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Diligence in Business Transactions: A Brief Primer

In a competitive economy, businesses make strategic decisions regarding acquisition targets in merger and acquisition transactions based upon projected outcomes related to post-transaction operations. In order to make informed decisions, the acquirers must have accurate and verifiable data about the assets or entities involved in the transaction. This data is generally obtained through the business due diligence process. When properly conducted, the due diligence process gives all parties the opportunity to evaluate whether the proposed transaction is likely to produce the expected results. Due diligence materials (*e.g.*, material contracts, litigation, prospective customer leads) are often the best source of key information for any business transaction.

Purpose of Due Diligence Process

A business seeking to acquire a target company will usually obtain some preliminary information regarding the business and financial performance of the target prior to executing a letter of intent. Often this information comes from publicly accessible sources, business reports, and even information obtained from the target itself. However, it is not until the due diligence process is undertaken that the acquirer may fully examine the inner workings of the target and determine the extent to which the actual performance of the target comports with such preliminary information. During the due diligence process, the acquirer will request, among other items, tax returns, financial statements (audited, if available), and other financial reports regarding accounts receivable, expenses, revenue-generating contracts, cash assets and indebtedness of the target. A review of this information helps to provide the acquirer with a detailed picture of the target's current and projected value. Moreover, careful scrutiny of these documents can reveal deficiencies regarding the target's internal controls, risk allocation or revenue projections. For complex transactions, acquirers may seek the assistance of forensic accountants or other financial experts to evaluate the target's financial data.

Issues for Global M&A Deals

Global transactions present unique challenges for businesses seeking to obtain and analyze diligence information. Some of these challenges are basic, such as language and cultural differences, while others are far more complex and require focused inquiries, such as decentralized computer systems and document retention policies, different accounting systems, and regulatory frameworks regarding foreign investment in or ownership of domestic entities. Cross-border transactions also implicate potential Foreign Corrupt Practices Act liabilities and the courts and legal systems of foreign jurisdictions. Careful diligence regarding the enforceability of deal terms is essential to ensuring that each party is getting what it expects out of the deal. Legal counsel with experience in these transactions can help clients navigate through all of the traps that may be encountered by the unwary.

Potential Issues Revealed in the Due Diligence Process

One of the purposes of the due diligence process is to uncover potential issues or liabilities associated with the target company. Transactional attorneys engaged in due diligence expect and are prepared to address such issues when they are discovered. Particularly in mergers and stock purchases, careful practitioners are mindful of the fact that liabilities of the target (including unknown liabilities) will become the responsibility of the acquirer after closing. A thorough diligence review is likely to reveal whether there are issues with the general corporate housekeeping of the target, or if current or past practices create potential anti-trust liabilities. Similarly, issues can arise with respect to a target company's employee benefit plan or tax reporting obligations. Seller's counsel can often work with the target to resolve these complex issues before the deal is consummated. Increasingly, sellers are looking to forensic accountants to review the financial reporting and accounting practices of a target to determine if there have been any irregularities or, in the extreme, fraud, with respect to the target's finances.

Key Components of Effective Due Diligence Strategies

The key to effective due diligence is organization and forward thinking from the beginning of the process. Due diligence outlines and checklists should be thoughtfully prepared and tailored to extract the information needed for each new due diligence project. Experienced transactional counsel will carefully consider, and the due diligence outline should account for, the specific risks and material benefits associated with the target. Crafting an adequate outline is only half the battle. As responses to the outline are received, the acquirer's counsel will review the responses and prepare follow-up inquiries as necessary and appropriate.

Effective due diligence also requires the acquiring company's business personnel to conduct the appropriate review of non-legal diligence materials and issues. Legal counsel and the acquiring company's business team should work together to ensure various aspects of the target company are appropriately reviewed by the right person. Generally, legal counsel will review the target company's organizational and governing documents, its potential liabilities, the contracts to which the target is a party, stock option plans, employment agreements and the need for IP protection. At the same time, the acquiring company's business team will review business items such as budgets, models, valuations, compensation levels, financial schedules, financial forecasts, staffing, future staffing plans, and other issues necessary to better understand the workings of the target, and the eventual integration of the two companies.

Review of public records can be a quick and effective way for an acquiring company to get a high-level picture of the target. Public records can supplement and verify the diligence information provided by the target. Useful public records include UCC financing statements, lien searches, land records, SEC filings, annual state corporate filings, tax returns, press releases, news articles, and government authority filings.

In addition to document gathering and review, most effective due diligence strategies include on-site diligence of a potential target, interviews with key management personnel, and on-site review of documents. On-site diligence allows a potential acquirer to "kick the tires" of the target business, and allows an acquirer to get a better sense of the workings of the target business, beyond the information obtained through written questions and answers.

In recent years, technology has become central to effective due diligence strategies. Virtual Data Rooms or Virtual Deal Rooms ("VDRs") have largely replaced paper-based data rooms traditionally set up in law firm offices. VDRs allow for online posting of important diligence documents and question-and-answer boards to facilitate discussion, and can accurately track when and where documents are being viewed, allowing for an increased level of security. While VDRs can present access and security issues, their decreased cost and effectiveness make VDRs the preferred method of conducting most due diligence efforts.

Conclusion

The due diligence process is an integral and important tool in mergers and acquisitions. Working with experienced counsel, potential acquirers can formulate and execute a thorough and cost-effective diligence process that will decrease the potential for hidden risks and liabilities, while maximizing the acquirer's ability to achieve the gains expected from the proposed transaction. Please contact a member of our **Corporate Practice Group** or one of the authors if you have any questions about this alert.

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