

SEMINAR: BUYING AND SELLING BUSINESSES

TOPIC: DUE DILIGENCE ON BUSINESS PURCHASES

Author: Selwyn Black
Partner
Parry Carroll
Commercial Lawyers
Level 14, 60 Carrington Street
SYDNEY NSW 2000
Ph: (02) 9221-3899
www.parrycarroll.com.au

This paper was prepared for a Television Education Network seminar on 19 August 2010.

Practitioners and purchasers should conduct their own due diligence in relation to the subject of this paper, rather than relying on it.

Liability limited by a scheme approved under Professional Standards Legislation

1.0 Why do due diligence?

Every buyer wants to know that they will get what they are paying for.

To try and achieve this, well advised buyers will seek to obtain comfort through one or more of the following:

- (a) Vendor warranties;
- (b) Personal inspection/trial periods; and
- (c) Due diligence.

Purchasers are also generally aware that despite the provisions of the Trade Practices Act and other laws, the basic principle remains caveat emptor (buyer beware).

The principle of caveat emptor received strong judicial support from the 2004 decision of the High Court in *Woolcock Street Investment Pty Limited v CDG Pty Limited*.

Woolcock purchased a commercial building and offices in Townville (**Complex**) from the trustee of a property trust some years after the complex was built. There was no warranty in the sale contract that the complex was free of defects and there was no assignment of the trustee's right against those responsible for any such defects. About a year after the purchase, the Complex showed signs of structural distress due to subsidence either of the foundations or the soil upon which they were built. CDG was the structural engineer employed by the trustee in 1987 to assist with design of the Complex. There was evidence that CDG had recommended to the trustee that a geotechnical report be obtained as to the load bearing capacity of the structure and the trustee had refused to incur the expense. It was likely that the subsidence was unlikely to cause any physical harm to anyone and that the only loss was economic.

The High Court by a majority found that CDG did not owe a duty to Woolcock. Woolcock's vulnerability to risk and its ability to protect itself from that risk was a key factor in determining whether CDG owed it a duty of care to avoid economic loss. The court found that Woolcock as a commercial investor was able to protect itself from the risk of subsidence. It could for example have obtained an expert's report before purchase or negotiated appropriate terms into the sale contract. It did neither and this was sufficient to negate any liability.

The decision makes the point that a failure to conduct due diligence or obtain suitable warranties may deny access to other relief. When taken with the 2004 amendments to the Trade Practices Act which gave effect to proportional liability (and reductions for loss due to

a claimant's failure to take reasonable care), it is clear that a buyer who cuts corners with their due diligence, largely does so at their own risk.

In the Woolcock case the purchaser had neither obtained a warranty from the vendor on the issue nor performed due diligence on the geotechnical condition. However is the availability of suitable warranties from a creditworthy vendor sufficient to avoid a suggestion of purchaser negligence or failure to take reasonable care?

I suspect the answer is that unqualified warranties if obtained from a suitably solvent vendor may materially reduce the extent of required due diligence, but even with the best of warranties and vendors a purchaser should at least test some of the critical assumptions behind their decision to buy, to determine whether or not further enquiry is necessary.

2.0 What precisely is due diligence?

The expression "due diligence" seems to derive from a 1933 US Securities law which provided a defence of "due diligence" to those who made reasonable investigation into the contents of a prospectus before its issue.

Whilst the term has gained other meanings and uses, it is still part of the process by which those participating in the issue of a prospectus in Australia may obtain a defence to claims of errors. I will return later to experience gained from that context.

"Due diligence" has been described as "the converse of negligence": Lord Diplock in *Tesco Supermarkets Ltd v Natrass* [1972] AC 153 – that's still not very useful in saying what exactly one is meant to do.

In the negligence case of *Wyong Shire Council v Shirt* [1980] HCA 12; (1980) 146 CLR 40 at 47, Mason J held that:

" In deciding whether there has been a breach of the duty of care the tribunal of fact must first ask itself whether a reasonable man in the defendant's position would have foreseen that his conduct involved a risk of injury to the plaintiff or to a class of persons including the plaintiff. If the answer be in the affirmative, it is then for the tribunal of fact to determine what a reasonable man would do by way of response to the risk. The perception of the reasonable man's response calls for a consideration of the magnitude of the risk and the degree of the probability of its occurrence, along with the expense, difficulty and inconvenience of taking alleviating action and any other conflicting responsibilities which the defendant may have. It is only when these matters are balanced out that the tribunal of fact can confidently assert what is the standard of response to be ascribed to the reasonable man placed in the defendant's position. (at p48) "

This concept of balancing the magnitude and probability of a risk with the expense difficulty and inconvenience of the necessary enquiry, as hypothetically carried out by persons professing the relevant skill, will determine what is required by “due diligence” (before any contractual additions and limitations). It appears a similar concept will apply to directors in performing their general statutory duties of care: *ASIC v Vines* [2005] NSWSC 738. In the same case Austin J noted that not every mistake will constitute negligence.

