

foreclosure may provide the right balance between the buyer's competing concerns.

Assignment for the Benefit of Creditors. In an ABC, the seller assigns its assets to a third party (the assignee) who is then responsible for selling the assets and distributing the proceeds to the seller's creditors (net of the assignee's fee). ABCs are governed by state law and vary significantly from state to state. Depending on a given state's law, an ABC may or may not be an option.

In addition, the fact that an ABC typically requires stockholder approval may also rule out an ABC as an option. While no structure provides absolute protection from a fraudulent transfer allegation, because an ABC involves a sale of the assets by an independent third-party fiduciary, the purchase of assets through an ABC may reduce the risk that a creditor will view the sale process as having been unfair or inadequate and bring a fraudulent transfer claim.

Friendly Foreclosure. In a friendly foreclosure, the secured creditor and the seller agree that the secured creditor will foreclose on the assets and then use its power as secured creditor to transfer title to the assets to a buyer. While the buyer should expect the secured creditor to seek to sell the assets on a purely "as-is, where-is" basis with little in the way of representations and warranties or indemnity, the structure may provide incremental protection against claims made by unsecured creditors and third parties asserting successor liability by virtue of the formal state law foreclosure process.

Dealing With Changed Circumstances

When evaluating acquiring a distressed company, buyers should be prepared for surprises. Frequently, in the course of due diligence, the liabilities will turn out to be greater than initially

thought, accounts receivable will be more difficult to collect than represented and issues surrounding employees will be thornier than anticipated.

This is sufficiently common in distressed company deals that while it should not necessarily be cause for undue alarm, it may well be cause for rethinking how the transaction should be structured. Where it may have initially seemed that the seller was more "troubled" than "distressed" and the buyer was willing to proceed with a more traditional stock purchase agreement, changed circumstances may lead to a conclusion that in fact, a 363 sale, ABC or friendly foreclosure may better balance the competing risks and benefits.

Ultimately, the buyer's objectives in terms of price, liabilities, timing, avoiding competing bids, keeping the employee and customer bases intact, etc., will all have to be taken into account. A buyer will need to remain flexible to preserve its ability to revise the proposed structure to take its diligence into account and to keep its eye on the ball in terms of what it wants to achieve. Similarly, as the larger economic picture continues to change and evolve, buyers should be mindful of any changing circumstances in their own business and whether a potential acquisition continues to be one that remains advisable.

Due Diligence: "That Deal Sounds Too Good to Be True"

**By Mark Jenkins, Senior Managing Director,
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Everyone has heard the saying, "It sounds too good to be true." In 2011, Time magazine provided a list of products through recent history that they

categorized as “The Too-Good-to-Be-True Product Hall of Fame.”⁸

The list included:

The Too-Good-to-Be-True Product Hall of Fame	
Company	Description
Reebok EasyTone Shoes and Apparel	Toned legs and glutes more than regular sneakers
Listerine	Can prevent and cure colds and sore throats
Splenda	Healthier and more natural than sugar
Dr. Clark's Zapper	Kills parasites, cancer and aids with electricity
Airborne	Dietary supplement which fights off colds
Q-Ray Bracelets	Pain relief from arthritis
Dannon Yogurt	DanActive helps prevent colds and flu
Kellogg's Rice Krispies Cereals	Helps support your child's immunity
ExtenZe	Male enhancement
Lydia Pinkham's Vegetable Compound	The product cures "all womanly ailments"
Dr. Koch's Cure-All	"Glyoxylide" could cure practically all human ills including tuberculosis and even cancer
Nivea My Silhouette! Skin Cream	Regular usage reduces consumers' body size
Oreck Halo Vacuum and ProShield Air Purifier	Reduce the risk of flu and other illnesses while reducing virtually all common germs and allergens
Norelco Clean Water Machine	Makes tap water clean or cleaner

Much like the Product Hall of Fame list, corporate acquisitions during the ongoing economic downturn may also reveal targets that sound “too good to be true.” Standard due diligence may not be enough to identify targets that will provide positive future returns with limited risks. Extra steps may be warranted depending on the circumstances.

Luckin Coffee

The recent events at Luckin Coffee provide an example of the potential need for heightened due diligence to address potential downside risks. According to the company’s website, Luckin was founded in 2017 in Beijing and headquartered in Xiamen, China. Luckin’s strategy was to provide discounted coffee through online ordering and for

pickup in small kiosks located on campuses and office buildings throughout China.

