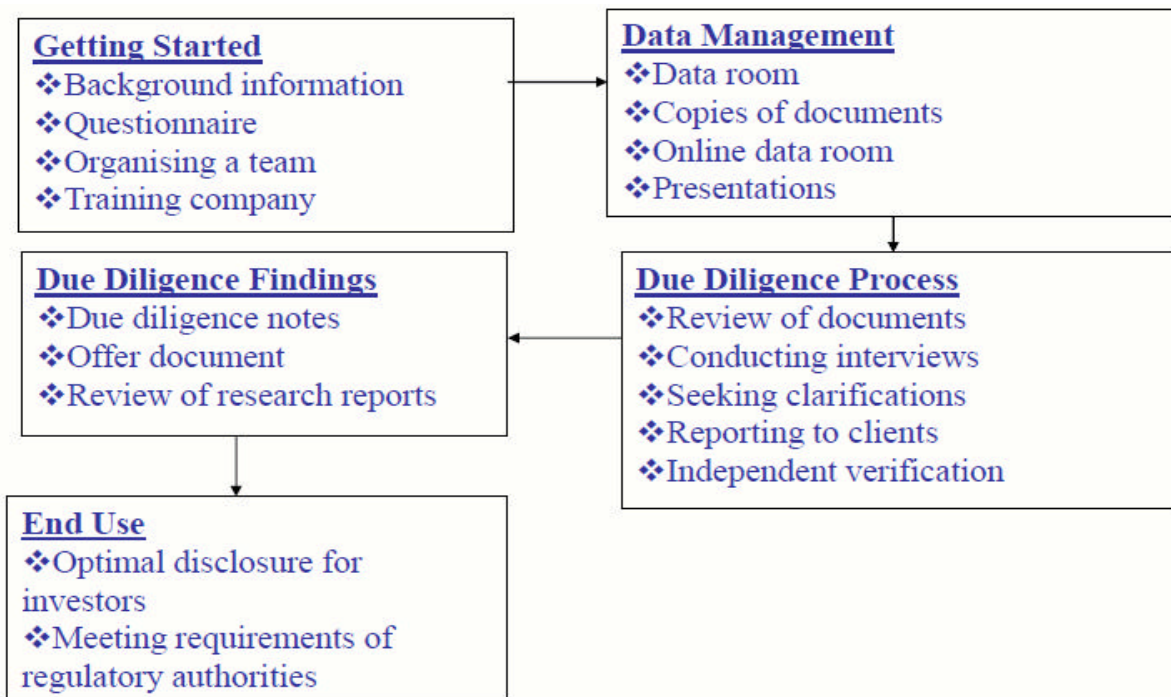


# Due Diligence Process

*Steps involved in legal due diligence*



Issues	Description
<p><b>Introduction to Due Diligence</b></p>	<p>Due diligence is a process of thorough and objective examination that is undertaken before corporate entities enter into major transactions such as mergers and acquisitions, issuing new stock or other securities, project finance, securitization, etc. One of the key objectives of due diligence is to minimize, to the maximum extent practicable, the possibility of there being unknown liabilities or risks. The exercise is multi-dimensional and involves investigation into the business, tax, financial, accounting and legal aspects of an issuer.</p>
<p><b>Due Diligence in India</b></p>	<ul style="list-style-type: none"> <li>The practice of undertaking a formal due diligence investigation is of comparatively recent origin in India and was mainly imported as a process by foreign investors/their legal and financial advisors after the economic liberalization reforms of 1991.</li> </ul>

- No statute defines the term 'due diligence'. However, the SEBI mandates certain parties to undertake a due diligence, in the context of issuance of securities by a company. For instance:
  - Regulation 64 of Chapter VI of the ICDR Regulations, requires the BRLMs to exercise due diligence and satisfy themselves about all the aspects of the issue. The BRLM is also required to call upon the issuer, its promoters or in case of an offer for sale, the selling shareholders, to fulfill their obligations as disclosed by them in the offer document.
  - Regulation 65 requires the BRLM to submit post-issue reports to the SEBI. The BRLM is also required to submit a due diligence certificate as per the format specified in Form G of Schedule VI, along with the final post-issue report. (Regulation 65 (3))
  - Under Regulation 83, a qualified institutions placement shall be managed by BRLM(s) registered with the SEBI who shall exercise due diligence. The BRLM, while seeking in-principle approval for listing of the eligible securities issued under the qualified institutions placement, is required to furnish to each stock exchange on which the same class of equity shares of the issuer are listed, a due diligence certificate stating that the eligible securities are being issued under qualified issuers placement.
  - Before the opening of the issue, the BRLM is required to submit a Due diligence certificate along

