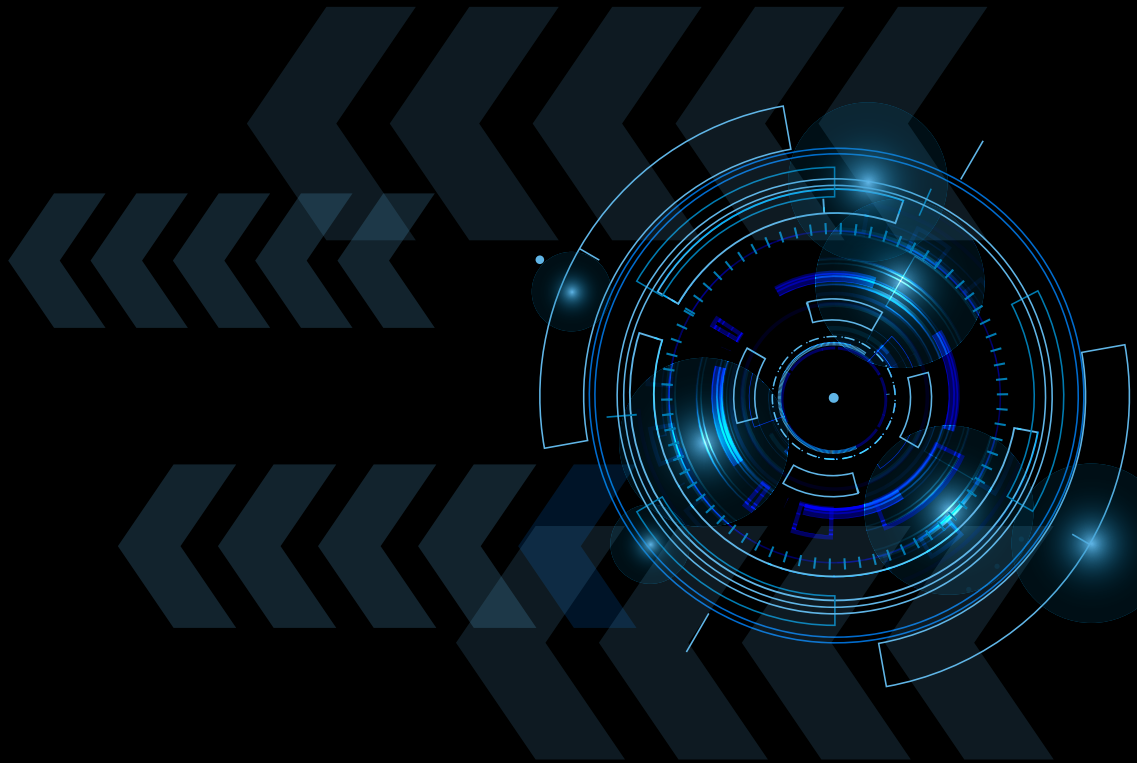


# The Value of Entity Management:

A Multi-Part Study By Deloitte

*Part 1: The Impact on Mergers & Acquisitions*



**Deloitte.**

Legal Business Services



# Part 1: The Impact on M&A

While much has been published on the topic of legal entity management—managing the books and records of a parent company's various legal entities in different geographic locations—by law firms and technology providers, almost all of it has been about how to manage entities and subsidiaries effectively. There has been little research on the strategic elements of entity management or, more importantly, what is the value of effective legal entity management. This multi-part study by Deloitte Legal Business Services\* aims to change that by researching the reasons that entity management is important. Not what must be done, but the reasons it must.

Part one is a study of the impact of effective entity management on M&A. The sources for our research are prominent outside counsel, sitting in-house M&A attorneys and subject-matter specialists from Deloitte.

For this study, we interviewed 12 M&A attorneys from law firms, including Hunton Andrews Kurth, Mayer Brown and Thompson Hine, as well as in-house counsel from Carrier and Dell. Combined, they have advised buyers and sellers on more than \$250 billion of transactions through their careers. This report covers what we distilled from their comments on the value of sound entity management in the context of M&A.

