3.4 Legal Due Diligence Issues

Gregory T Emms
Lee Crowder

On almost any type of acquisition, whether of assets or shares or whether by way of trade purchase, buy-in or buy-out, legal due diligence is essential, to a greater or lesser extent. The extent of the legal due diligence will depend on the circumstances. On a management buy-out (MBO), management might feel less inclined to spend money investigating matters with which they are familiar, although the institution(s) funding them may not be so relaxed. On the other hand, in a trade purchase or a management buy-in (MBI), the purchaser should consider investigating everything for which it will or may be taking responsibility. Entering into a transaction with eyes wide open and being aware of the issues (after any consequent renegotiation of the price) will almost certainly be a better outcome than a possible warranty or indemnity claim after the event.

Areas of investigation may include:

Contracts

The assignability or otherwise of contracts of the vendor or target company should be considered. In general, such issues are less problematic on share sales since the contracts will usually be in the name of the target company and the purchaser will need merely to understand the provisions of those contracts without the need to transfer them. More problematic are asset sales, where contracts will need to be transferred. Typically, many smaller-value contracts will simply be assumed without any formal agreement on the part of the other party to the contract, although this mechanism should not be relied upon, and a formal assignment of the agreement should be obtained, where the contract is of significance – for example, a finance contract relating to an important asset used by the target business. Sometimes, even in a share sale, consent or approval of another party to the contract will be required by virtue of change of control provisions. An example would be a contract with the Ministry of Defence or other government department. Generally, in the absence of any prohibition on the transfer of contracts, the benefit of a contract may be freely transferred whereas the transfer of the burden of a contract requires the agreement of the person who has the benefit of it (a novation).

Consents

Due diligence may reveal that external consents of one sort or another may be required in relation to particular types of business. Examples include licensed premises, transport businesses and newspapers.

Employees

Employees are a major area of concern. Clearly, the purchaser will need to be satisfied with the costs associated with employees and the terms of their employment. Many employers will have employees of a similar grade on standard form contracts or statements of terms and conditions of employment to ensure compliance with the Employment Rights Act 1996. Many, however, do not and a purchaser may wish to ensure that such issues are dealt with prior to completion. In relation to more senior or key employees, an analysis of the individual terms of employment is advisable. Obligations on termination of employment are important – purchasers will wish to see that such employees are restricted from competing with the target on termination and that such purported restrictions are in fact likely to be enforceable (as they are frequently overly ambitious in their scope and duration, thereby rendering them potentially unenforceable).

On a share sale, the employee's position is not usually affected. An employer will not usually change. Note, however, that a purchaser may wish to bring the new or incoming employees into line with its own pay and conditions structure post-deal and this can create its own problems.

In relation to an asset sale, where there is a purchase of an identifiable business or economic entity the business transfer will almost certainly give rise to an automatic transfer of the employment of the employees to the purchaser under the Transfer of Undertaking (Protection of Employment) Regulations 1981 (TUPE). Regulation 10 of TUPE obliges the vendor of the business to provide information and consult with employee representatives prior to the transfer. The purchaser is to provide information to the vendor of any 'measures' which it envisages taking in relation to the transferred employees, or if there are none, to provide assurance to that effect. 'Measures' would include alterations to pay and other remuneration levels, redundancies etc. The obligation under TUPE is not limited to employees of the vendor – employees of the purchaser who are affected are also to be consulted. Strictly speaking, where there are no 'measures' envisaged, the obligation to consult is reduced to an obligation merely to inform. In commercial terms, many employers find the prospect of discussing with employee representatives a proposed sale of the business totally unacceptable. There is often the need to maintain commercial confidentiality. Consultation with employee representatives means listening to representations made by them and taking account of them, although there is no obligation to agree or give effect to the representations. Failure to comply with notification and consultation provisions can lead to a 'protective' award of up to 13 weeks' pay being made by an employment tribunal, although the level of the award will depend upon the consequence of the failure to consult for the relevant employee(s). The obligation to consult may not apply where there are special circumstances rendering it impossible, for practical reasons, to consult (eg on a sale by an administrator or receiver), however a simple desire to keep the transaction confidential by the party would not usually be accepted as a special circumstance. Any liability arising from a failure to consult is likely to transfer from the vendor employer to the purchaser employer under TUPE along with other rights and obligations of employment, so the purchaser should be satisfied that the consultation has been undertaken.

