

By DASHA K. HODGE

THE ART OF INVESTIGATION: Trends and Best Practices in M&A Due Diligence

Due diligence may not be an M&A practitioner's favorite part of a transaction, but it can be the most important. Findings during the due diligence process can guide the price, structure, and terms of a transaction, and, in extreme cases, ultimately determine whether there will be a deal at all. This is why it is important to have a robust and thorough diligence process at the onset of a deal. The following discussion includes some baseline best practices for practitioners and highlights recent trends and areas of focus.

Establish Scope of Investigation

The first and foremost task in any due diligence undertaking is to establish the scope of the investigation. Work closely with your client and internal legal team to determine the areas of concern. While a due diligence process should be comprehensive, there may be special areas of concern for the client that should receive additional consideration.

Determine Deal Team Composition

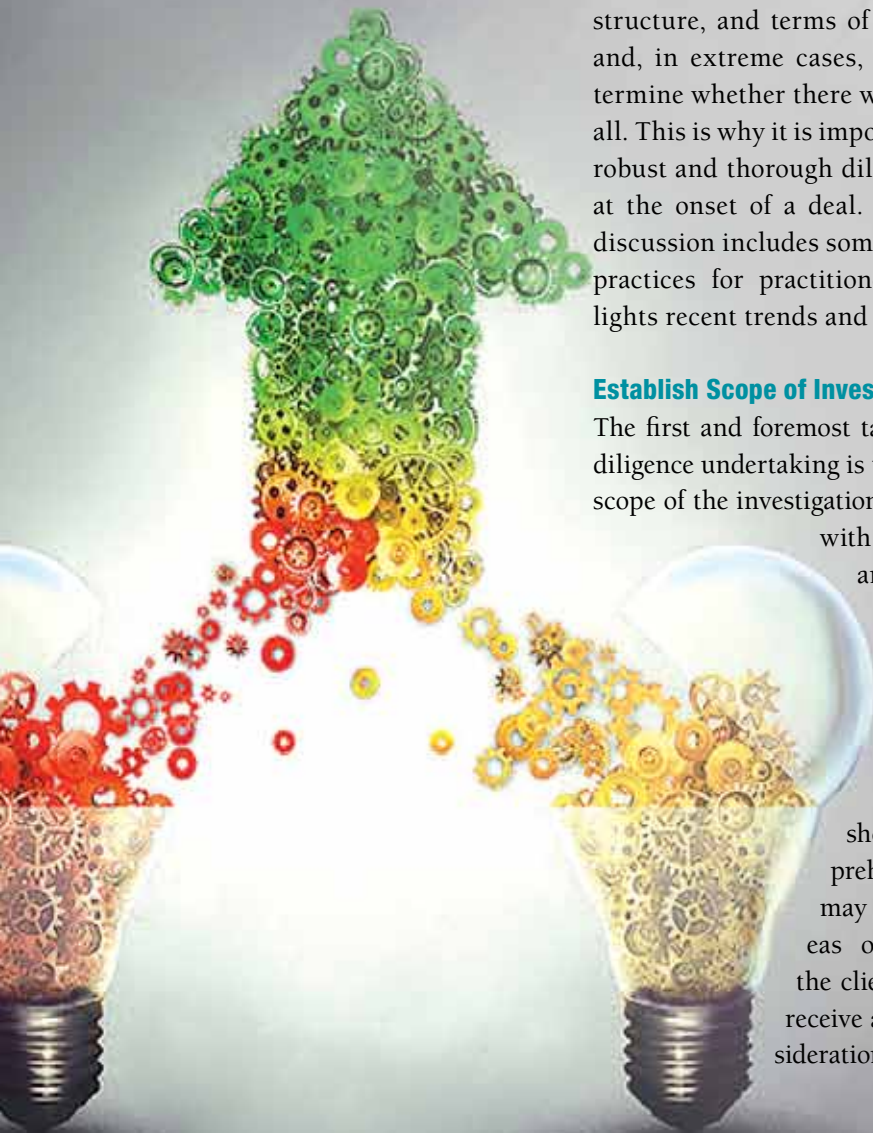
It is increasingly important to include team members with the right subject matter expertise on your due diligence team. This includes both internal and external team members. The client may have its internal team conducting certain investigations, and care should be taken that appropriate firm subject matter experts are coordinating with the corresponding client personnel. In addition, the client may also be working with (1) an investment bank, which conducts financial diligence and analysis, (2) an audit firm, which conducts diligence on financial statements, (3) tax advisors, who conduct diligence on tax and financial matters and tax-efficient structuring, and (4) other consultants who conduct diligence on a specific part of the business (for example, reserve engineers may audit a company's oil and gas reserves, an environmental consultant may audit a company's environmental compliance, and a risk management consultant may review insurance).

