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Due Diligence in the Digital Age: What We've Lost

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M&A professionals of a certain vintage fondly recall the due diligence trips of their youth. These offered the enthusiastic M&A warrior the opportunity to visit cultural meccas such as warehouses in Orlando, tanneries in upstate New York and nameless office parks across the Midwest. With a plane ticket in hand, young law firm associates would be transformed into members of an elite cross-disciplinary strike force including accountants, bankers and clients.

The target was the data room—this citadel would be guarded by a young Harvard Business School banker posing as a well-dressed librarian, checking documents in and out on a sheet clamped to a clipboard and watching over the data room prisoners. For the lucky ones, a visit to the company's offices and filing cabinets might be in store. Imagine the excitement of a young associate facing a wall of file drawers and being told "what you need is in there." Hours of sifting through hundreds of badly labeled folders to find unexecuted or incomplete documents followed. Copying of documents was not allowed, and phones back then did not take pictures, so the young professional had to read as fast as possible and focus only on what was important.


Credit: astevecoleimages/iStockphoto.com.

There were highlights in this process. One was the camaraderie of the team members at the end of the day. While the lawyers may have longed to bill hours all night, the guardians of the data room usually took a dim view of this. At closing time, well-organized clients would download with the team. Each of the reviewers, no matter how junior, would offer their commentary to the group. Listening to the reports, law firm associates would have the opportunity to hear about valuation models, tax returns and financial statement issues. The client would receive immediate feedback on the issues of the day and instruct the group's activities for the day to come. At the end of it all, the group could enjoy the best local food and drink available and bond for a few hours before it started all over again.

Fast forward 20 years…

The in-person data room is now extinct. Intralinks Dealspace and its kin are the new rulers of the virtual diligence realm. The new realm has its advantages, including better organization of documents, no travel expense and presumably fewer expenses and wasted "down time." The M&A professionals are now free to work at diligence at their own pace, in their own offices or homes and at all hours of the day and night.

However, virtual due diligence comes with some often-unacknowledged downsides. Consider the following:

• ***Out of Focus:*** In the past, data room participants often sat together, without computers, and did not take calls or respond to emails during data room hours. The time with the documents was limited and they were the sole focus during the day. Now, associates must multitask on several transactions and competing demands during the day. The presence of computers (and privacy) also introduces other potential distractions.

• ***Out of Touch:*** In the data room, multiple opportunities to connect with clients and financial and accounting professionals arose during the day. Questions and concerns could be addressed in real-time in conversation. Now, there is a greater risk that concerns are held back for a final report.

• ***Out of Order:*** Documents could not leave the data room and mindless summaries were not an option due to time constraints and writing or typing fatigue. Now, the ability to review hundreds of documents on command, at any time of day or night, lessens the need to prioritize and not waste time.

• ***Out of Time:*** Less exposure of junior lawyers to other diligence participants (bankers, lawyers, accountants, clients) is driven by today's cost pressures and increasing specialization in the legal field. We have lost the "town square" for communication that was the diligence trip. While it may seem cost effective to have a team member only spend time with his narrower area of expertise, losing the big picture lessens the overall quality of the work and lessens the ability to focus on the most important issues.

• ***Out of Context:*** With electronic media, it is easier to "cut and paste" excessive amounts of uninteresting, routine material into a diligence report. This material has the tendency to bury what is important.

• ***Out of Bounds:*** Working with a group in a data room means that a collective direction can be taken. A junior lawyer can easily "get lost" in the woods of a virtual data room. Given that the professional is sitting in her office, alone, it is less likely that someone will notice that she has gotten lost in a timely manner.

Despite some reservations, the virtual diligence model offers efficiencies, better access to information and is here to stay. Accordingly, we all need to recognize and address the downfalls. I'd like to share a few suggestions that I have found helpful:

• ***Understand the Plan:*** All members of the team must ensure they understand not only the basic deal structure, but also why the client wants to do the deal and what is planned for the business post-closing. How will synergies or growth be achieved and what needs to change in the current business to make this happen? If no one explains this to you, please ask.

• ***Know the Valuation:*** It is never too early for younger lawyers to start learning the basics of accounting and valuation. The diligence team needs to set materiality thresholds understanding the multiples of revenue and/or EBTIDA that the client is paying. In a 9X EBITDA transaction, not unusual in today's market, an undiscovered million-dollar expense item becomes a $9 million valuation issue. Don't be the team that misses this issue, or worse, sees it but doesn't understand its importance.

• ***Scope the Work:*** Before the whole team dives into the virtual data room, before a single document is reviewed, a work plan needs to be agreed on with the client. Is any outside help needed to review data room materials? Are languages or areas of law not covered by the firm presented in the data room? These issues should be addressed on day one. For clients frequently engaging in M&A, a standard diligence scope expectations document can be maintained and provided to outside counsel.

• ***Hold Team Meetings:*** Periodic team meetings should be scheduled at the start of the diligence process. The meetings can provide a framework for checking that sufficient progress is being made, and to provide and adjust direction midstream. Findings can also be reviewed in a format that encourages real-time questions and answers.

• ***Communicate Informally, Frequently:*** Supervising attorneys should check in more frequently with team members performing diligence to minimize wheel-spinning, answer questions as they arise and provide clear direction. More frequent contact between client and outside counsel (in advance of the delivery of a diligence report) is also a good idea. Pick up the phone and chat about updates on a more frequent basis. If a serious item arises, the outside lawyer should send an email right away with a summary so that the client can circulate it to others internally.

• ***Stay Abreast:*** Know what other professionals are finding in their diligence and how it ties in to your part of the job. Ask to see the tax, accounting and any other relevant due diligence summaries. The senior lawyer should ensure that, in turn, legal findings are fully reviewed and understood by the persons performing finance and accounting due diligence.

• ***Don't Summarize:*** The most common issue with diligence reports is that they regurgitate summaries of documents reviewed without applying the facts to the client's deal structure, post-closing plans or valuation model. Don't summarize, explain "why" something is important and how problems can be fixed. Clients can help to avoid this issue by providing their diligence report expectations up-front.

• ***Explore Technology:*** Some downsides of the virtual data room can be overcome by other technology. While a virtual data room can create the risk of attorneys "getting lost" in a sea of immaterial agreements, search tools can be a life saver (think store leases or customer subscription agreements). Kira Diligence Engine provides a search engine and contract term aggregation tool that saves on manual review time. Everyone's goal should be to spend the diligence hours in the budget to analyze the impact of contracts on a client's business plan (explaining the "why") rather than in preparing summaries. Other tools can lessen the risk of virtual data room isolation by facilitating communication among team members, allowing reports and documents to be shared and annotated securely among internal and external team members. The leading provider of board portals, Diligent Corporation, recently introduced its Diligent Teams product, with exciting potential future application in M&A transactions.

While the virtual data room has changed the landscape of diligence dramatically over the past decade, it is important to remember "how things used to be" and to try to replicate the best of the past. As legal advisors with ever quicker and better access to data, we need to resist the temptations of information overload. We must not function as mere reporters of legal terms – this job, ultimately, will be performed by technology – but as analytic, value-additive team members who support the client with our legal expertise in the valuation and business planning process.

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