 DOI: *https://doij.org/10.10000/IJLMH.113874*

INTERNATIONAL JOURNAL OF LAW MANAGEMENT & HUMANITIES

[ISSN 2581-5369]

Volume 5 | Issue 6

2022

© 2022 International Journal of Law Management & Humanities

Follow this and additional works at: https://www.ijlmh.com/
Under the aegis of VidhiAagaz – Inking Your Brain (https://www.vidhiaagaz.com/)

This article is brought to you for "free" and "open access" by the International Journal of Law Management & Humanities at VidhiAagaz. It has been accepted for inclusion in the International Journal of Law Management & Humanities after due review.

In case of **any suggestions or complaints**, kindly contact **Gyan@vidhiaagaz.com**.

To submit your Manuscript for Publication in the **International Journal of Law Management & Humanities**, kindly email your Manuscript to **submission@ijlmh.com.**

The Growing Significance of Due Diligence vis-à-vis M&A Transactions: Overviewing its Scope, Checklist, and Red Flags

PRISCILLA NISHA SAMUEL[1]

ABSTRACT

The term 'due diligence' is so commonly used in legal parlance. Black's Law Dictionary defines this concept as a 'measure of assiduity or prudence, something that is circumstantially expected and is ordinarily exercised by a person who is prudent/reasonable'. Since this paper aims to connect due diligence with M&A, it is crucial to establish that a merger is an amalgamation of two companies and, acquisition refers to when one company purchases another company's entire/partial shares to further control the latter. In this context, due diligence would include the procedure of investigating any person or business prior to entering into a contract with them. Not only does such diligence enable the consumer to crosscheck all legitimate information about the targeted company, but aids in laying the groundwork whilst simultaneously eliminating the obvious risks and loopholes. The researcher aims to first, cover M&A vis-à-vis due diligence broadly. Secondly, to study pre-due diligence and post-due diligence for potential red flags. Lastly, highlight solutions to tackle litigation risks. How does one become more diligent? What should one initially review before contracting with another? These elements will form the essence of the following paper.

Keywords: *due diligence, mergers, production process, red flags, checklist.*

I. INTRODUCTION

'Risk has mostly been a companion of rewards, inherent in analyzing opportunities against a company's weaknesses and strengths.'[2]

When deciding on a market access policy in India, companies should consider FDI, financial variants, confidentiality, and corporate laws, as well as direct and indirect taxes. The Companies Act and the FEMA Regulations should therefore be followed by all new businesses approaching the sector. By evidently recording and reporting long-term goals and their framework, strategic planning also acts as a means for reducing investment risk, as well as providing the foundation

[1] Author is a student at School of Law, Bennett University, Greater Noida., India.

[2] Report of NACD Blue Ribbon Commission on Risk Governance (2009).

© 2022. International Journal of Law Management & Humanities

for downstream decision-making, particularly those related to investment efforts. By analyzing a potential investment, due diligence is utilized to reduce unnecessary risk to any party involved in a project. The prudent investor understands the benefits of buying an existing firm but also recognizes the dangers that await the naive buyer. The cautious bidder reduces acquisition risks by conducting thorough due diligence prior to closing the sale. Due Diligence is a customary notion of practice in India that has no official mention in a statute. Although some businesses avoid due diligence because it is too expensive, this is usually a bad decision. Systematic due diligence can help you avoid a financial disaster or gain the target company for a lower price or on better terms.[3]

Institutions are much more susceptible to behavioral patterns that are opportunistic in essence and incoherent with the organization's corporate strategy goals if they lack such a solid basis. Strategic, institutional, and cultural challenges must be addressed by all parties participating in the merger process. The failures of M&As imply that the projected synergy gains vanish midway between the original M&A concept formulation and its execution. Strategic, institutional, and cultural challenges must be addressed by all parties participating in the merger process. The failures of M&As imply that the projected synergy gains vanish midway between the original M&A concept formulation and its execution. We believe that the over-emphasis on legal and monetary aspects of mergers and acquisitions, as well as the disregard for institutional and cultural concerns, is a major contributor to the disappearance of systems and information. In the end, ignoring such intangible issues is a crucial aspect that might mark the end of many mergers and acquisitions.

