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# Legal Due Diligence

*For Western India Regional Council of  
The Institute of Chartered Accountants of  
India*

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Bengaluru

Kolkata

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New Delhi



# Purpose of a Due Diligence

- Understanding the company / business / asset / property (Target) better
- To test the assumptions which form the basis for the transaction
- Help determine the valuation of the Target
- Identifying risks, liabilities, commitments
- Minimizing the risk of unexpected situations

*In Essence* – To assess the benefits and the liabilities of a proposed transaction by inquiring into all relevant aspects of the past, present, and predictable future of the Target



# Due Diligence may Influence

- Price
- Structure and terms
- Documentation
- The deal itself



# Lawyers in Due Diligence

- To check if there are any issues with the Target
- Divide issues into High Risk, Medium Risk and Low Risk and whether these would merit:
  - Alteration of the terms of the transaction
  - Conditions precedent and subsequent/covenants suggesting corrective actions
  - Specific representations, warranties and indemnities
  - The client "walking away" from the transaction i.e., Red flag / deal breaker



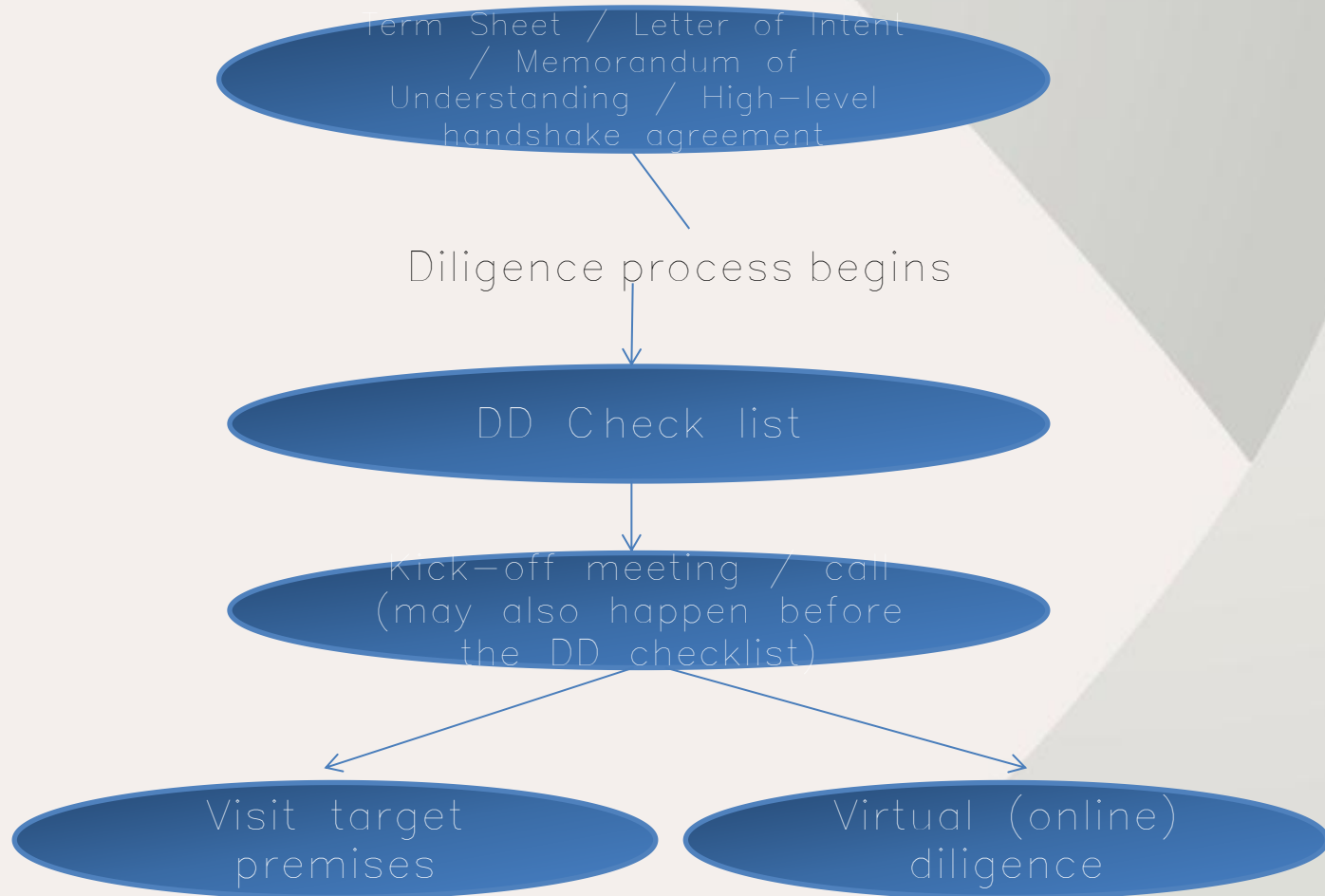
# Due Diligence – Different Scenarios

TRANSACTION	MAIN AREAS OF INVESTIGATION
M&A	To ascertain the status of assets, liabilities, commitments of the target company / business (mostly from the acquirer's perspective)
Joint Venture	To ascertain the assets and liabilities that will be a part of the joint venture vehicle
Debt Financing	The viability of the business / project and the status of the borrower / assessment of security
IPO/ Public Fund Raising	To ascertain assets, liabilities, commitments of the target for the purpose of determining the risks to the investing public
Asset Purchase	To ascertain the validity of title to the assets and the manner in which a

Nature of the transaction determines the diligence in conducted

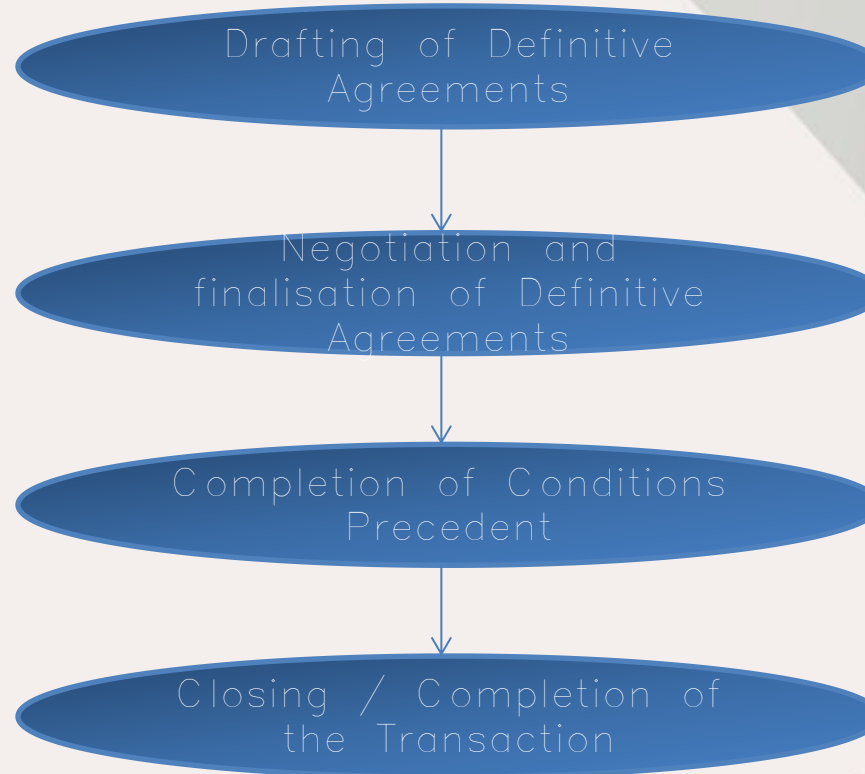


# Typical Stages of a Transaction





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## At / After the Initial Call / Meeting

