

**DUE DILIGENCE IN BUSINESS PROCESS: LEGAL INSIGHTS**

<sup>1</sup>T. Kameshwari Pranati and <sup>2</sup>Punam Karsh  
<sup>2</sup>L.L.M Students, Kalinga University, Raipur (C.G)

**ABSTRACT**

*Legal due diligence is a comprehensive procedure that entails examining, collecting, and evaluating all legal documents and information pertaining to the target company. This process enables both the buyer and seller to identify any possible legal risks, such as intellectual property intricacies or ongoing lawsuits, prior to completing the transaction. Legal due diligence may encompass the review of various aspects, including contracts such as customer, supply, operating, and employee contracts, as well as licenses and leases. It also involves assessing pending and potential lawsuits, intellectual property matters, compliance with all laws, and the payment of shares.*

*The buyer's counsel may look into permits and authorizations to identify any violations. Due diligence is a systematic examination of a business that can also assess commercial risks and opportunities.*

*In a legal perspective, due diligence in business processes involves thoroughly investigating and assessing potential risks, compliances issues, and legal obligations before entering into agreements or transactions. This ensures legal compliance, mitigates risks, and protects the interests of all parties involved.*

**RESEARCH OBJECTIVE**

This research aims to as follows-

- (1) To learn the concepts and types of due diligence in context of business process
- (2) To analyze involved risks and form a conclusion.
- (3) To gain some legal stand insights about it.

**RESEARCH PURPOSE**

The purpose of this paper to develop a better understanding about the due diligence in business processes and know legal insights on it and also to serve the purpose of compliance in my final year of course.

**RESEARCH METHEDOLOGY**

This research is made by using Secondary Research method which involves collecting and analyzing existing data from various sources.

**REFERENCES MADE**

Following references were made for this research –

**Primary Sources:**

1. The Sale of Goods Act, 1930, Section 16.
2. R. v. Steinberg [1931] O.R. 222 (C.A.).

**Secondary Sources:****Books:**

1. Spedding, Linda S. "Due diligence and corporate governance." Elsevier, 2005.
2. Rankine, "Due diligence: definitive steps to successful business combinations." Pearson Education, 2003.
3. Lawrence, Gary M. "Due Diligence in Business Transactions." Vol. 629. Law Journal Press, 2023.
4. Singh, S. K., "Angad Tiwary, and Nikhil Gupta. Business Law." 2021.

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5. Crilly, William M., and William M. Crilly. "Due diligence handbook." American Management Association, 1998.

### Journal Articles:

1. Harvey, Michael G., "Expanding the nature and scope of due diligence." *Journal of Business Venturing* 10, no. 1 (1995): 5-21.
2. Van Sandt, Barry K. "Due diligence: its importance, impact, and improbabilities." *Journal of petroleum technology* 42, no. 09 (1990): 1097-1101.

### CHAPTER I.

### INTRODUCTION

#### What is Due Diligence?

Due Diligence refers to an investigation, audit, or review to confirm facts or details about the concerned matter so as to make an analysis and find out the risks involved.<sup>1</sup>

In business, it is a systematic process that organizations use to verify or investigate or critically analyze a business entity before initiating a business. This could be with vendor, client, or third party. Due diligence can involve vetting issues and risks that can affect the business, and can take different forms depending on its purpose.

When it comes to due diligence on business process, it's about examining how a company operates from a legal perspective. This includes reviewing contracts, agreements, licenses, permits, and compliance with regulations. It is essential to ensure that the company's operations are legally sound and that there are no risks or liabilities that could affect its future performance or reputation. This process helps potential investors or buyers understand the legal aspects of the business they are getting involved with and identify any potential legal issues that need to be addressed.<sup>2</sup>

Legal due diligence is the systematic gathering, evaluation, and analysis of all legal papers and information pertaining to the target organisation, with the aim of reaching a judgement. It provides an opportunity for both parties to carefully examine any possible legal liabilities, such as litigation or patent and trademark information, prior to finalizing the agreement.<sup>3</sup>

- A legal due diligence involves a thorough examination of a company's legal standing to identify potential liabilities.
- This process requires the foresight, diligence, and attention to detail that a sensible and careful individual would normally apply in similar situations.
- The primary objective is to reduce and manage the associated risks.

#### Importance of Due Diligence

The role is to minimize risks for the transaction, to ensure that any risks that come up with the company, prior to the investor coming in, that the investor is adequately protected from those risks, which makes the due diligence extremely important. For example, lets a there is a company 'A' which is involved in a tax litigation which is quite the power on many companies, now if that something had gone wrong with the company before the investor

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<sup>1</sup>Harvey, Michael G., and Robert F. Lusch. "Expanding the nature and scope of due diligence." *Journal of Business Venturing* 10, no. 1 (1995): 5-21.

