LexisNexis®

Lexis Practice Advisor®

TOP 10

PRACTICE TIPS BY EXPERTS:
DUE DILIGENCE FOR SECURITIES OFFERINGS

by Craig E. Chapman and Richard S. Bass, Sidley Austin LLP

Due diligence is the investigation performed in connection with a securities offering. Due diligence is conducted for a number of reasons, including to:

- Confirm that the information disclosed or incorporated by reference in offering documents does not contain an untrue statement of a material fact or omit to state a material fact
- Ensure that there are no impediments to the offering, such as contractual covenants prohibiting the offering or requirements for third-party consents
- Reduce risk to the parties participating in offerings
- Allow the underwriters to establish an affirmative defense to disclosure liabilities under Sections 11 (5 U.S.C.S. § 77k) and 12(a)(2) (15 U.S.C.S. § 77l) of the Securities Act of 1933, as amended (Securities Act) in offerings registered with the Securities and Exchange Commission (SEC)
- Allow the underwriters to also negate an inference of fraud under Rule 10b-5 (17 CFR 230.10b-5) under the Securities Exchange Act of 1934, as amended, in all offerings (including private placements) where, although the due diligence defense under the Securities Act technically does not apply, a defendant's satisfaction of the due diligence standard would be relevant to the analysis of whether such person engaged in the intentional or reckless conduct required to prove a Rule 10b-5 violation

Parties including the issuer, issuer's counsel, the issuer's independent outside auditors, the underwriters, and underwriters' counsel will typically participate in the diligence process.

Below are 10 practice tips for counsel participating in due diligence for a securities offering in the United States.

1. ESTABLISH AN ADEQUATE DUE DILIGENCE DEFENSE FOR THE UNDERWRITERS.

While the precise standards under Section 11, Section 12(a)(2), and Rule 10b-5 differ somewhat, in order to establish a due diligence defense (or to negate an inference of intentional or reckless misconduct under Rule 10b-5), underwriters must generally sustain the burden of proving that they:

- Performed a reasonable investigation
- Had reasonable grounds to believe, and did believe, that there were no material misstatements or omissions in the offering documents

The foregoing standard applies to information that has not been expertized. A less rigorous standard applies to expertized information (i.e., information covered by the report of an expert, such as audited financial statements), so long as there are no red flags (as discussed below).

The adequacy of a due diligence investigation depends in part on facts and circumstances and, of course, is always subject to being second-guessed with the benefit of hindsight. The scope of a due diligence review is typically determined by, among other things, the type of:

- Issuer
- Security being offered
- Offering

This is consistent with case law and Rule 176 (17 C.F.R. § 230.176) under the Securities Act, both of which inform the adequacy of a due diligence review.

2. CONSIDER HOW THE TYPE OF ISSUER AFFECTS THE SCOPE OF YOUR DILIGENCE PROCESS.

Factors relating to the issuer, such as its size, operating history, results of operations, financial condition, prospects, industry, and domicile, are among the most important factors in determining the scope of a due diligence review.

For example, a recently established emerging growth company undertaking its initial public offering (IPO) will require a higher level of scrutiny than a well-established issuer with a large market capitalization issuing investment grade debt securities. Similarly, issuers engaged in certain industries (e.g., the mining industry) face risks that are particular to its industry and sector, and may also have specific industry disclosure obligations under the Securities Act and the rules thereunder.

In cross-border offerings by non-U.S. issuers, you will often work with local counsel in the issuer's home jurisdiction to conduct diligence. If the offering is made primarily in a non-U.S. jurisdiction, although your diligence obligations will typically be the same, it may be necessary to take a supplementary role in the diligence process led by local counsel to ensure that the diligence inquiry complies with U.S. standards.

3. ALSO CONSIDER HOW THE TYPE OF OFFERING AND THE ISSUER'S OFFERING HISTORY AFFECTS THE SCOPE OF YOUR DILIGENCE PROCESS.

Different offering types warrant different diligence processes. For example, an IPO almost always calls for a substantially more comprehensive investigation than an equity (or debt) offering by an existing SEC-registered, investment grade issuer with a stable business that frequently accesses the public capital markets. In addition, if you performed a due diligence investigation of the issuer in connection with a recent offering, your review typically can be limited to subsequent materials, thereby reducing the diligence materials that need to be reviewed and shortening the time needed to complete your investigation.

4. INVESTIGATE RED FLAGS

The term red flag refers to something that questions the accuracy and reliability of information and creates a warning that something may be amiss with the issuer.
If you encounter a red flag, you should:

- Run the issue to ground through additional diligence procedures
- Determine if it represents a material undisclosed issue
- If it is material, disclose it appropriately in the offering documents

The underwriters and their legal counsel should always be on the lookout for factors that could be characterized as red flags, such as disputes with auditors (including the auditors being fired or replaced); restatements of financial statements; going concern qualifications or emphasis of matter statements in the audit report (the latter of which are typically added to draw attention to matters of importance for understanding the financial statements); the loss of material contracts and new competitive threats to the issuer (or its industry); and changes in management or the board of directors outside of the ordinary course, among other things.