If a target has organized books and records, it conveys a feeling that management is on top of their company. Whether you are outside counsel or a potential buyer, it's comforting when you see that an investment has been made in keeping those records clear. It suggests a strong compliance program beyond just the minute books. It is people who run due diligence and those people extrapolate from the data they have. They can feel a general uneasiness if you're selling a business that's a mess.

– **Francesca Campbell**, *Vice President and Chief M&A Counsel, Carrier*

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\* The Deloitte US firms do not practice law or provide legal advice.

### The professionals we interviewed for this report include:

- » **Corby J. Baumann**, *Partner – Corporate Transactions & Securities Practice Group at Thompson Hine LLP*
- » **Philip O. Brandes**, *Partner and Co-Chair – Mergers & Acquisitions Practice Group at Mayer Brown*
- » **Francesca Campbell**, *Vice President, Chief M&A Counsel at Carrier and former Associate, Mergers & Acquisitions at Davis Polk & Wardwell LLP*
- » **David A. Carpenter**, *Partner and Co-Chair – Food & Beverage M&A Practice Group at Mayer Brown*
- » **Michael Dzikowski**, *Partner at Deloitte and Touche LLP's M&A Consultative Services*
- » **John Easterday**, *Partner at Deloitte Tax LLP*
- » **Kim Erlanson**, *Vice President, Corporate Transactions at Dell Technologies and former Corporate Associate at Weil, Gotshal & Manges LLP*
- » **Shon E. Glusky**, *Partner – Corporate Practice Group at Sheppard Mullin*
- » **Steven M. Haas**, *Partner – Mergers & Acquisitions at Hunton Andrews Kurth LLP*
- » **Matthew F. Herman**, *Partner and General Counsel at Goldfinch Partners and former Partner, Corporate and M&A at Freshfields Bruckhaus Deringer*
- » **Brad J. Schwartzberg**, *Partner and Co-Chair – Corporate + Transactions Practice Group at Davis+Gilbert LLP*
- » **Gavin Solotar**, *Managing Director at Spotlight Advisors, LLC and former Partner at Wachtell, Lipton, Rosen & Katz*

It's obvious when stated directly: organizations that manage their entities well generally reap the rewards of that labor when they engage in corporate transactions. Buyers feel more comfortable making an investment, as good subsidiary governance tends to suggest strong overall enterprise governance. Buoyed by that confidence, buyers are often willing to expedite both due diligence and the overall deal timeline—and to offer a higher price for a deal.

Conversely, when buyers have unanswered questions about their target's subsidiary management, they're likely to delay the deal to probe further. Along the way, they're likely to hedge their bets, double down on other concerns and lower their offer. Every moment that sellers spend scrambling to find records and fill documentation gaps costs them money—and potentially cuts into their profit. Often, sellers must engage a law firm to help them manage these gaps and cover their buyer's concerns, causing margins to plummet even lower.

What's the true impact of legal entity management, both good and bad, on M&A deals? We embarked on this study to better understand what buyers and sellers experience. Our findings validated our hypothesis that the quality of subsidiary management plays a critical role in determining deal value and timelines and illuminated six key lessons about the impacts of disorganized books and records.

Substandard legal entity management (LEM) can:

1. Jeopardize the credibility of the company and its management
2. Slow deals down—or even kill them
3. Increase deal risk for all parties and introduce personal liability for directors and officers
4. Drive the deal price down
5. Force a restructuring of the deal with attendant tax disadvantages
6. Grossly inflate professional fees

Let's take a closer look at each one.



1. Poor LEM can jeopardize the credibility of the company and its management.

It's a credibility issue. If I'm going to give you \$100 million, I want to know that the company you were running was run properly.

– **Shon Glusky**, *Partner, Corporate Practice Group, Sheppard Mullin*

A company with immaculately managed books conveys a sense of order and trustworthiness. Buyers don't have reason to question general counsel or the management team; they can see that everything is as it should be. "Better entity management gives the buyer more confidence in the organization," according to John Easterday, a partner at Deloitte Tax LLP.

