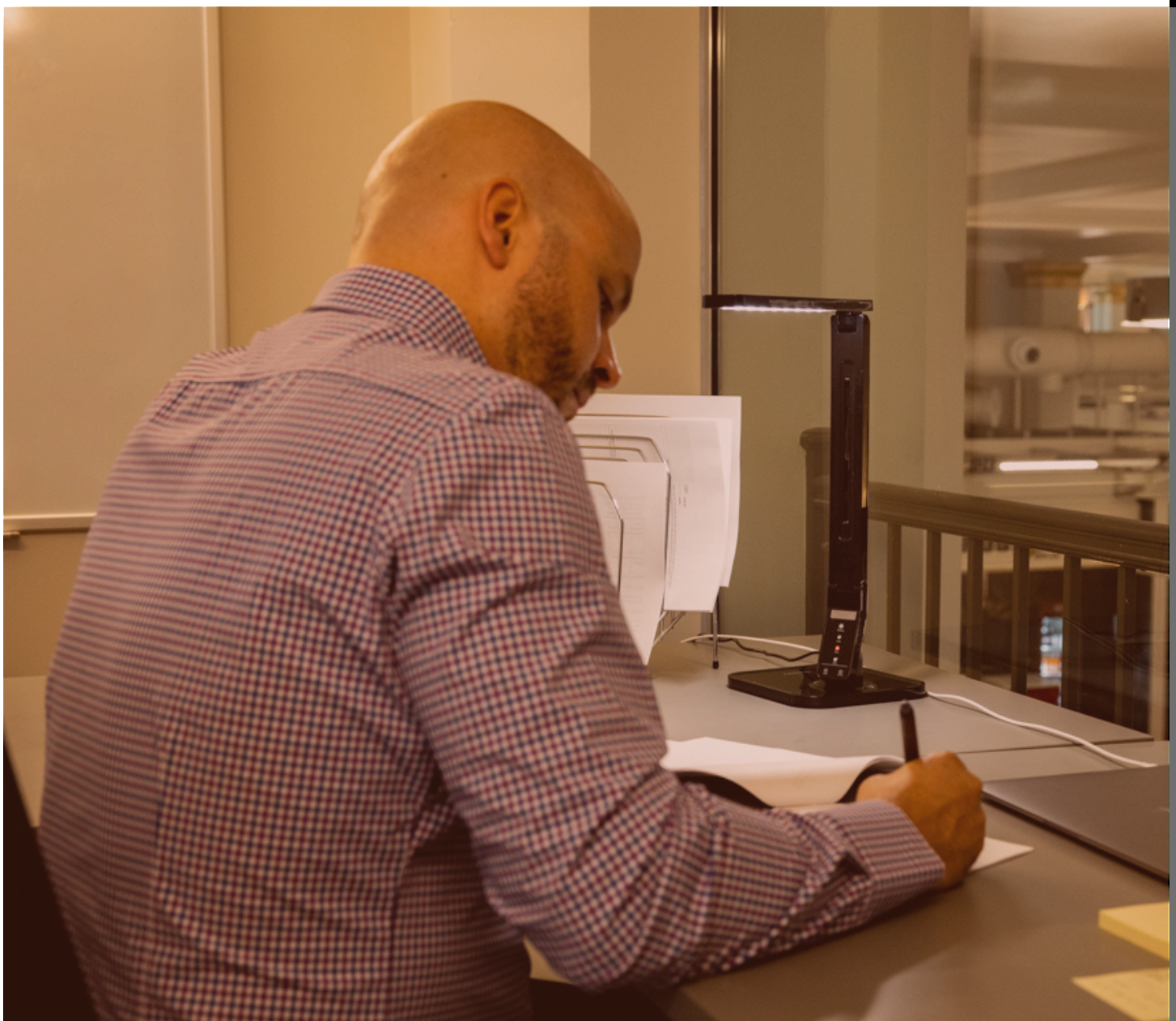
DUE DILIGENCE FOR PRIVATE MERGERS AND ACQUISITIONS

Due diligence is the investigation of a person or business. In the context of mergers and acquisitions, the parties use the due diligence process to gather information about each other and about the business or assets that are for sale. Although the seller occasionally conducts due diligence on the buyer, the due diligence process is usually more significant for the buyer.