However, purchasers may like to think that a due diligence report is like a guarantee or insurance against any problems with their purchase.

To avoid any misunderstanding and manage risk, it is clear that it is up to the consultants participating in a due diligence exercise to clearly agree in writing with the client as to what exactly the exercise will, and will not, involve. Advice, followed up by a written agreement as to the scope and steps involved in (and to be omitted from) the exercise is critical in allowing prospective purchasers to make informed choices, and for consultants to know what they are expected to do.

3.0 Checking against what?

Any exercise which simply involves wandering around looking for a problem to turn up, or which is confined to a review of the material provided by means of vendor disclosures or a vendor initiated due diligence bundle, misses the point.

What a purchaser wants to know is (so far as one can tell) **whether or not their expectations and understanding of the business is matched by reality.**

Accordingly the starting point for any proper due diligence exercise should be to ask the prospective purchaser for:

- (a) a copy of any marketing material including offering documents, advertisements, communications from the agent etc., which have induced the purchaser to put in an offer (**Marketing Material**);
- (b) a written list of those features which the purchaser regards as important in their decision to proceed (**Assumptions List**); and
- (c) details of any proposals the purchaser has in mind for the business (**Proposals**).

Accordingly, and subject to special circumstances and the limitations mentioned below, the due diligence exercise then becomes an exercise in testing out whether:

- (a) the key statements and representations in the Marketing Material are reasonably based;
- (b) the Assumptions are reasonably based; and
- (c) there are any business or regulatory impediments to achieving the Proposals, as these may be an integral part in the decision to buy.

This really goes back to something like the original concept of due diligence, which involved checking a prospectus – i.e. are the written representations and the Assumptions soundly based?

By having the Marketing Material, Assumptions List and Proposals, the due diligence exercise on purchase of a business becomes a question of determining whether the basis on which the purchaser proposes to proceed (as demonstrated by those documents), is soundly based.

It follows for example that purchasers with different proposals for the business, may require different areas to be covered in the due diligence exercise. The exercise should be tailored for the particular purchaser.

4.0 Limiting the scope of the due diligence exercise

After price, the next most negotiated term at the outset of a deal often seems to be the length of the due diligence period. The vendor will wish to limit this because they don't want to waste time with a party who may not sign, particularly if there are other purchasers in the offing. Promises of amazing performances by law firms seem to encourage purchasers to go along with suggestions for tighter and tighter due diligence periods.

This time factor, together with cost, quite properly leads to the need to limit the extent of a due diligence exercise.

The process of cutting down the exercise should be undertaken in consultation with the client, and documented so that the prospective purchaser accepts that some corners are being cut, with consequential risks.

The whole magic about the exercise is trying to work out which corners you can safely cut.

A review of the Marketing Material and the Assumptions Lists together with the Proposals will readily indicate some areas which can be ignored because:

1. they are in practice irrelevant – e.g. if a business is being purchased to obtain its freehold land for another use, the past trading performance of the business may be largely irrelevant.
2. some of the material may be easily covered by a particular consultant or a client’s own in-house expertise – e.g. much of the Marketing Material may be devoted to analysis of the market, comparable sales, discussion on capitalisation rates etc. If the purchaser is retaining a valuer, or is sufficiently confident of their in-house valuation expertise, then this area can be covered in-house by the valuer and needs no further external due diligence. However it is important that the due diligence team provides feedback to the valuer or those looking at the issue in-house, so that the valuation is not predicated on assumptions which may be incorrect.
3. they lack materiality – how significant is each particular aspect issue or assumption to the business or the purchase?

5.0 Preliminary comments on identifying material risks

In order to work out what are the key risks that require close attention, and what can be set aside as not material enough for the due diligence enquiry, one has to get to the heart of the business and understand **where the real value in the business lies and where potential risks lie**.

