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Seller Due Diligence

Olympic Success or Epic Fail

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Introduction

Any lawyer who has been involved in corporate M&A for a period of time will be familiar with the process known as due diligence (DD). Most M&A lawyers will likely have been involved in conducting the legal aspects of a DD process undertaken by a prospective buyer of either the shares or the assets of a target company. In a buyer DD process[i], the buyer or its professional advisors will undertake a structured process designed to seek information regarding the target, with a view to discovering the strengths, weaknesses, opportunities and threats possessed by or faced by the target. The buyer DD process usually proceeds via a list of questions and requests directed to the seller seeking information and documents of or pertaining to the target. Depending upon the parties involved, the risk appetite of the buyer and the size and general complexity of the potential transaction, the level of DD may be relatively limited or may be highly detailed and complex.

In general terms DD will be conducted in at least three categories namely legal DD, financial DD and operational DD. This paper deals with legal DD.

While the value of good quality and suitably thorough buyer DD is well understood by most buyers and law firms working in the corporate M&A area, the importance and value to both sellers and buyers of thorough DD conducted by sellers on themselves (seller DD) is less well canvased.

This paper considers the valuable contribution that sound seller DD can contribute to a transaction from the perspective of both a seller and a buyer and on the other hand, the problems, sometimes very serious or fatal problems for a potential transaction that can occur as a result of inadequate seller DD.

By seller DD, we mean the process in which a perspective seller of a company's shares or assets and the seller's professional advisors will inquire into and examine the affairs and circumstances of a company and the sale assets in preparation for a sale process. It is similar to the buyer DD process but is conducted by the seller and its advisors on the company shares or assets for sale.

There are a wide variety of ways by which a company may initiate a sale process. a request for expressions of interest, indications of offers, shortlisting of potential buyers or "straight to market" sale processes. In short, in a seller DD process, the seller will examine itself and the assets for sale to assess whether there are any factors that may be unattractive to potential buyers or potential impediments to a successful sale transaction. Discovering any such impediments prior to the commencement of the sale process will give the seller the opportunity to repair or obviate such impediments, thus enhancing the attractiveness of the sale offering. As part of that seller DD process, the seller will seek to anticipate all of the questions or issues that may be raised by potential buyers.

Synopsis

1. In corporate M&A, both asset sales and share sales, sellers often fail to undertake their own thorough DD before going to market.
2. Effective seller DD does involve time and cost but in our view, is most certainly worthwhile.
3. Thorough seller DD, before going to market, is likely to positively impact the prospects of a sale

and to maximize the sale price.

4. Sellers should undertake DD on prospective buyers where post-closing buyer commitments will be important for the seller, to ensure that those commitments are properly recorded in the transaction documents.
5. A thorough seller DD process is likely to enhance the prospects of a successful sale – Olympic gold medal success. On the other hand, an inadequate or non-existent seller DD process is likely to contribute to a difficult sale process with a less than ideal outcome or worse still, a failed sale process – an epic fail.

Seller DD – the problem

We have been involved in numerous M&A transactions where a seller has gone to the market without first having conducted any or any adequate seller DD process. Lack of seller DD can occur for several reasons. The seller's personnel having made the decision to go to market, just want to get on with it and don't want the time, the hard work, the cost, the distraction to staff or the risk of loss of confidentiality that will or may be involved in undertaking thorough seller DD.

We have heard various objections from sellers and their advisors against conducting rigorous seller DD at an early stage in the process:

- it will take too much time, cost too much, divert our/management's attention from running the business
- the buyers will tell us what information they want
- let's test the market first and see what buyer appetite looks like
- we don't want to ask a whole lot of questions or get people looking for documents and send out management questionnaires or we will tip off our people that something is going on
- we will need to keep this process really tight and confidential
- if we give out information and no deal happens, our competitors will have our crown jewels.

There is no doubt that a thorough seller DD process will involve work by the seller personnel and their advisors, that seller personnel involved in the process will have some level of their attention diverted from the seller's day to day operations and that cost will be involved. Where confidentiality is important, there will need to be steps undertaken to preserve confidentiality. There is a cost versus benefit assessment to be made. Invariably, the weight will be on the benefit side.

The seller's external corporate advisors might be saying that "now is the time to get to market so don't delay things with DD – we can sort that out in the context of a buyer's DD". A variation on that objection to early seller DD may be that if the seller will proceed via a call for expressions of interest or by a potential buyer shortlisting process, further seller DD can be conducted once the potential buyer market has been assessed and qualified.

These may all be genuine points of concern. Careful thought and detailed mapping out of the process ahead of time will be important. It also will be important for both personnel advising a seller's management and for external advisors that they understand and can clearly articulate the value to a

seller in conducting effective seller DD as part of a sale process.