	<p>with the draft offer document to the SEBI.</p> <ul style="list-style-type: none"> <li>o Under Regulation 8(2)(b), the lead banker is required to submit, after the issuance of observations by the SEBI or after the expiry of the stipulated period, if the SEBI has not issued observations, a due diligence certificate at the time of registering the prospectus with the Registrar of Companies.</li> <li>o Under Regulation 10(3)(a), the BRLM is required to submit to the SEBI, along with the offer document, a due diligence certificate including additional confirmations.</li> </ul>
<p><b>Types of Diligence</b></p>	<p>The approach to due diligence depends on the type of transaction and what is intended to be achieved. Due diligence may be of various types:</p> <ul style="list-style-type: none"> <li>• Commercial due diligence – review of industry, market, and business model of the issuer.</li> <li>• Reputational due diligence – review of credit worthiness and reputation of individual counterparties.</li> <li>• Financial due diligence- review of tax, financial position, policies and internal controls.</li> <li>• Legal due diligence – review of documentation to identify potential legal issues that may be risks/impediments to the (i) transaction or (ii) in the general operations of the issuer, that may affect the value or consideration in connection with the transaction.</li> </ul>
<p><b>The “why’s” of Diligence</b></p>	<p><b>Evaluation and structuring of the transaction</b></p> <ul style="list-style-type: none"> <li>o Identify issues relating to structuring and documentation.</li> <li>o Identify legal and contractual impediments.</li> </ul> <p><b>Confirm / verify representations and</b></p>

	<p><b>warranties</b></p> <ul style="list-style-type: none"> <li>○ Undertake processes to verify representations and warrants being provided.</li> </ul> <p><b>Validate Business Plan</b></p> <ul style="list-style-type: none"> <li>○ Examination of issues and key areas that need to be addressed in the business plan and determining the impact of the same on the proposed transaction.</li> <li>○ Identify, understand and if possible quantify risks and develop strategies to mitigate the same.</li> </ul> <p><b>Transaction Management</b></p> <ul style="list-style-type: none"> <li>○ Formulation of suggestions and solutions to deal with issues.</li> <li>○ Depending on the risks identified, place the client in a better position to negotiate or adjust the cost of the acquisition or tailor the warranties and indemnities.</li> </ul>
<p><b>Conducting a Due Diligence</b></p>	<ul style="list-style-type: none"> <li>○ Presentation/background information by the issuer.</li> <li>○ Sending the issuer a questionnaire.</li> <li>○ Organizing a due diligence team.</li> <li>○ Issuer to create a data room (virtual or physical).</li> <li>○ Review of documentation/ discussion with management.</li> <li>○ Bring down due diligence questionnaires/calls prior to closing of the transaction.</li> </ul>
<p><b>Scope of the Due Diligence</b></p>	<p>The scope of due diligence typically depends on the nature of transaction proposed to be undertaken. In a securities transaction, the broad objectives are as follows:</p> <ul style="list-style-type: none"> <li>• To obtain all material information in relation to the issuer for making disclosures in an offer document or subscription agreement, to enable investors to make an informed decision and to</li> </ul>

	<p>meet regulatory requirements.</p> <ul style="list-style-type: none"> <li>• To assess the nature and extent of the risks and highlight them.</li> </ul> <p>Additionally, the scope of a due diligence also depends on the mandate - whether complete review of the issuer or restricted to matters like litigation, employment, etc.</p>
<p><b>Diligence in Listed and Unlisted Companies in India</b></p>	<ul style="list-style-type: none"> <li>• Listed companies entail more extensive review of compliances, as well as a greater degree of caution with respect to the sharing of information and structuring of a transaction, as compared to unlisted companies.</li> <li>• In case of a listed company, the provisions of the SEBI (Prohibition of Insider Trading) Regulations, 1992, as amended are applicable. The due diligence should not include review of unpublished price sensitive information except in certain special circumstances. However, publicly available information under the listing agreement signed by the listed companies with the stock exchanges may not be adequate to base an investment decision. Therefore, in case of a listed company, care must be taken to ensure (in consultation with the legal advisors and relevant members of the transaction team) that the insider trading regulations are not violated in the due diligence process. This matter has to be dealt with on a case-by-case basis.</li> <li>• For listed companies, analysis of potential triggers of the SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997, as amended, in the case of a proposed acquisition or transfer will need to be made.</li> </ul>

