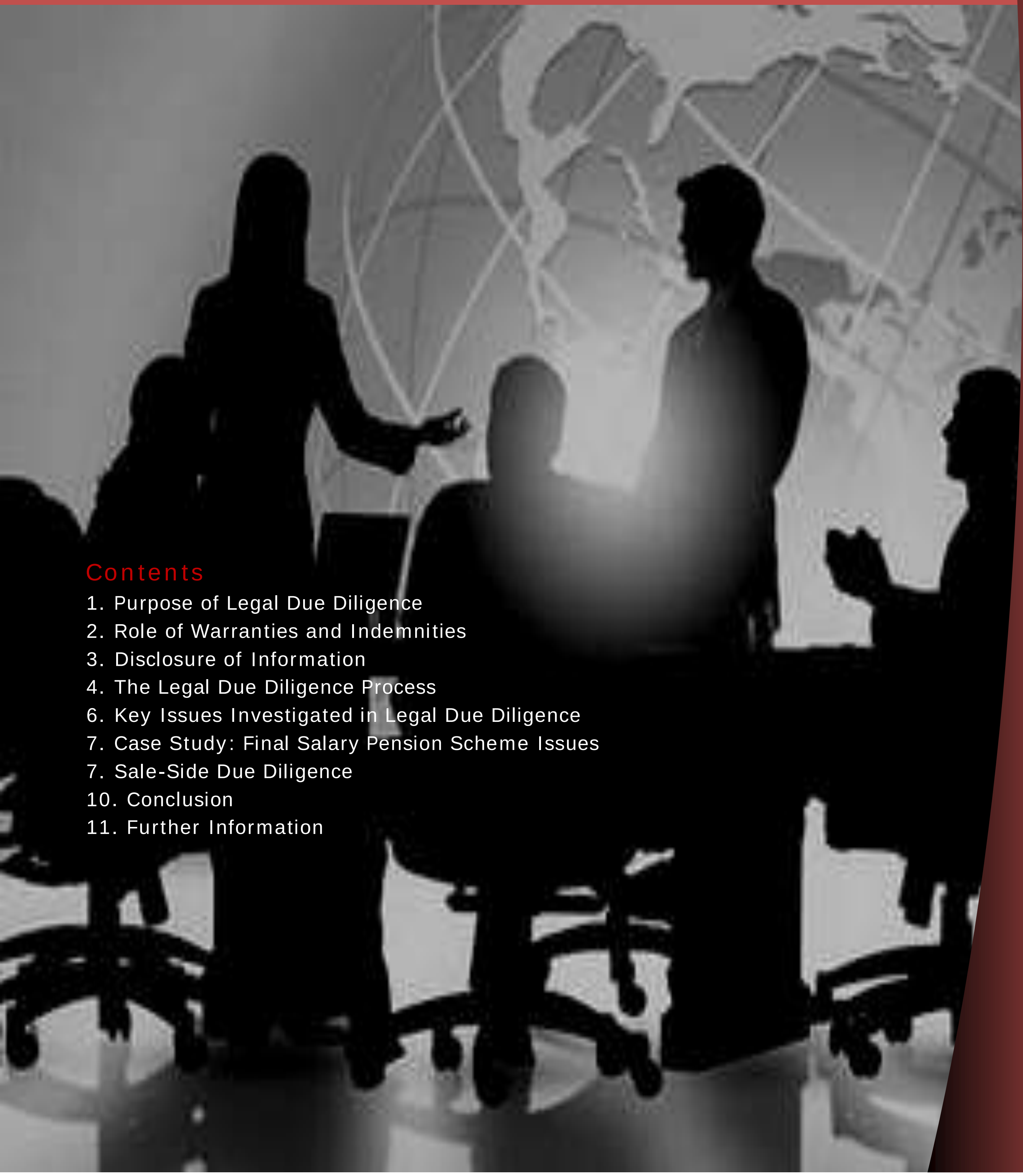
Key Issues in Legal Due Diligence

Expert knowledge means success



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Purpose of Legal Due Diligence

The term due diligence, as commonly applied to business and company acquisitions, has come to include a broad range of investigative activities on the part of a prospective buyer into the affairs of a target business/company. These activities range from the traditional legal and financial due diligence exercises to more recent developments, such as psychometric testing the management team. Whatever the extent of these investigations, the underlying purpose of any due diligence exercise is the management of risk.