Pensions

Pensions can frequently be the cause of great angst in share and business sales. This is particularly the case with employers having a large number of employees in their scheme. On a share sale, or particularly where there is a stand-alone company, pension issues will usually be limited to establishing what the actual and contingent liabilities of the employer are in relation to the pension scheme. Where a company or business is being extracted from a group, issues are more complicated – including calculation of transfer values etc.

Final salary or defined benefit schemes (now becoming far less common) are more problematic than money purchase or defined contribution schemes, since the employee entitlement in relation to a defined contribution scheme will simply be to his individual account within the fund. By contrast, in a defined benefit scheme, an employee will be entitled to a fraction of his final salary irrespective of the amount of contributions made and performance of the fund. The employer will be required (in relation to a final salary scheme) to ensure that the contributions it makes are sufficient to meet the fund's anticipated liabilities. The minimum funding requirement introduced by the Pensions Act 1995 has created a requirement for a valuation of the fund every three years on a prescribed basis. The effect of this is that many funds previously regarded as being well funded have now been required to obtain further funding by way of increased contribution rates from the employer.

In relation to money purchase schemes, the due diligence issues relate principally to an evaluation of relevant documents, satisfaction with the tax status of the scheme and whether contributions have been made by the employer as required. Similar considerations also apply in relation to final salary-type schemes.

On a sale of assets, employee rights under an occupational pension scheme (ie a pension scheme of either final salary- or money purchase-type whereby the trustees of the fund are nominated by the company and investment decisions made by those trustees (with advice), as compared to a group personal plan – usually an off-the-shelf policy purchased from an insurance company where the individual members have a discretion to direct the nature of their investment – are exempt from TUPE. The purchaser employer is not obliged either to make contributions or to assume liability for accrued benefits pre-completion. By contrast, obligations relating to a scheme that is not an occupational scheme, such as a group personal pension plan or an individual pension plan, are assumed under TUPE (eg the liability to make deductions from employees' salaries or to make contributions on the employees' behalf). However, notwithstanding that a purchaser does not acquire the liability under TUPE, he may be required by the terms of the asset purchase agreement to provide continuance of benefits to employees and, indeed, in most cases would be well advised to do so, so as to maintain employee goodwill.

A recent development has been the requirement of employers of more than five individuals to offer stakeholder pensions. These are government-designed schemes designed to provide low-charge and low-cost pension provision for employees who previously had not felt able to afford to make pension contributions. An employer's obligation in relation to stakeholder pensions is to facilitate pension provision and not, at the present time, to make contributions on the employee's behalf. During the due diligence process, compliance with stakeholder pension obligations should be checked. In many cases, the purchaser may wish to replicate or assume the arrangements carried on by the vendor. Clearly, in a share purchase, such arrangements will come by virtue of acquiring the legal entity. It will be necessary to establish whether or not there are any relevant employees and whether or not any exemption applies. It is thought likely that the current minimum employee number of five will be reduced in the future.

Merger control

Merger control issues should be considered on larger-value transactions. The responsibility for merger control will fall either within the ambit of UK or European Union (EU) authorities. EU merger control provisions are unlikely to apply other than to the larger transactions. A transaction should not seriously fail to be considered in the context of European law unless the aggregate community turnover of the 'concentration' (ie the combined business) exceeds €100 million. It is worth noting, however, that a 'concentration' includes a joint venture arrangement. The joint venture between two subsidiaries of two separate larger groups of companies could cause the aggregate turnover of both companies to be taken into account.

In the UK, merger control issues arise only if world-wide assets of the business being acquired exceed £70 million or the purchaser and the target are, prior to the transaction, in competition with each other and their combined UK market share exceeds 75 per cent of the total. In the UK, once these thresholds are crossed, the Office of Fair Trading has the power to investigate the transaction and to refer the transaction to the Competition Commission (formerly the Monopolies and Mergers Commission).

The Competition Commission or European Commission has the power to order various remedies including break-up, sales or restrictions on voting powers. However, it is possible to apply for prior clearance.

