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IMPORTANCE OF DUE DILIGENCE OVER CONTRACT IN COMMERCIAL TRANSACTION

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Abstract

The researcher, in this research paper explains about the term “**due diligence**”. This research paper talks about why pre – transactional due diligence is necessary in today’s business world. Here, it is further explained that why it is important to adopt it as a smart move before making any transactional decision to avoid any disputes, litigation issues or arbitration procedures between the companies or parties. As the researcher made you understand about the geography of the term ‘due diligence’. The research paper now talks about two things, from which first question which arises in every person’s mind is due diligence should be mandatory before any commercial transaction or forming any contract or not? And the next question which arises in human mind is that does the process of investigation during due diligence infringes the fundamental rights or we can say the right to privacy of any person? With these research questions the researcher concludes the research paper on the topic ‘**The importance of due diligence over contract in commercial transaction**’.

Keywords : Due diligence, Transactional, litigation issues

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INTRODUCTION

To make most literal meaning of the term, “due diligence” is an active and workable procedure to ensure that the parties involved in a commercial transaction respects human rights and are not contributing in any future conflicts. As India has a complex economic, regulatory, and legal landscape for doing business. In India, the success of a business venture is dependent on company’s ability. The success of a company is linked to the mitigation and risk management strategy. In this scenario, due diligence becomes a powerful tool which should be utilized by a company dealing with Indian businesses. It is ensured by due diligence process that the company manages with the risk before a business transaction. Transaction covered for due diligence process are M&A (Mergers & Acquisitions), partnership, joint ventures, public offers, property contracts, etc. It makes absolute business sense. It should be used as a paramount by all the parties involved in a commercial transaction. Due diligence should be made mandatory as nowadays people doesn’t want to get involved in any kind of litigation and arbitration issues. As people avoid being indulged in the process of due diligence thinking of the budget or the expenditure of the process the later results prove that the investigation of due diligence process consumes lesser money than the court cases of breach of contract or damages costs. While understanding the process of due diligence the investigation and questionnaire part lets us think about the infringement of the fundamental right of the target party or the right to privacy of the target party.

IMPORTANCE OF DUE DILIGENCE IN VARIOUS AREAS

- **In Mergers and Acquisitions**

If the question is that why due diligence is important in the transactional process of merger and acquisitions, the common answers to this question will be something like, “to get the seller the best deal” or “to get the most of the money of the buyer”. At some extent these answers are relevant. The exact reason of due diligence being important to mergers and acquisitions process from a buyer’s perspective to know the how’s and what’s of the business, about the management of business and its owners. The due diligence helps us understand the synergies and potential scalability of the business. It gives more access to customers from the buyer’s company.

- **In partnership**

Volkswagen AG and its affiliates value their reputation as an ethical company with high standards of integrity and high regard for complying with the law. Volkswagen’s Group Policy 29 on “business partner due diligence” (section 1.1) requires that all business partner intermediaries engaged by Volkswagen are to be

selected following thorough, documented due diligence process designed to assure that Volkswagen and the business partner get a long-term, collaborative relationship.² This statement lets us understand that many companies use diligence process as a rule or policy in their company to further avoid any issues related to the partnership.

- **In public offers**

Due diligence is regularly carried out by a company in the case of a planned public offering (IPO), to assess the market maturity of the IPO candidate. The investigation carried out in the process of due diligence must give the correct and complete information. In any case if the information is false, the issues and the supporting banks will be made liable for the damages faced by the pursuant.

- **In property or land contracts**

“A person is said to have notice” of a fact when they actually know that fact, or when, but for willful abstention from an inquiry or search they ought to have made, or gross negligence, they would have known it.³ The scope of due diligence is very wide in real estate contracts as it can be done in my forms. The characteristics of the title of property, the transaction or the property itself encourages the buyer to get involved in the investigation of the property or to know about the further use of property. It is very crucial to evaluate the responsibilities of the sellers and buyers in real estates contracts without being into the process of due diligence.

