Nothing To Be Afraid Of:
Underwriter Due Diligence in U.S. Registered Offerings of German Companies

Introduction

From 1995 to 2002, nearly 30 German issuers were listed on the New York Stock Exchange and the NASDAQ. While more than two-thirds of those issuers have since delisted and deregistered, the number of German issuers – particularly those with a technology focus – considering a U.S. registered securities offering has increased in recent years, partially due to the enactment of the U.S. Jumpstart Our Business Startups Act (the "JOBS Act"), which made the U.S. public offering process relatively more attractive to foreign issuers. This increase warrants a closer look at an important procedural aspect of every U.S. registered securities offering: the due diligence investigation undertaken by the underwriters.

Similar to German public offerings, an underwriter for a U.S. registered offering performs a due diligence investigation of an issuer and its business to develop the equity story based on which the securities are to be sold, as well as to refine the underwriter's valuation of the issuer. Due diligence also forms the basis for drafting accurate disclosure in the registration statement and prospectus for an offering. Finally, due diligence and the so-called "due diligence defense" (further explained below) help an underwriter to avoid civil liability for claims raised by investors under the U.S. securities laws.

Liability Regime under U.S. Securities Law and the Due Diligence Defense

In a U.S. registered securities offering – including offerings of foreign issuers – the participants are subject to liability under the U.S. Securities Act of 1933, as amended (the "Securities Act") and the U.S. Exchange Act of 1934, as amended (the "Exchange Act"). This liability regime does not differ significantly from the liability regime applicable in Germany under the German Securities Prospectus Act (*Wertpapierprospektgesetz*).

Liability under the Securities Act and the Exchange Act varies, but it generally attaches to offering participants when any part of the registration statement (or prospectus or oral communications used to offer or sell a security) contained an untrue statement of a material fact or omitted a material fact necessary in order to make the statements therein, in the light of the circumstances under which they were made, not misleading. The underwriters and other offering participants (excluding the issuer), however, have the availability of the due diligence defense, the requirements of which vary depending on the liability provision under which a claim is brought:

- In order to establish the due diligence defense under the Securities Act, an offering participant must essentially show that it did not act negligently. While the standards for this differ slightly depending on whether or not the alleged misstatement concerns an expertized part of a registration statement (such as the audited financials and accountants' report), offering participants must show that they conducted a "reasonable investigation," had a reasonable ground to believe and actually believed that the statement was true and that there was no omission of a material fact. The standard required is that of a "prudent man in the management of his own property."

- In order to establish the due diligence defense under the Exchange Act, an offering participant must meet a less stringent "gross negligence" standard, which will be

satisfied if appropriate due diligence has been exercised and the offering participant did not act intentionally or recklessly with regards to the alleged misstatement.

Conducting appropriate due diligence can similarly provide a defense under the "blue sky" laws of the various U.S. states, which also regulate the offering and sale of securities to protect the public from fraud.

Accordingly, conducting thorough due diligence is of paramount importance to the underwriters and forms a cornerstone of their risk management. By the same token, the underwriters' due diligence can be equally important to an issuer and its directors, who will also benefit from the process because the parties' interests are largely aligned. Last but not least, as part of the underwriters' due diligence, the law firms advising on a U.S. registered offering are expected to issue a "10b-5 Opinion" to the underwriters, confirming that nothing has come to their attention which causes them to believe that the registration statement, prospectus and other communications with respect to the offering contain an 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 were made, not misleading. This opinion can be given only after the law firms have conducted adequate due diligence of the issuer and meticulously reviewed the disclosure in the offering documents.

The Due Diligence Process and Establishing the Due Diligence Defense

In the capital markets context, due diligence refers to the process of obtaining, reviewing and analyzing information concerning the issuer in connection with an offering. However, there is no "one size fits all" due diligence process. Rather, due diligence is an art, not a science, and the time and effort required varies on a case-by-case basis.

The underwriters' due diligence aims at better understanding the issuer's business, strengths and risks in order to, together with the issuer, develop its strategy and solidify its equity story. The scope, focus and approach of due diligence depends on the details of the issuer's business, industry, technology, stage of development, shareholder structure and international operations. For example, an earlier stage biotechnology issuer operating within a dense regulatory framework and planning to use the offering proceeds to fund its further product development and drug approval process will require a different due diligence process than an established clean technology issuer operating renewable energy parks in Europe and planning to enter the U.S. market through acquisitions abroad. In the first example, the focus might be on IP and proprietary rights, the issuer's freedom to conduct its business and the regulatory framework in which the issuer operates. In the second example, the issuer's experience with acquiring, developing and operating renewable energy parks, as well as its supplier relationships, might be the focus. In both scenarios, however, due diligence ultimately enables the underwriters to better prepare the issuer for the offering process and allows them to get to know the issuer's management team, which significantly contributes to the success of the offering. The underwriters will also closely review and test the issuer's business plan, financial projections and underlying assumptions to confirm and further refine their valuation of the issuer.

