**Introduction to due diligence**

This element introduces the topics of due diligence and explains the process of due diligence in acquisitions.

The common law principle of “**caveat emptor”,** which means “let the buyer beware”, applies to the acquisition of a company or business. This means unless it will take the risk of any liabilities.

It is the **buyer’s responsibility to** ensure that it obtains sufficiently detailed information relating to the company or business that it is going to purchase before completion. This process of gathering information is called **due diligence**. This means the buyer will be aware of liabilities, and can include appropriate protections.

**The purpose of due diligence**

The key purposes of due diligence include the following:

* to ascertain whether the proposed acquisition is a good **commercial investment**;
* to identify potential risks which may affect the structure of the transaction (for example, the discovery of unexpected large-scale liabilities may make an asset sale the only viable option);
* to provide the buyer with **knowledge** that will assist it in negotiations, in particular with regard to the price;
* to help the buyer identify where it may require **contractual protections** such as warranties and indemnities;
* to establish whether **shareholder consents/ contractual consents/ approvals** from regulatory authorities are required before the acquisition can proceed; and
* to assist the buyer to **understand** the target’s business which will help the buyer to integrate the target within its existing activities post-completion.

**Due diligence: General principles**

A buyer will conduct due diligence on both a share sale and an asset sale.

On a **share sale**, the buyer will acquire the target company with all its assets and liabilities. Extensive investigation will therefore usually be required in relation to all aspects of the target company.

On an **asset sale**, the due diligence can be limited to those specific assets and liabilities that the buyer will be acquiring.

A complete due diligence exercise typically covers 3 main aspects:

* Legal due diligence
* Financial due diligence
* Commercial due diligence

How the due diligence process is actually initiated depends on whether the transaction is a **bilateral sale** or an **auction sale**.

**The role of data rooms in due diligence**

A seller needs to provide large amounts of information and documents to the buyer and each of their advisers. In most cases the parties will use a **virtual data room.**

Virtual data rooms may be accessed remotely by the different parties and are often provided on a separate platform. A seller can opt for a physical data room, which would normally be located at the offices of either the seller’s accountants’ or the seller’s solicitors, but this is very unusual.

A data room has several benefits:

* the distribution of information is centralised and more easily controlled;
* it is simple to keep track of the information supplied to the buyer and what has been reviewed.

On an auction sale there are additional benefits including that:

* it ensures that equal access to information is given to all potential buyers;
* it limits the potential buyers’ access to the target’s management team.

Data rooms will often be segregated to ensure that only "clean teams" review competitively sensitive information and only HR professionals review employee data (which will be anonymised for data protection reasons).

**Due diligence: The process**

On a bilateral sale the seller will prepare due diligence materials for review which will often be placed in a data room. This is sometimes, but not always, in response to a **due diligence questionnaire** prepared by the buyer's solicitors.

Buyer's solicitors will submit requests for further information (through the Q&A function in a virtual data room if there is one) as it learns more about the target.

Buyer’s solicitors will review the information supplied and produce a **due diligence report** for their client.

On an auction sale the seller’s solicitors will set up a data room and provide a due diligence questionnaire. In some cases, the seller’s solicitors may include a vendor due diligence report. Selected bidders will then be permitted to review the information and submit limited requests for further information. Vendor due diligence is also useful as it enables the seller to identify issues that may need to be resolved prior to the sale. You will learn more about auction sales in later Topics.

**Due diligence: Financial and commercial**

The buyer will appoint a firm of accountants to carry out a **financial due diligence** review and produce an **accountants’ report** on (for example):

* Target’s past trading history
* Target’s current trading position
* Forecast trading results
* Suppliers and customers
* Target’s main competitors
* An analysis of the target’s tax affairs
* Target’s accounting systems and financial controls

The buyer may also want its advisers to carry out **commercial due diligence** on:

* the projected market conditions and the industry and competition
* the target business’ strengths and weaknesses
* Operational issues such as sales and marketing

Depending on the nature of the target’s business, the buyer may also commission relevant reports such as: an environmental report; IP/IT report; insurance review; and pensions review.

**Legal due diligence** focuses on establishing the key legal issues affecting the target, including the legal obligations and liabilities which the buyer will be acquiring. It covers a wide range of areas and will be conducted by a number of different specialist teams across the firm.

