Purchaser and Vendor Sale of Business Due Diligence: The Key Essentials

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Television Education Network

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TABLE OF CONTENTS

1 INTRODUCTION

1.1 Due diligence has become an essential step in any sale or purchase of a business. It originally derived from the caveat emptor (buyer beware) principle, and was therefore historically only undertaken by buyers prior to purchasing an asset.

1.2 Now, due diligence investigations are utilised by both sellers and buyers, especially in light of increased regulatory compliance burdens, increased complexity in business structures, and therefore increased consequences of getting things wrong. Sellers undertake due diligence investigations on the target business and the selling entity to identify and manage potential problems before going to market, and in order to compile vendor due diligence reports. Buyers undertake due diligence investigations to identify risks or abnormalities in the business and (if relevant) the entity that they are proposing to buy, which will determine whether or not they proceed with the purchase.[1]

1.3 Whether you are acting for a buyer or a seller of a business, thorough due diligence investigations can uncover both skeletons and treasure.

1.4 This Paper will briefly consider the general due diligence process, and will then focus on some specific characteristics from both the seller's side and the buyer's side.

1.5 **Seller due diligence** (also called vendor due diligence) is primarily undertaken where the seller will be releasing a "Vendor Due Diligence Report". In this case, the seller conducts due diligence on the business being sold and the selling entity, and compiles their findings into a vendor due diligence report. The vendor due diligence report is then released to prospective buyers. Seller due diligence is most common in a seller-led transaction, for example where there are multiple bidders (such as a sale by tender) and the seller wishes to keep control of the process by reducing the amount of time and resources committed to responding to due diligence queries from multiple potential buyers.

1.6 **Buyer due diligence** is undertaken in almost every business purchase (whether there is a vendor due diligence phase or not). Where there is no vendor due diligence phase, the buyer is responsible for conducting all due diligence investigations on the target business and selling entity. Where there is a vendor due diligence phase, the buyer's investigations will usually be limited to supplementary issues that the buyer may wish to investigate outside of the vendor due diligence report (for example, where the vendor due diligence report has raised "red flags").

1.7 This Paper does not address disclosure for an initial public offering.

2 WHERE DOES DUE DILIGENCE FIT IN THE PROCESS?

2.1 Due diligence is undertaken in business sales and purchases and M&A transactions. The private equity boom in Australia in the last decade has also placed due diligence into the

[1] This will only be effective if the buyer undertakes their due diligence investigations prior to signing a contract of sale, OR if the contract of sale is subject to a due diligence condition under which the buyer may terminate the contract.

spotlight; private equity investors require certainty about what they are buying into, and comfort that they are getting value for what they are paying for.[2]

2.2 The purpose of due diligence is to enable a buyer/transferee (collectively called the "**buyer**" for the purpose of this Paper) to conduct an investigation of the seller/transferor (collectively called the "**seller**" for the purpose of this Paper) and the target business, to inform a buyer's decision about whether to acquire the seller entity and/or business and at what price point, and whether any caveats/conditions are needed in respect of that acquisition.

2.3 Due diligence is effectively a risk management strategy. As the regulatory landscape changes, and with it a growth in complexity in corporate governance and compliance, the risks connected with non-compliance or legal transgressions increase. **However, at its heart, sale of business due diligence is about the robustness of the repeatability of the historic net profits of the business (and the identification of risks to that profitability) <u>and</u> any impairment to the value of hard assets being acquired**. Buyers therefore need to engage in appropriate due diligence processes to mitigate and reduce these risks.[3] The level and detail of due diligence required should be determined on the basis of the nature of the transaction, the industry of the target business and the risk profile of the particular business. The aim is to identify, investigate, assess and address any "red flags".

2.4 Broadly speaking, identified red flags can be addressed by:

2.4.1 Re-structuring the transaction; for example, changing a share sale to an asset sale on the basis that specific contingent liabilities will not be transferred to the buyer at settlement (more on this later in this Paper);

2.4.2 Requiring the seller to remedy the red flag, with such remedy being a condition of settlement;

2.4.3 Adjusting the purchase price;

2.4.4 Retaining part of the purchase price for a period after settlement, pending certain deliverables;

2.4.5 Obtaining warranties and indemnities from the seller in the contract of sale, and ensuring that remedies are commensurate with the risk that the red flag represents.

KEYS TO WARRANTIES AND INDEMNITIES:

a Warranties and indemnities are usually long, complex and found towards the end of the document. In a contract review, consider starting with these first;

b A buyer should consider having the warranties and indemnities secured via Bank Guarantee (or at least a right of set-off, with Independent Expert valuation

[2] Helen McCombie, 'Due Diligence', *Australian Institute of Company Directors* (Article, 1 July 2007) <http://www.companydirectors.com.au/director-resource-centre/publications/company-director-magazine/2000-to-2009-back-editions/2007/july/due-diligence>.

[3] 'General Procedure for M&A Transactions in Germany', *Clifford Chance* (Brochure) 6 <http://globalmandatoolkit.cliffordchance.com/downloads/Broschuere-MA-Transactions-Lowres.pdf>.

of the loss and damage, against a retained amount or a vendor finance component).

2.4.6 Implementing internal policies into the buyer's business post-settlement to reduce the risk presented by the red flag, and to ensure no repetition of the circumstances giving rise to the red flag;

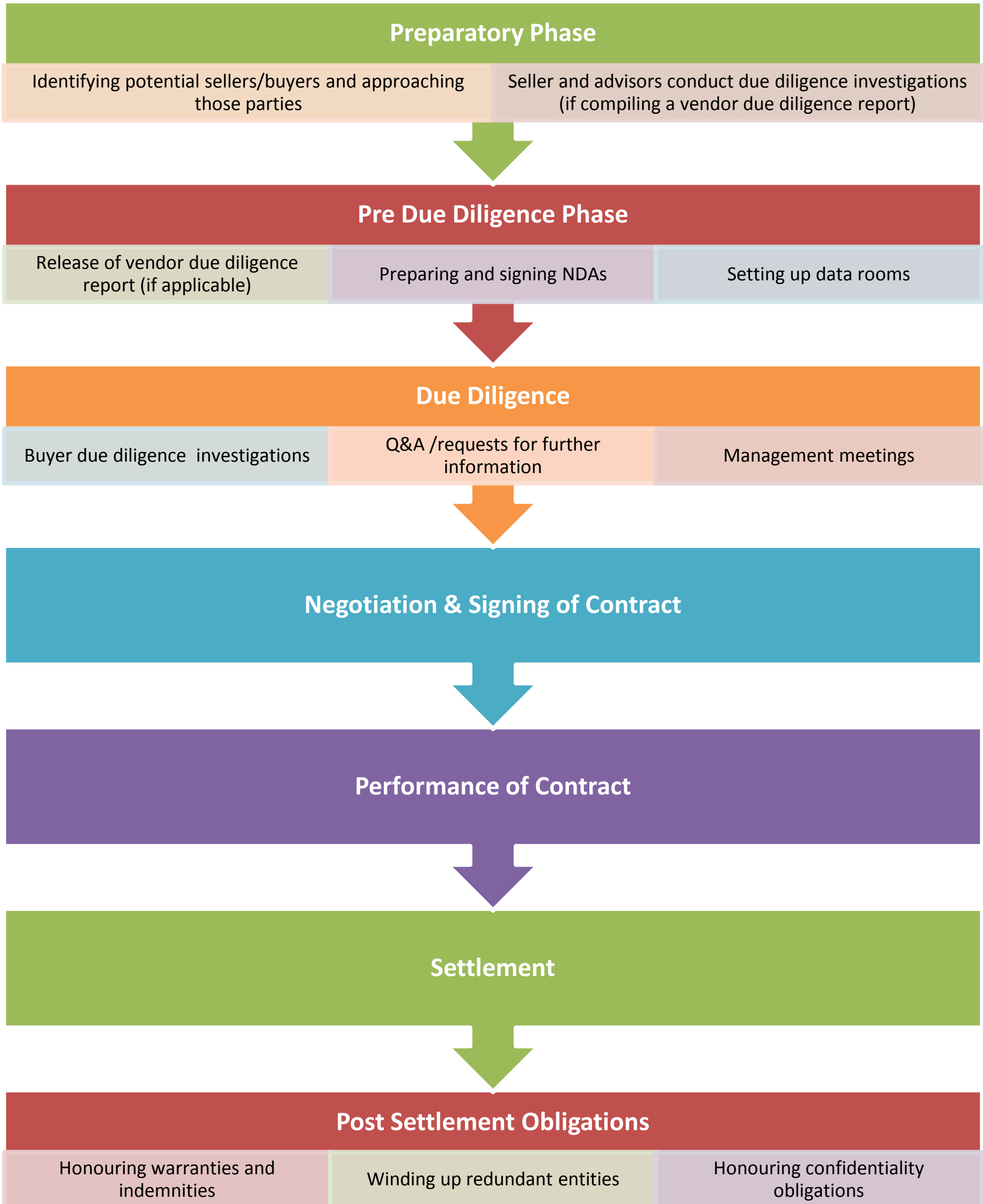
2.4.7 Acknowledging the risk that the red flag presents, and electing to proceed with the transaction on that basis; or

