Planning a significant due diligence process can be daunting, even for experienced deal makers. Some foresight and a little preparation can make the process go smoothly. Spending a few hours at the outset thinking through the process carefully can also save a client a tremendous amount of time and money as the deal progresses. By anticipating and preventing roadblocks, focusing in on key issues, determining what deliverables will be most useful and avoiding duplication of efforts, an advisor can develop an effective approach to any M&A due diligence process. Ensuring that diligence findings are communicated efficiently and properly assimilated into the deal negotiations makes all the effort worthwhile. This article outlines ten practical tips for organizing a due diligence exercise to maximize the benefits of the process, while staying on schedule and reducing costs.

This article is part of the “Speed Reading” series in which the authors highlight practical tips and recurring issues in M&A transactions. Other “Speed Reading” articles are: Aquila and Sawyer on Rights Plans, 2010 Emerging Issues 5027 and Aquila and Sawyer on Issues in a Public Company Merger Agreement, 2010 Emerging Issues 4883.

1. Scoping Out the Assignment

Before starting due diligence, advisors and their clients should pause to discuss the scope of the project. The discussion should cover the following topics, among others:

- **Scope.** What is the scope of due diligence? Is the purpose of the diligence exercise merely to identify issues that could impact the transaction valuation, structure and/or deal timing, or are the diligence findings also expected to form a basis for future integration work?

- **Work Product.** What kind of work product does the client want to receive? Detailed document-by-document summaries or an executive summary that only highlights material issues? The answer will be closely related to the
scope of the project and the expected audience for the report. Delivering a two-hundred page report to a board of directors usually is not appropriate, but the head of an integration team may be thrilled to receive that level of detail.

- **Materiality.** Is there a materiality threshold below which the findings are unlikely to justify the expense of performing diligence? This question is becoming increasingly important because virtual data rooms have made it possible for a seller to give a buyer access to its entire electronic contract database without making any effort to distinguish between a multi-year, multi-million dollar key supplier agreement, on the one hand, and a landscaping contract for the corporate headquarters, on the other hand.

- **Transaction Structure.** How will the transaction be structured? If the target is a public company that files periodic reports and audited financial statements with the SEC, a buyer might elect to (or, in a hostile deal, might have to) rely on a more cursory due diligence review (understanding, of course, that relying primarily on the seller’s public disclosures will leave the buyer exposed to undisclosed risks). In contrast, if the transaction is a small asset sale with detailed disclosure schedules, the due diligence may need to be much more granular.

- **Risk Allocation.** What liabilities is the buyer expected to assume? If the business deal is that the buyer will be fully indemnified against all environmental liabilities, for example, it may be more important for the buyer’s diligence team to spend its time and money analyzing the credit risk associated with accepting an indemnity from the seller rather than performing a detailed review of the underlying environmental risks.

- **Known Risks.** Should the team focus on any particular types of risks given the identity of the seller or the nature of the industry?

2. Pulling Together the Team and Coordinating Results

When it comes to performing due diligence, advisors are not “one size fits all”. Depending on the type of transaction and the industry, a buyer may need to hire multiple specialized diligence providers, such as a tax and financial accounting firm, an actuarial firm (more common in certain insurance deals), a loan portfolio consultant (more common in loan portfolio or banking deals), outside counsel including, in some cases, local
counsel, an employee benefits/human resources consultant, an environmental consultant and/or a real property title search firm.

Expanding the team can create coordination challenges, but specialists can often be more cost-effective and deliver better results than generalists in particular subject-matter areas. For example, although internal counsel or outside counsel may be able to review a target’s Foreign Corrupt Practices Act compliance policies and procedures, a forensic accountant or similar specialist is better placed to review the target’s financial books and records to verify whether the target is compliant with those policies.

