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INDIA'S AGE OF GROWTH AND THE SIGNIFICANCE OF DUE DILIGENCE: A CRITICAL ANALYSIS

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ABSTRACT

India's large labor force, untapped resources and powerful wealth has set it on a pedestal as the most desirable, lucrative destination for foreign investments. With the advancement of Globalization, a lot of companies have eyed investment in India and vice versa. However due to a lot of reasons such as Unawareness, less defined substantive laws, no common grounds, different legal entities and background, ease of doing business, access to consumer option, and the cultural context have proven to be an obstacle to foreign firms' open investment.

Due Diligence is one part of the process which ensures the fairest practice and allowance of mergers and acquisition. It is divided into a simple process and requires certain documents. However, the process is not legally framed or written anywhere, nor is it substantive in nature, as a result of such limitations of due diligence the malpractices tend to continue in the status quo.

The authors in this paper aim to highlight the existing problems and limitations with due diligence in regards to mergers and acquisitions with respect to cross border transactions or otherwise and provide suggestive solutions to curb the problem, with nuances of existing legal framework and its loopholes.

INTRODUCTION

India's expansionist policies have enhanced the growth of foreign Direct Investments in India. After the economic liberalization, Mergers and Acquisitions become a common activity throughout India. In a supremely competitive global market environment, Mergers and Acquisitions have been one of the fastest strategic options for companies to have certain advantages in the market. A merger is a combination of two companies, with one company merging itself into other and losing its identity and brand name, while the other more prominent company gains more importance and consolidates the other company or gains some advantage out of it. In simpler words, Merger is an arrangement that cumulates the assets of two or more companies and gives their whole control under one company. Acquisition simply means buying the ownership in a tangible or intangible asset such as purchase by one company of controlling interest in the share capital of another company or in the voting rights of an existing company All the companies in India who decide their market access policy should be mindful of FDI, security, corporate laws, financial derivatives and direct and indirect taxation. All companies and businesses entering the industry must comply with the FEMA Regulations and the Companies Act.

Under the Indian Law, the terms related to mergers and acquisitions are defined accordingly under the following laws: The term 'amalgamation' is used synonymously with the term merger and both these terms are used interchangeably but both these terms are not precisely defined in The Companies Act, 1956. Section 390 to 395 of Companies Act, 1956 deal with arrangements, amalgamations, mergers and the procedure to be followed for getting the arrangement, compromise or the scheme of amalgamation approved in India but the term merger or acquisition is not defined within the Act. However, the Income Tax Act, 1961 defines the term 'amalgamation' under section 2(1B) of the Act as the merger of one or more companies to form one company in such a manner that all the properties and liabilities of the amalgamating company(s) become the properties and liabilities of the amalgamated company, and not less than three-fourth shareholders of the amalgamating company become the shareholders of the amalgamated company.

A key part of all-important business deals is ethical due diligence. Although it might be a rigorous procedure, the process ends up being more effective, cost friendly, and saves resources until the business verifies the reasons for legitimate due diligence and the purpose for which it is typically carried out. Contingent to the stance of the target company towards the acquirer, a corporation that is the subject of a merger or acquisition or a consolidation attempt may resort to various precautions.

1) Companies Act, 1956[1]
2) Competition Act, 2002[2]

[1] The Companies Act, 2013, Sections 390-396, No. 18, Acts of Parliament, 2013 (India).
[2] The Competition Act, 2022, Sections 5 and 6, 23, No. 12, Acts of Parliament, 2003 (India).

3) SEBI (Substantial Acquisition of Shares and Takeovers) Regulations, 1997[3]
4) Income Tax Act, 1961[4]
5) Foreign Investment Promotion Board (FIPB)

These are the major legal institutions in India that govern the procedure of Mergers and Acquisitions.

CROSS BORDER TRANSACTIONS

Cross Border Mergers and Acquisitions have become a key activity in the international business market scale. As much as it is procedural, it is also a very a difficult task, where a lot of legal check- in mechanisms and accountability needs to be set up. A few difficulties that are faced during Cross Border Mergers and Acquisitions are; Long Distance Communication Problem, Misunderstandings from different types of business norms, difficulty in not having a common ground or legality and key fundamental differences with regards to management and administration.

