The First Annual Business Acquisition Law Conference

Topic: Due Diligence – Doing What Needs To Be Done

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1. Why do due diligence

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

To try and achieve this, well advised purchasers 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 Competition and Consumer Act and other laws, the basic principle remains *caveat emptor* (let the buyer beware). The principle received strong judicial support from the 2004 High Court decision in *Woolcock Street Investment Pty Limited v CDG Pty Limited* [2004] HCA 16; (2004) 216 CLR 515.

> 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 provisions of the Competition and Consumer Act 2010 which give effect to proportional liability (and

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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 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. 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 (see section 731 of the Corporations Act 2001). 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, Mason J at [14] 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

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standard of response to be ascribed to the reasonable man placed in the defendant's position."

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. 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.

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 a task in testing out whether:

(a) the key statements and representations in the Marketing Material are reasonably based;

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(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 business purchase due diligence exercise 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. What can be disclosed by vendor for due diligence purposes

A vendor will generally need to disclose sufficient information to achieve the following commercial and legal outcomes:

(a) Entice a purchaser to enter a contract and to proceed to completion by allowing the purchaser to determine whether their expectations, understanding, and valuation of the business are likely to be matched by reality;

(b) Avoid a breach of contract or warranty; and

(c) Comply with any legal disclosure requirements.

In practice, the information a vendor will need to disclose varies depending on:

(a) what has lead the purchaser to consider the transaction (the Marketing Material, Assumptions List and Proposals);

(b) the type of transaction (purchase of business assets or purchase of shares);

(c) the nature and size of the business and its assets;

(d) the reputation of the vendor;

(e) the risks;

(f) whether or not the deal is fully priced; and

(g) the stage of the transaction (pre-exchange, pre-completion or post-completion).

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A vendor will often hesitate to disclose confidential information to prospective buyers as they fear the ramifications of the transaction not completing. If the transaction does not go ahead the purchaser may use the information disclosed for their own benefit for example by:

(a) going into competition with the vendor;

(b) providing information to a competitor; or

(c) being in a better bargaining position with parties who had relationships with the vendor (for example, customers or suppliers).

I have a matter at the moment where I act for the proposed purchaser of a company. The vendor built the USD $30 million plus business from the ground up and treats it as his life's work. The purchaser is a multinational and a potential competitor. Out of fear, the vendor has refused to disclose any information whatsoever relating to the accounts of the company until exchange. In circumstances like this where you act for a purchaser, and you have a vendor who may be brilliant in their line of business but inexperienced in commercial deals, it is necessary to look at options to alleviate the vendor's fears so far as reasonable.

Risks to the vendor can be minimised by:

(a) entering into confidentiality or non disclosure agreements which state that the information provided may not be disclosed any third parties other than their advisors and may only be used for the purpose of assessing whether to proceed with the transaction;

(b) masking certain elements of the disclosure material until exchange or completion. Examples include:

    (i) disclosing the legal risks of an agreement but not revealing its commercial terms;

    (ii) disclosing the sales figures from each customer but not disclosing their names;

    (iii) providing a total sales figure but not disclosing what the figure is comprised of; and

(c) providing particularly valuable information (such as IP) to a respected consultancy firm who can advise the purchaser as to its effectiveness/applicable rights, without disclosing the "formula".

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5. 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:

(a) they are in practice irrelevant – e.g. if a business is being purchased to obtain its freehold land for another use, the purchaser would not be concerned with the past trading performance of the business.

(b) 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.

(c) they lack materiality – how significant is each particular aspect issue or assumption to the business or the purchase?

6. 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**.

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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?**

(a) If largely sourced from a few clients, the agreements with those clients and the relationships with those clients should be closely examined;

(b) Regardless of the spread of clients, one should analyse why customers come to this business – what is their angle?;

(c) If it is a particular product, then the sources of supply of that product, and any associated patent or design issues, become critical;

(d) 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?;

(e) 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?;

(f) 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.

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7. 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 committee 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.

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(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.

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8. 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

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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.

9. 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

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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

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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.

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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.

(g) 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.

10. Controlling and managing the flow of information

If you consider a transaction where there is one accountant, one client and one lawyer on each side, 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.

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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.