2.4.8 Electing not to proceed with the purchase and terminating the contract of sale under the due diligence condition.[4]

3 THE BIG PICTURE

3.1 A typical sale of business process would take the following structure *[see next page]*:

[4] 'General Procedure for M&A Transactions in Germany', *Clifford Chance* (Brochure) 6 <http://globalmandatoolkit.cliffordchance.com/downloads/Broschuere-MA-Transactions-Lowres.pdf>.


Preparatory Phase
Identifying potential sellers/buyers and approaching those parties
Seller and advisors conduct due diligence investigations (if compiling a vendor due diligence report)
Pre Due Diligence Phase
Release of vendor due diligence report (if applicable)
Preparing and signing NDAs
Setting up data rooms
Due Diligence
Buyer due diligence investigations
Q&A /requests for further information
Management meetings
Negotiation & Signing of Contract
Performance of Contract
Settlement
Post Settlement Obligations
Honouring warranties and indemnities
Winding up redundant entities
Honouring confidentiality obligations

3.2 Some comments on the Preparatory Phase

The structure of the Preparatory Phase will depend on whether the process is being steered predominantly by the seller or the buyer. Where the seller intends to release a vendor due diligence report, this phase will be very laborious for the seller and their advisors, as they will be required to conduct in-depth due diligence investigations on the selling entity and the target business, determining what information will be released to prospective buyers, and compiling their findings into a vendor due diligence report (usually in conjunction with a third party advisor). This Paper goes into more detail on this aspect below. For a buyer-steered transaction, the buyer will at this stage only need to start considering the due diligence investigations that they might like to undertake.

3.3 Some comments on the Due Diligence Phase

3.3.1 The purpose of this phase is for the buyer to assess risk and ultimately determine whether to acquire the target business. A successful due diligence is one that allows a buyer to walk away from a bad deal[5]. The buyer will want to:

a Confirm that the seller has good title to the assets or shares of the target business;

b Investigate potential liabilities or risks;

c Confirm the value of the business;

d Learn about the business operations in detail; and

e Identify any impediments to the transaction, such as third party consents and regulatory approvals.[6]

3.3.2 If no vendor due diligence report was provided as part of the pre due diligence phase, then the buyer will have a significant burden to carry during this phase.

3.3.3 If a vendor due diligence report was provided, the only investigations that the buyer will be making in this phase are around supplementary information that they may require, or in relation to "red flags".

3.3.4 This phase can go through a number of iterations, where investigations are undertaken, questions are asked, further information is requested, more investigations are undertaken, and so on. For large transactions, due diligence information is often stored in a common data room accessible by both the buyer and the seller and their advisors.

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[5] Helen McCombie, 'Due Diligence', *Australian Institute of Company Directors* (Article, 1 July 2007) <http://www.companydirectors.com.au/director-resource-centre/publications/company-director-magazine/2000-to-2009-back-editions/2007/july/due-diligence>.

[6] 'Seller due diligence for a private equity portfolio company', *Thomson Reuters Practical Law* (Article, 2019) <https://content.next.westlaw.com/Document/I369eb08f15c511e89bf099c0ee06c731/View/FullText.html?contextData=(sc.Default)&transitionType=Default&firstPage=true&bhcp=1>.

3.3.5 It is also common at this stage for the first draft of the contract of sale to be prepared by one party and put to the other party; whichever party prepares this draft will depend on whether the transaction is being seller driven (in which case the seller's advisors will usually prepare it) or buyer driven.

3.3.6 This stage is appropriate for determining, especially in the case of a merger, whether the seller and buyer and their key personalities have an alignment of mission and can work cohesively together. This can be tested by inviting key personnel as guests to board meetings, and holding management meetings between the key stakeholders.

3.3.7 From the buyer's side, it is at this stage where they will compile the lion's share of the tailored warranties and indemnities that they will seek in the contract of sale. The specific warranties and indemnities that they seek will be tailored to the results of their due diligence investigations.

3.3.8 Larger transactions will normally include a Terms Sheet or Heads of Agreement pre Buyer Due Diligence. **From a seller's perspective, it is essential to have the formulae for purchase price determination agreed pre Due Diligence Phase, and ideally some "hurt money" left on the table if the Buyer walks away from the deal.**

4 IMPORTANCE OF DUE DILIGENCE FROM THE PERSPECTIVE OF PROFESSIONAL ADVISORS

4.1 To the extent that professional advisors, such as accounting firms, lawyers and other professionals assist clients in their due diligence enquiries (whether they are assisting a seller or a buyer), they have a duty to take reasonable care and make investigations such that a prudent practitioner would be expected to make in the circumstances.

4.2 A case illustrating the importance of this is the 1997 Western Australian case of *Unioil International Pty Ltd v Deloitte Touche Tohmatsu* (1997) WAR 98:

4.2.1 In this case, the plaintiffs ended up making a "*disastrous investment into a group of companies known as the UFI group*". The plaintiff retained Deloitte (an accounting firm) and Corrs (a law firm) to carry out due diligence investigations on the transaction. After Deloitte and Corrs had undertaken their due diligence investigations and given their "tick of approval" for the transaction to proceed, the plaintiff purchased 19.7% of the shares in UFI at an ultimate price of almost $2 million.

4.2.2 The case then goes on to explain that "*By the end of December 1994, four months after the Agreements had been entered into, the plaintiffs discerned that UFI was experiencing various financial difficulties which had not been expected by them. These were caused by a number of factors, the most important being the existence of a vast number of claims by purchasers of pools for breaches of warranty, and the failure of the group to maintain forecast production and sales. On 16 January 1995, pursuant to resolutions of the boards of directors of UFI Illawarra and UFI Manufacturing [subsidiaries of UFI], an administrator was appointed to these two companies. ... On 10 February 1995 a receiver was appointed to each of UFI Illawarra and UFI Manufacturing. On 28 February 1995 a receiver was appointed to UFI. An attempt was made to effect schemes of arrangement with the group's creditors but* *this was not successful and UFI Manufacturing and UFI Illawarra were placed in liquidation.* ***The liabilities of the group far exceed its assets and UFI is hopelessly insolvent****.*"

4.2.3 The plaintiffs sought to attribute this loss to Deloitte and Corrs on the basis that they failed to fulfil their contractual tortious and statutory duties in carrying out the due diligence investigations for which they were retained. **Both Deloitte and Corrs were found by the court to be negligent, on the basis that (among other things) they had failed to make proper enquiries.**[7]

5 CASE STUDIES

5.1 There are many examples of where not undertaking thorough due diligence investigations have had drastic consequences for buyers, including causing the buying entity to become insolvent.

