Due Diligence When Buying a Business

Paper written by Steven Brown, Etienne Lawyers, B.Ec, LL.B, (Sydney), M. App. Fin (Macquarie), FAICD, Accredited Business Law Specialist, for Buying and Selling a Business Seminar 12 March 2008, Presented at the Radisson Plaza Hotel, 27 O'Connell Street, Sydney.

Introduction

This paper is about due diligence, what it is in the context of buying a business, who it can be used, and what lessons the case law has in regards the use of due diligence.

What is due diligence?

Buying a business as assets, or through merger[1] or share acquisition is an arduous, expensive and while potentially rewarding inherently risky undertaking. Because such transactions are inherently risky, it is critical for purchasers to do their homework and gathering information about the business. The investigative process is commonly referred to as conducting *due diligence*.

Due diligence is the process of negating caveat emptor, by making sure the purchaser knows all that they can about the business they have purchasing having regard to the time, and money they wish to spend on such an investigative exercise.

The expression "due diligence" has different meanings in different contexts[2].

Irrespective of the context in which the term due diligence is used, due diligence has been described as a doing detective work, doing your home work, thinking things through, and by others as doing a background check on a business[3].

In the context of business purchasers, mergers and acquisitions, there is no statutory or judicial definition of "due diligence".

The expression "diligence" means assiduous or attentive to duties. ***Tesco Supermarkets Ltd v Nattrass*** [1972] AC 153, Lord Diplock said that:

"Due diligence is in law the converse of negligence and negligence connotes a reprehensible state of mind - a lack of care for the consequences of his physical acts on the part of a person doing them."

His Lordship's statement does not really help us determine what is involved in conducting due diligence. From the point of view of a purchaser, a due diligence report is often considered to be a guarantee against any problems arising with respect to the purchase of business assets. In essence, as is the case with much of what lawyers do, due diligence is about risk management.

In the context of initial public offering prospectuses, the concept of the due diligence defence has its origin in the ***Securities Act 1933 US***, Section 11 (b)(iii) of which provides a defence to a claim that there was an untrue statement of a material fact or an omission of a material fact in a registration statement (the US equivalent of our prospectus). The defence is satisfied where a defendant can show that after reasonable investigation he had reasonable grounds to believe and did so believe at the time when the registration statement became effective that the statement was true and there was no omission of a material fact. In the US the defence is not available to the corporation itself[4].

The Securities Act specifies the standard of reasonableness required as being the standard required of a prudent man in the management of his own property. Although the legislation has been in existence for over 60 years the exact nature and scope of this standard has remained vague. The US Courts have on the few occasions when they have been called on to consider the matter [***Escot vs Barchris Construction Corporation*** 283F SUP]' 643 (USOC 1968); ***Feit vs Leaseco Data Processing Equipment Corporation*** 332F SUP]' 554 (USDC 197fl] laid down the following principles as being relevant to a due diligence investigation:

(a) the extent of the investigation is that required of a prudent man in the circumstances of the particular issue of securities in question;

(b) the investigation must elicit those facts which a reasonable person would consider important in determining whether to invest in the securities in question; and

(c) data and information furnished by the issuing company should be independently verified as far as is reasonably possible.

Pronouncements of Australian professional bodies provide limited guidance as to what constitutes an adequate due diligence investigation. Most have not issued any guidelines relating directly to due diligence reviews. However they have embodied in their Ethical Rulings concepts such as the duty of the professional to act with competence and diligence.

What is due diligence in the context of buying a business?

In the context of buying businesses, mergers and acquisitions, due diligence describes the purchasers general duty to exercise care in proceeding with the transaction. As such, it spans investigation into all relevant aspects of the past, present, and predictable future of the business the target of the sale, merger or acquisition to minimise the risk of unknown events suddenly occurring at a time when the cash flow of the purchaser can least bear it.

How does due diligence minimize a purchasers risk in buying a business?

Conducting proper due diligence helps purchasers avoid the following problems:

- Confirm that the business is what it appears to be;
- Identify potential "deal killer" defects in the target and avoid a bad business transaction;
- Confirm that the corporate entity that conducts the business if being taken over is sound and without unknown contingent liabilities;
- Gain information that will be useful for valuing assets, defining representations and warranties, and/or negotiating price concessions;
- Verification that the transaction complies with investment or acquisition criteria;
- Discovering that the purchase price of the business is too high;
- Avoid misunderstandings as to the type and condition of the business being bought;
- Investigate the state of management of the business;
- Confirm the status of pending lawsuits; and
- Identify the extent and quantum of contingent liabilities

How the investigative process of due diligence is conducted to ascertain the answers to the above questions will be dealt with later in the paper.

Who Conducts Due Diligence?

