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M&A due diligence: A primer on transactions involving private sellers

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A merger or acquisition is often one of the most important decisions a company will ever make. M&A activity can completely change the trajectory of a company's future and has the capacity to spectacularly fail or succeed.

Consider some of the most profitable (e.g., Disney and Pixar, Disney and Marvel, Exxon and Mobil, and Google and Android) and some of the most unsuccessful deals ever (e.g., America Online and Time Warner, and Sprint and Nextel).

Despite a strong U.S. economy, there have been fewer global mergers and acquisitions in 2019 compared to prior years.[1]

With fewer (but often higher-priced) deals, the stakes are greater than ever to consummate the right deal at a proper valuation. Accordingly, due diligence has taken on increased importance in the M&A deal-making process.

This article focuses on the legal due diligence process, and certain best practices for the management thereof, in transactions involving private sellers.[2] We will provide a high-level review of some of the pain points in the legal diligence process and identify several techniques for the management of information flows through a specialist-fueled legal deal team.

We will also briefly touch on the impact that the advent of representation and warranty insurance policies has had on the due diligence process and what an insurance company may expect to receive prior to underwriting a policy.

THE DUE DILIGENCE PROCESS

During the due diligence stage, interested parties explore potential issues that may affect the transaction terms that define a finalized purchase agreement.

In addition to placing a meaningful value on a target's assets, including its technology and human capital, privately held corporate due diligence should be approached through a multi-disciplinary review. The review should encompass not only consideration of the ownership of tangible and intangible assets but also a thorough examination of the regulatory, tax, technology, culture and entrepreneurial risks.[3]

Most large firms will keep their corporate deal teams appraised of proposed transactions for which they have been engaged. These teams will rely heavily on subject-matter experts in areas including intellectual property, tax, real estate, employment and the environment, as well as others.

Although the parties typically set a proposed purchase price prior to beginning the substantive due diligence process, issues discovered in any of these areas may impact a proposed valuation and result in a price change.

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This, combined with all of the moving parts leading to the consummation of such transactions, makes the process extremely complex and daunting for all parties involved.

Effective management of these stages, especially the multi-faceted due diligence process, will minimize inefficiencies and limit the likelihood that dreaded "deal fatigue" — or feelings of frustration and helplessness while the transaction runs its course — will hinder a potential buyer's efforts to learn all it can about its target.

Communication within deal teams is critical to maximizing return on time invested during the due diligence process. For example, issues that are uncovered by employment and benefits specialists may have an impact on those in the intellectual property group.

Changes to the larger deal structure (e.g., converting from an asset deal to a stock deal) or upcoming opportunities to raise issues to a target's management team should be disseminated to the larger deal team as soon as possible to increase the value of the team's efforts.

STAGES

Although the due diligence process is usually lengthy and often unwieldy, it can be thought of in the following stages.

I. Letters of intent and management presentations

Long before outside legal due diligence teams become involved in a proposed M&A transaction, business-level discussions are held, often facilitated by investment bankers, to determine whether a potential buyer views the proposed acquisition of a particular seller's business (which we will call the seller), at the price expected by the seller, as worth pursuing.

To aid in this analysis, the seller and its investment banker often will prepare and distribute to potential buyers a management presentation highlighting the value proposition of the company.

If the value proposition for a potential acquisition is in the buyer's interest, the parties — generally assisted by outside counsel — will execute a letter of intent that sets forth initial deal terms and proposed timelines for the buyer to conduct due diligence. The LOI also typically bars the seller from engaging in discussions with other potential buyers during a defined exclusivity period.

Simultaneously with (or shortly after) the execution of the LOI, the buyer's legal due diligence team, having reviewed the management presentation and LOI, will determine an appropriate course of action for the management of its legal due diligence process.

II. Due diligence and the purchase agreement

Every M&A transaction must be memorialized in a purchase agreement. Whether it takes the form of a stock purchase, asset sale or merger, attorneys for buyers and sellers will carefully negotiate an agreement that reflects the LOI and any ongoing negotiations between the parties.