5.2 *FAI Insurances purchase of HIH Insurance Group* – In 1998, HIH Insurance Group ("**HIH**") purchased FAI Insurances ("**FAI**") for $300 million. In 2001, HIH (then worth $5 billion) collapsed. The blame for this collapse was placed squarely on its purchase of FAI[8]. It has been reported that when HIH bought FAI, it didn't conduct any significant due diligence investigations because the FAI managing director wouldn't allow it. As a result HIH reportedly relied only on publicly available information which did not reveal significant under-reserving of FAI's insurance business. The estimated losses incurred were $590 million.[9]

5.3 *National Australia Bank purchase of Homeside Inc* – In 1998 National Australia Bank ("**NAB**") purchased Homeside Inc, one of the largest mortgage services in America. However, NAB sold Homeside Inc in 2002 at a $4 billion loss. There has been commentary attributing this offloading on NAB's failure to understand the American mortgage market[10], and questions have also been raised as to the adequacy of NAB's due diligence processes at the time of the purchase[11].

5.4 *BHP Billiton purchase of Magma Copper* – Suspicions have also been raised around BHP Billiton's ("**BHP**") due diligence processes in its purchase of Magma Copper in Arizona in 1996. Magma Copper's San Manual Copper Mine was considered to be "the jewel in the

[7] *Unioil International Pty Ltd v Deloitte Touche Tohmatsu* (1997) WAR 98.

[8] 'FAI cops blame for collapse', *The Sydney Morning Herald* (Article, 30 April 2002) <https://www.smh.com.au/national/fai-cops-blame-for-collapse-20020430-gdf8lb.html>.

[9] Helen McCombie, 'Due Diligence', *Australian Institute of Company Directors* (Article, 1 July 2007) <http://www.companydirectors.com.au/director-resource-centre/publications/company-director-magazine/2000-to-2009-back-editions/2007/july/due-diligence>.

[10] Pat McConnell, 'National Australia Bank – 30 Years of Strategy Failure', *The Conversation* (Article, 23 February 2016) <http://theconversation.com/national-australia-bank-30-years-of-strategy-failure-55159>.

[11] Helen McCombie, 'Due Diligence', *Australian Institute of Company Directors* (Article, 1 July 2007) <http://www.companydirectors.com.au/director-resource-centre/publications/company-director-magazine/2000-to-2009-back-editions/2007/july/due-diligence>.

crown" at the time of purchase[12], however less than 3 years after the acquisition BHP put it on maintenance and wrote off $3.97 billion – the entire cost of the acquisition[13]. BHP then completely shut the mine down in 2003[14].

6 VENDOR DUE DILIGENCE

6.1 Summary

6.1.1 "Vendor due diligence" is a concept that is slowly gaining in popularity in Australia, following favourable reception in the United Kingdom, Europe and the United States of America. It requires the seller to undertake due diligence investigations on itself and the transaction in question, and compile the findings in a vendor due diligence report which it releases to prospective buyers. This removes the need for individual prospective buyers to each undertake their own full due diligence investigations and shifts much of the burden of due diligence investigations to the seller.

6.1.2 Vendor due diligence has two main benefits for a seller when compared to purchaser due diligence: **firstly**, the seller becomes aware ahead of time of any potential issues which may cause a buyer to seek a reduction in the purchase price or insist on onerous terms for a seller, and allows the seller to manage those risks at the outset or at the very least prepare itself for the consequences of those risks. **Secondly**, it simplifies the due diligence process at the front end, and avoids much of the "back and forth" for the seller in responding to enquiries that may occur where multiple prospective buyers are undertaking their own independent due diligence investigations.

6.1.3 As stated in clause 3.3.1, the buyer has matters that they would like to accomplish through due diligence. If the seller can assist the buyer to accomplish these things more quickly and easily through a vendor due diligence report, then the transaction is likely to proceed more smoothly and quicker than it otherwise would.[15]

6.1.4 Vendor due diligence is common in large-scale prospective purchases or M&A's where there are multiple bidders.

6.2 Who should undertake vendor due diligence?

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[12] Cecelia Jamasmie, 'Rio Tinto, BHP a step closer to open US largest copper mine', *Mining.com* (Article, 12 November 2013) <http://www.mining.com/rio-tinto-bhp-a-step-closer-to-open-us-largest-copper-mine-94236/>.

[13] Helen McCombie, 'Due Diligence', *Australian Institute of Company Directors* (Article, 1 July 2007) <http://www.companydirectors.com.au/director-resource-centre/publications/company-director-magazine/2000-to-2009-back-editions/2007/july/due-diligence>.

[14] Cecelia Jamasmie, 'Rio Tinto, BHP a step closer to open US largest copper mine', *Mining.com* (Article, 12 November 2013) <http://www.mining.com/rio-tinto-bhp-a-step-closer-to-open-us-largest-copper-mine-94236/>.

[15] 'Seller due diligence for a private equity portfolio company', *Thomson Reuters Practical Law* (Article, 2019) <https://content.next.westlaw.com/Document/I369eb08f15c511e89bf099c0ee06c731/View/FullText.html?contextData=(sc.Default)&transitionType=Default&firstPage=true&bhcp=1>.

6.2.1 It is common for a vendor to retain an independent third party professional advisor (such as an accounting firm) to conduct the due diligence investigations and compile the report on its behalf. Otherwise, vendor due diligence reports can be prepared internally by the management team of the seller (supported by their in-house counsel and financial teams), or by a combination of professional advisors, including lawyers, accountants and specialist industry consultants.

6.2.2 There is a school of thought which suggests that it is advisable to have an independent third party professional advisor conduct the due diligence investigations rather than the management team of the seller. This retains impartiality and reduces the risk that the bias of management, who may be keen to close out a particular sale, may affect the content of a vendor due diligence report.[16]

6.2.3 There is also commentary that there may be a risk that a professional advisor could have a conflict of interest, given that they are acting for the seller in producing a report that they know will be relied upon by both the seller and the buyer. However, such conflicts can usually be managed by:

a providing facts only in the report, without providing an opinion or comment;

b limiting the liability of the professional advisor in the terms of engagement with the seller (which are commonly novated to buyers); and

c stating that any assessment of risk, analysis, implications upon the value of the asset, impacts on any insurances and any impact on any contractual terms resulting from the due diligence report are matters for the seller and the buyer and are not the responsibility of the professional advisor.[17]

A "belts and braces" approach would be to also ensure that the professional advisor does not also assist the seller in the sale of business process, and that the seller retains separate legal advisers to assist them with the sale process (although this does not always happen in practice).

6.2.4 Usually the seller will pay for the cost of the preparation of the seller's due diligence report. Some sellers consider this to be a worthwhile investment and consider it to be a replacement for other insurances that they would otherwise need to spend on, such as warranty and indemnity insurance (although there is, in my view, merit in paying for both). Sometimes, sellers require equal contributions from all prospective buyers, or they require the whole cost to be paid by the winning buyer as a plus adjustment to the settlement price.

6.3 **Starting Point**

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[16] Helen McCombie, 'Due Diligence', *Australian Institute of Company Directors* (Article, 1 July 2007) <http://www.companydirectors.com.au/director-resource-centre/publications/company-director-magazine/2000-to-2009-back-editions/2007/july/due-diligence>.

[17] Murray Landis (K & L Gates), *Vendor Due Diligence Shifts the Burden* (29 October 2006) Mondaq <http://www.mondaq.com/australia/x/43778/Corporate+Governance/Vendor+Due+Diligence+Shifts+The+Burden>.