WHAT IS DUE DILEGENCE

The undefined term 'due diligence' was defined by the apex Indian court as "thorough research; it means such diligence as might be practiced by a responsible man in the management in his own relations."[5] It derives its roots from the famous maxim of consumer law which is 'caveat emptor' meaning 'buyer beware'. This principle implies that a buyer must satisfy himself before entering into a transaction and it is embraced by the entire corporate diaspora all over the world who now use the process of Due diligence before entering into any transaction.[6]

Due diligence is the process of evaluating and investigating a prospective business decision by getting information about the financial, legal, intellectual and other material information from the other party.[7] Due diligence is often used in transactions of merger, acquisitions and investments by venture capitalists and angel investors to ensure that the company they are investing into is one which has no secret drawbacks which makes it a bad investment on their part. In essence, due diligence is a strategy undertaken to ensure that the acquirer does not face unexpected legal or contractual contingencies in the future.

Due diligence involves the application of Section 3 of Transfer of Property Act which says that, "a person is said to have notice of a fact when he actually knows that fact, or when, but for wilful abstention from an enquiry or search

[3] Securities & Exchange Board of India Act, 1992, Section 30, No. 15, Acts of Parliament, 1992 (India).
[4] The Income Tax Act, 1961, Section 2(1B), No. 43, Acts of Parliament, 1961 (India).
[5] Chander Kanta Bansal v. Rajinder Singh Anand, AIR 2008 SC 2234.
[6] Flink, S., 2012. Due Diligence and Valuation Policy: Caveat Emptor Squared. *PIPEs: A Guide to Private Investments in Public Equity, 2nd, Revised and Updated Edition*, pp.221-242.
[7] Chenoy Ceil, Role of Due Diligence in Mergers and Acquisition, SSRN, pg. 3 (2013), https://ssrn.com/abstract=2294836

which he ought to have made, or gross negligence, he would have known it."[8] The interpretation of this section says that due diligence ought to be treated as a mandatory practice if a person wants to claim that he possessed the knowledge of any fact while dealing in properties because the statute anyways assumes knowledge in absence of due diligence which is why the person entering into the transaction is better off in conducting due diligence.

Moreover, Section 27(1) of the SEBI act says that, "Where an offence under this Act has been committed by a company, every person who at the time the offence was committed was in charge of, and was responsible to, the company for the conduct of the business of the company, as well as the company, shall be deemed to be guilty of the offence and shall be liable to be proceeded against and punished accordingly. Provided that nothing contained in this sub-section shall render any such person liable to any punishment provided in this Act, if he proves that the offence was committed without his knowledge or that he had exercised all due diligence to prevent the commission of such offence."[9] This means a proper due diligence can be used as a defence to escape liability against company offences under SEBI act.

Business transactions always involve risks and by performing due diligence this risk can be minimized. Startups or new companies are always the one with innovative ideas which makes them lucrative for investors. These investors are cognizant that the startup is a high value asset for them in future but they also accept the risk associated with a volatile new business whose performance is contingent on externalities. The scope of these externalities extends to legal cases pending for intellectual property, un-discharged contractual liabilities for seed investors, hostile work culture policies like no maternity leaves, etc. All of these affect the long-term sustainability of a business and hence due diligence is outsourced to law firms and consultancy firms to ensure that the parties get the fruits they desire. A business has multiple factors which impacts its operations like production, finance, sales, management and many more. All these factors involve various complex nuances which need to be inspected in order to ensure that the transaction is fair and without unknown negative consequences.

Failure to exercise due diligence can be cataclysmic for any business in the future because unknown flaws and facts will materialize much after the deal has been closed and will adversely affect the investor or acquirer. Therefore, using aid of an attorney and charted accountant can allow the parties to be satisfied that the deal they are entering into is free from attachment of negative deal breakers and the issues identified during due diligence can be dealt with before the deal is finalized for the betterment of both parties.[10]

While entering into a transaction of merger, acquisition or investment, the buyer conducts a due diligence under which both parties are obliged to disclose all facts including their transactions, outstanding payments, key partners, pending law suits, management design, etc. This way both parties can agree on desired changes before concluding

[8] Transfer of Property Act, Section 3, No. 4, Acts of Parliament, 1882 (India).
[9] The Securities and Exchange Board of India Act, Section 27(1), No. 15, Acts of Parliament, 1992 (India)
[10] Lineberry, C. and Carleton, J.R., 2004. *Achieving post-merger success: A stakeholder's guide to cultural due diligence, assessment, and integration*. John Wiley & Sons, pg. 117-119.

the deal or agree to take on specific liabilities and indemnifications with respect to all previous conduct which extends to even after the deal.