- Understand the transaction structure and key aspects of the Target
- Identify the laws applicable to the Target and check if there are any regulatory risks involved
- Prepare additional requisitions (if required, based on the above)
- Review documents provided for due diligence
- Make sure that the items in the checklist are addressed
- Prepare additional requisitions based on the review carried out and refer to main checklist for any pending items





# Typical Areas of Due Diligence / Checklist

- Corporate Affairs
- Material contracts
- Licenses / compliances / filings (including regulatory, e.g. RBI filings)
- Loans and borrowings
- Employee Matters
- Property – Tangible & Intellectual
- Insurance
- Litigation



# Corporate Affairs

Information / Documents to be reviewed:

- Charter documents
- Statutory registers
- Board / committee and shareholder minutes
- RoC / SEBI and other statutory filings
- Capital history
- Composition of Board

What to look out for:

- Whether statutorily compliant
- Material items discussed at the board / shareholders level
- Capital structure of the target + validity of the capital structure
- Restriction on transfer or issuance of shares
- Special shareholder rights



# Fact Pattern

- ABC is a private limited company
- The board of directors of ABC held a meeting where 2 Directors were present
- The Articles of Association of ABC require 3 Directors to constitute quorum
- At this meeting the Board resolved to issue shares to Mr Y
- No forms in connection with the allotment were filed with the RoC
- Mr Y has signed a term sheet to sell his shares to Investor A

Issues?

Risk?



# Material Contracts

## Information / Documents to be reviewed:

- Material agreements including all procurements, vendor, supplier, distributor and customer contracts or contracts otherwise material to the Target
- Prior investment agreements
- Joint venture agreements

## What to look out for:

- Onerous obligations – indemnity and warranty obligations of the target and other obligations (non-compete and non-solicit obligations of target)
- Validity (stamping , registration, term)
- Assignability / change in control issues
- Termination provisions
- Special rights of shareholders / third parties



# Fact Pattern

- ABC (a private limited company) is engaged in manufacturing food products
- The essence of ABC business is the flavorings obtained from XYZ (a company in Delhi)
- ABC has not entered into a written contract with XYZ
- ABC has 3 distributors on a non-exclusive basis and has written agreements with these distributors which are unstamped
- No fixed term has been prescribed for the duration of the contract. Courts in Karnataka have the exclusive jurisdiction to try disputes

Issues?

Risk?



# Licenses

Information / Documents to be reviewed:

- Regulatory and statutory licenses, consents and approvals required by the target to carry out its business
- Statutory filings, correspondences and undertakings with or given to any regulator

What to look out for:

- Whether statutorily compliant
- Conditions imposed on target by virtue of licences
- Change in control issues



# Loans and Borrowings

## Information / Documents to be reviewed:

- Audited / unaudited financials
- Secured / unsecured loan documents and renewal letters
- Security documents
- Cross check against RoC filings + registers
- Loans disbursed / investments made by target company

## What to look out for:

- Type of capital borrowed + limits — working capital, term loan, etc
- Type of security created — mortgage, hypothecation, pledge, guarantee
- Covenants that the Target is subject to + compliance thereof
- Defaults and related issues
- Consents / approvals required for the transaction
- 2011 Intra group financing, including any loans from shareholders



# Fact Pattern

- ABC (a private limited company, which is about to receive investments) has availed of a term loan from Bank B
- The covenants of the loan agreement include: prior permission of Bank B to be sought for (i) any issue of capital, (ii) amending charter documents, or (iii) incurring additional indebtedness
- Breach in covenants will amount to an event of default in case of which Bank B is entitled to (i) demand immediate repayment of the term loan, (ii) enforce security, (iii) convert outstanding indebtedness into equity of ABC
- The loan agreement is unstamped

Issues?

Risk?