Sales process and data

Smaller sales transactions may take place in a one step process. The seller may know the likely relevant buyer market and may directly approach potential buyers. Alternatively, the seller may engage a business broker or professional adviser to assist with locating and identifying potential buyers.

In these smaller transactions, the seller or the seller's agent may prepare an information memorandum (IM). There may be some steps designed to weed out tire kickers. If a potential buyer is not already known by the seller or the seller's agent to be genuinely interested in a transaction, the potential buyer may be asked some basic questions to elicit its level of interest and capacity to execute a transaction. One approach we have seen is for potential buyers to have to pay a fee in order to receive the IM and be admitted to the sale process. Typically, the IM and potentially additional information, will then be provided to the potential buyer/s. Alternatively, the seller or the seller's agent may set up an electronic data room. The data room may be in the form of a Dropbox or share file arrangement or a third-party professional data room supplier may be engaged. In this one step process, a substantial amount of seller information will be made available to the potential buyer/s.

In these types of transactions, the level of both seller DD and buyer DD is often somewhat truncated. Speed and efficiency in terms of time, personnel effort and cost are highly important. Sellers are well advised to anticipate and to prepare and provide the information that potential buyers will seek.

A key element for a seller in its DD is to identify issues with the company or the sale assets that may be seen as detrimental by potential buyers and to address and rectify those issues *before* the sale process commences and certainly before those issues are pointed out by a potential buyer. A buyer pointing out problem issues not identified and addressed by the seller is a primary reason for delays and additional costs and crucially, for reductions in the purchase price proposed by buyer (in the vernacular, "chiseling").

In larger transactions[ii], it is commonplace to see a multi-stage process. This may occur both if the seller puts itself or its assets up for sale or if a prospective buyer approaches a target with an unsolicited offer. In the case of an unsolicited offer, the target may decide to test the market by canvassing for other potential buyers.

In a multi-stage process, the seller and its advisors typically will prepare an IM tailored to the size and complexity of the offering[iii]. In undertaking that step, the seller will be well advised to conduct thorough seller DD. The seller will need to be assured that the information provided to potential buyers is sufficiently detailed and is accurate and not misleading by inclusion or omission. The comments above about the seller identifying and addressing problem issues certainly apply.

The seller typically will establish a data room and will populate it with the documents and information that potential buyers can be anticipated to require in conducting their buyer DD. Logical and efficient organization and indexing of data room contents will assist in facilitating an efficient DD process. On the contrary, random or haphazard population of a data room will slow down buyers' DD, will lead to

increased buyer requests for information and will add cost for both potential buyers and the seller.

Frequently, a seller will invite potential buyers to submit a non-binding purchase offer in the form of an expression of interest (EOI) or a non-binding indicative offer (NBIO). Typically, an EOI or NBIO does not constitute a binding purchase offer by the buyer. In order to solicit EOIs or NBIOs, the seller will give potential buyer/s access to enough information in the data room as is calculated to allow potential buyers to realistically assess the opportunity and to submit sensible purchase offers. The seller will then review submitted offers with a view to selecting the party or parties (if any) with which the seller will continue negotiations. In this step, potential buyers are likely not to be given access to highly confidential or commercially sensitive seller information, on the basis that if a transaction does not proceed, the seller does not want third parties to have that key information.[iv]

In the next step of the process, the seller would select a preferred potential buyer/s with which to go forward. If parties were not given access to all data room information at the EOI/NBIO round, full access would now be given. The parties would negotiate formal transaction documents, particularly a share or asset sale and purchase agreement.

In some processes, potential buyers may be asked to submit a firm or binding offer as distinct from an EOI or NBIO. In that circumstance, it would be a term of the potential buyer being invited to participate that if it was selected as the preferred buyer, it will be obligated to proceed with a purchase at its submitted price unless the second, detailed stage of DD disclosed some material adverse event or material adverse change that was not disclosed by the first round of DD. What constitutes a material adverse event or a material adverse change will be defined. With this process, it will be necessary that the data provided to potential purchasers during the first step is sufficient to allow potential buyers to submit binding offers and is accurate so as to reduce or obviate the risk of potential buyers walking away or being able to escape from a binding offer because further, adverse information is discovered during the second step of the process[v]. This demands that prior to commencement of the process, the seller will have conducted a substantial level of seller DD. The risk for a seller in not conducting thorough seller DD prior to the start of the process is that potential buyers, notwithstanding that they have submitted an offer, either walk away or seek to reduce their offer because in the course of further buyer DD, they discover material adverse information about the seller, perhaps information of which the seller was unaware.