When negotiating engagement letters with specialists to perform due diligence, keep the following in mind:

- Make sure the engagement letter accurately describes the scope of the project;
- The legal “boilerplate” is usually very favorable to the specialist, but in many cases can be negotiated to reflect a more reasonable middle-ground; keep in mind, however, that a protracted negotiation with a service provider over the terms of its engagement may delay the diligence schedule;
- Fees are usually negotiable, within a range of reasonableness;
- Consider capping reimbursement for expenses at a reasonable level, above which the specialists will need to revert to the client to get consent for additional extraordinary expenditures;
- Consider whether the engagement letter should include a confidentiality provision and/or a restriction on the specialist’s ability to accept an assignment that creates a conflict of interest,
- If time is of the essence, consider including deadlines for delivery of the specialist’s reports;
- If specific individuals’ expertise is key, consider specifying that those individuals must comprise part of the specialist’s team for the project; and
- Make sure the restrictions on the use of the specialist’s report do not unduly constrain the client from sharing copies of the report with all key
members of the diligence team, including outside financial advisors and outside counsel, and making any requisite regulatory filings.

To manage the challenges of coordinating a large diligence team, consider establishing the following procedures at the outset, among others:

- Identify a “team leader” who will coordinate scheduling access to data rooms, management presentations, site visits, calls and meetings for the full diligence team; the team leader will also be the “go to” person to whom the team will identify urgent substantive and process-related issues;

- Create a working group list with contact information for everybody on the team;

- Create a “deliverables” calendar to highlight key deadlines for the presentation of due diligence reports; if reports will be presented directly to a board of directors, keep in mind that the directors should receive any written materials a couple of days in advance of the meeting if possible;

- Hold a “kick-off” meeting to identify clearly how to divvy up responsibilities, to discuss the scope of the assignment and to discuss any procedural requirements (such as potential antitrust restrictions on access, which are discussed below);

- Hold periodic team calls to identify challenges in accessing information and allocate resources (both your team’s and the counterparty’s) most efficiently and to ensure that issues that impact more than one subject matter area are brought to the attention of others on the team; and

- Invite the primary draftsperson for the transaction agreements to attend diligence calls/meetings (or get a download afterwards) so that he or she can take into account the issues reported during these sessions when drafting risk allocation provisions.

3. Vendor Due Diligence and Lender Due Diligence

Many due diligence providers contractually restrict who can receive copies of their reports. Make sure you discuss with them in advance whether they are being engaged to prepare a vendor due diligence report (that is, to represent seller and prepare a report
that buyers will be allowed to review) or a report that will be shared with lenders to minimize the lenders’ due diligence costs. U.S. law firms generally will not permit non-clients to rely on their due diligence reports, and will require lenders and others to sign “non-reliance” letters as a condition of receiving a copy of their report. Typically the non-reliance letters include an extensive release from liability. Sharing reports can provide a big cost-savings to a target that is seeking to provide stapled financing, or to a buyer who is urgently seeking to pull together a bid with committed financing.

Setting aside the “reliance” issue, dealing with lender due diligence in a transaction can present additional coordination challenges for a diligence team. Lenders may be focused on different diligence issues than a buyer, such as the lender’s ability to take security interests in the target’s assets. Too many detailed diligence requests from a lender have the potential to overwhelm and distract an unsophisticated target’s deal team from negotiating key deal terms like price and deal certainty. On the other hand, any failure to work cooperatively with a lender to satisfy its diligence requests can delay the ability to get commitment letters or cause the lenders to require a dreaded “diligence out”. It is best to discuss up front with potential lenders what their pre-signing diligence requirements will be, and how best to integrate the lender’s diligence into the overall process and timetable.

4. Complying with Antitrust Laws and Other Regulatory Considerations

After a diligence team “scopes out” the assignment, the team should consult with legal counsel to confirm whether there are any antitrust or other regulatory constraints on their work. For example, certain regulated industries impose restrictions on sharing certain types of information, such as exam reports in the case of some banks. In addition, when counterparties are key competitors in the same industry, it may be advisable to restrict access to certain types of competitively sensitive information. The parties can develop firewall procedures to ensure that individuals with responsibility for setting pricing at the buyer, for example, cannot access information about the target’s pricing or cost of goods sold. These procedures might include:

- Ensuring that the seller’s antitrust counsel reviews all data room materials and management presentations for competitively sensitive information prior to making them available to the buyer;

