

A Road Map For Combined Acquisition And PAI Due Diligence

Law360, New York (May 18, 2016, 12:15 PM ET) -- The need to integrate acquired businesses and produce synergies and economic returns quickly is an unavoidable current reality of the mergers and acquisitions market. One way savvy repeat buyers get a jump on those expectations is to start thinking about post-acquisition integration during acquisition due diligence (and quite often before acquisition due diligence at the initial transaction evaluation stage). In fact, many major acquisition players create an integration team the day a letter of intent or confidentiality agreement is signed, despite the risk that the proposed transaction may not be consummated. In addition, the popular wisdom (of lead acquisition teams) that integration matters should be handled post-closing because it will be more efficient to obtain the information internally post-closing is shifting. For example, prior to payment of the purchase price and with seller's undivided attention, it can be easier, not harder than post-closing to locate critical information in certain circumstances.



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This article is designed to briefly describe the difference between acquisition-only due diligence and combined acquisition and post-acquisition integration (PAI) due diligence and provide a short road map for best practices in combined acquisition and PAI due diligence.



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Acquisition-Only Due Diligence

Acquisition-only due diligence is designed to locate and address problems, issues and liabilities in a stand-alone business. Broadly, this is the basic "red flag" report provided by a law firm, accounting firm, benefits consultancy or other service provider who has not been provided with any specific instruction regarding the nature of the buyer's current business or operations. Transaction-only due diligence typically asks:

- "How does this business compare to other businesses overall?"
- "Are any of the business practices of this business, risky, unique or unusual?"
- "Is this business as advertised in the confidential information memorandum?"
- "Are the financial prospects of this business appealing and valid?"
- "Are there any contingent liabilities that may arise post-closing?"

Combined Acquisition and PAI Due Diligence

Combined acquisition and PAI due diligence expands the field of inquiry to ask:

- "What impediments exist to realizing value from the business after closing?"
- "What needs to change to operate the business as the buyer intends to operate it in the future?"
- "What does the buyer want the combined business to look like in future years?"
- "What does the buyer need to communicate to the due diligence team to identify roadblocks

to both closing and implementing the business plan post-closing?”

Although there is no guaranteed way to obtain all answers to these questions in early stages of due diligence (particularly where integration plans and status quo operation are still in flux), at root level combined acquisition and PAI due diligence is an exercise in gathering information about legal, financial, technological and other processes of the target business and putting that information in front of buyer team members who will understand, typically from prior integration experience, how those processes will need to be adopted, altered or abandoned in the business integration process.

Best Practices for Combined Acquisition and PAI Due Diligence

- **Cross-Functional Team:** Combined acquisition and PAI due diligence requires a broader cross-functional diligence team. Typical key players are information technology, operations, tax planning, compliance, risk management, human resources, commercial, treasury and marketing (in addition to the frequent lead acquisition team of legal, finance and transactional tax).
- **Centralized Team Management:** A larger due diligence team necessitates clearly designated transaction leaders as well as careful selection of the times during which to involve the broader due diligence team. Typically, when creating the initial due diligence request list and draft acquisition agreement, broad team participation is required. Later in the deal negotiation process, a smaller more nimble core negotiating team is often required to balance negotiating priorities.
- **Limited But Present Antitrust Restrictions:** Most, if not all, of the subjects targeted during PAI due diligence do not implicate significant antitrust information-sharing concerns. PAI due diligence does not typically require sharing restricted competitively sensitive information — such as pricing information, future strategic plans or detailed customer information. Antitrust counsel will also be able to advise on the limits of PAI due diligence activities.
- **Antitrust Information Clearance:** Despite the limited nature of antitrust restrictions, it can be helpful to set up an antitrust review group (sometimes involving external antitrust counsel) who will review the scope of each information request to seller to remove any inadvertently competitively sensitive requests, providing comfort and organizational control to the integration information-sharing process.
- **Consistent Team:** It can be critical to have at least a few members of the lead acquisition team continue to work on the implementation of post-acquisition integration after the closing. There is typically a voluminous and helpful store of information about the target company acquired by the lead negotiation team that can be leveraged in PAI. Using an external team that does not have to start from scratch on due diligence can also provide valuable cost savings.
- **The Search for Hidden Value:** Combined PAI and acquisition due diligence can result in

location of hidden deal value and early synergy discovery if the combined due diligence team is requested to note or raise benefits discovered in the course of PAI due diligence. Examples of hidden value include usage of same or similar data base systems, positive tax attributes, retrainable or previously cross-trained employees and many other items.