11. Dealing with an online data room

Historically, all due diligence material was physically compiled in a room at the premises of the vendor or their advisors to be inspected by representatives of the purchaser. In most circumstances, this is now considered inconvenient and impractical. This is particularly the case in today's globalised world in which business acquisitions commonly involve purchasers, vendors, and advisors who may be in different cities and countries around the world.

Modern due diligence is generally carried out through electronic means. The material is created or scanned in soft copy and distributed to the purchaser's representatives by flash drive, CD ROM, email or through the cloud. This has the advantage of allowing due diligence to be conducted by the purchaser's representatives at their convenience and in their own time. It is also easy for the vendor to replicate the material in the event there is more than one prospective purchaser who wishes to check it at any one time.

The advent of cloud computing has also further facilitated a relatively new form of disclosure through an online data room. Typically, the material is uploaded to a password protected website with distinct passwords being provided to each of the purchaser's representatives.

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The online data room has several advantages for vendors which, depending on the online data room service provider, may include:

(a) reduced risk of disclosure to unwanted parties;

(b) the material may be conveniently updated if further material is discovered;

(c) access to the material may be removed in the event the purchaser does not proceed;

(d) the purchaser will not necessarily retain a copy of the due diligence material that is uploaded;

(e) the online data room may be accessed through any device capable of accessing the internet; and

(f) you can track what each purchaser or their representative has looked at.

However an online data room service also has disadvantages:

(a) it may be more expensive than traditional due diligence methods such as burnt CD Rom;

(b) there has also been a tendency for vendors to upload large amounts of often irrelevant information to the online data room. This has a contractual significance, discussed further below in sub-topic 14.

Representatives of the purchaser should treat the information provided through an online data room as though it was given through more traditional means. If clarification or more information is required, or if unable to pinpoint the location of information (which may in part be due to too much irrelevant information in the data room) this should be raised with the vendor or their representatives.

12. What information should the data room contain

Regardless of whether due diligence is conducted through an online data room, CD Rom, or more traditional means, the vendor should provide the information necessary to achieve the aims outlined in sub-topic 4 above, subject to first obtaining any appropriate confidentiality agreement. A data room should not be used to upload irrelevant documentation to make the task of due diligence more difficult or time consuming for the other party.

13. Data room enquiries

Online data rooms commonly provide a question and answer function as part of its services. This allows purchasers to directly raise any issues they may have with the information in the room through the online data room service. A purchaser should not hesitate to ask the

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vendor to clarify, provide more information, or pinpoint the exact location of information in relation to the data room. If there are several prospective purchasers (e.g. a tender situation), it is wise to share the questions and answers (without identifying questioners) in the interests of transparency and efficiency.

14. The contractual significance of due diligence disclosure material

There has been a trend for vendors to assemble, index and update a due diligence "bundle" that may be available to prospective purchasers and which will (in hard or soft copy) 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.

A typical contract for sale will usually contain a term stating that warranties do not apply to anything that has been disclosed in writing by the vendor to the purchaser. Accordingly, inundating the purchaser with material can serve to insulate the vendor from a breach of warranty. 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, costly 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

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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:

(i) is fairly and accurately disclosed in the Data Room; or

(ii) 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.

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.

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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.

15. Disclosure letter – structuring disclosure to reduce risk of claim for breach of warranty

Where a term of the sale agreement states that warranties do not apply to anything that has been disclosed, a vendor must make disclosures in accordance with the agreement to ensure a breach of warranty claim cannot be made. Commonly, agreements will stipulate:

(a) how the disclosure must be made, for example in writing or in the agreement;

(b) to whom the disclosure must be made, for example a specified person;

(c) and when the disclosure must be made, for example, before exchange or a certain amount of time before completion.

Like the DSE/Tandy case, the contract may also stipulate that the disclosure must be reasonable, fair, accurate, or in plain language. The circumstances of the agreement will determine whether such a requirement has been met. It will be up to the vendor whether to:

(a) risk not complying with the requirement in the hope the warranty is not breached or that the disclosure made is held to have been made in accordance with the agreement and therefore the warranties do not apply; or

(b) make full and specific disclosure in accordance with the requirement thereby reducing risk of a claim for breach of warranty, and accepting the risk that the purchaser may seek an adjustment to the purchase price to account for the information disclosed or may decide not to purchase on the basis of the disclosure.

