1. INTRODUCTION

This guide is a summary of what to expect when involved in the due diligence or disclosure process in the context of private acquisitions and disposals. It can be used by those on the acquisition team who are responsible for negotiating the terms of the deal as well as the managers of the target business who will be responsible for gathering together the due diligence material and making disclosures. It aims to cover issues of concern to both sellers and purchasers.

The due diligence exercise is an important element of any acquisition. It is the means by which a purchaser verifies the deal it has struck. Done properly, “doing due diligence” may help to prevent the purchaser from doing a bad deal. However, what it involves is not precisely defined. Furthermore, as this guide will explain, it is not a process entirely without drawbacks.

Parting with due diligence information helps the seller limit its potential liability to the purchaser. It also draws together the information needed to prepare the seller’s disclosure letter. The seller will need to consider whether disclosing documents poses a problem because, for example, they are subject to third party confidentiality restrictions or legally privileged.

Although traditionally purchaser led, due diligence is increasingly seller initiated as auction sales and data rooms become more popular. Regardless of who initiates the process, the due diligence teams on both sides often comprise a large number of individuals. Not only the parties’ own personnel, but also their legal and financial advisers, accountants and various specialists are commonly involved. This makes clear demarcation of responsibilities, lines of communication and reporting procedures essential. What follows should give a flavour of why this is so important.

Having worked hard on due diligence, the parties’ teams have often run out of steam by the time it comes to dealing with the disclosure letter. This guide seeks to explain why it is important that both parties understand the role of the disclosure letter and appreciate the significance of the disclosure exercise.
2. PUTTING DUE DILIGENCE AND DISCLOSURE INTO CONTEXT

Private acquisitions and disposals

This guide deals with due diligence and disclosure in the context of the sale or purchase of shares in unlisted companies or businesses. Before considering in a little more detail what due diligence and disclosure actually are and why they are done, let's start by putting them into context. When are they done and what else does an acquisition involve?

Basic stages

The following is a very simplified cascade of events:

Traditional bilateral sale

- Striking the basic deal (and sometimes recording it in heads of agreement).
- Information gathering and planning.
- Purchaser due diligence.
- Drafting the principal documentation.
- Negotiating the principal documentation.
- Exchanging the acquisition agreement (often referred to as “signing”).
- If the acquisition is conditional, dealing with the conditions (for example, seeking shareholder approval or various merger, regulatory or industry consents).
- Completing (often referred to as “closing”) immediately after exchange, if there are no conditions, or, if there are, a few days after those conditions have been satisfied.
- Dealing with post-completion matters.

Auction sale

- Information gathering and planning (including despatching information memorandum and setting up data room).
- Seller drafts the principal documentation.
- Data room opens to selected first round bidders.
- Indicative offers by first round bidders.
- Second round bidders short listed.
- Second round bidders continue due diligence and submit final offers (including mark up of principal documentation).
- Striking the basic deal with preferred bidder (and sometimes granting exclusivity).
- Negotiating the principal documentation.
- Exchanging the acquisition agreement (often referred to as “signing”).
- If the acquisition is conditional, dealing with the conditions (for example, seeking shareholder approval or various merger, regulatory or industry consents).
- Completing (often referred to as “closing”) immediately after exchange, if there are no conditions, or, if there are, a few days after those conditions have been satisfied.
- Dealing with post-completion matters.
The role of due diligence

For the purchaser, due diligence forms the major part of the information gathering and planning stage. It involves gathering the information which enables the planning to take place. The purchaser uses the due diligence information to evaluate the business it wants to buy. For the seller, due diligence facilitates its disclosure exercise. Its disclosure of information as part of the due diligence process helps to limit its potential liability to the purchaser and draws together the information needed to prepare its disclosure letter.

