

**Legal Due Diligence**  
**A necessary Evil...?**

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## Introduction

The haste of joining in today's frenzy of M&A transactions has some companies viewing legal due diligence as a necessary evil and giving the process short shrift. There is no easy answer to this. Yet, cutting corners can destroy a merger, thwart strategic gains from the deal, and plunge a company into costly, distracting, and potentially ruinous litigation.

The purpose of this article is to analyze the need for a legal due diligence before closing any transaction be it an M&A or obtaining a private equity fund for a venture or simply a strategic alliance.

The paramount objective of legal Due Diligence is to gather information and identify any risks or problems associated with a business or an asset. However a Legal Due Diligence undertaken by lawyers should be distinguished from any financial, accounting or commercial review conducted by the client and its other advisers. Significant Due Diligence often precedes merger and acquisition transactions and extensive data rooms may need to be established to provide potential purchasers and their advisers with access to the relevant documents.

In recent years, Due Diligence has become increasingly common in the context of a competitive bid process where bidders are reluctant to undertake

their own Due Diligence until they have some exclusivity. A Due Diligence process can speed up the entire transaction and reduce total costs and disruption, and can also give the chance to identify and resolve any legal issues identified before potential purchasers commence their own Due Diligence. However, one should be aware that Due Diligence reports would be of any use only if the issues therein are resolved or deal being re-negotiated.

A legal due diligence therefore covers the legal aspects of a business transaction, liabilities of the target company, veracity of representations, potential legal pitfalls and other issues as discussed further in this article.

## Scope of Legal Due Diligence

Due diligence is understood by the legal, financial and business communities to mean the disclosure and assimilation of public and proprietary information related to the assets and liabilities of the business being purchased. This information includes financial, human resources, tax, environmental and legal matters.

Due diligence would include full understanding all of the obligations of the target company: debts, rights and obligations, pending and potential lawsuits, leases, warranties, all high and

impact laden contracts – both inter-corporate and intra-corporate.

The objectives of a legal Due Diligence exercise may vary from case to case. Some of the basic objectives may, however, be summarized as follows:

- Gathering of information from the target company,
- Uncovering of the target company's strong and weak sides, relevant risks and advantages in connection with the transaction,
- Minimizing the risk of unexpected situations,
- Improvement of the seller's bargaining position,
- Identification of areas where representations and warranties from the seller should be obtained in the acquisition agreement.
- Determined for each transaction in light of the size of the transaction, the perceived risks and budgetary constraints
- Asset purchases in opposition to stock purchases or mergers
- Very important to be meticulous in a stock purchase

- Does the acquisition make sound business sense?
- Is the business what it was represented to be?
- What assets and liabilities will be acquired at closing?
- What are the risks and prospects of the business after closing?
- The last but not the least goal is to know the target better than the current owner of the Company.

### Need of Due Diligence

Any sort of business or plan to take on a high-raking position, Due Diligence investigations simply gives the most complete picture of a company. The fact that Due Diligence investigations is so good at finding liabilities in a company, these investigations can help to negotiate a lower price in a negotiation and can help ensure that any claims made about a business are substantiated – before signing on the dotted line.

A company wishing to offer its shares to the public by way of initial public offering will need to ensure that it meets the requirements listed under SEBI. The process by which this is achieved is called "verification". Verification involves checking all statements of fact and

opinion made in the relevant offer document and keeping a full record of the evidence on which they are based. Verification also ensures that statements have been appropriately qualified and that all assumptions have been articulated. Appropriate Due Diligence is, of course, the cornerstone of this exercise.

Due Diligence investigations allows getting the current information that is needed to make good business and financial decisions. These investigations help to avoid costly mistakes and can also help to avoid lawsuits caused by a bad business partnership. Investigations such as these can also be crucial in negotiations – by helping cut through business claims to the actual facts about a corporation, they help to get the proof needed to negotiate better terms.

Due Diligence is about the management of risk. It involves maintaining a methodical system for organizing and analyzing the documents, data, and information provided by the information provider, and then quantitatively assessing the risks associated with any issues or problems discovered during the process. Only a careful and thorough Due Diligence process will help to avoid legal difficulties, unintended transfer of legal property and other drawbacks.