A vendor may be reluctant to disclose things that are only a possibility on the basis that the purchaser may have an inflated view of the risk, but the vendor should bear in mind the

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unpredictability of the consequences of a breach of warranty. These may include the risks of delay in completion, termination, and of significant claims. Those consequences would be unfortunate, by comparison with the scenario where, having disclosed the matter, the purchaser agreed to accept the risk at the outset.

Apart from the commercial calls for a vendor as to the extent of disclosure, there is a real challenge for lawyers in getting an understanding of the risk and of fairly describing and disclosing it in a manner which, with hindsight, will not be regarded as incomplete. It may often be valuable to run the wording of a disclosure past someone else in your office to see what it means to them. They are less likely to approach the words with the preconceptions and background of a vendor briefing, and so you have a better understanding as to how the words might be interpreted in the event of a dispute.

As noted earlier, disclosure can be in several forms, as the agreement may require. For example, there may be disclosure as to:

(a) matters fairly disclosed by documents in the due diligence “bundle”;

(b) matters fairly disclosed in the disclosure schedule.

There is a practice, which is by no means standard, of having the disclosures in a separate letter which may be an exhibit to the agreement rather than just included as a schedule. This is intended to minimise the risks for the vendor of the disclosures (which will sometimes involve disputes with third parties), becoming more widely known including through the stamping process or the production of the agreement to third parties.

Purchasers sometimes also wish to have the disclosure letter separate so it may not be seen by their financiers, who may wish to inspect the purchase contract.

The board of a purchaser may often wish to sight the “disclosure letter” or equivalent schedule before sign off on the contract, so they can best focus on the risks as identified by the vendor.

It should however be borne in mind that such a letter or schedule would not necessarily disclose everything, and the contract may leave a purchaser without remedy for matters disclosed elsewhere in the contract, or by means of the disclosure bundle. That gap may be covered by the due diligence report to the Board.

16. Specific issues

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

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diligence process since they will invariably turn up some issue that might otherwise have been overlooked. Checklists should be tailored to suit each particular transaction and after consultation with the client as to what their biggest concerns in relation to the business and vendor are.

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.

16.1 Reviewing leases and what to look for

(a) Ensure the lessor is the registered proprietor of the subject premises;

(b) Determine whether the lessee has a registered leasehold interest;

(c) Determine whether there have been any sub-leases or assignments;

(d) Assess:

- (i) The term of lease including any options;
- (ii) The method of rent calculation;
- (iii) The assignability of the lease;
- (iv) The permitted use of the premises and any contravention;
- (v) Any bond and/or security requirements including any mortgage of lease;
- (vi) Occupational health and safety requirements on the lessor or lessee;

(e) Determine whether there are any other leasehold interests, or dealings in relation to the premises which are contrary to the subject lease;

16.2 Investigating security interests and obtaining releases if necessary

(a) PPSR searches should be conducted on the vendor (ACN/ABN/former names);

(b) If there are any PPSR security interests, assess whether they are or may be secured over the business or assets which are the subject of the transaction and, if there are, request that the vendor:

- (i) arrange to have the security interests removed from the PPSR;
- (ii) seek a release from each secured party in relation to the security interests so far as they affect the property purchased; or

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(iii) make completion subject to the transfer of any money owed by the vendor to the secured party, from the proceeds of the sale of business and ensure you can determine what that amount will be (and that it will be paid to the secured party).

(c) If the above cannot be achieved, consider whether the purchaser wishes to continue with the transaction without getting title to the relevant assets.

16.3 Ensuring planning and industrial zones and other laws are appropriate to allow your business to operate

(a) Conduct searches with the relevant council or government agency to assess whether the purchaser's proposed business and use of premises are permitted;

(b) Assess whether the purchaser requires any licences, permits or any other approval to conduct the business or for future proposals;

(i) Are they currently held by the vendor?;

(ii) What is required for transfer of the licence, permit or approval?;

(iii) What are the conditions attaching to them?;

(c) As often as not the question is not whether or not there is an approval or zoning in place, but what are the conditions attaching. These can sometimes make the conduct of the business theoretically possible but in practice unworkable.

(d) Apart from planning instruments, some industries will have other restrictions including specific statutory provisions (e.g. limiting location or intensity of certain businesses). General issues of potential nuisance claims should be considered (e.g. noisy business on new site).

