Have you done your Due Diligence? Preparing for a Corporate Acquisition

by Christiane Najm - c.najm@tamimi.com - Dubai Maze Tower

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A legal due diligence review preceding a corporate or business acquisition deal is often perceived as being a lengthy and burdensome exercise, which can prolong the timeframe of a transaction and delay its closing. Whether the transaction is an acquisition, disposal, merger or reorganisation (commonly referred to as 'mergers and acquisitions' or 'M&A' transactions), the parties involved are usually eager to finalise the transaction within a short period of time and in the most cost-effective way possible.

Overview

When preparing for an M&A transaction, it is highly prudent for the parties to carry out an evaluation of the strengths and weaknesses of the target legal entity or entities and their respective businesses prior to entering into the transaction documentation. The purpose of this exercise is not only to provide the party undertaking the review with reliable and up-to-date information about the target entity, but also to identify and highlight any significant deficiencies or short-comings (i.e. 'red flag' items) that they were not previously aware of. Any legal or financial repercussions arising from the review that may hinder or prevent the closing of the transaction or that might have an impact on the anticipated return on investment will also be key to identify. A due diligence review will typically comprise a financial review (undertaken by accountants) and a study of the entity from a legal perspective (undertaken by lawyers) and possibly other types of review (e.g. tax, commercial and others).

Matters to be reviewed during the legal due diligence exercise will typically include the legal structure of the target entity, including corporate and regulatory matters (e.g. licences, constitutional documents, compliance with relevant legislation), the target's management structure and powers of attorney in place, business agreements binding on the company, banking facilities and liabilities of the target (review of the loan agreements and banking arrangements, guarantees, etc.), employment contracts and practices, supplier agreements, outstanding warranties, insurance policies, titles to and leases of real estate, environmental permits and compliance practices, ongoing or anticipated litigation and so on. The objective of this review is to gain an appreciation of the target's business as well as to uncover any irregularities or actual or potential liabilities to consider how they may best be dealt with.

It is good practice for a review to be focused and efficient. A due diligence review will rarely be general and all-encompassing, so as to cover the whole range of legal and contractual aspects of a business. It is more likely that it will be limited in scope, in order to identify those particular issues of concern or material importance in the context of the organisational structure and business of the target. Accordingly, the scope of the review will vary depending on the nature of the transaction, whether it is an acquisition, disposal, restructure, merger or another form of transaction and whether the business of the target relates to either retail sales, telecommunication, construction, the provision of services or another field of activity. In each instance, the parties will have a particular interest in the structure, business and assets of the target and will be concerned to identify any deficiency in these and how the value of them can be maximised. There will (or ought to) be a direct correlation between the extent of resources committed to a due diligence review and the value of the transaction. This is because a transaction involving the acquisition of a small company for a small purchase price will typically not justify an extensive, all-encompassing due diligence review. Whereas, when an acquisition involves the payment of a significant purchase price, a more thorough investigation of the target will likely be justified, such that the depth and breadth of the due diligence review will be proportionate to the overall value of the transaction.

By way of example, if a target company is a provider of telecommunications services, the due diligence review will typically focus on the licences of the target entity (including whether they adequately cover the scope of activity of the target business and whether they are still valid), agreements and arrangements in place with the target's customers and suppliers, and the state of its assets (i.e. whether they are in good condition, have benefitted from proper supporting arrangements, are not life-expired or close to being so and so on).

Where a transaction involves a business providing professional services, then the key value is likely to derive from the competence and experience of its employees. In this situation, particular attention would typically be directed not merely towards licences and business agreements (i.e. customer and supplier agreements, licences, lease contracts, etc.), but particularly to the contracts of employees (and mainly key employees), their salaries and benefits (including incentive arrangements), employment practices, capture of know-how and protection of intellectual property.

If the focus of the target company's business is the sale of products, then it is particularly important to review the target's ability to acquire, produce and sell them, such that the due diligence review should include detailed consideration of the supplier and customer contracts, title to factory and warehouse premises, equipment and machinery, relevant intellectual property rights required for production of products and in relation to new products under development (i.e. copyrights, patents registrations, licences and other registrations).