Luckin appeared to be a great buy for investors in 2019. According to several Wall Street Journal articles, Centurium, a Chinese private equity firm, created a fund in June 2018 that had invested US\$100 million into Luckin. Over several years, Luckin grew significantly to over 4,500 stores in China. In comparison, Starbucks has 4,292 stores in China. Centurium later added a US\$77.5 million investment in Luckin and was set for a second fund of \$2.5 billion in the first quarter of 2020.⁹ Numerous other high-profile investors invested in Luckin as well.

In early April 2020, however, Luckin announced that it was in the midst of an investigation of top executives due to allegations that the company had inflated revenues by \$310 million in 2019.¹⁰ In January 2020, Muddy Waters Research announced via its Twitter account that it had received an anonymous, 89-page investigative report that described the inflation of sales by Luckin Coffee. Muddy Waters said that it viewed the report as “credible,” and published it on Twitter.

The research underlying the report was extremely in-depth. The report’s authors surveilled numerous stores and developed a system, including video footage, to show that several sales metrics (such as number of items per store, number of items per order and sales price) were inflated.¹¹ Once the allegations and

⁸ <https://business.time.com/2011/10/11/14-products-with-notoriously-misleading-advertising-claims/slide/reebok-easytone-toning-shoes-and-apparel/>

⁹ See *Luckin Coffee Under Investigation by China's Top Commerce Regulator*, WSJ.com (4/27/20); <https://www.wsj.com/articles/luckin-coffee-under-investigation-by-chinas-top-commerce-regulator-11587967299>; *Luckin Coffee's Accounting Scandal Thwarts Backer's \$2.5 Billion Fund*, WSJ.com (4/17/20); https://www.wsj.com/articles/luckin-coffees-accounting-scandal-thwarts-backers-2-5-billion-fund-11587109890?mod=article_inline

¹⁰ Press Release, *Luckin Coffee Announces Formation of Independent Special Committee and Provides Certain Information Related to Ongoing Internal Investigation* (4/2/20); <http://investor.luckincoffee.com/news-releases/news-release-details/luckin-coffee-announces-formation-independent-special-committee>

¹¹ *Luckin Coffee: Fraud + Fundamentally Broken Business* <https://drive.google.com/file/d/1LKOYMPxVolsbWQx8j4G3-strg6mpQ7F/view>; *Chinese Regulators Target Luckin Coffee After Admission Of Fabricated Sales*, Forbes.com (4/27/20) <https://www.forbes.com/sites/ywang/2020/04/27/chinese-regulators-target-luckin-coffee-after-fabricating-sales/#5282b6055610>

ongoing investigation were disclosed by Luckin, the company's stock dropped 80% and Nasdaq eventually halted trading of its shares on April 7, 2020.

Due Diligence: What is Customary?

Situations like Luckin Coffee raise a number of potential questions surrounding the level of due diligence that should be conducted prior to an investment. The investigation in the research report referenced by Muddy Waters certainly went well beyond the scope of due diligence typically engaged in by potential buyers or private investors.

Should potential investors have hired hundreds of people to conduct surveillance on numerous stores? Depending on the amount and the nature of the investment, would that have been practical or even feasible? Would a standard due diligence investigation have caught the alleged issues at Luckin?

While there are many types of due diligence (and I will review a few of them below), Investopedia defines due diligence as: "an investigation, audit, or review performed to confirm the facts of a matter under consideration. In the financial world, due diligence requires an examination of financial records before entering into a proposed transaction with another party."¹² When it comes to conducting this investigation, there are a handful of practices that have come to typify the traditional due diligence investigation. In addition to the customary legal review, other areas or inquiry typically include financial and business due diligence, as well as compliance and "know your target" due diligence.

Financial Due Diligence. Buyers or lenders typically conduct a Financial Due Diligence/Quality of Earnings review of the target entity. The seller may also provide its own due diligence report (usually done by a third party to demonstrate objectivity).

