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Due Diligence in M&A Transaction

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ABSTRACT

Organisation is under the constant pressure to grow with the changing market and increasing competition but less than one quarter of merger and acquisitions are not able to achieve the desired financial objective. There are different stages of merger and acquisition in which due diligence plays crucial role in the success of the deal. The due diligence provides essential information that can be used in negotiating the deals, determining the price of the bid and making any new recommendations. With due diligence the companies can tackle the risks involved in certain deals and make the M&A effective and successful. The ultimate goal of this stage is to make sure that there are no hidden drawbacks associated with the transaction. With this a proper strategies can be formed and the acquiring companies will be well aware of every liabilities associated with the target company. In this article we are dealing with the due diligence in light of its characteristic to foresee the future harm and to determine the shortfalls of due diligence in non disclosure of agreement and takeovers. Further we are dealing with the importance of environment due diligence in current times. EDD's purpose is to issue an opinion of compliance with environmental law, to calculate the costs of detected environmental liabilities and to reduce the risks of legal disputes and how the emerging issue affects our daily life. Moreover this paper assesses whether the COVID-19 pandemic, how government responses to it and what were the actions taken by companies in relation to both constitute a "Material Adverse Effect" (MAE) under a particular MAE clause in a public company merger agreement. Material Adverse Change/Effect ('MAC') has become an important but chaotic legal notion. The paper draws two lessons from it (1) to understand the conceptual understanding of the due diligence, the process, principles and key areas and (2) Covid - 19 as a Material Adverse Effect (MAC) Under M&A.

Keywords: Merger and Acquisition, Non Disclosure Agreement and Takeovers, Due Diligence, Environmental Due diligence, Material Adverse Effect, Material Adverse Change, COVID-19, Pandemic.

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I. INTRODUCTION

From the year 1991 after the economic liberalization reform, the Indian economy opened itself to the foreign market which leads to rise in the merger and acquisition throughout the country. Merger and acquisition revolves around many steps among which due diligence are the most important step. It plays crucial role in the success of any M&A transaction. Due diligence is the process mainly to evaluate and investigate the prospective business decisions. It involves the process of finding the relevant data of the key business transactions of the target companies. There are various legal purpose of the due diligence, those are:

- (i) The party entering into the transaction have to ensure that the vendor have good title over the assets and are free from any encumbrance.
- (ii) That the assets have the values that are given by the vendor.
- (iii) That there are no risks associated with the assets which can reduce the value of the assets.
- (iv) That there are no other liabilities that may affect the acquiring company.

The main purpose of due diligence is to confirm that the business is genuine after gaining the information about the business of the target company. The information includes the valuing the assets, warranties, liabilities and negotiating the concession price accordingly through the due diligence. The information gathered can also be helpful in negotiating and drafting the agreement which includes all relative ancillary agreements. It give information about the post-indemnification rights of the acquiring company and other organisational documents such as contract of stakeholders and other contracts which includes licence permit, assignment clauses and other regulatory requirements. The regulatory requirements like government approval if required.

Generally, it appears that the due diligence process comes to an end after the draft for merger and acquisition is formed and has been approved by both the acquiring company and target company but due diligence is an ongoing process and continue till the existence of merged or amalgamated company. It is done mainly to evaluate the risk that may pop-up by the time.

In Section 1, we highlighted about the relevance of due diligence in M&A to prevent the foreseeable harm.

In Section 2, we have presented the pitfalls and challenges of non-disclosure of agreement and due diligence in takeovers.

In Section 3, we have discussed COVID-19 as a Material Adverse Effect (MAC) Under M&A.

In Section 4, we have outlined the importance of environmental due diligence in current times. Section 5, concludes by examining various theories proposed to explain the due diligence and its impact.

II. THE RELEVANCE OF DUE DILIGENCE IN M&A TO PREVENT FORCIBLE HARM

The relevance of due-diligence in merger and acquisition is very wide. It is extended from the review of corporate records and filings made with the registrar of the companies made according to the provisions of the Companies Act to the related party transactions and also include ancillary documents. The scope of due diligence generally depends on the sector which company operates. Among various stages of the m&a, the due diligence is used to explore all the aspects of the target company. It should uncover all the possible details of the target company before finalizing the agreement. Its main objective is to rectify business problems which can be negotiated and is likely to cause unexpected liabilities in near future or may also cause failure of the business in the later stage. As Sinickas (2004) M&A due diligence as “...where each party tries to leave all it can about the other party to eliminate misunderstanding and ensure the price is appropriate.” The due diligence mainly focuses on analysing the data of the target company. Typical area of due diligence are:

- (i) Corporate Organisation and structure
- (ii) Accounting and financial matters
- (iii) Tax matters
- (iv) Real property
- (v) Furniture, fixture and equipment
- (vi) Insurance
- (vii) Intellectual property
- (viii) Contracts
- (ix) Environmental matters
- (x) Employees
- (xi) Employees benefit plans
- (xii) Litigation ³

³ G. DeLong, Does Long-term performance of mergers match expectations? Evidence from the US Banking industry, *32 FINANCIAL MANAGEMENT* 2 (2003), at 5-26.

Proper due diligence determine the extent to which target company have capacity to maintain its own current as well as future requirements. It informs about the key findings and find out the synergies as well as deal killers. After that it determines the capability of both the sides and anticipates the growth of both the company. If the companies don't have the capacity, the cost and the impact of the financial deals need to be determined through complete evaluation. The acquiring company uses the information for negotiating, to set the bid prices and provide recommendations.

Due diligence validates the business plans and mitigate the risk associated with it and formulate solutions to deal with it. The process includes various steps. In the first step Liaisons with Regional Legal Advisor or General Counsel, Contracting Officer or OAA, Program office, or other office is required to plan the memo for due diligence. Secondly, the information should be gathered from the various documents such as public documents which include company report.

News articles, subscription reports etc. the Constitutional document of the company, annual reports and returns and other information of shareholdings, directors should be examined. In the third step, the documents obtained must be analysed to understand the strength and weakness of the target company. Later, the stock exchanges where the merging company is listed should be informed about the merger process and the copies of required documents should be mailed accordingly. Lastly, the memorandum of understanding should be drafted after the discussion and should be reviewed by the agency. The Board of Directors of both the company must approves the merger proposal and pass the resolutions for this. There are various factors which create obstruction form conducting due diligence. According to Perry and Herd, the danger is not that they will fail to complete the due diligence but rather that they will fail to complete the due diligence effectively. Which includes time restriction, cost constrains and various situations. Time restrictions are important factor which generally create problem by preventing the effective examination of the target company. Sometimes costly experts from various fields as without their opinion, there might be the possibility that the acquiring company may occur some damages in future. In case the deal is not so big, then it will be uneconomic to appoint the experts for due diligence. Lastly, the effect of situation around the m&a play crucial role. In case of foreign acquisitions and hotelier takeovers, many a times companies take shortcuts for due diligence. But the competitive nature of the market require the well informed due diligence.

III. NON-DISCLOSURE AGREEMENTS AND DUE DILIGENCE IN TAKEOVER: PITFALLS AND CHALLENGES

Due diligence are the review of the risks associated with the deal for both the bidder and the target company. Even though risks can be traced by the due diligence process but the mainfunction of the due diligence is to balance the risk between both the parties.⁴ The buyer candecide the future of the deal after due diligence, decision can be to abandon the deal but usually parties negotiate the provisions of contract. But the due diligence have few challenges, such as time and financial losses, loss of reputation and trust, leak of insider information, and market abuse.⁵

The time from the intention was made to make a bid to the final announcement of the bid or till the bidder decides to terminate the bid can be so long as well as very costly. Generally, the approval from the relevant authority is the time consuming process. There is no time limit for the due diligence. The takeovers usually affect the average purchase price in the target company. If the bid is attractive, the price will increase and, if the bidder walks away, the price will decrease, on insinuation there is something wrong with the target company.⁶ The due diligence can create financial loss sometimes as the price to appoint experts can be costlier. The target company can defend itself from takeover by taking high cost when evaluating the bid can make the company less attractive.

In due diligence risk of reputation of the target company is always present. The market value of the company is made up of tangible assets, intangible assets and goodwill.⁷ There is strong correlation between reputation of a listed company among public and its share price movement that is why reputation of company has huge role in destroying or enhancing its intangible value. Along with the reputation, there is risk of damage of trust for the securities market during due diligence for takeover. Therefore, it is duty of the target company to take care to not to take take any measures which may damage the reputation which ultimately damage the trust of the securities market.

The target company is under obligation to give insider information to the potential buyer in a due diligence. Although in case the final bid fail, then the obligation to make the insider information public falls. But the target company need to be careful to not to make insider information unnecessarily public. Providing insider information tom public might harm the

⁴ Sevenius, *Due diligence: besiktning av foretag*, p. 317 ff.