<sup>2</sup>Spedding, Linda S. *Due diligence and corporate governance*. Elsevier, 2005.

<sup>3</sup>Rankine, Denzil, Mark Bomer, and Graham Stedman. *Due diligence: definitive steps to successful business combinations*. Pearson Education, 2003.

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came in, before the investor has invested, now as a result the tax proceeding is against the company, investor should not be expected to take on that risk, in case the courts hold tax litigation against the company, it will run a loss. The investor ought to be protected against the loss unless if the investor himself agrees. So this how effectively risks are discovered in a company.<sup>4</sup>

### **Why do a Due Diligence?**

- According to Section 16,<sup>5</sup> unless specified by this Act or other applicable laws, there are no automatic guarantees or assurances regarding the quality or suitability of goods for any specific purpose in a sales contract. This means that the seller is not legally obliged to ensure the goods meet certain standards or fulfill a particular use unless explicitly agreed upon.<sup>6</sup>
- Caveat Emptor – ‘let the buyer beware’ is a common la doctrine that holds buyer responsible for examining property before purchase.<sup>7</sup>
- Goods once sold cannot be returned unless the ‘conditions’ not met. Can not claim for damages unless specific representation or warranties are made in the contract of sale.
- Due diligence allows to find out what specific conditions, representations and warranties ought to be sought.

In essence, this ensures that investors or purchasers of these goods have access to justice if issues arise with the goods or shares. Since shares represent partial ownership of a company, their value is tied to the company's performance. Thus, it is crucial for investors to verify that there are no hidden problems with the company or its shares. This is where due diligence becomes essential. It involves a thorough examination of the company's obligations, including its debts, leases, pending and potential lawsuits, agreements, and contracts. This meticulous investigation helps uncover any issues before making an investment.<sup>8</sup>

In *R v Steinberg*,<sup>9</sup> Ontario judge Harris wrote:

*“To require the steps taken by the company to absolutely prevent these occurrences under any circumstances whatsoever would go beyond due diligence, and would make the company a virtual insurer against any error. I do, not think that was the intention of the legislation; the words are all due diligence import an area of precaution sufficient to prevent the foreseeable, but not the unforeseen, the unexpected, the unknown, or the unintended.”*

The legal due diligence process is mostly seen with the Merger, Acquisition and amalgamation of business. As these requires the careful analysis of business procedures, most importantly the legal papers play a key role in understanding and beforehand preparations for the risks involved.

## **CHAPTER II**

### **ASPECTS OF LEGAL DUE DILIGENCE**

These includes-<sup>10</sup>

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<sup>4</sup>Lawrence, Gary M. *Due Diligence in Business Transactions*. Vol. 629. Law Journal Press, 2023.

<sup>5</sup>Section 16 in The Sale of Goods Act, 1930.

<sup>6</sup>Singh, S. K., Angad Tiwary, and Nikhil Gupta. *Business Law*. RAJEEV BANSAL, 2021.

<sup>7</sup> ibid

<sup>8</sup>Van Sandt, Barry K. "Due diligence: its importance, impact, and improbabilities." *Journal of petroleum technology* 42, no. 09 (1990): 1097-1101.

<sup>9</sup>R. v. Steinberg [1931] O.R. 222 (C.A.).

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### **1. Corporate Secretarial**

It is an overview of Company's compliance for verification of company's existence and incorporation. It includes Basic Company documents (Certificate of Incorporation, Memorandum of Association, and Article of Associations), All filings with Registrar of Company, Annual returns, Balance sheets, Charges, Board and Shareholder Resolutions, Appointment of Directors, Auditors, Issue and transfer of shares.

### **2. Property**

It is related with the properties owned by the company, conditions and insurance related documents. It includes Sale/ Lease deeds, Intellectual Property documents such as Patent and Trademark registrations, Assignment/License agreements, Moveable property such as Capital assets and goods.

### **3. Debt.**

The documents related with restrictions on share transfer on loan agreement, or properties subject to securities, Charges created under ROC. It involves Loan agreements, Sanction Letter, Security Document, ROC filings, Corporate Guarantees made by the Company.

### **4. Litigation**

This topic includes Aggregate of financial claims against the company, Contingent Liabilities, potentially ruinous legal proceedings. It involves the All ongoing legal proceeding documents and claims filed with the company but not responded to.

### **5. Permits and Licenses**

It refers to the documents related to the Restrictions under licenses which are Tax related materials like PAN, TAN, TIN and industry specific documents.

### **6. Substantial Agreements**

The concerned matters under this head are what are the occasions under which the 3rd party may cancel the agreement or what happens when a substantial agreement is canceled. It refers to the documents such as Any Agreements which represents more than 25% of revenue of the company and on which company is dependent for its operation.