If, on the other hand, a business hasn't exercised care in maintaining its entities' corporate records, buyers may start to wonder what else has escaped the management team's focus—and what other problems they may be buying with this deal. In our research, 59% of respondents said that poor entity management causes buyers to question whether subsidiaries are, in fact, wholly owned by sellers.

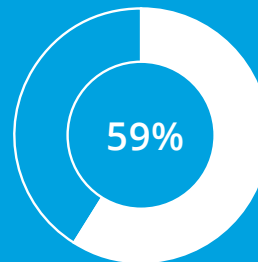
Sloppy LEM can lead to questions that ultimately decrease confidence and trust. That's what we heard about in the cautionary tale of a private equity firm that initially offered \$47 million to buy a company. But when the private equity firm inspected the seller's records, it found that leases hadn't been executed properly and only half of the stock option agreements were signed. These shortcomings caused the private equity firm to question the seller so much that it ended up discounting its price.

Our research showed that poor LEM leads buyers to draw one of two conclusions: either the seller's legal team is inept, or the seller is hiding something.

When entities aren't cleanly managed, buyers may start questioning the competency of the entire legal and compliance function. Philip Brandes, partner and co-chair of Mayer Brown's M&A and private equity practice, said that this leads organizations to rethink legal relationships, inside and out. David Carpenter, another Mayer Brown partner and co-chair of the firm's Food & Beverage M&A Practice Group, added, "It's pretty obvious that if they're not doing a good job on the basic blocking and tackling [of corporate governance], there are going to be some discussions between

the outside lawyers, internal lawyers and business folks on the buyer side. They're going to say, 'You know, it doesn't look like you've got the strongest group here.'"

Disorganization may raise the deeper concern that poor entity management isn't mere incompetence but is instead an intentional attempt to shield evidence of misconduct. Corby Baumann, partner at Thompson Hine, suggested, "As a seller, if you're disorganized, sometimes this will lead the buyer to think that it's nefarious in some way. For example, the buyer may think that the seller is taking advantage of the process to minimize certain unfavorable matters." If a buyer thinks a seller isn't playing straight, it might impose additional due diligence burdens—plus the costs that come with them.



**say that poor entity management causes buyers to question whether subsidiaries are owned by sellers**

## 2. Poor LEM can slow deals down—or even kill them.

Proper director and officer appointments are essential when you need a subsidiary board to approve an action or you need subsidiary officers to execute a document, so it's quite problematic when you can't actually confirm that there are validly elected directors or properly appointed officers. These issues can usually be fixed, but the inability to promptly execute documents or obtain required internal approvals creates headaches and can delay deals.

– **Steven Haas**, *Partner and Co-Head,  
M&A Team, Hunton Andrews Kurth LLP*

Organized LEM can help sellers prepare to compete in a tight market. Not only does it give buyers more confidence in what they're buying, but it also helps them thoroughly—and quickly—evaluate the transaction. The less friction due diligence encounters, the more the deal timeline can be accelerated.

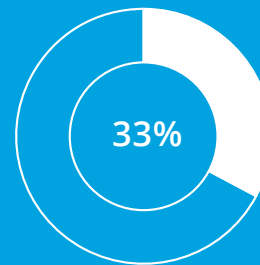
But when organizations haven't engaged in thoughtful, diligent LEM, deals can go awry. Buyers must be able to trace each subsidiary's capital structure, stock interests, subsidiary ownership, options, puts, voting rights and more. Sellers commonly need to scramble to collect the corporate records that support this understanding, including stock records, bylaws and the like. But if they have to fill gaps in the corporate record, serious issues can arise. "It could be embarrassing if there is exposure, and it could create an issue that must be remedied before going to market," says Gavin Solotar, Managing Director at Spotlight Advisors, LLC and former partner at Wachtell Lipton.

Our interviewees said a lack of organized entity management has caused significant closing delays, typically averaging four weeks. One of the primary causes of those delays, according to 33% of our interviewees, is unclear director and officer appointments and resignations.

