INSIDE THE MINDS

Business Due Diligence Strategies

Leading Lawyers on Conducting Due Diligence in Today's M&A Deals

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A Look at Due Diligence

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Introduction

Invariably and early in any M&A process, the term "due diligence" will be thrown around by the principals or their advisors. To one party, due diligence might mean a perfunctory review of the seller's financial statements and key contracts. To another, due diligence could constitute an exacting evaluation of every document produced by the seller and its advisors since the company's inception; meetings with its management, customers, and suppliers; and guided tours of all facilities. Still, others may view due diligence as management meetings coupled with a checklist of items to be crossed off and a confirmation that no red flags were raised while checking each box.

The reality, of course, is that M&A due diligence may be none, all, or a combination of these processes. M&A due diligence is inherently context-specific, and the investigation undertaken will vary depending on a number of factors, including:

- Is there a clear purchaser and seller in the proposed transaction, or do the parties contemplate a "merger of equals" or joint venture transaction?
- Does the proposed transaction contemplate a sale of an entire company, a division, or a specific set of assets?
- Will the transaction consideration be paid with cash, stock, a debt instrument, or some form of combination?
- Are the parties engaged in exclusive negotiations, or is the seller conducting an auction?
- What are the time pressures toward reaching a definitive transaction agreement?
- Is the seller a Securities and Exchange Commission-reporting company with publicly filed, audited financial statements, annual reports, and material contracts?
- Is the seller a willing participant in the proposed transaction, or is the prospective purchaser looking to make a hostile bid?
- Are the parties competitors engaged in the same line of business?

The answers to these questions and other transaction-specific inquiries will shape the due diligence investigation to be undertaken by the transacting parties, with the result being that no two due diligence processes will be, or should be, exactly alike.

The focus of this chapter is limited to the due diligence investigation undertaken by a purchaser in an M&A transaction ("buy-side diligence"). While the goals of buy-side diligence are invariably driven by the particular transaction under consideration, an overarching goal of any buy-side diligence process must be a determination as to whether the contemplated transaction serves the purchaser's strategic objectives. If and when that fundamental principle is established in the affirmative, the objective of those performing buy-side diligence should pivot to an identification and evaluation of the risks and opportunities presented by the proposed transaction.

It should be noted at the outset that the identification of risk is not in and of itself problematic. In fact, it would be surprising (and likely troubling) if a purchaser and its advisors did not uncover any risk in their buy-side diligence investigation. Rather, as risks are identified in buy-side diligence, the aim of the purchaser should be to minimize and/or allocate the risk. Certain risks can be minimized or even eliminated by choice of transaction structure, while other risks can, based on the parties' respective negotiating leverage, be allocated among the purchaser and seller via the terms of the definitive transaction agreement.

The identification of opportunities during buy-side diligence is a key component in the purchaser's ability to maximize value post-closing via the integration of the business or assets being purchased. These M&A opportunities are, of course, transaction-specific and could range from the fairly mundane (e.g., a realization that the seller's back-office intellectual technology systems are more efficient than the purchaser's systems) to those that can be game-changing for the strategic direction of the purchaser (e.g., purchasing a company led by a uniquely talented visionary like Steve Jobs).

Given the sheer number of risks and opportunities presented by any M&A transaction, the visceral reaction from the eager, neophyte purchaser would be to thoroughly evaluate every risk and opportunity presented in the proposed transaction, craft an airtight purchase agreement that leaves all risk with the seller and allows the purchaser to capture all the value-maximizing opportunities, quickly close the transaction, and ride off into the sunset with a full integration plan in tow. Experienced dealmakers, however, recognize that constraints on the due diligence process invariably limit this utopian ideal. These might include constraints imposed directly by the seller, such as auction process deadlines or prohibitions on communications with customers and suppliers, as well as such extraneous issues as the vagaries of the financial markets or the impact of natural disasters. Given these factors, the purchaser and its advisors must instead focus on the key operational, financial, and legal aspects of the proposed transaction.

Scope of Due Diligence

The initial step in any buy-side diligence process should be a discussion between the purchaser and its advisors to map out the scope of the due diligence task. For example, is the purpose of the diligence to identify or confirm transaction valuation, transaction structure, and/or transaction timing, or are the diligence findings also expected to be a driving force behind the post-closing integration? In another scenario, should the due diligence team limit its scope to any particular type of risk? In certain instances (particularly where the purchaser and seller operate in the same industry, thus allowing the purchaser to have a clear understanding of the seller's business as well as relationships with a similar set of customers and suppliers), the purchaser may want to focus its due diligence review on a subset of risk such as environmental liability, product development pipeline, or employee retention.