### **7. Employees**

Under this head the involved documents are list of employees, registrations under EPF, ESIC, CLRA, etc and employment agreements with KMPs.

The mentioned above are the documents which plays an important role for legal due diligence as it creates the facts and provides as evidences to drive conclusion and facilitates the reduction of involved risks.

## **CHAPTER III.**

### **LEGAL DUE DILIGENCE PROCESS**

Following are the involved steps which are followed by the lawyers as due diligence in business-

- 1) Documents Requisition
- 2) Document Review
- 3) Consultation with target
- 4) If adequately explained
- 5) If not Adequately explained

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<sup>10</sup>Rankine, Denzil, Mark Bomer, and Graham Stedman. *Due diligence: definitive steps to successful business combinations*. Pearson Education, 2003.

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According to Crilly's Due Diligence Handbook, the due diligence process involves gathering adequate information about a company so that an individual or organization can make an educated decision regarding its worth for a particular objective.<sup>11</sup>

During legal due diligence, the acquiring entity primarily directs its attention towards two pivotal aspects:

1. Ascertain the present standing of the target company - This constitutes the fundamental core of the legal due diligence process as it lays the groundwork for future endeavors. A thorough examination aids in comprehensively grasping the nature of the acquisition and facilitates prudent strategizing. Additionally, it enables an evaluation of the current status quo of the target company.
2. Assess the ramifications of the business - This endeavor seeks to delve into the cause-and-effect dynamics of the target business, elucidating avenues for optimization in favor of the acquiring party. The appointed legal advisor undertakes a meticulous cost-benefit analysis to gauge the risks inherent in the acquisition, alongside the potential gains and losses entailed in the transaction.

### **1<sup>st</sup> STEP is to PLAN**

The first stage in this procedure should include engaging the services of a competent legal team that will meticulously organise and strategize the whole investigation or due diligence process.

### **2<sup>nd</sup> STEP is to RESEARCH**

In order to conduct a thorough and effective legal due diligence, it is essential for the parties involved to meticulously review all pertinent documents, such as the AOA, MOA, registration papers, accounts, balance sheets, assets-liabilities papers, leases, contracts, agreements, deeds, and other relevant documentation. After obtaining all the necessary legal papers, including as incorporation documents, shareholder warrants, outstanding warrants, licences, and permissions, the next step in the procedure is to proceed with inspection and reviews.

### **3<sup>rd</sup> STEP is ANALYSIS**

Upon completing the second phase, it is necessary to do a thorough analysis in order to determine the legal risks involved, following the review and inspection process. The legal due diligence procedure concludes when the buyer is sufficiently content and has thoroughly examined all pertinent matters about the firm, enabling them to have a comprehensive understanding of the market before to signing the main agreement.

### **4<sup>th</sup> STEP is PRESENTATION**

The results of the legal due diligence are thereafter provided to the counsel/advisor for further examination and analysis. The findings should be provided in an organised fashion, such as a memorandum format, which includes a summary of all the documents obtained, the significant problems involved, and the potential remedies expressed as comments or key points. In order to get a more efficient report that addresses their primary problems and prioritises them, the buyer should clearly communicate their objectives and expectations to their adviser.

## **CHAPTER 1V**

### **CONCLUSION**

Legal due diligence is the systematic gathering, arranging, and examination of all the legal records, data, and information pertaining to the specific firm under consideration. It provides an opportunity for both the purchaser and vendor to carefully examine any possible legal liabilities, such as lawsuits or intellectual property specifics, before to finalising the transaction. By comprehending the target firm and assessing any possible liabilities, both parties may collaboratively reach informed decisions in commercial concerns.

This may involve a review of:

- Contracts

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<sup>11</sup>Crilly, William M., and William M. Crilly. Due diligence handbook. American Management Association, 1998.

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- Licenses
- Leases
- Pending / potential lawsuits
- Patent, Trademark, Copyright issues
- Financial Statements
- Restriction agreements
- Representations and warranties
- Documents such as company by-laws, limited liability , stakeholder agreements

The due diligence procedure often lasts for more than 1-2 months due to its extensive nature. Typically, this is the duration required for the buyer to do a comprehensive assessment of the firm, including all legal concerns. Nevertheless, the procedure might be very time-consuming and expensive, contingent upon the available resources and discoveries.

Due Diligence Process includes various steps which includes Planning, researching, analyzing and risk assessment and providing solutions for risks involved by legal advisor. Legal Due diligence is crucial in various contexts like Merger, acquisitions, investments, or partnerships. It helps uncover potential legal risks, liabilities, or compliance issues associated with a business or transactions. By conducting thorough legal due diligence, parties can make informed decisions, mitigates risks, negotiate better terms, and safeguard their interests. It is like a safety net in the complex web of business dealings, ensuring transparency and legal compliance.