5. PARTICIPATE IN BUSINESS AND AUDITOR DILIGENCE MEETINGS AND CALLS

To develop a general understanding of the issuer's business, results of operations, financial condition, strategy, and prospects, you will participate in business and auditor diligence meetings or calls. The underwriters, together with their counsel, typically prepare a list of business and auditor due diligence questions. If particular issues have been identified as the result of documentary or other diligence procedures, these can be added to the diligence questions. The initial full-scale due diligence sessions will be supplemented by bring-down calls with the issuer and in certain cases the auditors at appropriate times during the offering process, such as immediately before launch, pricing, and closing.

Prior to preparing or commenting on business or auditor diligence questions or preparing the due diligence document request list (as discussed below), you should become familiar with the issuer and its operations by reviewing its SEC filings (for SEC-registered companies), other available disclosure documents (such as private placement or bank syndication memoranda), issuer-specific and industry analyst reports (again, typically only for public companies in respect of issuer-specific reports), and the issuer's website, particularly its financial reports, press releases, and, if applicable, investor or analyst presentations. It can also be helpful to search the Internet for information about the issuer and to set up news alerts from services such as Google or subscription base providers so that you are notified of events affecting the issuer during the offering process and, for frequent issuers, between offerings.

If the issuer has undertaken a recent acquisition or if any such acquisitions are pending or probable—particularly if target company financial statements (and/or other target company disclosure) are required to be included in the offering document—it will be necessary to conduct appropriate due diligence in relation to the target company, including a session with the target company auditors.

6. REVIEW DOCUMENTS OF THE ISSUER AND ITS SUBSIDIARIES

In most offerings, counsel to the underwriters will submit a document request list to the issuer and its counsel, which is typically updated during the offering process. The purpose of documentary review is to confirm that all material information related to the issuer is adequately disclosed in the offer document.

The documents reviewed are generally extensive, but the request should be tailored to the issuer's circumstances. At a minimum, documents reviewed typically include:

- Organizational documents
- Board and committee minutes and presentations for the issuer and its subsidiaries
- Directors' and officers' questionnaires
- Material agreements
- Financial Statements
- Finance documents and other material debt instruments
- Corporate policies and procedures
- Documents relating to compliance with applicable laws and regulations, including the Sarbanes-Oxley Act and anti-corruption laws (e.g., the Foreign Corrupt Practices Act, Office of Foreign Asset Control (OFAC) rules, anti-money laundering rules, and, if applicable, similar foreign laws)
- Accountants' letters to management and management responses

- Attorney's litigation letters to accountants
- Litigation files of the issuer and its subsidiaries
- Tax filings and related matters

You should determine how far back diligence should be conducted. This can be a short period if you recently participated on an offering by the issuer or as long as five years (plus any stub period) if you are completing diligence in the case of an IPO or for an infrequent issuer.

Additionally, you should determine how you will memorialize your legal diligence review. Some firms follow the practice of writing extensive memoranda summarizing the contents of the documents they reviewed. Others may simply retain a list of the diligence calls/meetings they attended and documents they reviewed.

Especially in the case of issuers new to the capital markets who may not be familiar with the documentary due diligence process, you may need to help the issuer organize and execute their response to a request for documents. To the extent possible, you should encourage the issuer to use electronic or virtual data rooms to keep travel time and costs down. If you are simply updating the diligence that you conducted nine months ago, it may be possible to achieve the same result by having the issuer email documents to you or place such documents on a secure file sharing platform. Certain issuers may not be willing to do this for board materials and other sensitive documents.

7. WORK WITH THE ISSUER AND ITS AUDITORS TO OBTAIN A COMFORT LETTER

You will request that the issuer's auditor deliver a letter that is intended to provide the underwriters with assurances (i.e., comfort) on the following four primary areas:

- The auditor is independent.
- The relevant financial statements have been audited or reviewed, and any interim financial statements have been prepared on the same basis as the audited annual financial statements.
- The financial information contained or incorporated by reference in the offering documents has been accurately derived from the issuer's financial statements or accounting records.
- There have been no adverse changes in specified balance sheet items from the date of the issuer's most recent audited or reviewed financial statements to a cut-off date (typically a few business days before the date of the comfort letter) and, from the date of such financials to the cut-off date, there have been no adverse changes in specified income statement items compared to the same period in the prior year.

