enables the business to finance its inventory, thereby overcoming seasonality as it relates to product. The bank will typically request a list of the company's suppliers. If the bank is not comfortable with a supplier, it will not fund the P.O. The terms are typically 120 days from the date of shipment. Upon presentation of appropriate shipping documents, the payment is made to the supplier. Problems do arise when the customers do not pay timely or when there are delays in shipments to customers. In my experience, the bank is usually willing to extend the date of repayment.

Bank Guarantee

A bank guarantee is exactly what it implies. It can be used as a performance bond to ensure the company performs as intended under a contract. It is also used for the Value Added Tax ("V.A.T.") Duty Deferment Scheme when goods are imported to the U.K. It is given to Her Majesty's Revenue and Customs ("H.M.R.C.") – the U.K. equivalent of the I.R.S. – to ensure the company can meet the cost of all duty and V.A.T.

Other

Some other terms to be aware of as you go through the due diligence process are "bank support" and "comfort letter." Bank support is a euphemism for work out. This will require more work on the business's part and more monitoring by the bank. If you hear the words "business support," I would not hold out hope that the bank will assign the financing to a new owner. With that said, the bank may be interested in working with the new owner and request a comfort letter that states the foreign owner in the U.S. company will provide resources in support of the U.K. entity. The

resources expected will be cash. The bank will present this as a non-binding document, but legal advice I have obtained in the U.K. has always cautioned against signing the comfort letter.

EMPLOYMENT

Perhaps more than any other area of due diligence, U.K. employment norms are difficult for Americans to comprehend.

In the U.S., we are accustomed to employment at will – a concept in employment law whereby an employer can dismiss an employee for any reason without warning. This concept does not exist in the U.K.

Generally, only senior executives have employment agreements in the U.S. This is not true in the U.K. In the U.K., all employees have employment (“service”) agreements, which set forth hours of work, vacation time (“holiday”), benefits, grounds for termination, and payment once terminated. It is important to review these agreements carefully, especially for senior executives of the target company.

In my experience, employees in the U.K. can be terminated (“made redundant”). However, one must follow the procedures established in the employment agreement. For example, I was involved in the termination of a senior financial professional. The terms of her employment agreement were such that she was entitled to six months’ pay after termination (referred to in the U.K. as “Garden Leave”). For a period of time, this company was paying terminated employees a nice sum while, in some cases, also employing their replacements.

A by-product of having an employment agreement is that U.K. employees take their responsibilities very seriously. They will generally work the hours required in their agreements but not longer, or at least not on a consistent long-term basis, as is common in the U.S.

The mistake many Americans make is to presume that the target company’s workforce will abide by American standards – working on weekends, working for more than eight hours daily, limiting vacation time to two weeks. I have unsuccessfully tried to impart this aspect of American work culture. It does not work.

During your due diligence, you must begin to think through which employees you will keep, the cost involved for terminating the others, and how you intend to manage them from 3,000 miles away. A sure-fire way to encourage significant turnover is to have an American present in the U.K. from the onset or to insist on American work habits. If that is the intent of the acquirer, let me save you time, money, and aggravation. Pass up the opportunity. This is the one area that cannot be overcome with money alone. There must be a plan and cultural sensitivity. Even with such a plan, it will not go smoothly and a great deal of patience will be required.

OFFICE LEASES

Office leases in the U.K. operate in a similar fashion to those in the U.S. There is one major difference: the concept of “dilapidations.” As many an attorney can attest, dilapidations constitute the disrepair for which a tenant is liable upon vacating the premises (*e.g.*, repairs, redecoration, and reinstatement of alterations). In other

words, the tenant must leave the premises as it was provided.

Obtain the target company's leases and review the language. In the U.K., it is unlikely that a lease does not contain language as to dilapidations. Financial Reporting Standard 12 ("F.R.S. 12") and International Accounting Standard 37 ("I.A.S. 37") set forth the requirements to accrue the amount. If you have company with audited financial statements, the financial statements should provide for a dilapidations reserve, which will be described in the footnote under "Provisions for Liabilities." This will indicate the amount included in the financial statements but not the actual total liability, as the accrual usually occurs ratably over the life of the lease. Read the lease agreement carefully and speak with experts. The last thing an advisor or business owner wants to see is a lease expiring in the near term costing the business hundreds of thousands of pounds sterling for the privilege of leaving the premises.

