



A Perfect Fit: New Frontiers of Due Diligence in Strategic Acquisitions

**By Roger E. Barton and
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What is “perfect fit”? The concept of a perfect fit can mean many things to different people, especially in the context of a due diligence assessment of a target company involving a “strategic acquisition.”

The traditional view in strategic acquisitions has been that “perfect fit” means the acquisition target will, among other things, complement an existing business portfolio by enhancing product quality, extending product lines and markets, lowering production costs, increasing distribution channels, and otherwise providing *business synergies*. Real-life examples of the traditional view of a perfect fit analysis can be gleaned from post-closing statements in any one of hundreds of media announcements that routinely follow an acquisition.

Measuring for a Perfect Fit

But perfect fit also requires measures—some of which are objective, some of which are subjective, some financial and others non-financial.

If you are reading this article, you are likely to be a decision maker or you are likely to be a legal, accounting, banking, or business development professional who advises decision makers—the people who make “perfect fit” judgments, who develop a company’s vision and who determine a company’s direction and strategy. The decision makers are CEOs, board members, and division or group presidents. They all make their decisions based on *their* understanding of what *perfect fit* means.

Expanding the Traditional View

The goal of this article is to expand on the traditional view of what makes a “perfect fit” by suggesting a perspective and the need for some non-financial measures that are becoming increasingly important. These measures have to do with the perfect fit of a company’s culture of integrity, ethics, and compliance—its culture of embracing or rejecting best practices and good governance.

The Questions that Must be Asked

Decision makers must ask the question: “What am I getting myself into?”

When answering this question in the context of a target company’s culture of integrity, ethics, compliance, and governance, useful non-financial measures take on a subjective meaning and directly address “form, fit, and function,” a term often used in the context of government and defense contracting that is also of use here.

When a decision maker looks at a target company, another inevitable question is: “Who *are* these people?”

- How do they conduct their business affairs?
- Am I going to be able to work with them?
- What is their reputation for integrity, compliance, and ethics?
- Are they known for their best practices or something less flattering?
- How likely is it that they can proactively help me achieve my performance goals and expectations within a culture that is both ethical and compliant?

Public and Private Companies

Whether the acquiring entity is a public or private company, decision makers operate in an environment influenced greatly by the Delaware courts. Delaware decisions suggest that companies must have systems in place that can reasonably be expected to give them warning of compliance problems so that corrective action can be implemented by Sarbanes-Oxley, which focuses on transparency and accurate

Ed. Note: This is the first article in this month’s special section on mergers and acquisitions. Please also see Jeffrey Williams, “Fairness Opinions: A Turning of the Tide” on page 15 and Michael A. Papile, “The Nine Myths of Fairness Opinions” on page 18.

Director Summary: Putting two companies together in a strategic acquisition requires determining how the companies will blend, and whether they will create a “perfect fit.” The authors provide a checklist of questions, both objective and subjective, to help measure the potential fit in the areas of integrity and ethics.



financial reporting; and the revised Federal Sentencing Guidelines, which require that an organization's compliance program not only exist but that it be effective. Increasingly, institutional shareholders of public companies and large private equity investors for private companies also are changing the environment by insisting on certain governance standards they deem important.

Decision makers cannot ignore these influences when determining if an acquisition is a "perfect fit" any more than they can ignore the traditional measures—both are important.

Due Diligence Required

Due diligence is the process used to determine perfect fit, but decision makers and those who advise them would be well served not to let their due diligence become mechanical.

The traditional due diligence should continue, of course, but decision makers should be aware that there is a risk associated with not designing a due diligence process that is appropriate to the specific business targeted in each acquisition scenario, and a risk associated with not including measures that assess integrity, ethics, compliance, and governance issues.

Stretching the Parameters of Due Diligence

Decision makers are best served by advisors who create due diligence processes and checklists that are fluid and flexible enough to accommodate the specific facts and circumstances of each transaction, and that assess whether or not the target company's culture meets the standards imposed by the current business and legal environment with respect to ethics, transparency, compliance, and best practices.

Subjective and objective measures that could be included in a due diligence process, if not already there, are shown in the box below.

Adding these measures and focus areas can go a long way toward establishing a basis for making a determination about perfect fit from the perspective of a company's culture of integrity, ethics, compliance, and governance.

Whether the target company you buy is a perfect fit or not is always going to be judged in hindsight. The point is that integrity, ethics, compliance, and governance are more important than ever and should be included in any due diligence assessment. ■

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Subjective and Objective Measures

Reputation among peers

- Best in class?
- Need to watch them?

Reputation among customers

- Take no prisoners?
- Heavy handed?
- Litigious?
- Willing to work with you to solve problems?

Risk profile and assessment as compared to peers

- Compliance risks large or small associated with the particular business?
- How do they fare relative to peers?

Litigation, regulatory, and government investigation track record

- Need to look beyond what is "material" to see trends.
- Number of cases.
- Number of investigations.

- Win/loss record.
- Claims settled and for how much.
- Are they involved in a "hazardous" industry?

Visibility of CEO as champion of an ethical culture

- It is true: the head coach does make a difference.

Background check procedures in place for senior executives

Code of conduct and compliance program in place

- Do they have a code of conduct and compliance program?
- Do they "walk the talk" or is it a program that is just on the shelf?
- Do they have a respected senior-level executive who is responsible for compliance/ethics?
- Do they have regular compliance/ethics training?
- Do they monitor/audit their compliance program?

- Do they have a culture that metes out consistent discipline and learns from mistakes?
- How knowledgeable, involved, and accountable is their board when it comes to compliance and ethics?
- Do they have an "adequate budget" for "compliance" initiatives?

Internal audit coverage and findings generally

Resource allocation

- Best practice or mere compliance approach?
- Are the auditors seen as cops or coaches?

Repeat audit items

- Consequences for repeat items?
- Is the target company's audit committee overseeing the company's systems to ensure they provide appropriate early warnings for compliance anomalies?