6.3.1 The starting point for an advisor is to gain an understanding of the seller, its business, its industry and its history **before** going to market if possible. A good way to get across this initially is to use a very basic Due Diligence Checklist with questions directed at the seller. This would include areas such as:

a **The seller**:

i Structure of the selling entity/entities (company, trust, partnership etc);

ii If multiple sellers, consider intended apportionment of purchase price and apportionment of liability;

iii Whether the sale is to be an asset sale or a share sale;

iv Consider the nature of the business and industry of the seller;

b **Restrictions on transfer**:

i Does any party need to consent to the sale (franchisor, lessor, financier etc)?

ii Any financing arrangements, and whether the proceeds of sale will be sufficient to discharge loans from financiers. If not, consider what arrangements can be made to release selling entity/target business from financing arrangements;

c **Assets**, and who those assets are owned by:

i Plant and equipment;

ii Intellectual property (see below);

iii Real property/lease interests;

iv Licences/permits;

v Motor vehicles,

(it is best to obtain a complete list of assets, and confirm which assets are owned and which assets and leased/hired);

d **Intellectual property:**

i Identify intellectual property such as business names, trade marks, copyrights, patents, designs, software, databases, other developed intellectual property;

ii Obtain copies of all intellectual property agreements;

iii Obtain copies of contracts between the seller and any contractor/employee who developed intellectual property, to ensure that the contracts contained a clause assigning any intellectual property rights to the seller;

e **Stock:**

i Quantity;

ii Age (and especially absolute stock);

iii Consider when the seller intends that stock-take is to occur and intended method of valuation of stock;

iv Obtain copies of all agreements between the seller and third parties containing retention of title clauses;

f **Work in progress:**

i Quantity and intended method of valuation;

g **Liabilities:**

i Current liabilities → are they on current terms? How will they be repaid?

ii Contingent liabilities → details, agreed method of fulfilment (e.g. warranty claims), consider intended compensation for buyer if pre-purchase contingent liabilities arise post-purchase;

h **Debtors** → Is it intended that these debtors will be purchased as part of the sale?

i **Contracts:**

i Identify and obtain copies of all material contracts;

ii What consents are necessary for assignment?

j **Restraints the seller and key staff are prepared to give;**

k **Premises:**

i Property searches;

ii Consider whether transfer of fee simple, new lease, assignment of existing lease, or sub-lease is required;

iii Obtain copies of all leases/licences/sub-leases;

iv Identify consents required (i.e. assignment or deemed assignment of lease requirements – see below);

l **Staff:**

i Names, start dates, obtain copies of employment contracts;

ii Consider required termination notice period (see below);

m **Expected sale price:**

i Required deposit;

ii Agreed method of compensation (up front payment, staged purchase, post-settlement adjustment mechanisms);

iii If deferred payment, what security the seller requires;

iv Personal guarantees required by seller;

n **Business records:**

i Balance sheet;

ii Profit and loss statement;

iii Details of previous, current or potential litigation;

iv Bank accounts;

v Ages of debtors;

vi Insurance;

vii Credit terms;

viii Material contracts;

ix Employee and contractor records;

o **Duty**;

p **Other tax** (incl GST treatment on sale);

q **Other conditions required by seller**.

6.3.2 It is noted that this checklist is not exhaustive and any “checklist” should be approached on a case-by-case basis.

6.3.3 This will provide a good initial platform for an advisor to gain an understanding of the seller’s business and to determine what further enquiries should be made. Following this initial checklist, a prudent advisor would conduct more specific due diligence on the seller and the target business based on their understanding of the seller’s business.

6.4 Vendor Due Diligence Process

6.4.1 At the start of the process a seller will determine the scope of the initial due diligence report and brief the third party advisor. The third party advisor, after conducting investigations, will prepare the report in draft and provide it to the seller for review. Following approval by the seller, it is released to prospective buyers (subject to NDA's).

6.4.2 After considering the vendor due diligence report, prospective buyers may request additional due diligence to be conducted by the seller on a specific area. If the seller chooses to comply with the request, they will generally issue an updated vendor due diligence report (which includes the new due diligence material) and provide the updated report to all prospective buyers. This ensures that all prospective buyers are receiving equal disclosure, and one prospective buyer is not gaining an unfair advantage against others by possessing additional information regarding the transaction that others are not privy to.

6.4.3 It is very common in countries such as Germany, and it is becomingly increasingly more common in Australia, for the parties (including the third party professional advisor who prepared the report) to execute "release and reliance letters".

6.4.4 *Release letters* permit one party (usually the seller, being the client of the party compiling the report) to disclose the report to a third party (usually a potential buyer), provided that:

a confidentiality obligations are impressed upon that third party; and

b the third party undertakes to use the report solely for the purpose of assessing the transaction in question; and

c any liability of the compiling party to the third party is excluded.

6.4.5 *Reliance letters* are used less commonly than release letters, and the market is divided on whether or not they should be used. When used, they are generally only provided to "winning" buyers who go to contract. In this circumstance the party compiling the vendor due diligence report may issue a letter to a third party (i.e. the winning buyer), permitting them to rely on the due diligence report and undertaking that the content of the report is accurate (failing which they may be liable to the third party). These letters, however, typically include an aggregate limit of the potential liability of the compiling party to all third parties who may receive the report, and exclude an obligation for the compiling party to update the report as new facts and circumstances arise.

6.5 The benefits of vendor due diligence

6.5.1 *Where time is limited* – As the searches and investigations have been conducted ahead of time, there will be minimal delays during the contract process while waiting on search results to be returned (in respect of the information disclosed in the vendor due diligence report). This can remove the time delays commonly experienced in transactions where due diligence is being undertaken by the buyer (in which case, for reasons of costs, due diligence investigations are generally not commenced until the business is under contract).

6.5.2 *Contracts can be less conditional for sellers [benefit to seller only]* – Buyers usually have the opportunity to consider the due diligence report prior to making the decision to enter into a binding contract of sale, which can negate the need for a due diligence condition. This will of course not be the case where a buyer wishes to conduct their own additional due diligence investigations, in which case it would be usual for them to insist upon a due diligence condition being included in the contract of sale, notwithstanding the provision of the vendor due diligence report. However, if the seller wields sufficient bargaining power, they may refuse to include a due diligence special condition.

6.5.3 *Limits seller disruption* – Reduces the number of different due diligence requests directed at the seller from multiple prospective buyers, so that management's focus may remain on running the business rather than responding to due diligence requests. It also reduces the amount of back-and-forth between a seller and an individual prospective buyer.

6.5.4 *Where the transaction is multi-faceted or complex* – Prior to the time of the sale of business, the seller is able to take the time to consider complex elements of the transaction, make appropriate investigations and adjustments, and present the results of those investigations in a manner which can be easily processed by the prospective buyer, thereby streamlining the sale process and addressing areas of confusion and ambiguity at the outset.

6.5.5 *Peace of mind for seller* – It enables the early identification and analysis of key risks that may present concerns for prospective buyers and negatively affect the seller in the sale process. It gives the seller the opportunity to either mitigate or at least contextualize risks to prospective buyers.

6.5.6 *Enables the seller to control the due diligence process [benefit to seller only]* – The seller is able to control (to a limited extent) the content of the due diligence report, the way in which due diligence material is presented, the information flow and the time at which the report is provided to prospective buyers; all of which can lead to securing a higher price for the business. It also reduces the bargaining power of a prospective buyer who may seek to negotiate a reduction in the purchase price by identifying a last-minute issue.

6.5.7 *Provides certainty to prospective buyers* – A vendor due diligence report can provide greater certainty to a prospective buyer regarding the nature of business, cash flow and other business matters. This can help a prospective buyer with pricing decisions, based for example on the amount of gearing that they expect that the business can support.

6.5.8 *Less cost to prospective buyer* – This reduces the cost, effort and time associated with the acquisition.

6.5.9 *Seller can seek to limit their liability* – On the basis of disclosures that they have made in the vendor due diligence report, which the sale contract will acknowledge.

6.6 Problems identified in vendor due diligence reports

6.6.1 As noted above, sellers may be concerned that commissioning a vendor due diligence report may bring issues and risks to the buyer's attention. However, matters that will be material to any reasonable buyer are often more cost-effectively addressed in pre-contractual negotiations as opposed to a post settlement dispute.

6.6.2 Some problems, the seller may be able to manage and eliminate by making adjustments prior to the business being put on the market. For more entrenched issues that are not easily resolved, it is a likely that a buyer undertaking thorough due diligence would uncover the same issues and risks, so a vendor due diligence report puts the seller on the front foot in presenting those issues and providing the opportunity for the seller to directly address those issues, rather than the buyer discovering the issues independently without the benefit of an accompanying explanation from the seller.