What's more, poorly organized minute books—especially if they're delivered at the eleventh hour—might diminish the willingness and ability of law firms to write any opinion letters required by financiers. Records mishaps like these certainly won't expedite the timeline; rather, they introduce further delays and expenses if firms must draft post-closing covenants to clean up the mess.


"Lenders often ask for a tremendous amount of diligence," says Kim Erlanson, Vice President, Corporate Transactions at Dell Technologies. "To secure financing, it is not uncommon for the assets being pledged to include the stock of the target's subsidiaries. If evidence of ownership is not satisfactory to the lenders, there could be delays in getting the financing closed."

Sometimes due diligence reveals a lack of clarity around who owns and runs subsidiaries. Equity leakage, where subsidiaries have unexpected ownership claims, can slow or derail a deal. When no one knows who a subsidiary's directors and officers are, immediate remediation is called for before any transaction can close. Long dormant and forgotten subsidiaries that haven't been dissolved properly can pose a significant hurdle.



**say unclear D&O resignations  
cause deals to delay**

A potentially more expensive issue is subsidiaries that may not have been properly wound down. "In order to shut down a legal entity, an accountant has to make sure that there are no intercompany balances left in that legal entity. It may take hundreds of thousands of dollars on a project to just figure out what those intercompany balances are," says Michael Dziczkowski, partner in Deloitte & Touche LLP's M&A Consultative Services.



3. Poor LEM can increase deal risk for all parties and introduce personal liability for directors and officers.

Managing entities carefully is, of course, a two-way street. Due diligence memos should be entirely factual. Risks should be both limited and clearly apparent.

But due diligence memos are not always completely accurate. Management may not be fully aware of problems, even where they exist. Or they may admit—directly or indirectly—that they haven't been able to tie out the capitalization of their subsidiaries. “If a seller doesn't know who owns subsidiaries and can't get independent verification, an insurance company might say, ‘We found a bunch of stuff that we can't insure on and we're not going to take the risk.’ This can certainly cause a repricing of the deal,” says Sheppard Mullin's Glusky.

Should that happen, insurers might also refuse to underwrite the risk associated with the transaction. The buyer then has to ask the seller for indemnification, which further complicates negotiations, slows down the deal's progress and heightens risk. Now sellers are in the position of questioning how the buyer's company has been run. As a result, sellers may reprice the deal to counter the risk, insist on an expensive representation and warranty or indemnity package, or even, in egregious cases, walk away completely. There is also a financial impact. “Issues that cannot be cleaned up pre-closing may lead to additional indemnification by the seller, which can be an indirect way to negatively impact deal price,” says Dell's Erlanson.

Even worse, a buyer's directors and officers may face personal liability, including fines, if a seller hasn't kept up with an entity's legal obligations. For example, the buyer's directors and officers may be on the hook if an entity fails to pay sales tax. In cases like these, Easterday advised, “If a buyer is going to take on that liability, it's best to work with jurisdictions to fix the issue, which can be expensive.”



Issues that cannot be cleaned up pre-closing may lead to additional indemnification by the seller, which can be an indirect way to negatively impact deal price.

– **Kim Erlanson**, *Vice President, Corporate Transactions at Dell Technologies*

The background of the slide features a series of overlapping, wavy, translucent bands in shades of green and blue, creating a sense of motion and depth against a solid black background. A solid blue rectangular box is positioned on the left side, containing white text.

4. Poor LEM can drive  
the deal price down.

Deals are priced on the assumption that entities and their records have been managed carefully, and that what the buyer sees is what the buyer is going to get.

Should questions arise about entity management, though, both buyer and seller can suffer significant consequences. If the buyer risks additional exposure or embarrassment or if issues surface that must be remedied before going to market, a conversation about price may ensue.


Sometimes entities need to be shut down as part of a deal, and it's no surprise that the accounting can be complicated, as there can be no intercompany balances left. Interviewees also advised that any deal that requires a carve-out is especially likely to have higher costs.