- **Deal Issues vs. Integration Issues:** Typically, only certain costs associated with integration can be characterized as acquisition due diligence issues for which remedy or coverage is requested in the acquisition agreement. For example, environmental or other legacy liabilities are common deal issues, while the cost of internally liquidating and transferring assets out of duplicate operational entities where both buyer and seller have legal entities and operations in local jurisdictions is a frequent occurrence but not a common source of remedy or coverage in acquisition agreements. Many sophisticated acquirers have (1) an increased willingness to share internal integration cost and synergy estimates at the due diligence phase with the lead transaction team to help identify deal issues and (2) a specific process to separately categorize initial one-time costs versus ongoing costs to ensure integration issues are subject to the same cost-assessment protocols that deal issues receive.

Common Issues Which Can Be Avoided

Issue	Risk	Solution
<i>Regulatory Compliance Costs</i>	Compliance program upgrades can be costly for public companies to conduct post-closing even where violations do not exist.	Informational representations regarding current compliance practice diligence disclosure can often be sought with minimal pushback from prospective target companies to help assess the degree of upgrade that may be required.
<i>Location of Legal Books and Records</i>	Locating complete original books and records can be a gating item for post-closing integration activities in certain jurisdictions. It is significantly more difficult to locate original books and records post-closing if new team members are charged with their maintenance.	Consider requesting a representation in the acquisition agreement that specifies the location of all such books or records on the closing date.
<i>Post-Closing Director and Officer Changes</i>	Large numbers of director and officer changes are sometimes desirable shortly after closing of a transaction to apply the buyer's standard slate of officers to acquired entities. In some countries, such changes can take several weeks or	Consider insisting on long-form secretary certificates in the acquisition agreement containing the information required. Provide the seller information regarding why the long

	months to plan and execute.	forms are required so that the request is more carefully considered.
<i>Status of Legal Corporate Maintenance</i>	Post-closing adoption and ratification of cleanup corporate record-keeping can be slow and may be required for basic PAI post-closing legal actions such as mergers of local entities and asset transfers.	Request copies of the underlying information present in the secretary certificate in advance of closing so post-closing changes can be quickly implemented.
<i>Branding Matters</i>	If the buyer wishes to employ its brand (or the seller has retained some brands that must be separated from the sold business), it may be necessary to make fairly quick changes to corporate subsidiary entity names, stationary, signage and other items. In certain jurisdictions, such changes are regulated by law and must occur in accordance with an order of operations and procedure.	Request information from the integration team early on branding concerns such that preclosing forms can be prepared for quick post-closing action.
<i>Tax Planning</i>	Post-closing tax planning-based reorganizations sometimes requires more granular analysis of assets, liabilities and intercompany accounts and often creates post-closing delays if the due diligence is conducted post-closing.	While transaction documents are being negotiated, there is often a period of time prior to closing where information that is not the subject of representations and warranties can be sought and is willingly provided.
<i>Cash and Trade Management Policies</i>	Factoring of receivables, self-insurance programs, customer credits and prepaid expenses, trade guarantees, and other cash and trade management policies often create significant expense to unwind post-closing.	Work with treasury and risk management to carefully craft the definition of indebtedness and current liabilities in working capital and net debt adjustments of the acquisition agreement to ensure these items are at least raised in due diligence/financial calculations for assessment.
<i>Volume of Due</i>	With a larger due diligence team	Consider site visits or conference calls with target corporation

*Diligence
Requests
and Follow-
Up Requests*

focused on both PAI and acquisition matters, an increased volume of requests can sometimes create extended due diligence timing.

management and, where possible, cross-functional meetings to resolve more detailed matters in a quick face-to-face manner.

Conclusion

As certain sophisticated acquirers adopt the approach of using combined acquisition and PAI due diligence, we are seeing an ancillary effect on “market” deal terms for private transactions. The results of the more detailed combined acquisition approach has generated more requests and attempts to negotiate special indemnities, customized preclosing cleanup covenants for specific liabilities or states or affairs, and selected highly detailed integration presentations, which sometimes are appropriate for inclusion in acquisition agreements.

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