

## Due Diligence

### **I. Introduction**

Due diligence is a process of thorough and objective examination that is undertaken before corporate entities enter into major transactions such as mergers and acquisitions, joint ventures, issuing new stock or other securities, project finance, securitization, etc. One of the key objectives of due diligence is to minimize, to the maximum extent practicable, the possibility of there being unknown liabilities or risks.

The term “due diligence” first came into common use as a result of the United States’ Securities Act, 1933. The practice of undertaking a formal due diligence investigation is of comparatively recent origin in India and was mainly imported as a process by foreign investors/their legal and financial advisors after the economic liberalization reforms of 1991. No statute defines the term ‘due diligence’.

### **II. Types of Diligence**

The approach to due diligence depends on the type of transaction and what is intended to be achieved. Due diligence may be of various types:

- Commercial due diligence – review of industry, market, and business model of the issuer.
- Reputational due diligence – review of credit worthiness and reputation of individual counterparties.
- Financial due diligence - review of tax, financial position, policies and internal controls.
- Legal due diligence (for short “LDD”) – review of documentation to identify potential legal issues that may be risks/impediments to the transaction or in the general operations of the issuer, that may affect the value or consideration in connection with the transaction.

### **III. Broad heads of LDD**

#### **1. Corporate Structure:**

- Shareholding of the Company
- Valid issuance of securities
- Special provisions in the articles of association impeding the transaction (e.g. right of first refusal, outstanding options to restrict, participate in or otherwise impact a future securities offering)
- Powers of company to consummate the transaction
- Corporate compliance (review board, shareholders minutes to check authorization for appointments, execution of contracts, loans, leases, filings with regulators etc)
- Contracts in which directors, promoters or group companies, controlling shareholders and key managerial personnel are interested including contracts/ arrangements with related parties

#### **2. Contracts**

- Validity and enforceability

- Rights and obligations under material contracts
- Authorizations or intimations required in respect of the transaction
- Provisions for novation /assignment
- Receipt or provisions of goods/services at concessional rates
- Change of control provisions
- Existence or avoidance of material breaches
- Receipt of notice in relation to an alleged breach
- Stamp duty
- Tax implications
- Disclosure or confidentiality restrictions or requirements

### 3. Employment

- Terms and conditions of employment
- Contractual/statutory obligations – transferring/altering terms of employment.
- Whether contract labourers are engaged – registration of contract labour
- Payments to and terms of various funds (provident fund, gratuity and superannuation)
- Existence of unions and wage settlements
- Disputes with unions or individual employees
- Existence of employee stock option or purchase plans

### 4. Insurance

- Adequacy of insurance cover given market practice/ terms of loans and validity
- Cover for business interruption
- Provisions for assignment or change in loss payee
- Exclusions in each policy
- Claims raised under any policy and status of such claims

### 5. Borrowings

- Details of borrowings (standard & special terms)
- Compliance with obligations under facilities
- Charges over assets and procedure for their release
- Prior consent of lenders for transfer or change in controlling interest or security issuance
- Existence of guarantees and their continuation after transfer, if applicable
- Existence of public deposits, and compliance with applicable regulatory requirements in this respect
- Credit provided to or obtained from related parties

### 6. Licenses and approvals

- Existence and validity of licenses and permissions (including under environmental laws)

- Adequacy of existing licenses
- Any notice received or action pending in relation to breach of conditions contained in any license
- Procedure for transfer of licenses or change in control provisions
- Licenses specific to issuer (income and sales tax registrations) versus those specific to the company's business (e.g. license under Factories Act)

#### 7. Real Property

- Title to property- whether freehold or leasehold
- Provisions of lease/leave & license where interest is leasehold
- Need for lessor's consent for assignment/change in control provisions
- Validity/period of lease/license
- Registration of title

#### 8. Intellectual Property

- Ownership and registration of intellectual property (including existence of licenses to or from third parties)
- Issues relating to assignment
- Rights pursuant to license agreement - validity and assign ability
- Infringement of intellectual property rights of the company or third party rights.

#### 9. Litigation

- Determination of disputes including actions before regulatory and quasi judicial authorities, closed cases, civil judgments, bankruptcy cases and any threatened litigation
- Defense taken
- Determination of the materiality of the dispute
- Assessing the impact of adverse decisions - monetarily and on business
- Review of counsel's opinion on risk assessment.

#### IV. Why is LDD necessary?

Some of the primary reasons for conducting LDD are outlined below:

- **Better Understand Your Business** - LDD is necessary to give the concerned person the information that it needs to learn about the target company and to structure its transaction with the company.
- **Help to Value the Target Company** - The concerned person will use the information learned in the LDD process to determine the consideration price with the company.
- **Help in Drafting the Relevant Documentation** - The information learned in the LDD process will be helpful for both the counsels in drafting and negotiating the merger or acquisition/joint venture agreement and related

ancillary agreements. Further, the concerned person needs to prepare a disclosure schedule, to be delivered at the time the primary transaction agreement is executed

- **Identify Impediments to Closing** - In the LDD process the parties will attempt to identify everything that must happen before the transaction can close.
- **Legal Opinions** - Often the counsels will be expected to render a legal opinion at the closing of the transaction. In order to reach the relevant legal conclusions in the legal opinions, counsel will need to rely on factual information provided by the target company. The LDD process provides counsel with the opportunity to learn this information.

#### V. **Checklist**

The following documents and information are required from the Company in connection with the Target Business of the Company:

- i. Corporate Books and Records
- ii. Governmental Regulation and Filing
- iii. Debt and Loan Documentation
- iv. Business and Material Agreements
- v. Acquisition and Dispositions
- vi. Real Property i.e. Immovable Property
- vii. General Property
- viii. Litigation Documentation
- ix. Employment Related Matters
- x. Contingent Liability
- xi. Insurance
- xii. Intellectual Property
- xiii. Environmental Matters
- xiv. Financial Assistance
- xv. Industry Specific Consents and Approvals
- xvi. Business and Operations Descriptions
- xvii. Miscellaneous e.g. certificate from the Company's secretary and auditors, ISO Certification etc

The above is not an exhaustive list.