A good starting point for this is to obtain a break down of the sources of revenue – i.e. **where does the money come from?**

- If largely sourced from a few clients, the agreements with those clients and the relationships with those clients should be closely examined;
- Regardless of the spread of clients, one should analyse why customers come to this business – what is their angle?;
- If it is a particular product, then the sources of supply of that product, and any associated patent or design issues, become critical;
- If it is a particular location, then what are the rights to that location? For example, how long is the lease? What options are there? Will there be any difficulty in taking an assignment of the lease? What is the condition of the building?;

- If it is relationships with particular personnel, then what are their terms of employment and future plans? Are any restraints available? What would be the effect of their departure?;
- If it is a particular brand or logo, how secure are the intellectual property rights?

Sometimes there will be a mix of these, which will require several areas to be covered. However by looking at these issues, one gains a sense of what is more or less important and one can prepare a working list of priorities in terms of their materiality or significance to a purchaser, in assessing whether or not to proceed.

In forming a view as to the priorities and material issues, there is no substitute for a review of the Marketing Material followed by an on-site inspection, a very close review of the accounts for the business and client input as to their assumptions and proposals.

This, together with an understanding as to why the seller wants to sell and why the buyer wants to buy can create a working list of issues in priority order and will enable you to discard aspects which might take time or involve significant costs, without being really important in the scheme of things.

Before the working list and due diligence scope is nailed down, it is also important to consult with everyone participating in the due diligence exercise.

6.0 Who participates in a due diligence exercise?

It would be rare that a due diligence exercise will only involve one only consultant or person having legal, technical, accounting or valuation expertise. There will generally be at least two or more of these disciplines required. In my experience, some of the worst due diligence exercises have occurred where a client instructs different consultants who go off in different directions without swapping notes or proper co-ordination.

Accordingly, part of the critical initial agreement with any client as to what a due diligence exercise will involve, must be agreement on who will co-ordinate the work of the client and various consultants, and as to how that co-ordination will occur.

It has been suggested that in the absence of such an agreement, then the first consultant in the door may have a responsibility for co-ordinating the work of others that follow, if they have been introduced by the first consultant (e.g. where an accountant introduces a lawyer or vice versa).

In other cases, each consultant may have a responsibility for ensuring appropriate co-ordination, unless they have agreed with the client at the outset that the client will be responsible for co-ordination between the various consultants involved in the due diligence process.

There are a number of options as to how this critical co-ordination can occur. In my view, consultants involved in business purchases can learn a great deal from the methodology developed for the issue of a prospectus, which includes the following steps:

- (a) A due diligence committee is formed consisting of representatives of the various consultants (including legal advisors, investigating accountants, financial advisor and valuer) as well as (in the prospectus context) representatives of the executive and non-executive directors and the underwriter (and potentially their consultants).
- (b) The committee meets and identifies a working list of key issues – and that list is updated regularly.
- (c) The committees meets and agrees on materiality standards.
- (d) Draft proposals as to work scope from each consultant are tabled as to what they recommend be covered by their own report. Those proposals are reviewed and discussed by all the members of the committee to try and ensure that key risks are identified and covered.
- (e) The committee agrees a works program based on those proposals, and decisions on proposals by the various consultants and client representatives, and then meets regularly to implement it.
- (f) Issues arising from work by the various consultants, including interim reports and questions, are circulated to the committee members.
- (g) Questionnaires are designed and administered to management to try and elicit information on key areas and the answers are reviewed by the committee or members of them.
- (h) Records are kept of each step.
- (i) There is feedback to the client and between the consultants along the way and decisions may be made along the way as to certain areas where investigation is to be expanded or deemed unnecessary; and
- (j) A consolidated report of the committee is furnished to the directors of the issuer.

This may seem excessive for the purchase of a small business, but even in that context it is desirable for say the lawyer, accountant and, if applicable, valuer or technical expert to meet at the beginning, get a general agreement as to what each is covering, then circulate their proposed scopes of work to the client and each other and try and resolve those scopes, including determining who is responsible for co-ordinating the work of all the consultants and client.

I would recommend that, much in the manner of the prospectus due diligence exercise, the client and consultants involved in a business purchase meet early on and review their respective scopes of work to work out who may be best to look at each aspect of each key risk identified on the list mentioned earlier. Sometimes more than one consultant will be involved in examining a risk – e.g. in relation to the revenue the lawyers may examine the key agreements with clients or suppliers whilst the auditors, accountants or the client's external accounting personnel may check what is being invoiced and banked, and also the reliability of the recording systems to ensure that income and expenditure is appropriately being recorded.

It is also useful for lawyers to feed back to the client and accountant the information they have on the expenses side where the information available to them (e.g. copy head lease, land tax assessment) allows verification of the budget or past figures. In one hotel due diligence this turned up accumulated under payment of head lease rent.