The legal due diligence investigation is usually undertaken in conjunction with other due diligence exercises, notably financial. This guideline concentrates on the traditional and commonly used approach to legal due diligence on the part of a prospective buyer of a target company (target). Sale-side legal due diligence is discussed on page 9.

The historical English common law position imposed no obligation on the selling and buying parties to disclose material to each other, but instead allowed each party to look after their own interests. Although a number of exceptions to this non-disclosure principle have developed today, the maxim of *caveat emptor* (let the buyer beware) and the principle of freedom of contract are the starting points for any discussion on legal due diligence.

At its most basic level, a buyer who fails to carry out due diligence on a target before buying it will:

- Have little knowledge of how it operates and whether it is either a suitable investment (in the case of, say, a venture capitalist) or a good business fit (in the case of a trade buyer).
- Be unable to identify the assets and liabilities of the target (which the buyer will own and have assumed, respectively, on completion).
- Be unable to determine whether the price demanded by the seller is a fair price.
- Without being armed with detailed information about the target (including the accuracy of historical financial records, whether target has good title to its assets and their value and the extent of existing and future liabilities), no buyer is in a position to make an informed decision about whether to buy a target at all, let alone how much to pay for it.

Broadly, the legal due diligence process plays two roles. Firstly, it gathers information on the target for the buyer. Secondly, it enables the buyer and its legal team to assess the appropriate share of risk between the selling and buying parties. Often a buyer is at a disadvantage in early negotiations with the seller, because he does not have the information on the target to identify and assess the risks accurately. One of the first things a buyer needs to decide is the extent to which he wishes to redress this information imbalance. That decision will be based on a number of factors, including whether the buyer has obtained exclusivity, how much time is available to carry out a legal due diligence exercise and how much that will cost the buyer. Once the buyer has decided on the level of information he needs to obtain via a legal due diligence process, the second element of the investigation will focus on identifying the risks to the buyer of proceeding to completion at a given price.

A well-structured and well-implemented legal due diligence exercise will arm the buyer with information on the target. This information enables the buyer to walk away from a transaction at a relatively early stage without “losing face” and incurring substantial costs. It avoids the buyer being placed in a post-completion position of discovering “holes” in the newly acquired business that it did not expect or provide for, leaving it having to claim against the seller for compensation.

A buyer with superior knowledge gained through legal due diligence is able to use the information effectively in a number of ways:

- To negotiate on price if findings identify problems within target which suggest the price previously agreed is too high.
- To assess accurately the real cost of each risk and decide which risk he is prepared to take.
- To play up a risk he is prepared to take in order to obtain a concession against a risk he is more concerned about.

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- To exclude parts of the business which are too great a risk to purchase.
- To enable his management to understand fully the target's business following acquisition and to facilitate its integration into the buyer's group. This is, of course, less likely on management buy-outs. The benefits of a well-executed legal due diligence exercise cannot be under-estimated. Reliance on contractual remedies is unlikely ever to be sufficient for any buyer to overcome the old adage of "knowledge is power".

Risk can be apportioned through negotiation of the terms upon which the transaction is to be made, the price itself and any particular terms relating to such things as retention, earn-outs, ratchets and insurance protection taken out by the buyer. Risk can also be managed through the extent of warranties and indemnities to be given by the seller.

The Role of Warranties and Indemnities

Although the legal due diligence exercise is very valuable, it does carry with it some limitations. As well as requiring the buyer to commit to speculative management time and advisers' costs upfront, the success of the exercise often depends on the quality and relevance of the information provided by the seller, which in turn exposes the buyer to the risk of misrepresentation and/or non-disclosure by the seller.

It is therefore important to support the due diligence process by obtaining an appropriate set of warranties and sometimes indemnities from the seller. One of the most crucial warranties from a buyer's perspective is that the information supplied by the seller is accurate. This form of warranty provides meaningful protection to the buyer, as it reinforces the responsibility on the seller to provide accurate information.

The inclusion of warranties and indemnities in the sale and purchase agreement will afford the buyer a claim against the seller in respect of undisclosed problems arising in the target, which are the subject matter of the relevant warranty or indemnity. The protection afforded by these contractual provisions is limited for a number of reasons:

- The nature and extent of warranties and indemnities will not be finally agreed until either exchange or completion when the documentation is signed. Unless specific provisions are included to allow the buyer to rescind the contract after exchange but before completion if he discovers a breach of warranty, this is too late for the buyer to carry out any legal due diligence to assess the issue properly.
- Warranties and indemnities usually have limitations attached to them. The most widely used limitations are time (warranty claims after two years are unusual) and materiality (in which case the buyer has already incurred a "loss").
- Damages may not adequately compensate the buyer. This is particularly relevant for a venture capital investor who would want to be compensated for loss of his expected internal rate of return (IRR) and not just to put the buyer (newco) in the position it would have been had the breach of warranty not occurred.
- Unless security in the form of a retention or deferred consideration has been agreed, the seller may not be able to satisfy the claim financially.
- It is much easier for a seller and a buyer to work together before completion in the legal due diligence process, where both parties are focused on getting to completion, than for a buyer to try to claim for breach of contract by the seller after completion.