The purchaser and its advisors should also, at the outset, discuss the work-product deliverables that the purchaser's operations/integration team and outside advisors will produce and to whom they will be delivered. The scope of the project and the intended audience will, of course, drive the deliverables. Succinct executive summaries and detailed analytical reports are not mutually exclusive—however, reaching the intended audience of the particular deliverable is vital. For instance, delivering a 300-page report to a chief executive officer or board of directors generally is not particularly useful, but the head of operations/integration may expect to receive such level of detail. In any case, the purchaser—in conjunction with its advisors—should implement a process that facilitates the free flow of pertinent information getting to decision makers, with any "show-stoppers" being reported to the leader of the purchaser's deal team in real time.

The old "time is money" adage certainly rings true in the M&A context. As such, it is useful when discussing the scope of a buy-side diligence process to determine whether there is a materiality threshold below which the findings are unlikely to justify the time, opportunity cost, and expense of performing the diligence. This determination is becoming increasingly salient as the proliferation of virtual data rooms has made it possible for a seller to readily provide a purchaser with access to its entire database of contracts just by a click of a button. The effortlessness of providing copious information too frequently results in "data dumps" of expired, immaterial, or irrelevant information being furnished to purchasers via virtual data rooms. A purchaser will, of course, be more concerned with a key customer agreement than, say, a contract for janitorial services, but if a purchaser instructs its advisors to review and summarize every contract provided in the virtual data room regardless of materiality, the purchaser is likely to get a summary of that janitorial services contract.

The structure of the proposed transaction will also have a significant impact on the appropriate scope of buy-side diligence. For example, if the proposed transaction is a purchase of specified assets (e.g., mines in Latin America), the purchaser should not spend the time or money to conduct a review of assets and liabilities that will not be assumed in the sale (e.g., the real property records and environmental reports related to the seller's headquarters in Arkansas). If the transaction is structured as a merger and the target is a public company that files periodic reports, material contracts, and financial statements with the Securities and Exchange Commission, a purchaser might elect to—or, in a hostile deal, might have to—rely on a more cursory due diligence review with a high level of materiality. On the other hand, if the transaction is a merger involving a privately held seller, it is likely that the parties will produce detailed disclosure schedules containing nearly all of the company's contracts, thus necessitating a granular buy-side diligence review.

Additionally, the business deal on risk allocation among the parties will drive the scope of the buy-side diligence review. For example, in a transaction where the purchaser has post-closing recourse against the seller for losses relating to environmental liabilities, it would likely not be cost effective for the purchaser to spend significant time and money analyzing the seller's environmental liabilities. Instead, the purchaser would more likely focus its investigation on the seller's financial position and ability to satisfy post-closing indemnification obligations to the purchaser. In a transaction where the purchaser has no post-closing recourse against the seller—as is the case in virtually every merger agreement where the seller is a public company—a purchaser should (given the difficulty a purchaser faces in being relieved of its obligations to consummate the transaction) view the due diligence investigation as its only bite at the apple to identify and allocate risk prior to signing the definitive transaction agreement.

Confidentiality

Prior to the buy-side diligence team being granted access to the seller's confidential information, the seller and purchaser will almost invariably enter into a confidentiality agreement that, broadly speaking, prohibits the purchaser from disclosing the seller's confidential information or using that information other than in connection with the proposed M&A transaction. In connection with entering into the confidentiality agreement, the seller and the buy-side diligence team should coordinate with their respective legal counsel to understand antitrust or other regulatory constraints on the diligence investigation as well as to establish diligence procedures.

With respect to antitrust constraints, the parties—particularly if they are competitors operating in the same industry—will want to ensure that pricing and other competitively sensitive information is redacted from documentation provided to the purchaser. Additionally, the parties may choose to designate certain members of the buy-side diligence team as a "need-to-know" group for certain functions. By taking that step, competitively sensitive information will only be provided to a limited group of the buy-side diligence team who are prohibited from sharing such information with their colleagues outside the need-to-know group.

