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Introduction and traditional due diligence

1 Introduction and traditional due diligence

CHAPTER OVERVIEW **1.1**

In today's business world, the concepts of due diligence and corporate governance are of increasing importance. Both concepts have broadened as regards their scope and meaning. Indeed their application has also come to overlap as a result of the regulatory and voluntary frameworks that are emerging globally. From purely economic roots they have come to encompass many aspects of corporate behaviour. Moreover, in view of the corporate scandals that continue to attract media headlines and demonstrate the need for improved corporate governance, all organisations – regardless of their size or location – should regard these issues as paramount. An understanding and respect for due diligence and corporate governance make absolute business sense. Moreover in our modern demanding global marketplace, the value of diligence can be demonstrated aptly in the following thoughts and quotations:

> 'Without diligence, no prize' (Ohne Fleiss, Kein Preis), German Proverb;
>
> 'What we hope to do with ease, we must first learn to do with diligence', Samuel Johnson; and
>
> 'The expectations of life depend upon diligence; the mechanic that would perfect his work must first sharpen his tools', Confucius.

Methodology **1.2**

An overview of the traditional approach to legal due diligence is dealt with in this chapter. This handbook takes the approach that the due diligence process is an ongoing exercise. It extends to areas of business activity that go well beyond the transaction/deal with which it is usually associated to embrace many aspects of business operations and performance. However, this chapter will focus in some detail on giving an account of the processes, context and typical aspects of due diligence in its traditional mould, that is, that relating to corporate transactions and particularly merger and acquisition activity. As such, this chapter gives an overview of the legal issues and concepts relating to due diligence in corporate transaction, the process, documentation and some information regarding typical stumbling blocks and tactics. The chapter also begins to flag the route to a view of due diligence through a corporate governance framework (which will be seen to be necessary, given current trends). It concludes with three helpful appendices contrasting typical due diligence steps and a specimen auction or tender process letter.

Definition of due diligence **1.3**

Traditionally due diligence has involved a process of discovery that is relevant in key business transactions, as well as operational activities. As is seen in more detail below, due diligence has become the norm in decision-making as regards:

- joint ventures;
- mergers and acquisitions;
- selecting appropriate partners;
- choosing the right jurisdiction or location;
- buying and selling assets.

In the context of such transactions, highly defined methodologies have evolved, some of which may be found in the sample checklists in **Item 1** of Appendix to this chapter and the Appendix to **Chapter 2**. Historically the process was rather drawn out since it involved the physical examination of extensive documentation on site. More recently the development of technology has brought about effective due diligence that can be much more timely and pressured, involving both Internet and Intranet capability (see **Chapter 9**).

Any search of a law dictionary reveals the meaning of 'due' as payable or immediately enforceable. 'Diligence' involves care, attention and application. In Scottish law 'diligence' also means proceeding for payment. Together, therefore, the words have an interesting emphasis on the enforceability of the process. Having regard to the purpose of due diligence and the evolution of the term, it is no surprise that the legal process has become increasingly comprehensive as regulatory and other business frameworks have developed.

It is essential, however, to set some parameters around the terms that we want to review and analyse. For due diligence, there is an endless variety of related words in the dictionary that we can apply. For the present purpose it is not very useful to set out all of the available definitions, nor to suggest all the legal terms that appertain to due diligence. It is more helpful to propose a few meanings that support the premise in this chapter. For example, Charles Bacon, CEO of Due.Com Group of Companies (a US group providing decision-making software to support due diligence), has defined traditional due diligence as:

> '… mainly a legal and financial course of action, first designed to avoid litigation and risk, second to determine the value, price and risk of a transaction, and third to confirm various facts, data and representations'.

A variation on that definition is to:

> 'Assist management to justify the price of a merger, acquisition, alliance or joint venture by verifying, validating and analysing available data.'
>
> *(Charles Bacon, CEO, Due.Com)*

Due diligence activities, as with everything, need a starting point. If there are talks about a possible merger, each party to the transaction must be willing to commence a due diligence activity. However, this is where the definition of the activity of due diligence can become blurred. In a merger situation, there would normally be a significant amount of due diligence prior to any informal or formal conversation. The diligence required is to determine whether there is enough information that can lead to conversations about a possible merger. Thus the starting point for any due diligence activity is never one single step with a single starting point. Consequently, the actions surrounding due diligence must be adaptable within a framework that places the organisation and its owners, employees and advisers in a constant state of data collection and data organisation that can support whatever process is being started.

Therefore, a third definition of due diligence can be to:

> 'Provide a framework within which organisations can continuously confirm that their actions and transactions are supported by the policies, procedures, and management decision-making methodologies.'
>
> *(Charles Bacon, CEO, Due.Com)*

All companies will perform due diligence in some manner – informally or formally. Of course, larger organisations require a more structured formal approach. Too many people doing everything their own way can create an abundance of data with no information. On the other hand, smaller organisations may do everything informally with no notes, no documentation and a lot of ad hoc decision-making. Within each company, there needs to be an understanding of how due diligence works for the common good. Classically this is the role of management as they set the policies, procedures and culture of the company and how it conducts its business.

US origins **1.4**

In the context of commercial transactions, the term 'due diligence' evidently originated in the USA in section 11(b)(3) of the *Securities Act of 1933*. This section provided a defence of due diligence to those who had made reasonable investigation into matters contained in a prospectus for the issue of securities. This process of evaluation in the USA has been termed 'due diligence' since then. Moreover, its scope has been extended internationally beyond investigations into the accuracy of prospectuses to include:

- any investigation into the acquisition of a company or assets in a commercial context;
- risk analysis in financing;
- general pre-contractual enquiries.

For further discussion of commercial due diligence in selected sectors see **Chapter 6**.

The clear majority of traditional due diligence projects are directed and performed by legal professionals and secondarily by tax and audit financial professionals. It is widely recognised that the legal professional's primary obligation in traditional due diligence concerns the prospective liabilities, and the financial professional's primary obligation concerns the financial data integrity. In the USA, there is a frequently used phrase 'ledgers and liability' that clearly shows this emphasis. Indeed, even in the USA, which has led the way as regards due diligence developments, due diligence is not yet a focus that the educational community has recognised. As a separate discipline, due diligence is not taught in law schools. Within the business education community, due diligence is only covered within the accounting world, typically integrated as an audit topic.

Due diligence in practice
The practice of due diligence has evolved over decades by tradition in the USA. Practitioners comment that not only is it customary to never question whether the foundations of traditional due diligence are sound, but it is a widespread practice to look no further into a prospective acquisition or merger beyond the mere basics.

In the US business community, when a transaction is underway and as the target or the candidate becomes more impatient as the due diligence process gets longer, the reluctance to push for important information also rises. Subsequently the due diligence process is curtailed. As the time lengthens and the costs rise, it becomes easier to justify minimising or even ignoring anything that is more difficult. The reality is that many, if not most, firms suffer from mild to extreme reluctance to consult more qualified outside expertise. Finally, all too often, the deal is done before any real due diligence, traditional or otherwise, takes place.

The application of due diligence 1.5

Different meanings of due diligence can apply in different situations:

- A buyer or seller of a company or business or assets – the investigation of the assets and liabilities of a company or business for the purposes of buying or selling its assets.
- A lender providing finance – the assessment of the viability of the project and the status of the borrower; this will often involve the banker's lawyers checking the due diligence undertaken by the borrower's lawyers where the borrower is acquiring another company.

- A potential joint venture partner – the investigation of the assets being transferred to the joint venture vehicle and potential joint venture partners.
- The state enterprise for the purposes of privatisation.
- A company listing on a recognised stock exchange – the process of verifying when preparing the listing prospectus, and entering into a contract – an analysis of the ability of the other party, or parties, to the contract to perform.
- A state body undergoing privatisation – the investigation of its assets and liabilities.

Essentially in all such situations there will be:

- the transfer of assets from one party to another or the creation of obligations;
- the existence of risks that may affect the future value of such assets or obligations;
- the need to apportion the risks between the parties.

Therefore, due diligence is applicable in varying extents or degrees whenever there are asset swap transactions and the creation of obligations. In view of the many circumstances that may arise, it is important to note that the same level of due diligence cannot be applied uniformly. Even where the due diligence process is required for a corporate sale or business, the documentation should be applied selectively. It is self-evident that the detail, scope and intensity of the process will have to be adapted according to the size, value and significance of the transaction, as well as having regard to the human resources available to each of the parties to the transaction. For instance, in a deal that involves a company purchase run by the chief executive of the purchaser, the finance director of the vendor's group of companies and one partner from each of the purchaser's and vendor's lawyers and accountants, the organisation of dedicated due diligence teams and data centres will not be required.

Legal due diligence

The purpose **1.6**

The purpose of legal due diligence by a purchaser (buyer) or party entering a joint venture is to ensure that:

- the assets have the value that the vendor (seller) has given them;
- the vendor has good title to those assets free from encumbrances, including intellectual property and – in particular – the key assets that are being acquired;
- there are no risks, liabilities or commitments that reduce the value or use of the assets, for example another party having the right to use them;
- there are no other existing or potential liabilities that may adversely affect the object of the due diligence (the target or candidate).

Primarily, therefore, the purpose of the legal due diligence relates to the verification of the legal affairs and good standing of the target, which, in turn, impact on or verify the consideration being given.

Topics usually covered by traditional due diligence

Topic	**Examples**
Assets	Primarily, assets are considered tangible property, such as buildings, computers, furniture, etc. However, other important assets include people, contractors, business ideas, and product relevance in the marketplace.
Contracts	Contracts for work to be done and commitments by others to do work for the company. The contract can be with individuals or companies. Keep in mind that it is not just the contract terms but whether the terms are in fact enforceable. A lot of employment contracts have appropriate terms, but if the individual has a serious accident and is incapacitated, none of the work-related terms may be enforceable.
Customers	Customers for products and services are important elements – who they are and where they are. When reviewing this topic, consider whether there is a secondary market for the resale of products such as through Amazon or eBay. Customer support may start to come from locations not anticipated.
Employee agreements	This requires appropriate legal support to make sure that the agreement is not so restrictive that the employee could easily break the agreement for it being unfair, etc. These agreements may also require consistency which is a process that due diligence can support.
Employee benefits	This is not just about health insurance. Due diligence requires the comparison of planned benefits with the benefits that are actually received.
Environmental issues	These can form a significant part of any due diligence activity. Environmental impact statements have to be considered a never-ending part of business operations as well as the business planning. Regulators from government agencies as well as non-governmental organised groups can delay or prevent a specific development project (see also **Chapter 16** for further discussion of environmental issues).
Facilities, plant and equipment	Classically, this item is included within the asset category. It is separated here to indicate the requirements for a continuing due diligence for the potential retirement or sale of any old facility that is no longer effectively supporting the enterprise business. Examples of this can be old buildings. In the USA recently many municipalities have torn down old sports stadiums to construct new ones with 21st century features like adequate bathrooms and enough executive suites.