Negotiations between a seller and buyer on the trade-off between due diligence and warranties can take a number of forms. The most common are:

- The seller attempting to formally disclose (against the warranties – and even the indemnities – in the substantive documents) all the due diligence information provided to the buyer.
- The buyer requiring the seller to warrant the factual accuracy of the legal due diligence report.
- The seller bombarding the buyer with information to gear up his level of knowledge in an attempt to limit the buyer's ability to claim for breach of warranty on the basis that the buyer was already aware of the issue but elected to complete the transaction anyway.

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For all of these reasons, the ideal solution is for a buyer to conduct a thorough legal due diligence investigation and at the same time to obtain from the seller a substantive and comprehensive set of warranties and indemnities.

Disclosure of Information

It has already been noted that a buyer relies on the quality of information provided by the seller in its due diligence investigations. A seller may prefer not to disclose certain "problem areas" for fear that a buyer will walk away or seek to negotiate on price. However, a seller who replies inaccurately or withholds information (whether innocently or by design) is ill-advised and the reasons for needing to take care with responses are principally three-fold.

(a) Financial Services and Markets Act 2000 s. 397

This section provides that a person who:

"makes a statement, promise or forecast which he knows is misleading, false or deceptive in a material particular"; or "dishonestly conceals any material facts whether in connection with a statement, promise or forecast made by him or otherwise"; or

"recklessly makes (dishonestly or otherwise) a statement, promise or forecast which is misleading, false or deceptive in a material particular";

for the purpose of inducing (or is reckless as to whether it may induce) another person to enter into a relevant agreement or investment, is guilty of an offence, punishable by a fine or imprisonment.

(b) Misrepresentation

Section 2(1) of the Misrepresentation Act 1967 provides:

"where a person has entered into a contract after a misrepresentation has been made to him by another party thereto and as a result thereof he has suffered loss, then, if the person making the misrepresentation would be liable to damages in respect thereof had the misrepresentation been made fraudulently, that person shall be so liable notwithstanding that the misrepresentation was not made fraudulently, unless he proves that he had reasonable ground to believe and did believe up to the time the contract was made that the facts represented were true."

It can be seen that if a seller makes a misrepresentation, even innocently, a buyer may be able to claim. The basis of the claim will be to return the buyer to the position he was in prior to the misrepresentation or damages.

(c) Fraud

An action for fraud under s.19 of Theft Act 1968 is committed by any director, manager or similar officer of a company whereby, following an act of deception whether deliberate, reckless or by indifference or disregard as to whether a statement is true or false, the property of another person or a pecuniary advantage is obtained.

On conviction for such an offence, the person concerned is liable on indictment to imprisonment for a term not exceeding either ten years (obtaining property) or five years (obtaining pecuniary advantage) or on summary conviction to imprisonment for a term not exceeding six months or a fine not exceeding the prescribed sum or both.

Against the background of the criminal sanctions discussed above, a seller's approach to the disclosure of information about target to the buyer is crucial.

The extent to which a seller is prepared to warrant the accuracy of the information it gives to the buyer without being able to formally disclose the information itself as against the warranties forms part of the general negotiations between the parties.

The ideal position for a buyer is for the seller to warrant the accuracy of all information provided during the due diligence investigation, to give a full set of warranties and indemnities in the sale and purchase agreement and a limited amount of disclosure against those warranties and indemnities. Also, on the buyer's wish list will be a warranty from the seller as to the accuracy of the various due diligence reports prepared by the buyer's advisers – but without allowing those reports to be formally disclosed.

The ideal position for a seller is to provide a limited and specific set of warranties but not a generic warranty as to the accuracy of all due diligence information provided. The

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seller will also want to formally disclose all due diligence material provided to the buyer, including any reports prepared by the buyer's advisers on the basis of that information. The seller will resist warranting the accuracy of the buyer's due diligence reports on the basis that they have been independently commissioned by the buyer and are not the seller's responsibility.