WHAT IS DUE DILIGENCE?

REASONS FOR DUE DILIGENCE

In any significant merger or acquisition the buyer gathers information about what it is buying before making a commitment. Primarily, the buyer uses this information to decide whether the proposed acquisition is a sound commercial investment. In an extreme case, a buyer may decide to abandon the transaction after performing due diligence, but more commonly, a buyer uses the information to negotiate contractual protections (such as indemnification) or to adjust the purchase price.

A due diligence inquiry should establish the following key information about the target business: confirm that the seller has good title to the stock or assets of the target business; investigate potential liabilities or risks; confirm the value of the target business; identify steps necessary to integrate the target business; learn more about the operations of the target business; identify any impediments to the transaction, such as third party consents, a required stockholder vote or prohibitions on transfer; and, determine whether any ancillary documents will be needed.

SELLER DUE DILIGENCE

If the buyer is issuing stock to the seller as consideration or if the transaction is a merger of equals, the seller needs to conduct a more thorough due diligence investigation.

If the buyer is issuing stock, the seller should: confirm that the buyer has authority to issue the stock; confirm the value of the buyer's stock; and, identify any impediments to the issuance.

In a merger of equals, the parties need to: confirm value of the transaction; identify steps necessary to integrate the companies; learn more about each others' businesses; and, identify any impediments to the transaction.

WHAT IS DUE DILIGENCE?

SCOPE OF DUE DILIGENCE

The scope of a due diligence investigation is determined by many factors. It is important to determine the scope at the outset because it influences how many people are needed, how much time is required, whether outside experts are engaged, and depth of review. Common factors that determine the scope of a due diligence review are:

- Deal structure. For example, if the transaction is a stock acquisition or merger, the buyer will likely need information on the entire business. In an asset acquisition, the buyer may only focus on the specific assets (and liabilities) it is acquiring.
- Industry. The industry of the target business may influence what areas of due diligence you concentrate on. For example, if the buyer is acquiring a chemical manufacturing company, extensive environmental due diligence may be required. If the target operates in a heavily regulated area, the buyer needs assurance that the target business is in compliance with applicable regulations.
- Global presence. If the target business has global operations, it is important to assess its compliance with applicable bribery and corruption laws such as the requirements of the Foreign Corrupt Practices Act of 1977.
- Competition. If the buyer and seller compete with each other they may want (or be required by antitrust laws) to keep certain information (such as, pricing) confidential until after the transaction is consummated.
- Access to seller and target business. The seller often restricts access to itself or the managers of the target business in order to limit interference and protect its proprietary information.
- Cost. The buyer may limit the scope of the due diligence investigation to reduce its expenses. Sometimes, a buyer conducts its investigation in stages and only increases spending when the likelihood of the deal closing increases.
- Time constraints. The parties may wish to complete the transaction by a certain date (such as fiscal year end) or the seller may have enough bargaining power to limit the time allowed for due diligence (for example, in an auction).

ORGANIZING THE DUE DILIGENCE PROCESS

Usually the corporate legal team acts as the "control center" for the buyer's due diligence process. This entails defining the due diligence task, requesting materials, distributing materials and ensuring communication among the due diligence team.

DEFINING THE DUE DILIGENCE TASK

Before you begin a due diligence review, the lead lawyer should establish with the client: a due diligence budget; scope of review; what type of oral or written report is required; deadline for completion of due diligence review and delivery of report; whether any outside consultants should be engaged; if certain areas should be a primary focus; if there are any threshold issues that could make or break the deal (known as deal breakers); and, process for communication with the seller and the management of the target business. For example, you may be required to communicate through a third party such as, an investment banker.

Once you have defined the due diligence task, you can assemble the due diligence team. It is important to explain any limitations or restrictions to team members (budgetary or other) and any areas which are significant to the client.

THE DUE DILIGENCE TEAM

The make-up of the due diligence team depends on the specifics of the transaction, but usually includes legal, business, accounting and tax specialists. Generally, the legal team consists of corporate lawyers and other specialists (such as environmental, employee benefits, real estate and intellectual property lawyers). The buyer may conduct its own business due diligence or hire investment bankers or other consultants to review information. Usually the buyer will also engage accountants and tax specialists to assist with the financial review of the target business.

