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M&A: The intersection of due diligence and governance

Introduction: Due diligence should be important, and yet…

Merger and acquisition (M&A) activity can be an important component—even a critical one—for a company's growth strategy. A successful acquisition can help a company make a quantum leap in terms of market presence, filling in gaps in a company's product or service portfolio, and improving profitability and other performance metrics. On the other hand, transactions that don't ultimately perform as expected, including not providing positive returns or resulting in large negative surprises, can cause serious damage to companies and their boards of directors, ranging from litigation to the ouster of managements and even board members. In 2015, through lawsuits, shareholders challenged 65% of M&A deals valued at over $100 million or more, involving Delaware-incorporated companies.[1]



The role of the board and committees:

- As a matter of corporate governance, the board's role in the M&A process is that of oversight
- Ideally, boards and managements should work together to facilitate a comprehensive due diligence process
- Given the potential risks inherent in any acquisition, boards and management teams should work together to assure that the due diligence process is successfully implemented

Given the potential consequences of M&A activity to companies and their boards, directors have a stake in overseeing the transaction process from an early stage through to post-closing integration. A critical aspect of this oversight responsibility relates to the due diligence process. Specifically, boards should seek to satisfy themselves that management conducts a robust due diligence process designed to ferret out potential risks and valuation considerations, assess their magnitude and the probability of the risks' occurrence, consider whether mitigation is possible, and respond accordingly. In other words, due diligence done well can provide significant insights into the target company and allows for a more informed assessment of the potential risks and anticipated benefits of the transaction. Thus, it is in the board's interest to emphasize the importance of, and facilitate, a well thought-out diligence process.

Over the years, M&A practitioners in the legal, accounting, and other professions have heard reasons cited why due diligence is not a necessity:

- Timing
- Cost
- Existing knowledge of the industry
- Don't see the value in due diligence

[1] Calculated from the Less Suited table in "Judge Who Shoots Down Merger Lawsuits," The Wall Street Journal, January 10, 2016, www.wsj.com/articles/the-judge-who-shoots-down-merger-lawsuits-1452076201

Why due diligence should be considered

Transactions that undergo a due diligence process are more likely to be successful[2] than those that do not. Some of the key reasons why due diligence is imperative are as follows:

- **Inherent bias**—Both buyers and sellers can be inherently (if unintentionally) biased. Sellers typically present optimistic forecasts and/or base their forecasts on growth assumptions that may be unrealistic. Buyers can be unrealistic about the extent of synergies and the speed with which they may be achieved. (This may be particularly true when the acquirer is a public company required to disclose pro forma financial information).

- **Incentives**—The parties to a transaction—executives and other employees of both the buyer and seller—as well as some of their external advisors can receive sizeable payouts if the transaction closes, and may take a haircut, or receive little or nothing, if it does not.

- **Inaccurate financial information**—Even if prepared with the best of intentions, financial information can be incomplete, inaccurate or misleading, due to myriad difficulties involved in identifying contingencies, nonrecurring matters, the outcomes of tax issues and other related items.

- **Benefits in negotiation**—Due diligence can facilitate better negotiation of deal terms, such as those pertaining to net working capital targets and definitions, net debt definitions, and optimal allocations of tax benefits and exposures. A full understanding of tax benefits and exposures may lead to renegotiating deal terms and structure to achieve desired tax benefits.

- **Risk analysis**—Due diligence may uncover potential exposures in areas such as product liability, environmental concerns and compliance with the Foreign Corrupt Practices Act that can turn even a small transaction into a "bet-the-company" transaction.

- **Inability to seek/obtain restitution**—Once the transaction is completed there is usually no one to blame, and no party from whom to seek or obtain restitution for problems discovered after the fact.

It is important to note that even when due diligence does not uncover significant concerns or deal problems, it can nonetheless impact the basics of the deal—valuation and price. For example, the due diligence process may yield information about matters such as reserve releases or other non-recurring items, tax exposures, benefit payouts, or other financial obligations, that individually or cumulatively can provide the buyer with an opportunity to renegotiate fundamentals such as the purchase price and potential escrows or holdbacks. In the event renegotiation is not feasible or successful, the buyer will be faced with better information to decide as to whether to proceed with the transaction at the original price. Thorough due diligence will not per se make a transaction successful; however, it can help expose and mitigate a number of the potential threats and risks to a successful transaction and lead to better informed pricing, valuation or necessary adjustments.