As one would expect, a compromise is generally reached at a point somewhere between these two opening positions and the bargaining strength of the parties will usually determine the end result. On buy-outs, the seller is arguably in a strong position to insist on disclosure of its responses on the basis that it owns the information and the buy-out will have no chance of taking place if the management team are not permitted to disclose information to its prospective investors and incorporate that information about target into the business plan it provides to them.

A commonly seen compromise is that a seller will be willing to warrant the factual accuracy of due diligence information and the buyer's due diligence reports but stops short of warranting any opinion it has given or the advisers have provided in the report. Often on a management buy-out, a seller has had little or no involvement in the running of target before the buy-out, and therefore it will be reluctant to give many warranties other than as to matters of which it has actual knowledge or control. If it has been reliant on the management team to respond to the due diligence questionnaire, the seller will be reluctant to warrant the accuracy of the responses. In such circumstances, a venture capitalist may be forced to insist that the management team warrant the responses and/or the report(s) in the investment agreement. Whilst this will afford the venture capitalist a direct right of action (rather than through the newco), the quantum of any recovery is likely to be subject to far lower financial thresholds than if the warranty were from the seller, and clearly this approach will be of no benefit to the newco or its senior debt provider. In addition, no venture capitalist would relish the pursuit of a claim for breach of warranty against the management team of an investee company.

The Legal Due Diligence Process

In order for the buyer's legal team to conduct an effective due diligence investigation that will help the buyer concentrate on the issues that are likely to dictate whether the transaction will proceed and to what extent the price should be adjusted, they must understand target's business and the buyer's reasons for wanting to buy that business.

Prior to commencement of the legal due diligence exercise, the buyer's lawyers need to understand why target is an attractive opportunity for the buyer, what the buyer's plans are for the business and where target is susceptible to problems or risks. Early meetings with the buyer and target's management to understand the nature of the business are essential to enable the investigating lawyers to scope their work and frame the questions designed to elicit the information they require to undertake their work effectively.

The lawyers should attempt to make use of any other means available to them to improve their understanding of the business and the industry in which it operates. Valuable information can be gleaned from the work of the market and financial due diligence providers. Both of these may, prior to commencement of the legal due diligence work, have established the contracts and relationships which account significantly for target's revenues. They may also have identified issues which may materially affect target's business. The dialogue between all of the due diligence providers should be ongoing to ensure a free flow of information between them as the process continues.

With the knowledge that has been gleaned from discussions with the buyer, management and the other due diligence providers, together with any information which has been discovered from initial searches or, for example, from company websites, the lawyers should pull together the terms of the reference for their work. As well as identifying to the buyer what work will be undertaken, it is advisable to include in the terms of reference a materiality threshold under which the buyer does not wish the lawyers to report, unless the issue may be "material" for a non-financial reason. This has the advantage of the lawyers being able to evaluate quickly whether or not a subject area is likely to warrant investigation, so that

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they do not waste time reviewing areas of target's business which will not assist the buyer in its core objective – namely of understanding whether they should be proceeding with the acquisition and, if so, at what price.

The terms of reference for the legal due diligence should include those specific areas for investigation which have been identified but should not attempt to be specific on the entirety of the review that will be undertaken. This is because whilst certain issues will be known about at the time the terms of reference are compiled, many issues will not become known until the due diligence work is underway.

Once the terms of reference have been approved by all of the prospective addressees of the report (i.e. the bank, venture capital investors and the newco in a buy-out situation and the buyer and possibly its bankers otherwise), they should be signed and returned to the lawyers.

Once the terms of reference have been agreed for the legal due diligence review, it will be the responsibility of the lawyers to draft a questionnaire designed to elicit the information and documentation required to conduct the review. This should involve amending any standard questionnaire by deleting requests for information which are not relevant to the review and by including further questions to ensure that all of the relevant documentation and information is requested.

It is important for the lawyers to understand why they are asking for the information on the questionnaire. This sounds self-evident, but the use of "standard" questionnaires by junior lawyers without any attempt to tailor them to a target's business is not helpful but does happen frequently. An illustration of areas that are usually the core of a legal due diligence exercise is set out page 8. Whether or not the information is required will depend on the scope of the review agreed with the buyer and the nature of target's business.

The information gathering exercise on acquisitions for trade buyers is normally performed by an executive of the seller. In buy-out transactions, the exercise may be performed by one of the management team which is being backed by the venture capitalist on the buy-out. This may put the relevant manager in the invidious position of being responsible for providing information which will be reviewed in a report addressed to the newco, of which he may be a director and indeed a shareholder after the buy-out has completed.