PROCEDURE OF DUE DILIGENCE

The procedure of due diligence is very time consuming and evaluative but at the same time it is very beneficial to adopt the procedure of due diligence. The procedure is mainly conducted in the form of levels of investigation. After completion of the process of due diligence the report mainly focuses on some confined areas which will be further explain in this chapter. The levels of the procedure are here described: -

- **LEVEL 1** – this level initiates with organizing a due diligence team to start investigating on the documents provided and the scope of the deal. Further it works on the investigation about the issuer of the process, the target party and about the synergies between their deals.

² <http://www.volkswagenag.com>

³ Section 3, transfer of property act, 1882.

- LEVEL 2 – here in this level the data room is created whether it be physical or online. In these data rooms the presentation about the research done on the documents, the detailed study done on both the parties and the scope of the deal is presented before the client. These presentations clarify the doubts based on false agreements and the reputation of the parties.
- LEVEL 3- third level of the procedure involves independent interviews of the parties and separate questionnaire rounds. After these interviews and questionnaires, the due diligence team compiles the results and arrange a meeting of the parties which further includes a group discussion about the deal.
- LEVEL 4- the last but not the least level of the procedure which compiles all the investigation and studies into a report which helps both the parties to draw a conclusion over the do's and don't of the deal.

Areas of focus in the due diligence report

- Viability – to get the clarified picture about the viability of the company the due diligence team studies about the financial planning of the party or the company.
- Monetary aspects - it is necessary to know about the monetary schemes of both the parties which shows that the transaction can be fulfilled with or without any issue.
- Environment – no person can work in isolation which further proves that one should have a work environment and studying about that work environment makes the report more doubt free.
- Existing liabilities of the party- it is the main feature of a due diligence report which make us take a sigh of relief that the person or company with whom one or the existing company is making contract does not have any pending litigation or regulatory issues.
- Synergy's effect – it is very important to built a synergy or relationship between two parties or companies to agree on the conditions to form a valid contract.
- Personnel – this also could be as important as the effect of synergy, monetary aspects or the liabilities of the party because it is very important to know about the one whom we are forming a contract with that why he/she is making the contract or how he/she is managing with his/her capability.
- Technology – this is important in the case of mergers and acquisitions; it talks about the technology target company is presently having or they are going to provide what machineries. It will let the existing company decide the future plans about installing new technology.

Due diligence should be made mandatory?

According to the research, the process of due diligence has certain merits and demerits which will be discussed below and on the basis of those merits and demerits the conclusion will be drawn that it should be mandatory or not in India. After discussing the merits and the demerits of the pre – transactional due diligence the further discussion will be about although this process includes demerits but then also emendation of this procedure will be beneficial for the whole society, how? At the last the in this chapter the discussion will be about the position of the due diligence made mandatory in other countries and the position of taking it seriously in India.

Merits or the reasons to adopt it: -

- Protects from losses and damages - conducting pre transactional due diligence will help to know the history and geography of the party whom with the contract is made which will further decrease the risk of breach of contract or the damages. This results in the protection from damages.
- Affordable – if one is not involving in any such procedure and later on faces damages or litigation issues, one has to hire a lawyer or a litigation professional to deal with that issue for the party in problem. The hiring of litigation or arbitration professionals will cost very high and the cost of due diligence procedure will be lesser than that. This proves that it is much better to use this method before entering into any such contract. Hence, it is affordable than the court case expenditure.
- Time saver for the parties – rather than involving in a time-consuming litigation or arbitration procedures one should hire a due diligence professional which will consume less time of the both the parties involving in a commercial transaction.
- Lessen the burden of legal professionals – if the process will be adopted by every person before getting involved in commercial transaction, there will be lesser chance of facing damages and involving into a litigation issue which will further decrease the number of contractual cases.

