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Path to a Successful M&A Transaction: An Effective Legal Due Diligence

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Introduction

- *Caveat emptor* - 'Buyer beware'
 - Concept: Level of judgment, care, prudence, determination and activity that a person would reasonably be expected to do under particular circumstances
 - Application: Process of evaluation of a prospective business decision by obtaining and reviewing the legal and commercial state of a target

- Statutory recognition:
 - Section 3, Transfer of Property Act - '*a person is said to have notice*' of a when he actually knows that fact, or when, but for wilful abstention from an enquiry or search which he ought to have made or gross negligence, he would have known it
 - Section 27(1), SEBI Act - Offences by companies - Provided that nothing contained in this sub-section shall render any such person liable to any punishment provided in this Act, if he proves that the offence was committed without his knowledge or that he had exercised all due diligence to prevent the commission of such offence



Duty of Care and Professional Liability

- Duty of care - Higher than ordinary standard since a lawyer, being a professional, impliedly assures the person dealing with him that the skill which he professes to possess shall be exercised with reasonable degree of care and caution (Jacob Mathew v. State of Punjab, 2005 SC)
- Liability - governed by principle of negligence - may be held liable for:
 - not possessing the requisite skill which he professed to have possessed,
 - not exercising with reasonable competence, the skill which he did possess (Jacob Mathew v. State of Punjab, 2005 SC)



Duty of Care and Professional Liability

- Standard to determine 'negligence' - that of an ordinary competent person exercising ordinary skill in that profession - not necessary for every professional to possess the highest level of expertise in that branch which he practices (IMA v V. P. Shanta (1995, SC), Jacob Mathew v. State of Punjab, (2005 SC))
- Negligence would depend on facts of each case and on the extent of clients reliance on DD findings
- Biggest concern from a service industry standpoint is the loss of reputation



Duty of Care and Professional Liability

- Liability Mitigation - Standard qualifications in the Legal Due Diligence Report
 - Report limited to state of affairs on date information was disclosed in data room
 - Assumption of conformity to the originals of all documents submitted as copies
 - Reliance upon statements and communications received from authorised officials of target
 - Qualifications as to independent investigations



Limitations of Legal Due Diligence

- Depends largely on the quantity and quality of data provided by the Issuer - potential risk of non-disclosure or misrepresentation
- Limitations on timing
- Exposure to unknown investors and also possibly in foreign jurisdictions
- Judgment of the person conducting the diligence - Many risks are 'latent' even if raw data disclosed - interpretation is equally important and often crucial
- Review restricted to sanitized, vetted reports and interviews with key employees - the real dirt may be elsewhere (e.g. e-mails and other correspondence)
- Roadblocks in sharing proprietary information



Objective and Utility

Investor	Target
Informed decision making	Disclosure to investor
Ascertaining liabilities	Avoid fraud/ misrepresentation claims later
Assistance in valuation negotiations	If compliance level is already good, may help in valuation negotiations
Risk allocation	If there are gaps in compliance, these can be addressed



Understanding Client Objectives

- Know your client and the thought process
 - Strategic reasons/ Investment thesis
 - Familiarity with India
 - Risk appetite
 - Materiality thresholds
- Deal Structure - this may change post legal due diligence
 - Asset Sale
 - Business Transfer
 - Share Acquisition
- Deal Size
 - Minority stake
 - Majority/ controlling stake
 - 100% acquisition



Types of M&A Transaction

Asset Sale

Business Transfer

Share Acquisition



Types of M&A Transactions

HEAD	BUSINESS TRANSFER	ASSET SALE	SHARE ACQUISITION
Entity	<ul style="list-style-type: none"> Unless the buyer already has an Indian entity that can be used, the buyer will need to set up a new Indian entity, and this will have a timing impact. The Indian buyer entity will need to have at least one Indian resident director The Indian buyer entity will also need to obtain business, tax, and governmental registrations, and the capital contribution in the buyer entity will need to be reported to the RBI 	<ul style="list-style-type: none"> Same position as for business transfer 	<ul style="list-style-type: none"> No Indian entity is needed in a share sale structure
Documents	<ul style="list-style-type: none"> The target and the buyer entity will need to enter into a business transfer agreement In addition, certain transfers (e.g. for immovable property or IP) will require separate transfer documentation Novation/ assignment agreements will be required to transfer contracts New employment agreements will need to be executed 	<ul style="list-style-type: none"> Same position as for business transfer 	<ul style="list-style-type: none"> The buyer/ buyer entity and the sellers will need to enter into a share purchase/ subscription agreement The share transfer reporting will need to be accompanied by a valuation report from a chartered accountant (see "Exchange control" below)
Consents	<ul style="list-style-type: none"> To transfer certain assets, consents will need to be obtained from the relevant third parties and governmental/ regulatory 	<ul style="list-style-type: none"> Same position as for business transfer 	<ul style="list-style-type: none"> All contracts (financing documents, in



Types of Legal Due Diligence

- Capital markets due diligence
 - Merchant Banker certificate to SEBI - Veracity and adequacy of disclosures in the offer documents - Regulation 64 of SEBI (ICDR) Regulations and Schedule VI (Format of due diligence certificate)
- Property due diligence
 - Definition of 'notice' under the Transfer of Property Act includes *'wilful abstention from an enquiry or search which he ought to have made'*
- Bank's security due diligence
 - Bank's may require a legal opinion (following due diligence) on validity of title of property to be provided as security for borrowing



Types of M&A Legal Due Diligence

- Acquisition-side Legal Due Diligence
 - Advising a potential acquirer of shares/ asset/ business

- Vendor Legal Due Diligence
 - Advising a potential seller of shares/ asset/ business

- Variations
 - Depending on client type : (i) financial investor or (ii) strategic investor
 - Depending on client familiarity: (i) foreign client or (ii) Indian client
 - Part of a global transaction or India-specific



Types of M&A Legal Due Diligence

- Handling an acquisition-side legal due diligence where the seller provides a vendor legal due diligence report
 - Limit review to report or supporting documents?
 - What is the scope of the report?
 - What are the information gaps?
 - What are the 'right' questions to ask?
 - Do we document Q&A, and if so, how important is it?