6.7 **Some vendor due diligence hotspots**

6.7.1 *Currency and enforceability of contracts*

a The selling entity is likely to be party to contracts under which it has obligations, including with suppliers, customers, lessors or government agencies. The provisions of each separate contract must be individually considered in light of a sale event.

b In the case of an **asset sale**, ordinarily the third party contract will need to be assigned to the buyer, novated to the buyer, or terminated - and this should be a condition of settlement. It is usual for the third party contract to require that preliminary steps be complied with prior to securing an assignment or novation, such as providing documentary evidence to assure the third party that the buyer is capable of meeting its obligations under the third party contract, or the directors of the buyer providing replacement personal guarantees to guarantee the obligations of the buyer. Often, these third party contracts state that such consent to assignment "must not be unreasonably withheld", so if the seller can prove that the buyer is a reputable and trustworthy replacement, usually an assignment or novation will be successful.

c In the case of a **share sale**, the contract remains with the seller company, while the ownership of the underlying shares changes hands. Many contracts will contain "change in control" prohibitions (also called deemed assignment clauses), which require the seller to obtain the other party's consent prior to a change in control event (commonly defined in contracts as a change in control of more than 50% of the company's issued share capital, but this varies). If this is not complied with, the company will be considered to be in breach of the contract.

d It is particularly important that the seller has secure contracts with the suppliers and (where possible) the clients that it relies upon in conducting its business. An advisor should identify which supplier/client relationships are integral to the seller's business, and consider the security that these material contracts provide. For example, if the success of the business relies upon its location in a high foot traffic area, the lease should be considered for security of tenure and adequacy of the remaining lease term. The advisors should also consider whether material contracts have expired and if the relationship is being conducted simply on the basis of the parties' conduct, and consider renewing these contracts prior to going to market.

e In my experience, this is often a case of taking the other contracting party "on the journey". This process should be started as early as possible; ideally before a contract is signed.

6.7.2 *Employees*

a Investigations regarding employees of the selling entity are relevant in both vendor due diligence and purchaser due diligence.

b A vendor due diligence report should consider the ability to retain employees in the business. This requires consideration of every employee's employment contract, including but not limited to length of service, termination rights and accumulated leave entitlements.

c Where the sale of business is an **asset sale**, the seller and the buyer should carefully consider the notice of termination period set out in each employment contract. While the employee may be offered immediate employment in the buyer entity, the termination of employment by the seller is a necessary precursor to the employee being able to accept employment in the buyer entity. Such termination is still considered to be a termination of employment under the *Fair Work Act 2009* and therefore subject to the minimum notice period requirements. Sellers should seek to provide the requisite notice where possible, to avoid a potential unfair dismissal claim under the *Fair Work Act 2009*.

d Where the sale of business is a **share sale**, this is not a risk to the vendor as the employee is continuing their employment in the same entity.

6.7.3 *Non arms-length arrangements*

Purchasers should also consider whether any non-arms length transactions may affect the profitability of the company after settlement. For example, does a related party own the premises from which the business is operated and charge less than market rent? Do any of the key executives (such as the founder) work for less than market salary?[18] In this case, it would be prudent for a purchaser to look beyond the material that is presented in the vendor due diligence report and consider the profitability of the business were these matters to be "normalised" to market rates.

6.7.4 *Corporate records*

Has the seller got complete and up-to-date corporate records? If not, what impact does this have upon the target business' regulatory compliance? This will involve

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[18] Helen McCombie, 'Due Diligence', *Australian Institute of Company Directors* (Article, 1 July 2007) <http://www.companydirectors.com.au/director-resource-centre/publications/company-director-magazine/2000-to-2009-back-editions/2007/july/due-diligence>.

consideration of whether the company's records with ASIC are up-to-date, and whether there are adequate records of minutes, resolutions and director appointments and resignations. This should be considered in the vendor due diligence report.

6.7.5 *Required third party consents*

A seller should consider whether any third party consents are required to effect the sale (such as lessor consent to an assignment of lease, or government consent to assign or novate a material contract) and consider making these enquiries prior to signing a contract of sale.

6.7.6 *Licenses and registrations*

If a seller requires industry specific licenses or registrations to conduct their business, their currency should be checked prior to going to market and renewed if necessary. These licenses and registrations should be included as part of the vendor due diligence report.

6.7.7 *Intellectual property*

a It is sometimes initially unclear as to who the legal owner of intellectual property is. For example, if an employee or contractor developed intellectual property in the course of their work for the seller, they will likely own such developments unless their contract contained clauses to the effect that such intellectual property is assigned to the seller. If the contacts lacked these requisite clauses, a seller may seek to remedy this by obtaining written assignments from those employees or contractors prior to going to market.

b If the seller is using intellectual property that it does not own, advisors should consider the adequacy and remaining tenure of any licence of the intellectual property to the seller, and any requirement to obtain the licensor's consent to a change of licensee (whether by assignment in the case of an asset sale, or potential deemed assignment in the case of a share sale).

6.8 How much should go in the vendor due diligence report?

6.8.1 *Content*

a There is a balance between disclosing everything in a vendor due diligence report that a buyer may need to make an informed decision about the sale (including assessing risks associated with the target business), and disclosing confidential information – especially where a prospective buyer is a competitor which may not end up buying the target business. Confidential information that a seller may be hesitant to disclose could include:

i Details of customers/clients;

ii Agreements under which the seller is subject to confidentiality and non-disclosure obligations;

iii Details of arrangements (either with suppliers or customers) which would be of particular interest and potential value to a competitor;

iv Trade secrets – such as recipes, formulas and processes; and

v Details of development of a new product which has not yet been released.

b By receiving a vendor due diligence report, the prospective purchaser is essentially gaining a "free look" into the seller, its financial position and its activities. There are some strategies that a seller can employ to lessen the risk and unfairness that this represents, outlined below.

6.8.2 *De-identifying information*

a To combat this tension, sellers can disclose this information while de-identifying it or aggregating information. This will also assist the seller in complying with confidentiality obligations that they may have in material contracts with third parties, and privacy laws relating to personal information.

6.8.3 *NDA*

a Another strategy that sellers often use, is requiring the prospective buyer to sign a Non-Disclosure Agreement before the prospective buyer receives the vendor due diligence report, or before the seller discloses information to a purchaser pursuant to a due diligence request → **this is relevant for purchaser due diligence as well**.

6.8.4 *Non-refundable deposit*

a If a seller is particularly concerned about the content that they are releasing to a prospective buyer, they can do a staged release of information coupled with a non-refundable deposit, which would look like:

i Specific limited de-identified information is released to all prospective purchasers in "Phase 1";

ii The seller then chooses a "winning" buyer who signs a contract which is subject to further due diligence investigations by the buyer;

iii The buyer is required to put down a non-refundable deposit which would be forfeited in the event that they terminate under due diligence (this ensures that the buyer has "skin in the game" and is not simply using the process to gain a free look into the seller's enterprise); and

iv The seller then releases the "Phase 2" information, which includes more specific information.

b **It is noted that the concept of a non-refundable deposit can also be used in a smaller-scale contract which is subject to buyer due diligence**, with no vendor due diligence report.

6.9 Due diligence and the Contract of Sale

6.9.1 Buyers rely on the information contained in a vendor due diligence report. It therefore becomes important from the buyer's perspective that the contract of sale contains adequate:

a Warranties from the seller verifying that the information in the vendor due diligence report is true and correct as to the information contained within it as at a specific date; and

b Indemnities from the seller to respond to an event where a matter in the due diligence report is subsequently found to be incorrect or misleading.