The role of warranties and the disclosure letter

Traditionally, it was the warranties set out in a schedule to the acquisition agreement which flushed out information about the target business. Warranties are statements about the company or business (given at exchange and often repeated at completion if there is a gap between the two) which give the purchaser the basis of a claim for damages if they prove to be incorrect and the purchaser suffers loss as a consequence. The warranty schedule, comprising a large number of specific, often repetitive, statements about the target business, was information seeking. One of its major roles was to identify areas of concern to the purchaser. The seller then used the warranty schedule as a checklist for giving information to the purchaser in its disclosure letter. The process of the seller and its advisers checking the accuracy of the warranties, and recording any inaccuracies in the seller’s disclosure letter, gave the purchaser the information it wanted to evaluate the deal it had struck.

Over the last decade, as “doing due diligence” has become an increasingly important element of any acquisition, the checklist function of the warranty schedule has become less significant due to the provision of sophisticated due diligence questionnaires and data room access at the outset of the transaction.

The warranties and the disclosure letter also perform a risk allocation function. To the extent that warranties are given and are not qualified by information given in the disclosure letter, the seller is accepting liability. To the extent that warranties are not given or are limited in their scope by the disclosure letter, the purchaser is taking the risk. The recent general increased bargaining strength of many sellers (particularly private equity sellers) has led to the risk allocation function of warranties becoming less important and their main function is once again that of information extraction.

Overlap

Of course, breaking an acquisition down into stages is a little artificial in that there is a degree of overlap between each stage. For example, the fact that the information gathering process has not been completed will not stop the solicitors drafting the documentation. In fact, the information gathering process will usually continue right up to the point of exchange. Sometimes documents are signed before or at the information gathering and planning stage. For example, the parties may enter into heads of agreement, also known as a letter of intent, which record the basic terms of the deal but are rarely legally binding. The seller will want each prospective purchaser to give it
a confidentiality undertaking before it provides it with any information about the target company or business. The purchaser may well ask the seller to give it the benefit of an exclusivity, or lock-out, agreement, whereby the seller agrees not to sell the company or business to anyone else for a certain period. See Diagram 1.

The timetable

As to the actual timetable in which the deal must be done, this needs to be carefully considered in each case. The desire of the parties (especially the seller) to proceed to exchange as quickly as possible needs to be balanced against the complexity of the business concerned and giving the purchaser sufficient time to digest its due diligence. If the transaction is conditional, this will also impact on the timetable although it is usually in the interests of both parties to keep any gap between exchange and completion to a minimum. It is in neither party’s interest to leave the business “hanging”, uncertain as to where its future lies.
Diagram 1: When due diligence and disclosure are done

- Purchaser carries out due diligence exercise
- Seller gives purchaser its disclosure letter
- Seller makes further disclosures?
- Purchaser uses information gathered to run its new business
- Seller gives purchaser warranties
- Seller repeats warranties?
- Dealing with any conditions
- Post-completion matters
- Negotiating the documentation
- Drafting the documentation
- Information gathering and planning / data room access
- Ex Change
- Completion
- Complet I on

Diagram 1: When due diligence and disclosure are done
3. DUE DILIGENCE

3.1 What is due diligence?

Origins

Due diligence is a term of art rather than science. It means many things to many people. Although many attribute its origins to US securities law, that does not seem to use the words “due diligence” at all. It is a term which has probably been imported across the Atlantic and is, in essence, all about obtaining information on a company or a business by a variety of people for a variety of reasons. Lawyers, bankers and businessmen often talk about “doing due diligence” as if it were a defined term which quite clearly meant the same thing to everyone. In fact, it means different things to different people and different things in different circumstances.

A certain level of due diligence is required where securities are to be issued. Very little is expected where there is a hostile takeover. However, in the context of private acquisitions, the parties have more scope for defining what due diligence means.

It is probably in this context that the due diligence exercise is the broadest and most time-consuming. Throughout the last ten years, the scope of due diligence exercises has become wider and involved a greater number of professional advisers. In many cases, more time is spent doing due diligence than negotiating the acquisition agreement itself.

3.2 Why do due diligence?

Caveat emptor

In English law, the principle underlying the sale of shares or a business is caveat emptor, or “let the buyer beware”. Generally speaking, the seller is under no duty to reveal defects in the company or business to the purchaser. Most purchasers want to make their purchase with their eyes open. They would rather incur costs in carrying out investigations than risk doing a bad deal.