16.4 When do you need to undertake an environmental audit

(a) Environmental risk is rightly a focus, because it is the best example of where the liabilities assumed by a Purchaser may be significantly more than the purchase price. In particular, the initial obligation to remedy contamination will often attach to the latest occupier and their rights of recourse to earlier occupiers may in practice be valueless because of difficulties of proof, limitation periods and common clauses in contracts restricting action against the prior vendor for contamination risks. Accordingly environmental due diligence is critical, and if in doubt a full review should be undertaken.

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(b) Ideally, one lead coordinator should lead all technical due diligence such as mechanical, electrical and environmental/structural due diligence. In these areas, it is often the case that some issues may overlap, and discoveries in one area may affect the others. For example, checking the mechanical or electrical systems may identify asbestos etc. A lead coordinator should be responsible for ensuring co-ordination so that nothing falls between the cracks compared to where you retain different contractors for different parts of the technical due diligence. Some issues relating to the benefits of having a lead coordinator are also detailed in sub-topic 10.

(c) An environmental review should proceed by way of two phases:

(i) Phase 1 – public records such as the history of site (through enquiries and searches with council or historical photographic evidence), and searches in relation to any defaults, judgments or orders for any environmental issues.

(ii) Phase 2 – where the subject premises are or were industrial, or had anything in their history suggesting any risk of contamination, or where the proposed use will require a higher degree of confidence or statutory conditions (e.g. residential, school etc), this level of enquiry should be conducted. Phase 2 involves physical inspection of the premises by experts with relevant qualifications. There may be some issues in terms of obtaining access for testing, with vendors requiring insurance, obligations to make good etc. There are some familiar formulas for resolving these issues, which may need to be worked through.

16.5 Checking the accounts and other corporate data

(a) Check whether all financial statements, tax returns, BAS statements and other documents have been regularly lodged on a timely basis and audited;

(b) Check all accounts and books to determine if they have been properly maintained;

(c) Consider the cash flows and consider its consistency, growth, sources;

(d) Consider liabilities and contingent liabilities

(i) Do they form part of the normal operations of the business;

(ii) Are there any warranties or liabilities for goods and services supplied;

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(iii) 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;

(e) Consider how the purchaser will fund/manage business and what working capital is required;

(f) Consider the amount of receivables and the average number of days required to recover them;

(g) Assess whether there are any extraordinary items which have not been disclosed;

(h) Assess the customer lists and note the potential impact if a customer is lost;

(i) Expenses

(i) Check expenses and accounts on a suitable random sample/materiality basis and against industry standards;

(ii) 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 affect profitability for the purchaser in operating the business;

(iii) Generally test expenses against industry averages and against relationship to sales – how sensitive the expenses are to any upturn or downturn in the business.

16.6 Reviewing employment contracts

(a) Assess who the essential employees of the business are;

(b) Should persons paid as contractors, be correctly classified as employees?

(c) Assess whether the essential employees are willing to continue their in their role post completion, and if so, on what terms;

(d) Assess whether the essential employees may be replaced if needed;

(e) Consider restraints on key employees;

(f) Identify which staff may not be required;

(g) Consider timing and method of informing staff of the sale;

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(h) Consider how business will be staffed up to completion;

(i) Consider the effect the sale (or any future proposals) may have on employment conditions and costs including for other businesses;

(j) Also note the impact of fair work legislation which may pass employment liabilities onto the successor of the business. Whilst it may be possible to have some employee liabilities paid out with appropriate terms/offers (e.g. redundancy period of service and annual leave), other entitlements may not be capable of being paid out (e.g. long service leave, personal leave) and will therefore pass to the purchaser. Frequently a vendor will insist the purchaser take on all periods of service entitlements and that they offer full continuity of conditions, to reduce the vendor's redundancy risk. As a result a purchaser may have a significant exposure if employees have not been obtaining their full entitlements. That exposure may include:

  (i) the business in the purchaser's hands is not as profitable because their true expenses will be higher;

  (ii) employees will be entitled to their accrued but unpaid entitlements from the purchaser at their correct rates, including any future increases up to the time of payment, even if not paid at the correct rate pre sale;

  (iii) the effect of any underpayment may be compounded by the need to add payroll tax and workers compensation, as well as superannuation, where applicable;

  (iv) historical shortfalls in payment and interest risks, particularly on purchase of a company.