Lead and co-investors, corporate development staff, lawyers, accountants, investment bankers, loan officers and other professionals involved in a transaction may have a need or an obligation to conduct independent due diligence. The management of the targeted business typically assists these parties in obtaining due diligence information but because it is unwise to totally rely on management, usually a committee of the purchasers advisers conduct the due diligence, by coordinating all of those of the purchasers side and all of those on the vendors side.

When is *Due Diligence* Conducted?

Initial data collection and evaluation commences when a business opportunity first arises and continues throughout the talks. 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.

What is the rationale behind conducting due diligence?

As mentioned, due diligence has been described as doing detective work, doing your home work, thinking things through, and by others as doing a background check on a business. Before moving to the process used to secure answers to questions, as advisers we need to understand the philosophy and reasoning for conducting due diligence so we can pass this on to our clients. To do this consider what the following adviser found when under taking due diligence on acquiring of a vending route business.

> "I was evaluating a distributorship that consisted of placing vending equipment into hotels, restaurants and apartment complexes. The business is considered to be a "vending route" operation. Some of the products included beverage units, change machines and laundry equipment. The business had a fairly good installed base of these units and I believed that there was room for growth. The business also had a large inventory of machines available for

new accounts (approximately $400,000). The Master Distributor seemed to be good with order turnaround so I couldn't understand why such high inventory levels were needed. The vendor told me that having these levels was a big part of their customer service and they could beat out the competition because the customers could order today and receive it tomorrow, while the competition had to order it from their Master Distributor and deliver it a week or so later. It seemed like a reasonable response. However, it triggered an alarm for me. Having this level of inventory was very expensive and it just didn't seem logical.

The business itself was simple: the machines were put into these locations at no cost to the location. The Revenue that the units produced was split between the business and the location. It was a solid business with good cash flow and no receivables.

I began my research using all of the tools outlined in this chapter. I started visiting the customer locations to see the vending units. Not stopping there, I visited as many potential customer locations to see what they currently had in place and to see the condition of the competitor's units. During my visits, I noticed that the business I was looking at had stickers on each machine with their company name, address and phone number. The competitors also had stickers on their machines, but on theirs I kept finding ones that read: "For Service Call XYZ Company." I found this a little odd. I questioned the vendor why the competition referred only to "service" and he didn't. He answered: "we all do things a little differently." Somehow this didn't seem right to me.

I started to call around to these locations. I told them that I was considering making an investment in a vending route operator and I was wondering if I could ask them a few questions. Almost all were happy to oblige. I came to discover that almost none of them would ever consider renewing this "Revenue Split" type of arrangement in the future. They told me that the "trend" is in buying the machines themselves. This way they no longer were getting them free but neither did they have to split the Revenue. Thereafter, they contracted with the distributor to provide ongoing maintenance. In fact, the business I was looking at was probably the last one left in the area who

> still did it "the old way." There was an industry-wide shift away from the business model of the company I was thinking of buying. The whole industry had changed. The competitors were distributors in theory but almost all their volume now came from parts and service and sales of the actual machines. No more recurring revenue split. In fact, most distributors now sold the machines at cost just to get the service contracts! Their profits came from long-term service contracts and they were no longer required to keep inventory. The business I was evaluating was like a dinosaur. The reason they had this entire inventory was because they refused to do business under these new terms. Purchasers can now see how a new trend can change an entire business strategy and without a plan to investigate the industry and competition, this may never have come to the surface."[5]

Purchasers need to be inquisitive when receiving information obtained from due diligence. Being a passive recipient of information without asking why is it so can lead to disaster: remember due diligence is all about detective work.

DUE DILIGENCE INVESTIGATION

It is difficult in the absence of judicial authority to formulate a legal definition of due diligence with any real degree of precision. The determination of due diligence is necessarily a question of fact which will depend upon the circumstances surrounding each particular transaction. Each particular transaction will have its own distinctive features and will require its own special brand of due diligence investigation. However, at the very least, the due diligence exercise will require the type of comprehensive and inquisitorial review and investigation which a prudent adviser would bring to bear on the matter.

How is due diligence conducted?

If a vendor is actively marketing a business or a part of its business, as occurs when brand is sold, the vendor to assist prospective purchasers collates all of the information that the vendor thinks a purchaser would want to see and investigate before committing to purchase and places it in one place. This one place is called the Data Room. Data rooms facilitate sales by prospective purchasers all having access to the same information and by the information being located in one place, alleviates the vendors employees from being concerned with the numerous third parties being on the vendors premises during the due diligence period. The reason for this is that often employees become concerned when they suspect something is going on but they do not know what. To alleviate the unnecessary fears of employees the use of off site data rooms has become more prevalent.