⁵ Julia Karlsson, *Pre-bid target board discretion in public takeovers with focus on due diligence*, pp. 29 (2017).

⁶ Stattin, *Takeover: offentliga uppkopserbjudanden pa aktiemarknaden enligt svensk ratt*, p.207.

⁷ Julia Karlsson, *Pre-bid target board discretion in public takeovers with focus on due diligence*, pp. 31 (2017).

company. To protect the information from the leak, the target company can take precaution that they make orderly disclosure.

Therefore, the challenges should be reduced as due diligence pumps in fresh blood into the economy and enhanced its abilities while merger and acquisition. A future generation due diligence will improve the financial performance and strength of the company.

IV. COVID-19 AS A MATERIAL ADVERSE EFFECT (MAC) UNDER M&A

This brings us to the key question of whether the COVID-19 pandemic, the governmental responses to it (such as orders to close businesses or the restriction of their operations), and the actions that the companies themselves may have taken in relation to one or both of them these, have resulted in a “material adverse effect” on a company within the meaning of the Base Definition of a typical MAE clause. As explained above, the key question will be what effect such events have had on the company’s overall earnings potential, better understood as meaning the present value of the company’s future cashflows.

Needless to say, everything will depend on the particular adverse effects suffered by the company in question and how these effects change reasonable expectations of the company’s future cashflows. Leaving aside those few businesses whose results may have actually improved during the pandemic, at one end of the spectrum will be companies that have continued to operate more or less normally, such as businesses deemed essential under governmental lockdown orders or businesses whose employees can work remotely from home without major losses in productivity. For businesses in this group, revenues and profits may have decreased slightly due to general economic decline resulting from the pandemic,⁸ but they could otherwise it would otherwise be essentially intact.

Even for these businesses, however, the effect of the pandemic on the present value of future cash flows is extremely difficult to assess. Clearly, the short-term economic conditions will be extremely bad in the near future. Chairman Powell recently stated, “We’re going to see economic data for the second quarter [of 2020] that’s worse than any data we’ve seen for the economy.”⁹ Currently, the Federal Reserve Bank of New York’s Now cast model predicts, for the second quarter of 2020, a decline in GDP of 31.1% at an annual rate,¹⁰ by far the largest

⁸ Real GDP declined at a 4.8% annual rate in 2020Q1 according to the Bureau of Economic Analysis. See Bureau of Economic Analysis, Gross Domestic Product, First Quarter 2020 Advance Estimate, available at <https://www.bea.gov/news/2020/gross-domestic-product-1st-quarter-2020-advance-estimate>.

⁹ Jerome Powell, Transcript of Chair Powell’s Press Conference (April 29, 2020) at 13, available at <https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20200429.pdf>.

¹⁰ Federal Reserve Bank of New York, Nowcast (May 15, 2020), available at <https://www.newyorkfed.org/research/policy/nowcast>.

decline on record. The economists surveyed by The Wall Street Journal predict an even larger decline, 32.3%, for the same period.¹¹ Whatever the expected cashflows of a business were before the advent of the pandemic, they are almost certainly significantly lower today. Even for companies relatively unaffected by the pandemic and lockdown orders, declines of at least 30% or more for Q2 of 2020 may be warranted. Furthermore, although most economists also expect that when the economy reopens, economic activity will rebound, no one knows the critical details of how and when the economy will reopen and how and when economic activity will then rebound. As Chairman Powell recently put it, “Both the depth and the duration of the economic downturn are extraordinarily uncertain and will depend in large part on how quickly the virus is brought under control.”¹² By way of comparison, the total decline in GDP during the recession following the financial crisis of 2007-2008 was only about 2.25%

In sum, although whether any particular company has suffered a material adverse effect will always depend on the particular facts of the case, for many companies it will be substantially certain that they have suffered such an effect. With the economy suffering an extremely larger downturn likely 2.5 times or more the size of the recession following the financial crisis of 2007-2008-it is extremely likely that the cashflows of the company, as reasonably estimated today, will be significantly lower than they were reasonably estimated to be before the COVID-19 pandemic began¹³. Moreover, the extreme uncertainty surrounding how and when the economy will reopen and what permanent damage has been done to the economy makes every company’s future cashflows more risky, which requires that they be reduced to present value at a higher discount rate, which of course results in a lower present value. Combining reduced expected cashflows with significantly higher discount rates strongly suggests that a typical company will have suffered a material adverse effect because of COVID-19 and related events.

