HOW M&A FOMENTS LITIGATION

DUE DILIGENCE IS THE ISSUE

By Arthur H. Rosenbloom

It is axiomatic that effective due diligence is critical in deciding whether to complete an M & A transaction and upon what terms. However, in some transactions, when the backslapping ends, one of the parties, (most frequently the buyer) asserts that the other side has been less than forthcoming about problems during due diligence.

While the catalog of issues giving rise to litigation is virtually endless, several areas stand out as more likely to produce problems than others. One concerns title to assets. For example, in a transaction in which Target is being acquired principally for its intellectual property, the matter may turn on whether Target breached its representation and warranty respecting the exclusivity of those assets, especially if it turns out that there was an actual or threatened claim of patent infringement.

Another frequently litigated area concerns fraudulent or negligently presented financial statements. Target's auditors are often joined as defendants.

A third area concerns regulatory compliance. In one case in which I served as plaintiff's expert, plaintiff acquired a manufacturing facility that proved to have been zoned only for retail sales.

Yet another area giving rise to concern is allegedly undisclosed problems with suppliers or customers.

CLAIMS

Due diligence litigation claims are principally premised on breach of the acquisition contract's representation and warranties, or breach of covenants.

A representation and warranty asserts that the designated facts are true. Examples include Target's representation that its financial statements have been prepared in accordance with generally accepted accounting principles, or Buyer's representation that its board has approved the acquisition agreement.

A covenant is a promise to act or refrain from acting. For example, Target will covenant that between contract signing and closing, it will conduct operations in historical fashion, with no acquisitions, divestments, increases in executive compensation, or changes in dividend policy, without Buyer's written consent. Both parties may covenant to cooperate in required regulatory filings.

As a consequence of alleged breaches of representations and warranties or covenants, plaintiffs typically assert causes of action based on breach of contract, or intentional or negligent misrepresentation. In addition to affirmative defenses such as failure to state a claim or waiver of claim by Buyer, Targets will frequently assert that they provided adequate notice of the matters giving rise to the claim. They may also counterclaim, asserting that any damage sustained by Buyer was caused by its own mismanagement or failure to provide adequate funding post-closing.

The parties' pleadings reveal the central issue in due diligence litigation: Did Target try to pull the wool over Buyer's eyes, or was Buyer's due diligence shoddy? Were post-closing problems the result of risks the Buyer willingly undertook, or its mismanagement?

BATTLEGROUND AREAS

Outcomes in due diligence litigation are highly sensitive to the facts and circumstances of the deal. The following represent some of the key battleground areas.

Merger documents: The outcome could turn on the extent to which defendant's counsel had won a drafting battle. Similarly, the depth or lack thereof of specific information set forth in the schedules preceding a purchase agreement could be an element affecting the question of what risks the buyer assumed.

Careful drafting by Target's counsel may narrow the grounds for a later attack by Buyer based on disclosures in the schedules. The magic words are "The inclusion of any information in any Schedule attached hereto or other document delivered by Target pursuant to this agreement shall not be deemed to be an admission of the materiality of such item, nor establish a standard of materiality for any purpose whatsoever."

Of course, plaintiff's rights and its consequent ability to assert claims under indemnification provisions in the agreement are limited to the period in the agreement that defendant's representations and warranties survive the closing.

Material in Target's data room: It is customary for Target companies to supply data concerning its legal, business, tax and accounting affairs in a data room. It is now typical for Targets to organize "virtual data rooms" accessible to Buyer and its representatives by computer.

It is important to note that Target initially determines what will be included in the data room. Buyers are well advised to insist that specific matters on which they seek disclosure be made available. After the litigation begins and the parties' positions become crystallized, there may emerge honest differences of opinion as to what information was material. So for example, the financial distress of a large supplier of the Target may be regarded as highly material by Buyer, but not Target, who understands that such distress is transient. Of such differences of opinion are lawsuits made.

Responses to Buyer's pre-closing due diligence: A review of the contents of the data room is one phase in the due diligence that begins when Buyer first decides to pursue Target. It proceeds up to and sometimes following the acquisition contract signing, as a Buyer's condition to closing.

After Buyer's review of the data room, it is typical for Buyers to have questions. Evidence pertaining to these inquiries will, during pre-trial discovery, center around disclosures or the absence thereof. Other questions often concern correspondence, emails and telephone conversations as set forth in phone logs.

Damage issues: Assuming plaintiff carries its burden of proof and demonstrates liability, it must then quantify and prove damages. While discussions of how to quantify out-of-pocket, benefit of the bargain and other damage theories is beyond the scope of this article, it is useful to observe the two most typical kinds of damages sought in M&A due diligence lawsuits: dollar-for-dollar and a multiple of P/E.

Assuming defendant is held liable for breaching its representations or covenants, damages (at least for closely held targets) will be determined and collected through an indemnification provision typically included as part of the M&A agreement. In theory, damages for breach of contract involving the sale of a business may be collected on a dollar-for-dollar basis, or on an earnings multiple basis.

IN ONE CASE THE PLAINTIFF ACQUIRED A MANUFACTURING FACILITY THAT PROVED TO HAVE BEEN ZONED ONLY FOR RETAIL SALES.

A dollar-for-dollar recovery compensates plaintiffs for damages that flow through the balance sheet (e.g. over-valued hard assets), some of which (e.g. unsalable inventory) may also flow through the income statement. Defendants clearly prefer this more modest measure of damages, versus damages predicated on an earnings multiple basis.

As a general proposition, dollar-for-dollar damages rather than damages based on a P/E multiple is the norm. This is probably because of the seismic effect on damages resulting from applying the P/E multiple approach. However, a P/E multiple approach might be applied where there is a specific contractual language mandating such an approach.

In addition, while I know of no authority specifically supporting this view, it would appear reasonable that a P/E multiple approach might properly be applied where the loss resulting from the breach materially impacts the Target's fair market value. An example would be an undisclosed regulatory investigation of a Target wealth management firm and its top officials, whose honesty and competence can be shown to have been Buyer's principal reason for entering the transaction.

Outcomes in due diligence litigation are highly fact sensitive, with the scale tilting according to the facts adduced. Thus, parties and their experts are well advised to comb their own records of the transaction before litigation to determine the strengths and weaknesses of their positions.

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