

Legal Due Diligence

Typically, due diligence was carried out by investors wishing to assess their risk before making an investment in target companies. Nowadays, with the advent of The Business Protection from Misleading Marketing Regulations 2008 ('The Regulations'), which came into effect on 26 May 2008, companies have to carry out their own due diligence on aspects of their businesses as part of their risk management measures, writes Dr Rosanna Cooper.

In this article, I am going to concentrate on the key areas that either investors and/or companies should focus on in conducting legal due diligence.

1. Introduction

Investor

The purpose of an investor carrying out a due diligence is to enable an investor to decide whether to proceed with an investment, establish areas of risk that may require particular attention and to observe how the company is addressing such risks i.e. the risk management measures the company has in place and ultimately whether it would be worthwhile investing in this business or whether to withdraw.

A professional advisor usually undertakes due diligence for an investor by gathering all possible information about the target company or its assets. The advisor would prepare a report with recommendations on:

- Whether to invest in the business, giving an indication of the risks involved;
- If so, on what terms?;
- At what valuation?;
- The validity of the information provided including past performance and the credentials of the directors; and
- The potential represented by the company's business plan.

In undertaking a legal due diligence, an advisor would request legal documents from the target company and in some cases interview board members, managers and staff. However, there are other types of due diligence that an investor may carry out such as a financial, commercial, technical and management due diligence.

The target company must prepare for its documents to be scrutinised by professional lawyers. Investors usually concentrate on two types of due diligence, business and legal. Dr Cooper provides a checklist for investors intending to undertake a legal due diligence, however, this list is by no means an exhaustive one.

Companies should increase their risk management measures by conducting their own due diligence of their businesses, especially where those companies' goods and/or services are high risk. One area in which **all** companies must obtain legal clearance is their advertising, by complying with the Regulations.

Internal Due Diligence

The Regulations have implemented a number of restrictions on companies wishing to advertise their business and/or compare their products or services to those of their competitors. There is now an obligation on companies to carry out due diligence in relation to any proposed or current advertising.

The Regulations place a prohibition on misleading advertising. Advertising is misleading if it deceives or is likely to deceive businesses, potentially affecting their economic behaviour. See <http://www.rtcoopers.com/misleading.php>

The Regulations focuses on comparative advertising.

Comparative Advertising

Comparative advertising is where one business deliberately features a competing business or its product in its advertisement. If a business elects to use comparative advertising, there are a number of conditions that must be met. For example:

- The business must not compare products or materials which are not designed for a very similar purpose;
- There must be no confusion on the part of traders as to the advertiser of the product in question and the competitor;
- The presentation of imitations or replicas of products bearing a protected trade mark or trade name is prohibited;
- The business must not take unfair advantage of the reputation of a competing business' trade marks, trade names, other distinguishing marks, or information relating to the competing business' country of origin; and
- It prohibits businesses to mislead traders or consumers.

Offence

Any advertising that misleads traders will amount to a criminal offence. Both the Office of Fair Trading ('OFT') and Trading Standards now have the power to make an application to the courts for an injunction to prevent the breach of any sections of the Regulations.

Therefore, businesses and their employees must take all reasonable steps to carry out extensive due diligence to ensure that any advertisements used by their business in promoting their goods and/or services are legal. Companies that are in any doubt should take legal advice.

Where a business simply publishes or arranges for the publication of advertising, such as in a magazine, an offence will not be committed. This exception applies where the OFT or Trading Standards have no reason to suspect that the publication of a particular advertisement would amount to an offence. The penalty for breach of the Regulations is a fine of up to £5,000, and in certain extreme cases, in up to two years' imprisonment.

You would need to retain all paperwork to prove that you undertook the requisite due diligence for your advertisement, in case criminal sanctions are imposed on your business. If you have conducted your due diligence, you may have a defence under the Regulations. However, it is advisable to seek legal advice wherever possible to clear your advertisements.

The Regulations are an important reminder to those engaged in advertising their products and/or services that they must adhere to strict legal rules.

2. Legal Due Diligence

RT Coopers conducts legal due diligence in a range of industry sectors. When we are instructed to carry out a legal or commercial due diligence, the firm sends a due diligence questionnaire to the target company requesting detailed information from the company and to reply to the questions within a limited timeframe, to keep in line with their timescales. From the information received, the firm would compile a report and make key recommendations. We have set out below the key aspects of a due diligence checklist. If due diligence is carried out for an investor, the target company would generally be expected to disclose key documents such as:

- Employment contracts;
- Board minutes, resolutions and any minutes of shareholders meetings;
- Signed confidentiality agreements;
- Licensing agreements and assignments including any agreements with employees;
- Articles of Association and Memorandum of Association;
- Terms of Business;
- Any litigation-related documents; and
- Any patents, copyrights, trade marks and other intellectual property-related documents.

3. Due Diligence Checklist

Below is a checklist of the key aspects of a legal due diligence:

- **Corporate Documents**
 - A list of all corporate documents including organisation charts, subsidiaries and other affiliates, percentage ownership and jurisdiction of each subsidiary;
 - A list of directors and key management/supervisory staff;
 - Summary of number of employees;
 - Stock transfer and certificate books, ledgers and records of the company, class of shares and list of shareholders;
 - For each class of debt, provide listing of debt holders;
 - Names, addresses, and contacts of company's professional advisors; and
 - List of major clients and their locations.