For non-U.S. issuers that do not prepare and publish quarterly financial statements, but instead publish yearly financial statements (which are customarily audited) and half-yearly interim financial statements (which are customarily reviewed), issues will often arise if the comfort letter is to be delivered more than 135 days following the balance sheet date of the issuer's most recent audited or reviewed financial statements. In such cases, the auditors may not be able to deliver a comfort letter with a standard negative assurance statement in relation to this "change period," which may be unacceptable to the underwriters and which, in turn, may require enhanced due diligence procedures in respect of the financial disclosure in the offer document.

You should ask for a draft of the comfort letter early in the process to ensure that key items are covered. Underwriters' counsel will typically deliver a circle up of the offering documents and incorporated documents indicating the data they would like covered by the comfort letter. Comfort letters are typically delivered at the time of the pricing of an offering and updated at closing in a short form bring-down letter (i.e., updating the auditor's procedures and stating that nothing has changed since the original comfort letter or listing what has changed since then).

If the issuer has switched auditors recently, you may need to, in addition to determining if the switch constitutes a red flag, request a comfort letter from the former auditor (as well as the current auditor) to the extent that financial statements prepared on the former auditor's watch are included in or incorporated by reference in the offering documents. A diligence session may also be required with the prior audit firm (in addition to the diligence session with the current audit firm).

In addition, if a significant mergers and acquisitions transaction has occurred or is pending or probable, and financial statements for the target company are included in the offer document, it will generally be necessary for a comfort letter to be delivered by the target company's audit firm.

8. WORK WITH THE ISSUER TO PROVIDE BACKUP FOR INFORMATION CONTAINED IN THE OFFERING DOCUMENTS

You should submit backup requests to the issuer to verify industry statistics, market share data, demographic data, and similar data included in the offering documents or the incorporated documents. Backup data requested may also include other financial or statistical information about the issuer that the issuer's auditors are not able to cover in the comfort letter.

As in the case of the comfort letter, counsel for the underwriters prepares a circle-up of the disclosure and incorporated documents indicating the items for which backup is requested. An alternative approach is to prepare an Excel or Word table that lists each requested item and leaves spaces for responses by the issuer.

9. SUPPLEMENT THE DUE DILIGENCE INVESTIGATION THROUGH OFFICERS' CERTIFICATES AND OTHER CLOSING DOCUMENTATION

You should request certificates from appropriate officers of the issuer, to be delivered at closing, that certify or attest to matters such as:

- The issuer's organizational documents and good standing
- Board of director and committee resolutions authorizing the offering

- Completeness of the minutes of the issuer and its subsidiaries
- The incumbency of officers signing the transaction documents
- Satisfaction of the closing conditions in the underwriting agreement
- Re-affirmation of representations and warranties in the underwriting agreement as of the closing date

If there is information in the offering document that the auditors cannot verify and that the issuer cannot support through backup from their records or third party sources, you may wish to consider adding such matters to the above referenced officer certificate, or requesting a separate certificate from the chief financial officer of the issuer attesting to the accuracy of such information.

10. OBTAIN APPROPRIATE LEGAL OPINIONS AND NEGATIVE ASSURANCE STATEMENTS

Issuer's counsel is typically required, as a condition precedent in the underwriting agreement, to deliver opinions on:

- Corporate matters such as:
- The corporate existence of the issuer and its material subsidiaries
- The issuer's capitalization (for IPOs and other early-stage companies)
- The accuracy of any regulatory, and similar disclosure in the offering documents
- Transactional matters such as:
- The issuer's authorization of the transaction
- The validity of the securities being sold and the transaction documents
- The accuracy of the tax disclosure, the description of the securities, the plan of distribution or underwriting section, and the transaction documents, in each case as contained in the offering document
- Compliance with or exemption from the SEC registration requirements (if a non- SEC registered deal), and compliance of the registration statement and prospectus (if SEC registered) and any SEC filings incorporated by reference into the offering documents with SEC form requirements
- The absence of a requirement for the issuer to register under the Investment Company Act of 1940
- Consents and filings for sale of the securities having been obtained or made
- The transaction not contravening or contradicting any of the issuer's material contracts or organizational documents or specified laws or regulations

Underwriters' counsel typically delivers a legal opinion that covers some but not all of these matters.

In addition, both issuer's counsel and underwriters' counsel are typically required to deliver a negative assurance statement to the underwriters, which may be contained in a separate letter or included in the letter containing their legal opinions. Negative assurance statements confirm that nothing has come to counsel's attention to cause it to believe that the offering documents contain or incorporate by reference any untrue statement of a material fact or omit to state a material fact necessary to make the statements therein, in the light of the circumstances under which they are made, not misleading. Negative assurance statements routinely carve out financial statements, other financial information, and sometimes statistical information, as well as certain other expertized information such as reserves statements for mining companies. Negative assurance statements are not legal opinions of counsel; instead, they are statements of belief based upon certain specified procedures undertaken by such counsel in connection with the preparation of the offer document, as described in the letter.