Use of Technology

In addition to having the right personnel, understand what tools you have at your disposal. Most legal due diligence is conducted virtually, using virtual data rooms, with only an occasional need for a site visit. In addition, data analytics tools are increasingly used to conduct diligence, including analyzing and synthesizing large data sets.

Representation and Warranty Insurance (RWI)

RWI has become a common and central component of M&A transactions. Knowing at the onset of a transaction that parties will be looking to insurance for post-closing liability related to breaches of representations and warranties may impact due diligence. An insurer will want comfort that the buyer has completed comprehensive diligence before binding a policy. To this end, the lawyers will prepare a



due diligence memorandum and hold a “management call” with the target’s management, counsel, and the insurer to review the memorandum and answer any specific questions. A common

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exclusion from RWI coverage are liabilities resulting from facts the buyer knew about prior to binding the policy. However, this should not be viewed as an incentive to conduct anything less than a thorough due diligence review. If there are liabilities uncovered prior to signing, the appropriate remedy may be to negotiate a purchase price adjustment or a special indemnity from the seller for the uncovered liability.

Environmental, Social, and Governance (ESG) Diligence

As in other areas of corporate governance, there is a growing trend in diligence toward assessing a target’s ESG performance. Acquirers and their stakeholders recognize the potential financial and reputational risks associated with ESG issues and are allocating more time and resources to assessing the risks and benefits of a potential transaction through an ESG lens.

Cybersecurity


With the inescapable reliance on technology and the increasing threat of cyberattacks, acquirers are increasingly focused on assessing the existence and effectiveness of a target company’s cybersecurity policies and incident response plans and identifying any po-

tential vulnerabilities.

Data Privacy

Given the increasing complexity of data privacy regulations, such as the General Data Protection Regulation (GDPR) and California’s Consumer Protection Act (CCPA),¹ acquirers are focused on ensuring that the target is in compliance with applicable regulations. An acquirer will want to evaluate the target’s data protection measures, including data encryption, access controls, and data backup and recovery systems.

COVID-19 Effects

The COVID-19 pandemic changed the practice of law in many respects, and due diligence was no exception. For example, COVID-19 has increased the need for supply chain diligence, as the COVID-19 pandemic highlighted the vulnerabilities of global supply chains. As a result, acquirers are more focused on understanding the full scope of the supply chain of the business being acquired, including understanding supplier risks, contingency planning, and ESG matters. Another effect of COVID-19 and the related governmental response was to add a layer of financial diligence, in the form of diligence relating to COVID-19 relief and status of any loans received by the target company. 



Dasha K. Hodge is a corporate and M&A counsel in the Houston office of Akin Gump Strauss Hauer & Feld LLP. She is also a member of The Houston Lawyer editorial board.

Endnotes

1. At the time of writing, Texas has not adopted a similar data privacy law. However, on April 5, 2023, the Texas House of Representatives voted in favor of House Bill 4 for the Texas Data Privacy and Security Act. The Texas Senate subsequently approved the bill, and as of this writing, the legislation is currently awaiting signature by Governor Abbott.



**A Fireside Chat
with Hon.
George C. Hanks**
Wednesday, July 26, 2023
11:30 AM to 1:00 PM
Marriott Marquis



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