Also the parties conducting due diligence generally create a checklist of needed information. Management of the target business or company prepares some of the information. Financial statements, business plans and other documents are reviewed. In addition, interviews and site visits are conducted. Finally, thorough research is conducted with external sources -- including customers, suppliers, industry experts, trade organizations, market research firms, and others.

The requirements of a sound due diligence investigation

Put simply, a due diligence investigation is an enquiry which seeks to ensure that all information which should be in the hands of the purchaser is made available and verified. How extensive the probe is taken will depend on the size, complexity and nature of the company's operations and the extent to which it already has effective reporting and disclosure systems in place.

As due diligence is an investigation of the business as a whole and not just its financial performance, it is prudent for the purchaser to form a committee that comprises those advisers who will control the due diligence process (the "Committee"). The Committee usually consists of representatives of the purchaser, and the purchasers lawyers, accountants and some times financiers. Senior executives, lawyers, accountants and other appropriate experts should be nominated with responsibility for reporting to the Committee for different areas of the targets operations, for instance, industrial relations, marketing, sales, occupational health and safety, and legal compliance ("Reporting Persons"). The Report Persons should be answerable for the material accuracy of statements in the draft due diligence report, establish that there are no material omissions and be able to verify all statements in their area of responsibility. Depending on the nature of the business or transactions others may be permanently on the committee or co-opted on to the committee to undertaken specific tasks and no longer participate on the conclusion of those tasks.

One person on the committee should assume control and conduct of the proceedings generally, and closely scrutinise the results obtained. In turn, the whole committee, must be satisfied in the first place with the adequacy of the due diligence process to be used, should receive progress reports or at least the final report and address their minds to the contents, questioning where that appears desirable and, if necessary, calling for further reports.

The Committee is to approve the scope of the due diligence, to receive regular progress reports and where necessary to redirect the due diligence efforts with a view to ensuring that by the end of the due diligence period a complete and thorough understanding has been obtained of all the relevant matters before the prospectus is finalised. Finally the Committee must report fully to the purchaser.

Due Diligence Committee Meeting frequency and procedures

Committee meetings should be held regularly to review progress of the due diligence. Meetings are intended to be quick updates and requests for prompt decision making. They are intended to enable the due diligence process to flow smoothly with no bottlenecks and to provide assurance that the process is operating according to schedule and that all significant issues that have been identified are raised and resolved.

Minutes of each Due Diligence Committee meeting should be taken.

In addition to the regular invitees to the meeting, selected individuals dealing with specific aspects of the due diligence may be invited to report on their particular area of responsibility.

Due Diligence Questionnaires and Report

It is essential that there is a very clear trail of the scope of the due diligence, the approved programme of work checklists, the procedures performed (and by whom) and the results of the procedures. An overall comprehensive report in respect of each aspect of the due diligence should also be prepared. This will be done so that the company, directors, underwriters and all involved with the making a decision regarding the transaction have a clear understanding of the results of the due diligence process and to provide evidence that all reasonable enquires have been undertaken.

The Committee after considering what if any information is in the data room will usually prepare a Due Diligence Questionnaire for the vendor to answer. A due diligence questionnaire is usually prepared to assist the Committee in deciding what areas probing investigation is required and those areas of the targets operations where lesser investigation is warranted.

For instance, in reviewing material contracts of the target, it is useful to have a standard review forms to record the outcome of each contract reviewed. Similarly using standard forms to report on other areas of information collected by the due diligence investigation provides for ease in comparing and reporting on the results uncovered. The greater the volume of material the more people that will be need to conduct and record the outcome of staff interviews, discussions with the vendor and its advisers, review of assets and encumbrances, and review of IP rights, consequently if a standard reporting format is not used the various means adopted by those reporting delays the collating process and makes its harder to complete an accurate due diligence report.

Often the standard reporting information comprises the basis of the advice set out in the due diligence report by the Committee. The standard reporting procedure allows the Committee to substantiate the statements made in the due diligence report by way of the contents of the secondary information. The quality of the work involved in preparing, and organizing the secondary information is a good indicator of the quality of the due diligence report.

The end result of the process of the due diligence enquiries is usually a due diligence report. The due diligence report is usually built around a checklist of the information required and issues that should be considered. When purchasers are reviewing a report, care should be taken when reviewing the checklist to ensure that the original assumptions have been adequately addressed in the report.

The report should set out clearly the limitations on the scope of the report originally agreed or which have been agreed in the course of preparing the report. The report should also set out the assumptions that have been made, the sources of the information provided and explain what was actually done by the team to obtain and record the information.

