Undertaking Due Diligence and its Challenges – A Perspective of the 'IBC' Regime

written by Prithiviraj Senthil Nathan | January 15, 2020

It has been more than three years since the enactment of the Insolvency and Bankruptcy Code, 2016 ("IBC"), which has generated a positive impact on the distressed Merger and Acquisition ("M&A") space where many sensed an opportunity to acquire assets. This is evident from data published by the Insolvency and Bankruptcy Board of India which highlights the significant surge in the sale of distressed assets comprising 12% of the total M&A[1]. The said surge is contributed by the companies in the sectors of steel, power, real estate and infrastructure[2]. Having said that, undertaking due diligence on these distressed assets remains a challenge, even today. One of the main reasons is the nature of the asset itself being distressed, one would not any kind of information or access. This, in turn, would lead to the derailment of the resolution of a clutch of assets. The recent example being the case of Amtek Auto (with its subsidiaries like Metalyst Forgings and Castex Technologies) where the potential acquirer, Liberty House, refused to pay for the asset, citing such discrepancies in information shared at the time of due diligence and what exists at present. This article provides an overview of the legal framework for undertaking diligence in distressed M&A and the potential risks and challenges in the process.

What is due diligence? Is it mandated by law?

Due diligence is a process undertaken usually by an acquiring/purchasing entity with or without the assistance of the experts in order to evaluate the target entity's business, capabilities, assets as well as financial performance. The process is usually initiated when the stakeholders (involving the acquirer/target company/promoters) execute the term-sheet/confidentiality (binding or non-binding) document reflecting the commercials of the proposed deal. By undertaking diligence, the acquiring entity ensures visibility in order to determine the genuineness and legitimacy of the target entity which would protect itself from future financial, commercial and legal problems. Further, the diligence process has a significant bearing on the

outcome of the M&A transaction, in terms of the final commercials, appropriate reps and warranties to be obtained, negotiation leverage and investment decision.

A number of provisions of the Companies Act, 2013[3] and Securities and Exchange Board of India ("SEBI") Regulations[4] cast a duty on the director to exercise due care and skill.

They are duty-bound to act in the best interests of the company while entering into business transactions. In this regard, reference may be drawn to the landmark decision of the Delaware Supreme Court in *Smith v. Van Gorkom.*[5] The Court, in the case, held the board of directors to be grossly negligent and personally liable in approving a cash-out merger proposal which assured shareholders a premium of 39-62 percent (depending upon the method of calculation) over the market price without exercising reasonable care. Further, the Court opined that in cases where the directors have failed to act in a presumably reasonable manner, they would enjoy no protection and can be held personally liable. The Court went on to lay down an ideal procedure for the Directors to follow in arriving at a business decision. The Courts’ opinion categorically stresses careful planning and structuring of Board participation when initiating a major corporate transaction such as the sale of the company.

Recently, in *Nirma Industries and Anr. v. Securities and Exchange Board of India* [6], the Supreme Court, applying the aforementioned principle to investment acquisitions, strictly interpreted Regulation 27 (d) of the SEBI (Substantial Acquisition of Shares and Takeovers Regulations) 1997 and held that that due care and caution must be exercised by the investor company in ensuring appropriate due diligence in respect of the target company before investing. While doing so, the Court indicated that Nirma Industries were aware of various litigations and therefore, could not plead ignorance of the litigation and the dangers of the investment.

Due-diligence exercise in IBC regime

Due diligence is a key exercise in the distressed M&A, given the nature of the asset (which is distressed). Unlike a normal M&A transaction, the acquirer/purchaser, in the distressed M&A transaction, cannot have the cushion of relying upon representations and warranties contemplated/to be contemplated in the transaction documents. Additionally, an escrow mechanism which is a useful tool for the acquirer against the warranty or indemnity claims (in a normal M&A transaction) will not be ideal in a distressing situation as it is likely to affect the purchase price and the timing of its payment.

During the diligence process of a distressed M&A, the acquirer had to work with the Insolvency Professional (“IRP”) and not with the board or its nominees of the target company against the traditional practice. This is in line with the corporate resolution

insolvency
process enumerated in IBBI (Insolvency Resolution Process for Corporate Persons) Regulations, 2016 (“CIRP Regulations”) which suspends the powers of the Board of Directors, once the IRPs are appointed by National Company Law Tribunal (“NCLT”). Thus,
with the suspension of the Board of Directors, the officers and managers of the
corporate debtor are required to report to the IRP. This also means that it is
the duty of the IRP to protect and preserve the corporate debtor’s properties and manage the operations of the corporate debtor as a going concern.
At this juncture, it is important to understand the Corporate Insolvency Resolution Process (“CIRP”) which is summarised below:

1. Admission of the application by NCLT filed
either by the operational creditor or corporate debtor;

- Moratorium order is
passed by the NCLT prohibiting the institution of suits or continuation of pending
suits or enforcement of any security interest created by the corporate debtor in respect of its property including the transfer of assets by the corporate debtor[7]. This order of moratorium remains in
effect till the completion of the CIRP or earlier if NCLT approves a resolution
plan or passes an order for liquidation of the corporate debtor[8];
- Appointment of IRP for
30 days by the NCLT;
- Constitution of the committee
of creditors (“COC”) by IRP comprising all financial creditors (other than related parties) of the corporate debtor. Upon constitution, prior approval of the COC (i.e., obtaining consent 2/3rd members) is
required for certain matters including but not limited to creating any security
interest over the assets of the corporate debtor, changing the capital structure of the corporate debtor, change in the management, etc;
- Drawing the resolution
plan: IRP initiates the process by preparing an information memorandum containing the necessary data prescribed. This is followed by an invitation by
the Resolution Applicant who can invite only those applicants to submit a resolution plan who fulfil the criteria as laid down by him with the approval of the COC.
- Approval of the
resolution plan by the COC and NCLT.