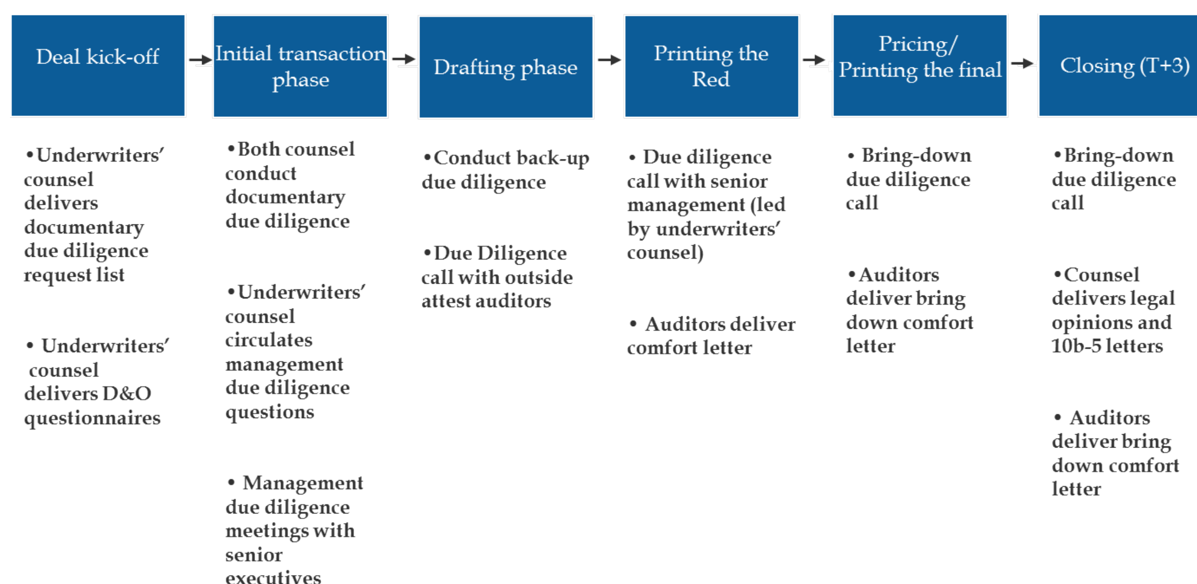
While not as common in German offerings, it is standard practice in U.S. registered offerings for underwriters, as part of their due diligence, to contact an issuer's key customers (and, to a lesser extent, suppliers) in order to verify certain information relating to their relationships with the issuer. While customers are often willing to participate in such calls, this requires a

careful selection of the business partners to contact and a cautious approach, so as not to alert third parties of the pending offering and its details.

In order for underwriters to show a "reasonable investigation" and establish the due diligence defense, a number of standard measures are typically implemented. Because a reasonable investigation requires independent verification, underwriters cannot simply rely on management's representations or materials prepared by the issuer, but must rather make a reasonable effort to independently verify any information received or offered. This means investigating sources outside of the issuer (*e.g.*, obtaining comfort letters from auditors and speaking with customers, suppliers, lenders, accountants, counsel and other advisors). It can also mean investigating sources other than management within the issuer, such as by speaking with employees, reviewing internal documentation and conducting site inspections. The extent of the due diligence required varies depending on the circumstances, as well as the specific requirements of the underwriters. However, its scope should not surprise German issuers, as it has much in common with similar processes that are required in Europe, especially in the M&A context.

Overview and timeline

The various stages of due diligence in a U.S. registered securities offering, from commencement until closing, may look like the following:



Documentary due diligence

Documentary due diligence consists primarily of reviewing documents (*e.g.*, corporate documents, contracts, correspondence and other business documents) assembled in an online data room by the issuer and its advisors covering the last three years and the interim period through the closing of the offering. The underwriters and their advisors, as well as advisors to the issuer, expect these documents to be assembled and structured in accordance with a due diligence request letter, which tries to comprehensively list all documents that could possibly exist, with a view toward addressing all disclosure and risk assessment questions related to the issuer. While German issuers may at first be overwhelmed by and find such requests

overreaching, it must be remembered that the request significantly helps to structure and tailor the scope of the due diligence process by helping to distinguish material from immaterial information. For example, legal counsel to the underwriters typically analyzes which subsidiaries of the issuer are to be considered material for purposes of the offering (and, accordingly, for which subsidiaries information must be provided) and attaches a minimum value to contracts and assets below which no information must be provided. Furthermore, the mere existence of the request is part of the due diligence process, since it serves as a reminder to tick off certain questions which must be asked. Ultimately, the number of documents to be produced is much less dramatic than initially feared by the issuer. Documentary due diligence can also extend to the issuer's website, analyst reports (if any), strategic documents and marketing literature.