The seller's concern will be that if the manager provides insufficient or incorrect responses and documentation, the newco may be able to claim against the seller for breach of warranty (if, for example, the replies have been warranted) after completion. Alternatively, if the manager discloses too much information, the newco may be put off the acquisition or argue for a price reduction. For this reason, sellers may seek to have the exercise of pulling together responses to the questionnaire performed by managers of target who will not be involved in target going forward (if such persons are available). Alternatively, a seller may seek to cover its risk by obtaining a warranty from management that no information has been withheld, or by seeking a limitation on the newco's ability to claim for breach of warranty for matters of which the management team are or should have been aware.

Once the seller's representative has collated the requested information and documentation, it will be sent to the buyer's lawyers. It is in the seller's interests to take copies, as the documentation and information provided may be useful for disclosure purposes. It is good practice for the lawyers to appoint a due diligence project manager who will be responsible for retaining a master set of the information and documentation provided and for disseminating it to the wider legal due diligence team. This team will normally comprise specialists in areas such as property, commercial contracts, intellectual property, IT, employment and so on. In order to achieve a commercially sensitive review, it is imperative for the project manager to communicate to the wider legal due diligence team the agreed scope of the review prior to commencement of the legal due diligence process.

Once the initial reviews have been completed by the members of the legal due diligence team, the individual submissions to the report should be collated and edited by the legal due diligence project manager into a first draft report. The purpose of editing is not merely to ensure that the style of the report is consistent, but also to ensure that the report amounts to a cohesive single document faithful to the report's terms of reference rather than a patchwork of contributions.

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It is good practice for contributors to prepare an executive summary, which will highlight major issues that may affect the buyer's decision to purchase target or its view on price. The executive summary will also highlight to the lawyers working on the terms of the acquisition the issues where sale and purchase agreement protections are recommended in the form of warranties and indemnities.

Whilst performing the review, the legal due diligence team should also be encouraged to identify issues within target which, whilst not deal-critical, could be dealt with after completion to improve the legal framework within which target operates. An example of this would be poorly drafted terms and conditions of trading, which may not affect the buyer's views on price but merit attention going forward. Setting out suggestions for improvements to target in the report can help the buyer with its integration planning.

The initial review work should also identify what information is outstanding and what further information should be requested given the review work that has been undertaken to date. The project manager should pull these items together in the form of a supplementary questionnaire to be sent to the seller. And so the process will continue until all of the key issues affecting target have been evaluated and the work specified in the terms of reference finalised.

The format the report will take should be agreed with the buyer at the outset. The report should be organised in a way and written in a language which will allow the findings to be most easily understood. Normally, the most effective format is to set out the key issues in an executive summary at the front of the report. Having set out the issues, the lawyer can provide most value to the client by recommending solutions to them. These solutions may be to reconsider deal structure (e.g. purchase of assets rather than shares), to suggest price reductions or retentions or to recommend contractual cover in the form of warranties and indemnities. It is necessary for the legal due diligence team to liaise closely with their colleagues who are negotiating the sale documentation to ensure that the recommendations set out in the legal due diligence report are reflected in the documentation or at least are considered in the light of the overall deal.