The due diligence report will usually be separated into sections dealing with the various areas of enquiry (e.g. contract review, review of property, plant and equipment, IP review, employment issues, environmental issues and so on).
The due diligence report should be prepared simultaneously with the steps set out above and will be amended to reflect the findings of the reports and further investigations. This is because the act of preparing the report often throws up additional issues that should be investigated.

When purchasers read a report, your focus will generally be on the contents of the report's executive summary setting out the principal findings of the due diligence enquiries. The critical point for the Committee is to state the outcomes in a manner that properly states the risk — overstating an issue can be just as bad as understating it. There are risks associated with every business purchase and the aim for the Committee is not to prevent the potential purchase but rather to help the potential purchaser make an informed decision on whether or not to purchase and, if so, on what terms. Remember, price is the moderator for the risk taken. A high risk business can still be a worth while purchase provided the price paid is worth the risk being taken. The more secure the business the higher the price. The more risky the transaction the lesser is the price: At least that is the theory.

Scope of the due diligence process

As a matter of practice the scope of a due diligence review however extends beyond purely financial considerations and will generally include obtaining sufficient information to enable reasonable conclusions to be drawn on all matters relevant to a purchaser's decision to buy the target and to ensure that no material consideration is omitted from the consideration.

The scope of the due diligence conducted will depend on the extent to which those involved in the decisions making process consider it necessary to conduct detailed investigations to ensure that the due diligence report uncovers what they require to know to be satisfied to proceed with the purchase given the cost they will be paying for the business. At one end of the spectrum, the process may simply rely on existing internal reporting and disclosure processes where these processes are detailed and reliable and it is felt that these processes are so watertight that it will not be necessary to probe the vendor further. It would, of course, be necessary to convince outsiders involved in the decision making process of the purchase, such as financiers, underwriters and auditors, that this was appropriate. At the other end of the spectrum, the due diligence process can be an exhaustive and detailed examination of all of the target's operations conducted by relevant advisers.

The Committee cannot reasonably check everything when conducting due diligence and usually, both vendor and purchaser will want all done in a short period. This is particularly the case when the target is a small to medium enterprise ("SME"). Generally, the vendor will be concerned about the purchaser pulling out and the purchaser will be concerned about cost. The objective when considering scope is to determine what investigation s can be safely cut from the enquiries without you being exposed to unnecessary risk, lit involves understanding the business and determining where the real value lies and also what the principal risks are for the business.

The Securities Institute of Australia[6] in 1993 publishes a Due Diligence Guide[7] for prospectuses. As the process of acquiring shares is just one method of acquiring a business, the procedures in the Due Diligence Guide are useful for advisers to consider in scoping a due diligence investigation. The due diligence checklist in the SIA Due Diligence Guide has seven main areas of investigation:

1. Background;
2. Management & Control;
3. Industry & Competitors;
4. Human Resources;
5. Operations
6. Legal
7. Financial

Within each section there are questions ranging from 10 in Background, to 135 in Financial. For advisers seeking to scope a due diligence investigation the SIA Due Diligence Guide is an excellent though some what now dated starting point.

Just how detailed and extensive the process is, will depend on the judgment of those involved.

Some of the main risks that purchasers need information about to manage the risk in buying a purchase or engaging in a merger or acquisition include:

(a) Where does the target's revenue cone from and what are its major cost items?

(b) The "material contracts" entered into by the target with customers and/or supplier.

(c) If the target sells a particular product, the sources of supply of the product and any intellectual property issues relating to the supply must be considered.

(d) If the target has only a few customers, the agreements that have been reached with the customers should be closely examined as well as the strength of the relationship between the target and the customers.

(e) It is important to consider what brings the customers to the target. Does the target have a competitive advantage in relation to its manufacture and/or sale of the product?

(f) Where the location of the business is important, the report should consider the rights of the target to that location and the condition of the business premises. If there is a lease, the report should consider the residual term, the options and whether or not there will be any difficulty in taking an assignment of the lease.

(g) The report should identify the key personnel of the business, their terms of employment, their plans and the effect of the departure of any such employees.

(h) The nature and security of the intellectual property rights of the target should always be considered.

(i) How big is the market?

(j) Is it growing?

(k) What are the key factors that can impact the business either positively or negatively?

(l) Is there any looming legislation that will affect the industry, the business?

(m) What key publications and other media are being used to advertise?

(n) What are the advertising costs?

(o) Who are the competitors?

(p) Can your business compete with them? How?

(q) Where does the vendor’s business fit amongst the competition?

(r) What is the competition spending on advertising?

(s) Where is the competition advertising?

(t) Does the industry seem fun?

(u) Are there any major growth areas?

(v) Are there any new product trends?

(w) What are the industry distribution channels?

(x) What sales/marketing applications are being used within industry?

(y) Who is the industry/market leader?

(z) How is this business ranked within the industry?

