



LEGAL DUE DILIGENCE IN BUY-SIDE M&A TRANSACTIONS

September 19, 2023

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The Big Picture

- What is ‘due diligence’?
 - Investigation of a business in connection with a transaction or potential transaction
 - Legal, Financial (Accounting/Tax), Business
- Factors that can affect diligence:
 - Relative size/sophistication of the parties
 - Whether buyer is strategic or financial
 - Financial is all about the financial statements / numbers / ROI
 - Strategic has more concern about fit: cannibalization, culture, relationships
 - Public v. private—the deal may be reportable; may require a stockholder vote and proxy; need to be concerned about incorporation of financials
 - Industry
 - Risk tolerance of buyer

More on Big Picture

- What is the structure, consideration and tax treatment?
 - Some diligence may be required to figure out, pre-LOI, the appropriate structure
 - Asset deals:
 - Asset deals reduce exposure to existing liabilities, but require consent to assignment of more contracts
 - Allows for a step up in basis
 - Can also be done in a stock acquisition of an S corporation
 - ‘F reorg’ – IRC Section 368(a)(1)(F) reorganization (isolates risk of not being an S corp. to the seller)
 - 338(h)(10) Election
 - Equity purchase (or Forward/Reverse Triangular Merger if lots of equity holders)
 - Will be step up if an LLC; otherwise not a step up
 - Reduces number of consents
 - Cash v. Stock (or some rollover equity): seller liquidity concerns; minority protections
 - Simultaneous v. Subsequent signing and closing—antitrust/ Seller sensitivity/ SH consent

Buyer Side Due Diligence

- Why does Buyer do diligence?
 - Two functions:
 - Buyer is paying and wants to know about imperfections/risks in the business
 - Benefit of the bargain: is this company worth what we're paying
 - Indemnity (private deals): seller failure to disclose *to the reps* creates an indemnity claim
 - Sandbagging?
 - Anything that would reduce the attractiveness of the business at the expected price
 - Integration: diligence will provide buyer info about how the business is operated
- Process
 - Get a broad sense of what needs to be reviewed
 - This may dictate who is on the team. Clean room?
 - Who's doing what: in-house v. outside counsel; financial / accounting / tax, vs. legal, regulatory
 - Legal will have a legal diligence checklist
 - The other members of the team may in turn have other specific diligence requests
 - Assemble the diligence checklist
 - Set expectations
 - Timing/Deadlines of seller response and team member review
 - Diligence Report v. Diligence Memo

Buyer Side Due Diligence – Key Legal Issues

- Tax issues (may be handled by a tax department / CPAs)
 - Failure to pay sales taxes, employee retention credit
 - Faulty subchapter S Election
 - No foreign shareholders
 - No entity shareholders
 - Spouses signed S election Form 2553
 - Single class of stock
 - Pro Rata distributions
- Capitalization
 - Original Issuances
 - Board Consents, Purchase Agreements, Payment, Securities Exemptions, Stock Certificates
 - Cross-check against K-1s
 - Transfers – Assignments/Purchase Agreements/Redemption Agreements
 - Options – EIP approvals, board and shareholder consents, grant notices, valuation, executed documents

Buyer-Side Due Diligence – Key Legal Issues

– Title to Assets

- Lien/Litigation Searches
- Unperfected security interests
- Prepayment Penalties
- Contingent Obligations (e.g., guarantees)

– Contractual Issues

- Consents and Prohibitions on Transfer
 - Assignment v. Change of Control
 - » If silent, consider checking governing law
 - Permits/Licenses—QUALCOMM example
 - ROFRs, Privacy Policies, other transfer restrictions
- Non-Competes, MFNs, exclusive arrangements
- Term/Termination—do key contracts expire next month? Are they terminable at-will?
- Indemnification

Buyer-Side Due Diligence – Key Legal Issues

- Past acquisitions
 - Ongoing obligations
 - Earn-outs
 - Indemnification obligations
 - Escrowed funds
- Employment Issues
 - Misclassification: exempt vs. non-exempt; employee vs. contractor
 - Privacy Concerns
 - I-9/Legality issues
 - Handbook Review
- Related Party Transactions: seller owns building on non-standard lease? Uses sister-in-law as a supplier?
- Qualification to do Business

Buyer-Side Due Diligence – Key Legal Issues

– Regulatory Issues

- Industry Specific
- Government Contracts

– Litigation

- History / status
- Do you want a common interest agreement?

Interplay of reps and diligence

- Why get reps in addition to the diligence (I already told you that!)
 - Getting it in writing (with an indemnity claim if it's inaccurate)
 - BUT: indemnity claims are first-aid; diligence helps avoid the injury
 - Diligence helps identify:
 - Appropriate reps
 - The attorneys will have a base set of representations to use in the agreement
 - Diligence may highlight the need for more detailed or additional reps
 - 'Knowledge' parties
 - 'Standalone' indemnities
 - Employment issues
 - Litigation
 - Failure to comply with law
 - Failure to pay / report tax

Buyer Side Due Diligence – Business Issues

- Confirming Full Disclosure
- Identifying Risks and Synergies
- Identifying Key Employees and Customers
- Planning Integration
- Financial Terms (Value/Purchase Price Adjustments, Earn-Outs, Taxes)
- Capital needs
- Hiring/Transfer of Employees
- Dealbreakers

Follow-up requests

- As initial diligence uncovers issues, you may need to send follow-up diligence requests. And follow-ups to follow-ups.
- It's tempting to keep digging forever, and you'll likely keep finding issues. So when is the right moment to stop?
 - May depend on your company's risk sensitivity
 - How “close to the line” are you on the deal price?
 - Is there a timing urgency?
 - When you start seeing the same info over and over: and the information you're getting is all consistent with what you've been told before
 - When you request additional info, it only raises minor issues
- Other signs?

In Closing

Any questions?

Thank you!

Questions? Please feel free to
contact us any time for guidance.



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