II. Scope of legal due diligence vis-à-vis Mergers and Acquisition transactions – whether smoothly exercisable despite buyer-seller hindrances?

The notion of *due diligence* originates from common law (developed by judges through the phase of adjudicating disputes). Wherein the basic question arises – what degree of diligence could amount to 'due' diligence? Would it be ordinary, extraordinary, or to the slightest extent? Statutorily stating, the expected extent is ordinary. Several domestic and international judgments surfacing from common law jurisdictions substantiate this statement. For instance, the Supreme Court held in *Nirma Industries vs. SEBI*[4] that the shareholder company must

[3] Mitchell L. Marks, Phillip H. Mirvis & Leo F. Bradkovich, '*Making Mergers and Acquisitions Work: Strategic and Psychological Preparation.*', JSTOR Vol. 15, No. 2, pp. 80-82 *available at* – https://www.jstor.org/stable/4165737

[4] Nirma Industries vs. SEBI (2013) 8 SCC 20.

© 2022. International Journal of Law Management & Humanities [ISSN 2581-5369]

exercise caution and care in conducting appropriate due diligence on the target company prior to actually investing. Additionally, the Court stated that Nirma Industries had been conscious of various lawsuits and thus could not claim the gullibility of the lawsuits or the investment and related risks. In *Chander Bansal vs. Rajinder Singh*[5], the court held that due diligence would include thorough research, one that is practiced by a responsible being in the management of his relations. Further, in *Slemons vs. Paterson*[6], the Court opined due diligence to be a relative term, short of an exact definition. However, what is tantamount to due diligence in terms of 'due care, 'negligence' or 'diligence' is colossally circumstantial from case to case[7].

Discussing cultural clashes in M&A Transactions

Due diligence is used to develop workplace modifications, employee rights, levels of engagement and motivation, as well as the company's atmosphere. The goal is to establish any job responsibilities, determine potential human costs and risks, optimize HR issues that must be rectified during integration, evaluate cultural adaptability, and budget for and plan post-deal HR adaptations.

Since the dawn of time, cultural due diligence has been carried out on an ad hoc basis. When agreements are announced but do not follow through, it is generally because there is a fear that the cultures of the two organizations would not sync. Mitchell Marks (San Francisco-based analyst who has written significantly on cultural due diligence), points out that there are four main strategies to cultural due diligence[8]: *firstly,* including cultural considerations in the early stages of merger negotiations, *secondly,* recruiting and training members of the due diligence crew a focus on cultural factors, *thirdly,* including cultural parameters in data collecting for due diligence and *lastly,* employing formal tools to determine whether or not a company's culture is a good match. Take the example of the investigation conducted by Sales and Mirvis in 1984[9], wherein they focused particularly on corporate ideology, values, and interpersonal and commercial behaviors as cultural factors. The researchers discovered that cultural differences between connecting organizations led to sheer polarization, negative assessments of the other company, uncertainty, and ethnocentrism among members of the combined firms during the initial year after the transaction concluded. Furthermore, the investigators discovered that these unfavorable features lessened slightly after three years but remained visible across the united

[5] Chander Bansal vs. Rajinder Singh Anand AIR 2008 SC 2234.
[6] Slemons vs. Paterson, Cal. App., 92 P 612 (1939).
[7] *Ibid*.
[8] Mitchell L. Marks, '*Adding Cultural Fit to your Due Diligence Checklist*', Mergers & Acquisitions, Dec. 1999 pp.15-19.
[9] Belmakki Oualid, '*The Impact of Cultural Issues on M&A*', SSRN (Oct 1st, 2011) *available at* – https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1978293

institution.[10]

To prepare the merged firm for an unavoidable change in the business context, acquirers should conduct institutional due diligence with a flexible mindset, conscious of the **multi-dimensionality** of the challenges. Although we might not anticipate the results of an M&A with confidence and utmost surety, cultural due diligence may and should be an effective policy against the catastrophes that all too often precede M&As if done correctly.