7.0 Examples of appropriate task allocation

I think it is important that as lawyers we do not approach due diligence on the basis that we should review all the legal documents and let someone else worry about everything else, since that is not an effective use of resources.

My undergraduate auditing studies and subsequent dealings with auditors have given me the utmost respect for the techniques used by auditors to form a view as to the accounts of an enterprise.

In particular, auditors are aware that they cannot check everything and accordingly they have well developed techniques to try and obtain a view based on a limited amount of time and cost. Those techniques include:

- (a) closely examining a limited number of transactions and matters on a random sample basis; and

- (b) examining the internal business systems, on the basis that if the systems of the business are working well then there is a degree of comfort as to the future of the business and as to the reliability of the corporate information.

In my view lawyers should recognise the strengths of auditors, the value of sighting audited accounts, and should refer for review by auditors those issues which are best handled by them.

Example 1

On the purchase of an office building, it is important to examine the leases and rents payable but no less important to have someone check what was actually invoiced and banked.

This may throw up that some of the customers are unable to pay, and raise issues as to the reliability of future cash flow.

Whilst a lawyer can highlight the outgoings definition, it may need an auditor to check whether everything billed to tenants for outgoings are properly recoverable within the definition.

Example 2

We were involved in a transaction involving over a hundred monthly car space licences. Given that any of the licensees could have terminated on one month's notice, there was little value in us reviewing all of them. We therefore suggested that the client examine the pattern of invoicing and banking car space revenue over some years, the sources of the car park customers and other factors that might affect future payments. Our legal review of all the licences might have shown the usual deficiencies and inaccuracies which often occur when property managers complete legal documents, but because the licensees could depart on one month's notice, such a review would not have greatly assisted the client in its decision making.

Of course, we looked at the basic form of the licence agreement to consider what may be required for an assignment of the existing licence terms.

Obviously in the case of longer term contracts with customers or tenants, legal review is extremely important as the "underwriting" by tenants or customers of revenue will be part of the assets being purchased.

The point is however that no review of the documents is sufficient if one does not have the client or an accountant or auditor check the revenue actually being received.

Case Study

In reviewing some older cases for this seminar, I came across one where a purchaser bought a new dairy farming business which subsequently failed. The purchaser had obtained the property from one party and purchased a number of cows, and the accountants had done some detailed review as to the likely revenue and expenses.

Probably all the due diligence was sufficient except for one point. The accountants had assumed a certain volume of milk per cow per day, and that assumption turned out to be very wrong.

This demonstrates the importance of examining the key assumptions and ensuring each is soundly based. If there is an assumption as to the volume of milk produced by each cow, then the appropriate expert should be asked to verify that the assumption has a reasonable basis.

8.0 Contractual due diligence periods

Due diligence may be conducted:

- (a) before exchange of contracts;
- (b) between exchange and completion; and
- (c) sometimes a balance sheet verification exercise may occur after completion.

To explain the last of these categories, the parties will sometimes agree that the final price is to be determined by the preparation and completion of accounts prepared or reviewed by an auditor after completion. The auditor will obviously make enquiries of a limited due diligence nature in verifying the accounts, and where the price is based upon assets and liabilities rather than profitability, the price may be adjusted and determined according to the results of that enquiry.

There are times where this approach is appropriate, but I would urge anyone documenting an agreement to have the price determined in that manner, to consult in advance with the auditor whom the parties propose to carry out the task, since the auditor may have certain limitations and requirements (including as to access to information, their form of sign-off, and as to payment of their fees).

It is also important that one has a very clear definition as to the basis on which such accounts are to be prepared – are we applying international standards, Australian standards and any special definitions or treatments?

As an example, the parties may pre-agree the amount to be included for goodwill. The definition of liabilities should also be reviewed so that for example it requires the inclusion in liabilities (and if applicable in calculating any profit or loss) of full provision for all contingent liabilities which may affect the enterprise.

The issue of contingent liabilities is particularly important on the purchase of a business via the acquisition of a company because the purchaser will inherit those liabilities, but it still may be applicable to the direct purchase of a business. For example, one should consider and make appropriate provision for the future cost of any warranty claims due to defective goods or services provided in the past by the business.

Whilst there may be no strict liability on a purchaser to meet such warranty or liability claims, in practice it will generally be critical that the purchaser does so in order to retain the goodwill of the business they are buying.