Such an agreement will include agreed-upon representations and warranties reflecting the current state of the seller at the time of the agreement's execution (and/or at the time of the proposed transaction's closing if not simultaneous with execution of the purchase agreement).

During the due diligence process, legal counsel for the buyer should keep in mind the representations and warranties that the buyer ultimately will want to receive from the seller and craft diligence requests appropriately so it can discover and address any potential nonconformances by the seller's business.

The foregoing is especially important in transactions involving representation and warranty insurance, where an insurer will provide recourse to a buyer for the seller's violations of any representations and warranties that are covered by the RWI policy.

Insurance companies providing RWI coverage understandably want to know that the buyer has conducted proper due diligence for any representations and warranties that are to be covered by the policy.

For the insurance underwriters to feel comfortable approving the coverage in the RWI policy, insurers usually require a summary of the buyer's due diligence efforts and often conduct a call with the buyer and its legal counsel to discuss those diligence efforts (e.g., scope of the review, significant findings, and divergences between those findings and the representations set forth in the purchase agreement).

Insurers may (and usually do) exclude from the RWI policy any representations or warranties for which such efforts are deemed by the underwriter to be insufficient.

Often, as legal advisers on a buyer's deal team comb over the documents produced in a data room, responses from diligence calls, and any follow-up communications they have had with the seller's legal advisers, the buyer will prepare a legal due diligence memorandum.

Over the course of the diligence process in RWI deals, the purchase agreement should be revised, and any identified exceptions to the agreement's representations and warranties should be included in the disclosure schedules in order to avoid wholesale policy exclusions.

III. Legal diligence request lists and data room management

Although most large law firms have standardized diligence request lists for proposed transactions — and even subsets of such lists for more specialized transactions (e.g., a diligence request list produced for an ad-tech company will likely differ from one produced for a government contractor), best practice is to tailor the request list based on the information gleaned from the LOI and management presentation, as well as any publicly available information about the seller.

Reviewing any public information — or even the information on the seller's website — can be very informative in guiding these tailoring efforts.

Often, the seller or its investment banker will have already set up a data room containing relevant documentation (e.g., corporate documents, commercial contracts, intellectual property assets and employment agreements), which the buyer's legal due diligence team should review before preparing its request list.

As the seller begins to respond to diligence requests and populate the data room, the buyer's legal diligence advisers should not limit their review solely to documents produced pursuant to those requests.

The buyer will often learn critical information based on the requests made by its technical and operational advisers. Depending on the nature of the transaction, such information may be critical in drafting ancillary agreements (such as a transition services agreement in transactions where only a single business line is purchased from a larger enterprise and much-needed operational support is not acquired).

On transactions with larger groups of attorneys (both in-house and external counsel) and advisers reviewing data room production on behalf of the buyer, an annotated index of the data room should be created and circulated among the deal team members to assign areas of responsibility (and specific folders) among the applicable stakeholders.

Failing to create an annotated index often leads to confusion, duplicate review and, in the worst case scenario, important documents not being reviewed. An annotated index allows the team to "divide and conquer" rather than languish searching through a poorly organized data room.

With proper communication channels in place, specialists can then push incorrectly assigned documents to the proper person to ensure all relevant subject-matter experts have looked at all documents requiring their attention.

IV. Due diligence calls

At different points during the due diligence process, the management teams of the parties — along with their respective legal advisers — may participate in telephone calls to address questions better answered in a conversational manner than through document production or email exchanges.

As with diligence request lists, many large law firms have "canned" diligence call agendas already prepared. Nonetheless modeling the agendas for the specific transaction, based on diligence conducted prior to the call, will almost always yield the best results.

Tailored call agendas, like customized diligence request lists, generally afford the buyer the best opportunity to ask pointed, specific questions on issues that it uncovered during the due diligence process and offer the seller an opportunity to provide any additional context, reconcile apparent discrepancies, or perhaps even propose remediation plans for certain deficiencies.

When a buyer is conducting due diligence for a deal involving RWI, these calls are an excellent opportunity to have the seller confirm the accuracy of any specific representations in the current purchase agreement for which there has been no responsive document production to date.