As each business is different, the importance of each of these factors will vary. Consequently, when you are advising purchasers, you should discuss these issues with them so that they can instruct you on their priorities for the due diligence report. Certainty of objectives between purchasers and their advisers must be clear at all times.

Where To Get The Data?

Gathering information on any business is a very important part of the due diligence process. As seen, information is obtained from the vendor and its management. However, regardless of how helpful the vendor may be, purchasers must go outside this circle to gather objective and useful information.

Unless a purchaser is in the same industry already as the target being considered, purchasers are a bit behind the eight ball because a large part of the information purchasers can access is usually generic. However, if you advise your clients to focus their attention on getting answers to very specific questions, useful information can be quickly obtained.

The key question/challenge purchasers face is: how can purchasers be expected to learn about an entire business, let alone an industry in a few weeks?

As a rule, good businesses sell fast. Unfortunately, purchasers probably won't have the luxury of leisurely investigating any good business. Purchasers must work fast, but NEVER at the expense of overlooking a critical component.

The most important thing to remember is that purchasers must begin to gather information on any business, the industry, the competition, the market, the suppliers, the sales strategy and every other possible component to the business as soon as a business becomes of interest to purchasers. In other words, the first time purchasers see the listing, if purchasers are interested, purchasers must begin to learn as much as purchasers can about it.

There are certain things purchasers can do to immerse yourself into the industry. Whether purchasers are looking at buying a local bakery or an aircraft manufacturing plant, if purchasers do their homework effectively, purchasers will be able to gather a tremendous amount of useful information. Like all aspects of purchasing a business, purchasers can only make a good decision if purchasers are well informed. Between libraries, websites, associations, competitors and affiliations, purchasers can gather some very potent and useful data.

The good news about the due diligence process is that there are many resources available to purchasers. Other than obtaining information from the vendor purchasers should investigate what they can uncover about the business and industry from the following resources:

- Industry Associations
- Local Associations (they may or may not be members, but find out who these are in any case)
- Industry “Bible” (every industry has at least one main trade publication)
- Copies of any industry subscriptions they receive (get copies… it’s good reading and pay attention to the advertisements)
- Previous trade show materials (from any trade shows that the business has exhibited or attended and even if it is from a few years ago)
- Sales/Marketing material from the vendor’s target
- Sales/Marketing material of the vendor’s competition (be wary if the vendor doesn’t have any!)
- The names, addresses, Website and phone numbers of as many competitors as possible
- The Internet & Websites where purchasers can search for additional information
- Key customers (they may not want to do this so purchasers must do so discreetly. Check shipping cartons during your tour or note any names that they may refer to during your conversations).

As a guide, some of the questions that the Committee may want to discuss with these third parties include:

- Who are industry leaders?
- What are the current trends in the industry?
- What is the size of the market?
- Is the market growing?
- Is your area a growth area?
- What are the competitors doing?
- If they owned this type of business what would their advertising and marketing strategy be?
- Would they buy this type of business?
- Do they sell their subscriber list?
- Are there any publications or other resources they recommend?
- Any industry consultants they can suggest? If there are any, call them ASAP. Go through the same pitch, let them know that purchasers will be interested in their services once the purchase process moves along… but in the interim: “Can I ask purchasers a few questions…”)
- What trade shows should purchasers attend?
- At which trade shows should industry participant’s exhibit?
- Have them send to the purchaser lots of back issues and try to get hold of their annual Directory Listing (this will disclose all of your client’s potential competition).

How Much Due Diligence Needs to Be Conducted?

There is no correct answer to this question. The amount of due diligence purchasers conduct is based on many factors, including prior experiences, the size of the transaction, the likelihood of closing a transaction, tolerance for risk, time constraints, cost factors, and resource availability. It is impossible to learn everything about a business but it is important to learn enough such that purchasers lower your risks to the appropriate level and make good, informed business decisions.

What must be keep in mind is that the due diligence process being a detective work means that you and the purchaser must be openly inquisitive, every searching and seeking the rationale behind why the vendor does what he is doing. With being inquisitive in mind consider the following points:

Focus - When entering into a due diligence purchasers must be clear as to what your objectives are. Key concerns and objectives should be explained to advisers clearly.

Materiality - Determining the appropriate level of what is material to be applied in conducting the due diligence - ensures that the process is focused on your objectives and the identification of legal issues. It is a matter of determining what is reasonably likely to affect the value of what is being sold. Common sense not just predetermined figures should prevail.

Confidentiality - Before the purchaser has any access to any material the vendor will usually require some sort of confidentiality undertaking from the people involved in the due diligence, especially those people who will have access to confidential information. This agreement should permit full discussion and advice between the purchaser and all its advisers in respect of the confidential information.