(*Continued*)

Topic	Examples
Financial condition	Traditionally this is the province of the accountant. It has expanded to recognise the confluence of cash availability, debt limitations and restrictions, the industry's economic climate, the country's economic climate and the global economy. All of these components can be monitored on a continuing basis as part of the overall financial review of the business.
Foreign operations and activities	Globalisation is the major element of 21st century business. Outsourcing, multiple worldwide locations, different business and governmental regulations, currency conversions, transportation issues, employees and cultural differences all add up to substantial impact on company operations.
Legal factors	Legal issues from country to country, state to state, municipality to municipality all have to be considered and monitored.
Product issues	Product life cycles need to focus on old products, products about to be launched and products in the development pipeline. Moreover, due diligence includes the need to monitor competitor's products. It is a growing issue considering the expanding global economy.
Supplier issues	Companies are segmenting the manufacture and delivery of products and services. Some companies want to control all aspects of manufacture. As noted, trends in today's economic climate show that more companies are outsourcing parts of all of the development cycle. Due diligence needs to include the viability of the supplier's ability to deliver on time, on budget and within the established quality parameters. If the supplier declares bankruptcy there may be significant issues impacting the completion of company products as well as the financial impact of not receiving value for payments already made.
Tax issues	Tax increases, tax decreases and taxing authorities all need to be monitored. Due diligence needs to include the potential liability of taxes. On the other side of this coin is the potential for the impact of economic loss on the tax liability. In some cases, the liability may be greatly reduced and/or turn to a cash refund. In this event, due diligence needs to make sure that this is an accurate calculation and then consider what to do with the returned funds.

These topics are not the only categories of information that an appropriate due diligence exercise will want to assess and analyse. However, they do demonstrate the range of issues that should be addressed in order to fulfil the purpose of due diligence. When establishing due diligence activities, it is essential that the assessments have to expand beyond the most basic levels. This is true wherever the exercise is taking place (for an example of a simple due diligence exercise in India see **ITEM 1** of Appendix).

From a 21st century perspective, the traditional due diligence methods account for 10 to 25% of a complete due diligence process, especially in light of the fact that approximately two-thirds of all mergers and acquisitions fail completely, or fail to deliver the value expected. In the USA, the reported worst performer in 2007 was Vulcan Materials which makes construction aggregates. It agreed to purchase Florida Rock Industries for $4.5 billion just as the US Housing Market began its decline. Vulcan shares have underperformed the S&P index by 29% since the merger. Further comment on the level of failure is made below (see also **Chapters 2** and **8**). For the present purpose it should be noted that not all failures are due to the lack of data gathering and appropriate due diligence procedures. Quite often, it is the process of due diligence that reveals appropriate information that this merger is not a good deal for one or both parties. For example, the cultural due diligence exercise can assist towards more successful outcomes (see **Chapter 8**).

With enormous emphasis placed on the short term by most firms, especially those in the public markets, a quick increase in price or earnings for the stock market is in many cases the sole reason for a merger and acquisition transaction. For instance, according to the best and worst M&A deals last year reported in the *Financial Times* on 27 December 2007, technology groups Google and Oracle and energy companies XTO and Transocean enjoyed the best share price performance among US corporations making large domestic acquisitions according to Dealogic data. Such data shows that shareholders have been willing to reward big deals in these sectors whereas financial services groups have been unable to offset the problems of the credit squeeze with large acquisitions. The Dealogic analysis has been in place for four years and offered some evidence of investor reaction to big consolidation moves. Easy revenue increases or cost reductions often make management the ‘hero’, albeit almost always at the cost of the stakeholders in the long term. Having regard to the purpose of due diligence, in most places traditional business views are based on a historical perspective. Examples of this type of view are:

- What was the level of earnings?
- What did the CEO do?
- How were sales made in the last quarter?
- More analysis of completed transactions.

Following this model, traditional due diligence looks at the past, not the future, to assess what a company can accomplish from today onwards. This analytical method is often performed too quickly and with too narrow a focus on completed transactions that may not be an appropriate predictor of future behaviour. Clearly there are now more modern tools and resources available that can support a more thorough analytical process.

The process **1.7**

In most jurisdictions the typical traditional due diligence process in general looks at the target or candidate company, its financial performance, products, market and employees – usually in that order of priority. The typical traditional process starts with a legal questionnaire and disclosure documents attested by the candidate, and is coupled with a review, compilation or audit of financial records. Generally, a regulatory agency records search is performed. Most often various public records are searched. Often, research is added in areas such as the industry niche(s) of the candidate, and sometimes the media. Also, additional research is sometimes added by contacting various industry and government organisations. In the course of this process the use of warranties and indemnities has developed to facilitate the transaction. Although, as is discussed further below, the vendor may provide warranties that provide assurances on the above, the purchaser should check them in any event. The verification approach reduces the potential for conflict because problems can then be identified at an early stage. It can happen, for example, that the vendor is unaware of the problems or issues that emerge through the due diligence process. It is important to note that warranties and indemnities given by vendors often are qualified in certain respects as follows:

- Generally they are subject to time limits and last for only a few years, by operation of law and contract.
- Usually they are limited by amount, including a maximum liability under the warranties and an aggregate level of claims.
- The compensation can be incomplete either because of the inadmissibility of the claim or the restrictive method of calculating the damages, as well as the fact that sometimes it is difficult to evaluate the compensation accurately as in the case of loss of brand reputation (which is discussed in detail in **Chapter 7**).
- Normally there is a de minimis limit in respect of individual claims.
- Any claim will only be successful if it is conducted in accordance with the requirements for the conduct of claims.
- Claims can be disputed, thereby they can be expensive and drain resources.
- Even in the absence of a defence it can be costly and time consuming – as well distracting – to claim.
- The terms of the warranties and indemnities can be difficult to enforce.

The repercussions of entering litigation, as well as the available alternatives, are set out in **Chapter 5** when considering some organisational or management issues. In the light of the above, in many developed economies the due diligence process requires the vendor to disclose all relevant information. Such disclosure enables the purchaser to evaluate the target or candidate properly and to negotiate from the perspective of a level playing field. Therefore the process of legal due diligence can be used to provide information on the legal affairs of the target. Such information can, of course, assist in the decision whether or not to purchase and can check:

- the assumptions made by the purchaser or agreed with the vendor, for instance the rate of cancellation of contracts by customers;
- the valuation of the target;

- the operational capability of the target;
- the identification of any adverse factors.

Once the purchaser has such information the process enables options that include:

- proceeding with the transaction as agreed;
- cancelling or 'walking away' from the transaction;
- negotiating specific indemnities;
- changing the terms of the transaction.

Another important benefit of the legal due diligence process is that the information reveals how the target has been managed. This is very relevant to the overall discussion in the handbook that relates to corporate governance and the broader understanding of due diligence as an ongoing internal tool. It can take account of the background to the target and candidate and its objectives, including its chosen structure in the form of a company, partnership or owner manager operation. While many due diligence exercises involve very large transactions, there are also many smaller deals that attract the due diligence process. While some of the issues in the process are more suited to the larger transaction, others are equally applicable whatever its size. For example, late or inaccurate returns to the authorities, such as the Inland Revenue and corporate registries, will reflect upon the management of the business. They may also indicate financial difficulties, such as in financial statements lodged late with the corporate registries. Moreover, as suggested, once the purchase is completed the due diligence information can provide an invaluable tool in the ongoing management of the target. Some of the management aspects of a business are considered more fully throughout the handbook.

Areas of legal due diligence **1.8**

Key topics that are usually covered in the course of the due diligence process to fulfil its purpose have been indicated above. Moreover **Chapter 2** sets out the relevant issues in the context of corporate finance. Many competent due diligence professionals have begun to use a more comprehensive due diligence process. They have established a broad range of topics that have to be monitored and reviewed on a continuous basis that can also be useful in the overall context of corporate governance. As can also be seen from the discussion in **Chapter 9**, 21st century technology is the tool that enables this kind of continuous or ongoing due diligence. These areas include, but are not limited to, the following list:

- accounting issues;
- behaviour;
- business organisation streamlining;
- business planning;

- business processes streamlining;
- change;
- competitive analysis;
- culture;
- customer defections;
- distribution channels;
- employee retention;
- environmental issues;
- executive retention;
- global business operations;
- global partnering;
- human resources;
- information systems integration and compatibility;
- intellectual capital;
- intellectual property;
- internal auditing;
- interviewing customers;
- interviewing former employees;
- joint venture partner and other alliance reviews;
- legal contract reviews;
- litigation or claims reviews;
- logistics costs;
- manufacturing;
- operations;
- post-deal planning and integration;
- potential market growth;
- potential revenue growth;
- problem identification;
- product distribution;
- product portfolio expansion;
- quality assurance;
- quality control;
- research and development expansion;
- revenue losses;
- risk management;
- security matters;
- strategic planning;
- strategic questions;
- suppliers;
- supply chain;
- tax issues;
- technology – internal/external;
- technology – Internet//Intranet/Extranet;
- technology planning;
- vendors;
- warehousing.

It has been commented that the traditional due diligence process is largely driven from a legal perspective. The legal practitioner typically delivers numerous documents with the goal of being as legally reliable as possible. The legal professional specifically builds a careful legal paper trail, and gathers as much detail as possible regarding the legal condition of the candidate firm. With the benefit of technology, the point should once again be made that 21st century due diligence should enable an improved approach through ongoing information gathering that keeps the business abreast of its status in terms of corporate governance.

The discussion here focuses on circumstances in the UK by way of example. In the UK, the typical legal due diligence exercise will cover some or all of the areas listed. As has been noted in this handbook the selected checklists can only exemplify some of the general concerns, and provide the basic concerns that should be amended to reflect the individual circumstances of the transaction. Therefore, the list below does not purport to be conclusive and will require tailoring according to such factors as:

- whether the transaction is a share purchase or asset purchase;
- the target's industrial sector;
- the geographical location of its activities;
- the size of the transaction.

The principal selected headings of traditional due diligence are:

- corporate structure;
- company secretarial;
- corporate acquisitions and disposals;
- compliance programmes;
- trading activities;
- competition law;
- personnel;
- health and safety liabilities;
- pension schemes;
- land and buildings;
- environmental management;
- plant, equipment and other fixed assets;
- computer software;
- intellectual property;
- investments;
- lending to third parties;
- banking facilities/borrowing from third parties/financial grants;
- guarantees/indemnities/letters of credit;
- product liability;
- investigations, litigation, disputes;
- insurance;
- taxation;
- non-compliance with agreements/change of control;
- voidable transactions/reconstructions;

- impending legislative changes;
- compliance with special industry sector legislation;
- the effect of the Euro or different currencies on contracts, including payment arrangements.

Transaction documentation

Types of documents **1.9**

In a transaction, such as the sale of a business, the materials and main documents will typically include some of the following documentation:

(a) Pre-exchange – including:
  - due diligence preliminary enquiries, further enquiries and the seller's responses to them;
  - heads of agreement;
  - due diligence terms of reference – engagement letter – accountants;
  - instructions for accountants' short and long form report;
  - due diligence terms of reference – engagement letter – lawyers;
  - environmental audit – engagement letter;
  - exclusivity agreement;
  - confidentiality agreement;
  - data room letter;
  - due diligence rules of engagement;
  - funding comfort letter;
  - environmental comfort letter;
  - due diligence reports;
  - report on title;
  - legal opinion of foreign lawyers.

(b) Exchange of contracts – including:
  - disclosure letter;
  - sale and purchase agreement;
  - guarantees;
  - tax indemnity;
  - service agreements;
  - intellectual property assignments and licences;
  - real property transfers;
  - assignment of contracts;
  - directors' meeting minutes.