The quantification and inclusion in the accounts of contingent liabilities is a particularly difficult issue since we are talking about things which may never occur or which may be uncertain as to the outcome. This aspect should be considered carefully before a purchaser agrees to effectively defer part of the due diligence by having externally determined accounts prepared following completion to calculate the final price.

The second alternative mentioned, namely due diligence between exchange and completion, produced a number of issues in the case of *SDS Corporation Ltd v Pasdannay Pty Limited* [2004] WASC 26 (27 February 2004).

In this case the parties exchanged contracts with completion conditional upon the results of a due diligence investigation to be undertaken by the purchaser in its absolute discretion. There was an obligation of the vendor to ensure that the purchaser was provided with information required by the purchaser. The purchaser claims that the vendor did not provide the information, that accordingly the purchaser could not complete its due diligence investigation and that therefore the purchaser could not take the benefit of the contract.

The vendor contended that the agreement was subject to implied terms that they only need provide assistance *reasonably* required and *reasonably* necessary for the due diligence investigations. The purchaser claimed that because the vendor failed to provide the information, the purchaser was not able to secure the fulfilment of other relevant conditions including financier consents.

The court found that the alleged implied term was displaced by the express wording which referred to due diligence acceptable to the purchaser in its absolute discretion. It took the view that if the assistance requested came within the specific wording (namely relating to the business, business assets and patents), then there was *prima facie* an obligation on the

vendor to comply whether or not the request was reasonable, so long as the information was in the control or possession of the vendor. In the result, the purchaser obtained an order for specific performance – and it seems, although it is not quite clear, that this related to specific performance of the obligation to provide the requested information. The vendor’s claim that it had the right to terminate the contract was dismissed.

The case demonstrates some of the issues to be dealt with in any contractual due diligence period including:

- (a) the content of the information to be provided including access to personnel, copying facilities etc and access for financiers; and
- (b) whether the test as to whether or not the due diligence requirements had been met, is to be reasonable and objective or entirely subjective.

The particular case may be demonstrative of why vendors wish to ensure that any due diligence is completed before exchange of contracts. It may also be desirable for purchasers to complete their enquiries first if the test of whether they must proceed is to be objective rather than in their discretion.

Of course purchasers are reluctant to expend too much time and money on a due diligence enquiry where they may eventually be happy with the investigations, but the vendor may not sell, or may sell elsewhere.

The most common compromise between these differing interests is what I will call an exclusivity period agreement under which:

- (a) the vendor provides or agrees to provide a defined list of information if held and agrees to provide access by the purchaser and its consultants and financiers to its property and personnel including agreed procedures, copying arrangements and the like;
- (b) the purchaser commences conducting a due diligence exercise and commits to providing brief weekly reports to the Vendor as to progress and issues;
- (c) the parties pre-agree the basic elements of the deal;
- (d) the vendor agrees not to sell to another party within the specified period and the parties both agree to negotiate in good faith over the defined period on the complete agreement terms;
- (e) there are arrangements to deal with any conditions precedent that can be conveniently dealt with at that stage including for example obtaining any necessary FIRB approval etc; and
- (f) there are suitable confidentiality undertakings.

This still leaves either party with a risk of the deal falling through but at least there is a clearly defined period within which the parties will aim to make a decision one way or the other.

9.0 Controlling and managing the flow of information

If you consider a transaction where on each side there is only one accountant, one client and one lawyer, then there are at least nine ways information could flow from one side to the other, even before one gets to the issue of communication within each side.

It is in the interest of everyone to have a very clear understanding as to how information will pass. Each side should nominate a representative to receive and send communications on their behalf.

The purchaser and its consultants should consolidate their requests for information into one document which should go from their nominated representative to a nominated representative on the part of the vendor. That vendor's nominated representative should co-ordinate the responses.

In each case the party on each side responsible for communications should make sure that everyone at their end is copied in.

This avoids the irritation of different representatives of the purchaser asking the same question, or asking questions which have already been answered, and it avoids the potential confusion of contradictory answers coming from different people.

This should not inhibit phone calls for clarification or direct meetings between say just the respective accountants, tax advisors etc., but any outcome from those discussions should be copied to the other nominated representatives and members of the team.

It is also important that those involved in drafting and negotiating the contracts have feedback from the due diligence process as it proceeds, as that may very much affect the contract terms required by each party. I say this because frequently the negotiation of the contract terms will proceed in parallel with the due diligence procedure.

The communication should also go the other way since sometimes contract disclosures or curious provisions in the contract should properly provoke enquiry on the due diligence front.

