

SECTION 2

THE DUE DILIGENCE PROCESS

WHY DO DUE DILIGENCE?

- 2.1** In any acquisition, whether a share purchase or an asset purchase, the potential buyer will be taking on risks. Buyers therefore need to gather sufficient information to understand the strengths and weaknesses of the target business and understand any liabilities or risks that come with it. An assessment can then be made as to whether the advantages of making the acquisition outweigh the risks. This is particularly important as the principle of caveat emptor, or 'buyer beware', applies. This really does place the onus on the buyer to make sure it investigates thoroughly before committing to the acquisition.
- 2.2** For each buyer the commercial rationale for making an acquisition will be different. Identifying clearly from the outset the reasons for the transaction will direct the focus of the due diligence investigations. It will also help to highlight any matters which will amount to 'deal-breakers' for the buyer.
- 2.3** In addition to understanding the risks involved, the due diligence process should help the buyer to assess the true value of the target business to it. This will not necessarily be the same from buyer to buyer as there are many differing reasons for any acquisition to be contemplated.
- 2.4** A buyer with an existing business will want to be sure that the target business can viably be integrated into the existing group. There may be considerations around the cultural fit as well as more practical issues such as redundancies where there is duplication of functions.
- 2.5** We will consider later in this section how a buyer can try to reduce the risks it inherits through contractual measures. An effective due diligence programme will inform the level and type of contractual protection required and identify any risks which should be left in their entirety with the seller.

Fundamental due diligence issues

Any due diligence enquiry should at least establish the following about the target business:

- (1) Does the seller have good title to the shares in the target business or the assets being sold?
- (2) Is the target business or are the assets capable of being integrated within the buyer's existing business?
- (3) What is the true value of the business or assets to the buyer?
- (4) Are any consents required either for the transaction to proceed or for the full benefit of the acquisition to be realised by the buyer?

WHO DOES DUE DILIGENCE?

2.6 The key to a successful due diligence exercise is to get the right people involved. Usually, the core due diligence team will include the buyer's senior managers, the buyer's lawyers and the buyer's accountants. If the transaction has an international element, there may also be lawyers or accountants in other jurisdictions involved. In addition, if there are specialist areas under investigation, such as environmental issues or pensions, there may also be relevant experts in these areas in the team.

2.7 Given the potential size of this due diligence team, it is essential that each group is clear as to its remit and responsibilities and that a system of effective communication is established. All relevant lines of enquiry that emerge must be pursued properly by the most appropriate adviser. It is therefore sensible to appoint a leader to take on the role of coordinating the process. This would usually be the adviser who is closest to the commercial negotiations.

2.8 The engagement letters appointing advisers can become a useful tool for the buyer to demarcate the roles of each professional and set out key areas of focus for their investigations.

Managing the due diligence process

- (1) Involve the right people: buyer, solicitors, accountants, foreign lawyers, experts.
- (2) Establish clear leadership.
- (3) Maintain clear reporting lines.
- (4) Allocate responsibility clearly.
- (5) Involve the buyer throughout to decide what is of commercial importance from the results of the investigations.

WHAT DOES DUE DILIGENCE COVER?

2.9 In broad terms, in addition to the legal investigations which are the subject of this Guide, there will usually be both commercial and financial due diligence. Commercial due diligence looks at the transaction from a macro prospective and considers issues such as market conditions within the industry, marketing, competing products and so on. Effectively, the buyer wants to make sure that the reasons for considering making the acquisition can be supported by the results of its commercial investigation. This process should also start to identify a series of actions which the buyer will want to take post completion to integrate the business and maximise its potential.

2.10 Financial due diligence will almost certainly involve external accountants acting for the buyer but may also include analysis from within the buyer's existing finance team. The external accountants will review the audited accounts of the target business, but their primary role is to consider those areas of the finances of the target business which have been highlighted by the buyer as potentially affecting its decision to proceed or the price it is willing to pay. The accountants will also be responsible for assessing the tax position of the target business. In an asset purchase this will include confirming that the business can be transferred as a going concern and, for a share purchase, looking at matters such as available reliefs.

2.11 In all cases, whether legal, financial or commercial, the scope of the due diligence investigation needs to be defined. This will be influenced by a variety of factors. First, the knowledge of the buyer both of the target business itself and of the industry in which it operates, particularly any inherent risks, will be highly relevant. Then the strategic purpose of the acquisition for the buyer will influence the nature of the review at a very practical level. Consideration needs to be given to the value of the transaction as opposed to the costs of undertaking the review and a sensible balance struck between the two. There may well also be time constraints arising for any number of reasons. Occasionally, the sensitivity of the seller in releasing data will limit the extent of any review, particularly if this results in a data room being used (see 2.31–2.38). The buyer will need to weigh all of these factors when instructing external advisers and be prepared to adjust the approach should matters emerge which require more detailed enquiries. The box below summarises these considerations.

Trade Marks Registry	www.ipo.gov.uk/tm.htm
Patent Office	www.ipo.gov.uk/tm.htm
Designs Registry	www.ipo.gov.uk/tm.htm
Press searches	news.bbc.co.uk
Agency searches	www.dnb.co.uk
	www.lexisnexis.co.uk

REVIEWING INFORMATION

2.23 There will be a large quantity of information produced through the due diligence process. The Due Diligence Questionnaire should therefore allow for responses to be submitted piecemeal so that the buyer can make a start on its review of the data supplied whilst further information is being gathered.