(c) The closing or completion of the transaction – including:
  - shareholders' resolutions and circular;
  - announcements;
  - letters to customers;
  - stamp duty and company registry forms;
  - governmental consents;
  - release of charges and guarantees;
  - closing agenda.

Ongoing action for due diligence teams regarding transaction documentation **1.10**

Throughout the transaction, the legal due diligence team leader for both the seller and the buyer needs to peruse any transaction documentation which might affect the due diligence exercise. Each draft of the documentation should be checked for any amendments made affecting the due diligence. One document that the legal due diligence teams on both sides are usually responsible for is the disclosure letter. As will be seen from the discussion below and the appendices to this chapter, following the initial meeting with the client, the buyer or seller and its lawyers will have a number of tasks to undertake, including:

- selecting and instructing other advisers;
- the preparation of legal due diligence enquiries;
- agreeing terms of engagement and reference with them and any in-house due diligence teams;
- planning the campaign;
- agreeing various preliminary documents with the other side, including:
  - heads of agreement;
  - a confidentiality agreement;
  - a lock-out agreement;
  - rules of engagement;
- project and data management;
- starting the data acquisition/disclosure process.

Typical transaction procedures **1.11**

This chapter has already commented on the usual due diligence process. However, the due diligence process may vary according to the following situations:

- sale by auction;
- sale by treaty.

In the case of both a sale by auction and a sale by treaty, a number of preliminary steps may be taken:

(a) The seller will obtain a valuation of the target and possibly instruct a corporate financier to find a buyer.
(b) The seller will:
  (i) instruct its corporate financier (if any), accountants and lawyers to do some analysis of the target to identify any major issues to be addressed (such as subsidiaries to be split off);
  (ii) analyse the taxation ramifications of the sale for the seller;
  (iii) begin to prepare or 'groom' the target for sale.
(c) The seller may prepare an information memorandum regarding the target for potential interested parties.

(d) The seller will require any interested parties to execute a confidentiality agreement before issuing the information memorandum to them.
(e) The buyer may undertake some basic due diligence into markets, political risk, compatibility of organisational cultures.
(f) The buyer may also involve its accountants in some preliminary analysis of the seller's financial accounts.

Sale by auction or tender **1.12**

It is evident that the seller can improve the terms of its sale by creating a competitive environment where a number of bidders are given access to the due diligence data and make bids for the target. In many cases the sale is not strictly an auction in that the seller is not obliged to accept the highest bid. The typical sequence of events in a sale by auction is as follows:

- With the issue of the information memorandum, the seller may request that bidders respond by a specified date with an indication of the price to be offered and the assets desired.
- The seller is likely to issue a data room agreement to each bidder.
- Each bidder will be allotted a certain amount of access to the data room and possibly to target personnel for additional information.
- The bidders may submit requisitions for further information which the seller may respond to.
- The buyer's in-house due diligence team, if any, prepares their due diligence reports.
- The buyer's accountants prepare their draft due diligence report. Often, this is sent to the seller for comment on any inaccuracies.
- The buyer's lawyers may provide a due diligence report, which is not usually provided to the seller.
- The bidders submit their bids.
- The seller will select one or more bidders with whom to continue negotiations unless a bidder persuades the seller to enter into an exclusivity agreement whereby the seller agrees not to negotiate with any other party for a period of time or not to conclude a sale with any other party.
- The buyer may negotiate basic heads of terms with the seller.
- The buyer may be permitted additional time to undertake due diligence.
- The negotiations concerning the warranties, which have been ongoing for some time, are finalised close to exchange of the sale and purchase agreement.
- The seller's lawyers produce a draft disclosure letter, exempting facts and documents from the warranties.

It should be appreciated that this is a basic structure for the process of conducting a sale by auction or tender. An example of a sales process letter is also found in Item 3 of Appendix. All of these should, of course, be amended to reflect the individual circumstances of the transaction. Similar comment applies to the discussion of sale by treaty below in **1.13**.

Sale by treaty 1.13

The typical sequence of events in a sale by treaty is as follows:

- The buyer may negotiate basic heads of terms with the seller.
- The buyer may insist that the seller enters into an exclusivity agreement whereby the seller agrees not to negotiate with any other party for a period of time or not to conclude a sale with any other party.
- The seller nominates either a member of its own staff or of the target to handle the due diligence enquiries from the buyer and its professional teams.
- The buyer sends its in-house due diligence team to the target's offices where it is usually given a room or a data room is set up by the buyer (where the seller wishes to keep the buyer away from its offices). Alternatively, the data may all be sent to the buyer to analyse at their own offices.
- The buyer instructs its accountants to commence due diligence. They will also usually be based at the target's offices.
- The buyer and seller instruct their lawyers.
- In addition to the commencement of preparation of documentation, the buyer's lawyers forward a set of preliminary enquiries to the seller's lawyers. Normally, the seller will warrant the accuracy and completeness of the written responses.
- The buyer's lawyers are rarely based at the target's offices.
- At the same time as the due diligence teams commence work, the parties and their lawyers start to negotiate the various agreements. These activities will continue in parallel during the due diligence exercise, with the agreements and their terms being amended to reflect the results of the due diligence exercise.
- The seller's lawyers pass the preliminary enquiries to the seller's nominee for handling enquiries, who will arrange for the collation of requested documentation and for answers to the buyer's questions.
- The seller's lawyers will vet, filter and qualify the representative's responses and, where appropriate, restate them in their own terminology before sending them to the buyer's lawyers.
- The documents the seller has collected will usually be indexed and sorted into separate sets of folders known as the 'disclosure bundle'. The written responses will refer to the appropriate documents by their index number in the disclosure bundle.
- The seller's lawyers prepare further enquiries from time to time, based on the answers to the preliminary enquiries and earlier further enquiries and results of its independent information collection activities.
- Omissions in the disclosure bundle and any gaps in the written responses by the seller's lawyers are made good during the negotiations with additional written responses and deliveries of documents.
- The buyer's in-house due diligence team, if any, prepares their due diligence reports.
- The buyer's accountants prepared their draft due diligence report. Often, this is sent to the seller for comment on any inaccuracies.

- The buyer's lawyers may provide a due diligence report, which is not usually provided to the seller.
- The negotiations concerning the warranties, which have been ongoing for some time, are finalised close to exchange of the sale and purchase agreement.
- The seller's lawyers produce a draft disclosure letter, exempting facts and documents from the warranties.

The formal and informal due diligence processes 1.14

When considering the typical process concerning non-data room due diligence exercises, it can be seen that there are two due diligence processes underway. These are:

- The formal process, involving the buyer's lawyers.
- The informal process being undertaken by the buyer, the accountants, the merchant bank (if any) and any other advisers.

Often, the facts and data that the seller warrants the accuracy and completeness of are those supplied under the formal process, that is the facts and data that are:

- provided in the answers to the preliminary enquiries and further enquiries posed by the seller's lawyers;
- stated in the warranties.

The formal process tends to exclude most data that does not refer to the legal affairs of the target or candidate, thereby excluding much significant information obtained by the buyer, its accountants and other advisers.

Disclosure – the traditional approach 1.15

The traditional approach to handling the legal affairs of an acquisition target has often been to place primary reliance on the warranties provided by the seller. Some analysis of documentation and data on the target's legal affairs is made, but this tends to be largely confined to the documentation and data disclosed by the seller against the warranties that they have given. An example would be a warranty with which there is no outstanding litigation and a disclosure made against this in the disclosure letter, which outlines existing litigation and attaches relevant papers.

Disclosure is carried out by the seller in response to:

- the preliminary enquiries raised by the buyer's lawyers;
- the obligations on the seller to provide details of the warranted items contained in the warranties in the sale and purchase agreement;
- the benefit offered to the seller by disclosing information known as the 'excepted items' against the warranties in order to dilute the warranties.

The disclosure process often does not commence until the seller and buyer have entered into an agreement, in principle, or in the case of a controlled auction, until a non-binding bid is made. It should be noted that there is a certain amount of overlap between disclosure and due diligence which causes some confusion when referring to the respective exercises.

As a result, due diligence investigations into the legal affairs of targets or candidates are undertaken to varying degrees. Some buyers' lawyers do not undertake extensive investigations in advance of receiving the sellers' disclosures. This can mean that the extent of the buyer's knowledge of the legal affairs will depend on the extent of the 'warranted items' negotiated into the warranties. A problem with this approach is that it is always possible that the seller will negotiate down on the warranties and remove the reference to warranted items, so that very little information is actually provided to the buyer. Another disadvantage of relying on the disclosure exercise for information is that the seller will often only turn its mind to the process of collecting the disclosure documents once the negotiation of the warranties is complete, immediately prior to exchange. This will leave little time for quality data to be collected, let alone adequate time for the buyer's due diligence team to review and report on the data.

Due diligence and the seller's duty to disclose **1.16**

The obligations on the seller to disclose information are discussed here. As noted, this discussion principally relates to the English transaction.

The classical common law position is that there is no duty on the parties to disclose material facts to the other party. The historic approach of English contract law has been to allow each party to look after their own interests. This was the 'apotheosis of 19th century individualism' and a result of the application of the doctrine of 'laissez faire'. Accordingly, the maxims *caveat emptor* (let the buyer beware) and *caveat venditor* (let the seller beware) are the starting point for consideration of this issue. Over the years the traditional common law position has been gradually eroded and a variety of exceptions to the general non-disclosure rule evolved. These include:

- fiduciary relationships, including *uberrimae fides* (of the utmost good faith);
- the duty of disclosure on sellers in real property transactions;
- the obligation on the seller and the buyer not to make misrepresentations.

Fiduciary relationships **1.17**

These are relationships between persons that involve trust and confidence. Typical examples are those between solicitor and client, trustee and beneficiaries. In all such relationships there is a duty of disclosure of all material facts. This also applies to relationships that are *uberrimae fides*, that is of the utmost good faith, such as between insurer and insured. A failure to comply with the duty of good faith in an insurance situation will lead to the insurer being able to treat the contract of insurance as voidable. The obligation of utmost good faith can also be imposed contractually by a buyer and seller in a corporate transaction. The parties can expressly contract to create a duty of utmost good faith and thereby place a duty of disclosure of all material facts.

Real property transactions **1.18**

In the UK, particular rules have been developed by the courts in relation to transactions regarding land and buildings that is real property. This real property framework has been based on the fact that, traditionally, the nature and state of the seller's title could only be determined by the buyer questioning the seller. However this duty has been weakened to some extent by the regime for registering land which was introduced by the *Law of Property Act 1925*. As a result the seller is under an obligation to disclose to the buyer any latent defects in the title to the property which will not be removed before the completion of the transaction, or closing. (Note also the recent introduction of the Home Information Pack (HIP) for residential conveyancing whereby all homes marketed for sale from 14 December 2007 in England and Wales need a HIP; a key component is the Energy Performance Certificate (EPC)). According to English law a defect may be described as latent if:

- it cannot be discovered by the exercise of reasonable care on the inspection of the property;
- it amounts to a deficiency in the seller's documentary title which might affect his or her ownership of the property or his or her right to deal with it.

It has been suggested that there is no reason why the common law duty on the seller to disclose any latent defects in title should not apply in an asset purchase. This is because the property conveyance is occurring in much the same way as in any other real property transaction. However, the question is less clear and therefore more arguable in the case of a share acquisition as the transfer of the real property occurs as a corollary of the share purchase.