### Areas of Due Diligence

The Due Diligence process is applied in the following basic business situations provided herein below:

#### **Transactions involving sale and purchase of products or services;**

Purchase and sales agreements include a series of exhibits that, taken in their entirety, form Due Diligence of the purchase. These include actual sales contracts, rental contracts, employment contracts, inventory lists, customer lists, and equipment lists. These various "representations" and "warranties" are presented to back up the financial claims of both the buyer and seller. The importance of this kind of Due Diligence has been heightened in recent years with the emergence of the Internet and other transformative technologies.

#### **Transactions involving mergers, acquisitions, and partnerships of corporate entities.**

In cases of potential mergers and acquisitions, Due Diligence is a more comprehensive undertaking. The track record of past operations and the future prospects of the company are needed to know where the company has been and where its potential may carry it.

Traditional Due Diligence practices in acquisition/merger scenarios called for detailed examination of financial statements, accounts receivable, inventories, workers compensation, employment practices and employee benefits, pending and potential litigation,

tax situation, and intellectual property prior to signing on the dotted line. But in this dynamic business era, other areas should be looked at as well, including (if applicable): intellectual property rights, new products in the production pipeline, status of self-funded insurance programs, compliance with pertinent ordinances and regulations, competition, environmental practices, and background of key executives/personnel.

Many business experts also caution that the Due Diligence process is incomplete if it does not incorporate an element of objective self-analysis. A detailed assessment of the market that is the target of the proposed acquisition should also be undertaken prior to closing a deal. Both of these requirements can be completed in a reasonable period of time, even in today's fast-changing business environment, by companies that either 1) outsource the Due Diligence task to a reputable research firm or 2) build an efficient in-house program within their legal, marketing, or corporate security sectors. "Unquestionably, opportunities for growth through acquisition exist". "Exploiting these opportunities has risks, but to those companies that acquire only after a comprehensive and systemic assessment of the market place and competition, the rewards justify the risks. Limiting Due Diligence to financial and managerial review is rarely enough. Successful acquisition strategy depends on the structure and depth of the Due Diligence process."

### **Due- Diligence For Intellectual Property**

The increased profile, frequency, and value of intellectual property related transactions have elevated the need for all legal and financial professionals and Intellectual Property (IP) owner to have thorough understanding of the assessment and the valuation of these assets, and their role in commercial transaction. A detailed assessment of intellectual property asset is becoming an increasingly integrated part of commercial transaction. Acquiring or investing in a business that own IP assets require expanding the scope and depth of due diligence. IP due – diligence can also facilitate a company's thorough internal assessment of its own assets and can enhance Intellectual Property planning and management.

Due diligence is the process of investigating a party's ownership, right to use, and right to stop others from using the IP rights involved in sale or merger ---the nature of transaction and the rights being acquired will determine the extent and focus of the due diligence review. Due Diligence in IP for valuation would help in building strategy, where in:

- If Intellectual Property asset is underplayed the plans for maximization would be discussed.
- If the Trademark has been maximized to the point that it

has lost its cachet in the market place, reclaiming may be considered.

- If mark is undergoing generalization and is becoming generic, reclaiming the mark from slipping to generic status would need to be considered.
- Certain events can devalue an Intellectual Property Asset, in the same way a fire can suddenly destroy a piece of real property. These sudden events in respect of IP could be adverse publicity or personal injury arising from a product. An essential part of the due diligence and valuation process accounts for the impact of product and company-related events on assets - management can use risk information revealed in the due diligence.
- Due diligence could highlight contingent risk which do not always arise from Intellectual Property law itself but may be significantly affected by product liability and contract law and other non Intellectual Property realms.

Therefore Intellectual Property due diligence and valuation can be correlated with the overall legal due diligence to provide an accurate conclusion regarding the asset present and future value.

## Technical Due Diligence

"Technical due diligence" focuses on the technical feasibility and advisability of an effort, and the people, processes, and products involved in that effort. It attempts to determine the overall advisability of undertaking the effort. A well-conducted technical due diligence effort must also address how the participants will resolve differences in the process of achieving the desired results.

Technical due diligence efforts can also take place after the failure of a project -- providing valuable post mortem information that can be used in future projects. In some cases, a post mortem technical due diligence effort can be used to assess responsibilities and damages.