The drawbacks of contractual protection

The caveat emptor principle explains why purchasers seek contractual protection, most notably in the form of warranties, in the acquisition agreement. The warranties provide a contractual post-completion price adjustment mechanism. They do not, however, prevent the purchaser from doing a bad deal. It is the due diligence exercise which gathers the information needed to verify the price the purchaser has agreed to pay, to draft the acquisition agreement (including any specific indemnities which might be needed) and to plan the running of the business post-completion.

Due diligence is not a substitute for contractual protection, but it helps the parties work out what contractual protection is needed. Conversely, contractual protection is not a substitute for due diligence. The protection offered by warranties, while valuable, can be limited or difficult to enforce. For example, to pursue a successful warranty claim, the purchaser needs to establish loss (i.e. that it would have paid less for the shares or business) and it needs to have mitigated that
loss (i.e. taken all reasonable steps to have minimised it). In addition, the acquisition agreement may prescribe a minimum monetary threshold which must be reached before a warranty claim can be brought as well as imposing an overall cap on the seller’s liability under the warranties. Being involved in litigation takes money and management time and even if the purchaser is successful in its claim, there’s always the possibility that the seller may have become insolvent by the time it comes to enforcement.

The drawbacks of accounts

A word of warning about accounts. A purchaser will often review a company’s audited accounts at the negotiation stage when the purchase price is first struck. There have been a number of cases in the English courts (for example, the 1990 House of Lords decision of Caparo Industries v Dickman) which have established that, generally speaking, a purchaser cannot rely on a company’s audited accounts to give it any comfort as to the state of the company or its business unless the auditors have assumed a duty of care to the purchaser. This means that, again generally speaking, a company’s audited accounts are prepared for its existing shareholders and not for prospective investors. This reinforces the arguments in favour of the purchaser both carrying out a careful and considered due diligence exercise and negotiating suitable warranty protection, including appropriate accounts warranties.

Verifying the deal

Most purchasers acknowledge that it is best to investigate a business before committing to buy it. If the purchaser doesn’t like what it finds, it can, at worst, choose to withdraw from the transaction altogether but may change the structure of the transaction (perhaps to an asset rather than a share sale with a view to leaving undesirable liabilities behind), renegotiate the terms of the acquisition agreement (most probably to include an indemnity from the seller) and/or reduce the purchase price. The information the purchaser gathers during the due diligence process provides it with an important bargaining tool.

This is not, however, to say that due diligence is without its drawbacks. The knowledge the exercise gives the purchaser can further limit its ability to pursue a successful warranty claim (see further 3.7, Actual knowledge and due diligence, below). In addition, of course, the due diligence exercise may be time-consuming and add to the expense of the transaction.

3.3 Who does due diligence?

The purchaser’s team

The purchaser’s due diligence team usually comprises not only its own personnel but also its legal and financial advisers and accountants. The role of a purchaser’s own personnel is crucial. Only they are able to assess the commercial importance of and make commercial judgements about the information uncovered. Depending on the nature of the business being acquired, various specialists may be retained by the purchaser to carry out specific due diligence in a particular area. For example, the purchaser may retain IT consultants to carry out a technical audit of the
target’s computer systems or environmental consultants to carry out an environmental audit of the target’s manufacturing sites.

The seller’s team

Likewise the seller may have several individuals including its own employees, employees of the target and its advisers carrying out various tasks on the sale side. The seller needs to select its deal team carefully if it is to manage risk and its responsibility for statements made by such individuals. Clear lines should be established determining who is responsible for answering due diligence questions and who has authority to negotiate the deal on its behalf. Before a person is brought into negotiations, the seller must consider whether it is prepared to stand behind that person’s statements.

Responsibilities and reporting

Due to the number of people involved in a typical due diligence exercise, it is important that there should be both a clear demarcation of responsibilities and clear lines of communication. The different areas of responsibility assumed by advisers are typically set out in terms of engagement which describe the scope of the advisers’ work and their responsibilities as well as dealing with other issues such as fees. Often the purchaser’s solicitors will take responsibility for co-ordinating the exercise on behalf of the purchaser. Similarly, the seller’s solicitors will often assume this responsibility on behalf of the seller. Clear reporting procedures are vital. Each individual involved in due diligence needs to understand who they are acting for and reporting to.