Due diligence procedures will vary based on the proposed transaction. Answers to the types of questions listed below will shape the procedures:

- Who at the seller will the purchaser flow its diligence requests through?
- Does the seller have internal firewalls or other restrictions that prevent employees from gaining knowledge about the transaction?
- Is the seller's management team aware of and/or support the transaction?
- Is the seller conducting an auction whereby each potential purchaser has a designated time slot to meet with the seller's management team, or are the parties in exclusive negotiations during which the respective management teams are in frequent and often informal contact?
- Can the purchaser share its diligence findings with co-investors?
- Will the potential purchaser be reimbursed by the seller if it elects to proceed with an alternative transaction?

Once these procedures are established, the buy-side diligence team will roll up its sleeves and get to work.

Who Performs Due Diligence?

Like football, due diligence is the ultimate team sport. In football, eleven players are moving in unison to run a play called from the sidelines. In buy-side diligence, a team comprised of the purchaser's employees, subject matter experts, and outside advisors are executing the scope of the due diligence review prescribed by the leader of the purchaser's deal team. In football, a coach does not want his wide receiver trying to play left tackle, but he does want the wide receiver and left tackle to work together seamlessly and block for the running back. And, in due diligence, the leader of the purchaser's deal team does not want her corporate legal counsel to run actuarial models, but she does want the attorneys and actuaries to work in unison to ensure that a purchase price adjustment based on the seller's financial statements accurately reflects the business deal.

A buy-side diligence process will regularly employ a host of outside advisors and subject matter experts, although the range of advisors will depend on the type of transaction and the industries of the parties to the proposed transaction. It is not uncommon in a buy-side diligence process for the purchaser to have its own operations corporate development teams working alongside an investment banking firm; tax and financial accountants; legal counsel (which, in many instances, may include counsel with certain regulatory or other expertise and, depending on the geographic breadth of the business to be purchased, include various local counsel who focus on discrete statutory, contractual, or regulatory issues); an employee benefits/human resources consultant; an environmental consultant; and other industry-specific experts (e.g., actuaries in insurance transactions, loan portfolio consultants in banking transactions).

While a large team creates coordination challenges, specialists are generally cost-effective and able to deliver more superior results than generalists in particular subject matter areas. For example, although internal or outside counsel may be able to review a seller's Foreign Corrupt Practices Act compliance policies and procedures, a forensic accountant is better positioned to review the seller's financial books and records to verify whether the target is compliant with those policies and procedures.

Managing a large buy-side diligence team is a herculean task, particularly in an environment where time is of the essence and where most members of the team lack unfettered access to all information necessary to conduct the review. A set of procedures or a diligence "playbook" will, nonetheless, facilitate cooperation and achieve the prescribed goal.

At the outset, the diligence team should identify a leader who will coordinate scheduling, access to the virtual data room, management presentations, site visits, conference calls and meetings, and otherwise serve as the person to whom the team will identify substantive and process-related issues. Generally, this person is someone junior enough that he or she is not too far removed from administrative tasks, but is experienced enough that he or she can articulate the substantive issues and get the attention of the team's key decision maker.

Once a buy-side diligence team has been established, the team should hold a kick-off meeting or conference call to introduce one another, divvy up responsibilities, specify the scope of the assignment, discuss procedural and confidentiality requirements (including antitrust restrictions), and formulate an action plan. This action plan should include a calendar of all deliverables, as well as a deadline for the presentation of due diligence reports, necessary internal approvals, and markup of the transaction agreement and related exhibits. Despite the importance of a structured process, team members should not become so rigid and beholden to calendar milestones that they wait to report crucial information or hold off on making important follow-up inquires. Any show-stoppers or red flags should be reported immediately to the team leader.

To facilitate the flow of information, an effective diligence deal will have brief, periodic discussions regarding any procedural (e.g., challenges in accessing information) or substantive (e.g., discovery of a large, undisclosed liability) issues identified during the course of the diligence process. For example, it will be useful for the accountants to hear about a newly filed litigation claim that would not have been reserved for on the seller's latest available financial statements. Further to that point, it is worthwhile to invite the primary draftsperson for the transaction agreements to sit in on diligence calls or meetings, allowing them to take into account any issues reported during these sessions when drafting risk allocation provisions.

Types of Information Provided in Due Diligence

So, what type of due diligence material will the buy-side diligence team be receiving? The answer, of course, depends on the proposed transaction. However, various forms of buy-side diligence are commonplace, each useful in its own right and all complementary to one another.