- Redacting pricing and other competitively sensitive information from documents before providing copies in a data room;
• Setting up a separate “clean room”, or establishing “restricted access” passwords for virtual data rooms, to segregate competitively sensitive information from non-competitively sensitive information;

• Using a virtual data room program that tracks who accesses which information, and restricts people from printing or downloading competitively sensitive information;

• Ensuring that members of the diligence team sign individual letter agreements agreeing to observe the antitrust protocols;

• Limiting the number of people at the client who are able to receive and review diligence reports that may contain summaries of competitively sensitive issues; and

• Ensuring that a legal advisor attends all substantive meetings between the parties to make sure that discussions do not cross the line of what is permissible under applicable law.

It is essential that appropriate counsel, aware of all the facts and circumstances, is consulted before such procedures are put in place. Such counsel should be consulted regularly as the process moves forward. While firewall procedures may be necessary in some cases to protect both the buyer and the seller from liability, buyers should beware of unjustified seller claims that information is “sensitive” or “restricted” where the seller is merely trying to withhold key diligence information so that the buyer cannot take it into account in its valuation. Also, in an auction process, bidders should work with the seller to ensure they are not disadvantaged by the firewall procedures as compared to other bidders.

5. Preserving Confidentiality and Establishing Other Due Diligence Procedures

Before commencing any due diligence process, the parties should sign a confidentiality agreement and agree on other due diligence procedures with each other. The latter includes the following matters, among others:

• Will the buyer be granted an exclusivity period during the due diligence phase of the transaction?
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- Will the buyer be required to agree to a standstill as a condition of doing due diligence on the target?

- If the buyer is planning to bring in equity co-investors, can the equity co-investors conduct their own due diligence in their capacity as “representatives” of the buyer or will they need to sign separate confidentiality agreements?

- Will the buyer be permitted to make copies of the target’s data room information? If using an electronic data room, will the buyer be able to print and/or download files from the data room?

- Does the target have any particular issues for which diligence is expected to be costly and for which buyer would expect to be reimbursed if the target elects not to proceed with a transaction with the buyer?

- Would the target prefer that all diligence requests flow through an external representative, such as a financial advisor, so as not to overtax the management team?

- Does the target have any internal firewalls or other restrictions on which target employees can be “in the loop” about the transaction? Should the parties develop a “cover story” to explain buyer’s diligence to the target’s employees, such as pretending that the buyer is a potential lender that the target is considering using for a refinancing transaction?

6. Addressing Privilege Issues

A buyer usually will want to fully investigate a target’s litigation and regulatory issues. However, the target may worry that revealing too much about its litigation strategy, estimates of liability and internal investigations could destroy attorney-client privilege or similar protections the target may otherwise wish to preserve. The parties should consult with litigation counsel to assess whether it is possible to avoid this outcome. One option frequently explored by parties in M&A deals is entering into a joint defense agreement or a common interest agreement. The concept of such an agreement is that the buyer, who will succeed to all or some of the assets and liabilities of the target, should not be viewed as a third party because the buyer and the target share a common interest in the resolution of the claims. Even if litigation counsel advises that such an
agreement may be effective to preserve privilege, counsel may recommend that the parties take additional steps to bolster their arguments in favor of privilege, such as restricting access to the privileged information only to outside counsel. Tread carefully! Experienced litigation counsel must be consulted whenever dealing with potential privilege issues.

7. Getting Started Before Getting Access

A buyer can complete a lot of due diligence before even getting access to the target’s confidential information. This “desktop” due diligence often provides a good basis for previewing key issues that can shape an initial indication of interest in an auction process and/or considering whether to devote more resources to a potential acquisition. Examples of this type of due diligence include the following:

- SEC filings and comparable filings in other jurisdictions;
- Websites;
- One-Source Reports and similar subscription-based information sources;
- Background checks on management;
- Litigation docket searches;
- UCC lien searches;
- Obtaining good standing certificates from secretaries of state or similar offices;
- Environmental reports available from regulatory agencies; and
- Other publicly available regulatory filings and reports.