TYPES OF DUE DILIGENCE AND PROCESS

When undertaking Due diligence, the acquirer needs to focus on multiple aspects of the business being acquired. This makes the process of due diligence daunting and long even though rewarding in the end. The various forms of due diligence can be categorized as follows:

1. Administrative Due Diligence- This involves verifying administrative related items like information about workplaces, facilities and statistics about occupancy. This gives the buyer insights into what admin and operational cost will he incur after the transaction. A proper admin due diligence can allow the buyer to distinguish revenue with profit and make the decision wisely.[11]
2. Financial Due Diligence- This is the most important part of the due diligence process wherein the buyer needs to enquire the accuracy of books of account, projections and transactions are accurate. This includes checking for audited financial statements, unaudited financial statements, future projects and their revenue projections, capital expenditure plan and most importantly details of debtors and creditors. It also included cross checking and re-calculating details of major customer accounts, fixed and variable cost analysis, analysis of profit margins and internal control procedures, etc.[12]
3. Asset Due Diligence- Under this type of due diligence, the buyer inspects the account of all assets owned by the company in various capacities. This includes a schedule of fixed assets and physically inspecting them, real estate deeds, mortgages, title policies and permits if any.
4. Human Resource Due Diligence- The post-transaction entity still employs the same people and this is why HR due diligence becomes paramount. The employees need to adapt to the new work culture and this includes an analysis of all employees and their service terms and contracts, an analysis of all current salaries, bonuses and a summary of HR policies also.[13]
5. Environmental Due Diligence- Environmental due diligence is extremely important because contravention of any environmental policy or standard is punishable and the company can be penalized. During the

[11] Corporate Finance Institute, https://corporatefinanceinstitute.com/resources/knowledge/deals/types-of-due-diligence (last visited June 21, 2022)
[12] Nandini Shenai, Due Diligence for Companies under Indian law, SSRN, pg 8-9, 2021
[13] Horwitz, F.M., Anderssen, K., Bezuidenhout, A., Cohen, S., Kirsten, F., Mosoeunyane, K., Smith, N., Thole, K. and Van Heerden, A., 2002. Due diligence neglected: Managing human resources and organisational culture in mergers and acquisitions. *South African Journal of Business Management*, *33*(1), pp.1-10.

environmental due diligence, the buyer needs to make sure all environmental licenses and permits are takes, company's disposal methods are in sync with regulations, etc.[14]

6. Taxes Due Diligence- Under-reporting or misleading tax returns can put a business in jeopardy and to avoid that the buyer must exercise tax due diligence carefully. This includes inspecting copies of all tax returns, information relating to any past or pending tax audits, any pending tax litigations, etc.
7. Intellectual Property Due Diligence- Intellectual property is a very integral part of every business, one which makes it unique and attaches an identification marker to the brand value of the business. This is why while conducting due diligence, the buyer should look into schedule of patents, copyrights, trademarks, any pending applications or any pending claims for IP violations.
8. Legal Due Diligence- Under legal due diligence the buyer needs to look at the company's important documents like MoA, AoA, minutes of Board and General meetings, shares certificates issued to key managerial persons, all key contracts with vendors, licensing or franchising agreements and copies of all loans and financing agreements.

COMMON ISSUES IN INDIA

The process of Due Diligence covers four things largely;

a) strategic positioning
b) operational performance
c) financial and tax
d) legal evaluation.

While following the Due Diligence a lot of companies perform Due Diligence Frauds and other white-collar crimes in order to save themselves repercussions against the interest of their own companies.

- Companies being acquired always show inflated numbers
- Settling up the books and accounts before the process of due diligence begins
- Forged and False documents shown during the process

All these give rise to White Collar crimes committed by the companies in order to perform the desirable activities without being caught legally to pay fines or bear the punishment.

[14] Van Kalmthout, D., Romeo-Stuppy, K., Huber, L., von Eichborn, S. and Clément, C., 2021. Mandatory environmental and human rights due diligence. *Tobacco Induced Diseases*, *19*.

LIMITATIONS OF LEGAL DUE DILIGENCE

Legal Due Diligence is a complex and long process which involves large quantity of information to be processed spanning across various realms of corporate transactions. This creates certain limitations to legal due diligence which are as follows:[15]

1. There is always a potential risk of non-disclosure or misrepresentation when dealing with a lot of people and transactions. In order to secure a good deal within the merger or acquisition, the company would misrepresent certain issues to avoid scrutiny or to avoid lowering down the ask price. Legal agreements and compliances can also be misrepresented to lure the buyer which later could pose a risk for the latter to be stuck with legal complications. Given the amount of data both qualitatively and quantitatively, it becomes difficult to ensure that there is no such concealment or misrepresentation.
2. Often times the deal in place involves various stakeholders like investors, shareholders, creditors and customers. These stakeholders want the deal to be executed in a limited time. This need for rush also becomes a reason for ignorance of information within due diligence wherein the buyer ignores certain crucial elements in order to speed up the acquisition or merger.
3. Legal due diligence also includes dealing with IPs, agreements, transactions related to foreign jurisdictions. This requires more time and often difficulties to obtain transparency due to difference in legal systems of both areas. Often time, crucial information can be hidden due to this legal tussle.
4. Raw data can be interpreted very differently by different people. A single data item can have multiple consequences and interpretations. These interpretations are then contingent on the judgement of the person who is examining the data. If such a person ignores certain interpretations or is incapable of processing them then it could leave out scope for undesired contingencies in the future.
5. Lack of in-depth analysis can also be a boon to the process of due diligence because the buyer only focuses on sanitized and vetted reports which are made to please the buyer. A lot of times the real dirt can be suppressed in places where no one looks like emails and embezzlement might happen through blue collar workers who are never interviewed and aren't considered tantamount to the top-level management.