The purpose of documentary due diligence is to establish that the issuer's organizational documents, material contracts, permits, etc. are in proper order to ensure that the offering will not violate any laws, regulations or material contracts, as well as to gather information for the drafting process and serve as a basis for factual statements in the offering documents. It must be ascertained, *inter alia*, that the corporate governance documents and supervisory board composition of the issuer will comply with the governance rules applicable to companies listed on a U.S. stock exchange (this is an area to be addressed early in the process, as there are several differences between German and U.S. exchange requirements). Particular emphasis is placed on the review of board minutes, notes to financial statements, outstanding debt and existing securities granted, material contracts, auditor correspondence and accounting and third-party issues. If a "red flag" (*i.e.*, anything that raises questions or calls for further explanation) is discovered, additional investigations will follow until a satisfactory explanation has been provided or adequate risk disclosure has been incorporated into the offering documents.

If certain specialist areas, such as compliance with sanctions, anti-bribery and anti-money laundering laws, environmental, intellectual property or taxes, are important to the issuer's business, legal specialists may need to be involved. In light of U.S. laws on foreign trade, trade sanctions, corrupt practices and anti-bribery, which tend to be stricter than their European equivalents and often have a global reach extending to acts outside the United States, this may be an area of particular importance during due diligence. Where compliance of an issuer or its intermediaries, agents or consultants with the requirements under the U.S. Foreign Corrupt Practices Act (the "FCPA") is concerned, due diligence can become more complex. Equally sensitive are questions of compliance with the rules and regulations issued by the U.S. Office of Foreign Asset Control ("OFAC"). OFAC administers and enforces various economic sanctions programs against specifically designated countries, individuals and entities. While OFAC's embargo rules apply only to "U.S. persons," this term has been broadly interpreted and may include a foreign issuer with a presence or business dealings in the United States. OFAC's embargo rules also prohibit underwriters from assisting on transactions with an issuer who violates such rules, and U.S. banks may be sanctioned for a violation even if they were not aware of its existence. This is why there can be particular due diligence emphasis to ascertain OFAC compliance. This article does not purport to address these specific compliance areas, which warrant a separate publication. While trade sanctions and corrupt practices laws may not be an issue for most German issuers, it is important for all foreign issuers to bear these areas in mind when anticipating a due diligence investigation, especially if the issuer has a global presence.

Management due diligence

During management due diligence, the underwriters and their legal counsel meet and speak with the issuer's management to learn about the issuer and its business. These meetings are typically preceded by lists of questions that cover areas such as business and operations, industry and competition, strategy, acquisitions and dispositions, properties, management and employee matters, litigation and legal matters and financial and accounting matters. Most U.S. registered offerings commence with a live meeting with management and later feature "bring-down" calls with management to confirm diligence matters at the time of pre-marketing, launch, pricing and closing.

As part of management due diligence, as well as to comply with certain U.S. regulations, directors' and officers' due diligence questionnaires ("D&O Questionnaires") drafted by underwriters' counsel must be completed and signed by the members of the issuer's management and supervisory boards. D&O Questionnaires ask for certain information on each board member, including his current and former positions and a description of any business dealings with the issuer. Such D&O Questionnaires are similar to questionnaires used in German offerings to confirm certain requirements under the European Prospectus Directive.

Financial due diligence

Financial statements and other financial information are a central part of the offering documents and the offering. Although they are expertized sections of the registration statement, underwriters' reliance on audited financial statements "may not be blind," and any red flag concerning the reliability of this information imposes investigative obligations.

Financial due diligence focuses on receiving appropriate comfort letters from the issuer's independent registered public accountants, which form a critical part of the underwriters' "reasonable investigation." The purpose of such comfort letters is to evidence that the financial information in the offering document is accurate, has been independently verified and that there have been no changes in an issuer's financial affairs since the last financial statements included in the offering documents. Based on statements in the comfort letters, the underwriters can show that certain numbers used in the offering document came from a reliable source. Comfort letters also help the underwriters demonstrate reliance on experts for the audited financial statements contained in the offering documents and establish a "reasonable investigation" with respect to the unaudited financial statements, pro formas and numbers appearing in the offering documents. In U.S. registered offerings, there generally is only one comfort letter, issued under the U.S. accounting standard for the issuance of comfort letters (the accounting profession's AU Section 634 "Letters for Underwriters and Certain Other Requesting Parties," which is generally referred to as "SAS 72" because it was initially issued as Statement on Auditing Standards No. 72). In European offerings with an international element, however, there are generally two comfort letters: one under the German standard IDW PS 910 and another under a SAS 72 "look-alike" standard covering the international private placement tranche of the offering.

