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Due Diligence in Foreign Jurisdictions: What you need to Know

Due Diligence: The Purpose, the Procedure and Pitfalls

By
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Introduction

Due diligence is an essential element of every M&A and financing transaction. The results of the due diligence review inform the parties' negotiations and resulting written agreements, and absent full and accurate information, the parties will be unable to address significant areas of concern and potential liability. Incomplete or poor quality diligence can result in a failure to pay a fair price for a target company or its securities and, in the worst case, result in additional liability to the client and possibly liability for the law firm and other professionals involved in the transaction.²

The scope and methods for conducting appropriate, reasonable diligence has become somewhat standardized, indeed internationalized in the current environment in which many transactions transcend borders. But it is still essential to ensure that every diligence project is developed in the context of the unique characteristics of the particular transaction and the budgetary and other constraints of the client.

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² Gary M. Lawrence, *Due Diligence in Business Transactions*, looseleaf (New York: Law Journal Seminars, 1994) at 1-3 to 1-4.

This paper provides a general overview of the purposes and objectives of conducting a thorough due diligence review, the recommended procedures for engaging in the activity and two recent Canadian cases that point-up potential pitfalls of not getting it right. In addition, a list of recommended resources is provided at the conclusion of the paper.

The Purpose

What is Due Diligence?

Due diligence has been defined as “the diligence reasonably expected from, and ordinarily exercised by, a person who seeks to satisfy a legal requirement or to discharge an obligation”³. Under that definition, the scope of a diligence investigation duly conducted should at minimum be what is reasonably expected or ordinarily conducted in the circumstances. This is important because failing to do what is “ordinarily” done could result in professional liability.

What are the Main Objectives of Due Diligence?⁴

The three main objectives of a well-planned and properly executed due diligence review are full disclosure, transaction evaluation and limitation of professional liability. Additional benefits, though likely less important, are the elimination of inefficiencies, the identification of potential areas of cost savings and the implementation of improved corporate planning and policy-making.

³ *Black's Law Dictionary*, 8th ed., s.v. “due diligence”.

⁴ This portion of the paper is a summary of the information from *Due Diligence in Business Transaction*, *supra* note 2 at 1-8 to 1-10.

Full Disclosure

In almost any type of business transaction, whether it is an M&A deal or financing arrangement, a due diligence investigation will include disclosure of particular, frequently protected, information by one or more parties. In business transactions that are unrelated to securities offerings, the disclosure obligations often originate from the representations and warranties set out in the principal transaction documents. Properly implemented and executed due diligence investigations assist in ensuring that the representations and warranties in the transaction agreements are accurately made and that complete disclosure is made in the disclosure schedules to the agreements.

Transaction Evaluation

Parties to a transaction are interested in reaching the most economically and strategically beneficial deal. To achieve this goal, all relevant information about a target company must be disclosed and evaluated. A due diligence review conducted by a skilled team is the optimal way to ensure that the most important information is revealed and examined. With complete information, the parties are equipped to make informed business decisions.

Limitation of Professional Liability

At an increasing rate, lawyers and other business professionals have found their reputations and their assets at risk as a result of post-closing disputes, particularly if liability for the dispute turns on whether the underlying facts were or should have been known prior to closing. Regardless of origin, effective due diligence is a significant element of a broader goal of limiting a law firm's exposure to claims of misconduct. One critical component of attaining that goal is consistent documentation of the due diligence procedures employed and the scope of the

activities undertaken. By making these efforts, professional advisors are better able to demonstrate that a reasonable degree of care and prudence was utilized in the due diligence investigation, therefore reducing the risk of professional liability.

The Procedure⁵

Gather Information

The first step in the due diligence investigation is to acquire an extensive knowledge base about an entity. In the case of a business acquisition, the entity is the vendor or target business. Establishing a contact person early on in the process, generally the vendor's in-house or external counsel, can greatly assist in the investigation. Once contact is established, the information gathering stage begins. At this point, requests for material contracts, and any other non-public information, should be made. Simultaneously, the parties' legal counsel should start gathering relevant publicly available information, such as personal property registrations.