A company that has mismanaged or lost track of its entity management to the point that it cannot take measures to reduce tax exposure, as compared to the leading organizations in its industry, will command a lower purchase price. As Brad Schwartzberg, co-chair of the Corporate + Transactions Practice Group at Davis+Gilbert LLP, said, "The structure of an entity should be taken into consideration when planning for an exit, since an improperly structured entity could impact the ability to achieve favorable tax treatment on both sides of the table."



Issues that pop up, like those related to compensation, can impose costliness on a buyer, causing a conversation with respect to price.

– **Gavin Solotar**, *Managing Director,*  
*Spotlight Advisors, LLC*

The background of the slide is a close-up photograph of a green printed circuit board (PCB). The board is covered in a complex network of silver-colored conductive traces and numerous small, circular solder pads. A semi-transparent blue rectangle is overlaid on the left side of the image, containing white text.

## 5. Poor LEM can force a restructuring of the deal with attendant tax disadvantages.

There have been instances where I had to restructure a deal midstream from a stock transaction to an asset transaction as a result of material inconsistencies in the target's capital structure that were uncovered during due diligence.

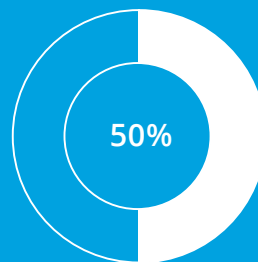
– **Brad Schwartzberg**, Co-Chair of the Corporate + Transactions Practice Group, Davis+Gilbert LLP

Well-managed companies generally have more and better deal structuring options.


Poor entity management, on the other hand, may limit the deal structures available to sellers. Half of our interviewees suggested that poor LEM can cause a change in deal structure.

If buyers aren't comfortable with the status of subsidiaries, a stock deal, which would transfer all of the seller's assets and liabilities to a buyer, can turn into an asset deal, where the buyer takes on only the risks of the specific assets that are sold. That allows the buyer to avoid dealing with the liabilities in the subsidiaries, but it leaves sellers—who must still wind down the subsidiaries—with a real problem. Buyers may also balk at a deal if they're worried about the tax advantages of an asset sale.

Poor LEM can cause the buyer to raise even more questions about other aspects of the deal. Brandes said, "If the company's a mess from an entity perspective, that's usually just the starting point. It can be an indication to the buyer that they'd better look hard to make sure that there aren't any other problems."



say poor LEM can cause a  
change in deal structure

A financial candlestick chart with green and orange bars, overlaid with a white line and a blue moving average. The chart is set against a dark background with a white grid. A blue rectangular text box is positioned in the middle-left of the image.

6. Poor LEM can grossly  
inflate professional fees.

A smooth transaction between well-managed companies should not encounter extravagant legal or other fees.

Yet when a seller is discovered to have poorly managed its entities, buyers tend to underestimate the hassle and cost of remediation. Dormant subsidiaries can be particularly thorny for buyers to address, as the longer ago a problem arose, the more it costs to remediate. This is especially true if there are issues surrounding directors' and officers' resignations.

In typical cases, professional fees for remediating substandard entity management range from \$20,000 to \$30,000, though they can easily be more. In one complicated situation, the parties incurred more than \$2 million in fees while cleaning up entity-related problems. Concerned buyers may require sellers to escrow funds for any unanticipated post-closing cleanup.

Our interviewees noted that lawyers often have to sort out the details and put the pieces together for the parties. As Baumann said, "Having reviewed data rooms that are not organized, including with respect to subsidiary and organizational matters, it can be very time-consuming and costly to review the materials to make sure that corporate governance and subsidiary matters have been handled appropriately."

Nor is a satisfactory outcome guaranteed. Baumann continued, "In conducting due diligence, buyers are going to want to verify all aspects of the corporate organization and structure, which may not be possible if the applicable documents are not available or have not been maintained. Failure to have appropriate documentation can lead to more legal and nonlegal fees for professional advisors to understand what has taken place and to put in place the appropriate documentation."