  Accordingly it is also important that even where the same employees will not be continuing with the business post completion, that the following be reviewed:

  (i) Any relevant statutory, workplace agreement and award provisions – e.g. they may impose additional obligations on a purchaser regardless of the contract terms;

  (ii) The number of employees;

  (iii) Their wages/salary and whether employees have been paid in accordance with their employment agreement or as required by any award or minimum wage;

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(iv) Length of employment;

(v) Present, past or potential worker's compensation claims or any other claims or industrial disputes;

(vi) The terms of employment and on which employees may be terminated;

(vii) Potential liabilities for redundancy in the event employees are not required to continue post completion, or where the purchaser may need to terminate their employment at a later date;

(viii) Potential for any other liabilities including long service leave, holiday pay, personal leave, bonuses, commissions;

(ix) On what basis is long service leave and other leave entitlements calculated in the vendor's books?;

(x) Are the records accurate? One technique may be to include in pre-completion letters of offer to employees, a statement as to the purchaser's understanding of the accrued periods and existing terms and a request for confirmation so that employees may, if they spot an obvious error, raise it at that time and that may become a pre-completion claim on the vendor rather than a problem arising down the track.

16.7 Checking for escape clauses in contracts for IT and other

(a) Assess whether there are any services agreements that the vendor is bound by;

(b) Are these agreements capable of assignment without consent, and does the purchaser wish to take them on?

(c) Are there any subsisting defaults that in effect the purchaser may take on, as matters that need to be dealt with before the purchaser can exercise rights under the assigned contract?

(d) Determine what rights of termination the parties to the contract may have under the agreements or otherwise. Is there a change of ownership or control clause, and will it apply to the subject transaction? If so, what is the threshold for it to be passed? Is it the reasonable approval of the other party or can they be unreasonable?

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(e) Also consider what the consequences of termination are if the purchaser or another party to the contract wish to terminate. Consider how the consequences may be minimised or whether the other party may be bought out of the agreement.

(f) Consider whether subcontracting is an option on an interim basis where assignment may trigger issues;

16.8 Checking if vendor has litigation on foot and how you should deal with it if there is

(a) Seek details of any disputes, whether or not in writing, and whether or not involving court proceedings;

(b) Conduct searches for existing orders, writs and judgments on the vendor and of online and other court lists and Austlii;

(c) If there is litigation on foot, consider whether the litigation poses a risk to the transaction:

(i) Is there a risk the assets being sold may be clawed back through insolvency or other provisions?;

(ii) Is there a risk the operation of the business may be disrupted, for example by way of injunction or the seizure of key assets or customer claims?;

(iii) Does this say something about the vendor and its risk profile/ability to meet warranty claims/candour?

16.9 Checking what's owed on superannuation

(a) Assess the superannuation payments owed by the vendor to employees;

(b) Assess whether all superannuation payments were made in line with the applicable rate and are otherwise compliant with the relevant laws in force at the time;

16.10 Checking for third party consents – don't avoid doing the obvious

(a) Releases or consents may be required in relation to PPSR security interests including from mortgagees;

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(b) Releases or consents may be required in respect of services agreements on a change of ownership including:

(i) Transfer of phone and fax numbers;

(ii) Transfer of domain name addresses;

(iii) Transfer of post office boxes;

(iv) Assignment of services agreements with IT, suppliers, customers etc.

(c) Is there a competition issue or a further issue that may require consent?

16.11 Reviewing trading relationships of vendor – ensuring supplies remain on foot

(a) Assess what supplies, if any, are required for carrying on the business;

(b) Assess who the suppliers are and the terms on which the supplies are provided;

(c) Assess whether material supply contracts involving the vendor may be assigned in the event of a change in the ownership of the business;

(d) Assess whether there are alternative suppliers available in the event the supply contract is not assignable or its terms are unfavourable to the purchaser. In this regard information regarding other potential suppliers or negotiations with suppliers should be included as part of the assets acquired through the acquisition;

(e) Assess whether all existing supplies on hand that are proposed to be acquired by the purchaser under the sale agreement have been paid for the vendor;

(f) What are stock levels/delivery times and is there a potential for stock shortages? On completion of an acquisition a purchaser will wish to demonstrate good service to customers, not fall short.