V. IMPORTANCE OF ENVIRONMENTAL DUE DILIGENCE IN CURRENT TIMES

Environmental due diligence plays an increasingly important role in corporate and real estate transactions. Unfortunately, parties often fail to perform adequate environmental due diligence or do not complete it early enough to be able to use the information effectively in the transaction. As a result, the parties to a transaction may find themselves burdened with unforeseen liabilities. Environmental due diligence is only one characteristic of the developing

¹¹ Wall Street Journal, Economic Forecasting Survey (May 15, 2020), available at <https://www.wsj.com/graphics/econsurvey/>.

¹² Jerome Powell, Transcript of Chair Powell’s Press Conference (April 29, 2020) at 2, available at <https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20200429.pdf>.

¹³ The total decline in GDP in the 2007-2008 recession was 2.24%. See Federal Reserve Bank of St. Louis, GDP Series Data, at <https://fred.stlouisfed.org/series/GDP>. If GDP in Q2 of 2020 declines at a 31% annual rate, the loss would be almost 8%.

area of environmental liability risk management which includes, such as other things such as environmental damage insurance, legal compliance audits, contract risk allocation and pollution prevention. Environmental concerns are now being taken much more seriously. In recent years, the environment has become a much more widespread problem in the public eye. This has led to the development of new, stricter environmental legislation and increased the severity of the penalties for violations of the legislation. The risks are now high for those who are unable to address environmental issues. Environmental Due Diligence plays an important role for investments in facilities and acquisitions. Environmental due diligence audits provide investors with a more informed view of an organization or facility's "progress" by assessing current environmental risks or legislative non-compliance. Reducing these risks or correcting legislative non-compliance is a definitely, costly problem and can devalue the value of an investment. Environmental Due Diligence truly acts to reduce risks and prevent unnecessary expenses. The Regulation on Environmental Damage (Prevention and Remediation) adopts the "polluter pays" principle to address the issue of legislative violations. This legislation actually aims to prevent and repair environmental damage caused by industrial activities. In particular, this has increased the importance of maintaining legal compliance and, in turn, has increased the importance of Environmental Due Diligence. Furthermore, this type of legislation has traditionally been applicable only to major producers, but now SMEs are also responsible for their actions. The importance of environmental legislation and the obligation of environmental due diligence are likely to increase further in the future. Over time, the legislation becomes more complex and targeted in order to achieve its goal: to minimize damage to the environment. Especially in the UK, the government is constantly raising the bar for environmental targets and the EU is also adding its environmental targets.

VI. CONCLUSION

Due diligence is very critical component of merger and acquisition process. Its importance is rising day by day with the development of the market. It has become more than just a process as due diligence is now used to find out whether the targeted value can be achieved, or whether the timeframe can be achieved. It is also used to manage all the risks associated with the deal. There is an ardent need to ascertain the full picture of the potential liabilities as well as benefits associated with the merger and acquisition as it is necessary to modify the process and nature of due diligence process. It has been found that the tangible assets can be examined properly to identify the future of the potential deal as it can easily be quantified since intangible assets are difficult to assess.

The higher cost of M&A failure give rise to the need of the process of due diligence as it evaluate the operating data prior to coalition of the operating units. As well as the time frame for the due diligence should also be increased, so that the data and information regarding assets can be properly developed. The track record of the merger and acquisition mainly deals with the shortcomings of the traditional approach of due diligence. Many a times even after the thorough examination of the legal as well as financial aspects of the deal do not guarantee the success of the M&A. So, the focus on the less tangible might increase the chance of the success.

The risk of shortening environmental due diligence cannot be overstated. During mergers and acquisitions (M&A) there is a tendency to consider such due diligence simply as another box to check before closing. Conducting proper environmental due diligence has a huge advantage. This allows parties to enter into a transaction with a more complete picture of the ownership involved, potentially qualify for liability protections, appropriately allocate risks and adequately remedy environmental impacts. These benefits substantially outweigh the time, costs and burdens that the due diligence process may present, not to mention the consequences of not identifying these issues in advance.

The main conclusions reached in this short paper that whether the Covid-19 pandemic and related government orders that close or curtail operation shutting businesses or curtailing their operations constitute a “Material Adverse Change/Effect” in the meaning of a specific business amalgamation agreement.