Due Diligence in distresses M& A diligence must be
initiated by analysing the reasons for the distress. This analysis is important
from the purchasers’ perspective to find out risks associated with distressed assets which could be either genuine business reasons or other reasons like a fraud
(or business and fraud), etc. The analysis must be based on target review of the contracts, vendor and employee, debtors and write-offs.

Therefore, the due diligence process is similar to the standard
M&A, which should involve financial, technical and legal diligence with an addition
that the reasons that led to the asset becoming distressed must be suitably factored. The diligence should be focusing on the overall industry of the target, its related parties (including the group companies), documents shared in the data room and information available in the public domain.

Challenges in undertaking due diligence

Some
of the challenges in undertaking the diligence in distress M&A is interspersed below:

1. Lack of information: Undertaking a
due-diligence of a corporate debtor has constraints in the form of a lack of information shared. This is mainly due to the dependency of the information at
various levels starting with the IRP, COCand existing management for providing
relevant information. This lack of quality often results in the discrepancy that could lead to disputes as in the Liberty House case[9].

- Access to
the information: Since the management of the affairs of
the corporate debtor vest in the IRP, having access to the information itself is a challenge. This has to do with the IRP, who, in most cases does not possess knowledge on the industry (apart from the fact that IRP has very little
visibility on the target) and simply relies on
the promoters and other officers of the corporate debtor for such information.
The promoters, being already removed, are usually not very cooperative and leave a huge piece of unknown information with the IRPs. Though, the IBC mandates the promoter or any
other person to co-operate with the IRP and provides IRP a right to approach NCLT with an application for necessary directions in case of default. Exercising
the right would create more issues from a practical perspective.
- Time Factor: Thirdly, unlike in a normal M&A situation,
where the stakeholders have time to negotiate with third parties to obtain consents or negotiate changes to allow the sale to proceed, in distressed sale,
there could be scenarios of interaction with third parties who have interests in sale assets and over whom the seller has no control. This can create significant
delays in the consummation of a transaction.
- The issue of contingent and past liabilities will make it difficult for
the due diligent expert (being it legal or financial) to arrive at the correct
findings and make recommendations towards the same.
- Given the nature of the asset, and due to the necessity of involving different
types of experts to perform the diligence, expenses in the form of their professional fees can add up to the acquirer, and in the distressed M&A, it

is unlikely that a seller can absorb those. The acquirer can request for a discount
from their chosen advisers if a transaction does not close.

Effective Planning – A Key in Diligence

While there are challenges in undertaking diligence,
effective planning and strategizing can, to an extent, help in overcoming the issues. The diligence process can be bifurcated into pre-closing diligence and post-closing
tasks. Pre-losing diligence must be initiated with the acquirer’s identification
of the correct industry experts to conduct the diligence. Such an expert should
understand the people involved in the business and how the business functions. He/she must be mindful of the limited
access of the information about the target company and must insist on setting up a dedicated data room that will ensure that the available
data is made accessible to the diligence team. In this regard, having a detailed sector-specific checklist prior to the initiation of the diligence and
a comprehensive additional information/documents list, post review of the documents (shared in one go) with the representative of the target will help ensure
quick completion of the process. During
the diligence process, the expert must identify the operational issues and identify if
there are any instances of fraud in the former management.
In cases of distressed companies,
usually, initial days’ post-acquisition will be key to the acquirer to perform a
complete check on the key functions and operations to understand if there are gaping holes or inappropriate business practices to be addressed. Hence, the diligence report must suitably contain recommendations to this effect in their
report.

Conclusion

With an increasing contribution of distressed M&A to the
overall M&A growth, it is important that strategies are set in place which will increase chances for the success of the transaction. While there are challenges,
one will be able to overcome these by having a right expert who possesses overall
knowledge about the industry of the target and by laying effective planning and strategy in order to ensure successful closure of the transaction.

- [1] https://www.kroll.com/-/media/kroll/pdfs/publications/spotlight-asia-kroll-ma-ocotber-2018.ashx
- [2] https://www.kroll.com/-/media/kroll/pdfs/publications/spotlight-asia-kroll-ma-ocotber-2018.ashx
- [3] Section 166 of the Companies Act 2013;

- [4] Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2018
- [5] 488 A.2d 858 (Del. 1985)
- [6] (2013) 8 SCC 20, decided on May 9, 2013
- [7] Section 14 (1) Insolvency and Bankruptcy Code, 2016
- [8] Section 14 (4) Insolvency and Bankruptcy Code, 2016

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