Key Issues Investigated in Legal Due Diligence

Issues	Why a Concern?
(1) Understand sel**ler's** group structure.	Is there a seller group being left behind and is this a competition risk? Determine strength of seller's covenants. Are the sellers unusual, e.g. venture capitalists or trustees, as this will impact on warranties that will be given?
(2) Establish which **assets are key to target's** business that they are owned by target.	Buyer needs information on the assets owned and used by target, particularly if they are in need of replacing. Buyer can asses likely cost of renewing and / or purchasing new assets and can dispose of those that are surplus to requirements.
(3) Understand customer and supplier base and review key contracts with them.	Over-dependence on a small number of customers may be risky. Existing arrangements with suppliers may not suit the buyer's plans for the business. Key contractual terms to watch out for are change of control, bars on assignment, fixed pricing or overly long or short terms and/or notice periods.
(4) Establish target's intellectual property rights (IPRs).	Trade names are often taken for granted by sellers but can be lost if not properly protected. Buyer is also looking to see that target is not infringing a third party's IPRs (risk of litigation) and that third parties are not unlawfully using target's IPRs (are there proper procedures in place to detect infringements, monitor use of trademarks, ensure correct use by licencees etc?)
(5) Target's right and ability to use its IT systems (particularly after completion). Who has written key software?	Unless target's IT is independent of the seller's group, buyer may need to negotiate some form of service or support arrangement. If a third party (not an employee) has written software, he can obtain IPRs in that software. Buyer needs to avoid risk of exploitation by that third party. If written by an employee, check that IPRs rest with target.
(6) Identify target's facilities and what security has been granted.	If existing facilities are to be replaced by the buyer, there may be early repayment penalties. The seller may have given guarantees in respect of target. To the extent that these cannot be released by completion, the seller will expect an indemnity from the buyer until release.
(7) Identify the key managers and review their service agreements.	Buyer needs to be guided by the seller on the identity of key managers; buyer should also check if they have been offered a sale-related bonus. Buyer should check that the key contractual terms (notice periods, levels of remuneration and benefits, restrictive covenants) are appropriate for its business and how much of a differential there is between the buyer's existing key managers' terms.
(8) Check nature of **target's pension** scheme(s) and that it/they comply with stakeholder requirements.	Check level of contributions for target and employees and that they are not in arrears. Identify any deficits in final salary scheme and whether scheme is still open (see case study below).
(9) Establish target's title to its properties.	Buyer needs to establish target's title, particularly if financiers' offer is subject to taking security on these assets. Also need to check for contingent liabilities on previously owned/occupied properties.
(10) Identify the status of any existing or prospective litigation.	Buyer will be interested in establishing risk, quantum and likelihood of success of both actual and prospective litigation and particularly if it is an insured risk.

Case study: final salary pension scheme issues

In the autumn of 2003, a Midlands-based manufacturing company needed to refinance in order to raise money to bring out a new product range. The company had a final salary scheme, which was closed to new entrants 18 months previously, and a defined contribution element to the pension scheme had been introduced in its place. The latest available actuarial valuation was over three years old; it showed a relatively small deficit of £2m but this had been calculated on an ongoing basis. The investors were advised that new legislation was due to come into force in 2005 which would require that schemes be valued on a scheme-specific basis and that the deficit would be much greater. Acting on this advice, the investors obtained an independent assessment of the actual deficit and were advised the value of the deficit ranged from £20m (valued on a basis consistent with FRS17) to £60m (if the scheme were to be wound up). This was a difficult enough position for the investors, but in addition the scheme rules provided that the company had the power to set the employer contribution rates but had to act on the advice of the actuary. The investors were advised that the actuary was very likely to increase the contribution rates dramatically once an up-to-date valuation was obtained. Furthermore, if the company failed to act on the advice of the actuary, this would trigger a winding up event and, since June 2003, any defined benefit scheme that is wound up must be wound up on the basis of a full buy-out of benefits (i.e. the £60m figure).

In order to address the investors' concerns, proposals were put forward to the scheme trustees (which were ultimately accepted) to change the scheme rules to provide that the company would only be obliged to set contribution rates after consulting with the actuary (as opposed to having to follow his advice); that contribution levels would be fixed for five years; that the trustees would have the power to wind up the scheme if these fixed contribution rates were not paid by the company; and if contributions exceeded these fixed rates prior to the investors' loan being repaid, a £20m redemption penalty would apply.

The investors were happy with the compromise reached because they expected to have exited before the five-year period during which contributions were fixed. The trustees were able to protect the existence of the scheme (albeit varied) and the company was able to protect the jobs of its 2,000 workers.

Sale-side due diligence

Although this publication has focused primarily on the legal due diligence investigation from the buyer's perspective, it is worth mentioning that a seller preparing a target for sale should also consider utilising sale-side due diligence as a way of optimising its position in – and sale receipt from – the sale process.

Vendor due diligence (or pre-sale planning as it is often referred to) can help a seller control a sale process, maximise the price it obtains for target and assist in negotiating more favourable terms in the substantive sale documentation.

In order to maximise value, sellers often bring in their legal and financial advisers well in advance of commencing the sale process to discuss vendor financial due diligence and how best to disclose information on target. A seller will clearly want the target to be shown in the best light in the vendor financial due diligence report to make the business as appealing an opportunity for prospective buyers as possible. Bearing in mind the sanctions on a seller for not properly disclosing information, it is in the seller's interests to provide accurate information and to plan ahead for those issues a buyer will be most interested in and concerned about.

A well-prepared seller who brings in his advisers to carry out a health check on target before beginning the formal sale process will have the time and the opportunity to "tidy up" business housekeeping issues that have been previously overlooked, to correct any defect in title to assets and, if time permits, to document terms of business with key suppliers and customers that have not been put in writing.

