



Due Diligence

A Practical Guide

Vanessa Williams

Second Edition


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Due Diligence A Practical Guide

Commercial and Legal Advice • Sample
Documents on CD-ROM

Second Edition

Vanessa Williams



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PREFACE

The concept for this book arose from the coming together of the following realisations:

- (1) that when performed well, a thorough due diligence exercise can have a significant impact on the structure, nature and ultimate success of an acquisition; and
- (2) that it is often professionals at the beginning of their careers who are responsible for its execution.

It was this mismatch between outcome and experience that I set out to bridge.

The result, I hope, is an accessible digest of why and how we do legal due diligence and what our findings can mean for the overall viability and success of the transaction. The accompanying set of key Sample Documents and notes aims to equip the early stage practitioner, accountants, business owners, entrepreneurs, investors or general practice lawyers with the tools to perform this important task.

This second edition both reflects changes in legislation and looks in depth at some common issues that can derail a transaction if not explored fully in the due diligence process. In addition, it considers how due diligence can inform post-acquisition integration and how ongoing business health-checks enable the business to maximise performance and minimise risk after completion.

Vanessa Williams

Across the Board
Excello Law

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In its final weeks this book was written in the memory of my dear friend, Trina Robertshaw, who provided endless quiet encouragement and support and whose presence will be forever missed.

This second edition would not have come into existence without the persistence of Mary Kenny and the encouragement of Kate Hather (both of Jordans), who guided it into its final form. A special thank you goes also to Cheryl Prophett (Proof Positive) for tirelessly editing endless proofs.

Finally, this work is dedicated to my husband, Dr Mike Williams, who is himself a professional author. It was in his office, lined with books and imbued with his creative spirit, that this second edition was born. His generosity and patience whilst I commandeered his literary sanctuary made it all possible and I would be lost without him.

Thank you.

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SECTION 1

INTRODUCTION

INTRODUCTION

1.1 The concept of due diligence originated in the US Securities Act 1933. This included a defence which could be used by brokers or dealers when accused of inadequate disclosure to investors of material information about shares being brokered. Effectively, as long as the brokers or dealers conducted a 'due diligence' investigation into the company whose equity they were selling, and disclosed to the investor what they found, they would not be held liable for non-disclosure of information that failed to be covered in the process of that investigation. It did not take long before it became standard practice to conduct due diligence investigations, initially in relation to public offerings, but over time with private mergers and acquisitions as well.

1.2 The concept of 'due diligence' was therefore born. Today a working definition of due diligence would be: the process of investigation through which a potential purchaser gains a complete understanding of the target business or its assets for acquisition, evaluating both the strengths and the weaknesses of the business and reaching conclusions as to whether to proceed with a purchase, reduce the price or restructure the transaction.

1.3 The difficult economic conditions in recent years have lifted due diligence to higher prominence. Somewhat ironically, perhaps in response to their own failings, the banks now place much greater significance on due diligence. This is not just in the context of corporate lending, but in their general business banking criteria. Businesses also are taking a much more vigilant approach to all their significant contracts and are evaluating suppliers on the stability of their corporate structure as well as on price. Due diligence is no longer the preserve of large-scale corporate transactions. It is a living breathing part of daily business life. There is no better time to understand its potential as a powerful business tool both in gaining competitive advantage and in minimising business risk.

OBJECTIVE OF THE GUIDE

1.4 The objective of this Guide is to provide business owners, entrepreneurs, investors, business angels, early stage and general practice

lawyers and accountants with an understanding of the purpose of legal due diligence and the tools required to undertake the process. The Guide deals with due diligence in the context of private companies both in day-to-day business and more particularly in corporate transactions whether asset purchases or share purchases. It does not include reference to public companies, neither does it offer any detailed advice on tax and financial matters which would normally be covered by accountants involved in the transaction.

1.5 The text is supplemented by a series of Sample Documents which form the principal documents required in a due diligence process. They are accompanied by notes on their applicability and use.

1.6 The intention is to give straightforward practical advice in plain English. With the aim of keeping the text of this manual concise, a directory of useful links is included in this introduction at **1.11**.

STRUCTURE

1.7 Following this introductory section, the book is spilt into six further sections as follows:

- **Section 2** covers the purpose of due diligence and the impact it may have on the structure of the proposed transaction.
- **Section 3** reviews the process of disclosing information to the buyer and issues of confidentiality.
- **Section 4** deals with obtaining and reviewing the information to be gathered through a due diligence process.
- **Section 5** looks at some specific areas where issues commonly arise in more detail.
- **Section 6** considers the process of post-completion integration.
- **Section 7** contains Sample Documents with explanatory notes and guidance, which are both also included on the accompanying CD-ROM.

LIMITATIONS OF ADVICE AND HEALTH WARNING

1.8 The advice is intended to be readable and intelligible at the same time as being accurate. However, some of the issues are complex and there is only scope within this Guide to provide an overview. Consequently, if

any advice or suggested Sample Document does not fit the particular facts, specific advice from a specialist lawyer should be obtained.

1.9 Although every care has been taken in the preparation of this Guide, neither the author nor the publisher shall be liable for any misstatement or inaccuracy, nor any indirect damage including loss of profit. The law stated is accurate at December 2012.

1.10 Reference to any organisation or body or the provision of any website address does not constitute a recommendation by the author or the publisher, nor does it imply that any of these parties has verified the accuracy of any information provided by that organisation or body.

DIRECTORY OF USEFUL LINKS

1.11 Public registers can be found on the following websites:

- Companies House
www.companieshouse.gov.uk
- Intellectual Property Office
www.ipo.gov.uk
- Land Registry/Land Registry Charges
www.landregistry.gov.uk
- Insolvency Service
www.bis.gov.uk/insolvency/personal-insolvency/individual-insolvency-register
- Companies Court
www.justice.gov.uk/courts/rcj-rolls-building/bankruptcy-and-companies-court
- Trade Marks Registry/Patent Office/Designs Registry
www.ipo.gov.uk/tm.htm
- Press searches
<http://news.bbc.co.uk>
- Agency searches
www.dnb.co.uk
www.lexisnexis.co.uk

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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 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. The engagement letter can also set out agreement on the information flow to and from the adviser and regulate the making of any public announcements about the transaction.

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) The buyer must 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,