## Process Of Due Diligence

There is no definitive form of a legal due diligence. The investigative aspects as well as form of the legal Due Diligence process varies depending upon the scope of work dictated by the client, the focus, special areas of weakness, the type of business, etc. However, the basic philosophy of a legal Due Diligence is common to most processes followed.

A legal Due Diligence will occur in the three stages outlined herein below. However, it is important to note lawyers will endeavor to tailor the process to the

needs of the client. Before commencing, the legal team will want to discuss the client's expectations for the Due Diligence, the proposed time frame and any limitations on the exercise.

When lawyers are instructed to carry out a legal Due Diligence, the firm (legal firm) sends a Due Diligence questionnaire to the target company requesting detailed information from the company and to reply to the questions within a limited timeframe, to keep in line with the investor's timescale. From the information received, the firm would compile a report and make key recommendation to the investor.

#### **Identification of relevant documents**

Whether it is the party conducting Due Diligence or the party in respect of which Due Diligence is being conducted, who decides what information the Due Diligence will be based on, at some point consideration must be given to which documents are relevant to the Due Diligence investigation. Relevance of documents will depend on the nature of the transaction and the commercial drivers of the parties.

#### **Review of documentation**

The party conducting Due Diligence, or its legal advisers, will be provided with access to relevant documentation for review. Confidentiality undertakings by the parties may be required during this process.

#### **Reporting**

The final step in the Due Diligence process is the preparation of a Due Diligence report summarizing the material reviewed and identifying any material legal issues and risks. In some cases it may be more appropriate for the report to be prepared on an 'exceptions' basis where, instead of providing a summary of all materials reviewed, only material legal issues are reported on. Reference may be had to the Due Diligence report when it comes to negotiating warranties in the transaction documents.

#### **Due Diligence Checklist**

A proper Due Diligence investigation requires detailed information about many different aspects of an entity, including its legal and financial obligations, management and employment issues, tangible and intangible assets, contracts, pending litigation, and business strategies. Effective Due Diligence is both an art and a science. The art of Due Diligence lies in asking intelligent questions that can hone in on and elucidate information needed for a proper understanding of the business or transaction under consideration. The science of Due Diligence is in the preparation of comprehensive and customized checklists detailing the specific questions that should be presented to the information provider.

- Corporate Documents of the Company and its Subsidiaries
- Undertaking and declaration to be obtained
- Material Contracts and Agreements
- Litigation
- Indebtedness
- Trade union and Labour relations
- Financial Information
- Confirmations
- Title to Property and Real-Estate
- Insurance
- Undisclosed Liability
- Direct and Indirect Taxation
- Governmental Regulations
- Employees and Related Parties
- Guarantees
- Exchange control
- Statutory documents
- Products and Equipment
- Environmental Matters
- Intellectual Property
- Miscellaneous

## Conclusion

Legal Due Diligence is one of the means to enable the parties to finalize commercial negotiations. It is not an end in itself but is also useful for post-closing follow-up. Lawyers help client and its other advisors to understand, evaluate and respond to legal issues. A properly administered legal due diligence obviates most of these issues.

The only real drawback to Due Diligence investigations is that they are sometimes met with disapproval from companies. If you investigate a company and find irregular business practices, that company may be quite resentful. On the other hand, most investigators are very discreet and no legitimate companies would object to an inquiry, anyway. The out-come of the Due Diligence process may be tainted (either consciously or unconsciously) by owners, managers, and researchers who stand to benefit personally or professionally from the proposed activity.

Businesses should be vigilant against letting such casual or flawed attitudes impact their own processes, for an efficient Due Diligence process can save companies from making costly mistakes that may have profound consequences for the firm's other operational areas and/or its corporate reputation.

Admittedly a due diligence is a difficult and extensive experience. It is complex and intricate in view of the fact that more negatives may be established or envisaged. The line of questioning that is essential for collating information sometimes may come across as negative, intrusive and often misunderstood. However, this pressure must be overcome if the transaction need to be successful, since the margin of error for survival in such critical transactions are very thin and getting thinner. Ideally due diligence should start even before negotiations are

underway. Another advantage, beginning the process early on could prevent long, costly effort to unwind a transaction that should never have been entered into in the first place.

In view of the stakes involved, such approach is necessary, even if convoluted and torturous.