

## Performance of Due Diligence in Transactions

**DUE DILIGENCE IS A PHASE OF EVERY TRANSACTION**, from a bank loan to a corporate merger. It is how the parties determine if and how they should proceed. The process typically involves reviewing a company's documents and in some instances visiting a company's facilities or interviewing employees.

Perhaps because it is time-consuming, due diligence is often unappreciated, but wrongfully so—no one wants to purchase a company only to discover that it is in substantial debt or about to be sued by a former employee with several well-documented reasons to be disgruntled. Despite the critical role of due diligence, it is not always well understood, especially by new associates, who often are the ones assigned primary responsibility. It is therefore crucial that a transactional attorney understand the purpose of diligence and how it relates to the particular deal.

Due diligence generally falls into two overlapping categories: business and legal. Business diligence focuses on a company's financial situation, operations, and prospects. This is often handled by the involved businesses themselves or their financial advisers rather than their legal representatives.

Diligence should be a cooperative process. It should be undertaken by the reviewed entity's own counsel as well as the counsel for the other side. Both sides have the same goal of getting the transaction completed, and they need to work together in order to address any issues that may come to light. Unfortunately, many companies and their counsel become defensive when subject to due diligence review.

Generally, diligence begins with delivery of a due diligence checklist, which requests the documents and information that the attorney needs to review. Diligence lists, modified as appropriate for the transaction at hand, will often request documents showing corporate organization, management, capitalization, financial statements, tax information, regulatory licensing, intellectual property, employees, and material contracts.

Diligence requests usually involve several rounds of back and forth with requests for additional documentation and clarification as the reviewing party becomes more familiar with the subject company. For example, if initial diligence reveals that there are a number of regulatory licenses involved in a business, that will be an area of focus, and more documentation may be required. In other instances, the disclosed documentation may be incomplete. For example, an amendment to but not the original agreement may be provided in response to a request, so another request needs to be sent asking for the original. Other lines of inquiry may be appropriately abandoned. For example, a company may respond to a set of document requests about real property ownership by indicating it does not own any real property.

In most scenarios, diligence requests will result in the disclosure of significant amounts of documentation, and the reviewer must

determine how the submitted disclosures relate to the purposes of diligence in the particular transaction, if at all. Legal diligence can generally be described as serving three purposes.

First, diligence helps identify what needs to be done. Lawyers need to inform clients what actions must be taken before the transaction can be completed. A common hurdle involves change-in-control provisions in material contracts. If a company is about to undergo a merger, its contracts need to be examined for a provision that a merger will be considered a breach of contract. If an important contract forbids the company from entering into a merger, consent from

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the contract party must be obtained. Other examples include the need for shareholder consent to the transaction or government approval to transfer a license.

Second, lawyers need to know what must be disclosed in a transaction. Most agreements contain representations and warranties—statements in which the party represents that certain facts are true. For example, a company will need to represent that it has been duly organized and that it has the power to enter into the proposed transaction. It also may represent that it is in compliance with all relevant environmental laws and has paid its taxes. A company that makes a false representation may be in breach of the transactional agreements and could be subject to future liability. However, if any problems with disclosures are identified before the completion of the transaction, the parties can work together to modify the representations to disclose the pertinent facts and avoid the breach.

Third, lawyers need to identify legal issues that may affect a client's business decisions and advise the client regarding potential resolutions to these issues. For example, if diligence reveals an exclusive license agreement that would conflict with the client's current or future business plans, the client should be made aware of this issue and what the options may be.

Keeping these purposes in mind will help the reviewer focus on what is important in the transaction and process the plethora of information received into something useful that will guide how the transaction may proceed. ■

**Alison M. Pear is a transactional attorney specializing in securities and mergers and acquisitions at TroyGould PC in Century City.**