Process

Whilst a legal due diligence review involves all parties to the transaction, in a sale and purchase transaction, it is the prospective seller's responsibility to make available to the purchaser all those agreements, licences, reports and other items requested to undertake the necessary review. The seller will often facilitate this process by preparing a data-room, either a physical or virtual one, in which it will make available all those documents and items requested by the purchaser and its lawyers. Where the seller does not effectively assist in providing the requested documents, the due diligence exercise risks becoming a longer and more difficult exercise. For this reason, it is important that the parties to a prospective transaction agree, ideally during the preliminary discussions when considering the key terms of the transaction (i.e. when negotiating the 'memorandum of understanding' or 'letter of intent') the extent of obligations of the parties during the due diligence phase. It should be clearly agreed that there will be a prompt and transparent disclosure of information and documentation and there should be provision for the extension of time for the due diligence period if the seller does not adequately respond to requests for documents and information.

Time-frame

The time-frame for completing a due diligence largely depends on the volume of documentation and information to be reviewed and the timing of when the bulk of this documentation is made available for review. The seller will either need to produce copies of documentation or create a data-room and provide sufficient access to it to the lawyers, accountants and other professionals reviewing the documentation for the purchaser. The seller should also provide answers to queries raised by the purchaser's advisors during the review that arise out of the materials provided. Where this is the case, then the due diligence can be completed within a reasonable timeline taking into consideration the size of the transaction, the business of the target and its activities. The timeline will most likely need to be extended where a seller is not sufficiently cooperative and is reluctant to providing materials and information requested or fails to do so promptly.

Sometimes parties will agree to split a due diligence review into distinct phases. Each phase would involve a review of specific documents or facets of the target company or business. Where this occurs, the parties will fix milestones for the progress of the review, for example by agreeing to move on to the next phase of the due diligence exercise when the purchaser is satisfied with the outcome of the preceding phase, so that the seller discloses information it feels comfortable in sharing in tandem with progress being made towards concluding the transaction.

Benefits

The benefits of a legal due diligence review are that it enables the party commissioning it to assess the rights, dues, obligations and liabilities of the target or the target group of companies or their business, which are the subject of the transaction. In a sale and purchase transaction, it is most notably beneficial for the purchaser as it will assist the purchaser to evaluate the risks of entering into the transaction, the assets, liabilities and responsibilities of the target company or business and the extent of the further investment that the purchaser will need to make in the target in order to realise its objective in acquiring that target.

Based on the results of the due diligence review and having obtained awareness and insight into the business and its liabilities, the lawyers advising the purchaser will be able to analyse the position of the target and advise the purchaser on the best course of action. For example, where a liability, potential liability or deficiency in the target is identified for the first time, the purchaser may want to negotiate a reduction in the purchase price it is now willing to pay the seller. A deficiency may also be addressed in the drafting of the final acquisition agreement either through the provision of an indemnity or an appropriate, specific warranty. The purchaser may call on the seller to remedy the issue before the transaction proceeds. Alternatively, the purchaser may take out appropriate insurance to cover the issue or it may decide that the issue is so serious that it does not wish to proceed with the transaction at all. Where a due diligence review is conducted pre-transaction by a seller, then it affords the opportunity to remedy issues in advance or to prepare an explanation of them with a view to lessening the impact of them on the sale negotiations.

Conclusion

The due diligence review is typically considered a crucial step to be undertaken in nearly all M&A transactions. The risks associated with entering into transactional documentation without conducting at least a reasonable degree of pre-transaction due diligence can be significant (for both parties). The review will aim to allow the relevant parties to be informed as to the true nature and features of the target company or companies and their respective businesses, thereby helping to ensure that all relevant precautions are taken when negotiating and preparing the transaction documentation. Recently, there has been a trend more and more towards parties obtaining warranty insurance cover to mitigate the risks associated with M&A transactions. Subject to certain exclusions, this insurance will protect the insured parties against expenses associated with errors or oversights arising in the due diligence process by the party responsible for providing documentation and information to the other. Accordingly, a properly structured due diligence review with a timeline, scope and structure agreed in advance by the parties to it is a very important element of any M&A transaction. Although the review is a significant part of the transaction in terms of commitment of time and resources, if properly managed and if properly advised by one’s lawyers, then it is typically possible to tailor the review to the circumstances of the transaction and the target involved. Accordingly, the results of the review will be produced as efficiently and cost-effectively as possible within a timeframe that meets the objectives of the parties to the transaction.