# Employee Matters

Information / Documents to be reviewed:

- Organizational chart
- Employment contract / appointment letters
- Employee handbooks, etc.
- ESOP schemes and other incentives, if any
- Classification of personnel – employees / consultants / contract labour
- Compliance with employee related legislation (public provident fund, gratuity, contract labour)
- Trade unions / collective bargaining agreements

What to look out for:

- Strength of IP policies/ confidentiality policies/ non-compete and non-solicitation policies
- Validity of employment agreements (term, stamped)
- Whether statutorily compliant



# Fact Pattern

- ABC (a private limited company) has 120 employees appointed by way of an appointment letter
- No employment agreements were entered
- ABC has not been contributing to provident fund

Issues?

Risk?



# Tangible Property – Real Estate

## Information / Documents to be reviewed:

- Details of where the target conducts business
- Sale deeds / Lease deeds / licence / sub-lease / sub-license agreements
- Title reports, if any
- Documents relating to any disputes over premises (may also get covered under the “Litigation”)

## What to look out for:

- Owned / lease premises
- Tenure of leases / licences etc.
- Validity of owned / lease premises (stamped, registered)
- Related party usage of premises
- Encumbrances / rights of third parties

Real Estate Diligence is not a substitute for a title search



# Fact Pattern

- ABC (a private limited company) has taken premises on lease for a term of 5 years
- Lease document has not been registered
- The premises for which the lease has been entered into is ABC's main place of business

Issues?

Risk?



# Intellectual Property

## Information/Documents to be reviewed:

- All patent, trademark, service mark, trade name, patents, domain names, copyright and all other intellectual properties which are registered, for which registration has been applied for or which have not been applied for
- Target company's licensing / assignments arrangements (by the target as well as to the target)

## What to look out for:

- Infringement risk on the target company
- Check validity of classes registered
- Change in control issues
- Third party rights



# Fact Pattern

- ABC (a private limited company) is a start-up in possession of new technology and has been advertising it
- It has invited experts to verify and comment on the benefits of the technology
- It has does not have any documentation in place with the experts and has not made any filings to obtain patents in relation to the new technology
- ABC is now looking for investors.

Issues?

Risk?



# Litigation

## Information / Documents to be reviewed:

- Details of pending and threatened legal proceeding involving target including but not limited to any notices received / sent by the target for litigation / arbitration proceedings
- Details of any compromise / settlement entered into by the target
- Details of any orders / judgements / decrees / awards that target is subject to
- Opinion by the target on the possibility of liabilities from the litigation/proceedings

## What to look out for:

- Liabilities of the target and possible eventualities



# Fact Pattern

- ABC (a private limited company) entered into a contract with XYZ in 2007, which included a non-compete provision prohibiting ABC from conducting business B
- ABC violated the non-compete provision of the agreement.
- XYZ filed a suit in 2008. The suit was decreed in favour of XYZ and ABC was prohibited from carrying out business B for a period of 5 years.
- The MoA of ABC permits ABC to conduct business B.

Issues?

Risk?





# Insurance

Information / Documents to be reviewed:

- All insurance policies taken by target for itself and for its employees
- Details of any claims made thereunder

What to look out for:

- Whether compliant with contractual obligations
- Validity and terms of insurance policies



# Limitations of Due Diligence

Internal factors:

- Quality of checklist
- Time management / constraints
- Trained team

External factors:

- Depends on the quantity and quality of data supplied
- Potential non-disclosure and misrepresentation



# Warranties & Indemnities

Are warranties and indemnities a substitute for Due Diligence?

- Option A : Yes
- Option B : No
- Option C : No difference



## Option B

- Due Diligence forms a part of the pre-transaction process which is necessary for the investor / acquirer to arrive at a conclusion on whether or not to go ahead with the transaction
- The extent of representations, warranties and indemnities will never be certain until the definitive agreements are executed and usually diligence aids in determining these representations and warranties
- Representations and warranties may be qualified and be subject to limitations
- Indemnities may be subject to limitations
- Damages may not fully compensate for the damages suffered; quantum of damages awarded in India is not substantial



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