16.12 Inventory control – checking the forward order book

(a) Assess what obligations, if any, the business has to provide goods or services to customers immediately post completion, and beyond;

(b) Assess the future sources of supply;

(c) Assess past inventory turnovers and consider whether there are sufficient inventories in stock to ensure a seamless transition and the satisfaction of customer orders

(d) Inspect condition of existing inventory;

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(e) Agree on a method of valuation;

(f) Identifying obsolete or slow moving stock;

(g) Minimum and maximum stock levels for completion;

16.13 Enquiries as to the vendor (and where applicable as to guarantors)

(a) Historical ASIC search;

(b) Personal Property and other security registers;

(c) Search AUSTLII, online Court data bases, and (if available) lower court records for details of court proceedings;

(d) Check with Department of Fair Trading as to complaints;

(e) Review Financial Review clippings service;

(f) Review any trust deed;

(g) Suggest client obtain credit reference search;

(h) Consider similar enquiries in relation to any separate guarantors/warrantors;

(i) Examine constitution of vendor to see if there are any restrictions on sale or other relevant terms;

(j) Examine listing requirements as to any restrictions on sale;

(k) 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);

(l) Certificate of good standing and searches in place of incorporation if outside Australia;

(m) Review ABN register;

(n) Sight certificates as to relevant minutes, completeness of corporate documents.

16.14 Plant and Equipment

(a) List and verify;

(b) Sold at what value (sight prior depreciation numbers);

(c) Determine which are owned or leased;

(d) Obtain copies of finance arrangements;

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(e) Check condition;

(f) Obligation to repair and maintain till completion;

(g) Are there service and maintenance manuals?

(h) Availability of spares/replacements;

(i) Maintenance contracts and warranties held?

(j) Are they assignable?

(k) PPSA searches

16.15 Debtors

(a) 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)?

(b) Credit references on key debtors.

(c) Method of valuation.

(d) Bad and doubtful debts.

(e) Any exclusions.

(f) Review and obtain assignment of documents required to enforce.

(g) What is the state of the records?

(h) Evidence required to enforce (eg of delivery).

(i) If not purchased, who to collect, and effect of recovery action on continuing customers.

(j) Consider tax consequences – e.g. what happens if not recovered?

16.16 Goodwill

(a) Search business name, trade mark register, phone books, internet usage and domains and other usage of names and trade marks.

(b) Consider obtaining report from IP search expert.

(c) What about sellers own name/personal names?

(d) Product names – same searches for them.

(e) Obtain understanding of area of business, extent of business – may suggest what are reasonable and enforceable limits for any restraint.

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(f) Consider respective importance of value of personal goodwill, location goodwill, goodwill attaching to name or trade mark.

(g) Consider requirements for tuition by seller before and after completion.

(h) 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.

(i) Consider what evidence there is as to prior usage/reputation (may be significant in relation to common law/reputation rights if trade mark not upheld).

16.17 Intellectual Property

(a) Obtain a listing of software licences held.

(b) Consider their terms and assignability.

(c) Identify other intellectual property – what rights are there?

(d) Extend this to know-how.

(e) Obtain details of any infringements claimed by or against the vendor.

(f) Inspect user agreements.

(g) Obtain search of design, patent and trade mark registers, as to whether registered, and for competing applications or registrations.

(h) Who has, and has access to, client list?

(i) Determine who created material claimed to be owned, whether by way of copyright or otherwise.

(j) Did contractor assign rights (e.g. to logo)?

(k) Consider confidential information, how protected.

(l) Consider what arrangements there are with contractors in relation to intellectual property.

(m) Are any moral rights applicable?

(n) Checking ownership of trademarks

    (i) Assess whether the vendor is the registered owner of the marks;

    (ii) Assess whether the marks remain registered;

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(iii) Assess whether there are any grounds for the trademarks to be contested;

(A) Was the mark created by another party and their interests assigned;

(B) Non-use;

(C) Similarity with another mark;

(D) Any infringements claimed by or against the vendor;

(o) Checking ownership of copyright

(i) Assess whether the vendor is the owner of the work

(A) Who created the work;

(B) Under what arrangement was the work created;

(C) Under what arrangement was the work licensed;

(ii) Assess whether there are any grounds for the copyright to be contested;

(A) Similarity with another work;

(B) Copyright created under an arrangement;

(C) Any infringements claimed by or against the vendor;

16.18 Premises

(a) Property searches;

(b) Other usual enquiries;

(c) Environmental inspections;

(d) Inspection by structural engineers;

(e) Inspection by services engineers;