Matters subject to the duty of disclosure **1.19**

The seller is under an obligation to disclose such information as that referred to here following, including as was decided by the Court of Appeal as long ago as 1899 in the case *Re Brewer and Hankin's Contract (1899) 80 LT 127* where they were outside his knowledge:

- type and tenure of title;
- leases and tenancies;
- matters registered at the Central Land Charges Department;
- local land charges;
- restrictive covenants;
- easements;
- exceptions and reservations.

Due to the heavy burden of common law disclosure on the seller, the parties may agree to vary the duty. This is done as a matter of course in English property transactions.

Remedies **1.20**

The remedies for breach of the duty of disclosure by the seller in the case of real property transactions fall into three categories flowing from the type of breach.

1. Non-disclosure

   Where the non-disclosure relates to a substantial defect, the buyer will be entitled to rescind the contract before the completion of the transaction, or closing. They may alternatively seek a reduction in the purchase price.

2. Misdescription

   The failure to disclose a matter in relation to the type or tenure of the seller's title or a misleading physical description of the property in the particulars of sale leads to liability in misdescription rather than non-disclosure. The remedies for misdescription are similar to those for non-disclosure.

3. Misrepresentation

   This is a vast area of discussion that has led to legislation and extensive case law that has been the subject of textbooks. Therefore it should be appreciated that the discussion of the law of misrepresentation that is set out below is only intended to cover the position in the broadest sense in order to provide some basic guidance to personnel involved in the due diligence exercise.

Misrepresentation – an outline **1.21**

When considering a due diligence exercise, there are two general circumstances in which the seller might make a misrepresentation to the buyer:

- by way of an incorrect statement (often a warranty) contained in the sale and purchase agreement or a statement made in the disclosure letter (including the disclosure bundle);
- by way of an incorrect statement outside the formal due diligence or transactional process, such as a written statement in documentation not contained in the disclosure bundle or an oral statement.

The seller should monitor and vet all data disclosed to the buyer throughout the transaction, both at the time it is made and as at the date of exchange, to ensure it is still accurate. The personnel of the seller should also take care to avoid making statements outside the sale and purchase agreement or disclosure letter/disclosure bundle, whether orally or in writing, which might later be used by the buyer to rescind the sale and purchase agreement or claim damages from the seller. Conversely, the personnel acting for the buyer should take steps to accurately record any statements which the seller makes to them, which they rely upon in entering into the agreement.

Generally, agreements relating to the sale and purchase of a business or a joint venture will specifically list those statements that the buyer is relying upon in entering into the agreement. These warranties are usually negotiated and worded with some care. There is usually an 'entire agreement' provision in the agreement, whereby the buyer acknowledges that it has not entered into the agreement in reliance on any representations other than those contained in the agreement or the disclosure letter. However, such a provision will only be effective if the seller can prove that it satisfies the requirement of reasonableness as stated in section 11(1) of the *Unfair Contract Terms Act 1977*. Section 11(1) provides the requirement of reasonableness. This requires that the term should have been a fair and reasonable one to be included, having regard to the circumstances which were, or ought reasonably to have been, known to or in the contemplation of the parties when the contract was made.

In a commercial transaction, particularly one where the parties are seasoned business people, the buyer may have difficulty in persuading a court that it was not reasonable to include an entire agreement clause in an agreement which contained an extensive list of warranties. The buyer may also have difficulty in persuading the court to find that he or she relied on the representation in entering into the agreement, when he or she had the opportunity to include this in the warranties but did not do so.

Nevertheless, the courts have held entire agreement clauses in commercial contracts to be unfair. In *Goff v Gauthier (1991) (62 P & CR 388)*, which involved a contract for sale of land, the seller orally represented to the buyer that he would withdraw from negotiations with the buyer unless contracts were exchanged immediately. The court found that the seller had no such intention and his statement was a misrepresentation that induced the buyer to enter into the contract. The buyer was permitted to rescind the contract notwithstanding the entire agreement clause which was held to be unreasonable within the meaning *of* section 11(1).

Accordingly, circumstances can arise where a misrepresentation might be actionable by a buyer in a business acquisition, avoiding an entire agreement clause. This might particularly apply where the misrepresentation was outside the usual ambit of the warranties, as in the *Goff* case, or where the warranties were brief. Entire agreement clauses may also be held to be unreasonable if they purport to exclude claims based on misrepresentation even where there was fraud. For instance in *Thomas Witter Ltd v TBP Industries Ltd [1996] 2 All ER 573* the court held the clause to be void on the grounds of unreasonableness because it purported to exclude liability for misrepresentation. Therefore, the seller should draft the provision so as to preserve the buyer's rights in the case of fraud.

The courts have also shown that they will construe entire agreement clauses narrowly. Accordingly, sellers are well advised to seek an acknowledgement from the buyer that it does not enter into the agreement in reliance on any other representations.

There are many cases in which statements will be made during the pre-contractual negotiations and will be at risk of change during the course of those negotiations. For example, *With v O'Flanagan [1936] Ch 575, [1936] 1 All ER 727*, demonstrated this concern. A dental practice was to be sold and accurate supporting financial information was provided. The negotiation took five months to conclude during which time the seller fell ill and income was lost. These losses were not notified to the buyer who purchased the business in good faith based on the original figures. It was held that, as the buyer had continued to place reliance on the original figures believing them to be true, those figures being uncorrected amounted to a misrepresentation.

Another matter relates to silence. It has long been understood that, by itself, silence will not amount to a misrepresentation (see *Keats v Lord Cadogan (1851) 10 CB 591*). However, if a party is deliberately silent regarding certain information which, if known, would distort the information provided, then there may be an actionable misrepresentation. There is also no reason why the parties to the agreement cannot place themselves under an obligation of disclosure, as long as that obligation was carefully drafted, so that the detail of the disclosure required was unambiguous. In addition, if a party makes a disclosure upon a particular matter which details certain facts but omits others, this may be regarded as a misrepresentation. The test is whether, by only proving certain facts, they would mislead the party placing reliance upon them in the absence of having knowledge of the omitted set of facts.

One of the key sources of information that a buyer will rely on will be the audited financial statements of the target. The question therefore arises whether the buyer has any recourse against the seller's accountants if those accounts prove to be incorrect. Under English law in 1990 the matter was considered and decided in *Caparo Industries plc v Dickman [1990] 1 All ER 568*. The House of Lords unanimously rejected the concept that auditors owed an unlimited duty of care in the preparation of accounts which extended to anyone who used those accounts. Accordingly, the buyer should identify those facts and statements presented in the financial accounts on which it is relying and seek warranties on them from the seller.

There may be other circumstances where the target's accountants may be liable to the buyer and each case should be considered on its facts. The buyer may actually experience some difficulty claiming against the target's auditors even they had prepared draft accounts at the request of the buyer and make certain statements regarding the level of profits (see *McNaughton (James) Papers Group Ltd v Hicks Anderson & Co [1991] 1 All ER 134*). Accordingly, a buyer should ensure that it takes appropriate warranties from the seller to increase its protection and to avoid any defence of contributory negligence by the accountants for not having done so.

Where the buyer relies on a prospectus previously issued by the target, the buyer may have a remedy under section 150 or section 166 of the *Financial Services Act 1986*. These sections provide protection for those acquiring shares. It should be noted, however, that the House of Lords' decision in the old reported case of *Peek v Gurney [1861–73] All ER 116, LR 6 HL 377*, supported in *Al-Nakib Investments (Jersey) Ltd v Longcroft [1990] 3 All ER 321*, held that the purchaser of shares must be an original allotee to succeed in an action for misstatement in a prospectus.

Remedies for misrepresentation **1.22**

Where the buyer wishes to make a claim that it has been induced to enter into the contract in reliance on a misrepresentation, its remedy will depend on whether the misrepresentation was contained in the warranties or otherwise. The sale and purchase agreement will usually provide for remedies in the event of breach of warranty, which will generally be damages or, rather exceptionally, rescission (setting aside a voidable contract). Alternatively, the buyer may be able to claim rescission or damages on the basis of misrepresentation. Misrepresentations made outside the formal documentation would also be made under this heading.

Criminal sanctions **1.23**

A key concern for the seller and its advisers must be to ensure that they do not become exposed to criminal sanctions when dealing with the buyer. This may be as a result of regulation making it an offence to make misleading statements in a sale of shares knowing them to be misleading or reckless as to their truth, for the purpose of inducing any person to enter into an agreement to acquire securities. This will affect the sale of shares but not the sale of assets. In addition, two or more persons may be guilty of the common law offence of conspiracy to defraud if fraudulent statements are made with the intention to deceive. This would apply to both sales of shares and sales of assets.

Contract subject to due diligence **1.24**

In the vast majority of commercial transactions to which due diligence is applied, the due diligence exercise is carried out prior to signing and exchange of contracts. However there may be cases, especially where the seller is desperate to dispose of the target or candidate company or business, where contracts are signed and exchanged subject to the buyer being satisfied with the results of a subsequent due diligence exercise. The due diligence is then carried out within specific time limits. Generally such an arrangement is unsatisfactory from the perspective of the seller because it gives the unscrupulous buyer an open-ended opportunity to withdraw from the contract. Moreover, the obligations on the buyer to act in good faith and de minimis provisions are capable of being disregarded. It is often argued that such a deal structure amounts in reality to the grant by the seller to the buyer of an exclusive option to purchase the target during a specific period of time. Therefore, however desperate the seller may be, the disadvantages may well outweigh any advantages.

Legal due diligence – the limitations 1.25

The key to a successful due diligence exercise is the data. It is important to bear in mind that all investigations undergone in the due diligence process depend very much on the quantity and quality of the data supplied by and on behalf of the vendor. The purchaser has to rely on such information in making any decision regarding the target. Therefore the purchaser is very much exposed to potential non-disclosure and misrepresentation by the vendor. This is considered further above (see for example **1.15** and **1.21**) in the context of English law.

Having regard to such limitation in the due diligence process it is important for the purchaser to support the due diligence investigation by obtaining warranties from the vendor on those matters that are uneconomic or impossible for the purchaser to check. It is of course important for the vendor to warrant the completeness and accuracy of the date supplied to the purchaser.

Financial professionals concentrate primarily on comprehending and delivering historical financial reports, and often a valuation of the candidate – traditional financial review focusing on what was, rather than what lies ahead. Over the past decade there has been significant growth in understanding the need to focus on all aspects of future financial issues. This is not only for the repayment of outstanding debt, such as a mortgage; rather it is for the consideration of all current and future financial obligations. This includes knowing what obligations are falling due and when, synchronised with the company's capability to make payment as scheduled. Thus due diligence is both an internal and an external looking effort.

The legal or the financial viewpoints are not focused on the actual validation of the acquisition or the merger deal. Traditional due diligence is essentially an audit of legal and financial aspects of deals. Legal and financial reviewers, lawyers and accountants work within the same context and structure as due diligence is an essential part of any decision process.

Financial due diligence 1.26

Financial due diligence entails:

- identification of the commercial rationale for the transaction or deal in terms of growth, technology or synergy savings;
- the differentiation between facts, assumptions and projections;
- the financial facts, assumptions and projections.

The underlying process regarding the facts involves accountancy policies with a degree of central control. The accuracy is affected by the access to auditors, late adjustments and the management accounts and financial accounts. Qualitative issues relate to the budgeting style, performance pressure and internal audit.

