Westlaw Today
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Due diligence vs. protections and remedies for buyers in acquisitions

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MARCH 27, 2024

The due diligence stage of an acquisition process serves multiple purposes, from business discovery to risk mitigation, also informing valuation, synergy identification, ensuring compliance, and supporting strategic decision making throughout the transaction. But there are sometimes hidden issues that even thorough due diligence might not uncover.

There are numerous concerns that can come to light after the transaction is complete. They can include anything from errors, omissions, or fraudulent activity related to financial statements, IP risks, or undisclosed liabilities (in particular, in relation to tax and employment risks). There can also be hidden operational issues such as inefficient processes or supply chain vulnerabilities.

When due diligence fails to identify issues with the target company, it can obviously pose significant challenges for the buyer.

In addition, while the diligence process is conducted primarily based on information provided by the seller, it is important for buyer to conduct independent searches (e.g. USPTO search, litigation and lien searches) to corroborate such information provided by the seller.

When due diligence fails to identify issues with the target company, it can obviously pose significant challenges for the buyer. Further, the attention generated by the public announcements of transactions and the revelation of a "deep pocket" buyer could potentially attract legitimate or frivolous actions against the target, for example patent trolls.

So, while thorough due diligence is essential in acquisitions, buyers should also implement strategies to protect themselves against undisclosed issues that may come to light after the deal closes. Below, we look at some options available to buyers.

Structuring the transaction

Broadly speaking, an acquisition is typically structured as either (i) an asset deal, where the buyer and the seller negotiate which of the target's assets/liabilities the buyer would acquire or assume in the transaction, or (ii) a stock deal, where buyer purchase all (or a portion of) the equity interest of the target company from the seller and by extension, assuming all liabilities of the target.

Thus, structuring a transaction as an asset deal gives the buyer the ability to cherry-pick specifical liabilities to assume and to leave out the undesired liabilities. However, this alone does not give the buyer full protection of the potential exposures, as the buyer may still inherit certain "successor liabilities" by the operation of law as a result of the transaction, and it is important for buyers to determine the extent of successor liabilities with their attorneys in the context of the target's operations.

Insurance

Buyers may consider purchasing insurance policies, most notably representations and warranties insurance policies ("RWIs"), that provide coverage for losses resulting from breaches of the seller's representations and warranties, including those related to hidden liabilities or inaccuracies in financial statements.

Recently, we are seeing a downward trend in premium for RWI policies, which makes them more accessible for buyers and available for smaller transactions. There are numerous reasons why procuring an RWI would be a preferred way to manage a buyer's risks, including (i) in a bid process, submitting a bid with RWI would make the bid more competitive since the seller's post-closing exposures are more limited, (ii) if the target's founders and key employees (who are usually holders of target's stock or other equity interest) would remain employed post-closing, recovery of losses from these founders/key employees (e.g. through indemnification) may impact the employer/employee relationships and thereby jeopardizing synergy intended in the transaction, and (iii) recovery of losses from the seller is dependent on the availability of seller's financial resources post-closing.

We have also recently started to see that insurance products designed to cover known risks identified in the diligence process are becoming increasingly available. As part of the RWI procurement process, the insurer and its counsel would review the buyer's diligence reports and conduct diligence calls with the buyer and its advisors to ensure that a robust diligence process up to the insurer's standard has been conducted.

However, RWI policies typically come with a retention amount and may contain exclusions to known or unknown risks depending on the circumstances of the transaction.

Indemnification

The purchase agreement usually includes expansive representations and warranties from the seller and corresponding indemnification provisions that obligate the seller to compensate the buyer for losses resulting from breaches of such representations and warranties, whether or not uncovered in the diligence process. To the extent that circumstances exist that would render certain representations and warranties untrue, the seller may request to qualify them by disclosing such risks in the disclosure schedule, thereby shifting the risks to the buyer.

Indemnification provisions are almost always present in transactions without RWIs.

There are also limitations to indemnification provisions, for example on the maximum liability, deductible/tipping basket, and the survival period (i.e. the period during which the buyer may bring claims against the seller), all of which (and the actual representations and warranties and the disclosure schedule) are heavily negotiated during the process.

Indemnification provisions are almost always present in transactions without RWIs. For transactions with RWIs, the buyers may consider either to not impose any indemnification provision on sellers (in particular, in bidding processes) to make their offers more competitive, or to retain indemnification provisions to cover potential losses, for example losses within the retention amount, or exclusions to the RWI policies.

Negotiate remedies

The subject matter discussed above may impact how attractive a buyer's offer is to the seller, how the diligence process is conducted, buyer's and seller's post-closing taxes, and, accordingly and more importantly, whether the transaction would make sense to either the buyer or the seller. It is paramount that these deal points be negotiated from the outset (typically prior to the signature of a letter of intent) to ensure a smooth process.

Escrow or holdback

When negotiating the purchase agreement, the buyer can ask for a portion of the purchase price to be placed in escrow with a financial institution escrow agent or withheld by the buyer for a certain period of time after the transaction closes. This provides a partial guaranty for the seller to honor its indemnification obligations after the closing. To the extent that certain risks are identified in the diligence process, it is not uncommon for the buyer to include a special indemnity escrow/holdback to protect the buyer from such known risks.

Continued due diligence

Even after the transaction is complete, it is important to continue to monitor the target company's performance and operations. Representations and warranties given by seller usually survive for a definitive period after the closing (e.g. 1-3 years for "general representations" and a longer period for certain customary "fundamental representations").

It is important that the buyer in a transaction be mindful of such timelines and plan its post-closing diligence process accordingly. If possible, the buyer should negotiate for a survival period that extends beyond the target's first audit cycle as audits could reveal important details about the operations that were not apparent in the diligence process.

Nothing in life is foolproof. There is always a risk that something could be overlooked, hidden, or simply disregarded no matter how careful buyers are. It is essential to consider and address these kinds of protections upfront and know your options should you find yourself facing a surprise when the deal is done.

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This article was first published on Westlaw Today on March 27, 2024.