In some cases it may also be necessary to retain outside consultants in other areas such as regulatory compliance, environmental or insurance. Depending on the complexity of the transaction and the budget allocated to due diligence, the team can range from two or three people to a team of more than 20. Because the due diligence team can be large and comprised of multiple organizations, it is important to have a point person to organize and coordinate the process. The point person may be the buyer, but often the buyer delegates this responsibility to its lawyers.

DUE DILIGENCE REQUEST

Sometimes the seller will make due diligence materials available at the outset of a transaction, but often a buyer must submit a due diligence request for information. A due diligence request is a list of questions and requests for documents organized by topic. The initial due diligence request is usually supplemented by further requests as the negotiations proceed and as the buyer learns more about the target business.

The size of a due diligence request depends on the scope of the due diligence review. For example, in a stock acquisition the due diligence request should cover the entire company. On the other hand, if the buyer is only acquiring real estate assets, the request will be limited to materials relating to those properties. Although a due diligence request must be broad enough to include a wide range of information, you should tailor your due diligence questions to the specific target business and the industry it operates in.

For example, if the target business is a financial services company, it has different types of material contracts than a manufacturing company. If a due diligence request is too generic or too broad, a seller may not understand what documents you are looking for. For example, if you request "all material contracts," the seller may have a different view of what constitutes a material contract than the buyer.

SOURCES OF INFORMATION

Documents. The bulk of due diligence review involves reading documents of the target business (for example, contracts, financial reports and corporate records). Usually due diligence materials are stored on an online data site. Sometimes, especially in smaller transactions, the seller may either send the buyer electronic or hard copies of documents. If the seller wants to limit dissemination of materials, the seller may create a physical data room at its offices or the office of the seller's attorney.

If the materials are stored on an online data site, the seller determines who is invited to the data site and gives password protected access. It is important to determine which due diligence team members need access to the data site so that you can submit a comprehensive request for access to the seller.

Access to Management. Some information is difficult to learn from just reading documents. The buyer will often ask to visit the target business site and talk with members of management. You may also have follow-up questions after reading due diligence materials which can be answered more completely during a phone call.

Publicly Available Information. If the target business is part of a United States public company group, you should review information available on the SEC's EDGAR system before making any requests. Even if the target business is privately held, you can often find background information, financial reports and press releases on the seller's or the target company's web site.

DISTRIBUTION AND ORGANIZATION OF MATERIALS

If the due diligence materials are available electronically or sent in hardcopy form, they need to be distributed to the due diligence team. Usually a junior corporate attorney is responsible for distribution and organization of the materials. If the materials are sent via hardcopy you should first create an index (if one is not provided) to keep track of what materials have been provided. If the materials are stored on an online data site, the data site usually generates an electronic index which can be printed out. If the materials are stored online they need to be printed (if permitted) and distributed to the appropriate team members.

It is helpful to develop a system for organizing the materials at the outset. A common way to organize materials is to place all due diligence items in folders with labels indicating the name of the document and index reference. Often a paralegal can help with this process. You should also ask a senior member of your team what your firm's record retention policy is. Some firms retain a complete copy of all due diligence materials. If this is the case, make an extra copy of the due diligence materials before distributing them to the team. Because the data site is updated with new materials throughout the transaction, it is important for one person to periodically check for any additions. You may think that you do not have time to organize the due diligence materials, but it will invariably save you a significant amount of time later in the process. Often you will be asked a question about a document that you reviewed days or weeks ago. It will save you anxiety and impress your team if you can locate the document quickly.

COMPETITIVELY SENSITIVE INFORMATION

If the parties are competitors, the seller may impose additional restrictions on the dissemination of materials. Competitors are prohibited by law from sharing certain information (for example, pricing). Even if not prohibited by law, a seller may be wary about sharing information (such as, customer names) before consummation of the transaction is certain. Parties can redact sensitive information or develop a procedure to limit access to those materials. Often only the attorneys will be provided access. In that case, the attorneys can review the documents for other important terms (for example, a change of control clause) and will be prohibited from sharing the confidential information with their clients. The parties should determine if any documents are competitively sensitive and agree on a procedure before beginning the due diligence review.