As regards the financial audit, the basis for assumptions will often be:

- seller knowledge;
- buyer knowledge;
- target information;
- speculation.

The basis for projections are the financial facts and assumptions, as well as commercial facts and assumptions. The gap between due diligence conclusions and contract has to be bridged by accounting warranties, completion accounts and commercial warranties. Due diligence conclusions are often a mix of facts, assumptions and projections. It may be said that value judgements with commercial and sustainable views, together with real advice, go beyond such conclusions in order to realise the due diligence objective and achieve a successful outcome (see also **Chapter 2**).

Risk and insurance due diligence **1.27**

Traditionally insurance brokers or advisers have focused on the target's existing insurance arrangements as the relevant element of risk financing. However as this meant a rather limited exercise, the discipline of risk and insurance due diligence evolved. The more modern approach considers as a priority the target's business, enabling a detailed risk profile to be developed. A clear risk profile is achieved by thorough identification, analysis and evaluation of the risks and exposures of the business, including:

- an assessment of hazard and risk by industry sector and territory;
- an analysis of past, present and future activities and product range;
- an analysis of the loss experience, specifically examining frequency, severity and trends, and may include the preparation of a claims survey if sufficient data is available;
- a review of potential liabilities and relevant outstanding litigation.

An examination and analysis of the target's current organisational and operational structures are conducted in relation to key issues, including:

- the overall risk management philosophy;
- environmental management;
- health and safety programmes;
- crisis management or disaster recovery planning;
- product safety procedures;
- asset protection procedures and methodologies.

The risk financing and risk retention decisions are also reviewed in order to analyse the target's risk financing arrangements. Current and past risk transfer arrangements are audited. Where relevant, an analysis of the involvement of a captive insurance company is also carried out. The main headings of this review are:

- risk financing methodology;
- critical analysis of insurance policies;
- determination of uninsured or underinsured risks;
- examination of self-insured risks;
- analysis of insurers' financial security.

Through the preparation of a risk profile the buyer can understand the candidate's past and present activities in order to assess its potential exposure to unexpected and unbudgeted risks. This has evident connection with the risk management and corporate governance of an organisation as discussed extensively throughout this handbook. The profile will cover any 'forgotten' past activities such as:

- any potential liabilities arising from historic joint ventures and other strategic alliances;
- the past trading activities or product range of dormant companies;
- latent disease liabilities such as asbestos or industrial deafness that could be the subject to future employers liability insurance claims that are unforeseen or unplanned;
- any discontinued product lines that could create a future liability;
- past exposure of employees or third parties to a variety of substances or situations known to cause harm or damage.

It is important to determine the extent of the target's exposure in comparison with the buyer's current activities or product lines. The priorities are to:

- ensure that all activities or product lines are identified;
- review the additional overseas exposures, including information on overseas subsidiaries and legislation or regulation of the respective jurisdictions;
- identify any dependency on a supplier, customer, assembler or manufacturer, particularly in the era of outsourcing;
- check whether or not the target undertakes design work or provides advice to third parties for a fee as this could mean a substantial increase in any exposure to negligence actions.

One critical area that the buyer must review is the outstanding litigation against the target. As a matter of course a schedule of outstanding litigation should be analysed in conjunction with the target's insurance arrangements. The problem of litigation and the threat to the successful business are discussed in more detail in **Chapter 5**.

The risk and insurance due diligence exercise enables the buyer to understand the level of exposure, as well as the adequacy of available cover to deal with the exposed risks. Indeed the key benefits to the buyer are:

- a clearer understanding of the target's business and its risks;
- the identifying of potential 'deal breakers' that mean the need to review the transaction as a whole;

- the prioritising of problem risk issues and potential solutions;
- a recognition of likely cost implications that can enable a keener purchase price to be negotiated;
- the focusing of necessary contractual warranties and indemnities.

Beneficiaries of due diligence 1.28

It should be noted that with the ever-increasing pressure from regulators, security exchanges and stakeholders, there are a growing number of beneficiaries of the due diligence process. When the parties are establishing the methodologies for the due diligence tasks, it is important that the user of this information is considered. For example in many places, if a government regulator is involved, there are specific forms and formats for data to be presented. It will be very frustrating and more expensive to have to recast the information multiple times just to conform to the regulator's penchant for specificity.

Shareholders, investors and stakeholders can be satisfied with accurate and timely information but generally more concerned with the overview or bottom line. In fact, most would prefer simpler rather than complex information. They may be making decisions about company compliance with a specific regulation, but they are also concerned with understanding the company's ability to survive and prosper.

It is important to ensure that employees are not forgotten in this process. Clerks, middle managers, management and all other related individuals who receive compensation from the company enjoy hearing about the company. Due diligence can include preparation of reports, without violating the rules of privacy and government regulations.

Transactional and operational concerns – integration value post-merger 1.29

Corporate mergers and acquisitions across the globe became popular over the last two decades due to:

- globalisation;
- liberalisation;
- technological developments; and
- an intensely competitive business environment.

Most recently, there was considerable transactional activity in 2007. While 2008 has witnessed a slowdown in activity, in this era of heightened corporate governance, it is important to assess the real value of a transaction once the deal has been done, having regard to the growing number of stakeholders. Despite the many processes that may be in place and the detailed checklists that have evolved in commercial circles, the question is often raised: how hard do firms try to gain value from acquisitions? One assertion has been that the majority of acquisitions and mergers do not deliver shareholder value. Indeed some 10 years ago research by the international consultant firm McKinsey in 1998 concluded that around 60% of mergers fail in financial terms. An earlier study in 1987 highlighted that 58% of acquisitions were later divested due to underperformance. In the course of other ongoing studies, other commentators have noted that 70% do not deliver intended value. Whatever is the actual figure today there is no doubt that it will also be high since often the full potential is not achieved and financial repercussions occur. It is interesting to note that many empirical studies show that M&As fail to create value for the shareholders of the acquirers. Synergistic gains from M&A may in fact result from:

- economies of scale;
- more profitable use of assets;
- exploitation of market power; and
- the use of complementary resources.

Key questions that have been asked are:

- Why is effective acquisition integration, that is the method whereby the paper strategy of combination begins to realise value, so elusive?
- Is it that target firms are chosen wrongly in the first place?
- Is it that doing the deal is seen as the conclusion to the merger rather than the beginning of the process of integration?

For in-house and advisory lawyers, the issue of integration is an important area. It is clear that in actually doing the deal itself, the momentum, pressure to close and limited time to assess all information can result in decisions that will seriously impact the ability to integrate in the longer term. This will range from operational detail through to more organisational concerns such as the loss of tacit, codified corporate knowledge that exists in the heads of key personnel that have left the business. Moreover the cultural aspects – which have become of increasing significance (see also **Chapter 8**) – are regularly given insufficient attention. A further example is in information technology (IT) where often only the most basic inventory of physical hardware is undertaken, when programming skills and long-term single-source service deals may in fact be the critical factors to consider (see also **Chapter 9**).

In all these areas, acquirers need advice and assurance that they will have the ability to retain and modify key assets (in the broadest sense of the word) post-merger. To this extent, a key input from legal advisers will be to anticipate the effect on integration that contractual financial arrangements, remuneration practice and the like will have.

In the 1970s and 1980s, acquisitions tended to be typified by the conglomerate approach – acquired companies were viewed as assets to be financially engineered to improve profits, and often a diverse set of companies was brought under one corporation to achieve a diversified portfolio. As such, acquired targets were often only integrated to the extent of being handed a heavyweight financial reporting handbook. Today, such an approach actually attracts a 'conglomerate discount' from analysts evaluating the share price of firms – shareholders can create a diversified portfolio of companies themselves.

Since the 1990s, the concept of related diversification by acquisition has been touted as a more effective route to wealth creation. That is, as noted above, for effective acquisition, acquirers should bring a synergy to target firms that will create more value than the previous entities when they were not combined. Such synergy may be brand image, manufacturing know-how, physical asset overlap, research and development skills, cultural aspects or just pure economies of scale. Some of these issues are considered further in **Chapters 7** and **8** in particular.

In reality, accessing true synergy in acquisitions means that:

- the acquirer is fully aware of the depth and breadth of its core skills;
- it is similarly aware of the target's skills; and
- there is always a clear and focused set of acquisition objectives for integration post-merger that will create new wealth from an optimised combination of assets whether intellectual, physical or informational.

Therefore the business school mantra of achieving synergy which is intellectually satisfying leads rather quickly to a potentially vast and complex web of practical detail.

Competitive advantage through successful acquisitions **1.30**

In the more straightforward days of conglomerate acquisition, financial control was often the only overlap that had to be managed. However, when a 'synergistic' acquisition takes place, marketing, manufacturing and IT functions may also have to be combined. Thus the risk and complexity of the acquisition is much higher.

Yet, as is clear from the chapters that follow, this risk and complexity, however daunting, is a vital area of corporate life that has to be managed effectively. There are a number of reasons for this. At the strategic level, it is likely that the ability to achieve successful acquisition will become a competitive advantage as corporations look more and more to this method of accessing growth and differentiation.

Tactics and price **1.31**

At the tactical level, the actual price paid for a target firm will reflect the proposed synergies to be achieved – for example one way of looking at the price of any target is:

- the fair market value of the firm;
- add or subtract any applicable premium or discounts;
- add the perceived operational synergies created by the merger.

If such synergies are not to be a major factor, then the process is merely asset capture (simply put, the purchase of an ongoing business' revenue stream) and the price paid should reflect this. If synergies are to be a major factor in price determination, then the realisation of post-merger synergies should be a priority for business managers. What is the reason for paying a premium for intended synergy and then not integrating properly to get the benefits paid for up front? In a sense this is a double blow for shareholders and other parties involved. A premium is paid for the target firm above true market value. If integration does not then follow, the price paid has been too high and the intended synergies have not materialised, investors lose both ways. Organisational and strategic research has led to the conclusion that unsuccessful or piecemeal integration often leads to merger and acquisition failure.

Integration options **1.32**

It has, therefore, also been asked whether the assessments of the above-mentioned 1987 study (see **1.29**) are correct. Do firms find that acquisitions become too difficult, and that asset capture remains the easiest and most worthwhile route – irrespective of whether or not this affects the overall success of the acquisition? Some answers are available from a study of all UK acquisitions in the period 1991–1994. The study conducted by the Warwick Business School used a framework which usefully highlighted different types of integrations undertaken in real life by acquiring corporations, as follows:

- Absorption – full integration of the acquisition by the buyer.
- Preservation – where the acquisition is not integrated at all and held at arm's length.
- Symbiotic – where there is mutual dependence (but not integration) between the two companies.
- Holding – which indicates that the acquired company is held to be (possibly) traded at a later date.

It has been argued that the simplest way to view these four alternatives is to note that they are separated along two dimensions:

- The amount of resource transferred.
- The degree to which the acquired company is left independent or not.

Data has shown that over three quarters of the companies studied had not attempted to integrate resources significantly. It was concluded that this was due to the inherently difficult nature of integration (and hence risk) and, in terms of acquiring good performing assets, the instinct was not to 'contaminate' the good work for risk of harming performance. The stark conclusion is that in the UK during the 1990s most acquisitions were of a 'purchasing asset' variety involving little or no transfer of resources between buyer and target. Moreover more recent analyses have indicated that whereas companies have become more sophisticated in due diligence and in the M&A process value to shareholders has remained disappointing (see data referred to in **1.6** above).