Without such confirmation, a buyer may be unable to justify such representations to a wary RWI underwriter.

The length and subject matter addressed on these calls vary from deal to deal. What is a constant, however, is that the buyer's corporate deal team will quarterback these calls, which often last for hours.

Specialists are then rotated on and off the call to handle their specific substantive areas. It is not uncommon for the seller to invite subject matter experts (e.g., the chief technology officer for intellectual property issues, the chief financial officer for the financial discussion, the head of human resources for employment matters, and the chief privacy officer for privacy considerations) to participate, and the buyer will often have its external legal counsel and third-party consultants involved.

V. Legal due diligence memoranda

Often, as legal advisers on a buyer's deal team comb over the documents produced in a data room, responses from diligence calls, and any follow-up communications they have had with the seller's legal advisers, the buyer will prepare a legal due diligence memorandum.

Such a memorandum will, at a minimum, address any red flags identified during the due diligence process, in order to inform the buyer and any other potential stakeholders (such as lenders in a leveraged-buyout or underwriters to a transaction subject to RWI) of any material risks identified prior to the execution of a purchase agreement.

The memorandum generally provides a summary of the efforts undertaken by the buyer's legal diligence team during the due diligence process and disclaims any areas that were not examined. There is no standard length (or even a requirement) for a due diligence memorandum.

The level of detail will generally reflect the size and nature of the transaction, the sophistication of the buyer, and expectations as to what may be required by additional stakeholders.

Buyers, lenders and RWI underwriters will review the memorandum, which helps inform their decision-making process. Buyers are in regular communication with their legal due diligence team throughout the transaction process and will often review several drafts of the memorandum at different phases of the deal.

Lenders and underwriters, however, generally receive only the final version of the memorandum and are not part of the drafting process. As such, in order to take a deeper dive into the diligence process, they will typically conduct a call with the legal due diligence team to discuss and probe the memorandum's findings.

Legal advisers should presume that any issues identified in the memo will be topics on which lenders and underwriters will want further details, and they should be prepared to provide them.

CONCLUSION

As the axiom goes, an ounce of prevention is worth a pound of cure. In today's complex, highly regulated, global marketplace, it is essential that buyers conduct comprehensive and tailored due diligence customized for the specifics of their transactions.

Overlooking or failing to identify a material issue during the diligence process can have catastrophic effects. Buyers and their deal-making teams should be guided by these important principles.

Notes

[1] The Institute for Mergers, Acquisitions and Alliances reported that through Dec. 13, 2019, there were 46,467 transactions announced worldwide, with a total value of $3.536 trillion. These preliminary numbers, compared with 2018, which saw a full-year total of 52,912 transactions announced worldwide, and a total value of $4.134 trillion, represent a 12.1% decrease in transactions and a 14.46% decrease in total deal value. *See M&A Statistics*, Institute for Mergers, Acquisitions & Alliances (https://bit.ly/2FqXRZq) (last updated Dec. 13, 2019); *see also* Jens Kengelbach, Georg Keienburg, Jeff Gell, Jesper Nielsen, Maximilian Bader, Dominik Degen & Sonke Sievers, Boston Consulting Group, *The 2019 M&A Report: Downturns Are a Better Time for Deal Hunting*, Sept. 25, 2019, (https://on.bcg.com/2s4eZBe) (finding more U.S. megadeals in the first and second quarters of 2019 compared with the same quarters in 2018).

[2] This article does not address auction sales. Although the due diligence process in auction sales is similar to the process for the transactions described above, it is usually on a more compressed time frame in auction deals and often does not cover all of the issues as exhaustively due to the competitive nature of the opportunity.

[3] *See* Michael G. Harvey & Robert F. Lusch, *Expanding the Nature and Scope of Due Diligence*, 10 J. BUS. VENTURING (1995) (arguing that with successful "corporate marriages" through M&A being at about 50%, maturation within the practice area should include multidisciplinary review teams to access actionable data and intangible assets, beyond the traditional legal, accounting/financial and environmental audits).

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