CATEGORIES OF MATERIALS AND COMMON ISSUES

A corporate attorney encounters many different types of documents in a comprehensive due diligence review and should watch for many different kinds of issues. The types of documents and issues will be determined by the specifics of the transaction and target business.

The following is a list of common categories of documents encountered in a due diligence review and common issues that arise.

- Organizational documents (for example, certificate of incorporation, by-laws, limited liability company agreement or stockholders agreement). Common issues that you should consider are:
- Capitalization and equity ownership: Who owns the equity in the target business? Is there an equity holder or group of equity holders that has control of the target business? Are there any subsidiaries? What equity is outstanding? How much equity is authorized? Is there room for further issuances?
- Consent issues: Are any votes or consents required in connection with the transaction? What actions require consent of equity holders or the board of directors?
- Transfer restrictions and preemptive rights: Are there any restrictions on the transfer of equity? Do equity holders have preemptive rights in future issuances?
- Dividends: What is the dividend policy? Can the board of directors change this policy without a vote?
- Unusual provisions: Look for any provisions that could impact the transaction or future operation of the target business. For example, you should note if there is a poison pill or if a stockholder is guaranteed representation on the board of directors.
- Contracts (for example, customer and supply contracts, operating contracts and licenses). Common issues that you should consider are:
- Parties: Who are the parties to the contract?
- Change of control: Is there a change of control provision? Does this transaction constitute a change of control?

CATEGORIES OF MATERIALS AND COMMON ISSUES (CONT.)

- Assignment: Is the contract assignable? Is consent required? How is an assignment defined? Does the transaction structure require an assignment? Does a change of control constitute an assignment?
- Termination: When does the contract terminate? Is there an automatic renewal provision? Can either party terminate without consent? Does a change of control give either party a right to terminate the contract?
- Economics: What are the basic economics of the contract? Are the economics of the contract fixed or do they fluctuate? How is the pricing determined?
- Unusual provisions: Look for any provisions that could impact the transaction or future operation of the target business. Are there any provisions that restrict the target business or provide benefits to the other party? For example, you should note a most favored nations provision (MFN) or non-compete provision.
- Final executed copy: Is there a final executed copy of the agreement? If not provided in the diligence materials, does one exist?
- Merger and acquisition agreements.
- Parties: Who are the parties to the agreement?
- Purchase price adjustments and earn-outs: Are there any outstanding purchase price adjustments or earn-outs that affect the target business?
- Escrow: Are there any funds in escrow? What are the funds earmarked for? What are the conditions of release?
- Survival of representations and warranties and indemnification: Has the survival period of the representations and warranties run out? Have any indemnification claims been made? Does the target business anticipate future indemnification claims?
- Unusual provisions: Look for any provisions that could impact the transaction or future operation of the target business. For example, you should note if there is a non-compete obligation currently in effect or if the target business has taken responsibility for any ongoing liabilities of the other party.
- Final executed copy: Is there a final executed copy of the agreement? If not provided in the diligence materials, does one exist?

CATEGORIES OF MATERIALS AND COMMON ISSUES (CONT.)

- Finance documents (for example, loan agreements, hedging agreements, guarantees, and promissory notes).
- Parties: Who are the parties to the agreement?
- Basic terms: What debt is outstanding? What are the interest rates? When do the loans mature? Are there any mandatory prepayment obligations or prepayment penalties?
- Contingent obligations: It is important to note any contingent obligations such as, guarantees. It is also important to note if any debt is guaranteed by third parties (for example, a parent company guaranty).
- Restrictive covenants: Look for any restrictive covenants that impact the transaction or future operation of the target business.
- Change of control: Is there a change of control provision? Does this transaction constitute a change of control?
- Liens: Are there any liens on the target business or its assets? Has the stock of the target company been pledged?
- Final executed copy: Is there a final executed copy of the agreement? If not provided in the diligence materials, does one exist?
- Litigation.
- Pending claims: How many claims are currently pending? What is the estimate of damages? What is the current status of each claim? What is the likelihood of success on the merits?
- Litigation history: Were there any large claims paid out in the past? Any class actions? What kind of claims is the target business a party to?
- Litigation trends: What are the common types of litigation? What is the average amount of damages? Are most claims settled or litigated?