The information flowing backwards and forwards has an additional value, namely it should assist the purchaser and its advisors to regularly review, and they should make a point of reviewing, the list of issues being examined – as items are nailed down they might be ticked off whilst additional issues may emerge. This should be an ongoing process.

10.0 The contractual significance of due diligence disclosure material

There has been a welcome trend for vendors to assemble, index and update a due diligence bundle that may be available to prospective purchasers and which will form an exhibit to the sale contract.

The benefits to vendors from this process are:

- (a) by facilitating due diligence by purchasers, you may encourage more purchasers to bid and expedite the due diligence period before someone will buy; and
- (b) vendors seek to limit liability for misrepresentation or non-disclosure by reasonably full disclosure.

Whilst it is understandable that vendors will wish to include in the contract a term that effectively says to the purchaser don't sue us for what we told you, the tendency to include perhaps too much irrelevant material in the due diligence disclosure bundle creates a nightmare for the purchaser.

In this exercise the onus is placed on the purchaser to review and consider the consequences and significance of what becomes an enormous bundle of material, some of which is irrelevant and time consuming to review.

This issue received a thorough examination in the case of *DSE (Holdings) Pty Limited v Intertan Inc & anor* – Federal Court 3011 of 2002 (decided 9 September 2004).

This involved the purchase by Dick Smith Electronics (DSE)/Woolworths of the Tandy Group.

The sale was originally to proceed by the purchase of a number of companies but at some point one was excluded without an appropriate adjustment to the price to deal with the intercompany debt.

Tandy contended that DSE and its advisors knew or ought to have known that the accounts included in the due diligence bundle were consolidated accounts and that accordingly they did not need to disclose the intercompany debt. Alternatively they argued that an earlier set of accounts included in the data room did disclose the debt and that the purchaser was prevented from making any complaint because a clause in the agreement provided that each warranty given “was subject to any matter or transaction that:

- (a) is fairly and accurately disclosed in the Data Room; or
- (b) is fairly and accurately disclosed in the Stage 1 Due Diligence Information.”

DSE succeeded on its submission as to the identification of the accounts to be the reference point for the final calculation and their interpretation.

Mr Justice Allsop went on to find in the alternative that the conduct of Tandy in relation to their references to accounts taken together with a subsequent conversation and failure to disclose the consequences of removing the company and its effect, constituted grounds for relief on the basis of estoppel, rectification or misleading and deceptive conduct. When all the conduct of Tandy was taken together, it was not displaced by the due diligence material.

Tandy contended that the substantial cause of loss was the failure by DSE to properly examine the material made available to it in the data room. The Judge rejected this submission and said that whilst there was oversight made by both sides, this was not a neglect such as to disentitle DSE to relief.

The Judge also considered a DSE claim for breach of warranty and the Tandy defence claim that the relevant liability was “fairly and accurately disclosed” so not actionable under the contract terms. The Judge noted that as the parties had adopted the December 2000 accounts as the reference point for the transaction, disclosure in the June 2000 accounts was not something that was going to attract attention – indeed there may have been no good cause to look at those accounts. His Honour reached the conclusion that a fair disclosure of the intercompany debt would have required something such as stand alone accounts for the relevant entities.

Whilst DSE succeeded based on a whole package of circumstances, the case clearly demonstrates some of the risks involved in current due diligence practices.

The case also illustrates the importance of putting some limitations on any clause which seeks to deny any claim for breach of warranty based upon matters disclosed. Limitations to consider include:

- (a) that included in the DSE/Tandy case, namely that “the matter should be fairly and accurately disclosed”; and
- (b) some warranties should never be subject to an exception for disclosure. For example, the warranty as to title should not be subject to a claim by a vendor that a breach is excused because the disclosure material included a copy of the vendor mortgages and charges. There may be other warranties which should also never be made subject to disclosure, including as to the capacity of the vendor.

11.0 Specific issues (specific items in the accounts)

A critical part of the due diligence process is the preparation of checklists of information required and of issues to consider. An approach based entirely on pre-prepared checklists risks missing the wood for the trees. However checklists are a

key part of any due diligence process since they will invariably turn up some issue that might otherwise have been overlooked.

I will not attempt to prepare a definitive checklist or even recommend a form of checklist, but I list below some of the issues which should be considered.