A fair amount of due diligence information can be accessed by the purchaser prior to the seller providing access to its confidential information. This "desktop" due diligence often previews key issues that help shape a purchaser's view on whether it plans to devote additional resources to a potential transaction. Desktop due diligence includes a review of Securities and Exchange Commission filings or comparable filings in other jurisdictions (for public companies); the seller's website; reports from subscription-based information sources (such as Hoovers, One Source, and Shark Repellent); background checks on the seller's management team or board of directors (from private investigative providers such as Kroll); litigation docket searches; Uniform Commercial Code lien searches;

environmental reports from regulatory agencies; and any other publicly available regulatory filings and reports.

Once the desktop diligence is underway and the purchaser has a fundamental understanding of the seller's business, a critical next step in the buy-side diligence process—ideally before the purchaser's diligence team commences a large, document-heavy review—is to arrange meetings between the purchaser's and seller's management teams and subject matter experts. Typically, these meetings are centered on management presentations from department leaders and subject matter experts across the seller's business functions (e.g., operations, accounting, finance, human resources, legal, information technology, real estate, regulatory compliance). These presentations are generally followed by question-and-answer sessions that offer the purchaser an opportunity to sharpen its diligence approach and key-in on the principal risks and opportunities presented by the proposed transaction.

In transactions where real property or other tangible assets are material to the purchaser's decision as to whether to proceed, the purchaser will likely want to visit the seller's properties. By visiting the facilities and discussing the seller's operations with local managers, the purchaser can collect valuable information about the quality of those operations. It is important that the purchaser have a modicum of control over the locations being visited. This approach allows the purchaser to gain a fair and accurate picture of the seller's properties, rather than only touring the most up-to-date and pristine locations. Still, the purchaser's request for site visits must be balanced against the seller's legitimate concern for confidentiality, as a team of "suits" walking the property could tip off employees that an important transaction is in the works.

A nearly universal component in any buy-side diligence investigation is the seller's population of a virtual data room (generally on the website of a third-party host, such as IntraLinks or Merrill DataSite). Virtual data rooms are typically organized by folders and subfolders that contain documents related to the seller's various operations, for example:

- Organizational documents
    - Company organizational chart

    - Charter and bylaws for the company and each subsidiary
    - Certificates of good standing
    - Minutes of meetings of the board of directors

- Financial

    - Audited financials
    - Unaudited financials
    - Accounting policies
    - Management reports
    - Insurance and risk management

- Tax

    - Federal tax returns
    - State tax returns
    - Net operating loss analyses

- Sales and marketing materials

    - Pricing
    - Revenue by channel
    - Customer list

- Information technology

    - Systems
    - Disaster recovery
    - Network architecture

- Intellectual property

    - Patents
    - Software license agreements

- Human resources
    - Compensation plans
    - Health plans
    - Labor agreements
    - 401k plan
    - Policies and practices
- Real estate
    - Owned real property
    - Leased real property
    - Environmental reports
- Operating contracts
    - Customer contracts
    - Supply contracts
- Litigation
    - Claims against the company
    - Claims filed by the company
- Indebtedness
    - Credit agreements
    - Security agreements
    - Uniform Commercial Code filings
- Regulatory
    - Licenses
    - Correspondence with regulators

Prior to the buy-side diligence team being granted access to a virtual data room, it is customary for the purchaser to send the seller a due diligence request list, detailing the categories of information the purchaser would like to review. Diligence request lists are often derived from an off-the-shelf, generic form lifted from legal counsel's files. Not surprisingly, the form diligence request lists are purposely all-encompassing and meant to serve as a baseline, rather than final, request list. As such, it is crucial that these boilerplate diligence request lists be carefully tailored by the purchaser and its advisors before being sent to the seller. A focused diligence request list will demonstrate to the seller that the purchaser is putting in a concerted effort and thinking critically about the proposed transaction. A tailored request list will also be beneficial to the purchaser, as it can prevent the seller from engaging in "document dumps" under which the seller posts hundreds or thousands of documents that are irrelevant to the buy-side diligence review and, consequently, waste the buy-side diligence team's time and efforts.