Can a purchaser Overdo their Due Diligence Effort?

Yes. Too much due diligence can offend a target to the point where they walk away from a deal. It can also result in "analysis paralysis" that prevents purchasers from completing a transaction or provides time for a better competing offer to emerge. Accordingly, it is important that due diligence be prioritized and executed expeditiously. Appropriate investigation and verification into the most important issues often must be balanced by a sensible level of trust concerning lesser issues.

How Much Time is Allocated for Due Diligence Completion?

Time allocated for completion can vary widely with each situation. Many preliminary agreements define the timeframes in which due diligence will be conducted. Time schedules through the closing of a transaction are typically tight -- parties should ensure that adequate time is allocated to due diligence.

Note that there is no set amount of time that must pass during due diligence — take as long as purchasers need to answer all of your questions.

How Should a purchaser Prioritize Tasks Within the Due Diligence Effort?

Every transaction will have different due diligence priorities. For example, if the main reason purchasers are acquiring a target is to get access to a new product they are developing to accelerate your own time to market, then the highest priority task is to ensure that the product is near completion, that there are no major obstacles to completion, and that the end product will meet your business objectives. In another transaction, the highest priority might be to ensure that a major lawsuit is going to be resolved to your satisfaction.

Does Due Diligence Ensure that a Business Transaction Will Be Successful?

A well-run due diligence program cannot guarantee that a business transaction will be successful. It can only improve the odds. Risk cannot be totally eliminated through due diligence and success can never be guaranteed.

What have the Australian Courts said about due diligence?

The Australian Courts have only considered due diligence in a few instances.

From the few instances we can draw the following conclusions:

Lesson 1

It is important that purchasers understand the implications of a due diligence agreement. This is illustrated by ***Plessey Components Pty Ltd v Cant*** ((NSW Supreme Court, 4 May 1992, Unreported decision, BC9201903)[8]. In that case, the purchaser was permitted to review the books and records of the vendor on a confidential basis. The purchaser was required to deposit $150,000 with the vendor which was to be returned with interest if the sale did not proceed. After this agreement, the vendor started to receive interest from third parties. The vendor sold to a third party without giving the purchaser an opportunity to match the third party's higher offer as required under the draft sales contract. His Honour Justice Young J (as he then was) held that the parties had entered into binding agreement under which the potential purchaser had a right to inspect the books and records of the target, prior to negotiations for a purchase of the assets.

If due diligence is to be undertaken, particularly of a large and complex business, it is prudent that each party's obligations be clearly defined in a written agreement. The parties need to consider and agree on the following:

(a) The nature and extent of the enquiries to be made by the purchaser and its professional advisers. Generally, the Committee should be able to examine all aspects of the vendor's business, including financial records and to interview the key employees.

(b) The time period for the due diligence will need to be agreed. The vendor will usually want to limit the time period because they do not want to waste time with a potential purchaser who ultimately decides not to proceed.

(c) The number and identity of the Committee members who will have access to the information.

(d) The purchaser and its advisers will have to agree on complete confidentiality during the due diligence process.

Lesson 2

The implications of carrying out due diligence after signing of the contract should always be considered. The main issue is the circumstances in which the purchaser will be entitled to withdraw from the contract if it is not satisfied with the outcome of its enquiries.

Usually, the choice is between the carrying out of due diligence before entering into the contract or between the signing of the contract and completion under the contract.

Two cases involving ***SDS Corporation Ltd v Pasdonnay Pty Ltd & Anor*** [2002] WASC 276[9] and [2004] WASC 26[10] illustrate the issues that arise. In these cases, completion under the contract was conditional upon the outcome of a due diligence investigation to be undertaken by the purchaser ***in its absolute discretion***. The vendor ("Pasdonnay" was obliged to provide the information required by the purchaser ("SDS"). SDS claimed that Pasdonnay did not provide all of the information and therefore SDS was not able to complete its due diligence enquiries.

SDS Corporation Ltd ("SDS") had entered into an agreement to purchase a business from Pasdonnay.

Amongst other provisions the contract for sale of business contained the following provisions:

"4. **CONDITIONS PRECEDENT**

4.1 **Conditions**

Completion is subject to and conditional on:

4.1.1 the results of the due diligence investigations to be undertaken by or on behalf of the Purchaser in relation to the Business, the Business Assets and the Patents being satisfactory to the Purchaser in its absolute discretion (for the avoidance of doubt, the due diligence investigations will include a review of the matters (if any) set out in the Disclosure Letter from the Asset Holders [the defendants, jointly and severally]);……

4.2 **Best Endeavours**

4.2.1 Subject to the Asset Holders complying with their obligations under clause 4.3.1, the Purchaser shall conduct due diligence investigations in relation to the Business, the Business Assets and the Patents.