City Code (Blue Book)

The purchaser or the target may be subject to the City Code on Takeovers and Mergers. The Code applies to companies listed on the Official List as well as the Alternative Investment Market (AIM) and OFEX or companies previously listed at any time during the past ten years. A company is also subject to the Code if it has filed a prospectus offering its own shares at Companies House within the last ten years. Many unlisted public limited companies (plcs) treat themselves as being bound by the Code, particularly if contemplating a listing on the public markets. One of the key provisions of the Code is the requirement that any shareholder or concert party which acquires or offers to acquire shares which will cause it to hold in excess of 30 per cent of the equity capital of the company, is required to make an offer for the whole of the company, unless the offer is 'whitewashed' (ie the other members agree that they do not require such an offer to be made to them). A company with less than 12 members may contract out of the Code if the panel agrees.

Anti-competitive practices

A purchaser should be wary of arrangements or practices carried on by the target that may breach domestic UK or European competition laws. Similar considerations apply to both asset and share purchases. If the same business is to be carried on by the same individuals post-completion, it is likely that the same practices as were followed under the vendor's regime will continue. Following the introduction of the Competition Act 1998, UK and EU competition laws are very similar.

European law applies in relation to arrangements that may affect trade between member states whereas UK law applies to arrangements that may affect trade within the United Kingdom. Note that both regimes catch informal arrangements and understandings as well as formal written agreements. Arrangements that are problematic are arrangements that prevent, restrict or distort competition. There are two categories of agreement or arrangement, namely:

- horizontal: arrangements or agreements between different parties operating at the same level in the market, ie those that are ostensibly in competition with each other. Such arrangements include agreements about pricing, carve-ups of territory and agreements not to compete with one another.
- vertical: agreements or arrangements between different parties operating at different levels in the market place, eg manufacturer and retailer. Such arrangements include restrictions on sale prices, and where and to whom goods may be sold.

A block exemption may apply – perhaps the best known is the block exemption allowing exclusive distributorships in the motor trade. However, if there is a suspicion by the purchaser that there are anti-competitive agreements or arrangements in place, individual exemptions should be obtained from the relevant authorities. If no exemption has been obtained, there is the risk of a significant fine being imposed. Also highly significant from the purchaser's perspective is an understanding of the extent to which the profitability of the business or company being purchased depends upon anti-competitive practices, which may not continue.

Before the Competition Act 1998 came into force, a different regime applied under the Restrictive Trade Practices Act 1976. This was a registration-based system whereby restrictive agreements were required to be registered with the Office of Fair Trading. Proof of the registration of any such agreements should be sought. Unregistered restrictions will be void.

Prohibitions imposed by both European and UK domestic law on the abuse of a dominant market position are more likely to be of relevance only in larger transactions or in relation to a business where the market is small. For this purpose, 'dominant' means the ability of a business or company to act independently of market forces, and is generally presumed if a business controls over 50 per cent of a particular market. Prohibition on abuse would apply to such practices as excessive pricing, refusal to deal with specified customers or groups of customers, or the imposition of onerous terms such as an obligation to buy further goods and/or services as a condition of the original sale. The acquisition by a purchaser of a competitor may have the effect of creating a combined entity that has a dominant market position. In addition, there is the possibility of the target having previously abused its dominant market position. The penalties include fines, in the case of Europe-wide markets, of up to 10 per cent of world-wide turnover of the group of companies in question.

Property issues

On sale of a limited company, the purchaser should be aware that a transfer of the shares of the target might fall within the definition of an assignment of the lease of the target's premises. Accordingly, landlord's consent may be required, even if there is no change of tenant.

Obtaining landlord's consent can be frustrating and time-consuming – the landlord and his lawyers have little incentive to comply with the timescale set by the vendor and purchaser. Sometimes such problems can lead to a 'view' being taken on obtaining the consent before completion. Sometimes an informal indication of the availability of the consent will be given, and the legal mechanics of the consent will follow later. Obviously much depends on the importance of the property to the business or company being acquired and an analysis of the ramifications, in practical terms, if consent is ultimately not given.

The effect of the Landlord and Tenant (Covenants) Act 1995 (which operates in certain cases to reverse the previous rather draconian position where an original tenant was always liable under a lease irrespective of subsequent assignments) means that landlords are more careful about assignment clauses and to whom they allow an assignment to be made, since they will no longer have the covenant of the original tenant to rely upon. Note that this only applies to post-1996 leases: a target which was a former tenant of an older lease may be contingently liable for premises no longer occupied if the current tenant defaults. A landlord may not unreasonably withhold consent, although this does not apply where a lease contains an absolute prohibition on assignment.

The purchaser should also be alert to the possibility of a tenant being exposed to claims from a landlord under the current lease – for example, repairing and/or decorating obligations.