Legal due diligence

The purchaser’s solicitors are usually responsible for carrying out what is known as the “legal due diligence”. Exactly what this involves needs to be agreed upon between the purchaser and its solicitors. Among other things, it typically involves reviewing all, or sometimes just the key or material, contracts to which the target is a party. This may involve reviewing and summarising the principal terms and identifying, for example, whether the contract would be affected by a change in control of the target company where the acquisition is a share sale or whether it is assignable in the context of an assets sale. The results of this exercise are usually set out in a legal report. Other professional advisers may also prepare reports, most notably any investigating accountants and possibly tax and environmental specialists, pensions actuaries and insurance brokers.

3.4 The due diligence questionnaire

Drawing up the questionnaire

Traditionally, the purchaser’s solicitors will draw up the due diligence questionnaire which initiates the due diligence process. Where, however, the sale is by way of a tender or auction process, the seller initiates the due diligence process (see further 3.6, Data rooms, below). The traditional due diligence questionnaire sets out the areas to be addressed and provides a list of questions to be put to the seller. Each section is usually self-contained so that it can be dealt with by the appropriate personnel and advisers of both the seller and the purchaser. The due diligence
questionnaire should begin by defining any materiality levels which have been agreed by the parties in respect of any particular set of questions with a view to limiting the number of items to be examined. This will not only save time and expense, but should mean that the parties focus on key issues. For example, in the section dealing with contracts, a materiality level may be decided upon by reference to the value of contracts or their duration. Where, however, there are many similar contracts each with a low value but significant when taken together, the purchaser will often elect to look at samples of these.

Reviewing the questionnaire

The legal due diligence questionnaire should be carefully reviewed by the purchaser’s personnel (or the seller’s personnel where information is being gathered by the seller to set up a data room) to ensure that the due diligence questions are relevant and to add any additional questions which may be specific to the business in question. For example, environmental due diligence questions may be particularly important where the target is a manufacturer whereas when considering a marketing consultancy business the due diligence questions would be more likely to focus on arrangements with employees. If the seller has already given the purchaser or its investigating accountants certain information about the business (or in the context of an auction sale the seller’s accountants have prepared a financial vendor due diligence report), the due diligence questionnaire should not duplicate requests for that information. Ideally, the questionnaire should be both relevant and focused. It needs to be comprehensive but without being irritating. See Diagram 2.

3.5 Gathering and analysing due diligence material

Clear instructions

Clear lines of communication need to be established internally by both parties. The seller’s team and its advisers need to know who is responsible for answering which questions and the purchaser’s team and its advisers need to be clear about who is analysing the answers and copy documents received or made available in the data room and to whom they are reporting their findings. This is particularly important as the personnel carrying out the due diligence are unlikely to be the same individuals as those who are negotiating the terms of the deal, although there may be some overlap. It is important that both the purchaser and the seller make personnel of appropriate seniority available to oversee the due diligence process internally. This helps it to run as smoothly as possible and ensures, for example, that information is gathered or requested within the agreed timescale.

Those involved in the due diligence exercise need to have clear instructions from those putting the deal together as to what they should be looking for. Asking members of the due diligence team to report back on “anything unusual” is not particularly meaningful taken in isolation. Purchasers often put together a pro forma template of commercial considerations to be considered when, for example, its personnel review a contract. Its legal advisers will often have a similar template dealing with purely legal considerations. Taken together, these help to give the purchaser the overall picture it needs.
Initial due diligence questions

- Definition of any materiality levels
1. Corporate structure
2. Accounts
3. Contracts and commitments
4. Insurance
5. Trading
6. Bank accounts and borrowings
7. Licences
8. Litigation and claims
9. Competition
10. Ownership and condition of assets
11. Intellectual property
12. Information technology
13. Property
14. Environment
15. Employees
16. Pensions
17. Taxation
When gathering the due diligence information together to present to the purchaser, the seller’s team needs to be aware of three potential difficulties which are often overlooked, namely third party confidentiality issues, legal privilege and data protection.

