

## Due diligence issues that face M&As

Due diligence issues that face M&As

By Vikrant Pachnanda and Vineet Unnikrishnan\*

Cite as: (2011) PL November S-2 It's not just for merger and acquisition anymore, years old practices no longer meet the challenges of defining and running an organisation, due diligence methods must be revamped to serve in today's fast-paced and perilous environment.1 -Charles F. Bacon

With increasing globalisation and liberalisation, as the Indian Prime Minister Dr. Manmohan Singh says "If you are a global company and India is not on your map, then you have missed the bus", cross-border mergers and acquisitions, are becoming a more prevalent feature of the Indian corporate landscape. When an Indian company considers an acquisition or a merger, it needs to ensure that all bases and risks are covered that arise during such an acquisition or a merge. The sheer range of concerns has expanded as the pace and volume of international deals have increased. Significant amount of pre-work is needed in evaluating transactions related to merger and acquisitions and also to identify and address issues in order to realise their intended benefit. It is in the usual course observed that majority of the transactions do not achieve their intended objective either because of inefficiency while conducting the due diligence of the company or because of lack of proper integration efforts once the transaction has consummated.

What is due diligence? Due diligence is a form of research conducted by investors to ensure that they are exactly what they agreed to acquire and emphasises understanding and quantifying the risk of the proposed deal.2 Black's Law Dictionary defines due diligence as "the diligence reasonably expected from, and ordinarily exercised by, a person who seeks to satisfy a legal requirement or to discharge an obligation". It thus, describes a general duty to exercise care in any transaction and conducts investigations into all the relevant aspects of the past, present, and predictable future of the business of a target company.

One of the main reasons for a due diligence is that it is essential for a buyer to determine the genuineness and legitimacy of the company's ownership of its assets, and whether the transfer of their title needs a third party approval, and if it is subjected to any statutory, regulatory or contractual approval.3 Moreover, the buyer should also be aware and acquaint himself with all the existing and potential liabilities that it would get into, all of which would require a comprehensive 360 degree approach of due diligence.4 Ultimately the purpose of due diligence conducted by a company is to minimise the risks involved and to anticipate and protect itself from future financial, commercial and legal problems.

Hence, it is very essential to have a sound understanding of the financial, commercial and legal problems of the target company in order to:

- (1) Provide an important input to valuation by forecasting potential growth, key success factors and ways to increase profit margins;
- (2) Secure the best possible negotiating position for a buyer by enhancing his negotiation power;
- (3) Aid post-deal integration by exposing stewardship and other issues ahead of a deal allowing for efficient integration planning;
- (4) Minimise risk by providing a thorough understanding of the company and its markets;
- (5) Expose potential deal-breakers at the inception to avoid unnecessary investment of resources.

Commercial due diligence is normally undertaken in context of a change of shareholding in a business including acquisitions, joint ventures and managed or leverage buyouts. Many companies also conduct due diligence in situations where there are no changes of ownership but when a company relies on another party for its business success e.g. when looking for distributors or suppliers. Commercial due diligence differs from legal and financial due diligence as the former focuses more on future performance of the targeted company as this form of due diligence aims to develop a clear understanding of the target company as a competitor in specific markets and also the buyer needs to get a clear understanding of the industry and specific market segments in which the target company competes. Since commercial due diligence is more dependent on sources external to the target, it also involves more complexity in terms of data gathering and analysis.

Legal due diligence on the other hand is performed by lawyers and is significant in assisting business people who are unfamiliar with the local jurisdiction, to draw out factual information which assists them in assessing the viability of their objectives while financial due diligence is carried by auditors to investigate the financial aspects of the target company.

**Responsibility of Directors** A Director is duty-bound to fulfil his fiduciary obligations towards the company and always act in the best interests of the company. The standard of care and skill required from a Director was enunciated in *City Equitable Fire Insurance Co., Ltd., In re*, whereby it laid down a very mild duty of care and skill on the Directors of the company and operated on the presumption that the Directors, in making a business decision, acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company, unless the contrary was proved.7 However, the principle endorsed in the aforementioned judgment is redundant in the present day context.

The position of the directorship comes with a very exorbitant standard of care and diligence and the business judgment rule has witnessed a high degree of modification.<sup>8</sup> A landmark case law which merits a mention is that of *Smith v. Van Gorkom*<sup>9</sup>, which was the harbinger of the principles of informed decision-making and process due care. In the aforesaid case law, the Court reasoned that in addition to the Director's fiduciary duty of informing himself in preparation for a decision, there is an affirmative duty on the Director to protect the interests of the company, which is to be realised in a critical manner after assessing all the material information available under the prevailing circumstances.<sup>10</sup>

Further the Court, as regards the business judgment rule is concerned, opined that the Directors will enjoy no protection in cases where they have failed to act in a presumably reasonable manner. The focal point of the Court's derivation was the process by which the Board made its decision, exhaustively specifying its many purported process failures,<sup>11</sup> and thus establishing the requirement of a procedural, or process due care as a prerequisite for invoking the business judgment rule.<sup>12</sup> The Court also went on to lay down an ideal procedure for the Directors to follow in arriving at a business decision. The Court's opinion categorically accentuates the necessity of undertaking careful planning and structuring of Board participation when initiating a major corporate transaction such as the sale of the company.

**Levels that surround a due diligence** There are four distinct levels of a due diligence which a company looks into before it goes in for a merger or an acquisition. This move acts as a safeguard for the acquirer company in its future prospects.

