A General Introduction to Due Diligence: Look Before You Leap

Introduction

An average consumer in today's digital age has greater access to information than at any time in the past. Before purchasing a bicycle, for example, a consumer can obtain detailed product information and technical specifications, read reviews and recommendations, and compare the bicycle with similar offerings from the manufacturer or its competitors. Using such information, the consumer can assess the bicycle's components and quality, consider the appropriateness of its price, identify any potential concerns (or "red flags") that would support a decision not to purchase the bicycle and, ultimately, make an informed decision—to buy or not to buy—without the fear of buyer's remorse. Today's consumers would undoubtedly agree that *scientia potentia est*, or "knowledge is power."

That Latin aphorism is no less true in the context of acquiring a business or making an investment decision. In the context of mergers and acquisitions (M&As) and venture capital or growth equity investing, potential acquirers and investors, respectively (referred throughout this chapter, collectively, as "acquirers"), are presented with business opportunities that would require significant investments of time, money and other resources, and each opportunity must be evaluated for its potential risks and rewards. However, unlike the bicycle, information about a potential target (e.g., financial information, business development plans, clinical trial data, etc.) is rarely publicly available (unless the target is a public company that files reports with the US Securities and Exchange Commission) and, in most cases, inaccessible to an acquirer without engaging in an information-gathering process directly with the target. That process is known as "conducting due diligence" and is the process by which an acquirer investigates the target to better understand the business and value proposition and to identify risks related to the business or the opportunity. An effective due diligence process can save an acquirer time and money, minimize the potential for buyer's remorse and provide a framework for mitigating any inherent transaction risk.

What is the purpose of due diligence?

In general, there are three main objectives to the due diligence process: 1) to gain a working knowledge about the potential target and its operations, 2) to assess the target's value and 3) to identify risks related to the potential acquisition (or investment). To meet the various objectives, the acquirer engages in a fact-finding process to understand the target's operations or operating plans, identify possible synergies and discover risks related to the target's business. To conduct due diligence on (or "to diligence"—when the term is used as a verb) a proposed valuation of the target, an acquirer will review the target's financial statements, including balance sheets and income and cash flow statements, and management projections, and less conspicuous evidence of value, including other known liabilities, potential litigation, insurance coverage, employment and consulting arrangements, regulatory compliance, material contracts and the target's intellectual property portfolio. Risks or potential liabilities identified during the due diligence process can be evaluated and, depending on the particular risk, can be mitigated by pre-transaction remediation, post-transaction obligations or allocating the economic risk of such items to one party or the other. Ultimately, a potential transaction's financial and strategic success may depend on the quality and depth of the acquirer's due diligence process.

How is the due diligence process conducted?

The due diligence process is an examination of the target's business by the acquirer and its legal, financial, tax and other advisors. The inquiry usually takes the form of a set of questions and information requests, often referred to as the "due diligence request list," which requires the target to respond to the acquirer with specific answers or documents. The responses and documents often are provided in "data rooms" that can be physical locations, but which, in recent years, have almost universally become secure file sharing websites to which documents can be uploaded digitally by the target and accessed remotely by the acquirer and its advisors. Teleconferences and in-person discussions also can be used to respond to diligence requests, and targets should be prepared to make their management teams and key personnel available to answer substantive questions about the business and its operations. Interviews can be an efficient way for targets to address concerns raised by the acquirer's initial diligence findings.

The length of the due diligence process varies based on the size and complexity of the target's business and the transaction. The process can take as little as days to complete or, alternatively, it can span months leading up to, and during the negotiation of, a transaction. The questions and information requests posted by an acquirer in a proposed transaction cover a wide array of topics and may be provided directly by the acquirer or indirectly by its legal and financial advisors. Often, the back-and-forth between the acquirer and its advisors, on the one hand, and the target, on the other, will continue until the acquirer is comfortable that it has adequately investigated the target, as evidenced by a thorough understanding of the target's business and satisfactory responses to all of its due diligence questions and follow-up questions.

What is the scope of the due diligence process?

As noted above, the due diligence inquiry's scope can be broad or narrow, depending on the transaction and the target, and it often will cover a wide array of topics. Common factors influencing the scope of the diligence process include the type of transaction and deal structure (i.e., stock purchase, asset purchase, strategic investment, financial investment, partnership, etc.), the relevant industry, whether the target has international activities, the existence of known issues and cost and time constraints. For example, the person buying the bicycle might ask the manufacturer questions about the materials used in the bicycle's frame and may request the results of any stress testing conducted on the frame, which could provide evidence of the frame's durability or reveal a disadvantage of the bicycle in question. In the context of a business acquisition or an investment, the due diligence request list will likely be lengthy and address various aspects of the target's business, including, but not limited to:

- structure and background
- capitalization
- finances and accounting
- real and personal property
- litigation
- environmental compliance
- business practices (e.g., sales and distribution, marketing, warranty and product liability issues, etc.)
- contracts
- regulatory compliance
- employment/labor matters
- management matters
- affiliate transactions
- insurance matters
- intellectual property

A target should be prepared to provide copies of all its important documents.

The review of the responses to the due diligence request often is handled by a multi-disciplinary team including the acquirer and its legal, financial, tax and other advisors. In particular, the legal team will often include corporate lawyers and specialists in various subject matters, including real estate, litigation, environmental matters, labor and employment matters and regulatory matters. Frequently, the acquirer itself will handle the due diligence of the target's business plan and sales and marketing matters and will rely on its accountants and tax advisors to review the target's financial information.

What is the result of the due diligence process?

For the reasons outlined above, the due diligence process can be long and complicated, and it often involves dozens of individuals working many hours on behalf of the acquirer. Those efforts are generally reduced to written findings and conclusions and compiled into what is referred to as "due diligence memorandum" or "diligence reports." The due diligence memorandum is primarily for the acquirer's use, but it also may be provided to certain third parties for specific analysis or advice.[1] Those diligence reports contain key findings and often highlight potential areas of concern regarding the target.

However, the formal diligence report, while a tangible byproduct of the due diligence process, is typically not regarded as the "result" of the diligence process. The result of the due diligence process is often subtlety reflected in one form or another in the consummated transaction—or not so subtlety reflected, in the event the transaction is abandoned because of a fact or circumstance uncovered during the due diligence process. Acquirers can use due diligence findings in many ways, but this intensive process often results in one or more of three potential outcomes: confirmation of the acquirer's understanding of the target, reduction to the purchase price (or valuation) and the inclusion of provisions in the definitive transaction document, allocating certain business risks to the target, as opposed to the acquirer (typically via indemnification obligations).[2] In the latter cases, the acquirer is using the information discovered during the diligence process to negotiate more-favorable—or more-appropriate—terms for the transaction. Of course, it is also possible that something discovered during the diligence process will cause the acquirer to walk away from the transaction, which highlights the overall importance of the due diligence process.

Whether buying a bicycle or a business, knowledge is power, and the due diligence process is a valuable information-gathering tool. A thorough and thoughtful due diligence process can help a potential acquirer decide whether to pursue a proposed transition and, if so, on what terms.

References

1. Depending on the nature of the transaction, the acquirer may be working with lenders (in a leveraged buyout transaction, for example) or insurance underwriters (if representation and warranty insurance are being procured). In such cases, the acquirer's legal counsel should be consulted to assess attorney-client privilege, confidentiality and reliance issues before sharing any work product with such third parties.
2. A fourth possible, but less common, outcome is for the target to undertake predetermined remedial measures prior to the consummation of the proposed transaction.