DIRECTOR RESPONSIBILITIES

It may seem odd to include director responsibilities in a document on due diligence. However, this is a serious consideration as it bestows rights, obligations, and liability on an individual.

Prior to becoming a director of a privately-held U.K. company, I had the usual American view when it came to the housekeeping for a corporation. How many of you or your clients maintain corporate minutes, meeting agendas, resolutions, and the like? Most in the U.S. first give consideration of the requirements when the company is put up for sale or when bank financing requires up-to-date resolutions, minutes, etc.

A private company director in the U.K. is expected to follow the rules of the articles of association, keep company records, report changes, and file the company's accounts and tax return. The responsibility is greater, more along the lines of a director of a publicly-held company in the U.S., as can be seen in the following examples.

Example 1

> A director has responsibility if a company overtrades. This occurs where a company requires more resources either in people, working capital, or other circumstances than is available and the company runs the risk of not meeting its obligations. Most people would consider start-ups at risk, but in my experience, most privately-held companies in the U.K. are thinly capitalized. If this is the case, one will hear terms such as "trading within our means."

Example 2

> Another area where a director can be held responsible is with regard to health and safety. Health and safety deals with anything involving the people who work for the company. Examples of health and safety concerns include electrical cords not being properly adhered to the floor causing a danger for falls, employees speeding in company cars, or multiple tickets for speeding received by employees. If there is a serious accident and the company cannot demonstrate that it sent the employee to driver training, the director can be held responsible.

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Arguably, these are items where the executives and directors can be held liable in the U.S., as well. But can a director in the U.S. be held criminally responsible? In the U.K., a director most certainly can.

For the reasons mentioned above, it is imperative to determine who will be a director post-closing. It will also be imperative that the entity will be appropriately managed to ensure the various laws and responsibilities are carried out properly to reduce exposure for the individuals involved. As a director, I travel, phone, and review internal financial information to ensure I am carrying out my fiduciary responsibility. In addition, there is an agenda for each board meeting. A standing item on the agenda is health and safety.

"Those that prove successful take the cultural differences seriously and are sensitive and respectful of those differences."

MORE THOUGHTS ON FINANCIAL INFORMATION

As I have covered, U.K. directors have responsibility and liability for their companies. Consequently, the attitude towards financial reporting is more sensitive when it comes to overtrading and profitability. There is a desire to ensure the company is profitable, and accounting principles are often used to achieve this end, especially if there is bank financing involved. Therefore, be wary of significant prepaid assets, or even fixed assets, for that matter.

In the course of a manufacturing company due diligence, I found designs capitalized. I am not referring to molds. I am referring to wages capitalized for designing patterns on the basis the patterns would be reused. As I analyzed the data and recast the capitalized assets as expenses, the company went from marginally profitable to significantly unprofitable. In another due diligence, I was presented with various refinancings of debt through government programs. The U.K. has some interesting programs for small and midsize enterprises ("S.M.E.'s"). However, in this case, the programs were used to mask cash flow problems and kick the repayment problem down the road. Potential buyers beware.

FINAL OBSERVATIONS

The information presented can be considered a quick start as to finding documents, overcoming terminology, and understanding financing.

As professionals, we get too caught up in the data. Keep in mind that the items making due diligence in the U.K. more difficult are not only the regulations and banking, but also the cultural differences. The cultural differences are huge. Do not be surprised if you tell a British manager to stay out of an area and she actually steps aside. Also do not be surprised if this same manager has a solution but does not proactively come forth with it.

Having worked for many years with colleagues in the U.K., there is a saying I have heard time and again: "The Americans have landed." It is not flattering, but meant to imply we are here to save the day and know what to do to save it. Indeed, we have arrived, and bringing this cultural awareness with us is important. After all, the due diligence is being conducted to acquire and/or merge the U.K. operation into the U.S. operations of the acquirer. Significant dollars and effort have been expended, and the difference between success and failure is a simple understanding of what makes us different.

I do not have any empirical data to support the following assertion, only anecdotal evidence in speaking with friends and colleagues who have worked for U.K. companies post-acquisition by American companies. Those that prove successful take the cultural differences seriously and are sensitive and respectful of those differences. Those that are not sensitive and respectful of the cultural differences can expect to waste years trying to get the business to run smoothly and profitably. Remember what George Bernard Shaw said in 1910: "England and America are two countries separated by a common language." In my experience, what was true then is even more true now.