**Third party confidentiality**

Certain contracts may contain confidentiality clauses which mean that copies of them cannot be disclosed to, and their subject matter cannot be discussed with, the purchaser unless the other contracting party gives its consent. In most circumstances, timing and confidentiality considerations prevent that consent from being sought. In some cases, it may be possible to blank out the confidential features of a document before sending a copy to the purchaser. In others, giving generic information, for example about a class of contracts, might not involve breach of a third party confidentiality restriction. The specifics of confidentiality clauses vary considerably and need to be addressed on a case by case basis. The seller should aim to identify, as early as possible, which contracts are affected by this issue.

**Legal privilege**

With regard to legal privilege, it is a general rule that documents relevant to litigious proceedings must be disclosed to the other side unless they are privileged. Where documents are prepared for the purpose of giving legal advice, they attract legal privilege and need not be disclosed. As a consequence, a document produced specifically for a potential purchaser commenting on proceedings would not be privileged. Producing such a document is, therefore, potentially risky. In addition, privilege can be lost where a privileged document is used for a non-privileged purpose. Accordingly, a letter of advice commenting on the chances of a litigation suit succeeding would risk losing privilege if shown to a potential purchaser. It would be being used for a non-privileged purpose, namely to enable the purchaser to assess the impact of the litigation on the value of the business it is proposing to buy. The seller needs to consider this issue with its legal advisers before disclosing privileged documents.

**Data protection**

The Data Protection Act 1998 requires that a person who controls personal data must comply with certain data protection principles. These principles include a requirement that processing (including disclosure) of the data must be fair. In addition, the data controller must specify the purposes for which he is obtaining the data and the data are not to be processed in any manner incompatible with those specified purposes.

“Personal data” for the purposes of the Act is data relating to a living individual: the Act does not apply to data about companies. “Data” includes manual data recorded as part of a relevant filing system, in addition to data held in a form in which it can be processed by computer. A “relevant filing system” is a set of information relating to individuals to the extent that it is structured, either by reference to individuals or by reference to criteria relating to individuals, in such a way that specific information relating to a particular individual is readily accessible. For example, if a list of employees, or a list of customers or suppliers which includes details of individuals, is made available to a purchaser there may be a technical breach of the data protection principles. The
Information Commissioner has expressed the view that in these circumstances such data should be anonymised as far as possible and disclosed on the basis that they are to be used for the purpose of assessment of the purchase only and destroyed or returned once they are no longer required.

Tracking information

The seller and its team will need to track the information given to the purchaser and should maintain an efficient indexing system. This will enable it to ensure that the information is formally disclosed in the disclosure letter and to rely on the fact that the information has been given to the purchaser in defending any warranty claims (as to which see 3.7, Actual knowledge and due diligence, below). Similarly, the purchaser and its team need to keep track of information received. Documents received in response to the initial due diligence questionnaire or made available in the data room will doubtless lead to supplementary queries. It is sensible for the purchaser and its team to maintain a master copy of all questions raised (to be ticked off when dealt with) and copy documents received. The seller and its team should, similarly, keep a record of questions answered and copy documents sent to the other side. Original documents should not be parted with and a complete set of copy documents disclosed during the due diligence process should be kept by the seller.

3.6 Data rooms

A common due diligence tool

Traditionally, the due diligence exercise is led by the purchaser’s solicitors originating a due diligence questionnaire. Where a company or business is to be sold by way of a tender or limited auction process, the seller usually initiates the process by establishing a data room. As the seller will be dealing with a number of bidders, it needs to take control of the due diligence process to avoid duplicating its efforts in responding to several different potential purchasers’ inquiries. It will also want to keep control over the dissemination of its confidential information. It will, therefore, usually conduct its own internal due diligence investigation, gathering and cataloguing information in response to a due diligence questionnaire prepared by its own solicitors. The results of the internal investigation will be evaluated by the seller’s personnel and advisers and relevant and appropriate information given to the shortlisted bidders.