Categories of Due Diligence

Business school and management literature is replete with thoughts on how to define and, ultimately, achieve "corporate strategy." For each potential M&A transaction, a purchaser must first determine whether the contemplated transaction could, in fact, further the purchaser's strategic objectives. A firm grasp on the purchaser's strategy should therefore always precede a buy-side diligence investigation, with the deal consummated only if the buy-side diligence confirms that the transaction can further the company's strategic objectives. Strategic due diligence starts with a question as to whether an M&A transaction is essential to fulfill the company's strategy and, if so, what company, business, or assets are the most attractive (and available) candidates to target. From there, the purchaser's strategic buy-side diligence will serve to confirm whether the transaction can further the company's strategic objectives, whether a deal can be achieved at a fair price, and whether the purchaser can effectively integrate the transaction post-closing.

Part-in-parcel with strategic due diligence is an assessment from the purchaser's employees who "live in the trenches" (i.e., the operations team) as to whether the business or assets being evaluated are capable of furthering the prescribed strategic objective. While the focus of most areas of diligence tends to be retrospective, operational diligence is very much a forward-looking analysis on ways to maximize value post-closing. Whether the strategic rationale of the transaction relates to exploiting efficiencies resulting from economies of scale, leveraging complementary products, or expanding into new markets, operational diligence will harmonize the other areas of due diligence (finance, legal, tax, human resources, information technology, etc.) and provide the information needed to develop the post-closing integration plan.

Financial due diligence—the process by which the purchaser verifies the seller's financial statements and evaluates the seller's economic viability and future prospects—is complementary to both strategic and operational due diligence. The evaluation of the seller's financial statements dovetails with strategic due diligence by helping the purchaser form an opinion on the value to be ascribed to the business, both on a standalone basis and as part of the purchaser. Financial due diligence complements the operations team by evaluating the seller's economic viability and prospects, as well as the capital demands required to meet the transaction's strategic objectives.

Tax due diligence, broadly speaking, can be categorized into two buckets: tax planning and tax compliance. Tax planning should be performed early in any buy-side process and must always be a prerequisite to agreeing on transaction structure, as the parties' or certain jurisdictions' tax attributes can cause significant liabilities or present tremendous opportunities for tax savings. Tax compliance is backward-looking, with its complexity depending on the seller's tax policies and the jurisdictions in which it operates. In each case, the significance the purchaser places on tax planning or compliance will be heavily influenced by the structure of the transaction. For example, tax compliance is a greater concern for buyers in a merger or stock purchase than in a deal involving an asset acquisition. In a merger or stock transaction, the purchaser assumes the seller's prior tax liabilities, while in an asset purchase, the seller's tax liabilities generally do become the obligations of the purchaser (though some tax liabilities associated with the purchased assets may be).

Buy-side diligence on employment, labor, and other human resource matters can and often do become deal-breakers, particularly in transactions where the seller's most important assets—and a significant driver of the proposed transaction—are the people who walk in and out of the building each day. As such, during the buy-side diligence process, significant time is spent studying the seller's compensation and employee benefit package and how that package may (or may not) fit within the purchaser's structure. This investigation allows the purchaser to determine the ease with which it can integrate and properly motivate the seller's "human capital." It is not uncommon for the seller's senior executives to have employment agreements or other equity incentive awards that provide substantial cash payments or equity vesting upon the consummation of an M&A transaction. Those agreements and arrangements need to be understood and taken into account by the purchaser in establishing the purchase price and in determining whether key executives are incentivized to stick around after closing or whether management team members can afford to retire and live their dream. A separate human resources issue that is front and center in many M&A transactions is whether the seller's employees are represented by labor unions or have other collective bargaining rights. Certain M&A transactions provide opportunities to alter arrangements with labor, providing a significant value driver, particularly in cases of distressed M&A deals.

The growing recognition of the importance and value of intellectual property has resulted in heightened attention paid by deal-makers to such issues in the M&A process, with intellectual property often driving the value and structure of the transaction. Intellectual property subject matter experts on the buy-side diligence team will likely spend significant time identifying the seller's owned and licensed intellectual property and tracing its origin from its development or acquisition. Further, intellectual property contracts and licenses should be analyzed for change in control, assignment, and exclusivity provisions to ensure that the intellectual property rights can continue to support the purchaser's business on a going-forward basis.

Legal buy-side diligence, like the areas described above, is transaction-specific, multifaceted, and dovetails with the other categories of diligence. In addition to analyses of the seller's litigation exposure, compliance regime, pension liabilities, environmental liabilities, and other contingent liabilities, areas of particular focus for legal buy-side diligence typically include analyses of the seller's key contracts and, in mergers and stock purchases, the target company's capital structure.