The question arises – how does one define what constitutes a material adverse event (MAE) or a material adverse change (MAC)? The most usual approach we see is to define an MAE or MAC by reference to the impact that the event or change has on the target's profit and loss statement or balance sheet. The quantum of impact will typically be proportionate to the size of the target and the value of the proposed transaction. This may form part of a buyer's assessment of what constitutes materiality more generally[vi].

Frequently in going to market, a seller or the seller's corporate advisor will prepare a glossy IM that includes forecasts, broad statements about the size of the target's potential market, all the opportunities that the target has etc. – generally a sales document. The IM will set the expectations of potential buyers. We have seen several examples where subsequent buyer DD has disclosed a major

gap between what is stated in the IM and what can be substantiated by the seller. Often, the information that can be provided by the seller is insufficient to substantiate statements in the IM or worse, discloses a position that is contrary to statements in the IM. Such a lack of alignment between what is promoted and what can be substantiated can be very detrimental to a sales process. There is no excuse for a seller allowing this lack of alignment to arise. Thorough seller DD should prevent this danger. Sellers should not rush to market before they have properly prepared and ensured that they can substantiate statements made to the market.

A useful approach for sellers preparing to go to market is, in effect, to conduct buyer DD on themselves. Sellers and their advisors should be able to anticipate all of the issues that will be important for buyers and the enquiries that buyers will make.

The data room

Related to the above, sellers should anticipate how buyers will go about buyer DD. Sellers should ensure that their data room is properly structured and populated with the information that it can anticipate buyers will require. A poorly organized data room will be a negative in terms of a sale process. At the least, a data room that is poorly organized or that does not include all of the documents and information that a reasonable seller can anticipate potential buyers for the type of transaction will require, will make prospective buyers and their advisers grumpy. It will delay the process and is likely to result in an increased number of requests for information from buyers and their advisors, all of which increases costs for both the seller and the buyer. A badly organized or deficiently populated data room reflects the seller's business practices and will inform the view of potential buyers regarding the seller's business practices. This may lead to potential buyers not proceeding with a purchase offer or discounting their purchase offer because of concern about the status of the seller and its business practices. Poor DD diminishes the seller's credibility and deal "good will". It is likely to increase the buyer requirements for warranties, hold backs, earn outs and potentially, will increase the likelihood that buyers will require that representations and warranties insurance be put in place.

For any transaction where a reasonable volume of documents will be required for due diligence, our view is that establishing a data room through an experienced data room services vendor is a worthwhile exercise. Those data rooms enable a seller or its advisors to control the documents in the data room and who has access to those documents. Sellers are often able to see what documents are receiving most attention from potential buyers, which can be a very useful source of information for sellers, since they will know what matters are likely to be of most interest or concern to potential buyers. These data rooms incorporate facilities that enable potential buyers to log requests for further information and for sellers to respond to those requests, with those RFIs and responses being properly documented.

In transactions where probity[vii] is an important consideration, well organized data rooms facilitate transparency about information provided to bidders or potential purchasers, including additional information provided in response to buyer RFIs.

A further important benefit of a well-organized and operated data room relates to the representations and warranties that a seller will be asked to give in a sale and purchase agreement (SPA). Invariably, in

an SPA the seller will be required to give a range of representations and warranties. Those representations and warranties typically will be qualified by information that the seller has fully and fairly disclosed to the buyer in the due diligence process. The better the quality of the seller disclosure, the better the chance that the seller will be able to negotiate less demanding warranties. A well-structured data room will enable the seller to easily produce a list of all documents provided in the data room and a list of all RFIs and answers. This information can be supplied as an attachment to the SPA by way of disclosure qualification of representations and warranties.

Considerations

A seller undertaking a seller DD process will assist the seller to assess how well its own document management system works and to identify gaps in its document management and even more importantly, issues in its business that potential buyers are likely to find and that could give rise to risks that a transaction may not get done. The seller's ability to respond to and collate information based on a seller DD checklist provided by the seller's advisors may show a seller just how well its information is organized or alternatively, may point out to a seller just how badly its management of contracts and key documents is organized. Sellers will discover how quickly their management systems enable them to identify and find documents, how well documents and other information is stored and sorted for materiality and security and whether they have adequate document capture, retention and management structures in place. The discipline imposed by undertaking a seller DD process will also assist a seller to consider and manage information flows that will be relevant in the context of a transaction. For example, a seller will be prompted to consider what information has what degree of confidentiality and to whom and when can information be disclosed? If the seller's financiers need to be consulted – inevitably this will be the case in the context of a transaction - can the seller readily provide the information that its financiers will require in order for the transaction to be effected? The seller DD process may also assist the seller to consider what information should be released to customers and the market generally and when that information should be released.