Providing documents to the bidders

Access to the due diligence information will normally be given in a data room. The data room may be a hard copy paper data room typically located at the offices of the seller’s solicitors or its financial advisers. Recently, virtual data rooms have become popular. A virtual data room is the on-line equivalent of the conventional, hard copy data room. A data system, available over the internet, stores documentation to be accessed by potential purchasers of the company or business for due diligence purposes. Most of the documentation will need to be scanned before it can be made available in this way. A virtual data room allows multiple access by different bidders at the same time streamlining the due diligence process.
Where a paper data room is set up, the seller usually lays down a procedure for its operation. Typically this covers larger issues such as confidentiality and copying but also extends to prescribing the arrangements with regard to the supply of refreshments and smoking in the data room.

**Understanding how the data room has been set up**

A purchaser visiting a data room will need to ensure that it understands how the data made available to it in the data room has been collected. It needs to understand the questions which have been asked (by the seller of itself) and what materiality thresholds have been applied in gathering documents. In the light of that understanding, the purchaser will need to ensure that any gaps are plugged.

### 3.7 Actual knowledge and due diligence

**A potential drawback**

The more comprehensive the purchaser’s due diligence exercise has been, the greater its knowledge of the business being acquired. While the obvious advantages of this have already been described, one potential drawback is that this knowledge may affect the purchaser’s ability to bring a warranty claim post-completion.

**What if the seller omits a disclosure?**

The scope of the warranties will be limited by disclosures made in the disclosure letter (see further 4.2, *What is the function of a disclosure letter?*, below). What if the purchaser has actual knowledge of something which is not disclosed in the disclosure letter? Can it nevertheless bring a successful warranty claim? The seller will argue that, if the purchaser was aware of the relevant facts before it entered into the acquisition agreement, it will have taken this into consideration in agreeing the price it would pay. Therefore, even if there is a breach of warranty, the purchaser cannot show that it has suffered any loss as a consequence and will only be awarded nominal damages.

The position remains unsettled. Acquisition agreements often attempt to deal with the problem contractually by specifying that no information of which the purchaser has actual knowledge (other than the disclosures in the disclosure letter) will preclude it from bringing or affect any warranty claim or reduce any amount recoverable. However, a case in this area (the 1991 Court of Appeal interlocutory decision of *Eurocopy v Teesdale*) suggests that even where such wording is included in an acquisition agreement, the purchaser’s actual knowledge may nevertheless affect warranty claims. That case was only a striking out application, as opposed to a full hearing, and so has no binding precedent value. A more recent case suggests that regard must be had by the court to the terms agreed in the acquisition agreement by the parties about the effect the purchaser’s knowledge would have on a warranty claim. Again this view has no binding precedent value. Such wording does, therefore, continue to be resisted by the seller and sought by the purchaser.
Whatever the outcome of that argument, the purchaser needs to be aware that any omission on the part of the seller to disclose information in the disclosure letter may not work to its advantage where it has actual knowledge of the matter. Similarly the seller needs to use all the due diligence information it has gathered to draft the disclosure letter with a view to ensuring that the disclosure exercise is as comprehensive as possible. It may find that its team, having worked hard on the due diligence exercise, has run out of steam by the time it comes to disclosure. It is important that the seller and its team appreciate the importance of the disclosure exercise (see further 4.2, *What is the function of a disclosure letter?*, below).
4. DISCLOSURE

4.1 What is a disclosure letter?

As its name implies, a disclosure letter takes the form of a letter. It is signed at the same time as the acquisition agreement to which it relates and sets out information about the target company or business which is inconsistent with the warranties set out in that acquisition agreement. The acquisition agreement will make specific reference to the disclosure letter providing that it operates so as to limit the scope of the warranties.

4.2 What is the function of a disclosure letter?

From the seller’s point of view, the sole function of the disclosure letter is that it limits its liability under the warranties in the acquisition agreement. Traditionally, the disclosure letter has two principal functions from the purchaser’s point of view. First, it flushes out information about the target business which may be pertinent to the running of that business and which will not necessarily have been flushed out by the due diligence exercise. Secondly, it identifies various potential problem areas which may lead to the structure of the transaction changing, the terms of the acquisition agreement being renegotiated (probably to include indemnities from the seller) or the purchase price being renegotiated. In extreme cases, problem disclosures can lead to the purchaser withdrawing from a transaction.