In any M&A transaction where the seller's valuable assets include contracts with third parties, the buy-side diligence team must assess whether those contracts are impacted or otherwise prohibited by the proposed transaction, for example via assignment, change of control, termination payments, or other consent rights. The impact of the M&A transaction on the contract in question will, of course, depend on the relationship of the seller and counterparty to the contract, the language and governing law of the contract, and the contemplated transaction structure. Additionally, the legal buy-side diligence team will analyze the seller's contracts for exclusivity, non-competition, and other restrictions on the operation of the business on a going-forward basis.

A thorough review of the target company's various equity securities—which may include common stock (voting and non-voting), various classes of preferred stock (each with their distinct rights), warrants, options, and other hybrid securities—is a prerequisite to structuring any stock purchase or merger, as the various classes of equity securities may receive disparate treatment in the proposed transaction. For instance, different classes of equity may have different voting rights with respect to the transaction, and some classes of equity may either be forced or unable to participate in the proposed transaction via the terms of tag-along or drag-along rights or rights of first refusal contained in a stockholders' or similar agreement.

The Interrelationship Between Due Diligence and Transaction Agreement

The buy-side diligence investigation should, in the first instance, serve to identify risks associated with the M&A transaction and subsequently, via negotiation of a definitive transaction agreement, allocate those risks. At the outset, a key distinction should be made between transaction agreements where the purchaser is afforded some recourse against the seller via post-closing indemnification, which is customary in most transactions not involving the sale of an entire publicly traded company (e.g., an asset sale, a sale of a division or subsidiary, a merger of a privately held company), versus deals where the purchaser has no recourse against the seller post-closing, which is the case in virtually every sale of a publicly traded company. In the latter case, the risk allocation provisions in the definitive transaction agreement function as limitations on the purchaser's obligation to close the transaction. In either case, absent sufficiently unambiguous termination rights bargained for by the purchaser, case law in Delaware (the governing law for the majority of M&A transactions) severely curbs the purchaser's ability to walk away from closing once a definitive agreement has been signed.

The findings of the buy-side diligence investigation are most often reflected in the representations and warranties, disclosure schedules, conditions to closing, and indemnification provisions of the definitive transaction agreement. Representations and warranties—statements of fact made by one party to another (in this case, by the seller to the purchaser) at a particular point in time—can be described as the lynchpin of the risk allocation provisions in the definitive transaction agreement, as they trigger the other provisions referenced above. In addition to industry- and transaction-specific representations and warranties, customary representations and warranties given by a seller in an M&A transaction include statements as to the seller's:

- Due organization
- Authority to enter into the transaction agreement
- Absence of violations of its organizational documents, laws, or contracts
- Capitalization
- Compliance with laws
- Accuracy of financial statements
- Absence of undisclosed liabilities
- Absence of material changes
- Subsidiaries
- Litigation
- Insurance
- Material contracts
- Labor and employment matters
- Employee benefit matters
- Intellectual property
- Taxes
- Title to property

The representations and warranties should be tailored based on the buy-side diligence investigation, with the parties negotiating which representations and warranties will be provided, whether they will be qualified by certain "materiality" or "knowledge" standards, and the date the representation and warranty will be made.

In many instances, the seller will be unable to make an unqualified representation or warranty. In such cases, the seller will seek to either not provide the representation or warranty or, alternatively, list in a schedule to the transaction agreement certain exceptions to that representation and warranty. The lists of these exceptions to the representations and warranties (commonly referred to as the "disclosure schedules") are crucial to the diligence process. They prompt the seller to meticulously scrub each statement and kick to the disclosure schedule representations and warranties that it is unable to make which, in turn, allows the purchaser to better assess, and hopefully ascribe value to, potential liabilities of the seller. In certain instances, these potential liabilities may not have been discovered during the initial buy-side diligence investigation but are instead fleshed out via the negotiation of the representations and warranties.

It is generally a condition to the purchaser's obligation to close the M&A transaction that the seller's representations and warranties were true and correct as of the signing of the agreement and are true and correct as of the closing of the agreement. This condition (colloquially referred to as the "bring-down" condition) is often qualified by a "materiality" or "material adverse effect" standard such that the purchaser is not required to close the transaction only if there has been a significant breach of the representations and warranties. Despite the legal difficulty, a purchaser may have in walking away from a deal as a result of a breach of a representation and warranty discovered post-signing but before closing, such findings can provide the purchaser with valuable ammunition if it wishes to recut the deal.