Make the Due Diligence Plan

The second step involves formulating the due diligence plan. The scope of the plan depends on a host of factors including: the purpose of the due diligence, the budget allocated for the due diligence and the availability of the contact person. The plan should identify and focus on issues that are of greatest interest and risk to the client, so the client should participate in formulating the plan.⁶

⁵ The information related to due diligence procedures is a summary from Denise McKenzie, "Due Diligence Investigations" *The Licensing Journal* 22:5 (May 2002), 10. Although this article focuses primarily on due diligence procedures in the context of an intellectual property transaction, much of the procedural information can be applied to all variety of business transactions.

⁶ See *supra* note 2 at 1-39 to 1-83 for an excellent and detailed checklist that lawyers can provide their clients.

Verify the Information

Once the due diligence plan has been established and information provided, the information must be reviewed and independently verified. Verification involves reviewing the documents and other information produced and discussing any inconsistencies with the contact person. Negative information should be brought to the client's attention and, in some cases, brought to the target's attention.

Avoiding Problems

Two recent Canadian decisions are germane to a due diligence discussion as they reveal courts' views of the standard required when conducting due diligence. While experienced counsel may utilize an established due diligence plan, modified to suit particular transactions, counsel should become acquainted with the novel requirements and considerations set out in case law. Awareness of these novel requirements allows counsel to prepare the best possible due diligence plan and helps to prevent professional liability issues after completion of the transaction.

Corporate Searches⁷

In a business acquisition, the purchase agreement generally includes representations and warranties in respect of the vendor and its business or assets being purchased. To a certain extent, the purchaser can rely on these representations and warranties: should the representations and warranties prove to be untrue or inaccurate, the purchaser can

⁷ This portion of the paper is a summary from Stanley W.L. Freedman and Chantale Blais, "Ordering and Reviewing Searches" (Paper presented at the Conducting Effective Due Diligence course, Continuing Legal Education, Osgoode Hall Law School, Toronto, Ontario, October 2004).

either decline to close the transaction or, after closing, bring an action for damages (provided the transaction document contemplates these remedies/outcomes)⁸.

Regardless of the protection afforded by representations and warranties, purchaser's counsel customarily undertakes its own searches and investigations to verify and substantiate information provided by the vendor. Though each transaction possesses unique characteristics and may demand the completion of specific searches, the following searches are considered "essential" and should be conducted in a business acquisition:

- i. verification of the business name and its existence;
- ii. confirmation that the vendor's charter documents do not contain restrictions;
- iii. security perfected pursuant to personal property security legislation, e.g. in Ontario, the *Personal Property Security Act*, R.S.O. 1990, c. P.10;
- iv. security given pursuant to section 427 of the federal *Bank Act*, S.C. 1991, c. 46;
- v. writs of execution pursuant to execution legislation, e.g. in Ontario, the *Execution Act*, R.S.O. 1990 c. E.24; and
- vi. filing of a Proposal, a Notice of Intention to make a Proposal or a Voluntary Assignment into bankruptcy, and petitions for receiving orders, all pursuant to the federal *Bankruptcy and Insolvency Act*, R.S.C. 1985, c. B-3.

⁸ See the next subsequent for additional considerations regarding representations and warranties.

In addition to the searches listed above, counsel may be interested to know about a Prince Edward Island Supreme Court decision holding that Goods and Services Tax (“GST”) searches should be included in the standard corporate search repertoire. Specifically, the court in *Gillis v. Schurman*⁹ held that a solicitor’s failure to complete a GST search, which would have been completed by a reasonably competent and diligent solicitor, constituted a breach of the duty of care. A summary of the case is instructive.

Gillis v. Schurman

The two plaintiffs, both new to the business world, entered into an agreement to purchase together all shares of a business for \$62,500. In the process of arranging financing and at the bank’s suggestion, the plaintiffs retained the defendant solicitor to complete the necessary legal work; the deal closed shortly thereafter. More than one year later, the plaintiffs contacted the defendant solicitor to advise that Revenue Canada (now the Canada Revenue Agency) was seeking to collect approximately \$12,000 in unpaid GST from the company, an amount from as far back as 1990. The plaintiffs brought the action seeking payment by the defendant solicitor of the unpaid taxes, which coupled with penalties and interest, amounted to an excess of \$35,000.

