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Buying a business: Gods of small things

If you're planning to buy a business in our fragile economy, you need to know what you're getting. So use lawyers who will scrutinise every little contract

For the past two years, the lack of merger and acquisition (M&A) activity in construction has been blamed on the seizing up of credit markets. There are signs of an M&A thaw, however, and buyers in construction and engineering with access to capital and the ability to spot value could create a boom in the second half of this year.

The cost of capital is high in today's economy, so investors need certainty about the contracts they will inherit, including the liabilities, obligations, rights and remedies that result from them.

The buyers of construction businesses are finding that marrying two complex businesses requires a mountain of due diligence, especially in a world where the hidden and unknown liabilities in many financial contracts nearly brought the financial system to a standstill.

Speeding up the M&A process and "futureproofing" an acquisition through effective due diligence can provide the confidence that investors, lenders and guarantors need, easing transactions and increasing valuations.

Construction firms are now dusting off their dedicated M&A teams, which can range from a lone individual scouring the market to 30 experts all working with an eye for the next big deal. They identify a target and, led by the strategic legal advice of their company's in-house counsel, will typically employ a panel of law firms and advisers who specialize in construction M&A.

Construction companies typically pay a premium for this because such firms and advisers understand how transactions are managed in the industry.

No two deals are the same but, typically, the general counsel or in-house lawyer at the acquiring company will manage the potential stakeholder concerns (including those of management and investors), and offload the higher-end due diligence to an adviser.

In this relationship, the general counsel will receive what is known as an exception-based due diligence analysis report, explaining and analyzing critical information for the acquiring company. The information in this report often determines whether the deal moves forward. Unfortunately, the exception-based due diligence report outlines only a fraction of the true contractual liability held by the target firm.

With a target company likely to have thousands of contracts in force with suppliers, employees, clients and other third parties, it is inevitable that many issues would have emerged that were considered too expensive to investigate within the exception-based due diligence analysis provided by the typical panel law firm.

It is possible to identify the potential concerns of a buyer and mitigate the risk through "deep dive" due diligence. This process completely reviews the entire portfolio of active contracts, ranking them by importance and revenue, cost or liability contribution.

This work is carried out by lawyers at legal process outsourcing (LPO) providers. The LPO provider supplies full-time lawyers based offshore at a cost-effective rate (often fixed and based on contract volume) and supported by a service level agreement. This runs concurrently with, or eliminates the need for, exception-based due diligence.

The benefit to the client is a complete analysis of the target company's contractual liabilities. With the law firm and the LPO team working together seamlessly, the due diligence exercise quickly becomes a smooth integration exercise.

As the likelihood of a construction sector M&A boom grows, it is increasingly important for lenders and managers to receive an accurate picture of the potential contractual situation. How many thousands of contracts have been fully executed? What are the indemnities, penalties or warranties attached? These may carry a negligible liability individually, but only a lawyer-led full investigation that understands the nature of the M&A process can provide sufficient due diligence for the board to make an informed decision.

It is difficult to attract the attention of directors responsible for a growth strategy that targets acquisitions valued in the hundreds of millions, when you are speaking of contracts worth hundreds of thousands each. But you will have a significantly greater chance of catching their eye if you show them a clear picture of the risk to their capital.

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