As due diligence exercises have become more sophisticated and comprehensive in recent years, it is the risk allocation, rather than the information giving function, which has become increasingly significant from the purchaser’s point of view.

4.3 What does a disclosure letter look like?

As mentioned, a disclosure letter takes the form of a letter written from the seller to the purchaser. The body of the disclosure letter itself consists of various numbered paragraphs which fall into one of three categories, namely interpretation provisions, general disclosures and specific disclosures. In addition, the disclosure letter will have attached to it copies of documents which are referred to in the disclosure letter, the contents of which are also disclosed. These are usually initialled by or on behalf of both the purchaser and the seller for the purposes of identification and are together known as the “disclosure bundle”.

4.4 General disclosures

Typical general disclosures

Unlike specific disclosures which are tailored by the seller to the particular target company or business and so different in the context of each acquisition, general disclosures are subject to some standardisation. Examples of general disclosures commonly encountered in a seller’s first draft disclosure letter are those relating to:

> Searches - the purchaser is deemed to have full knowledge of all matters which would be revealed by a search against the target company, for example, at Companies House.
> Statutory books - all matters disclosed in the statutory books of the target company, including its board minutes, are deemed to be disclosed.

> Accounts - all information contained or referred to in the audited accounts for, say, the last three years, the notes to and reports on those accounts is deemed to be disclosed.

> Correspondence - all correspondence which has passed not only between the seller and purchaser but also as between their respective employees and professional advisers is deemed to be disclosed.

> The due diligence exercise - all matters uncovered by the purchaser in the course of its due diligence exercise or the documents listed on the data room index are deemed to be disclosed.

General disclosures like this will be the subject of negotiation between the parties’ respective solicitors. For example, the purchaser’s solicitors will almost certainly seek to strike out the public domain disclosure and while accepting the searches disclosure may want to limit it to documents filed in the recent past, for example, the last three years.

**Fair disclosure**

Until recently, perhaps the most important thing which the seller needed to appreciate about general disclosures is that they did not necessarily give it the protection which they might appear to and were therefore no substitute for specific disclosure. The balance now appears to be moving in favour of the seller.

Previously a number of cases established a disclosure test which inclined in favour of the purchaser (the 1996 interlocutory Court of Session decision in *New Hearts Limited v Cosmopolitan Investments Limited*) by suggesting that disclosures must be specific, some might say “fair”, if they are to afford the seller any protection. The judiciary said that merely giving the purchaser the means of working out a disclosure will not necessarily constitute disclosure and that disclosure requires some positive statement of the actual position. However, more recently the judiciary has said that there is no general rule that disclosures must be construed restrictively and that they should be construed in accordance with the agreed disclosure standards in the acquisition agreement.

### 4.5 Specific disclosures

**Target specific**

These are the disclosures which are tailored to each particular transaction and often identify the potential problem areas which could lead to last minute renegotiation of the deal.
Identifying problem areas

For example, assume that an acquisition agreement contains a warranty that no legal proceedings have been issued against the target company. If no disclosure is set out in the disclosure letter revealing that proceedings have been issued (and provided the purchaser has no actual knowledge that they have), then any liability which might arise in respect of proceedings which in fact have been issued would rest with the seller.

Supposing the seller discloses that proceedings have been issued; this would deprive the purchaser of any breach of warranty claim in respect of those proceedings.

If a substantial sum was being claimed, the purchaser may ask the seller to give it an indemnity not only in respect of those proceedings but more generally in respect of others which may be issued in the future arising from similar circumstances. This would clearly put the risk of any liability back on the seller.

The purchaser may also ask for a retention, namely that part of the consideration monies will be held back (until the outcome of the litigation is known) and applied towards any actual liability which arises.

Furthermore, if, following further investigation by the purchaser, it felt that it was possible there might be many similar claims, and it was not possible to quantify what the ultimate liability might be, the purchaser may withdraw from the transaction altogether or, if it has been structured as a share sale, consider proceeding by way of an asset sale.