11.1 Enquiries as to the vendor

- Historical ASIC search;
- Personal Property and other security registers;
- Search AUSTLII and lower court records for details of court proceedings;
- Check with Department of Fair Trading as to complaints;
- Review Financial Review clippings service;
- Review any trust deed;
- Suggest client obtain credit reference search;
- Consider similar enquiries in relation to any separate guarantors/warrantors;
- Examine constitution of vendor to see if there are any restrictions on sale or other relevant terms;
- Examine listing requirements as to any restrictions on sale;
- Consider effect of constitution/listing requirements/Corporations Act on any issue of shares, if consideration includes the issue of shares (there is further due diligence required on the vendor in such event);
- Certificate of good standing and searches in place of incorporation if outside Australia;
- Review ABN register;
- Sight certificates as to relevant minutes, completeness of corporate documents.

11.2 Plant and Equipment

- List and verify;
- Sold at what value (sight prior depreciation numbers);
- Determine which are owned or leased;
- Obtain copies of finance arrangements;
- Check condition;
- Obligation to repair and maintain till completion;
- Are there service and maintenance manuals?
- Availability of spares/replacements;
- Maintenance contracts and warranties held?
- Are they assignable?

11.3 Stock

- Inspect condition;
- Method of valuation;
- Identifying obsolete or slow moving stock;
- Minimum and maximum stock levels for completion;
- Future sources of supply.

11.4 Debtors

- To be purchased or not (may involve review of sale terms, past delayed and bad debt rates, diversity and identity of debtors and risk of dispute)?
- Credit references on key debtors;
- Method of valuation;
- Bad and doubtful debts;
- Any exclusions;
- Review and obtain assignment of documents required to enforce;
- What is the state of the records?
- Evidence required to enforce (eg of delivery);
- If not purchased, who to collect, and effect of recovery action on continuing customers.

11.5 Goodwill

- Search business name, trade mark register, phone books, internet usage and domains and other usage of names and trade marks;
- What about sellers own name/personal names?
- Product names – same searches for them;
- Obtain understanding of area of business, extent of business – may suggest what are reasonable and enforceable limits for any restraint;
- Consider respective importance of value of personal goodwill, location goodwill, goodwill attaching to name or trade mark;
- Consider requirements for tuition by seller before and after completion.
- Consider and investigate what pre-purchase events may damage goodwill, including customer or ACCC action, vigorous collection of receivables by vendor post settlement, failure to provide after sales service.

11.6 Intellectual Property

- Obtain a listing of software licences held;
- Consider their terms and assignability;

- Identify other intellectual property – what rights are there?;
- Extend this to know-how;
- Obtain details of any infringements claimed by or against the vendor;
- Inspect user agreements;
- Obtain search of design, patent and trade mark registers, as to whether registered, and for competing applications or registrations;
- Who has, and has access to, client list?
- Determine who created material claimed to be owned, whether by way of copyright or otherwise;
- Did contractor assign rights (e.g. to logo)?;
- Consider confidential information, how protected;
- Consider what arrangements there are with contractors in relation to intellectual property;
- Are any moral rights applicable?

11.7 Premises

- Property searches;
- Other usual enquiries;
- Environmental inspections;
- Inspection by structural engineers;
- Inspection by services engineers;
- Inspection as to compliance with current and original building code of Australia/similar requirements;
- Obtain and review as to compliance with development consent conditions and construction certifications;
- Review lease terms and assignability provisions;
- Review bond/security requirements and assignability;
- Consider whether future use will come within existing consent and usage terms;
- Occupational health and safety requirements;
- Review any existing leases/sub-leases;
- Occupancy certificate;
- Building certificate;
- Capital allowance schedule;
- Survey;
- Lettable area survey;

- Details of disputes;
- Plans for surrounding area;

11.8 Material Contracts

- Inspect all material contracts;
- Are all contracts to be assigned?
- What conditions are necessary for consent to assignment?;
- What if consent is not forthcoming?;
- What are expected conditions of consent to transfer?;
- Does the purchaser want to take all the contracts?;
- Are there any existing defaults or disputes?

11.9 Staff

- Identify key staff;
- Identify staff who may not be required;
- Examine entitlements including annual leave, long service leave, personal leave and other periods of service entitlements including to potential redundancy pay and sick leave;
- On what basis is long service leave and other leave entitlements calculated in the vendor's books?
- Examine relevant statutory, workplace agreement and award provisions – e.g. they may impose additional obligations on a purchaser regardless of the contract terms;
- Examine employment agreements;
- Examine superannuation arrangements;
- Consider timing and method of informing staff, restraints;
- Consider what will happen to staff not employed, including redundancy issues;
- Consider how business will be staffed and staff retained up to completion and beyond it;
- Consider the effect the sale and purchase (or any future proposals) may have on employment conditions and costs including for other businesses;
- Details of any potential or existing industrial disputes.