2.24 As responses to the Due Diligence Questionnaire come in, the buyer's solicitors need to establish a system for collating and storing the information in a readily accessible and identifiable manner. This is usually done through a series of lever-arch files indexed to correspond to the numbers on the Due Diligence Questionnaire. The data supplied then needs to be reviewed carefully, both to check that it is complete and that the question has been properly answered. An assessment as to whether any follow-up questions are required will need to be made. Clear communication with all other advisers and experts at this stage is critical to ensure that no lines of enquiry are omitted.

2.25 The principal areas of enquiry for both a share purchase and an asset purchase are as follows:

- Constitutional/Structural Information
- Accounts
- Borrowings/Finance
- Recent Events
- Compliance/Litigation
- Licences/Regulations
- Environment

- Contractual Arrangements
- Anti-Trust/Competition
- Employees
- Pensions
- Health/Safety
- Tax
- General Assets
- Insurance
- Intellectual Property
- Computer Systems/Data
- Real Property
- Products/Services

2.26 The significance of each these areas will depend on the purpose for which the acquisition is being made, the nature of the business, the sector within which it operates, the time and money available and the buyer's plans for the future of the business. The emphasis will shift depending on whether the purchase is one of shares or assets. In a share purchase there will be a heavier emphasis on the target business's corporate structure and tax affairs, whilst in an asset purchase the buyer is more interested in the transferability and condition of the assets being purchased.

2.27 However, what both have in common is the central focus around material contracts. There will be contractual obligations arising through every aspect of the operation of the target business including customer and supply contracts, terms and conditions of employment, intellectual property licences, loan agreements for the provision of capital, leases for equipment such as photocopiers and possibly also leases for the business premises. In addition to contracts relating to the ongoing operation of the business, there may also be historic contracts which have continuing obligations and are therefore still relevant. For example, if the target business previously made an acquisition of another company, the target business may still have the benefit of ongoing warranties and indemnities in relation to the acquired company.

2.28 In order to identify which contracts are the most significant for the target business, the Due Diligence Questionnaire would usually set some

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SECTION 3

REVIEWING THE INFORMATION

INTRODUCTION

3.1 The purpose of this section is to provide a more detailed commentary on the obtaining and reviewing of information during a legal due diligence process. This section follows the order of enquiries set out in the Due Diligence Questionnaires for both share purchases and assets purchases set out in Section 4 as **Sample Documents 3** and **4**. The comments in this section will apply equally to a share purchase or an asset purchase unless specifically identified otherwise within the text.

CONSTITUTIONAL/STRUCTURAL INFORMATION

3.2 In a share purchase it is clearly fundamental to make sure that those proposing to sell the shares do actually have good title to them. The Due Diligence Questionnaire is the starting point. In addition the buyer should carry out searches at Companies House to check whether the details shown there correspond with the information provided by the seller. It is important to note that Companies House will only show the names of shareholders identified in the last annual return and therefore any subsequent transfers or allotments of shares which have taken place since the date to which the last annual return was made up will not be identified. Furthermore, as the annual return is completed by the seller, inaccuracies can occur and therefore the target business's register of members should also be inspected. This is the only conclusive evidence as to the identity of the registered shareholders. The register of members will not, however, reveal whether the beneficial ownership is held by somebody else. If the buyer becomes aware of shares being held on trust it would be prudent for the beneficial owner to be made a party to the sale and purchase agreement.

3.3 Whilst investigating the register of members, it is worth checking the entries in the registers of allotments and transfers as well as the register of members in order to identify how the shares came into the ownership of the seller. Any inconsistencies should be investigated further.

3.4 The Articles of Association of the target business should be inspected for any pre-emption rights that exist in relation to the transfer of the shares on a share purchase. On the basis that in most cases the entire issued share capital of the target business is being sold, this is not normally a problem as in the sale and purchase agreement each seller can agree to waive any pre-emption rights attaching to their shares. However, if only a proportion of shares are being sold, the buyer will need a written waiver of pre-emption rights from those shareholders who are retaining their shares.

3.5 In both a share purchase and an asset purchase the buyer will need to be sure that the seller has the ability to enter into the sale and purchase agreement and to sell the shares or assets concerned. This can be checked in a number of ways:

- Where the seller is a company, the Memorandum and Articles of Association should first be checked to establish that they contain power for the company to sell the shares or assets concerned and to ensure that the directors are authorised to exercise that power without any restriction. The buyer should also request a copy of the minutes of the board meeting authorising the sale. When checking these minutes the buyer should make sure that the meeting has been held in accordance with the company's articles (for example, was it quorate, was proper notice given, were any other special requirements met?), that directors' interests have been properly declared and that those individuals proposing to sign the sale agreement have been duly authorised to do so by the board. It is also prudent for the buyer to check at Companies House whether the company is in receivership, administration or liquidation as different procedures will then apply for authorising the transaction.
- Where the seller is an individual the buyer must first make sure that the seller is not a minor as contracts made by a minor can in some instances be set aside. A bankruptcy search in the Land Charges Registry should then be carried out and if there is any outstanding bankruptcy order or a bankruptcy petition then the consent of the trustee in bankruptcy or the court respectively will be required for the sale to proceed.

3.6 In both a share and asset purchase the buyer should investigate the corporate structure of the seller. It is also worth checking the certificate of incorporation and any certificates of incorporation on change of name of the target business or of the seller as appropriate just to make sure that the target business is the correct entity. The Memorandum and Articles of Association of the target business will then reveal whether the target business is currently operating within its constitution. In a share purchase the buyer will also want to check that there are no unreasonable restrictions on the directors and their ability to manage the target