Legal Due Diligence is not...

- A legal opinion / substitute for a legal opinion
- Meant for third parties (no-reliance letters)
- A comment on/ summary of all documents in relation to the target company
 - Importance of being earnest with your list of documents
- A document containing business, financial, tax, environmental or employment diligence (scope exclusions)



Scope and Exclusions

- Substantive Scope
 - Regulatory issues (business and transactional)
 - Licenses
 - Material contracts
 - Corporate compliances
 - Finance (loan and security documents)
 - Real Estate
 - Intellectual Property
 - Employment compliances
 - Litigation (existing and threatened)
 - Insurance



Scope and Exclusions

- Time Scope - 3 years, 3 financial years, update diligence
- Standard Exclusions
 - Business
 - Financial
 - Tax
 - Environment
 - Employment



Managing a Legal Due Diligence

- Regular, meaningful client updates
 - Significant issues should be discussed as soon as identified and not at the end of a 6 week diligence in the legal due diligence report
- Periodic updating of list of documents
 - Importance of being able to identify all documents reviewed (indemnity claim on the basis that a document not disclosed) x
- Effective requisitions
 - Dividing questions into documents and clarifications
 - Referencing document location in virtual data room
 - Request for conference calls/ meetings if lists do not work
- Use of third party consultants
 - Understanding client objectives
 - Ability to prioritise issues
 - Sharing of information



Legal Due Diligence Report

- Who is your client and what does your client expect?
 - Client unfamiliar with Indian laws (eg foreign investor with no Indian offices) - may need more explanation and hand holding
 - Indian clients and foreign clients with Indian offices (experience in doing business in India - crisp statement of issue and solution
 - General trend moving away from the “treatise-format” and towards issues lists and exceptions-only reports

- Client discussion items
 - Value drivers
 - Focus areas
 - Thresholds



Risk Identification I

Classification of Issues

- Material
 - Does it affect the proposed transaction structure? (Purchase of/ subscription to securities or acquisition of business)
 - FDI - Does it affect the ability to purchase (securities)?
 - Prior consent for a license necessary for business
 - Failure to file/ significant delay in filings with material regulators/ government bodies (RBI - NBFCS, IRDAI - insurance companies)

- Housekeeping
 - If the penalty/ aggregate penalties were quantified - would the amount be significant (think big - the deal size may be in Crores)
 - Delayed filings with the Registrar of Companies and statutory employment law regulators



Risk Mitigation | Typical Solutions

- Condition precedent
 - Action required prior to Completion Date
 - To comply with regulatory requirements (eg CCI approval, government approval, hiving off business due to FDI issues), comply with contractual requirements (eg prior consent or waiver of termination right)

- Condition subsequent
 - Action required after Completion Date
 - To address corporate secretarial filings, less important CPs pushed back, follow-up for receipt of registration applied for

- Specific representation & Indemnity

- Specific Indemnity



Risk Mitigation | Practical Solutions

- Example 1: Two directors are required to sign all board minutes and there are minutes for three meetings where only one director has signed
 - Compounding or quantify penalty + specific representation + specific covenant on post-Completion conduct?
- Example 2: Target does not have shops and establishment registration for 3 offices
 - Registration to be obtained as a condition precedent + specific indemnity or quantify penalty + application filed as a condition precedent + follow-up to obtain registration as a condition subsequent
- Example 3: Target is an exclusive distributor of Samsung mobile phones, but it has executed distribution agreements with Apple
 - Deal breaker or novate Apple contracts into a different entity prior to Completion along with a specific indemnity?



Risk Mitigation | Practical Solutions

- Example 4: Target has executed 80 supply contracts with prior approval clauses, but client (acquirer) wants to close quickly
 - Wait for all consents before Completion or identify with client the top 10 revenue-generating customers it is interested in (based on list provided by Target) + apply to all counterparties for approval but decide to only wait for the top 10 customers to approve
- Example 5: Lease agreement for 5 of Target's offices are not adequately stamped and registered
 - Apply for adjudication with stamp duty authority + pay stamp duty prior to Completion or execution of fresh lease or quantify risk and recommend execution of fresh lease upon expiry of existing lease



Risk Mitigation | Practical Solutions

- Example 6: Target has engaged contract labourers at its manufacturing plants but has not obtained principal employer registration under the Contract Labour (Regulation and Abolition) Act 1970
 - Ask Target to obtain registration prior to Completion + specific indemnity or recommend termination + specific indemnity or quantify penalty + application for registration to be filed prior to Completion + approval to be obtained post-Completion
- Example 7: Target has executed 7 loan agreements, one loan agreement provides that the lender may convert debt into equity and Target has received a notice of default from that lender
 - Deal breaker or obtain waiver for exercise of conversion right + recommend repayment of this loan prior to Completion (if Target has sufficient funds) or using the invested funds upon Completion
- Example 8: Target has executed 7 loan agreements, each providing for acceleration due to cross-default and Target shares a notice of default
 - Deal breaker or write to each lender for a waiver from exercise of cross-



Impact on M&A Transaction

- Translating recommendations in legal due diligence report into transaction documents
 - Condition Precedent
 - Condition Subsequent
 - Warranties
 - Indemnity
- Review of disclosure letter provided by Target or seller
 - Verification of existing risks (including quantum and extent)
 - Identification of new risks (not disclosed during diligence)



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