Transactions that undergo a due diligence process are more likely to be successful

Key elements of due diligence

Due diligence is a broad concept that can cover a significant number of areas, as highlighted below. Due diligence can be performed in different ways—e.g., by internal teams, external advisors, specialists, experienced/senior industry players or, as is often the case, by a combination of the above, leveraging the buyer's knowledge with the deep transaction experience of M&A and industry professionals.

Many companies approach diligence as a high-level analysis limited to a search for "red flags," deal killers or fatal flaws. While that may be an appropriate starting point based on time and cost, a comprehensive approach includes more detailed analysis of the target's information, industry and economic outlook. Beyond the fatal flaw analysis, due diligence can surface fundamental insights, risks and exposures that can have a significant impact on valuation, the terms of the transaction agreement, culture/people risks, technology, operations or the regulatory environment that can materially change a buyer's interest in or valuation of the deal. A structured due diligence process can also help management assess the likelihood of the success of, and limit surprises during, the post- transaction period.

While not a comprehensive list, below are the more critical work streams that should considered in a thorough due diligence process.

- **Commercial/operational diligence** helps buyers understand the market segments in which the target operates, the industry and business outlook for its products, key competitors, and the effectiveness of its operating model. Commercial due diligence can be critical when an acquisition is in a new area for the buyer, and should involve detailed primary and secondary research as well as interviews or surveys of competitors, suppliers, and customers. Operational due diligence can cover key functional areas of the target,

[2] "Post-Deal Success Starts at Due Diligence Stage," Bureau of National Affairs *Corporate Counsel Weekly*, November 25, 2015; Volume 45, page 357.

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including sales, marketing, operations and technology, and assesses the current state of each, identifying gaps, the ability to support future growth, and the level of investment that may be required.

- **Legal diligence** looks at potential legal exposures and risks, usually including review of key commercial agreements, IP and contracts. Counsel's involvement in overall due diligence is crucial in the negotiation and drafting of the acquisition agreement, transition services agreements, and need for indemnities, escrows and post-acquisition true-up mechanisms (e.g., net working capital/net debt adjustment clauses).

- **Financial and accounting diligence** generally includes a detailed analysis of audited financial statements, monthly or quarterly historical financial information, reading of the audit work papers, analysis of the details supporting publicly available financial information, as well as interviews of financial management and the external auditors. This process can yield significant observations on the target's earnings (such as non-recurring or one-time activities and reserve releases), and insights into post-transaction needs for net working capital, and can shed light on debt-like exposures and trends in operating results and capital expenditures, among other areas.

- **Tax diligence** provides a deep dive into the target's tax profile—including both potential tax exposures and available tax attributes (net operating losses, credits, etc.)—by analyzing significant tax returns, financial statements and supporting information, as well as conducting interviews of tax management and advisors. Tax diligence typically focuses on both US (and, if relevant, non-US) income and non-income tax areas, including sales and use, employment/payroll, property, and transfer tax items. It also can provide insights into the post-acquisition depreciable/amortizable tax basis that will likely help the acquirer to estimate future cash tax liabilities, and is often a valuable exercise in terms of identifying structuring opportunities for the transaction.

- **Employee benefit and human resources due diligence** typically includes a detailed review of the company's relationships with its employees, such as union agreements, regular benefits, executive compensation, and postemployment obligations. In addition to flushing out exposures, it can help identify cost structure changes that can occur if the target's employees join the buyer's benefit plans post-acquisition.

- **Foreign Corrupt Practices Act due diligence** can include an assessment of policies and procedures to mitigate the risk of foreign bribery and a review of payment information to assess and, if necessary, mitigate post-acquisition exposures arising from pre-acquisition compliance violations.

- **Reputational due diligence** can include background checks on the target, its shareholders and key executives. Prior instances of fraud, corruption, money laundering, trade compliance, labor and product safety or other adverse issues can be identified through focused integrity due diligence research. Public records can also reveal financial red flags such as bankruptcies, liens and excessive litigation for the company and/or its principals.

- **Integration and synergy due diligence** focuses on analyzing how the businesses will likely come together post-closing and the potential benefits and related costs of performing an integration of the businesses. Typical focuses are on the selling, general and administrative (SG&A) areas of a company such as finance, legal, information technology, human resources, and other enabling areas, but when appropriate should also include potential impacts on revenues and cost of sales. Proper diligence can result in a more robust estimate of planned synergies and related integration costs, as well as help identify any dis-synergies in combining the businesses.