The best option **1.33**

Although evidence has revealed that only in a minority of cases extensive integration occurs, a number of key changes do happen in all acquisition types. The most common changes are ones which are symbolically important, signalling progress to staff and the city. Therefore management changes, financial reporting changes and communication changes are all quick to take place. Changes that are relatively easy to accomplish and have high impact, such as senior staff movement, will be pursued first. Longer term, if at all, the more complex areas will be tackled such as site rationalisations and IT systems. Therefore, given the focus on share price and city evaluation that drives much business strategy, not least because of the share options link between senior management and company stock price, acquisition integration tends to focus on early indications of success which is a less risky and preferable approach to a longer-term involved integration which may take time to signal success.

In the long run, however, the early win approach may be detrimental to value. If the acquired target is not brought in to the wider corporate structure and is left to continue much as before, it is unlikely that the acquirer will have accessed that premium he paid for in the deal. This may well be part of the reason for the number of divestments that have to be undertaken (see also **Chapter 8**).

The fact that the above study (see **1.32**) was conducted in the UK means that the stock market impact on managerial action will inevitably be a major factor, as it will be in the USA – that is countries with highly active and liquid stock markets. It may, however, be that in European or Asian countries with more conservative stock markets that the focus on short-term delivery is less intrusive – this may facilitate more measured analysis and implementation of integration, and a comparative analysis would be useful. True value creation from acquisitions therefore appears to be only pursued in a minority of actual instances – a clear opportunity for genuine wealth creation therefore remains.

Priorities **1.34**

Textbooks and journals on how to integrate successfully are now commonplace in management literature. They tend to cite sensible advice such as:

- communicate thoroughly with all employees;
- set clear objectives and initiate appropriate organisational change;
- have clear milestones;
- ensure normal business is not hampered;
- act quickly to avoid losing momentum and enthusiasm.

Both the Warwick study (see **1.32**) and this integration literature tend to be descriptive and have not attempted to draw out contingent circumstances of acquisitions. That is, it may well be inappropriate (although technically preferable) to try all elements of integration depending on what the acquirer's objectives actually are. Indeed, there is evidence to suggest that post-merger synergy may not be a primary objective at all – competitive reaction, revenue capture for growth or other strategic issues may actually dominate, and require that resource is only expended on specific key areas. Acquirers should, however, stand back and realise what it is they are actually stating by following this thinking: 'I am deliberately purchasing assets to which I will not add value, and from whom I will probably not gain value in the long run'.

Whatever the case, recent merger activity in the UK suggests that the integration issue is receiving more attention. Interviewed about the merger of Price Waterhouse and Coopers & Lybrand, the integration manager (a good asset) noted a simple but insightful point about the finer details:

> 'The two firms bill their clients and do their time sheers differently. It will probably take two years to sort all that out, and its going to take a huge investment.'

This is a realistic assessment of the kind of effort required and highlights the reality that even with best intentions it is often very difficult in the short term to make significant progress in certain areas – a realistic and flexible evaluation of these areas could ensure expectation about progress is managed.

For example, integrating the culture of two combining firms (often given high profile in merging episodes both in publications on the subject and by management) is very likely not to occur much beneath the surface in the timescale of integration – irrespective of what best practice advises. In many instances, even after several years, a parent culture tends to linger with many individuals. It might be better to realise that the cultures will continue to have a certain flavour and that this is either acceptable or, if it is not, a replacement of key staff may have to occur. In any event, a fundamental review as to how important this is actually going to be should be undertaken and, if it seems manageable but resource consuming, this fact should be reflected in the purchase price. Cultural issues are worthy of a separate debate and are considered to an extent in **Chapter 8**.

It is clear that extensive post-merger integration, if attempted, will often be a difficult and time-consuming task. It therefore would seem to make sense that as part of a negotiated target price this investment in resource and time be used to counter inflated premiums for the target firm. This addresses, in part, the problem of shareholder value return and in fact may be a salutary action to undertake in terms of assessing how viable the wider acquisition or merger will actually be.

In-house lawyers are often key players in determining the strategy and implementation of acquisitions and so it is important that they can provide guidance to their colleagues on the importance of effective integration. Furthermore, when advising on a transaction both in-house and private practice lawyers need to be aware of the buyer's purpose for making the acquisition and integration will be a factor in this. This will influence the due diligence, the transactional documentation and the negotiations. For instance, the purchase of a service sector business, such as an insurance brokerage, will involve a different set of legal analysis and transaction if the personnel are not being acquired.

The facts are, however, that often mergers and acquisitions provide such a strong momentum of their own that it tends to sweep aside all but the most obvious of post-merger integration considerations. In order to realise the objectives of good corporate governance and to achieve realistic purchase prices, and fully access post-merger value, these aspects should be prioritised before rather than after the event.

Other business issues **1.35**

At this stage it is useful to bear in mind the due diligence exercise in the context of other business issues and the general objective to understand the:

- risks and rewards of due diligence;
- repercussions of the analysis; and
- interaction with risk management and corporate governance.

Practitioners emphasise the importance of understanding how due diligence must not be blinded by only looking within the company. The external environment in which the company operates, hires personnel, deals with suppliers, etc. is a significant component. In this context the term 'environment' is used to group together the elements that support and impact the company.

To recap, the mission of any due diligence exercise starts with verification of the company goals. The goals have to be prepared and be able to be articulated. A statement such as: 'we want to compete in the bicycle market' is much too vague and does not provide any support for people who are trying to implement a business plan. Clarity and specificity is much better than vague assumptions and generalities if the business goals are to be understood and achieved. Another important reason for clarity is to enable the due diligence team to be able to recognise when the business is heading off course and when the company is moving ahead – the objective is not to find reasons and justifications to keep going. While there are always exceptions to every procedure, the more business operations are guided by consistent principles, the easier it is to identify the exceptions and determine whether this time such an exception is justified or not. With enough exceptions, a company's operations handbook needs to be adjusted to embrace this exception as it is now a standard procedure, not an exception.

There are several key objectives for company operations to support a due diligence environment. Ongoing due diligence demonstrates:

- the company business capabilities;
- the stability of the company, the industry and the overall economy;
- the revenue and expense flows for business operations;
- company support methods;

- risks – business, personnel, economy, environment;
- a clear strengths and weaknesses assessment of the company; and
- specific business continuity issues.

Ongoing due diligence helps to create the framework that enables companies to operate effectively. While each company is different, the objectives are typically the same, to:

- sustain profitability;
- reduce risk to the company;
- achieve business goals and objectives; and
- improve quality of life.

Drivers for ongoing due diligence **1.36**

Some consideration has been given above to the drivers for the due diligence process mainly in the context of transactions. Mention has also been made of the growing importance of ongoing internal due diligence that supports the corporate culture and good corporate governance positively (see further **Chapter 4**). In view of concerns raised by the high failure integration rate, it is useful to close this chapter with some highlights of the business issues to set the scene for the **Chapters** that follow.

External drivers **1.37**

External drivers include:

- regulatory issues;
- company standards;
- corporate governance issues and trends;
- investor/lender/stakeholder confidence;
- consumer confidence;
- consumer satisfaction;
- government compliance issues.

This list continues to expand – what is essential to understand is how the environment outside the organisation needs to be included within the elements that due diligence reviews. The due diligence team needs access to where this information can be gathered on an ongoing basis. Very often trade associations are a good source for this information and the data collected can be used to compare the company operations with other companies, industries and countries.

Internal drivers **1.38**

Internal drivers include:

- employee satisfaction;
- management satisfaction;
- supplier relationships;

- operational procedures;
- operational implementation; and
- multi-office relationships.

While this list is more limited than the external list, this does not mean that any of this information has limits and boundaries that are set in stone. As regards internal due diligence, the team needs to be attentive to the results of interactions among employees and management. Proper implementation requires overall co-ordination and consistency by the people who are empowered to perform the various company tasks. For example, if a bookkeeper is allowed to change the data of a sales entry unilaterally without any transaction trail, then chaos could result. There could also be a problem that could lead to fraud and/or the commission of criminal acts. Exposure to such risks is not what business wants and supports the appropriate use of due diligent activities.

Practical issues **1.39**

In the context of this discussion, practical examples of combining internal and external activities are joint deals, transactions, joint ventures and other relationships. For this work due diligence is actually two sided. Each company within the relationship will have due diligence to perform:

- company one will want to investigate and examine company two and vice versa;
- company two will need to assess company one.

Mergers are especially the subject of a due diligence exercise by each company, their lawyers, their accountants, government regulators (if public companies), insurance advisers and so on.

Bearing in mind the importance of the quality of data, the key is to have each due diligence team determine the level of exposure based on what can or cannot be answered. Many deals or negotiations never get past due diligence because there is not enough documentation about the company's operations. The deal can be filled with risk as there cannot be a total investigation just as there is never a complete investigation of the medical, emotional, financial history for each party to a marriage. There has to be a balance that is part of the risk reward formula for all due diligence activities. For example, in the case of a £50 million deal, not being able to verify a £1,000 transaction may not be worth the thousands that it takes to validate the transaction.

This is where the experience and capability of the due diligence team is essential.

First, they have to possess training and expertise to be able to recognise the important and the unimportant. Second, they need to have the appropriate tools necessary to perform their tasks. The tools can include, but not be limited to:

- Internet research capability;
- legal data bases – especially for lawyers;

- tax data bases – especially for accountants and lawyers;
- industry perspective and data;
- access to company personnel;
- access to all relevant regulations – securities, government, environment, etc.; and
- appropriate computer and resource tools that support this work.

As due diligence continues to expand, companies will rely on the information gathering that can sustain the enterprise, reduce the risk of business activity and reward the various stakeholders.

Other due diligence drivers **1.40**

There are other drivers for the due diligence process that exist and should be mentioned by way of a summary. They are described below.

Macro and micro issues **1.41**

The company operations have to be able to feed appropriate data into the due diligence mixing bowl. Macro issues include the larger pictures, especially those issues that the company has absolutely no control over. For example, the global economy, global politics and global terrorism are examples of very real issues that have to be monitored with appropriate plans in place and ready to be implemented, the moment that a due diligence alert has been sounded. As is discussed below at **1.42**, very practical issues must be considered when embarking on activities that involve foreign risks or jurisdictions.

If country one, which is a buyer of your goods and services, has a major weather-related disaster, a number of events may be triggered. All sales to that country may be suspended, employees may not be reachable or worse, an inventory already in place may be destroyed. As is discussed further in **1.42** and in **CHAPTER 5**, due diligence efforts can include monitoring possible disasters, and if predictable, taking precautions in the days leading up to the event. Another part of due diligence is understanding the potential of such risks occurring and establishing procedures way in advance of any possible catastrophe that has a full set of operational procedures of what to do. The quality control needed by senior management is to verify that such procedures are in place and employees have been alerted and trained.

The interaction with risk management and corporate governance **1.42**

Risk management and corporate governance have become increasingly linked with due diligence in the last few years. Risk is often regarded dealing with the unknown. It requires making decisions without all of the facts that are absolutely required to determine the outcome. For instance, in sport, horse racing provides the gambler with a chance to exercise risk decision-making. They can establish all they can about the horse, speed of the track, weight, weather conditions, etc. and then make a bet on who he or she thinks will win, place or show. In business, of course, the more responsible players have to reduce the gambling aspect and lower the risk of being wrong. This is particularly true of overseas decisions. When dealing with parties or transaction overseas there are some key issues to bear in mind.