Given that the lawyers handling these deals typically work for major law firms, the fees add up quickly. Campbell observed, "You don't want to have to pay a BigLaw firm to clean records up to get a deal to close. It's expensive when you have to pay \$500 to \$1,200 per hour for BigLaw associates to fix ministerial issues."



Quite often, buyers and sellers underestimate the amount of time and effort associated with cleaning up corporate matters in subsidiaries that they transfer as part of M&A; they do not see any of these items as rising to the "top 5" list in urgency as part of deal execution. However, on closing, buyers can face time-consuming and not inexpensive workstreams, especially in non-US jurisdictions or in regulated industry verticals.

– **Matthew F. Herman**, *Partner and General Counsel of Goldfinch Partners*

# Turning It Around: The Benefits of Strong Legal Enterprise Management

In a competitive market, sellers need every advantage they can get.

While our research revealed strong disadvantages associated with poor LEM, the inverse was also true: world-class LEM can deliver a valuable edge that helps companies stand out from the crowd. Sound subsidiary management confers three key benefits:

- » **Greater confidence:** Buyers who can see that assets have been carefully managed have greater confidence in their purchase. Careful LEM dispels any concerns about potential red flags.
- » **Faster decisions:** Good LEM expedites buyers' assessment of any problem areas, helping both parties quickly discern whether issues can be accommodated with pricing, indemnity or a restructuring solution so that they can recalibrate their interest in the deal. It also accelerates the deal timeline by allowing buyers to engage in more targeted, rather than comprehensive, due diligence.
- » **Higher offers:** Well-managed entities give buyers a sense of assurance about the quality of the deal they're signing up for. As a result, they worry less about potential liability, costs and other unpleasant surprises, and they feel motivated to put forward their best offer, unburdened by excessive fees.

How can sellers leverage these benefits? By investing the time and resources up front to have their legal, compliance and tax teams review their entity structures and records, resolve any gaps and manage those assets carefully going forward. It's an investment that can provide considerable returns, including the opportunity to improve the seller's cash flow and raise transaction multiples and deal prices.

Companies that are organized can do better pricewise because it's going to come through the financial statements and provide better cash flows and a lower risk profile. I've seen that lead to a better purchase price for the seller.

– **John Easterday**, *Partner, Deloitte Tax LLP*

# View from the Practice

*In part 1 of our study on the value of entity management, our research uncovered some of the potential implications of substandard LEM on mergers and acquisitions. Based on their years of experience, here are the key takeaways from the subject-matter specialists in our practice.*

- » When a company's legal entity function has challenges with legal entity data, it may have a ripple effect on other functions such as Tax, Finance, Accounting and Treasury. Normally those functions expect the Legal Department to provide this data, which means when Legal cannot produce good entity management data, the other functions are also lagging behind.
- » When basic entity management is missing (corporate records, annual compliance and governance procedures), it may point to other red flags about the organization such as:
  - » Are the legal department's resources stretched? If so, why? Is the company resource stretched and therefore not able to hire resources to manage LEM?
  - » If the GC is heavily focused on contracting and therefore not able to focus on corporate/ LEM, then what are the other red flags in the overall compliance program?
  - » Aren't Tax and Accounting needing entity data information? Why haven't they requested this data and Legal produced it?
- » Normally when entity management specialists get brought in, it's after entity management processes have already failed. It's when most of the records are missing and the company in many cases has missing stand-alone statutory accounts for legal entities.
- » When legal entity data seems incomplete or contains inconsistencies, it can raise concerns about whether enough attention and resources are being devoted to fundamental governance functions.
- » Loose and unmanaged subsidiaries across the board pose risks for the unknown assets or intercompany balances left behind in them. There may be litigation risks sitting within companies that buyers will not want to take on. This is a key driver on why many companies will rationalize unneeded entities to decrease risk to the buyer and increase their asset value. There is risk if they haven't rationalized or a cost to do so during the M&A process.
- » Entities not maintained in active status can forfeit or delay the ability to execute on important transactions, including contracts with governmental agencies, raise creditor concerns, and/or forfeit or delay certain legal protections or rights in jurisdictions where compliance has lapsed.



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