III. Responsibility of acquirers to spot and address potential red flags – whether such responsibility arises prior to the acquisition process or after or both?

If the target is chosen correctly, M&A transfers have the capacity to change an entity's future and put it on a path of growth. On the other hand, making the wrong decision will have a negative impact on the acquirer's growth and stakeholder profits, and may even result in their decline. As a result, such transactions must be approached with caution, which is where the relevance of such due diligence mechanism comes into play. Risk variables related to key legalities are outlined while conducting due diligence through examination and the categorization of red flags. A *red flag* is a typical knowledge that seems to be irregular or contradictory to the legal standard. It could also include any liabilities of the target company that could arise later as a danger/hazard if left unaddressed. Simply put, it is an indicator or warning faced by the target company such as non-compliance, litigation baggage, etc. In the field of corporate law, red flags could be looked for within corporate records, intellectual assets, loans, human resources, licenses, permits, and other advances.[11]

There are several key areas wherein red flags could emerge and the company intending to acquire must bear these arenas in mind. These include – *non-compliances, liabilities, violations, and litigation*. The first arena worth addressing includes **non-compliances.** This is typically one of the key areas of emphasis within legal due diligence and determining a company's conformity is a rigorous procedure. The term 'compliances' refers to all of the pertinent and necessary provisions of numerous statutes, regulations, and norms that the company must follow. Generally, in Indian business contexts, such compliances (and the lack thereof) entail the Companies Act of 2013 [the company's charter papers, such as the MOA or AOA, the keeping of the conference minutes record, minutes of board sessions, the preservation of statutory records and share certificates can all be used to evaluate compliance with this Act.

---

[10] *Ibid.*

[11] Patrick A. Gaughan, '*Mergers, Acquisitions, Corporate Restructurings*', WILEY 7th ed. pp. 469-470.

Non-compliances must be documented and evaluated], various Labor Laws [all relevant Central and state employment laws must be followed by the firm, when completing labor law due diligence, make sure that all required returns have been filed on time under different labor welfare and employee-benefit plan regulations], and at times certain Intellectual Property Rights and other licenses.[12]

The second area worth addressing deals with **liabilities**. It is necessary to determine whether the corporation has any ongoing or imminent financial liabilities stemming from loans and advances, as well as bank debt from financial institutions or other enterprises or individuals. Contractual liability may also exist as a result of agreements made by the company in the ordinary course of business. Contracts such as supply, service, and maintenance are examples of these. The responsibilities and obligations stemming from such contracts should be recorded since they may have a bearing on the proposed deal or the business and its operational procedure. The third arena following liabilities includes **violations**. This is to investigate whether the corporation has broken any relevant laws or legislation and standards. Infringement of certain laws might result in harsh punishments, including imprisonment. Infractions of corporation law, labor law, environmental license violations, and so on are among them. Tax law infractions such as evading taxes and tax fraud should also be investigated and assessed throughout the red-flagging procedure. Lastly, the last arena wherein red flags could emerge pertains to **litigation**. All lawsuits to which the target firm is a party should be evaluated as components of the due diligence phase. The essential dispute concerns must be determined if the target corporation has several litigation matters. It is also necessary to consider the views of legal representation handling these cases.[13]

Post-merger advancement due diligence process

This process which consists of six appraisal processes should be treated as a project throughout the proposed transaction and its due diligence phase. Other due diligence work streams may begin at the same time or a little later. Other investigations, such as economic, institutional, legal, and administrative due diligence initiatives, are likely to share information with the venture. Understanding the buyer's strategic justification for the sale and how it will promote post-closing development is the first stage in a business-due diligence assessment. Additionally, the target company's growth strategy must be identified and explored. The majority of mergers