SPECIALIST REVIEW

A portion of the due diligence review is conducted by legal specialists (such as real estate, intellectual property and environmental lawyers) and outside consultants (such as accountants and insurance consultants). Often a junior corporate attorney is responsible for distributing materials to the specialists and communicating instructions from the client. Sometimes a document that appears to be a corporate document will need specialist input. For example, a supply contract may have significant provisions relating to the intellectual property of the target company. In this case, the contract will likely need review by a corporate and an intellectual property attorney. The junior corporate attorney on a transaction may spend a large portion of time facilitating the specialist due diligence review.

DUE DILIGENCE CONSIDERATIONS FOR PRIVATE EQUITY BUYERS

A private equity buyer may have a different view on certain due diligence issues. Private equity buyers are often more risk averse because they are trying to make a relatively quick profit on a highly leveraged acquisition. Generally a buyer who is currently operating in the industry (known as a strategic buyer) is better equipped to absorb an operational loss or a messy litigation. As a result, private equity buyers often conduct more extensive due diligence reviews than other types of buyers and may seek greater contractual protections.

As opposed to a strategic buyer, a private equity buyer may not have certain operational capabilities. For example, if a private equity buyer buys a target business that does not have its own payroll department or IT systems, the private equity buyer will have to procure those services. A strategic buyer would likely have those services already in place for its existing business. As a result, a private equity buyer may need to focus on operational due diligence.

IMPACT ON THE TRANSACTION

Due diligence is a necessary part of any significant acquisition. Your findings can impact the transaction in the following ways:

- Purchase price. If a due diligence finding affects the valuation of the target company, the buyer may adjust the purchase price. For example, if you discover a $10 million liability that was previously unknown, the buyer may reduce their offer by that amount.
- Representations and warranties. A buyer often uses the representations and warranties as protection against unknown liabilities. If you discover that certain permits are very important to the operation of the business, the buyer will likely insist on a full representation and warranty that the target business is in compliance with all permits. If this representation and warranty turns out to be false, the buyer can seek indemnification post-closing.
- Indemnification. If you discover a liability that the buyer is unwilling to acquire, the seller may agree to indemnify the buyer for that specific liability. For example, the seller may indemnify buyer for any costs or expenses incurred in connection with a particular litigation.
- Disclosure schedules. The buyer uses its due diligence review to verify the disclosure schedules. Ideally the buyer should have an opportunity to investigate anything that seller lists on the disclosure schedules. If the disclosure schedules are inconsistent with the buyer's due diligence findings, the buyer may negotiate to add or remove certain disclosures.
- Deal termination. In extreme situations, due diligence findings may cause a party to terminate the transaction (known as deal breakers). There may be certain issues which either drastically affect the value of the target business or otherwise impact the buyer's desire to make the acquisition. For example, if a buyer is acquiring a company primarily for its supply channels and then discovers that none of the supply contracts are binding, the buyer may choose to terminate the deal. It is important to identify any deal breakers early so that you can focus on these issues and communicate any findings to your client as soon as possible.
- Pre-closing covenants. The due diligence findings may raise issues that the buyer wants the seller to correct prior to the closing. For example, if there are title defects in assets the buyer is acquiring, it may require the seller to correct these defects prior to closing.

HOW DUE DILIGENCE IMPACTS BUYER'S KNOWLEDGE

Sometimes a seller will try to use a buyer's due diligence review to preclude the buyer's recovery for breaches of representations and warranties. For example:

- If the buyer and seller are litigating the seller's breach of a representation and warranty and the buyer learned of the breach during its due diligence review, the seller may argue that the buyer is precluded from recovery because it closed over knowledge of the breach. It is unsettled whether a court will agree with this argument.
- The seller may try to insert a provision into the transaction agreement which states that the buyer is precluded from indemnification if buyer knew of a breach before closing (known as an anti-sandbagging provision). However, the buyer may object to this provision and argue for a pro-sandbagging provision reserving the right to bring indemnification claims against the seller for breach even if the buyer knew about the breach before the closing and proceeded to close the transaction.
- The seller may try to define buyer's knowledge as everything that was disclosed in the data room. The buyer may object to this definition.