Environmental issues

Concerns about environmental law fall broadly into two categories – namely, liability in relation to past breaches by the target or its predecessors and current practices.

Past breaches

Past breaches usually relate to contamination of land. Other breaches such as the release of chemicals into the atmosphere are naturally going to be much more difficult to prove. However, where a target company has in the past breached environmental laws its poor past track record may make it an unsympathetic target for prosecutors despite the new ownership. A minor infraction could result in a heavy penalty.

In relation to land, the Environment Act 1985 can make an occupier of land liable for clean-up costs, even if the current occupier was not the polluter. The responsibility for the remediation of contaminated land is primarily that of the polluter, but if the polluter cannot be found (eg if committed by a now-defunct company) environmental authorities can impose clean-up costs on the current owner of the land or even a tenant or other occupier. The degree of due diligence to be undertaken in relation to land depends upon the nature of the site. Greenfield sites are less likely to be contaminated than the site of a former chemical works. The nature of the business carried on on the site is also relevant. A relatively inexpensive 'desktop' survey can be helpful and will provide information about prior use of the site, groundwater levels and extraction points etc. One such desktop survey commissioned by a client of the author included the provision of photographs taken by the Luftwaffe (presumably with a view to bombing the site in question!). If there are doubts, expensive physical inspections may be necessary. This will usually involve drilling sample boreholes and making an analysis of the soil. Boreholes may need to be drilled through concrete floor plates, causing disruption and leaving open the issue of who is to be responsible for rectification of damage caused by drilling. Physical examinations can have a detrimental effect on the timing of a transaction.

Current practices

The purchaser needs to be comfortable that the target is complying with all relevant laws. If the business is carried on a 'prescribed process' without a licence, a regulatory authority could close the business down. There could also be costs associated with effecting compliance. Other current practice compliance issues include dealing with waste management and the possible need for a waste management licence. Even if a waste management licence is not required, the producer of the waste will need to ensure that the person who disposes of the waste has appropriate licences and facilities. In addition, there are obligations in relation to the recycling of waste packaging material and consents required for the discharge of certain trade effluents into public sewers.

Group companies and prior transactions

Where assets have been previously transferred at an undervalue, in the context of the insolvency of the transferring company, a court may be asked to make an order to reverse the transaction. Clearly, this would be a disaster for the purchaser of a company or assets from a company which made such a purchase. This is particularly the case in relation to a transaction between companies within the same group, or between persons otherwise 'connected', since the time period after the transaction in question during which reversal may be effected is extended to two years (otherwise six months). Furthermore, there is a case law to the effect that a disposal at an undervalue to a company within the same group, where the disposer has insufficient distributable reserves, constitutes an unlawful return of capital, which may make it susceptible to reversal. Accordingly, a purchaser should be wary of acquiring assets which are the subject of any such disposal.

Summary

Legal due diligence usually plays second fiddle to financial and accounting due diligence, for the simple reason that if the financial questions are not satisfied, a transaction will not proceed. Legal due diligence is usually undertaken by the purchaser's lawyers, sometimes by the provision of a written report. Whether such a report is required depends upon the nature and value of the transaction and the issues arising. Where a deal is funded by venture capitalists or banks, they may insist on a legal due diligence report, addressed to them, being prepared. The principle source of information for legal due diligence will naturally be the target company or business and its documents as well as its directors and managers. In addition, there are various external sources of information such as registries, local authorities etc.

What is a potential purchaser to do with the results of his due diligence investigation? Part of the benefit of the process is to satisfy the purchaser that he is in fact acquiring what he hopes to acquire, and that the benefit of the acquisition will be as anticipated. If defects are revealed, these may be dealt with either by the seller giving a specific warranty in relation to the defect identified or, in more serious cases, an indemnity (which does not required the claimant to demonstrate that loss has been suffered as a consequence of the breach). In more serious cases, a warranty or indemnity may be backed up by part of the sale proceeds being deposited in a separate escrow account, subject to release when the contingency or the issue in question has been satisfactorily dealt with. Such arrangements are frequently linked to mechanisms as regards the price. Clearly, if a defect is identified as being extremely serious, this may lead to a significant price reduction or indeed the deal not going ahead at all. In almost all cases, a reduction in price or a price reduction/adjustment mechanism will be preferable to a claim being made after the transaction has been completed.