Seller DD on potential buyers

The aspect of seller DD that is not so frequently considered is the DD that sellers should conduct on potential buyers. If a seller is going to sell the whole or a substantial part of its business, is the transaction only about the price (what the seller can take off the table)? For many sellers, perhaps the predominant answer in the end, is yes.

Sellers want to maximize the purchase price. Buyers want to ensure that they are getting everything for which they are paying. A common way that these two potentially competing aims may be reconciled is via an earnout. Typically, the buyer will pay a substantial percentage of the total maximum purchase price at closing and will then pay to the seller a potential further amount, calculated by reference to a range of factors that relate to the success of the transition of the business or the retention of the business post-closing. This latter payment is referred to as an earn out. An SPA may provide that in addition to the amount payable by the purchaser at closing, further amounts will be payable to the seller based on the degree to which key performance measures are achieved in (typically) one or two years after closing. Those measures often include whether the target business achieves a specified level of revenue or profit, or the number of customers retained or new business that is developed.[viii]

From the seller's perspective, the drafting of earn out clauses in SPAs is critical. Where the degree to which an earn out is earned is dependent on the performance of the business post-closing, a key consideration for a seller is what degree of control or influence does the seller have on the performance of the business post-closing. If the control of the business and its performance post-closing will largely or entirely reside with the buyer, then the seller will need to undertake very careful consideration of the buyer, the buyer's capacity to run the business, the buyer's willingness to devote the capital and other resources promised by the buyer pre-closing or that may be otherwise required for the business to flourish post-closing. Where an earn out is calculated by reference to accounting practice sensitive matters such as achievement of net profit targets, the seller will need to consider the propensity for the buyer to manipulate the accounts of the business post-closing so as to reduce net profit figures.

As mentioned above, it will be important for a seller to understand whether a buyer has the intent, the resource capacity (financial, personnel, markets) and strategy to see the business thrive post-closing. Where the target is to be integrated into the buyer's organization, it will be relevant for the seller to understand what the buyer's integration plan is.

Sellers having satisfied themselves about these matters will have a much better story to tell their personnel and at the right time, the market.

Another factor relevant for seller DD on a buyer will relate to the seller's personnel. Are the seller's employees staying in the business post-closing? Will the personnel be working essentially for the same management or will they have a new boss? How will the buyer treat the seller's personnel? Does the seller really care? Will the seller (e.g., a founder or leader of the target) be staying in the business post-closing. Apart from the earn out issue above, the seller will have a new boss. Sellers need to understand who they will be working for and potentially, ultimately reporting to. Sellers need to prepare themselves for the transition from being the boss to the "not boss". How will the seller feel about working for a new owner?

In a transaction, is the buyer saying that it will make a range of post-closing improvements, restructuring, providing key personnel, finance or other resource commitments, providing marketing plans and good homes for the seller's personnel? Sellers need to ensure that these buyer commitments are properly documented in the transaction documents. We very rarely see these matters included in what are typically very limited buyer warranties set out in SPAs. Sellers should consider whether a post-closing business plan is included as an annexure to an SPA.

A thorough seller DD process carried out on a purchaser is likely to improve not just expectations regarding earn outs but also to improve post-closing transition and integration and reduce the risk of value diminution.

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[i] DD will be referred to in some jurisdictions as buyer DD or seller DD and in some jurisdictions as purchaser DD or vendor DD. In this paper, we will refer to buyer DD and seller DD.

[ii] Publicly traded or stock exchange listed companies will have listing rules and other compliance obligations, including continuous disclosure obligations, which are likely to affect a sale process. This paper does not address those obligations and their impact on a sale process.

[iii] There are of course many steps leading to and involved in a sale process. This paper is limited to a general outline of steps related to the seller DD process.

[iv] This is likely the case even when, in accordance with usual practice, potential purchasers have executed an NDA as a condition of being granted access to the data room.

[v] In practice, while buyer offers may be expressed to be binding, if a buyer wants to escape after submitting its offer, contractually and commercially, there are a number of ways that can happen.

[vi] When conducting buyer DD, the buyer will set materiality thresholds so that matters that the buyer may consider are adverse or disadvantageous with respect to the target's affairs but that are likely to have a monetary impact below a stated materiality threshold need not be reported in the DD report by its advisers that will be provided to the buyer in the course of the buyer DD process. This paper is not considering buyer DD issues.

[vii] In tenders called by large corporations, government departments or instrumentalities, probity with respect to the conduct of the tender process very frequently will be a key consideration.

[viii] In many IMs, statements will be made about the "blue sky" opportunities that the target offers to buyers. The degree to which this blue sky is achieved post-closing may well be a factor in determining the extent of earn outs paid.