

DBULLETIN

Due Diligence

‘Due diligence’ on big corporate deals, or more often the lack of it, has made it to the front pages of the press. What is ‘due diligence’ and how can it be undertaken efficiently?

The basic objectives of a due diligence exercise will, generally, be to establish

- that the business being reviewed is performing in accordance with your expectations and should continue to do so; and
- the value of the assets of the counterparty and ascertain that there are no hidden liabilities.

For RSL's, due diligence will be important not only when entering into, for example, a joint venture with a developer but also in considering a group structure with another RSL.

The key issues for senior management are preparation and organisation. A specific and controlled due diligence exercise will enable the you to quantify the liabilities you are contemplating taking on, and, at the same time mitigating the cost of the professionals involved in completing the exercise.

Due diligence may ultimately be more significant than negotiation of any representations, because water-tight representations will not give you a right of action if the liabilities far outweigh what can be recovered from those making them (leaving aside the question of their financial standing).

It is up to you (whether you are an RSL, the acquirer or the merger parties as the case may be) to decide what investigations are necessary. Some senior management teams, with extensive deal experience, will want to do most of the due diligence themselves. For example, they will usually want to undertake

business due diligence (such as competition, the business strengths and weaknesses, forecasts and future strategy). On the other hand, if the team has little transactional experience, it is worthwhile discussing with its advisers what degree of investigation would be appropriate.

There may also be grounds for particular caution if there a large number of employees, for example, significant pension liabilities. Here even the experienced deal teams will seek outside advice.

Purchases of insolvent businesses or, for that matter, the assets of an insolvent business, from an insolvency practitioner, may offer the opportunity for a “cut price” deal. However, an dealing with insolvency practitioners is very different to dealing with the sellers of an ongoing business. Here it may helpful to have a ‘poacher turned gamekeeper’ at your side.

The retainer letter with each of your professional advisers, setting out the scope of, and responsibility for, work should be carefully reviewed at the outset of the deal. Given typical deal timetables, it may be difficult to change the scope of work or level of responsibility later in the deal, without incurring substantial additional fees.

Historically, accountants and solicitors have approached the due exercise in different ways. The accountants will inspect the working papers of the other party's accountants and have a longer dialogue with the other party's management and its accountants.

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In contrast, lawyers will often carry out a due diligence exercise based on the provision of relevant documents which will have been sourced in response to a questionnaire. The terms of reference of the legal due diligence exercise must be agreed with you. Care must be exercised about the level of the exercise, which could risk upsetting the other party - and the spirit of the negotiations.

You will need to involve its tax advisers from an early stage in the structuring of the transaction (for example, before heads of agreement are signed, if possible). Changes to the deal structure can lead to additional tax advice costs.

Consideration also needs to be given, at an early stage, to the level of investigation of the title to the properties and as to the extent to which reliance is to be placed on the representations from the sellers relating to the properties.

Where the property element is important, it may be desirable for the sellers' solicitors to formally certify the title to the buyer. Alternatively, you may want your own lawyers to investigate the title of the target company to the properties, and make, for example, the usual searches before the deal is concluded. If the other side's solicitors have acted on the acquisition of the properties by the other party, usually the first course will be quicker and cheaper, since they will already have examined the titles and may need to do little more than update searches. They will provide comfort on the marketability of the title in what is often called a Certificate of Title. If Certificates of Title are to be given, their form should

be agreed before the sale agreement is entered into. Furthermore, it should be established who is to pay for them.

Where the property element is not important, you may be ready to save the time and expense of an investigation of title or obtaining a Certificate of Title. Instead you may decide to rely, instead, on the representations as to title contained in a legal agreement. Incidentally, if borrowing funds for the deal, it will be necessary to check the banks own due diligence requirements.

If due diligence is to be of value, it must be carefully planned and carried out so that it identifies issues of commercial concern. It is essential that there is a clear demarcation of responsibilities with one person appointed to co-ordinate the exercise. Critically, they will need support, from their colleagues in assessing the results of the due diligence not only to ensure that the right members of the management team are looking at the relevant risks, but also to ensure the 'point person' does not end up with two day jobs!

Key points:

- By doing thorough initial research the RSL can concentrate on the known/likely risk areas.
- Clear demarcation of responsibility through well thought out retainer letters
- Single point of contact who has adequate support

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