Before sending a team of hundreds of service providers into a data room to start reviewing thousands of documents, a buyer should insist that the target schedule oral discus-
sions about key issues with its management team. In most deals, these discussions would include presentations by teams from the following departments: finance, operations, legal and information technology. In certain industries, they could also include: regulatory/compliance, facilities and other subject matter-specific areas. Live discussions of key issues can help the buyer to streamline its diligence and focus in on key areas. They can also put the diligence in context of the seller’s businesses and inform the buyer about key decisions, such as the appropriate level of materiality for focusing the scope of the due diligence. When pressed with the right questions by knowledgeable diligence teams, sellers’ management teams are often very open about key risks and what steps the seller has undertaken to mitigate issues. In an auction context, management presentations can also provide vitally important strategic information. For example, if the management team seems “rough” and unprepared to answer basic questions, the buyer might surmise that none of the other bidders in the process are serious contenders.

As a process matter, it is generally better to designate one or two individuals on the buyer’s team to lead Q&A sessions with seller’s management team. It is often possible to open a conference line to allow others from the buyer’s team to listen in to the discussions as silent participants.

In deals where the seller is divesting manufacturing facilities, the buyer may also want to conduct site visits. Seeing a seller’s facilities first-hand and discussing the seller’s operations with local site managers can reveal important information about the quality of the seller’s operations and technology, its safety and compliance standards and the morale of its work force. The buyer should make sure that it gets to influence the choice of locations and timing so that seller does not limit the visits to its best and most prepared facilities. A buyer’s desire for site visits, however, has to be balanced against the need for confidentiality. Having a team of ten “suits” walking through a plant on short notice without a good cover story is often the first tip-off to labor that a deal is in the works, which in turn can affect employee retention.

9. Putting a Value on an Issue

It can be frustrating for clients when their diligence teams spot potential risks but are not able to put a value on them. It can be equally frustrating for advisors when clients ask them to quantify speculative, unknown and contingent risks. To bridge this gap, it is sometimes helpful to categorize risks into different buckets, including the following:
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- Are they ordinary course industry-specific risks? If the buyer is already operating in the same industry as the seller, the buyer’s own management team will likely be best placed to analyze and quantify these risks.

- Are the risks covered by insurance or indemnities from third parties? Will the insurance or indemnities be available to the buyer post-closing? Can the buyer purchase insurance to cover the risk, and, if so, how much would the insurance cost?

- Has the target placed reserves on its financial statements for the risks? If so, how did it calculate the size of the reserves? How much of the reserves has it used in the past?

- If the target is a public company, has the risk been disclosed publicly such that the target’s market price may already include a discount to take account of the risk?

- Can an economist assist with quantifying the potential liability? This might be the case, for example, if the target is the subject of securities class action litigation.

- Does the target have any claims experience with similar risks that could be used as a guide to assess potential liabilities? Do comparable companies in the same industry disclose their historical claims experience in relation to similar risks?

- What steps, if any, has the target taken to mitigate the risk? Is the target following best practices to address the issue?

- Could the risk carry ancillary consequences, such as reputational harms, that would impact the buyer’s other businesses if the buyer proceeds with the transaction?

- Fundamentally, is the risk a deal-breaker such that the buyer would not be willing to proceed with the transaction due to the magnitude or nature of the exposure?
10. Recurring Substantive Issues in M&A Legal Due Diligence

Every transaction is unique, every company is unique and, accordingly, every due diligence process is unique. However, there are at least a few recurring issues that should be part of every M&A deal’s legal due diligence process. Here are some examples:

- **Change of Control and Anti-Assignment Provisions.** If a target’s most important assets include its contracts and relationships with third parties, the buyer’s diligence team needs to assess whether those contracts and relationships will survive unaffected by the transaction. The answer will depend in part on the language of the contract, the governing law of the contract and the structure of the transaction. The answer also depends on the buyer’s and the target’s relationship with the counterparty. Breaching a transfer restriction could trigger liquidated damages, termination rights or other mechanics that could impact the valuation of the transaction and the viability of the business post-closing. It is critical to understand how valuable the relationship is, whether the provision is applicable, and what the consequence of triggering the provision would be. Keep in mind that imposing liens in connection with transaction financing may also trigger consent requirements under these provisions.