- **Securities**
 - Copies of shareholders agreements;
 - Copies of partnership agreements (if a partnership);
 - All stock options, stock purchase and other employee benefit plans and forms of agreements;
 - Any private/public commitments relating to the stock of the company/partnership; and
 - Any debt arrangements, guarantees or indemnities between the directors and shareholders or partners.

- **Litigation**
 - Copies of any pending or threatened litigation, arbitration, claims and proceedings involving the company or the founders;
 - Summary of disputes with suppliers, competitors, or customers;
 - Any correspondence with the company's auditors or accountants in respect of any threatened or pending litigation, assessments or claims;
 - Orders or judgments of courts or governmental agencies; and
 - Settlement documentation.

- **Employees and Related Parties**
 - Summary of any threatened or pending employment disputes;
 - All employment and consulting agreements, loan agreements and documents relating to other transactions with officers, directors, key employees and related parties;
 - Schedule of all compensation paid to officers, directors and key employees for most recent fiscal year;
 - Summary of employee benefits and copies of any pension, profit sharing, deferred compensation and retirement plans;
 - Summary of management incentive or bonus plans, as well as other non-cash forms of compensation; and
 - Confidentiality agreements with employees.

- ❑ **Financial Information**
 - Audited financial statements since inception (unaudited if audited financials are unavailable);
 - Copy of business plan;
 - Revenue, gross margin and average selling price by product(s) and/or service(s);
 - Copies of any valuations of the company's stock; and
 - Description of all contingent liabilities.

- ❑ **Money Laundering**
 - Copies of all money laundering procedures and policies;
 - Any non-compliance with Money Laundering Regulations; and
 - Any criminal offences/fines/imprisonment against the company/directors/partners for non compliance.

- ❑ **Property**
 - List of real and material personal property owned by the company and all accompanying documents;
 - All outstanding leases with an original term greater than one year for real and personal properties to which the company is either a lessor or lessee; and
 - Documents pertaining to proprietary technology developed/owned by the Company, including any copyright or patent applications (This will also include information confirming that the Company's systems, software and technology is owned solely by the company and does not infringe on any other party's rights).

- ❑ **Taxation**
 - Any notice of assessment and income tax returns for the last three years; and
 - Evidence of company being current on all tax liabilities.

- ❑ **Insurance and Liability**
 - Schedule or copies of all material insurance policies of the company in force;
 - property, liabilities and operations, including product liabilities;
 - Details of any assets pledged as collateral;
 - Details of the company's compliance with loan covenants;
 - Details of all financial liabilities, recorded or contingent of the company; and
 - All other relevant documents pertaining to the company's insurance and liability exposure.

- ❑ **Acquisition, Partnership or Joint Venture Agreements**
 - All acquisition, partnership or joint venture agreements;
 - Documents pertaining to potential acquisitions or alliances; and
 - Any agreements regarding divestiture of assets.

- ❑ **Governmental Regulations**
 - Summary of health and safety enquiries for past three years; and
 - List of any governmental licences and or regulations and compliance.

- ❑ **Intellectual Property**
 - List and copies of patents held and applications made by the company;
 - List of trade marks, copyright and design rights (registered and unregistered) held and applications made by the company;
 - Identify all persons who created or participated in the creation of the company's intellectual property;
 - List and copies of licences for any form of intellectual property held by or granted by the company;

- Description of any pending or threatened infringement claims by or against the company; and
 - Description of any important know how owned or licensed to the company.
- **Products and Equipment**
- Copies of all material agreements/documents, list and copies of all contracts with dealers, distributors, agents and others;
 - Copies of product(s) warranties of the company; and
 - All equipment leases.
- **Environmental Matters**
- List and description of all current environmental litigation or proceedings;
 - Copies of policy memoranda, programs, procedures, training courses, emergency plans and other implemented measures relating to the environment;
 - List of all environmental permits and licenses required for the company's activities;
 - Description of the production and storage and related environmental risks;
 - Description of any emissions into air or water, waste water and other discharges, noise pollution and waste produced;
 - Description of any enquiries, inspections, examinations, investigations by environmental authorities;
 - Description of any injuries or illnesses of personnel, accidents, during the last five years, with effect upon environmental matters; and
 - Description of any other relevant matters with respect to the environment.
- **Misleading Advertising in respect of Company's own due diligence**

In carrying out due diligence in respect of advertising, a business must ensure that:

- The advertisement is clear, concise and any descriptions are correct and can be substantiated;
- No third party's trade marks are infringed in the advert in question. This is particularly important as the business should avoid placing itself in a position where it could become the subject of an infringement action;
- All codes of advertising and promotions are complied with;
- Any comparative advertising comply with the Regulations; and
- The content of any advertisement is not misleading in any way.

4. Conclusion

Companies must adopt risk management measures to ensure compliance with the law in all areas such as, data protection, employment law, intellectual property protection and intellectual property insurance.

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