**Investigation of the industry** This is the first level of due diligence. It applies not only to the business but also to the technical and human resource analysis and is the investigation done by the acquirer company of the industry to which the target company belongs. For example, if the acquisition is of an airline corporation, the acquirer should first study the aviation industry as to whether it is subject to government regulations, who are the potential investors in the industry, scope of FDI and if any restrictions on the same, financial results for comparable companies, IPR issues, etc. This analysis would have a greater impact on vertical and conglomerate mergers since the acquirer would be entering a new industry that he is not very familiar with.<sup>13</sup>

**Investigation around the target** This is the second level of due diligence which deals directly with the net worth of the target company in the industry. The Directors in this stage are duty-bound either by themselves or by specialised agencies to assess the company's market position, reputation, potential for growth and other allied factors.<sup>14</sup> For instance, when Proctor & Gamble acquired Gillette, it is not sufficient just to investigate on Gillette, but also require P&G to do a thorough analysis of the target by going through their business, management evaluation, financial condition, customer opinions, etc. Thus this stage is even more important for vertical and conglomerate mergers.

**Investigation of the documents** This is the third level of due diligence and also the most critical stage of the due diligence process. In this level, the acquirer has a direct communication of information and documents with the target company. The acquirer first expresses his intention to go ahead for the acquisition and thereafter solicits the required documents from the target company.<sup>15</sup> The acquirer's due diligence check-list for these required documents is given as an annexure for examination which requires all documents connected to the corporate records and licensing regulations of the company, regulatory filings, financial and other business related information, investments, litigation, taxation issues among others. There may be cases where the target company may not disclose the complete information, for instance, in matters related to pending litigation. Thus a stringent verification of the documents and the information procured is very important to overcome such problems.

**Investigation for public records** This is the fourth level of investigation which requires the acquirer company's examination of the public documents which mainly consists of a review of the incorporation documents, outstanding debts, pending litigation, HR issues, retirement plans among others.<sup>16</sup>

Thus, these four levels constitute the due diligence procedure which is undertaken by corporations before entering into an acquisition. In order to ensure that this procedure is undertaken successfully, corporations engage experts from outside the organisation as well, for example, tax consultants for taxation issues, lawyers for pending litigation and other legal issues and HR management agencies for labour and HR related matters.

**Conclusion** With globalisation increasing, the number of corporations growing inorganically in the form of mergers and acquisitions is also increasing thereby consolidating the market with fewer and larger entities. Therefore, success of M&A is important and strategies that increase such chances for success need to be mastered. India, which has seen many major M&A activity within the country, is slowly spreading its wings across the border. There have been significant acquisitions overseas by Indian companies in Europe, US and Asia Pacific regions recently.

While international banks are flushed with liquidity, financial markets on the other hand, are flooded with products like credit-linked notes that help banks to ease off their risk. The risk appetite of private equity players and investment banks has now increased and they are willing to fund companies growing either organically or inorganically. Many firms like GE, Nokia, Infosys and Google are focusing on delivering higher organic growth from internally created innovations within their core businesses.

Thus in our opinion, due diligence is a very essential procedure for a corporation and when suitably conducted, attaches a high degree of fairness to the whole transaction and also leads to a significant reduction in the risks associated with a cross-border acquisition of a foreign company. A future generation due diligence system and strategy will lead to a significant improvement in financial performance, strengthen competitive positions, expand organisations more effectively, preserve human performance and develop internal know-how. With the application of these improvements companies will be better equipped to expand and develop through mergers and acquisitions, spin-offs and alliances. It pumps in fresh blood into the economy as well as advances its abilities and success rate when acquiring or merging.

\*Associate, Luthra & Luthra Law Offices. \*\*Associate, Classis Law.

- Charles F. Bacon, CEO, Due Diligence Inc. and Due.com Companies, Colorado. Manish Raj, "Due Diligence in Global Deal Making: Emerging Problem and Solutions", (2008) 1 Comp LJ 14-21.
- Seth Dua & Associates, "Joint Ventures & Mergers and Acquisitions in India: Legal and Tax Aspects" (LexisNexis Butterworths, 2006) 5.
- L.M. Sharma, "Amalgamation, Merger and Acquisition" (Company Law Journal, 1997).
- The 360 degree approach to due diligence is nothing but a comprehensive investigation of the assets of a company. To conduct a thorough analysis of the target company, the buyer would have to look into the legal, financial, business and human resource aspects, and sometimes, even the technological considerations.
- L.M. Sharma, "Amalgamation, Merger and Acquisition" (Company Law Journal, 1997).
- 1925 Ch 407 : 1924 All ER Rep 485 (CA).
- Diane Holt Frankle, "Fiduciary Duties of Directors Considering a Proposal for an Acquisition of a Privately Held Co." 1376 PLI/Corp 687.
- *Dorchester Finance Co. v. Stebbing*, 1989 BCLC 498; *D&J Jan of London Ltd., In re*, 1993 BCLC 646; Paul L. Davies, *Gower's Principles of Modern Company Law* (6th Edn., Sweet and Maxwell, London, 1997) 641-642.
- 488 A 2d 858 : 1985 Del LEXIS 421 : 46 ALR 4th 821 (Del 1985).
- S.M. Rakshithaa, "Due Diligence in Mergers and Acquisitions" (2008) 1 Comp LJ 150-159.
- *Cede and Co. v. Technicolor Inc.*, 634 A 2d 345 (Del 1993).
- *Bank of Baroda Ltd. v. Mahindra Ugine Steel Co. Ltd.*, (1976) 46 Comp Cas 227 : (1975) 1 Comp LJ 265 (Guj); Stephen M. Bainbridge (*Foundation Press, New York, 2003*) 126.
- S.M. Rakshithaa, "Due Diligence in Mergers and Acquisitions" (2008) 1 Comp LJ 150-159.
- Ibid.
- Ibid.
- Ibid.