Another element of financial due diligence is conducting interviews with the auditors, who participate based on their knowledge of the issuer. Establishing auditor independence is typically not an issue in German offerings and is usually covered by a few targeted questions. In U.S. registered offerings, however, there is much more emphasis on this aspect, and establishing auditor independence in accordance with the applicable provisions of the U.S.

Sarbanes-Oxley Act of 2002 and the requirements of the Securities and Exchange Commission (the "SEC") regarding auditor independence frequently requires extensive analysis.

Statistical information

Due diligence extends to the disclosure in the offering documents on statistical information, which requires looking "behind the data." To ensure the accuracy of the statistical information in the offering documents, "back-up" due diligence is undertaken, which requires the issuer to provide back-up support for the statistics used and to explain how it reached conclusions in the supporting data. Of particular importance is the verification of the accuracy of statements on the issuer's market position with third-party sources.

Internal processes and controls

Another important aspect subject to due diligence (often through management interviews) is the internal processes of the issuer, as well as its internal and group reporting and the adequacy and effectiveness of risk control mechanisms it has in place. After the issuer is public, management will be required to attest to the effectiveness of the issuer's internal controls over financial reporting. During the diligence process, letters from the issuer's auditors are reviewed regarding whether there are any material weaknesses in the issuer's internal controls at the time of the offering. If so, these must be disclosed in the prospectus and the underwriters must diligence management's ability to cure the weaknesses going forward.

FINRA review of underwriter compensation

Although not part of the due diligence process, the review of the underwriters' compensation (as agreed upon in the underwriting agreement among the issuer, the underwriters and any selling shareholders) by the U.S. Financial Industry Regulatory Authority ("FINRA") is of equal importance to issuers. FINRA reviews underwriting terms and other contracts with the underwriters for items of value, applying an "unfair or unreasonable" standard. This review is important because the SEC will not declare a registration statement effective without FINRA's sign-off. In German offerings, there is no such review of the underwriters' compensation.

Advantages of Due Diligence for the Issuer, Including Dual-track Considerations

Despite the significant time and effort that is required of an issuer on the due diligence process in connection with a U.S. registered offering (which is not different than European offerings), an issuer typically benefits from this process. Apart from helping to shield an issuer from strict liability under the U.S. securities laws by allowing for adequate disclosure in the offering documents, the due diligence process often helps discover an issuer's legal issues, risks and weaknesses, which if detected early in the process may be addressed and solved prior to going to the market. Due diligence can also be an opportunity to restructure the information management of an issuer, put it on a new basis going forward and adjust it to be consistent with the requirements of a future public company.

Finally, properly planned and conducted due diligence offers efficiency advantages when the shareholders of an issuer are also contemplating (or not excluding) the possibility of a dual-track process (*i.e.*, running a trade sale process in parallel to a U.S. registered offering). Large

parts of an issuer's due diligence preparation and investigation undertaken for purposes of a U.S. registered offering can also be used for preparing and conducting a trade sale process, as the due diligence information required to enable a reasonable investigation by the underwriters does not differ substantially from the information that potential buyers will expect in order to prepare for an acquisition of an issuer's shares. In a dual-track process with coordinated due diligence, many resources (including third-party reports) can be leveraged, synergies can be achieved and double work avoided. Due diligence in preparation for an offering can at the same time constitute vendor due diligence in preparation for a trade sale. This allows a dual-track process to typically be less costly and burdensome than a failed trade sale process followed by a U.S. registered offering (or vice versa).

Summary

While there are many different approaches and focuses, an underwriter's due diligence investigation of an issuer in connection with a U.S. registered offering does not differ significantly from the investigation that would be done in connection with a German offering. And, while due diligence is undoubtedly a burden on an issuer, a well-prepared, structured and streamlined due diligence process, in line with required standards and U.S. market practice, can eliminate much of this burden.

Having experienced international legal counsel on both the underwriters' and the issuer's side who are able to adjust their approach to the specific situation of the issuer and its business, and who understand the differences between the two legal systems at play and seamlessly coordinate work between the U.S. and German teams, is crucial for keeping an issuer's time commitment to a minimum so it can remain focused on running its business and facing the challenges that a transformational transaction such as a U.S. registered offering presents for a German issuer.

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