6.9.2 Warranties and indemnities are onerous for a seller. A seller should consider each specific warranty and indemnity that they are giving (even if they are commonly considered to be standard warranties). They will often seek to qualify warranties with phrases such as "to the best of the seller's knowledge", or by specific inclusions or exclusions set out in a schedule to the contract of sale.[19]

6.9.3 Ordinarily the professional advisors who prepared the report could be exposed to legal liability if a seller's breach of a warranty or indemnity is due to the advisor's error or omission. Advisors can seek to qualify this risk by:

a clarifying in writing with the seller what aspects of due diligence that they are responsible for investigating (for example, an accountant will not investigate legal aspects and vice versa);

b including disclaimers in the report (such as the fact that they relied on specific information provided by the seller);

c including a list of assumptions which have been relied upon (if any) in preparing the report;

d including a statement that the use of the report is restricted to the transaction in question and can be used for no other purpose; and

e first providing the report to the seller in draft for consideration and approval,

however advisors will not be able to fully contract out of liability in the event that they make a genuine error or omission which leads to loss for the buyer or the seller. Additionally, if the advisor discovers adverse results which may result in the buyer being misled if that information is not disclosed, the advisor may be conflicted and need to withdraw from acting if they are instructed by a seller not to disclose that information in the vendor due diligence report.

6.9.4 The seller also has a level of exposure by providing information to a prospective buyer in the vendor due diligence report, as the buyer will be relying on the content of that report. The seller should therefore ensure that the contract of sale clearly states that:

[19] General Procedure for M&A Transactions in Germany', *Clifford Chance* (Brochure) 20 <http://globalmandatoolkit.cliffordchance.com/downloads/Broschuere-MA-Transactions-Lowres.pdf>.

a the parties acknowledge that the vendor due diligence report does not, and is not required to, contain all relevant information that a reasonable buyer may wish to obtain prior to purchasing the business;

b any further investigations are the responsibility of the buyer (at the buyer's cost); and

c the vendor due diligence report does not remove the requirement for a buyer to conduct their own due diligence investigations.

6.9.5 Ordinarily the seller would also seek to procure a release from the buyer relating to the results of any search results or information acquired by the seller from third parties, that are later found to be incorrect PROVIDED THAT such search results or information is included in the vendor due diligence report in the full and complete form as was provided to the seller by the third party.

6.10 Cleaning up the PPSR

6.10.1 In most cases, a seller will have given or taken a security interest under the *Personal Property Securities Act 2009* (Cth) ("**PPSA**") in the course of conducting its business.

6.10.2 A seller will need to consider the PPSA from two perspectives:

a Where they are a **grantor** (consider what security interests the seller has granted to secure the performance of its obligations, whether those security interests are correctly registered on the Personal Property Securities Register ("**PPSR**"), which security interests need to be assigned to the buyer, and which security interests are no longer relevant and need to be discharged); and

b Where they are a **secured party** (consider what security interests the seller holds to secure the performance of others' obligations to the seller, whether those security interests are correctly registered on the PPSR, and which security interests will need to be assigned to the buyer).

6.10.3 *Where the seller is the grantor:* Often the PPSR contains outdated or redundant security interests. For example, a seller grantor may have granted a PMSI over collateral to secure a loan that they have since repaid in full, and the secured party has not taken the administrative step of releasing their security interest in accordance with the loan agreement. Often, secured parties do not automatically release security interests and need to be prompted to do so. From a seller's perspective, it would be prudent to consider the security interests that they have granted to ensure that they are current. If they are not, they should procure the release of these interests prior to entering into a contract of sale. Often failing to do so can delay the settlement of a contract and present unnecessary risks for a seller. Consider especially retention of title security interests.

6.10.4 *Where the seller is the secured party:* Sellers should also consider whether they have perfected and correctly recorded on the PPSR the details of the security interests under which they are a secured party, by way of searching these interests on the PPSR. If they have not, they should do so prior to going to market. This may be a very large job – especially where the seller is in the business of selling products to consumers under retention of title terms.

6.10.5 In the case of an **asset sale**, usually a buyer will require that they receive unencumbered title to the assets that they are buying. The seller must satisfy themselves prior to the sale that they will be able to discharge all security interests as part of the sale (if they cannot, they may have solvency problems and should first be addressing that issue prior to entering into a sale agreement). Some security interests (e.g. retention of title security interests over stock) will not be able to be released and will need to be novated as part of the settlement arrangements (and drafted carefully in the contract).

6.10.6 For a **share sale**, sellers should beware of deemed assignment clauses in the agreement granting the security interest.

6.10.7 An often overlooked facet is the seller's standard terms and conditions. These should be checked to confirm that these terms and conditions are adequate to entitle the seller to register security interests over the personal property of its customers/clients where necessary. If the terms and conditions are not adequate, the seller may consider amending these standard terms prior to going to market. The benefits of the contracts containing terms and conditions should be assigned to the buyer on settlement of an asset sale. **NOTE:** The amended terms and conditions will only be relevant for go-forward contracts with customers/clients. Unless the seller can negotiate fresh contracts with its previously contracted customers/clients, they will likely be unable to rectify this deficiency in respect of those customers/clients.

7 TAX CONSIDERATIONS IN THE VENDOR DUE DILIGENCE PROCESS

7.1 Tax considerations will differ depending on whether the sale is an asset sale or a share sale. This should be considered by the seller prior to going to market, as it can have tectonic impacts on the proceeds of sale available to a seller. A seller should seek financial advice in relation to the tax aspects of the sale.

7.2 *Transfer duty* – An asset sale will usually incur more transfer duty than a share sale. Generally, transfer duty on an asset sale (excluding freehold property) will be paid in QLD, NT and WA (all subject to exceptions regarding the assets which are being transferred). Transfer duty on a share sale will generally not be paid in any state or territory.[20]

7.3 *CGT* – Capital gains tax will be relevant in both asset sales and share sales. Small businesses should seek specific financial advice on the concessions that may be available to them.[21]

7.4 *GST* – Usually businesses being sold by way of an asset sale are sold as a going concern and are GST-free. A going concern is being sold where:

[20] Gary Stephensen, 'QUEENSLAND STAMP DUTY: An impost on Business Purchasers', *Lloyds Business Brokers* (Article) <https://www.lloydsbrokers.com.au/Stamp-Duty-on-Business-update.htm>.

[21] 'Small Business CGT Concessions", *Australian Taxation Office* (Article, 5 October 2018) <https://www.ato.gov.au/general/capital-gains-tax/small-business-cgt-concessions/>.

7.4.1 The sale includes everything that is necessary for the continued operation of the business; and

7.4.2 The business is carried on until the day of the sale.[22]

This will usually necessarily include the contemporaneous transfer (or assignment in the case of a lease) of the premises from which the business is conducted. Depending on the nature of the business, actively marketing a vacant premises prior to and following settlement of a business sale can also suffice for the purpose of the going concern GST exemption.

7.5 *Buyer tax considerations* – If the buyer is buying shares in the target company, the buyer should also consider the tax history of the company as it will be inheriting all of its tax history and liabilities. Detailed warranties and indemnities are normally included in the contract of sale, along with the consideration of compliance of ATO payments, and adequacy of tax provisions in the accounts during due diligence.

8 PURCHASER/BUYER DUE DILIGENCE

8.1 Buyer due diligence is most common in smaller scale transactions, private sales, and in transactions where there are not multiple bidders. During buyer due diligence, the buyer and their advisors undertake all of the due diligence investigations where there is no vendor due diligence phase (where there is a vendor due diligence phase, they only undertake supplementary investigations). This portion of the Paper will focus on a transaction where there is no vendor due diligence phase.

8.2 In these transactions, the seller's attention and resources are directed towards striking a price and favourable commercial terms in the contract of sale, rather than compiling a vendor due diligence report.

8.3 A purpose of a buyer's due diligence is to ensure that the buyer is receiving **the business that it has agreed to buy** (including any assets), for **the price that it has agreed to pay** for them.

8.4 Any adverse issues arising as a result of the due diligence investigations will detract from the "business it has agreed to buy", and may lead to a reduction in the price that it has agreed to pay. It may even have such an adverse effect that the business no longer represents the business that it has agreed to buy, leading to termination.