[15] Pooja Patel, Path to a successful M&A Transaction: An effective legal due diligence, Institute of Company Secretaries of India (21st June, 2022, 11:47AM), https://www.icsi.edu/media/portals/72/year%202017/presentation/Legal%20Due%20Diligence%20-%20180217%20-%20Pooja%20Patel.pdf

DUTY OF CARE AND PROFESSSIONAL LIABILITY

Duty of care and professional liability is considered to be the best measure to ensure the required amount of due diligence which is time and again affirmed by different courts in the world.

"Higher than ordinary standard since a lawyer, being a professional, impliedly assures the person dealing with him that the skill which he professes to possess shall be exercised with reasonable degree of care and caution"[16]

According to Jacob Mathew vs State of Punjab, 2005 SC, *liability is governed by principle of negligence –may be held liable for: not possessing the requisite skill which he professed to have possessed and not exercising with reasonable competence, the skill which he did possess.*

Negligence should be defined keeping in mind the following three things:

a) that of an ordinary competent person exercising ordinary skill in that profession - not necessary for every professional to possess the highest level of expertise in that branch which he practices
b) Negligence would depend on facts of each case and on the extent of client's reliance on DD findings
c) Biggest concern from a service industry standpoint is the loss of reputation[17]

These should be the standards to ensure the call out for negligence and establish liability to ensure the process of Due Diligence being flawless.

SOLUTONS AND SUGESSTIONS

Indian startups are in a phase of rapid growth wherein we recently saw 250 startups being acquired recently.[18] This has brought ample amount of foreign investment in India along with a fast-paced economic development. In order to continue treading down this path, the process of Due Diligence needs to be taken care of with a heavy priority whenever involved in a M&A transaction. Here are a few suggestions for the same:

1. Work culture can have a huge impact on a post transaction entity. A hustle culture can be very daunting for employees where the extreme emphasis on productivity, in the long run, frustrates employees and the work environment becomes hostile against the management and the chain of command is affected. A non-cooperating staff is one of the major reasons of down fall for businesses. This is why work culture due diligence should be given equal importance as other forms of due diligence so that long term sustainability of the business can be preserved.

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[16] Jacob Mathew v. State of Punjab, [(2005) 6 SCC 1]

[17] Jacob Mathew v. State of Punjab, [(2005) 6 SCC 1]
[18] Entrackr, https://entrackr.com/2022/01/indian-startups-saw-over-250-acquisitions-in-2021-entrackr-report/ (last visited June 28th, 2022).

2. There should be mandatory due diligence with respect to human rights and labor standards. All the extra focus on productivity allows companies to compromise on labor standards and it goes far enough to even violate human rights. This includes but is not limited to long work hours, terrible leave policy, bad working conditions and environment, etc.
3. Defined committees for different types of diligence should be setup in order to avoid spontaneous mishaps. A strict mechanism for the process of Due Diligence should be framed down to be followed by all these committees.

CONCLUSION

Due to India's growing economy and fast paced Corporate culture; mergers, acquisitions and investments have boomed and are expected to grow manifolds over the next couple of years. In order to ensure that these companies take smart and wise decisions by investing in sustainable companies they will need to prioritize the process of Due Diligence and make sure that every box is checked in the list of a good due diligence so that their decisions can make them money and reduce trouble. Due diligence is of paramount significance for Indian startups who are looking forward to foreign investments from angel investors, banks or venture capitalists. These startups have an innovative USP and they only need funding to expand their operations and generate sizeable returns. This funding can only be procured if the investor is satisfied that the startup is not hiding anything and is fulfilling all parameters of being a good investment. The foreign investor will always adhere to global standards of Due Diligence which are precise and vast and this is why a culture of proper due diligence should be instilled in Indian companies so that this standard can be matched and more startups can gain the funding necessary for them to fly.

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16. Jacob Mathew v. State of Punjab, [(2005) 6 SCC 1]
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