- **Insurance due diligence, environmental due diligence, and engineering due diligence** are some other common workstreams in a typical due diligence approach and focus on exposures in these areas, as well as potential changes in run rate costs post-acquisition.

The role of the board and committees

As a matter of corporate governance, the board's role in the M&A process is that of oversight—in other words, the board is not expected to, and ordinarily should not, conduct due diligence itself. Rather, it should engage in oversight of the process.

The board is uniquely qualified to oversee the due diligence process. Today's public company boards are independent of management, and are typically in the best position to appropriately question and challenge management. Moreover, boards do not have the financial incentives, such as completion bonuses or success fees (or the lack thereof) that can create bias on the part of management, investment bankers and/or other external advisors as they conduct due diligence.

The role of board committees in the due diligence process can be more complex. Depending upon the nature of the companies, their industry and other factors, it may make sense to have one or more committees engage in more intense oversight of certain areas of the due diligence process; for example, in a highly regulated industry, a committee responsible for regulatory compliance might provide better oversight of that area. However, committee oversight can be problematic, as there is no one committee in a position to evaluate all risks, and the additional time of going through committees can slow the process. Moreover, spreading out due diligence oversight among several committees can create a risk of its own—committee "balkanization", where each committee is pursuing its own inquiries, but the "dots" may not be connected.

According to the *Corporate Development 2013: Pushing the boundaries in M&A survey*, 75% of the respondents stated their company has a clearly-defined M&A approval process, of which 54% indicated their boards must approve all M&A transactions and 82% of the respondents indicated their board approved M&A transactions of up to $50 million. "The M&A process should be designed to benefit from the experienced input of seasoned directors at the right times, and facilitate keeping the board appropriately informed throughout the process so it can fulfill its oversight responsibilities and duty of care to shareholders."

Practical approaches to board oversight of due diligence

Ideally, boards and managements should work together to facilitate a comprehensive due diligence process. Every due diligence process will be different, here are some practical steps that can help improve the likelihood of success:

- Management should inform the board of the pending acquisition at an early stage, including an initial assessment of anticipated risks and benefits, its approach to valuation, its due diligence plan and the transaction timeline, among other matters.

- The board should determine its appropriate oversight role (and that of its committees) in the due diligence process, based upon the size of the transaction, anticipated risk areas and other issues, bearing in mind that at some point the full board should evaluate and act on the transaction.

- In considering the engagement of outside advisors, the board should consider both tangible factors—for example, the advisors' experience and knowledge of the industry and other areas relevant to the transaction and financial incentives (such as success fees or fee haircuts) that could impact the advice rendered and perceptions as to the quality of the advice—as well as intangible factors, such as whether the board and management feel they can trust an advisor. In some cases, it may be advisable to retain additional advisors (for example, if it proves necessary to obtain additional valuations/fairness opinions). The board should also consider monitoring the performance of the company's outside advisors, as reliance upon advisors can be called into question if the advice rendered is later deemed to be inappropriate.

The M&A process should be designed to benefit from the experienced input of seasoned directors at the right times

- Management should keep the board informed of the transaction on an ongoing basis. Among other things, periodic board review and consideration of the transaction will help the board to fulfill its fiduciary duty of "due care" in evaluating the merits and risks of the transaction, making it less likely that the board will be held liable if the transaction does not work out well.

- In the absence of periodic discussions of the transaction, the board should ask management for updates. Acquisitions, particularly larger ones, should not be completed on the basis of a "set it and forget it" approach.

- Management should continue to keep the board informed about the status of the transaction during the pre-closing period and the period post-closing, when integration and other issues can impact the success of a transaction.

Conclusion

Any M&A transaction, no matter the size or structure, can have a significant impact upon the acquiring company. Developing and implementing a robust due diligence process can lead to a much better assessment of the risks and potential benefits of a transaction, enable the renegotiation of pricing and other key terms, and smooth the way towards a more effective integration.

Given the potential risks inherent in any acquisition, boards and management teams should work together to assure that the due diligence process is successfully implemented. Doing so will likely protect both and can lead to better results for all.

[3] Deloitte Financial Advisory Services LLP *Corporate Development 2013: Pushing boundaries in M&A*, pages 22 and 24.

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