Uncovering the skeletons

The process of due diligence in acquisitions

The last 5-10 years has seen frenetic activity in the mergers and acquisitions arena worldwide. In hindsight, we can look at many of those transactions and analyse what went wrong and where it went wrong.
Many argue that a high percentage of such transactions (possibly as high as 75 percent) have ultimately failed to produce the gains originally promised to shareholders. They have, instead, eroded or destroyed shareholder value.

Some of the many publicised failures were attributed to flawed corporate governance strategies, anticipated synergies that were either never available in the first place, or were never fully exploited through a proper integration process.

In some cases, one of the contributing reasons for such failures is an inadequate or incomplete due diligence process; witness the recent financial disasters in the insurance sector in Australia.

An inextricable link exists between the fundamental question of *value* in an acquisition transaction and how the due diligence process is used to test and verify that value. This article focuses predominantly on aspects of a *legal* due diligence process in a situation where a business or a company is for sale. In such a case, the business or company for sale is usually referred to as the "target".

What is due diligence and when does it take place?

In general, due diligence is a multi-faceted investigation, encompassing three core areas:

- legal
- accounting
- tax.

Where applicable, a fourth area on *environmental* issues can be added. The requirement for a due diligence process arises in the following instances:

- from a prospective *vendor* of a business or company
- from a prospective *purchaser* of (or prospective investor in) a business or company
- where required for capital raising.

The timing of a due diligence process depends upon whether the transaction is a trade sale or a competitive bidding situation.

What is vendor due diligence?

In vendor due diligence, the process is performed by a vendor seeking to understand the issues that might adversely affect the potential sale price of a company or business intended for sale.

Some of the issues that a vendor might seek to uncover could include:

- earning, profit, or other accounting misstatements or irregularities
- tax exposures
- litigation of significance
- employment issues
- pension fund and other compliance issues
- crucial contracts that may be in default or about to lapse.

A prudent vendor will prepare for many of the issues likely to be raised by the purchaser or the purchaser's advisers.

What is the value?

The first and most important issue for all parties in any acquisition is the question of value. That is, whether the valuation placed on the business by the vendor is fair and reasonable in the circumstances. The board of a prospective purchaser should, firstly, be satisfied about two fundamental questions before proceeding:

- whether the target represents a strategic fit for the purchaser
- that the price sought, or price range to be offered, is reasonable in the circumstances.

What are some elements of the due diligence process?

Reports. Due diligence should report on the effect of the sale upon the business. A well-conducted due diligence process produces a report that flags issues relevant to the new owner. It retains its usefulness even after the finalisation of the sale transaction.

Such a document will often be used and referred to many times during the integration process of the newly-acquired business. This report should not merely list any defaults, problems, or issues that the business has, but should also report on their likely effect in the hands of the purchaser. The report should also suggest ways to remedy any situation raised and should advise upon their cost. These issues and costs are factored into the proposed offer price–if they have not already been factored into the asking price, or if the purchaser's assessment of their effect is more pessimistic than the vendor's assessment.

"Users' manual" style of due diligence report. In an asset or business purchase, the due diligence report should resemble a users' manual, containing the information necessary to ensure that all "boxes are ticked" by a purchaser in ensuring the post-acquisition operation of the business. This will include a list of all steps necessary to effect the full and proper transfers to the new owner of licenses, assets, property and intellectual property.

Insurance and liability

Insurance issues are often overlooked in the due diligence process. A misjudgement in this area can be very costly.

The target's industry, business location, and claims history all have an effect on the purchaser's integration of insurance programmes.

The adequacy of any insurance programme and any gaps in coverage are also vital to accurately assess the viability of the target. Often, it is best to have an insurance broker conduct this form of due diligence—the findings of which should form a substantial part of the highlights of the final due diligence reports.

Data room and protocols. A data room is assembled by a vendor and consists of a dedicated room or facility containing all of the documentation about the target. This information forms the core of the purchaser's due diligence process. The data room protocol is usually a written document. It details the purchaser's and its advisors' access to the data room; the method for taking copies of any documents; and specifies those documents or categories of documents that cannot be copied. It will also contain procedures to be adopted for questions and answers.

The structure of the process. The structure of a due diligence process is largely influenced by two foundational factors:

- the nature of the sale transaction—whether it is to be a sale of shares or an asset sale
- the extent of the warranties offered by the vendor.

What is a legal audit and how does it relate to due diligence?

The traditional definition of a legal audit is similar to vendor due diligence without the sale process. It could also be described as a corporate "diagnostic health check".

Legal audits are becoming more common and are useful as a risk management and corporate governance tool.

Although companies are required to periodically audit their financial statements, they are not required to regularly examine the company's other affairs and circumstances, which might be relevant or even vital to a company's future. Directors are increasingly calling for legal audits, with a prudent director being additionally mindful of circumstances that might give rise to potential personal liability.

Conclusion

Expert advice on due diligence processes can be extremely valuable to a purchaser, especially in the early stages, when the scope and parameters within which the due diligence investigation is to be conducted are defined and set. If the scope is too narrowly judged, the value of the process can be considerably reduced, as something important might be missed. On the other hand, if the investigation is too broad, the costs and time required could prove disproportionate. In an extreme case, it could possibly even become detrimental to the viability of the acquisition itself. The method and process of conducting due diligence can also have a far-reaching and significant effect in the event that a party claims it was misled, or that facts were misstated or misrepresented.

The expertise required for the successful outcome of the due diligence process is not just in the task of the due diligence itself. It is also in understanding the relevant issues in the target company's core operating business, as well as understanding its context in the particular industry within which it operates.

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About the author

Frank Adoranti has 18 years of experience in commercial law, having worked in both private practice, as an in-house counsel and consultant for a number of multi-national corporations. He has managed legal and compliance affairs for companies in more than 20 countries, having acted in and negotiated significant transactions, as well as managing hundreds of millions of dollars of litigation. Frank has worked with companies in a diverse number of industries ranging from motorcycle grand prix racing, engineering, food services, distribution, consumer products and several others. In addition to his qualifications as a lawyer, he has an MBA, is a Chartered Secretary and also a Notary Public.

Author of the Commercial Contracts for Managers series. ***See page 18.***

The "big 3"

1 An accounting due diligence process might generally report on the following issues:

- trading performance
- abnormal/extraordinary items
- cash-flow statement
- statement of financial position
- historical and forecast financial performance
- other financial and accounting issues.

2 A tax due diligence process might generally report on the following issues:

- income tax
- goods and services tax
- fringe benefits tax
- state taxes and levies, such as land tax and stamp duties
- superannuation guarantee contributions
- employee withholding tax (pay as you go)
- status or likelihood of any tax audit, investigation, or litigation.

3 A legal due diligence might generally report on the following issues:

- corporate structure (including details of its companies, place and date of incorporation, registered office, directors, secretary, and shareholders)
- capitalisation (issued capital, classes of shares and rights or obligations attaching to them) and details of any other shareholdings
- minutes, company secretarial duties, and compliance
- employees, directors, and management
- assets (including details of ownership title and any encumbrances)—there might be separate sections in the report dedicated to plant, equipment, motor vehicles, and real estate
- intellectual property, such as business names, trademarks, patents and domain names
- acquisitions and disposals (if any)
- liabilities and commitments, such as guarantees
- details of material contracts entered into by the company
- environmental issues (if applicable)
- litigation
- any other matter or detail of significance not reported in any of the above.