8.5 The nature and extent of due diligence undertaken will of course be determined on a case-by-case basis. However, the types of searches, investigations and inquiries made are largely informed by whether the transaction is an asset sale or a share sale. Public companies are also less likely to have skeletons in the closet because of their continuous disclosure requirements.

8.6 Buyer due diligence is usually structured into business purchases in one of two ways:

[22] 'Selling a Going Concern", *Australian Taxation Office* (Article, 17 December 2018) <https://www.ato.gov.au/Business/GST/In-detail/Your-industry/Property/GST-and-property/?page=6>.

8.6.1 The buyer undertakes all due diligence on the target business prior to making an offer to purchase, following which a contract is negotiated which is not conditional upon buyer due diligence. This defers the initial expenditure on negotiating a formal contract until the buyer is ready to commit to the purchase; or

8.6.2 The parties negotiate a formal contract of sale with a due diligence period, pursuant to which the buyer can terminate the contract if they receive unsatisfactory search results. This involves significant expenditure at the outset in negotiating a full formal contract prior to undertaking due diligence investigations.

8.7 Income and profitability – what to look for and where

8.7.1 Prospective buyers should be obtaining independent financial advice, which will consider issues such as liquidity, debtors/creditors, levels of bank debt, loans, related party transactions, accounting principles used and lodgement of Tax Returns.

8.7.2 A buyer may wish to consider issues which will have an effect on its ability to generate income post-purchase, such as:

a *Method of generating revenue* – Consider how the business generates its revenue. Is it sustainable given the industry, current economic climate, its operating locations or its capability to service its customer base?

b *Consistency in revenue* – Has the business been generating consistent or gradually increasing revenue over the last few years? If there has been a sudden recent increase in revenue, what has caused this? For example, is this due to significant discounts or incentives recently offered by the seller in an effort to increase revenue prior to selling?

c *Security of income sources* – Are the business' main sources of income secure, or are they easily affected by circumstances outside of the buyer's control?

d *Customer base* – Is the business heavily reliant on a small number of customers, and can the business survive without those customers? Are those customers contractually obliged to remain loyal to the business for a sufficient amount of time?

e *Key personnel* – How reliant is the business on its key personnel? Will the reputation of the business be significantly damaged on the exit of the seller? If so, what mechanisms are being implemented to address this (such as contractually obliging a key person to remain as a consultant for a specific amount of time post-sale)?

f *Bad and doubtful debts* – Has appropriate provision been made in the accounts for bad and doubtful debts, or have these debts simply been recorded as ordinary debts owning to the company?

8.8 Key areas of liability – taxation and other key liability hotspots

8.8.1 *Contingent liabilities* – A prudent buyer would make enquiries as to whether any contingent liabilities exist in the selling entity. The results of these enquiries will determine whether the sale is structured as a share sale or an asset sale, as often contingent liabilities can be excluded from the scope of the sale and left in the selling entity. For example, if a selling entity has known cases of historical child sex abuse, an asset sale would be the best course in some states (such as Victoria) with an express exclusion for those contingent liabilities. However, be aware that some states (such as NSW and WA) have moved to a model making successor entities liable for child sex abuse related contingent liabilities incurred in the hands of the predecessor even if the transaction is by asset acquisition.

8.8.2 *Unfulfilled promises* – What promises might the seller have made to its customers or staff which remain unfulfilled? This is particularly important in the case of a share sale.

8.8.3 *Tax returns or audit* – When the transaction is a share sale, buyers should ensure that the contract of sale contains detailed machinery about responding to an audit (relating to a time period pre-settlement) and the involvement of the seller, as the seller will no doubt have provided indemnities about this.

8.9 **Investigating PPSA security interests and determining releases**

8.9.1 Buyers will need to consider PPSA arrangements that are in place, and the security/burden that this will confer on them post-settlement.

8.9.2 The manageability of this process will depend on the *size* and the *industry* of the business being acquired.

8.9.3 For example, investigating the security interests in relation to the sale of a medium-sized law firm will be relatively simple. The law firm may have granted several security interests to secure various obligations (such as photocopier leases or debt repayment obligations). These security interests should be readily discoverable by undertaking a PPSR search. It is unlikely that the law firm will have taken security interests to secure obligations owed to it, and will have nothing to disclose in this regard.

8.9.4 However, the PPSR due diligence process will be significantly more laborious in respect of a large company which hires out cranes, where those cranes will be located on another party's premises for the duration of the hire period. In order to protect their interest, the seller will likely have security interests registered over every crane. This will also be the case for companies which provide equipment to customers pursuant to hire/purchase agreements secured by registered security interests over the financed asset.

8.9.5 For excessively large transactions where it would be impractical or too costly to undertake due diligence searches of every PPSR security interest, the buyer could consider:

a Conducting random sample checks;

b Searching only security interests over a certain monetary threshold;

c Including warranties in the contract to the extent that all disclosed PPSR security interests are all of the interests in existence, and are all accurate, with an ability to recover from the seller in the event that either of these warranties are found to be incorrect after settlement; or d Outsourcing the due diligence investigations of PPSR security interests to a third party.

8.9.6 If accurate and perfected security interests are of importance to a buyer, a buyer's due diligence investigations should include reviewing the seller's security agreements with the grantors and cross-checking those security agreements with the corresponding correctly recorded PPSR registrations (including but not limited to correct grantor details, correct collateral details and if relevant correct serial/registration number).

8.9.7 If it is found that PPSR security interests are not registered or are incorrectly recorded, then if feasible (and if a late registration would still enjoy the priority that it would have if correctly registered at the correct time) the purchaser may wish to make settlement conditional upon the seller registering a correct security interest on the PPSR.

8.9.8 Having accurate and perfected security interests post-purchase are important for a buyer. If a security interest (of which the buyer is the secured party) over collateral is defective or is not registered on the PPSR, and if the grantor sells that collateral and a party buys that collateral without notice of the buyer's security interest in it, then that party is entitled to take that collateral free of any security interest even though the grantor did not originally have legal title to that collateral in the first place.

8.10 **Employee entitlement**s

8.10.1 This Paper considers above some key liability areas in respect of employees, which is relevant in both seller and buyer due diligence investigations.

8.10.2 A key area of liability for which financial provision is not often made, is employee entitlements on a sale of business.

8.10.3 Where there is a transfer of business, new employers need to recognise the employee's service with an old employer for the purpose of many of their entitlements (including sick/carers leave, requests for flexible working arrangements and parental leave)[23]. In most Australian states, accrued long service leave and accrued annual leave need to factored in as a liability as these are recognised by a buyer on the basis of the prior service of the employee.

8.10.4 In an **asset sale**, a buyer has three main options in relation to employees of the seller:

a **Offer the employee employment with the buyer post-settlement, on the basis of recognition of the period of prior service that an employee has with the seller or its predecessor** → in this case, a redundancy payment does not need to be made, and employee's accrued entitlements carry over to the buyer, and the parties would usually come to an agreement in which the seller

[23] 'Employee entitlements on a transfer of business', *Australian Government: Fair Work Ombudsman* (Article) <https://www.fairwork.gov.au/employee-entitlements/when-businesses-change-owners/employee-entitlements-on-a-transfer-of-business>.

would "pay" the buyer (usually as an adjustment to settlement figures) a percentage of the value of:

i Accrued employee sick leave;

ii Accrued employee annual leave; and

iii Accrued employee long service leave,

in respect of the employees that the buyer is employing post-settlement;

b **Offer the employee employment with the buyer under a fresh contract, without recognizing any period of service that an employee has with the seller or its predecessor** → This approach can be problematic for a seller, in which event the seller would usually be responsible for any redundancy payments and the payment for all accrued annual leave. This can also give rise to a risk of a claim by a disgruntled employee on the basis of unfair dismissal. Usually the apportionment of risk between the seller and buyer in this respect is addressed in the contract of sale;

c **Choose not to offer the employee employment with the buyer** → This approach can be problematic for a seller, in which event the seller would usually be responsible for any redundancy payments and the payment for all accrued annual leave. This can also give rise to a risk of a claim by a disgruntled employee. Usually the apportionment of risk between the seller and buyer in this respect is addressed in the contract of sale[24].