At issue in the case was whether the defendant solicitor’s failure to request and receive information about the company’s tax status prior to closing amounted to a breach of the solicitor’s duty owed to his clients. In addition, the plaintiffs claimed that the defendant solicitor did not adequately warn them about the potential for undisclosed liabilities to surface, even though standard searches were conducted.

⁹ (2003) 38 C.P.C. (5th) 184 (P.E.I.S.C. (T.D.)).

The court held that the defendant solicitor's failure to complete the GST search, a search that would have been completed by the "reasonably competent and diligent solicitor", constituted a breach of the duty of care owed to his clients. In respect of warning the plaintiffs about potential undisclosed liabilities, the court decided that on the facts, the defendant solicitor met this duty.

Although the court found in the plaintiffs' favour, they did not recover the amount owing because of a lack of causation. Prior to trial, the defendant solicitor corresponded with the Canada Revenue Agency and inquired about the tax status of the company as of the date of closing. The Canada Revenue Agency responded and indicated that at closing there were no outstanding GST returns and there was no debit balance. The defendant solicitor's breach became a moot point – even if he had completed all of the necessary searches, nothing would have been discovered prior to closing. As the defendant solicitor had adequately advised the plaintiffs of the potential for undisclosed liabilities, the plaintiffs' loss could not be attributed to a breach of duty. In obiter, the court stated that had the defendant solicitor been found liable, he would only have been liable for the original \$12,000 together with minimal interest and penalties; the plaintiffs had a duty to mitigate their loss, and the defendant solicitor would not be held liable for their failure to do so.

The *Gillis* decision reinforces a solicitor's duty to conduct all essential searches, which includes GST searches, in addition to the duty to warn clients of potential undisclosed liabilities. Counsel acting in share sales should add this search to their repertoire.

Duty of Good Faith

A recent Ontario Court of Appeal decision also is relevant to a due diligence discussion. In *Transamerica Life Inc. et al. v. ING Canada Inc.*¹⁰ the court dealt with whether a duty of good faith could be implied into purchase agreements. While lawyers may be accustomed to a duty of good faith being implied into employment contracts and franchise agreements, the potential for such a duty in the context of a share or asset sale could be an unwelcome development¹¹.

Transamerica Life

In *Transamerica Life*, ING sold all of its shares of NN Life Insurance Company (“NNLIC”) to Transamerica. Prior to closing, Transamerica conducted a due diligence review on all aspects of NNLIC’s business and operations. Throughout the review, Transamerica raised a number of concerns that were ultimately addressed by ING. After the deal closed, Transamerica brought an action against ING based on breach of the warranties and covenants in the share purchase agreement, specifically those relating to the accuracy of NNLIC’s records and financial statements and unusual transactions, etc. In defence, ING argued that there were no errors in NNLIC’s systems, and in the alternative, ING maintained that Transamerica learned of these errors when conducting due diligence and accordingly breached its duty of good faith by not disclosing these errors to ING. On motion, Transamerica argued that portions of ING’s defence should be struck. The motions judge struck ING’s pleas that Transamerica had implied duties of good faith because such a duty was not tenable at law.

¹⁰ (2003) 68 O.R. (3d) 547 (C.A.).

At the Court of Appeal, ING claimed that the motion judge erred in holding that implied duties of good faith in this case were not tenable at law. In the result, the majority decided that the analysis of whether to imply a duty of good faith should be completed at trial. Accordingly, the majority's decision left open the possibility that a duty of good faith could be implied into contracts between sophisticated parties, even though clear language is used in their agreements. Therein lies the potential for a buyer to be prejudiced by its own due diligence. Buyers have traditionally had the power either to postpone the deal or to close the transaction and resolve such issues later on. Unfortunately, this decision leaves uncertainty regarding whether completed acquisitions can later be challenged based on a breach of a duty of good faith¹².

Conclusion

A properly conducted due diligence review helps ensure that the parties to a transaction have a more balanced information base from which to make decisions and, in particular, can uncover material points of business risk and liability. Customizing the due diligence plan to the particular transaction is an important first step toward getting it right (and providing reasonable professional advice) in the circumstances.