In addition to the bring-down condition, the purchaser may bargain for other, more concrete walk-away rights via the closing conditions. If, during the course of the buy-side diligence investigation, the purchaser identifies something about the seller's business that is fundamental to the strategic objective of the transaction, such that the agreed-upon terms would no longer be as attractive to the purchaser if this feature of the transaction were not in place at closing, the seller may want to rely on a specific termination trigger rather than trying to prove a breach of a representation and warranty by an imprecise "materiality" standard. For instance, let us say the seller is a clothing manufacturer that derives the bulk of its revenues from the sale of a brand of clothing it manufactures via a licensing agreement with a licensor that owns a well-known brand. If the transaction agreement contemplated a merger of the seller into the purchaser and that licensing agreement were no longer in place at closing, the deal would likely not be attractive to the purchaser (at least based on the price agreed upon at signing). In such an instance, the purchaser would likely require that the transaction agreement contain a condition to closing that the licensor has consented to the M&A transaction and that the licensing agreement remains in place at closing, thereby shifting the entire risk of a pre-closing termination onto the seller.

While closing conditions allocate risk between signing and closing, indemnification provisions allocate risk for a prescribed period after the closing of the transaction. Indemnification obligations can cover risks identified in the diligence process (e.g., losses related to litigation filed but not finally adjudicated prior to closing) or unknown risks that the purchaser will argue the seller is in a better position to bear (e.g., future environmental liabilities). Indemnification provisions generally cover losses suffered by the purchaser because of the seller's breach of a representation or warranty, as well as specific "line-item" risks the purchaser identifies during its buy-side diligence investigation (e.g., losses related to a contested tax liability). Indemnification provisions are heavily negotiated and can be sliced and diced in a multitude of ways. Common limitations to the seller's indemnification obligations include *de minimis* amounts under which negligible losses are not covered, deductible or threshold amounts that serve as a proxy for what the parties deem to result in a sizeable enough loss to trigger the litany of indemnification procedures, and caps on liability such that the seller's liability is not open-ended. Each of the aforementioned limitations often do not apply to breaches of certain "fundamental" representations and warranties (e.g., organization of the seller, authority of the seller) and breaches that are a result of fraud or intentional misrepresentations.

Conclusion

No matter the size or shape of the proposed transaction, a thorough due diligence process that is tailored to the industry and geography are essential to negotiating and concluding a successful transaction.

Key Takeaways

- The controlling goal of the buy-side diligence process is to determine whether the proposed transaction serves the purchaser's strategic objectives. After this is determined in the positive, the goal of the due diligence must then focus on identifying and evaluating the risks and opportunities presented by the proposed transaction.
- Do not plan on identifying every risk and opportunity in the proposed deal, and then shifting all risk to the seller. This is an impossible ideal in the face of the constraints on the due diligence process.
- Constraints can be imposed directly by the seller, including auction process deadlines or prohibited communications with customers and suppliers, or they can be exterior issues, such as the economy or outside events such as natural disasters.
- The optimum strategy in the face of time and resource limits is to focus the due diligence on the key operational, financial, and legal aspects of the proposed transaction.
- Save time and resources and wasted effort by determining the materiality threshold below which the findings are unlikely to justify the expenditures in time, effort, and money to perform the diligence.
- Whenever possible, be specific in requests for information, to avoid data dumps of expired, immaterial, or irrelevant information provided via virtual data rooms.

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Mr. Aquila has been repeatedly cited as one of the world's leading mergers and acquisitions lawyers. He has been recognized as one of a small number of lawyers ranked by Chambers Global in Band 1 (their top tier), as an American Lawyer "Dealmaker of the Year," and as a recipient of the Atlas Award as "Global M&A Lawyer of the Year." For his work in corporate governance, he has been named by the National Association of Corporate Directors to their "Directorship 100"—one of the 100 most influential people in corporate governance and inside the boardroom. He is also a two-time winner of the Burton Award for Legal Achievement (2005 and 2010). In 2009, he was selected by the American Bar Association as a "Legal Rebel"—one of the profession's fifty leading innovators.

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