International dealings

International business is not new; the ancient Egyptians, Chinese, Romans and others were all active importers and exporters. Travel and communications may have developed and legal frameworks may have evolved, but many of the pitfalls awaiting the unwary global trader have changed very little. Air travel and the Internet may have shrunk the world, but it should never be forgotten that abroad is still different both in legal and cultural practice. Indeed, even when one is dealing with different member states of the EU or states of India, provinces of China or states of the USA differing considerations may apply. For example, executing a major project in California may have considerably greater legal and regulatory risk than if the same work was to be carried out in Massachusetts or Alabama in the USA.

All of the above examples demonstrate that where major business opportunities arise in a new and unfamiliar territory, due diligence is required and time should be taken to secure appropriate local advice both from professional advisers and from other businesses with local involvement. Most importantly every assumption underlying a bid or negotiating position should be tested. In view of the increasing activity in international business by organisations of all sizes, it is useful to consider some points or issues that may seem obvious but in fact often are not observed sufficiently as part of the risk management process.

Practical steps that can appear to be just common sense can in fact be very effective. For example:

- Foreign negotiators may claim that certain requirements they seek to impose are a requirement of local law. This should never be accepted without taking local advice, from professionals and local consulate or Embassy personnel.
- Where contracts are to be executed in duplicate copies in English and the local language, it is desirable that English be given precedence or at least equal status.
- The efficiency and impartiality of local courts and other dispute resolution bodies should be investigated, bearing in mind that even where judicial proceedings or arbitration in a third country is provided for, it will usually still be necessary to seek the enforcement of a judgement or award in the other party's country (see also **Chapter 5**).

- Any suggestion that while local laws or contractual provisions may contain onerous requirements, these are not enforced in practice, should be checked. This may well be quite true in relation to local businesses, but it is probable that the position will be different where a foreign company becomes involved.

In many cases it will be better to adopt practical mechanisms to protect vital interests such as:

- Where local protection of intellectual property rights (IPRs) is uncertain, it may be possible to retain confidential items such as source codes, and reserve the right to produce and supply crucial components or ingredients.
- Payment structures should be adopted that reduce exposure to default, even where documentary credits and export guarantee protection have been obtained.
- Insurance programmes should be considered for their applicability even where contractual provisions require local insurance to be obtained.

Use of English language

It may be thought that, with the use of English as the global business language, the process of reaching agreement has become simplified. It should not be assumed, however, that because senior management in the foreign organisation is reasonably fluent, this will also be the case at all operational levels. There can be unexpected difficulties with technical and legal terms with which even interpreters can have problems. Where all discussions have to go through interpreters the difficulties are multiplied. A good interpreter does not just turn words from one language to another, but is competent should translate ideas and concepts accurately. This requires that the interpreter should have personal business experience, or at least should have received a thorough briefing about the background to and key issues of the negotiations.

It is vital to appreciate that telephone calls, emails, video conferencing and the like have not replaced the need to meet face to face with a potential business partner to gain confidence in the latter's trustworthiness and ability. However thoroughly the target country may have been researched, there is also no substitute for personal experience of local conditions. It is important not to rush this process, particularly in more distant or unfamiliar locations. Indeed very practical hints and tips should be observed as part of corporate policy when considering overseas activities. It has been observed in many cases that just as with long distance driving tiredness can kill! Negotiations can fail and the other party can take unnecessary advantage. Proper time management and planning are essential to avoid costly and possibly long-lasting repercussions. This applies to travel schedules. It is even more unwise to set a tight and unchangeable departure deadline known to your negotiating partner.

For example, in one project it became well known to the Indian client that the UK bidder's visiting personnel were extremely keen to be on the pre-booked flight home by Friday afternoon. Unsurprisingly, key issues were tabled by the client on Friday morning, with Minutes of Agreement presented for signature just after lunch – when the visitors would be very anxious to get to the airport and would be ready to sign just about anything. Many later difficulties had their origins in such events.

Meeting schedules and local infrastructure
Other local issues reflect the injunction referred to earlier to leave no assumption untested. Project implementation may be dependent on port facilities, access routes, communication links or local services. Meetings in a capital or other major city may give a misleading impression of the facilities available at other locations in the country that may be relevant. Climatic conditions may vary widely with the seasons, and in many key places, such as India, power shortages may cause difficulties during the summer months.

Security advice should be obtained either from specialist advisers or the local Embassy especially where personnel are to be deployed in less-developed territories. In one memorable contract there was a provision allowing the contractor to call out the nearest army unit in the event of local difficulties. While this may have been the most practical measure in the circumstances, it did little for recruitment to the project. Similarly, while it is perfectly possible to obtain 'kidnap' insurance to provide for employer and employees in the event of abduction, even the best cover cannot fully compensate for the trauma to an employee or his family in such an event. In these circumstances, local personnel should be employed wherever possible, not because they are more 'expendable' but because they should be more familiar with the local environment and will not be as attractive targets as expatriates.

Apart from what might be termed the 'micro risks' that can arise during the negotiation and execution of projects, consideration should be given to the 'macro risks' attaching to the foreign territory as a whole. In this regard, an assessment should be made of the political and economic circumstances in the territory under consideration. Some key questions are:

- How stable and developed is the system of government?
- Are fundamental regulations capable of being changed by decree?
- Are there serious internal or external security risks?
- Are there United Nations or other sanctions in force, or likely to be applied?
- Where technology or components are wholly or partly of US origin, for instance, is there any need for clearance under the US Export Administration Regulations?

Political risks
Political instability often gives rise to adverse economic conditions, particularly where corruption has flourished under an authoritarian régime. For example, it was widely recognised in the early 1990s that Indonesia faced potential difficulties when the time came for the ageing President Suharto to leave office. However, at that time it was envisaged that Suharto (in power since 1965) would attempt to engineer a smooth transfer of power to a family member or other trusted associate. Corruption was endemic, with local banks acting as conduits for doubtful monies and providing loans on political rather than financial grounds. When the end came at the time of the Asian economic crisis in 1997, Suharto's fall was accompanied by mass insolvency and a currency collapse, as the Indonesian Rupaiah lost almost 90% of its value against Western currencies overnight. It can well be imagined what devastation these events caused to Western contractors and investors. Supplies of imported components and labour became impossibly expensive while local customers and partners could no longer make payments in hard currency.

Therefore, when operating internationally it is important to take time to fully examine the proposed area of operations, assessing its legal structure and business infrastructure, together with its political and economic prospects. Never miss an opportunity to discuss local conditions with other organisations already operating there. Experience is often the best teacher, better still if the experiences are those of others! Due diligence methods can also monitor situations that can be a level of risk. For instance and by way of analogy, airlines know that bad weather can be a risk to any aeroplane. Consequently, it is essential for all aviation personnel be provided with all data about weather between where they are and where they are going. In this way the risk of being hit by lightning, or worse, can be reduced to a manageable procedure. Airline pilots quite frequently request permission from ground controllers to change their altitude to avoid endangering the plane, passengers and people on the ground. The pilots and ground controllers are trained to be diligent about the risk that can lie ahead. In this example, the passengers are merely freight and along for the ride. Further discussion of exposure to such types of risks and their management is found in **Chapter 5**.

Transactional and operational assessments 1.43

Transaction auditing is a well-known component of the auditor's world. In this activity, the auditor, internal or external selects some number of transactions to determine their accuracy with the company's entire processing cycle. For due diligence, it is also essential to be able to identify specific operational transactions – financial or business. For example, if a patent application requires a series of steps then it is essential that each step be documented so that the work can be proven as being completed.

Operational assessments refer to how the company conducts its business. Planning or zoning requirements vary by country and region. International transportation of goods and services has different regulations and requirements than national business activities. The due diligence team is required to be able to access all that encompasses the business – before, during and after a specific business transaction.

Transactional issues **1.44**

Globalisation is also a potential mine field filled with places that require guidance and careful management. In some respects the due diligence exercise starts with the knowledge of the company's desire to do business within another country. The due diligence team takes over to establish the legal, financial and government regulations that need to be understood. Then procedures can be implemented to make sure that company actions fall within the required guidelines. In this case, it is an absolute requirement to perform due diligence prior to commencing any business activity. It would certainly be expensive, in terms of both time and money, to perform due diligence after the fact and reference should be made to the comments in the chapters that cover the international dimension of due diligence and corporate governance, particularly **Chapters 11–15**.

Reference

1. Angwin, R. and Wensley, R. The acquisition challenge, *Realising the Potential of Your Purchase*. Warwick Business School Paper, Vol. 1, No. 4, 1997. *(See para 1.32 p. 31)*

Appendix

Item 1

Overview of main issues for a due diligence exercise

Submitted by Kaden Borriss, Corporate Lawyers, Delhi

> 'Almost half of all acquisitions fail or do not achieve expectations. Improved advanced planning, target evaluation and due diligence can improve chances.'

The underlying purpose of due diligence is to observe, analyse and examine all the key areas and, as well as the minute details involved in any business, the company, immovable property, etc. that is under consideration. In the present summary we have classified the requirements of due diligence under three headings.

1. Acquisitions: the act of contracting or assuming/acquiring possession of something; 'the acquisition of wealth'; 'the acquisition of one company by another'.
2. Joint ventures: a partnership or conglomerate, formed often to share risk or expertise.
3. Purchase of immovable property, for example land and building, etc.

After the initial stages of buying a business/immovable property or entering a joint venture are complied with, such as that of search of a seller and interaction with the prospective seller to formulate a strategy and conclusion of a transaction, then follows the stage of due diligence. This is the last stage in the buying process. This is the time when the buyer will have access to all of the company's/owner's books, records and files. The buyer will have a predetermined due diligence period in which to investigate the information that it has been given so far to ensure that it is true and accurate. Due diligence is the way to discover everything before the actual purchase that the seller knows. Once the deal is closed there is little or nothing that can be done about it.

The basic requirements for acquisition of a business/joint venture are listed below.

1. Corporate books and records:
   - original certificate of incorporation of the company and all amendments thereto;
   - memorandum and articles;
   - closing record books for any material corporate transactions (e.g. reorganisation into holding company structure, joint ventures, etc.);
   - other relevant legal documents governing the organisation and management of the company;
   - minutes of annual general meetings and other board meetings;
   - shareholder list and other stock records, any shareholder agreements or any agreements relating to shareholders;
   - annual reports and other quarterly and special interim reports since most recent annual report.
2. Financial information:
   - consolidated financial statements, monthly income statements for most recent 12 months, internal financial (profit and loss, capital expenditures, etc.) projections and all supporting information, most recent business plan, list of any off-balance sheet liabilities not appearing in most recent financial statements, auditors' reports ('management letters'), management responses and summary of accounting policies to the extent not disclosed in financial statements;
   - tax materials and documents and records;
   - debt obligations.
3. Employee materials:
   - employment agreements (including, but not limited to, contracts with management personnel or entities affiliated with management personnel) and all other agreements with employees in any regard;

    - any labour disputes either pending or disposed of;
    - organisational information including detailed organisation chart, list of all directors and officers, biographies of senior management and any outside directors, schedule showing number of employees for each year and interim periods, and list and description of current operations of each key business unit.
4. Contingent liabilities:
    - litigation:
        - list of all pending, disposed of or threatened litigation, appeals, arbitration, administrative or other proceedings involving the company, any subsidiary or any joint venture involving the company or any subsidiary, or any officer or director (including parties, remedies sought and nature of action);
        - list and description of all pending, threatened government or other investigations involving the company, any subsidiary or any officer or director;
        - pleadings and other material documents in material litigation, arbitration and investigations and other proceedings;
        - decrees, judgments, etc. under which there are continuing or contingent obligations;
        - letters from lawyers to auditors concerning litigation and other legal proceedings;
    - regulatory compliance;
        - description of any violations of governmental laws or regulations;
        - material reports to governmental agencies;
        - reports, notices or other correspondence concerning any known or alleged violation of central or state laws and regulations;
        - agreements or commitments with governmental entities or other persons relating to clean up obligations or other environmental liabilities;
        - copies of correspondence between central or state government agencies and the company;
        - list of all governmental filings and consents required for a purchase of the stock of the company.
5. Contracts, agreements and other arrangements.
6. Intellectual property rights owned by the company, complete information and documentation.
7. Plant, real property and equipment.
8. Insurance information and documentation and up-to-date records.
9. Sales/marketing policies/strategies/records.