**Broad heads of a Legal Due Diligence Report**



**What to broadly look for in a legal due diligence?**

**Corporate Structure broadly look**

- Shareholding of the Company.
- Valid issuance of securities.
- Special provisions in the articles of association impeding the transaction (e.g. right of first refusal, outstanding options to restrict, participate in or otherwise impact a future securities offering).
- Powers of company to consummate the transaction.
- Corporate compliance (review board, shareholders minutes to check authorization for appointments, execution of contracts, loans, leases, filings with regulators etc).
- Contracts in which directors, promoters or group companies, controlling shareholders and key managerial personnel are interested including contracts/arrangements with related parties.

**Contracts**

- Validity and enforceability.
- Rights and obligations under material contracts.
- Authorizations or intimations required in respect of the transaction.
- Provisions for novation /assignment.
- Receipt or provisions of goods/services at concessional

rates.

- Change of control provisions.
- Existence or avoidance of material breaches.
- Receipt of notice in relation to an alleged breach.
- Stamp duty.
- Tax implications.
- Disclosure or confidentiality restrictions or requirements.

### **Employment**

- Terms and conditions of employment.
- Contractual/statutory obligations – transferring/altering terms of employment.
- Whether contract labourers are engaged – registration of contract labour.
- Payments to and terms of various funds (provident fund, gratuity and superannuation).
- Existence of unions and wage settlements.
- Disputes with unions or individual employees.
- Existence of employee stock option or purchase plans.

### **Insurance**

- Adequacy of insurance cover given market practice/ terms of loans and validity.
- Cover for business interruption.
- Provisions for assignment or change in loss payee.
- Exclusions in each policy.
- Claims raised under any policy and status of such claims.

### **Borrowings**

- Details of borrowings (standard & special terms).
- Compliance with obligations under facilities.
- Charges over assets and procedure for their release.
- Prior consent of lenders for transfer or change in

controlling interest or security issuance.

- Existence of guarantees and their continuation after transfer, if applicable.
- Existence of public deposits, and compliance with applicable regulatory requirements in this respect.
- Credit provided to or obtained from related parties.

#### **Licenses and approvals**

- Existence and validity of licenses and permissions (including under environmental laws).
- Adequacy of existing licenses.
- Any notice received or action pending in relation to breach of conditions contained in any license.
- Procedure for transfer of licenses or change in control provisions.
- Licenses specific to issuer (income and sales tax registrations) versus those specific to the company's business (e.g. license under Factories Act).

#### **Real Property**

- Title to property- whether freehold or leasehold.
- Provisions of lease/leave & license where interest is leasehold.
- Need for lessor's consent for assignment/change in control provisions.
- Validity/period of lease/license.
- Registration of title.

#### **Intellectual Property**

- Ownership and registration of intellectual property (including existence of licenses to or from third parties).
- Issues relating to assignment.
- Rights pursuant to license

	<p>agreement - validity and assignability.</p> <ul style="list-style-type: none"> <li>○ Infringement of intellectual property rights of the company or third party rights.</li> </ul> <p><b>Litigation</b></p> <ul style="list-style-type: none"> <li>○ Determination of disputes including actions before regulatory and quasi judicial authorities and any threatened litigation.</li> <li>○ Defence taken.</li> <li>○ Determination of the materiality of the dispute.</li> <li>○ Assessing the impact of adverse decisions - monetarily and on business.</li> <li>○ Review of counsel's opinion on risk assessment.</li> </ul>
<p><b>End use of Diligence</b></p>	<ul style="list-style-type: none"> <li>○ Identification and mitigation of risks in light of market practice and legal requirements.</li> <li>○ Changes in structure of the transaction.</li> <li>○ Price adjustment.</li> <li>○ Conditions precedent.</li> <li>○ Representations and warranties.</li> <li>○ Verification of disclosures.</li> <li>○ Retention of purchase price.</li> <li>○ Indemnity.</li> <li>○ Conditions subsequent to closing the transaction.</li> </ul>