(f) Inspection as to compliance with current and original building code of Australia/similar requirements;

(g) Obtain and review as to compliance with development consent conditions and construction certifications;

(h) Review lease terms and assignability provisions;

(i) Review bond/security requirements and assignability;

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(j) Consider whether future use will come within existing consent and usage terms;

(k) Occupational health and safety requirements;

(l) Review any existing leases/sub-leases;

(m) Occupancy certificate;

(n) Building certificate;

(o) Capital allowance schedule;

(p) Survey;

(q) Lettable area survey;

(r) Details of disputes;

(s) Plans for surrounding area;

(t) Energy Efficiency Rating

16.19 Material Contracts

(a) Inspect all material contracts;

(b) Are all contracts to be assigned?

(c) What conditions are necessary for consent to assignment?;

(d) What if consent is not forthcoming?;

(e) What are expected conditions of consent to transfer?;

(f) Does the purchaser want to take all the contracts?;

(g) Are there any existing defaults or disputes?

16.20 Title

(a) Search public records;

(b) Examining accounts to see any references to leasing charges and determine what is leased;

(c) Review company files as to dealings with financiers;

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

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16.21 Conditions Precedent

(a) What conditions precedent will apply – such as consent of lenders to transfer of debt, consent of landlords, FIRB or Competition and Consumer Act 2010?

(b) 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.

16.22 Regulatory issues

(a) Consider any regulatory issues that may apply including Competition and Consumer Act 2010, FIRB etc.

16.23 Tax

(a) Structure of purchase and purchaser;

(b) GST treatment;

(c) Fringe benefits tax – is this being properly accrued and paid and is it included in accounts/budget?;

(d) Superannuation guarantee levy – same points;

(e) Payroll tax;

(f) Other applicable taxes;

(g) Is there any stamp duty payable and unpaid (and which may need to be paid to enforce any agreement);

(h) What will be the cost base of assets acquired;

(i) Allocation of price and its consequences;

16.24 Insurance

(a) What is the claims record?

(b) What is the existing coverage?

(c) What will be the future cost of insurance – e.g. did the vendor have the benefit of any concessions?

(d) What information will the purchaser's insurers require of the vendor in order to provide and continue cover?

(e) At what point will risk pass?

(f) What will happen if there is damage before completion?

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16.25 Ongoing Management

(a) What is the current reporting structure?;

(b) What will be the reporting/decision making structure for the business between exchange and completion?;

(c) What management is critical and how will it be retained?

16.26 Likely Adjustments

(a) What prepayments are there in the business that the vendor may require to have adjusted in its favour?

(b) What accrued but unpaid liabilities are there that the purchaser may need to take over and meet?

16.27 Relationships with Third Parties

(a) Are there any joint ventures, partnerships, agency arrangements, alliances or other such arrangements with third parties relating to the business?

(b) Obtain details and consider requirements for assignment.

(c) PPSA searches may indicate additional relationships with third parties including suppliers etc that warrant investigation.

17. Due diligence in Occupational Health and Safety – not all warranties may be enforceable

Apart from Victoria and Western Australia, each Australian state and territory has implemented variants of the model workplace, health and safety laws developed by Safe Work Australia. These new laws impose duties on persons conducting businesses or undertakings to ensure the health and safety of workers (amongst others). One duty imposed requires officers of a person conducting a business or undertaking to exercise due diligence to ensure the company is compliant with the workplace, health and safety laws (see for example, section 27 of the *Work Health and Safety Act 2011* (NSW)). Therefore in jurisdictions where this or a similar provision has been enacted, if the purchaser of a business is a company, due diligence in relation to OHS must be conducted if that business is to be carried on by the company after completion.

Whilst a vendor may give warranties in relation to OHS issues up to the date of completion that may be insufficient to discharge the purchaser's own statutory due diligence obligations. The laws impose duties on the person conducting the business or undertaking. Accordingly, immediately on completion, a purchaser is required to be complaint with those laws and will

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be liable for any breaches. A prudent approach would be to obtain an expert OHS report ahead of purchase, for the following purposes:

(a) determine which areas of OHS may need to be strengthened or whether new procedures and controls may need to be implemented (and seek an adjustment to the purchase price or warranties as appropriate);

(b) determine what level of insurance cover is appropriate for the business given the OHS risks involved;

(c) comply with workplace, health and safety laws.

18. 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.

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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.

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