---

[12] Jacques Giard & Caroline Leblanc, '*Assessing the value of compliance due diligence in M&A – Insight into the challenges and benefits*, KROLL (Feb 17th, 2021) *available at* – https://www.kroll.com/en/insights/publications/financial-compliance-regulation/assessing-value-compliance-due-diligence-ma

[13] Ibid.

are tailored to match the inorganic growth plan. The due diligence crew will not be in a position to perform due diligence inquiries and assessments if it does not appreciate the purchaser's reasons and future direction. These six appraisals consist of – *one,* appraise inorganic growth rationales, *two,* locate and appraise assets, *three,* identify and appraise capabilities, *four,* identify and appraise growth drivers, *five,* identify and appraise investment perils, *six,* due diligence report and closure.

Case Analysis: *Nirma Industries vs. SEBI*

The *Nirma* case involved Nirma actively trying to retract an open offer made under the Takeover Regulations on the grounds that the target company's promoters had committed fraud and misappropriated funds. The responsibility of buyer's due diligence is one of the key precepts from the Hon'ble Court's ruling, in this case, further held by the Court that due care and cautiousness should be preferred as well as an investor's duties.[14]

Nirma utilized Regulation 27(1)[15] of the Takeover Code, which states that no public offer may be retracted once it has been made unless (a) the statutory approval needed has been rejected; (b) the sole acquirer, who is a natural person has passed away (c) such circumstances as SEBI believes warrant drawdown. When it came to the three exclusions, the Supreme Court was of the view that – 'In the event of statutory approval – this would apply if a public offer had to be withdrawn due to a legal impossibility and the needed statutory approval had been refused; (b) In the case of the lone acquirer- This would apply if the sole acquirer, who was a natural person, had died. Both exemptions under (a) and (b) are clearly in the same spectrum of impossibility, therefore clause (c), "such circumstances as in the opinion of SEBI justify withdrawal", would have to be understood in terms of the other two exemptions. This exception would only apply in situations when the acquirer would be unable to complete the public offer'. Only SEBI has been granted discretion in this matter. The Hon'ble Court also delved into the following matter pertaining to the 'implications for acquiring parties'.[16]

Note: The acquiring party should be cautious in doing due diligence to identify red flags and determine whether any obstacles can be overcome by the target firm well before the takeover actually takes place. Disposing of non-compliance or anomalies ought to be a pre-condition for approving the takeover, if at all achievable. In the end, the purchaser should not proceed until the prejudiced issues have been resolved. Permission to withdraw from an open offer will only be given if the acquiring firm's case is legitimate and the minority's claims are not harmed,

[14] Nirma Industries vs. SEBI (2013) 8 SCC 20.
[15] SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 – Reg. 27(1).
[16] Ibid.

according to established law. The basic goal is to allow minority shareholders to depart on the same conditions as those who sold shares to the target company's controlling buyer.

IV. Indian laws incidentally mandate the exercise of due diligence in M&A Transactions

Industries in need of advancement have largely used mergers and acquisitions to gain market share from competitors, generate revenue, and provide returns to shareholders. Mergers and acquisitions necessitate a reasonable fraction of due diligence by the purchaser, as it is critical for the buyer to understand what it will be purchasing and what all commitments it will conclude with the purchase, as well as the full scope of the target company's current liability, lawsuits issues, infringements, and so on, before agreeing to the transaction. This is especially essential in the instance of private companies when the target firm has still not been subjected to public examination and the buyer has limited access to information that would otherwise be available through public sources.[17]

Adverse developments can emerge when an investment contract or unyielding asset transfer is estimated or completed for a planned merger, acquisition, public offering, or the acquisition of some type of immovable asset.[18] Due diligence is essential for all transactions to result in a proper legal contract. Previous paperwork, understanding of how to enunciate titles, and the search for succession, including tax duties and verification, are all required. When the due diligence protocol is not handled properly, there is a risk for all parties: for instance, for the purchaser, a major risk or future opportunity is not explicitly discovered prior to the transaction's conclusion, while for the seller, unqualified transaction leadership yields in a lack of authenticity, errors, or difficulties.