**Legal due diligence: The key areas**

**Areas usually covered**

* Capacity of the seller
* Corporate structure
* Finance arrangements
* Contracts
* Sanctions/export control
* Real estate
* Employment
* IP & IT
* Pensions
* Historic transactions
* Legal compliance
* Material litigation
* Title to assets
* Data protection
* ABC/AML/Fraud
* Environmental
* Human rights/ modern slavery

**Due diligence: Report and buyer’s options**

How the **due diligence report** is presented will depend on the buyer’s needs.

* A **‘full form’** report sets out detailed information about all aspects of the target and its business. It will also include an **executive summary** which sets out the key findings of the due diligence review.
* An ‘**exceptions only’** or **'red flag'** report is a shorter, more targeted report focusing only on matters material to the transaction. An **oral report** takes the form of a presentation to the buyer's board or M&A team.

**The outcome:** The due diligence report should help the buyer to make an informed assessment of the potential risks and rewards of the proposed acquisition. This allows the buyer to consider the valuation; to include appropriate protections or to withdraw from the transaction.

**Legal due diligence – the scope**

Before producing the due diligence report (however it is to be presented) it is important to agree a **scope of work** with the client. This will set the parameters of what is to be reviewed. This will depend on the time available, the key risks or value drivers and the budget of the client for due diligence fees.

While conducting a detailed audit and review of the practices and documentation of the target may significantly reduce the risk for the buyer, it is not practicable. A company may have hundreds of customer contracts, but limiting the scope to review, for example, the top 10 by turnover may balance the review.

In addition, the scope may set out a **materiality threshold.** For example, it may be appropriate to include a threshold of £10,000 in an executive summary on a £1 million transaction. The same liability is unlikely to be included on a £10 billion transaction.

Some firms are using AI to conduct an initial review of a large volume of simple contracts to identify key points (e.g. change of control provisions) with lawyers evaluating the information produced.

**Legal due diligence – advice**

Once the scope and format of the due diligence report is determined lawyers can commence their review of the relevant documentation.

It is important that a lawyer does not just state a problem exists in the report, but they should advise the client of the future risk to the buyer and target and suggest appropriate protections. The options include:

* In the most severe cases withdraw from the transaction;
* Reduce the purchase price;
* Include a contractual protection\*:
  + Indemnities manage the risks arising from known liabilities that may be contingent, for example a claim that the target may or may not have to pay out.;
  + Warranties cover risks of unknown issues or require the seller to provide key information and confirmations;
* Require the target/seller to secure an action prior to completion, for example to secure the release of security. This may be referred to as a ‘completion deliverable’;
* Recommend post completion steps, for example to harmonise the terms of the employees.

In the first phase of due diligence it may also be appropriate to request further information from the seller to clarify the issue.

**\*Key contractual protections**

* A **warranty** is a statement of fact about the company or the business which the buyer is seeking to acquire which, if untrue, gives rise to a claim for damages against the seller.
* An **indemnity** is a promise made by the seller to reimburse the buyer if a particular circumstance arises and, if triggered, seeks to give the buyer £ for £ protection for the relevant matter.

You will consider these protections further in the next Topic

**Legal due diligence – the role of the corporate team**

The process of due diligence involves investigating the target in relation to all its activities.

Corporate lawyers therefore need to be able to not only review the corporate information but also to recognise potential issues relating to various specialist areas and then liaise with the relevant colleagues or specialist departments within the firm to deal with them.

Corporate lawyers will often be involved in project managing the delivery of the report, considering matters raised by specialists in the context of the wider transaction and will then be responsible for ensuring the recommendations are reflected, where appropriate, in the transaction documentation (e.g., acquisition agreement).

They will often be the principal client liaison reporting to the client.

It is therefore essential that the corporate team have a measure of understanding of some of the issues that may arise in **key specialist areas**. The remainder of the elements in this Topic will explore some of those areas.

**Summary**

* The due diligence process is extremely important for the buyer especially on a share sale due to the acquisition of the target company in its entirety (including its assets and liabilities (and any hidden liabilities)). Therefore, the buyer should conduct a thorough investigation of the target company.
* Specialist support involves the corporate department liaising with subject matter experts and specialist departments within the firm to deal with issues which arise during the due diligence process.
* The nature of the support required can vary depending on the structure of the transaction.