¹¹ Note that subsequent cases have questioned whether there is such an implied duty. See for example *IT/NET Inc. v. Cameron* (2006), 144 A.C.W.S. (3d) 1034.

¹² A. Paul Mahaffy "Asset and Share Purchases and the Duty of Good Faith: A Look at Due Diligence, Interim Period Obligations and the *Transamerica Life* Decision" (September 2004) 15:1 Business Beat 1.

There are many useful due diligence-related “how-to” sources of information and articles, many of which contain useful model diligence checklists. A sampling of some of the more recent and most useful sources is provided on the following pages.

Due Diligence Resources

American Bar Association, Business Law Section “Manual on International Due Diligence” (Forthcoming, 2006).

J.P. Bisnaire and James D. Scarlett, “Due Diligence Preparation and Conduct: What to Look for in Reviewing Documents” (Paper presented to the Second Annual Due Diligence Conference Toronto, Ontario, April 1999).

Stephen D. Bodley, “Due You Know What You Are Dueing and Why? An Overview”, *Corporate Due Diligence* (Continuing Legal Education, The Law Society of Upper Canada – Toronto, Ontario, March 2002).

Jason K.S. Bullen, “Why Perform Due Diligence?” (Paper presented at the Conducting Effective Corporate Due Diligence course, Continuing Legal Education, Osgoode Hall Law School, Toronto, Ontario, October 2005).

Jason K.S. Bullen and Cheryl Silver, “Minute Book Reviews” (Paper presented at the Conducting Effective Corporate Due Diligence course, Continuing Legal Education, Osgoode Hall Law School, Toronto, Ontario, October 2005).

Ian Goldberg, “Practical Issues Relating to Due Diligence” (Paper presented at the Six-Minute Business Lawyer conference, Continuing Legal Education, The Law Society of Upper Canada, Toronto, Ontario, May 2002).

Stanley W.L. Freedman and Chantale Blais, “Ordering and Reviewing Searches” (Paper presented at the Conducting Effective Corporate Due Diligence course, Continuing Legal Education, Osgoode Hall Law School, Toronto, Ontario, October 2004).

Robert T. Hollingshead, “Taking an Integrated Approach to Due Diligence” (Paper presented at the Due Diligence Best Practices Conference, Toronto, Ontario, May 2000).

Gary M. Lawrence, *Due Diligence in Business Transactions*, looseleaf (New York: Law Journal Seminars, 1994).

A. Paul Mahaffy, “Asset and Share Purchase and the Duty of Good Faith: A Look at Due Diligence, Interim Period Obligations and the *Transamerica Life* decision” *Business Beat* 15:1 (September 2004) 1.

A. Paul Mahaffy, “Due Diligence in a Wired World: A Comprehensive Checklist for Buying a Business; An Overview of the Purpose and Process of Due Diligence in Buying a Business” (Paper presented to the Canadian Bar Association. Toronto, Ontario, January 1998).

Denise McKenzie, “Due Diligence Investigations” *The Licensing Journal* 22:5 (May 2002), 10.

Craig Mitchell, “Just Checking: A Course on the Essentials of Corporate Due Diligence” (Paper presented at the Corporate Due Diligence course, Continuing Legal Education, The Law Society of Upper Canada – Toronto, Ontario, March 26, 2002).

Andre Perey, “Due Diligence in Joint Venture Transactions” (Paper presented at the Due Diligence Best Practices Conference, Toronto, Ontario, May 2000).

David N. Ross and John F. Fox, “Real Estate Due Diligence: The Purpose and the Process” (Paper presented at the Due Diligence Best Practices Conference, Toronto, Ontario, May 2000).

Gary R. Schiff, “Due Diligence or Bet the Firm: Take Your Pick!” (Paper presented at the Conducting Effective Corporate Due Diligence course, Continuing Legal Education, Osgoode Hall Law School, Toronto, Ontario, October 2005).

B. Bethune A. Whiston, “Pension and Benefits Due Diligence” (Paper presented at the Due Diligence Best Practices Conference, Toronto, Ontario, May 2000).