4.2.2 The Purchaser must use its Best Endeavours to procure the satisfaction of the Conditions in clause 4.1.2, clause 4.1.4 and clause 4.1.5.

4.2.3 Pasdonnay must use its best endeavours to satisfy the Condition in clause 4.1.3 and clause 4.1.5.

4.3 **Assistance**

4.3.1 the Asset Holders must provide all assistance required by the Purchaser to enable it to conduct the due diligence investigations to be conducted by the Purchaser in accordance with clause 4.2.1. Without limiting the generality of this clause 4.3.1, the Asset Holders will give the Purchaser:

(a) access to all information necessary for the Purchaser to conduct due diligence investigations in relation to the Business, the Business Assets and the Patents, such information to be all information necessary for the Purchaser to make an informed decision as to whether or not to purchase the Business Assets and enter the licence agreement;

(b) access to all relevant personnel, officers and advisers and to the Business Assets; and

(c) responses to any queries raised by the Purchaser in relation to the Business and/or the Business Assets and/or the Patents.

4.3.2 the Asset Holders must provide all reasonable assistance to the Purchaser in procuring the satisfaction of the Conditions in clause 4.1.2 and clause 4.1.4.

4.3.3 the Purchaser must provide all reasonable assistance to Pasdonnay in procuring the satisfaction of the condition in clause 4.1.3."

On 15 November 2002 SDS sought a prohibitory interlocutory injunction to prevent Pasdonnay from adversely affecting the business or disposing of the assets of the business the subject of the Agreement.

Judgment on both applications was delivered by Barker J on 22 November 2002 (***SDS Corporation Ltd v Pasdonnay Pty Ltd & Anor*** [2002] WASC 276).
His Honour granted both the mandatory interlocutory injunction and the prohibitory interlocutory injunction.

His Honour Barker J agreed with the contentions of SDS that that the purported termination of the agreement by Pasdonnay on the ground that SDS had not complied with its due diligence in accordance with the Agreement was without legal effect. The reasoning for it not having any legal effect was that the purported termination of the agreement by Pasdonnay (by notice on 8 November 2002), was that Pasdonnay was not entitled to terminate the Agreement for non-satisfaction of a condition precedent (to performance) which Pasdonnay was at the time itself in breach of the Agreement in such a way as to cause or contribute to the failure of the condition that Pasdonnay was alleging that SDS was in breach of. In this instance, SDS said that it is the conduct of Pasdonnay in refusing to comply with its request for further information to enable the completion of its due diligence investigations, that led to the non-satisfaction of the condition precedent.

On finally hearing the Court upheld SDS's complaints are ordered that Pasdonnay provide the information requested by SDS.

Pasdonnay argued that the agreement was subject to an implied term that it need only provide the assistance reasonably required and reasonably necessary for the due diligence investigation. SDS contended that because Pasdonnay failed to supply the information requested, SDS was unable to satisfy other conditions including financing approval.

The court concluded that the implied term we displaced by the express wording of the contract which referred to the due diligence acceptable to SDS in its absolute discretion. The court was of the view that Pasdonnay, as vendor, had an obligation to comply with the requests for information even if the information was unreasonable, so long as the information requested was in its possession or control. SDS obtained an order for specific performance apparently to provide the requested information. The vendor's claim that it had a right to terminate the contract was dismissed.

The case illustrates the importance of deciding what test should apply to the question whether or not the potential purchaser should be bound to complete after having completed the due diligence – is it to be objective or to some subjectivity. If purchasers are purchasing purchasers will generally like to retain some subjectivity as to the outcome of the due diligence. Vendors like to have the due diligence first before the contract is entered into so that the purchaser doe not have the option to walk if he does not like what he finds.

The outcome of the due diligence discussion is often an agreement on the basic terms of the deal with an exclusivity period under which:

(a) the purchaser provides a list to the purchaser of the information requested and agrees to respond to requests for further information and to provide access to the vendor's accountant and access to staff;

(b) the vendor agrees not to sell to a third party during an agreed period and the parties agree to negotiate in good faith over that period to finalise the terms of the contract of sale;

(c) the parties agree to work together to resolve other conditions precedent (e.g. consent of lessor to assignment of the lease, approval of third parties to the assignment of material contracts and so on); and

(d) each party agrees to keep the negotiations confidential.

Lesson 3

Hayle Holdings Pty Ltd v Australian Technology Group Ltd *[2000] FCA 1242*[11]

The case involved ATG seeking to invest money as a venture capitalist in Hayle Holdings. Hayle took action against ATG after ATG failed to invest in the business. Hayle alleged that ATG have engaged in misleading and deceptive conduct, in the main, by statements made orally from March 1995 to January 1995. For much of this period, ie from March 1995 until November 1995, the parties were engaged in a negotiation, the object of which was to reach agreement as to the provision of venture capital by ATG to Hayle. There were a large number of communications during that time, and the proposal changed and evolved as the negotiation progressed, until agreement was reached on 13 November 1995.