4.6 Timing issues

The first draft

The purchaser will want to see the seller’s first draft disclosure letter as soon as possible with a view to having all potential issues on the table as early as possible. Delivering the draft disclosure letter to the purchaser may not be as high on the seller’s list of priorities. The purchaser and its solicitors need to press for the first draft as soon as the warranty schedule is in a form which is unlikely to change substantially. Typically, the most sensitive disclosures (such as those which risk loss of legal privilege) are held back until the seller is confident that the transaction will exchange. This creates a tension in that by doing so the seller risks the purchaser seeking substantially to renegotiate or even pull out of the transaction at the last minute if the purchaser views those disclosures as material.

Agreeing a cut-off time

The disclosure letter will be constantly updated, possibly several times a day the nearer exchange looms, and so the purchaser’s solicitors might seek to agree with the seller’s solicitors a cut-
off time for making disclosures. If, however, last minute disclosures are in fact sent through, it may be difficult for the purchaser to refuse to accept these on the basis that it may have actual knowledge of a problem which could in any event prejudice its ability to bring a warranty claim.

The gap between exchange and completion

There is often a gap between exchange and completion where, for example, consents or clearances need to be sought to enable the acquisition to proceed. In these circumstances, the purchaser will usually ask for the warranties which have been given as at exchange to be repeated as at completion. This presents the seller with a problem in that matters may arise between exchange and completion which it also wants to disclose. The purchaser cannot agree to a second disclosure letter to be handed over on completion setting out any disclosures as against the repeated warranties. By that time, it will be too late for the purchaser to tackle any problems which those additional disclosures might reveal. The terms of the deal will have been struck at exchange. A compromise which may be reached is that the seller can make additional disclosures but, on reviewing them, the purchaser should then be presented with a choice of either withdrawing from the transaction or proceeding to complete on the basis that the warranties have been further watered down by any additional matters disclosed.

4.7 Actual knowledge and disclosure

If the draft disclosure letter does reveal a potential problem, then, bearing in mind the discussion about actual knowledge above (see 3.7, Actual knowledge and due diligence), the purchaser cannot seek to deal with the problem by simply deleting the offending disclosure. The problem needs to be tackled head-on. This means that specific disclosures in particular are really subject to limited negotiation. Any negotiation will focus on making them as clear and unambiguous as possible and in confronting the potential problems they may throw up.

A word of warning here. A seller is bound to make controversial or difficult disclosures, even where it suspects this may lead to the purchaser withdrawing from the transaction or requesting an indemnity, otherwise it may incur criminal liability under section 397 of the Financial Services and Markets Act 2000 in addition to possible liability under the common law. The effect of that section is that where, in the context of a share deal, a seller dishonestly conceals any material facts, he is guilty of an offence if he does so for the purpose of inducing, or is reckless as to whether it may induce, the purchaser to enter into the share purchase agreement. Anyone convicted under that section can face an unlimited fine and up to seven years’ imprisonment.

In addition, under the Fraud Act 2006, the offence of fraud may be committed in a number of ways, including fraud by false representation and by failing to disclose information where there is a legal duty to disclose (e.g. by statute or written contract). Penalties by way of fines and imprisonment up to 10 years apply to fraud.
4.8 Data rooms and disclosure

Where the seller has dealt with the due diligence exercise by establishing a data room, it may seek to disclose everything in the data room by way of a general disclosure in its disclosure letter. The purchaser’s solicitors will almost certainly strongly resist such a disclosure. In any event, the seller needs to be aware that deemed disclosure of everything in the data room may not work (see 4.4, General disclosures, above). The purchaser also needs to acknowledge that, regardless of whether or not such a disclosure is agreed to, if it and its advisers have reviewed the data room material, any actual knowledge of a matter might prevent it from bringing a warranty claim in any event (see 3.7, Actual knowledge and due diligence, above).

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This paper provides a summary of due diligence and disclosure procedures under English law. It is not intended to contain definitive legal advice which should be sought as appropriate in relation to any particular transaction. If further information or advice is required, please contact your usual adviser at Slaughter and May.

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