The basic requirements for acquisition of an immovable property are listed below:

- Files and other records with respect to the immovable property in possession of the land owner.
- Files and other records with respect to the immovable property in possession of the revenue authorities.
- Files, records and other documents with the Register of Companies.

- Contingent liabilities:
  - litigation:
    - list of all pending, disposed of or threatened litigation, appeals, arbitration, administrative or other proceedings involving the owner of the immovable property;
    - list and description of all pending or threatened government or other investigations involving the owner of the immovable property;
    - pleadings and other material documents in material litigation, arbitration and investigations and other proceedings;
    - decrees, judgments, etc. under which there are continuing or contingent obligations;
    - letters from lawyers to the owner or any other legal proceedings;
  - regulatory compliance:
    - description of any violations of governmental laws or regulations;
    - material reports to governmental agencies;
    - reports, notices or other correspondence concerning any known or alleged violation of central or state laws and regulations;
    - agreements or commitments with governmental entities or other persons relating to clean up obligations or other environmental liabilities;
    - copies of correspondence between central or state government agencies and the owner.
    - contracts, agreements, sale deeds, lease deeds, rent agreements and any other arrangements pertaining to the said immovable property.

Item 2

Initial steps in transactional due diligence in the UK

The initial steps taken in transactional due diligence in the UK are:

(a) Outline of general action.

(b) Typically a number of preliminary steps before the negotiations commence in earnest, in an asset transfer transaction such as a share purchase, asset purchase or joint venture, these include:
  - The seller takes a strategic decision to sell the company or business or to enter into a joint venture. This may have been instigated by the seller or initiated by an approach from a merchant bank or purchaser or potential joint venture partner.
  - The buyer takes a strategic decision to buy the company or business or to enter the joint venture. Again, this may have been instigated by the seller or initiated by an approach from a merchant bank or purchaser or potential joint venture partner.

(c) In larger transactions, the seller may undertake its own due diligence, particularly where a controlled bid is being employed.

(d) Discussion takes place between the buyer and seller and an agreement in principle is reached.

(e) Lawyers, accountants and other advisers are instructed.
(f) The first meeting between the seller or buyer and its advisers.
(g) The first meeting between the seller or buyer and its advisers is worthy of specific mention as it encompasses an overview of the issues affecting the transaction as a whole. These will include the following.

Overview of transactional issues

Issue	Explanation
Identity and residence of the buyer	Identity is important from the consideration of the strength of the covenant of the party. Residence is relevant from the point of view of enforceability of any agreements and the possibility of tax sheltering any profits arising from the transaction.
What are the key assets the buyer wishes to obtain in making the purchase?	Some typical key assets are: • management or technical expertise; • personnel; • client or customer base; • suppliers; • brand name(s); • technology, including intellectual property such as know-how; • production capacity; • distribution network; • land and buildings; • regulatory approvals and licences.
Security	Where the agreements are likely to provide for obligations which continue after closing, then the covenant of the obligated party may require to be backed up or reinforced by some form of guarantee or other security.
Consideration	Some input from the lawyers on general valuation considerations may be appreciated at the initial meeting.
Timescale	It will be helpful if the lawyers have an influence on determining a realistic timetable for the deal.
International aspects	International aspects of the transaction will need to be addressed at an early stage and the question of engaging foreign professional advisers should be tabled.
The structure of the transaction	• parties to the transaction; • asset or share purchase? • key assets being acquired? • valuation considerations; • assets hive down prior to sale of shares? • key liabilities to be minimised; • tax considerations; • general approach regarding indemnities; • security appropriate for indemnities? • restrictive covenants? • staggered closing appropriate?

(*Continued*)

Issue	Explanation
Funding	How is the transaction being funded? Consider the issues arising from this.
Stock exchange requirements	Are any of the parties governed by stock exchange rules? If so, what will this mean?
Other regulatory issues	Are there any other regulatory issues affecting the transaction or the parties individually, for example competition law, foreign exchange requirements?
Consents and conditions	Are there other consents and conditions to be obtained or satisfied, for example shareholder approval, key customers or suppliers?
Confidentiality	Are confidentiality agreements or undertakings in place: • from the buyer; • from the buyer's shareholders; • from the buyer's employees? Is there any confidential information, such as the customer list or secret processes, that the seller wishes to restrict?
Insurance	Will existing insurance arrangements pass?
Lock-out	Is an exclusivity arrangement negotiable for a period of, say, six months?
Heads of agreement	Any entered into? If so, consider the terms. If none, should they be prepared?
Funding comfort letter	Sometimes, whether or not a merchant bank is involved in the transaction, the buyer will be required to supply to the seller a letter confirming it has access to sufficient funds to enable it to close the transaction and, expressly or by implication, satisfy the purchase consideration.
Due diligence overall issues	Discuss the overall strategy. Consider due diligence checklist with buyer and its professional advisers.
Instruction of advisers	It is to the benefit of client and professional adviser to record appointments in connection with specific transactions in letters of engagement, to reduce the possibility of any subsequent disagreement or dispute.
Rules of engagement between buyer and seller	The parties will wish to set out guidelines for carrying out the due diligence exercise and these are normally set out in rules of engagement either in heads of agreement between the parties or a separate letter.
Data room letter	If a data room is to be used, then rules of engagement may be set out in a data room letter.
Other pre-closing documents	Refer to the list of transaction documents.
Civil sanctions for non-disclosure	The seller and target personnel should be reminded that misrepresentations, whether innocent or otherwise, can have serious civil repercussions.

Issues to be considered

Issue	Explanation
Specialised industry sectors issues	Such as the Chemical Sector, Food Sector or Automobile Sector regulations, etc.
Employment matters	• application of transfer of employment regulations; • new terms of employment; • restrictive covenants; • pension provisions.
Insurances	In major transactions it is not uncommon to employ insurance experts to assess risk and risk cover and review insurances generally.
Intellectual property and IT transfers	In the case of a business acquisition, intellectual property assets such as copyrights, registered designs, trademarks and patents will require to be transferred by the seller to the buyer under simple forms of assignment. In the case of share acquisitions, a review of the title to the assets will be required.
Real property transfers	In the case of a transfer of a business any real property assets will be transferred from the seller to the buyer under normal conveyancing procedures. In the case of leasehold property the landlord's licence or consent to the assignment of the lease will normally be required. In the case of share acquisitions, a review of the title to the assets will be required.
Position between exchange and closing	• consents; • closing accounts; • searches; • documents to be agreed; • all charges released.

Basic differences between a share acquisition and an asset purchase

Share acquisition	Asset purchase
Involves sale of share capital in the target by its shareholders to the buyer	Involves the target itself selling assets to the buyer.
Liabilities of the target continue to affect target after sale, unless agreed otherwise	More limited liabilities and commitments pass with the transfer of the target assets.
The target's rights are not affected after sale, unless there are 'change of control' provisions in effect	Tide to the assets and rights have to be transferred by the target to the buyer. Where those rights involve a contract with a third party, their consent may be required to the assignment or the agreement novated with them being a party, unless there is no burden attaching to the right and consent is not required by the agreement.

The due diligence exercise for a share acquisition is therefore complicated by a greater concern of the buyer to identify the liabilities attaching to the target. The potential for unknown liabilities raises a level of uncertainty less present in asset purchases, making asset purchases generally more desirable. However, asset purchases are often impracticable in larger businesses because of the volume of assets and rights which require assignment and novation. This problem of assigning rights has been overcome by certain legislation in England which allows the rights and liabilities of businesses to be transferred by operation of law and without the need to obtain the individual party's consent. Such legislation applies for instance to asset transfers by building societies and insurance companies.

Item 3

Specimen auction or tender process letter

This process could alternatively be contained in an agreement or in the information memorandum itself.

Dear Mr [ ]

SALE OF [name business] ('target')

We attach an information memorandum relating to the above company. This information memorandum has been of will be sent to qualified interested parties, all of whom are bound by similar confidentiality agreements in order to assist them in deciding whether they wish to enter into negotiations to acquire the whole of the issued share capital of the target or part thereof, some or all of the target's assets or a combination of the above.

This information memorandum is provided to you in commercial confidence and on the terms of the confidentiality agreement dated [ ].

Would you please forward to us your proposal in writing for the acquisition of target to our offices by [ ] on [ ], covering the following:

- The purchase price in [state currency] or formula for determining the same, that you are prepared to offer for 100% of the issued shares of target, subject to contract. This would be on the basis that [target's bank and inter-company borrowings have been discharged].
- Your intentions regarding any reorganisation or redundancies of target personnel.
- Confirmation that your bid is made as principal on your own account.
- Details of your financing arrangements for the transaction and a letter from your financial adviser or bank that you have the necessary finance.
- Any specific due diligence issues that you wish to address.
- Details of any regulatory or other consents required (including internal approvals), and the timing therefore.
- An estimate of your share of the [ ] market in [state territory]. Details of any competition clearances or notifications required. If none, a statement as to the reason why none are required.

- Confirmation that there are no other conditions attached to your bid.
- A statement of your ultimate ownership, together with copies of your annual reports for (two or three years).
- We do not envisage providing more information prior to indicative bids being submitted. However, if you do have queries they should be raised directly with [name] who can be contacted by telephone on [#] or email on [#]. (Where contact point is at target – if [he/she] is not immediately available you should leave your name, the company you represent and your number so that [he/she] can return the call. Under no circumstances should you try to discuss this sale or leave more substantive messages with any other member of staff at the target.

Process

Following receipt of indicative offers, the vendor intends to select a small number of bidders to proceed to the final stage of the process, involving:

- A meeting with the target management and a visit to the target's premises.
- Access to a data room maintained at [state location].
- Copies of due diligence reports prepared by the vendor's advisers (these will be arranged through us).
- A draft of the sale documentation will be distributed and bidders will be asked to submit their final offer for the target together with a copy of the documentation with any suggested amendments. Such offers will be binding on the bidders.
- Following receipt of such offers, the vendor will select a bidder with a view to finalising the transaction.

The vendor shall be under no obligation to accept the highest bid offered or any bid at all. The vendor reserves the right at any time and without notice or and without assigning any reason therefore to vary or discontinue the sale process or to sell the target to any person.

Yours sincerely,

[ ]

For and on behalf of [ ].