As part of the process ATG and Hayle entered into an agreement for ATG to conduct due diligence. During the due diligence period Hayle granted ATG exclusivity to negotiate a deal with it.

Hayle, amongst other claims alleged that the representations in the "Expression of Interest" letter of 3 August 1995, that:

> *"ATG was interested in entering into detailed due diligence with the purpose of deciding whether to* (invest)*"* $2 million dollars in Hayle was misleading and deceptive.

His Honour Hely J held that there was not any evidence that ATG was not then interested in investing $2 million in Hayle. That was never put to Dr Westlake. It is patent on the face of the document that there was a risk that the contemplated investment would not occur as par 10 "`busted deal' expenses" and par 12 "commitment" specifically adverted to that possibility. In any event, Mr Browne always knew and appreciated that there was a risk that ATG could decide not to go ahead with the deal at all, or to do so only on terms different from those which Mr Browne wanted (T 391-392). At paragraphs 312 to 313 Hely J stated:

> 312 No submissions were put in support of the contention that the representations contained in the letter of 3 August are false, misleading and deceptive in that Hayle Holdings reasonable operating expenses of not more than $80,000 per month up to $160,000 would not be reimbursed out of the first tranche. The letter of 3 August proposed that they should be paid out of the first tranche, and it was not put to Dr Westlake that ATG then had some different but uncommunicated intention. The fact that in the offers of 19 and 27 October a deal was proposed on the basis that these expenses should be paid out of the second tranche (a proposition then accepted by Mr Browne) does not mean that the statement in the letter of 3 August was false, misleading or deceptive. Again, it is self-evident that there was a risk that the expenses would not be reimbursed out of the first tranche because all that existed

at that stage was a proposal which might come to nothing, or the terms of which might change. Mr Browne knew and accepted that this was so…...

313 Although 2FASC par 40 alleges that insofar as the letter dated 3 August 1995 related to future matters, there were no reasonable grounds for making them, no submissions were put in elaboration of that contention. In my view, this contention has not been made out. The letter ought not to be treated as rising above what it says, namely that ATG was interested in entering into detailed due diligence in relation to the business of Hayle with a view to a possible investment on the terms proposed. There is no basis for a conclusion that ATG's intentions were otherwise than as stated. There was no cross-examination of Dr Westlake to that effect."

The case illustrates the importance of clear wording in letters of expression of interest and how by using a due diligence agreement claims of misleading and deceptive conduct can, albeit at expense be avoided.

End Notes

[1] Merger is the polite way of saying that one company has bought another and that one of the terms of the deal was to let the CEO of the target company or Chairman, say that it was a merger of equals, when really it was a sale and purchase usually when the target was not on the market to be sold. See Mergers & Acquisitions: Why & How http://www.ustyleit.com/Merger_and_Acquisition_Templates.htm

[2] Duncan, W D & Traves, S J, **Due Diligence**, LBC Information Services, Sydney, 1995, p 1; see also definition of "Due Diligence", Wikipedia, http://en.wikipedia.org/wiki/Due_diligence#_note-0#_note-0; Montgomery, P *Why Due Diligence*, **Due Diligence Masterclass**, BLEC Books, July 1991pp3-7.

[3] Anonymous author on following website http://www.allbusiness.com/buying-exiting-businesses/purchasing-a-business/569-1.html

[4] Securities Institute of Australia, **Due Diligence Guide**, 2nd edition, September 1993, para 2.1.

[5] Ritchie, **The Complete Due Diligence Guide**, Chapter 7, obtainable at http://www.diomo.com/-due

[6] The SIA is now FINSIA.

[7] The SIA Due Diligence Guide has not been republished and the author understands that it is currently not in print. Copies are only available in libraries.

[8] Skinner, S, Practical issues to consider when buying or selling a business, Talbot Olivier Solicitors, Paper October 2006; http://www.talbotolivier.com.au/upload/docs/Practical_Issues.pdf

[9] http://www.austlii.edu.au//cgi-bin/disp.pl/au/cases/wa/WASC/2002/276.html?query="due%20diligence"NEAR%20business#disp1

[10] http://www.austlii.edu.au//cgi-bin/disp.pl/au/cases/wa/WASC/2004/26.html?query="due%20diligence"NEAR%20business

[11] http://www.austlii.edu.au//cgi-bin/disp.pl/au/cases/cth/federal_ct/2000/1242.html?query="due%20diligence"NEAR%20business#disp110