8.10.5 However, an employee will not be entitled to any redundancy payment if they reject a buyer's job offer provided that the job offer:

a Is on terms and conditions that are similar (and not less favourable) to those of the employee's employment with the seller;

b Recognizes prior service with the seller for the purpose of future redundancy payments; and

c Would have been a transfer of employment.[25]

8.10.6 But what about the employees that the buyer chooses not to employ? This can result in liability for the buyer, depending on the arrangements that the parties come to in this respect. However, these are points of negotiation which are often changed by the parties.

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[24] In Queensland, clause 18.5 of the REIQ Standard Conditions of Sale | Business Sale places firmly in the buyer's hands:
- the financial responsibility for any redundancy payments the seller must make to any employee not chosen by the buyer; and
- the responsibility (by way of an indemnity from the buyer to the seller) for any loss arising from, or claim arising from or relating to, the redundancy of an employee not chosen by the buyer.

[25] 'Employee entitlements on a transfer of business', *Australian Government: Fair Work Ombudsman* (Article) <https://www.fairwork.gov.au/employee-entitlements/when-businesses-change-owners/employee-entitlements-on-a-transfer-of-business>.

8.10.7 In a **share sale**, these considerations are not as relevant, as the employees are being retained in the same entity – usually the buyer would assume liability for employee entitlements/redundancies. The parties often choose to make financial provision for basic employee entitlements in the contract of sale, usually by way of a settlement adjustment.

8.10.8 Consideration also needs to be given to any industrial instrument or award that an employee may be employed under, and the requirements under those instruments and awards on a sale of business.

8.11 Family trust elections

8.11.1 If the buyer is buying a business/company which is owned by a family trust, a buyer should be enquiring at the very commencement of the business purchase process whether the seller has made a "Family Trust Election" ("**FTE**") with the Australian Taxation Office ("**ATO**").

8.11.2 A trust can elect to be a family trust with the ATO by making a FTE. A FTE specifies one person whose family group will be the beneficiaries of the trust. A family group can include a company (such as the target company in this case). Distributions from the family trust should then be made to a person in the family group.

8.11.3 A FTE entitles the trust to access certain tax concessions. The trade-off is that any distributions made to a party that is not a member of the family group incurs family trust distribution tax which is the top marginal tax rate[26].

8.11.4 While the tax implications of the sale are ultimately the seller's burden, when the seller obtains financial advice as part of the sale process they may discover an unforeseen tax burden linked to the FTE which would result in them being liable to pay family trust distribution tax on the proceeds of sale at a rate of 49%, which may be in significant excess of what they had anticipated. This may cause a seller to withdraw from the sale to the extent that they are able to.

8.12 Reviewing IP ownership

8.12.1 A purchaser should consider whether any intellectual property used in the business is owned by the company in which shares are being acquired, or is being transferred with other assets in an asset sale.

8.12.2 The other consideration is whether:

a adequate steps have been taken to protect the intellectual property against infringement (i.e. trade marks or patents); and if not

b whether the company's use of the intellectual property is infringing upon another party's intellectual property rights.

8.13 Business Premises and Occupational Health and Safety Risks

[26] 'Family trusts – concessions', *Australian Taxation Office* (Article 5 July 2017) <https://www.ato.gov.au/General/Trusts/In-detail/Family-trusts---concessions/>.

8.13.1 Unless the target business is an online business, the business will probably have premises. As part of their due diligence investigations, a prudent purchaser or their delegate would physically inspect each of the business premises.

8.13.2 The scope of inspections would include the ordinary inspections undertaken as part of a purchase or lease of real property, including but not limited to:

a Title Search;

b Building and pest inspections;

c Building records search (purchase only);

d Land Tax search (purchase only);

e Contaminated land search; and

f Specialist inspections relevant to the industry of the business.

8.13.3 Additional enquiries that should be made of a seller in respect of the premises and business operating procedures are:

a Workplace Health and Safety Report and Workplace Health and Safety systems/procedures; and

b Risk Management Policies.

8.13.4 *Leases*

a If the business premises is leased, buyers need to carefully consider the contents of the lease for assignment and deemed assignment clauses.

b Where the sale is an **asset sale**, the seller and the buyer will first need to seek and obtain the lessor's permission to assign the lease from the seller to the buyer as lessee. The lessor will often require significant disclosure, assurances and security as a condition of granting their consent. Settlement of the contract should be conditional upon the lessor's consent to the assignment being granted.

c Where the sale is a **share sale**, the lease will remain with the target company. However, the parties should be wary of "deemed assignment" clauses, requiring the parties to obtain the lessor's consent (covered in seller due diligence above). Again, settlement of the contract should be conditional upon the granting of the lessor's consent in this circumstance.

8.14 Supply chain risk

8.14.1 Most businesses rely on third parties to provide some kinds of goods or services that they require to run their business.

8.14.2 Businesses which rely on these third party supply chains to provide good or services integral to their business operations are exposed to upstream supply chain risk.

Again, the level of risk that this poses to a business will depend on the industry of the business and the resulting level of reliance that the business has on third party suppliers. For example, manufacturing business will be heavily dependant on the supply of individual components from different third party suppliers.

8.14.3 Failure to receive goods on time, or interruption of services, can cause significant loss and delay to the business – from direct damage such as loss of profit, to secondary damage such as reputational loss or legal claims by clients/customers.

8.14.4 This risk can be partially managed by having appropriate agreements in place with third party suppliers, which have appropriate methods of recourse against the third party in the case of a loss event. However, the more unmanageable aspect is the risk presented by circumstances beyond the buyer's control – such as environmental and economic factors.

8.14.5 A purchaser may wish to consider undertaking due diligence on these upstream third parties in order to investigate the peripheral factors such as supplier capability, reliability and their exposure to risks, which may affect their running of their business post-settlement.

8.15 Other

8.15.1 **Material Adverse Change clauses** – much of the information revealed in the purchaser due diligence will be as at a certain date. Purchasers sometimes require the seller to include a material adverse change clause in the contract of sale, stating that a specific state of affairs (such as certain information revealed as part of the due diligence phase) is true and correct as at a specific time and will not change for a specific period of time (for example, true at the contract date, and will remain true as at the settlement date). These clauses are very buyer-favourable and are often refused by sellers.

9 CONCLUSION

9.1 Due diligence is, and should be, used in most business sales and purchases. In light of increasing regulatory burdens and complexity of entity structures, it is important for the parties to robustly understand the risks and rewards associated with the sale / acquisition of a business.

9.2 It is used by both sellers and buyers as a risk management strategy, to investigate the repeatability of the historic net profits of the business (unless the buyer has an alternative strategic reason for acquiring the business), and to identify any risks or historical facts that may impact on that profitability including impairments to hard assets being acquired.

9.3 There is no "standard" approach to due diligence investigations - they need to be conducted on a case by case basis. Effective due diligence is often a moving target; that is, investigations may reveal further matters for investigation and so on. Much of the due diligence investigations undertaken will turn on whether the transaction is to be as asset sale or a share sale.

9.4 Professional advisors (such as accounting firms and lawyers), if retained to conduct due diligence investigations on behalf of a seller or a buyer, should carefully consider their ability to discharge their duty to their client to take reasonable care and make reasonable investigations into the transaction in question such that a prudent practitioner would be expected to make in those circumstances, including considering:

9.4.1 the nature of the transaction;

9.4.2 the industry of the target business;

9.4.3 the risk profile of the business in question; and

9.4.4 any issues raised during the course of due diligence investigations.

9.5 If they fail to do so and their client suffers resulting loss, they may be found liable for negligence on the basis that they have failed to make proper investigations.

9.6 Due diligence is an excellent vehicle for managing parties' expectations at the commencement of a matter, and often triages issues which could otherwise become disputes post-settlement.