RECORDING AND COMMUNICATING YOUR FINDINGS

IMPORTANCE OF COMMUNICATION

Because due diligence is often conducted by very junior attorneys, constant communication is necessary. It often takes a very experienced attorney to identify significant issues. It is important to raise any issues with senior members of the team promptly because your findings may impact the negotiation of the transaction documents or the purchase price. If your client has identified any deal breakers or issues to focus on, you should communicate any findings as soon as possible. It is good practice to have regular status meetings with the internal due diligence team and to give periodic informal reports (for example, through an e-mail or telephone call) to your client.

DUE DILIGENCE SUMMARIES

It is important when reviewing due diligence to keep careful notes of your findings. Often attorneys create a written record summarizing the key terms and conditions of each document. You need to understand the scope of the due diligence review so that you can determine the level of detail you need to record. Different firms have different forms of due diligence summaries and you should ask a senior member of your team if there is a preferred style. Due diligence summaries maintain a record of what you have reviewed and will help you recall important issues. You are often asked to report on your due diligence findings days or weeks after you have reviewed the materials. Without a proper record you may be unable to properly report your findings. Sometimes due diligence summaries are shared with the client, but often the summaries are only used as an internal record.

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DUE DILIGENCE REPORT

The ultimate product of a due diligence review is the due diligence report (also known as a due diligence memorandum). Due diligence reports range from an oral presentation to a lengthy document with very detailed findings. You should ask your client what type of report they prefer at the start of the due diligence process. Generally, the length and level of detail in the report will correspond with the scope of the due diligence review. Like the due diligence review, it is often a junior corporate attorney's job to coordinate the preparation of the report. Although each specialist usually writes up their own findings, you need to fit all of the pieces together into a coherent product. If the report is lengthy, it is helpful to provide an executive summary highlighting the significant findings and issues. The due diligence report should be clear and concise so that your client can assess any issues quickly. Because drafting the due diligence report involves drafting the corporate sections and refining and reformatting the specialist portions, it is a time consuming process.

CAN A THIRD PARTY RELY ON THE DUE DILIGENCE REPORT?

Sometimes, such as when the buyer finances the acquisition, it is asked to share the due diligence report with a third party (for example, the financing bank or members of the buying syndicate). Some firms permit the client to share the report, provided that the third party executes a non-reliance letter. Although most non-reliance letters state that sharing the report does not serve as a waiver of attorney-client privilege, it is unsettled whether such a statement actually preserves privilege. While it is common in Europe and gaining popularity in the US, you should find out from the client whether it plans to share the report with any third parties, whether any third parties expect to rely on your reports and then consult with the senior member of the deal team to determine the appropriate course of action. If the client shares the report, you should remind that client that the third party may review the report with a different objective and that the information in the report may reveal sensitivities about the target company that the buyer may want to keep confidential.

ASSIGNMENT AND CHANGE OF CONTROL

ANTI-ASSIGNMENT PROVISIONS

In general, all rights under an agreement can be assigned and all duties delegated unless prohibited by law or public policy. However, the parties to an agreement can limit the general permissibility of assignment and delegation by explicitly agreeing to restrictions in the agreement (known as an anti-assignment provision).

If a transaction is structured as an asset acquisition, forward merger or a forward triangular merger, third party consents are required for those target company contracts which contain an anti-assignment provision. Typically anti-assignment provisions are not triggered in stock acquisitions or reverse triangular mergers unless the contracts contain change of control provisions.

CHANGE OF CONTROL PROVISIONS

A change of control provision gives the other party certain rights (such as consent, payment or termination) in connection with a sale transaction. Not all change of control provisions are triggered by the same action. A change of control may be triggered by a change of ownership, sale of assets or change in board members. Change of control provisions are not always clearly labeled. It may be called a change of control provision or it may be embedded in an assignment or termination section.