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Pre-sale planning or grooming by sellers is common and can greatly assist in ensuring sellers receive an optimum price. Normally the focus of pre-sale planning is financial and operational and is undertaken by accountants or boutique corporate finance houses that are instructed to market a business for sale. The process involves analysing the operation of target before commencement of a sale process and addressing any potential problem areas. An example would be the training of a second-tier management team, without which owner-managers will find it difficult to sell without being required to continue in the business.

In the knowledge that a buyer's lawyers will be investigating the legal framework of target, sellers are well advised to include a review of target's legal arrangements in their pre-sale planning. This need not involve the time and expense of a full due diligence exercise. It can, for example, be limited to a review of common problem areas in business or company sales, focused to address areas peculiar to a target's business or to its industry. As an example, if target is particularly reliant on a few key customer contracts, a pre-sale legal review can identify weaknesses with any of those contracts that may be problematic for a buyer. Alternatively, if target is particularly reliant on certain intellectual property, the pre-sale legal review can check whether or not target has good title to that intellectual property or a valid licence to use it.

A pre-sale review should identify problems and recommend how these may be dealt with. A seller will then have a number of options (which may depend on the nature of the problem):

- The seller may instruct its lawyers to remedy the problem. This would have an upfront cost, but may improve the offer price, particularly if remedying the problem improves the profitability of target and the price is based on an earnings multiple.
- The seller may make the tactical decision to ask buyers to bid with knowledge of the problem (for example, by including information on the problem in a data room set up to facilitate a sale – see below). Where there are a number of competitive bidders, the impact of the problem on price is likely to be far less than when the seller is in exclusive negotiations with one buyer.
- The seller may elect to do nothing but merely prepare itself to defend an argument from a buyer that the price should be reduced.

One of the most common methods used by sellers to control the sale process is to sell by auction and use a data room to control the disclosure of information about target and the identity of the parties allowed access to that information. Selling through auction processes is common in order to try and optimise sale proceeds. Auction processes vary but will often involve the seller or its advisers identifying potential buyers, obtaining confidentiality undertakings from them and sending them "teaser" letters, with a discrete amount of information on target. Interested bidders will notify their interest and (if selected by the seller) will be provided with a sales memorandum, with more detail on target. They may then be asked to submit indicative offers, following receipt of which the seller will normally allow a shortlist of potential buyers access to a data room, which will contain copies of much of the documentation a bidder will need to review in order to confirm its offer. Following receipt of revised or confirmed offers, normally one bidder will be afforded a period of exclusivity during which to finalise its due diligence work and close a purchase.

The setting up of a data room minimises the disruption to management by reducing the time management spends responding to numerous requests for information from prospective buyers and ensures that bid prices are made on the basis of similar information.

A well-assembled and well-organised data room – whether physical or electronic – will have the benefit of enhancing a buyer's understanding of target's business. Usually the majority of due diligence information and documentation included in a data room is legal in nature and needs to be reviewed by the buyer's legal advisers. However, all too often data rooms are, from a buyer's legal due diligence perspective, inadequate, poorly organised and leave the visiting team with too many queries. This gives the buyer an opportunity to make bids conditional upon further detailed due diligence work, whereas a seller whose data room is easy to understand and enables the buyer's team to understand target's key business issues, encourages bids to be well-informed and comparable on their terms.

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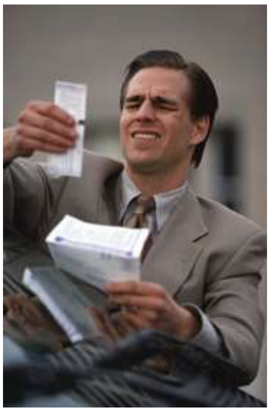

A well-prepared seller will already have instructed his legal team to carry out sale-side due diligence target and decisions will have been made to either remedy any defects or to disclose them upfront. This can be done in a "walk-through" document which is left in the data room. This document can also give a brief overview of target's business (so that visitors to the data room are able to get up to speed quickly), a summary of any complex arrangements, areas of concern, guidance on how the data room has been assembled and can answer bidders' likely questions in advance. Experience suggests that the effect on the sale process and on price of difficult issues affecting target's business is minimised when they are brought to the attention of bidders early in the auction process, rather than being discovered by a single bidder later on. A seller in this situation can also resist downward pressure on price in relation to issues clearly set out in the data room. Another useful method to enable a seller to optimise not just bidders' prices but the terms upon which they are prepared to buy target is to include a draft sale agreement in the data room and require a mark-up of that agreement to be submitted with the final bid. A prospective buyer who is anxious to get through to exclusive bidder status will often include a much "softer" mark-up of a sale agreement than he would ordinarily.