11.10 Title

- Search public records;
- Examining accounts to see any references to leasing charges and determine what is leased;

- Review company files as to dealings with financiers;
- Review files as to dealings with suppliers – e.g. is there a stock retention clause, rights of set-off etc?;

11.11 Expenses

- Check expenses and accounts on a random sample/materiality basis and against industry standards;
- Are there any expenses that will apply to a purchaser but are not included in the vendor's accounts – e.g. are there any employees paid at under market rate? Are there any contracts which are providing cheaper services but will on renewal increase in rate? Are all tax/fringe benefits tax/other liabilities being met? If not, these may be additional expenses for the purchaser in operating the business;
- Generally test expenses against industry averages and against relationship to sales – how sensitive the expenses are to any upturn or downturn in the business.

11.12 Conditions Precedent

- What conditions precedent will apply – such as consent of lenders to transfer of debt, consent of landlords, FIRB or Trade Practices Act?
- Consider the conditions that might be imposed to obtain the consent and what conditions the purchaser should be, and should not be, obliged to accept.

11.13 Licences and Permits

- Are there any licences and permits required for conduct of the business or for future proposals?;
- Are they held?;
- What is required for transfer?
- What are the conditions attaching to them?;

11.14 Regulatory issues

- Consider any regulatory issues that may apply including Trade Practices, FIRB etc.

11.15 Liabilities

- Consider current liabilities and contingent liabilities – including warranties or liabilities for goods and services supplied;
- Consider how the purchaser will fund/manage business and what working capital is required;

- Obtain an understanding of any contingent liabilities – often the best way is to have someone sit down with management on the other side and have an informal chat as to what their potential issues are.

11.16 Disputes

- Seek details of any disputes, whether or not in writing, and whether or not involving court proceedings.

11.17 Tax

- Structure of purchase and purchaser;
- GST treatment;
- Fringe benefits tax – is this being properly accrued and paid and is it included in accounts/budget?;
- Superannuation guarantee levy – same points;
- Payroll tax;
- Other applicable taxes;
- Is there any stamp duty payable and unpaid (and which may need to be paid to enforce any agreement);
- What will be the cost base of assets acquired;
- Allocation of price and its consequences;

11.18 Insurance

- What is the claims record?
- What is the existing coverage?
- What will be the future cost of insurance – e.g. did the vendor have the benefit of any concessions?
- What information will the purchaser's insurers require of the vendor in order to provide and continue cover?
- At what point will risk pass?
- What will happen if there is damage before completion?

11.19 Ongoing Management

- What is the current reporting structure?;
- What will be the reporting/decision making structure for the business between exchange and completion?;
- What management is critical and how will it be retained?

11.20 Likely Adjustments

- What prepayments are there in the business that the vendor may require to have adjusted in its favour?
- What accrued but unpaid liabilities are there that the purchaser may need to take over and meet?

11.21 Relationships with Third Parties

- Are there any joint ventures, partnerships, agency arrangements, alliances or other such arrangements with third parties relating to the business?
- Obtain details and consider requirements for assignment.

12.0 The due diligence report

The end result of the process should include the production of a due diligence report. This report should specify any limitations on the scope agreed with the client or which have emerged by reason of the particular circumstances.

It should indicate the assumptions which have been made, as well as identifying the sources of information and what was done.

Apart from these matters being dealt with at the beginning of the report, it is useful to divide the report into sections dealing with separate areas of enquiry, so that separate personnel within a firm can work on reporting on their specific areas – e.g. IP, property, environmental etc.

The report should not be something that is just done at the end of the job. Rather, as soon as the scope is agreed the initial sections/limitations and headings should be established. Then as the due diligence enquiry proceeds, paragraphs in each section should be filled in as points are covered so that the report is a draft work in progress throughout the process.

This approach has some significant benefits:

- (a) The very process of writing the report and then briefly reviewing it, will often throw up obvious questions that are not covered, or issues to be dealt as one proceeds;
- (b) If there are issues which might prevent the transaction occurring, it is important to draw them to the client's attention early, perhaps by way of a draft report, so that the client does not waste money on something which will not proceed;
- (c) Working on the report as one proceeds is more likely to produce a timely report, to assist the purchaser in making its final decision whether or not to proceed.

The final point is that an advisor may cause as much loss by overstating a problem as understating it. People only make money by taking a risk, so the aim is not to stop the client taking a risk. Rather, it is to assist the client to make an informed decision on whether to buy and, if so, on what terms.