Avoiding Due Diligence Pitfalls In Direct Deals

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A growing number of family offices and other investment managers are making direct investments in deals that would once have been the sole province of private equity firms, including control buyouts and growth transactions in companies and real assets. The direct investment trend is motivated by several factors, including the potential for higher returns and lower management fees than may be available in traditional PE investments, and the ability to have more control over the way investments are managed and to take a hands-on role in creating value. Whatever the reason, family offices and other investors are increasingly "going direct" — whether on a solo basis, by pooling resources in networks with other similar investors, or by co-investing alongside PE firms.

While direct deals present significant opportunities for investors, they also pose specialized challenges with respect to such areas as tax considerations, transaction structure, valuation and other critical deal elements. Based on our experience providing advice to family offices, PE firms and other investors, legal advisers and others conducting due diligence on private deals should be alert to various often-overlooked aspects of such transactions. While not an exhaustive list, the following is a brief summary of some issues relevant to private deals.

Tax-Efficient Structures

Historically, buyouts have often been structured as C corporate acquisitions. However, provisions of the U.S. tax code may make it more advantageous from a tax perspective to structure a transaction as the purchase of a partnership interest rather than using a corporation to acquire investments that are not in C corporate structure. In such cases, the acquisition price in excess of original tax cost may be amortized over 15 years, yielding a tax benefit that can be used to offset tax liabilities and result in more current after-tax cash flow to the partners. In essence, by not using a C corporate structure the acquirer can avoid a potential double taxation situation as well as a deferred tax liability on current cash flows.

GAAP Reporting and Valuation

In order to support a realistic valuation of the company or assets being acquired, investors in private deals need to review extensive documentation, including quarterly financial statements prepared in accordance with generally accepted accounting principles (GAAP), as well as annual budgets, tax returns and other materials. If the acquisition target does not have a track record of GAAP reporting, it could be difficult to arrive at a fair value for the assets. While it will be necessary for an acquiree to provide GAAP financial statements, valuing private entities remains a complex and challenging endeavor. Thus, having relevant comparable transactions, especially involving publicly traded companies if possible, will be another aid to valuation.

Relatedly, legal advisers should seek the input of tax and accounting experts as to how transactions are structured and described in deal documents in order to provide the correct accounting treatment. For example, it may be advantageous to the buyer to structure the deal to achieve a tax-basis step-up, which should be considered prior to and during the negotiations between the seller and the buyer. An example would be where a C corporation with a significant amount of losses in excess of the purchase price wants to sell — the buyer has to determine whether it would be better to buy the assets and get a step-up as well as a premium on an exit, or buy the corporation whose losses may be limited under Section 382 of the Internal Revenue Code.

Additionally, if the acquisition is accomplished using the structure of an alternative investment vehicle (AIV), that may have significant consequences. For example, if one invests in a flow-through for tax purposes, but some of the investors do not want effectively connected income (ECI), the solution would be to form a corporation for those investors to invest through. Their investment may be in the form of both debt and equity into the corporation.

Hidden Liabilities

In some cases, a private transaction will result in an investor receiving warrants or other derivative instruments issued by the acquiree. While it may seem logical to treat such derivative instruments as equity, they may in fact be treated as liabilities on the financial statements of the acquired company. Investors and their advisers should be aware of how such instruments are treated for accounting purposes. This can become a particularly difficult issue later on, when the investor(s) want to sell the investment, as these derivatives can become very expensive to settle and might have to be canceled or amended before the sale can proceed. One of the ways to alleviate the liability issues with warrants is to eliminate terms in the warrant agreements that provide for variable settlement.

Another overlooked liability may reside in the "golden parachutes" of senior executives of the acquired company. Depending on the terms of such agreements, the acquisition of a company by investors could constitute a change-of-control event and trigger a charge to the investors.

Custodial Rule Compliance

A family office or other investor that is structured as a registered investment advisor (RIA) must comply with U.S. Securities and Exchange Commission requirements relating to custody of client funds, securities or other assets. That is, if an RIA is

deemed to have custody of such assets, it must use a “qualified custodian” (such as a bank or registered broker-dealer) or be subject to a safekeeping agreement. Thus, investors in any fund or entity created by the RIA for the purpose of a direct deal should be sure that the proper custody requirements are being met.

In our experience, other deal-related elements that may not receive enough attention during due diligence include an in-depth review of contracts and royalty agreements, as well as sales projections. Compliance also can be a risk-prone area, and investors or their legal advisers should review the acquiree’s compliance manual, employee handbook and related documentation.

There are many more areas of due diligence that could become “hot button” issues in a private deal. The solution is for investors to assemble a due diligence team with the collective legal, tax, accounting, operational and industry-specific expertise to thoroughly vet the investment, and to enable open communication among the members of that team.

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