Procedures in a Financial Due Diligence/Quality of Earnings review may include, but are not limited to, the following:

- Financial Statement Analysis
 - Financial statement and/or tax return review including historical and underlying support to verify the information provided to the lender or acquirer is valid and accurate. This is not an audit or compilation of financial statements.
 - Conducting a "cash proof," which validates that a business is collecting the cash and paying the bills as reported in their financial statements.
 - Reviewing earnings adjustments, such as EBITDA, to determine if adjustments are truly one time or ongoing. Example: litigation costs may be ongoing or a one-time event due to a specific case.
- Analysis of Key Metrics and Projections
 - Review of accounts receivable and accounts payable aging to determine if customers are paying and when (and if) the target company is behind in paying its vendors.
 - Review of customer and vendor concentrations to determine if the company is relying on a few customers and vendors or if it has a diversified and consistent revenue / supply chain base.
 - Review of revenue projections and sales pipelines to see if forecasts are feasible.

¹² <https://www.investopedia.com/terms/d/duediligence.asp>

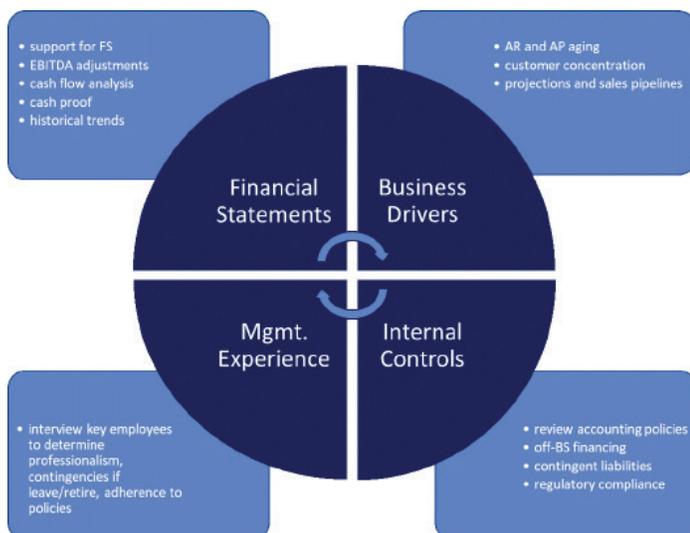
- Interviewing key personnel to obtain a better understanding of management's professionalism and experience, adherence to policies and procedures, and to determine if specific employees are the key to the entity's failure or success. Understanding the corporate culture of a company in an acquisition is critical as the buyer needs to know if the target's attitude concerning internal controls, ethics and compliance are in line with its control environment. In many fraud cases, financial restatements, investor scams, unethical behavior by upper management led to the losses of millions of dollars such as what appears to be "playing out" in the Luckin case.
- Conducting an internal controls review of accounting policies and procedures to determine if there are contingent liabilities, off-balance sheet financing or other risks, including the potential for fraud, waste or abuse. Figure 1 summarizes typical due diligence procedures discussed above.

Non-Financial / Compliance and "Know Your Target" Due Diligence. Financial due diligence is often considered the core component of the due diligence process, but a compliance review is also warranted as part of the overall due diligence procedures to identify adherence to legal and regulatory requirements, particularly in the case of international transactions or those involving highly-regulated industries.

This compliance due diligence includes a review of regulatory policies and procedures.

- In addition to general regulatory compliance, potentially high-risk compliance areas include:
 - o import/export regulations,
 - o FCPA and other anti-bribery regulations (See figure 2 for example procedures)
 - o industry-specific regulations (e.g., healthcare/FDA compliance)
- Failure to adhere to regulatory requirements can be costly and, in some cases, result in disgorgement of profits and potential incarceration of employees. The acquiring company can inherit these regulatory issues and be responsible for fines and penalties, even if they occurred before the acquisition.
- Background investigations on key employees and executive management of the target company are always a good idea and often lead to surprising results. For example, according to the report published by Muddy Waters, one of Luckin's co-founders and its Chief Marketing Officer had been convicted of illegal business operations arising out of conduct at another company that he co-founded.
- Approaching background investigations