An important consideration for sellers compiling material to be included within a data room is compliance with the Data Protection Act 1998 (DPA). Although the principles embedded in the DPA are relevant during the usual due diligence process where a seller must understand what it can lawfully disclose to a buyer, it is particularly important during an auction sale where more than one party is likely to be given access to that information.

The seller must know (or be advised) what personal data is involved in the transaction before it can determine the steps needed to protect that personal data. The tasks of reviewing the nature of the data, identifying its classification (i.e. personal data or sensitive personal data) and listing the classes of data subjects to which the personal data refers (e.g. employees, customers) must be undertaken. Disclosing personal data amounts to "processing" under the DPA and therefore the seller needs a justification for such disclosure.

The safest justification is that of consent of the data subject, but in practice it is understood and appreciated that it will not always be possible or desirable to approach data subjects as the proposed sale is likely to be confidential. Where consent cannot be obtained, the seller must act reasonably and seek out a practical solution. A good practice approach would include the following steps:

- Disclose only that personal data which it is necessary to disclose.
- Anonymise personal data as much as possible (for example, using a black line in employees' contracts of employments).
- Apply contractual conditions to the access/release of personal data, including using strict data room rules and putting in place a confidentiality undertaking with the prospective buyers.
- Put in place security measures for disclosure of the data room. In a physical data room, this involves controlling access to the data and maintaining a log of who has had access. In the case of a virtual data room, it involves incorporating the necessary technical security features.

Failure to process data in compliance with the DPA can attract criminal sanctions, enforcement action by the Information Commissioner and a claim for damages and/or distress by the data subject.

In addition to documentation relating to target's operations (financial, tax, commercial contracts, employment, property and so on), there are benefits to sellers in including in the data room reports by their financial and legal advisers on target – usually referred to as vendor due diligence reports. This is because:

- The reports can provide much of the information contained in the data room documents in a form that is easily accessible to potential bidders.
- The reports can be subsequently addressed to the successful bidder, who can then rely upon their contents.
- Problem areas can be reported to the seller during the review process by the reporting accountants and lawyers as discussed above.

"Failure to process data in compliance with the DPA can attract criminal sanctions, enforcement action by the Information Commissioner and a claim for damages and/or distress by the data subject."

In summary, a sale-side due diligence exercise undertaken by the seller's lawyers can help a seller maximise the proceeds of a sale. It is a discrete pre-sale assessment of the key legal issues affecting target planned for sale. The purpose of the review is to focus on issues affecting the value of target's business, rather than providing a full-scale legal audit. It is designed to identify issues which may hinder a sale or impact on price and recommends that these should be rectified. Recommendations can be:

- To disclose the problems clearly at the outset. This works best in a competitive auction process. The effect on price is minimised when there is tension in the sale process, rather than when problems are discovered by a preferred bidder during exclusivity. Bids received should then be genuine and be made by buyers in full knowledge of all target's problems, rather than mere starting points.
- To remedy the problems before the sale process commences, perhaps because the one-off cost of remedying the problems may be significantly less than the reduction to the sale price that might otherwise be suffered.

Conclusion

The most effective legal due diligence investigation will encompass the majority of the following criteria:

- A legal team that has taken the time to understand the nuances of target's business, the buyer's reasons for acquisition and any post-completion plans for target.
- A well-scoped due diligence exercise which concentrates on key issues affecting target's business, reports on an exceptions-only basis and has an appropriate level of materiality.
- A report which is concise and easy to read, usually containing an executive summary of important deal issues and, where possible, recommendations of when and how problems should be addressed.
- A conclusion to the investigation, which sets out which commercial risks the buyer will need to take a view on.
- A due diligence exercise that is appropriate for the stage at which the prospective buyer finds himself. For example, a full review before obtaining exclusivity is usually more than a buyer will require (or be willing to pay for).
- (In the case of sale-side due diligence) a well-organised and well-assembled data room that encourages genuine bids with few conditions.

"... a sale-side due diligence exercise undertaken by the seller's lawyers can help a seller maximise the proceeds of a sale."

Further Information

This guide is for general interest - it is always essential to take advice on specific issues. We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

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