V. Conclusion

Mergers and acquisitions are grown commonplace across India since the Indian sector opened up to international markets following the 1991 'economic freedom revolution'. Mergers and acquisitions have evolved as one of the most efficient strategies to reorganize businesses in order to gain competitive advantages. In a merger, one firm combines with another and risks losing ownership, whereas another dominant corporation obtains higher value and can accumulate or merge with another, but in an acquisition, the acquiring company acquires the holdings of acquired investors and stops to have a stake.

---

[17] ILO Team, '*Due Diligence Procedure in Private M&A*', INDIA LAW OFFICES LLP (March 24th, 2022), *available at* – https://www.indialawoffices.com/legal-articles/due-diligence-procedure-in-private-m-and-a
[18] Ibid.

Around 1/3rd of due diligence investigations uncovers major problems that could be deal-breakers. Almost half of them fail to complete the merger/acquisition deal on time.[19] To achieve a lucrative purchase, organizations must analyze all aspects, including strategic, economic, organizational, IT, and human resources, while conducting due diligence. Those who dismiss the experience are condemned to repeat it. Those who struggle to see ahead will perform accordingly. Despite the fact that the strategic plan is stated, it is not set in stone. It should strike a balance between a solid commitment to growth goals and a degree of flexibility in the strategies used. The team will have put forth its best work on tactics at this point of planning, with the understanding that those tactics may alter as they consider implementation, and more data gets accessible. As a result of this process, the organization will be in a better position to emphasize its investment goals. It will have discovered the most promising markets and the platforms best suited to extracting profit from them. Due diligence assists the customer in obtaining extensive information about the target firm and preparing themselves in accordance with the target company's vision. Due diligence assists the acquirer in avoiding potential hazards during the business transaction. Today, India offers considerable prospects for cross-cultural trade and mergers and acquisitions for businesses.

*****

[19] Trishla Dwivedi, '*Role of Due Diligence in Mergers and Acquisition of corporations*', TOI (Feb 26th, 2021) *available at* – https://timesofindia.indiatimes.com/readersblog/hail-to-feminism/role-of-due-diligence-in-mergers-and-acquisition-of-corporations-30024/

VI. Reference

Articles

1. Belmakki Oualid, '*The Impact of Cultural Issues on M&A*'.
2. Jacques Giard & Caroline Leblanc, '*Assessing the value of compliance due diligence in M&A – Insight into the challenges and benefits*.
3. ILO Team, '*Due Diligence Procedure in Private M&A*'.
4. Trishla Dwivedi, '*Role of Due Diligence in Mergers and Acquisition of corporations*.
5. Mitchell L. Marks, '*Adding Cultural Fit to your Due Diligence Checklist*', Mergers & Acquisitions, Dec. 1999 pp.15-19.
6. Patrick A. Gaughan, '*Mergers, Acquisitions, Corporate Restructurings*', WILEY 7th ed. pp. 469-470.
7. Mitchell L. Marks, Phillip H. Mirvis & Leo F. Bradkovich, '*Making Mergers and Acquisitions Work: Strategic and Psychological Preparation.*'.

Websites

1. SSRN (Oct 1st, 2011) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1978293
2. KROLL (Feb 17th, 2021) https://www.kroll.com/en/insights/publications/financial-compliance-regulation/assessing-value-compliance-due-diligence-ma
3. INDIA LAW OFFICES LLP (March 24th, 2022), https://www.indialawoffices.com/legal-articles/due-diligence-procedure-in-private-m-and-a
4. TOI (Feb 26th, 2021) https://timesofindia.indiatimes.com/readersblog/hail-to-feminism/role-of-due-diligence-in-mergers-and-acquisition-of-corporations-30024/
5. JSTOR Vol. 15, No. 2, pp. 80-82 *available at* – https://www.jstor.org/stable/4165737

*****