- **Non-Compete, Exclusivity and MFN Provisions.** If the buyer currently operates in (or plans to expand its operations into) the same industry as the target, the buyer needs to be very careful not to “acquire” non-compete, exclusivity or “most favored nation” provisions that could be broadly construed to apply to the buyer’s businesses, not just the target’s businesses. For example, if the target has entered into a contract that restricts target “and its affiliates” from selling widgets during the term of the contract, the buyer currently sells widgets and the transaction structure is such that the buyer will be an affiliate of the target post-closing, the buyer needs to evaluate carefully the consequences of violating the widget non-compete.

- **Related Party Transactions.** The buyer should investigate transactions between the target and related parties (or formerly related parties) carefully for at least two reasons: (i) the terms may not be arms-length (that is, the transactions may be on favorable terms that will not be available to the buyer upon renewal of the agreement, or the terms may be unusually ad-
verse to the buyers) and (ii) the buyer may have disclosure and compliance obligations related to the arrangements post-closing.

- **Debt Instruments.** Debt instruments can be the most complex documents to review in a due diligence process. Not only may they contain change of control defaults, but in the case of public debt the transaction structure may require the parties to determine how the issuer can conduct an issuer tender offer to repurchase the debt or a consent solicitation to address potential defaults resulting from the transaction. Restrictive covenants and ratings conditions in an indenture or credit agreement can also be a source of defaults in connection with a transaction. The buyer’s diligence team needs to understand not only the target’s debt instruments, but also how those instruments relate to the buyer’s existing debt (for example, to analyze the potential for cross-defaults).

- **Capital Structure.** A complete understanding of the target’s capital structure is fundamental to structuring any stock purchase, merger or similar transaction. The buyer needs to diligence the classes and series voting and non-voting equity securities (including options, warrants and other derivatives), and understand what rights each type of security will have to vote on the transaction and whether the securities can be cancelled in the transaction without the consent of the holder. A related question is whether a stockholders’ agreement or similar agreement gives any of the holders special rights that could be triggered by the transaction, like rights of first refusal/first offer, tag-along rights, drag-along rights, preemptive rights or registration rights.

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Even the most modest due diligence process entails the expenditure of significant time and resources. Making sure that the client obtains full value from the due diligence effort is essential. The person in charge of reviewing diligence reports from various advisors should be able to take that information and translate it into structuring discussions and risk allocation negotiations. Examples of practical applications of diligence information include the following:

- Reviewing the seller’s representations and warranties and evaluating the seller’s disclosure schedules;
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- Determining the optimal form and timing of consideration, including determining whether any post-closing earn-outs or purchase price adjustments are appropriate, and determining what accounting adjustments may be desirable for these calculations;

- Determining whether either party will require any transition services;

- Determining whether to make a Section 338(h)(10) election or whether other tax considerations will influence the transaction structuring;

- Determining whether to seek regulatory or third party consents pre-signing and between signing and closing, and determining what shareholder approvals are required;

- Assessing which of the target’s debt, if any, would need to be paid off at closing, and how the pay-off would be effected;

- Planning for customer, employee and investor outreach in connection with the announcement of the deal; and

- Analyzing employee compensation and benefits issues, structuring employee retention arrangements and analyzing the tax consequences of employee severance and change in control payments.

Remember that due diligence is not an end in and of itself. It is all too easy to get caught up in the process of following checklists, losing the forest for the trees and failing to adapt to changing dynamics as the process evolves. These ten tips for getting started in a diligence process are not one-size-fits-all suggestions and obviously do not address the myriad of substantive issues that can come to light in any given diligence process. However, thinking through these issues at the outset can help to prepare a diligence team to be effective, timely and efficient.

For more on due diligence, see Chapter 6, "Due Diligence" in M&A Practice Guide

For more on due diligence, see Chapter 2B, "Due Diligence in Mergers and Acquisitions," in Corporate Acquisitions and Mergers
For more on confidentiality and standstill agreements, see Chapter 5, "Preliminary Agreements," in M&A Practice Guide

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