

## The Due Diligence Process

| by Annabel Kok Keng Yen |

Due diligence is a critical success factor in an M&A transaction, as information gained during such an investigation would reveal material facts, potential risks and liabilities relating to the target company. Whether in a share or asset/business acquisition transaction, an acquirer would typically carry out a due diligence review of the target company in the preliminary stages of a transaction, that is, post-execution of the preliminary agreement, with a view of determining whether to proceed with the transaction and, if so, whether the intended deal structure is feasible.

### What it is

Due diligence is essentially a process of a thorough, detailed and comprehensive investigation into the affairs of a target company done by reviewing documents/information and interviewing persons with knowledge about the target company. The level, range and scope of a due diligence review varies in accordance with the type of due diligence conducted. The five primary categories of due diligence ordinarily conducted on a target company in the case of a share or asset/business acquisition are: financial, legal, accounting, commercial/operation and environmental.

This article will focus on the legal due diligence process and considerations to keep in mind when carrying out legal due diligence.

### Legal due diligence

The review encompasses a thorough analysis and review of documents/information relating to a target company, including its corporate structure, agreements, litigation

(subsisting and pending), real property, intellectual property and regulatory compliance. Key objectives of a legal due diligence review are to:

- (a) uncover potential legal exposures, risks, liabilities and commitments of the target company;
- (b) ensure that the seller has good title to assets belonging to the target company, including intellectual property and assets the buyer wishes to acquire; and
- (c) determine the current status of the target company. A legal due diligence review would allow an acquirer to understand what exactly the buyer would be attaining and to lay out a plan for future projects relating to the target company;

Information obtained during the legal due diligence process will also be useful in the drafting and negotiating of the definitive agreement; in particular, allocating risk when drafting the target company's representations and warranties and post-completion indemnification rights of the buyer.

### *Who is involved?*

Due to the difficulty in analysing sizeable amounts of information in relation to a target company in a legal due diligence review, a buyer would engage solicitors to undertake the review. Invariably, the due diligence solicitors would be involved in the preparation of the transaction documents. Representatives from the seller and key management personnel of the target would also play an important role in setting up the data room and furnishing information on the target's business operations.

### *Due diligence request list*

The legal due diligence review commences with the preparation of a list of documents and information in relation to the target company to be reviewed and circulating the same to the purchaser/target. Customary documents/information requested include key customer agreements, shareholder agreements, organisational structure and employee records, financing arrangements and regulatory matters. It is pertinent for such requisition lists to be detailed and tailored to the specific transaction for a more efficient, attentive and cost-effective review.

### *Disclosure of documents and information*

Once materials and records are prepared and organised, a disclosing party would distribute such documents and materials to the reviewing party's due diligence team. Such documents are typically organised in a central data room at the offices of the disclosing party or via an online "data room", where documents and information pertaining to the company are uploaded and shared in an online "warehouse" for the benefit of the reviewing party. Online "data rooms" have grown increasingly popular for companies to provide relevant information in a controlled environment and to ensure that their confidential and proprietary information are protected. Virtual data rooms are extremely useful as they allow the reviewing party's due diligence team to review documents in the comfort of their own offices and, in turn, reduces the cost of the due diligence review and expedites the M&A process.

Management interviews are necessary and an efficient way to expeditiously address key issues, resolve concerns in the legal due diligence process and assist the reviewing party in establishing a big picture of the seller's business and the target company. Such interviews are typically conducted with members of executive management of the target company.

## **Primary considerations**

These are some of the primary factors that can be considered in a legal due diligence review:

### *(a) Corporate information*

A review of a target company's statutory records and constitutional documents would ordinarily be conducted in a legal due diligence to ensure that the acquirer has an understanding of the shareholding structure of the target company, as well as group structure (which a purchaser would ultimately acquire).

### *(b) Material contracts and arrangements*

A purchaser should be aware of the contractual rights and obligations of the target company, particularly long-term and exclusive arrangements, outstanding debt obligations owed by the target company and potential exposure — for instance, where the target company has not complied with its contractual obligations.

In a share acquisition, the purchaser should ensure that there is no change of control provisions that may be triggered post-completion of the transaction.

In an asset acquisition, it is of significance to determine whether contracts and agreements that the target company is a party to can be assigned with or without obtaining the consent/approval of third parties or if they are required to be novated.

(c) *Intellectual property*

A legal due diligence review should seek to ensure that the target company is the registered owner and holds the right to the intellectual property it claims to own. The review should cover information relating to patents, trademarks, copyrights, design rights and other forms of registered or unregistered intellectual proprietary rights.

(d) *Regulatory investigations/disputes*

Any current or potential disputes or regulatory investigations or actions involving the target company should be identified. Due diligence solicitors would look into:

- the particulars of claim and defence;
- demand letters;
- orders or judgments against the target company; and
- particulars of any terms of settlement (negotiated or proposed).

(e) *Insurance*

Insurance policies taken out by a target company are a critical factor in determining its risk profile. In an M&A transaction, the buyer would want to ensure that any benefits of existing insurance policies will pass on to the acquirer and that any potential liabilities/risks are, to the extent possible, covered under existing insurance policies.

(f) *Licences and approvals*

It is not uncommon for regulatory bodies to impose prior approval or notification requirements as a condition to licences granted to a company in particular industry, where a change of control occurs. Such conditions are more common in highly regulated industries like manufacturing, insurance, telecommunications, aviation, oil and gas, and fund management.

Additionally, the government may, through regulatory bodies or agencies, impose foreign equity restrictions on a target company.

**Conclusion**

Although legal due diligence reviews are often termed as being routinely time-consuming and complex, being able to ascertain and evaluate a prospective corporate transaction is imperative to any company seeking to expand in today's challenging business environment.

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**About the author**



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