Demerits of due diligence: -

- Impact on the reputation – the whole history geography of the deal makes a bad impact on the reputation of that one party who has some small issues dealing with its managing or monetary aspects.
- May infringe fundamental rights – the procedure can infringe the right to privacy of a person about whom the investigation is to be done if the person himself has not given the consent for it.
- Lack of information – sometimes getting information about some technical things is not possible which can contribute to the future risk to of the transaction’s failure.

In spite of having these demerits this procedure is still beneficial for the business society, why?

Here is an explanation, as we discussed about both the merits and the demerits of due diligence, we give the answer of this general question that these demerits will not affect the parties as much as the damages or the legal issues will do. These demerits will be affecting accordingly to the area of transaction but the merits also cover up the risk caused by the demerits.

Position of due diligence in India –

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. Banks have been advised to ensure that a proper policy framework on ‘KNOW YOUR CUSTOMER’ and Anti-Money Laundering measures is formulated with the approval of their board and put in place. This master circular aims at consolidating all the instructions/guidelines issued by RBI on Know Your Customer (KYC) norms/ Anti-Money Laundering (AML) standards/Combating Financing of Terrorism (CFT) / obligations of banks under PMLA 2002.⁴

No law or statute defines the term ‘due diligence’. However certain parties have to undertake the process of due diligence, made mandatory by the Securities and Exchange Board of India (SEBI). The Book Running Lead Manager (BRLM) is required to adopt and practice due diligence to know about all the aspects of issue. It 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.⁵ 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.⁶ A qualified institutions placement shall be managed by BRLM(s) registered with the Securities and Exchange Board of India who shall exercise due diligence. The Book Running Lead Manager, 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.⁷ The lead banker is required to submit, after the issuance of observations by the Securities and Exchange Board of India or after the expiry of the stipulated period, if the SEBI has not observations, a due diligence certificate at the time of registering the prospectus with the Registrar of

⁴<http://www.rbi.org.in>

⁵ Regulation 64, chapter IV, ICDR Regulations.

⁶ Regulation 65, ICDR Regulations.

⁷ Regulation 83, ICDR Regulations.

Companies.⁸ the Book Running Lead Manager is required to submit to the SEBI along with the offer document, a due diligence certificate including additional confirmations.⁹

All these regulations show that in India the due diligence is mandated at some commercial transactions but these transactions are very huge at their place. If the process of due diligence will be mandated at every small or huge transaction that it will be so much of benefits.

Does the process infringe fundamental rights?

This is one of the most obvious question anyone can come up with that is it possible that the process of investigation about someone's property or business may infringe fundamental right or we can say right to privacy of a person?

According the research done on the procedure of pre transactional due diligence, the answer would be 'no' because there is always an agreement made by both the dealers or the parties before indulging into this procedure. The agreement we are talking about is helpful in making the parties aware of the investigation part of the process and taking permission from them to move forward with the procedure. As per the law if you trespass someone's privacy then it will be an offence. But as per the agreement the due diligence team takes consent of both the parties involving in the procedure. Therefore, the process of investigation during due diligence does not infringe the right to privacy of any of the party.

⁸ Regulation 8 (2)(b), ICDR Regulations.

⁹ Regulation 10 (3)(a), ICDR Regulation.

CONCLUSION

In this research paper we talked about the importance of pre transactional due diligence, we also got to know about the importance of this process. As we discussed the reasons to adopt this procedure, we also talked about the areas of transaction covered by due diligence. This paper also lets you know about that how this process works in four levels and then the areas of focus in the due diligence report. After conducting this process what will be the advantages and the disadvantages faced by the parties and how much each of them will affect their deal. Now as we are known to the environment of this term we talked about the emendation of this process before indulging into any type of commercial transaction. If this process will be made mandatory there would be a huge positive effect on the business world. At last we discussed about the infringement of right to privacy because of this procedure, which is not correct. After completing the research, we can conclude that this process does not infringe any fundamental right and making it mandatory will help the business world to work more efficiently and damage free.