

Due Diligence – when and why?

What is Due Diligence

The term “Due Diligence” is commonly used when referring to a process through which a potential buyer evaluates a target company, an enterprise or its assets. Typical due diligence usually focuses in particular on the area of law, taxes and finance with the aim on emphasizing strengths and weaknesses of the target and detecting risks connected with its acquisition. For the sake of simplification, we will use the term “enterprise” or “target” when talking about subject matter of the due diligence.

Simply put, the buyer conducting due diligence investigates all relevant aspects of the past, present, and predictable future of the target and makes sure that the target is in the condition as represented by the seller.

Conducting Due Diligence – When and Why?

As indicated above, due diligence is crucial if one intends to conduct merger & acquisitions, buy or sell specific assets, implement corporate restructuring, raise financing for large projects, etc. A thorough detailed due diligence is typically conducted after the parties involved in a proposed transaction have agreed in principle that a deal should be pursued and after a preliminary understanding has been reached, but prior to the signing of a binding contract.

In the case of a small enterprise purchase, the buyer will usually want to learn everything possible about the enterprise before signing the purchase agreement or, alternatively, if there isn't enough time to do that, the buyer will want to make sure that the representations of the seller concerning the business are rather comprehensive and that the definitive agreement allows him to withdraw from the deal if the due diligence conducted after signing the definitive agreement is not satisfactory.

Conducting the due diligence helps the buyer to avoid if not all, then at least some of the problems such as:

- misunderstanding as to the type and condition of the target;
- discovering that the purchase price of the target does not correspond to its value;
- bad management of the target;
- bad financial situations of the target;
- pending lawsuits related to the target;
- contingent liabilities.

Legal Due Diligence Process

Preparatory Stage

The importance of the preparatory stage of the due diligence cannot be overstated. Before the start of any due diligence procedures, it is critical to clarify the strategy of the due diligence, priorities, level of investigation, etc. At the “kick-off” meeting, it is i.a. essential to determine the nature of the transaction (e.g. stock sale, asset deal, enterprise sale etc.) as this will directly influence the focus and depth of related due diligence procedures. A materiality threshold may be determined at this stage of the due diligence process – i.e. that e.g. documents or contracts for amounts less than a specified amount of money will not be examined or issues with risk of less than a specified amount of money will not be explored. The materiality threshold, of course, depends also on the value of the transaction.

The parties conducting due diligence generally create a checklist of needed information. At the very beginning of the due diligence process, a due diligence questionnaire corresponding to the scope of investigation and focusing on the most critical areas is sent to the seller of the target in order to obtain all documents and information to be examined. A team is established and tailored according to the timing, structure, scope and strategy for the due diligence project. The due diligence team should include one co-ordinator who co-ordinates the team's activity in the data room and liaises with the target and potentially other individuals or entities (e.g. the client in the case that the due diligence is performed e.g. by lawyers). All team members shall hold regular meetings to share their findings and critical information, etc.

It is essential that all members of the team have good understanding of the target and the deal before they first enter the data room. The team members must be able to raise and discuss all issues surrounding the transaction from the very first moment in the data room. In some situations, it may be useful for the team to preliminarily discuss who will focus on which issues in the data room.

Data Room Stage

Once the data room stage commences, i.e. once the due diligence team members enter the premises where the documents, which are subject to investigation, are gathered, the co-ordinator assigns work or adjusts the scope of work for each team member based on the conditions of the data room, organisation of files, etc. The plan of the team's work is adjusted as regards timing, prioritisation of documents, and the request for additional information is being prepared.

The scope of due diligence, which shall be conducted is based on many factors, including prior experience, the size of the transaction, the likelihood of closing a transaction, tolerance for risk, time constraints, cost factors, and resource availability. As a rule, everything should be disclosed by the seller in due diligence. Although it is impossible to learn everything about the target, it is important to learn enough to lower the risks to the appropriate level and to be able to make good, informed business decisions. In fact, the seller's liability can become far lesser if the seller discloses rather than hides information in the due diligence. On the other hand, an appropriate investigation and verification into the most important issues often must be balanced by a reasonable level of trust concerning less important issues, so that the target is not offended to the point where it walks away from a deal.

Among the main documents, which should be provided by the target in the course of due diligence typically belong:

- constitutional and other corporate documents (founder's deed; articles of association; minutes and/or consents of the general meeting, board of directors and/or other bodies; etc.);
- licenses and permits related to operation of the enterprise;
- internal systems and procedures;
- key contracts;
- financial statements;
- tax and financial documents;
- customer lists;
- employment agreements; confidentiality agreements with employees;
- litigation-related documents;
- intellectual property-related documents.

While researching the files in the data room, it is crucial to record all identified issues by taking notes, using dictaphones, etc. Since good communication is often the key to the successful due diligence, any important findings shall be immediately reported to the co-ordinator. The co-ordinator, on the other hand, shall immediately inform the team of any important information received. The co-ordinator gets updates on the progress of work from all members of the team regularly. It is extremely practical to organise daily debriefs with the team members to discuss their findings. In particular, the co-ordinator communicates to others all information received during the day from the target company or, as the case may be, the client, and receives principal information from the team members.

Report Stage

Once the investigation is completed and respective findings obtained, all information important for making the actual decision must be transformed into a due diligence report.

Due diligence report is a detailed report about the good standing of the target in terms of all reviewed aspects. The due diligence report shall give the buyer a professional legal evaluation of what exactly is offered for sale, whether the target has any defaults in terms of e.g. invalid contracts, expired licenses, problems with state authorities etc., and develop a strategy to successfully deal with the identified issues, if possible.

Brief Summary

Business activity such as buying an enterprise is an arduous, yet potentially rewarding process, which can take weeks or even months. It is critical to do the homework when gathering information about the target, since the acquisition involves investing a fair amount of money as well as time. Conducting due diligence is essential to determine the purchase price and formulate the contractual warranties. Although the risk cannot be completely eliminated through due diligence and success can never be guaranteed, a well-run due diligence can significantly improve the odds that the transaction will be successful.

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