Figure 1 Typical Financial Due Diligence Procedures



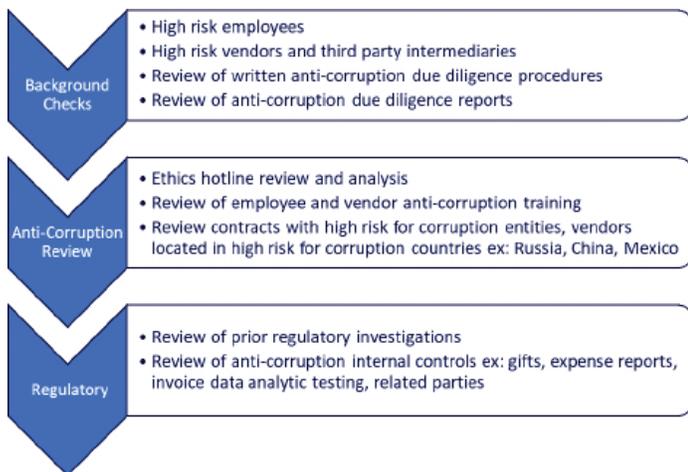
with proper resources is essential. Conducting an independent investigation in foreign countries is difficult in some cases. China is a prime example. Restrictions imposed by the Chinese government on oversight of its accounting firms by foreign regulators and limits on local investigations and public information availability can create significant challenges to background investigations. However, there are vetted firms that provide reliable local research in China, and retaining such firms is often key to obtaining a sound result.

other questions should be answered as part of the process, such as:

- Cash Flow**
 - In reviewing the target's customers and vendors, will there be customer cash collection issues, logistical delays and/or financial cash flow problems with the target's vendors?
- Business Insurance**
 - Does the target have business insurance coverage for any business interruptions, or will the target receive other funds for the temporary economic shutdown?
- Headcount**
 - Currently is headcount sufficient to run business? If layoffs have occurred, has this weakened internal controls and reduced segregation of duties such that fraud is likely to occur?
- Cybersecurity**
 - Are there cybersecurity issues if employees have had to work at home?

Figure 2 shows several anti-corruption procedures for targets that are conducting business in countries that have a high reputation risk for corruption.

Figure 2 Sample Compliance Due Diligence Anti-Corruption Procedures



In the current weak economy, sellers or borrowers might have additional incentives to exaggerate projections, downplay expenses or possibly hide compliance or internal control issues. Along with the above-mentioned due diligence procedures,

Lessons from Luckin Coffee

In the current environment, additional pressure to close deals may lead to overlooking red flags and/or “short cutting” traditional due diligence. Yet while there may have been shortcomings in the due diligence process, investors in Luckin Coffee likely engaged in many of the customary due diligence practices described above.

What the Luckin Coffee situation highlights are important due diligence considerations that go beyond those that might be encompassed in a traditional due diligence investigation. These include:

- The importance of understanding the implications of transparency issues when investing in China and other emerging market countries. As a recent statement by Securities and Exchange Commission Chair Jay Clayton noted, es: “... in many emerging markets, including China, there is substantially greater risk that disclosures will be incomplete or misleading and, in the event of investor harm, substantially less

access to recourse, in comparison to U.S. domestic companies.”¹³

- The importance of due diligence/background checks on the management team and their historical track record in prior transactions. For example, do founders and management team have track record of holding on to their investments in the entities for which they solicited public shareholders or have they cashed out quickly?
- The importance of fully understanding the market demand for a company’s products and its ability to compete with more established players in that market. For example, an important part of an investigation of a company like Luckin involves assessing the market opportunity for a beverage such as coffee in China, as well as the long-term prospects of competing with a dominant player such as Starbucks, which already had over 4,200 stores in China.

At the writing of this article, Luckin appears to have completed its internal investigation and on May 11, 2020, terminated its CEO and COO.¹⁴ Chinese securities regulators and the SEC are also reportedly reviewing the situation. Regardless of the outcome of these investigations, investors face an arduous task in recouping their investment in Luckin Coffee even if it continues operations.

Situations like that facing Luckin illustrate both how critical the due diligence process is and the need to appropriately tailor the due diligence investigation, particularly in situations involving emerging market companies.

This article began with a reference to the old adage, “it sounds too good to be true.” Perhaps we should end with an amended version: “If it sounds too good to be true, conduct proper due diligence, and you should know for sure.”

13 Public Statement, Emerging Market Investments Entail Significant Disclosure, Financial Reporting and Other Risks; Remedies are Limited (4/21/20) <https://www.sec.gov/news/public-statement/emerging-market-investments-disclosure-reporting>
14 SEC Investigates China’s Luckin Coffee Over Accounting Scandal, wsj.com (4/29/20); <https://www.wsj.com/articles/sec-investigates-starbucks-china-rival-luckin-over-accounting-scandal-11588152604>; *Behind the Fall of China’s Luckin Coffee: a Network of Fake Buyers and a Fictitious Employee*, wsj.com (5/28/20) <https://www.wsj.com/articles/behind-the-fall-of-chinas-luckin-coffee-a-network-of-fake-buyers-and-a-fictitious-employee-11590682336>

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