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Insights

Three Minute Update - Positioning for the Future: Due Diligence Throughout the Process of a Deal

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Due diligence serves as a key backbone to a successful M&A transaction. While performing preliminary due diligence can set a business up for success in preparing for a future transaction, as further explained in **this article**, diligence should take place throughout an M&A transaction – not only to allow a buyer the opportunity to verify or refute the assumptions it makes about a target company, but also to form the basis of negotiations between the parties and ultimately protect both parties against potential liabilities and losses.

Due diligence in the context of an M&A transaction describes the process for conducting a thorough investigation into a target company to understand its business, operations and financials in order to make decisions about a potential transaction. The process will certainly apply to the buyer to understand the target company, but a target may determine it needs to conduct some level of due diligence of the buyer, too. By obtaining and analyzing specifically requested information (in areas such as governance, finance, tax, customer relationships, employment matters, and intellectual property – just to name a few), a buyer is able to tailor an offer to the target as a result of its independent investigations, and a target will gain comfort that the buyer will be a good fit for the target's continued operations. Both parties will then use the results of the due diligence to negotiate specific limitations, exclusions, and restrictions throughout the transaction as a result of findings during due diligence.

Early in the deal process, a potential buyer will often receive "teaser" information about a target's valuations, growth opportunities, and market position that paints the target in the best light possible for a potential sale. While complete diligence requests are not typically initiated prior to negotiation of a letter of intent, a buyer will often obtain more complete financials and supporting information in order to work with their advisors to independently make an offer and negotiate a proposal in the form of a term sheet or letter of intent. A diligence request list will often be submitted to the target once the letter of intent is signed or nearing execution, which allows the buyer to take a deeper dive into the target's operations as the parties begin negotiating the purchase agreement and related transaction documents. In addition, sharing of information will almost always be based on the receiving party entering into a confidentiality agreement before information is shared, as further explained in **this article**.

During negotiations, the buyer and its deal advisors, often including accountants, lawyers, and brokers, will review all documentation requested about the business to independently analyze financial statements, understand strengths and weaknesses, and consider risks and potential liabilities that would impact the transaction and future success of the target. An analysis of the target company's financials, for example, can lead to the buyer proposing a more tax efficient deal structure, a reduced purchase price or modification of the target working capital to ensure short term obligations can be met post-closing. Information exchanged through due diligence may also significantly impact the representations and warranties in a purchase agreement – a representation may be modified based on diligence provided in order for it to be true and accurate. Disclosures from diligence requests can also identify specific indemnities to cover risks that a buyer is not willing to accept and will require the target to retain and cover any losses, whether because such matter is not in the ordinary course, occurred prior to any closing, or otherwise.

Comprehensive due diligence completed by both parties and utilized throughout the negotiation of the purchase agreement and related documents should ensure all required actions prior to closing are met and limit unexpected liabilities after the closing of a transaction. For example, complete diligence will identify any required consents, acknowledgments, or notices that must occur prior to closing, whether involving a governmental party involved in a regulated industry, a key customer or supplier because of assignment or change in control restrictions within any contract, or related parties as a result of governance documents of the target. Ensuring that each permit, authorization, or other contract that is key to the operations of the target is reviewed during the diligence period and that any required actions are taken serves to mitigate the risk that operations will not continue post-closing as they have historically. Further, obtaining any such consents, documenting exceptions to factual statements on disclosures schedules, tailoring language within the purchase agreement, or otherwise modifying the transaction to incorporate findings during the diligence period will often benefit both parties by limiting unexpected post-closing exposure – the target lessens the risk of breaching a representation or a warranty, and the buyer is made aware of potential risks and liabilities and will then address these within the transaction terms and structure.

The approach and scope of due diligence utilized in M&A transactions can vary widely based on many factors, including the type of transaction (asset acquisition, stock transaction, or merger), whether the parties involved are in regulated industries, and the size of the transaction and target, just to name a few variables. We recommend working early and often with your advisors, including accountants, investment bankers or brokers, and lawyers to work through due diligence and the deal process efficiently and effectively. A good team of advisors to assist with preparation of due diligence requests, review of documentation provided, and incorporation into the transaction will better assure effectively consummating a transaction. If you are considering acquiring a business or looking to sell and need assistance with the process from due diligence to closing, please contact **Sarah E. Jones** or **Travis D. Lovett** or any member of our **Business, Acquisitions and Securities Practice**.