

On Due Diligence, as the Issue of Legal Notion

Due Diligence, as a kind of assessment of enterprises, is mostly used in the case of M&A transactions. Due Diligence emerged in America, but it developed in the countries of continental European law. With economic advancement, many types of Due Diligence formed, namely, legal, economic, tax, environmental, etc. The list of types of Due Diligence is inexhaustible and its formation depends on the demand of specific enterprise. The conclusion, obtained as a result of conducting of Due Diligence, conditions the fate of M&A transaction, consequently, it is important both for the buyer and the seller.

Key Words: *Due Diligence, merger and acquisition of enterprises, economical, Tax, environmental Due Diligence, economic development, transaction, information asymmetry, goals of Due Diligence, identification of risks.*

1. Introduction

Due Diligence, as an important institute of corporate law, represents novelty for Georgian law. It often plays decisive role in enterprise merger and acquisition (M&A) transaction.

Initial emergence of *Due Diligence* is not related to enterprise merger and acquisition transactions, but presently the term *Due Diligence* is used just towards it. Increased role of enterprise merger and acquisition transactions in present-day economic relations, naturally, caused development of many institutions, related to it. *Due Diligence* is one of them. Preparation of such transactions at present occurs through *Due Diligence* directly.¹ Obtaining of maximum information at pre-transaction stage has obtained growing importance for modern entrepreneurs for avoidance of mistake, minimization of risks and securing purchaser from unnecessary surprises. It might be said that implementation of *Due Diligence* is very important for successful completion of merger and acquisition. Naturally, there are other factors, contributing to success or failure of the transaction, but in both cases people speak about *Due Diligence* being implemented improperly, unsuccessfully, or vice versa, successfully.

Although *Due Diligence* emerged in the bosom of law, presently it is not the property of the law only. On the contrary, it might be stated that it obtained economic burden and developed in this direction. This fact proves again, that economy doesn't exist without law and law doesn't exist without economy. Accordingly, an entrepreneur can't achieve the goal without examination of legal situation of the target object.

The present article presents information about the notion of *Due Diligence*, its origination, types and course, which is very important for understanding and proper perception of the institute.

2. American Roots and Definition of Due Diligence

The roots of the notion *Due Diligence* are in American law, implying "the required, relevant and proportional diligence". It represents shortened version of the notion *Due Diligence Investigation*. Thus, the notion

* Doctoral Student, TSU Faculty of Law, LL.M. Saarland.

¹ *Elfring C.*, Legal Due Diligence Reports, JuS-Beil, Heft 5/2007, Verlag C.H. Beck, 2007, 4.

expresses not the process of implementation of some action, activity, but, primarily, the scale of behavior,² which is very important. In American law Due Diligence, on the one hand, it serves as a scale of required behavior of the persons, involved in the transaction (purchaser, vendor and advisor), and, on the other hand, it is the result of the principle “caveat emptor” existing in the applicable trade law.³ It is important to know the difference in Due Diligence according to the trade law and corporate law. In conformity with the principle “caveat emptor”, existing in the trade law, the obligation of verification of the object of sale lies upon the purchaser and, after verification, he/she can demand the relevant security means from the vendor. This approach is different from the approach, existing in majority of the European law countries. As verification of the object of sale and minimization of risks should be in the purchaser’s interest, it is not clear why introduction of Due Diligence, as the scale of assessment, should have become necessary.⁴

The US Security Act of the 1933 required from issuers preparation of the so-called “registration application”, which should be presented to the Security Exchange Committee of the relevant state. The application should contain detailed information on the company, its assets and liabilities. By its essence, the report was similar to the *Due Diligence Report*, made up by the companies in the case of sale. The author of the application, the issuer, members of the Board of Directors, all advisors, participating in the preparation and examination of the application, are responsible for the application being prepared with “Due Diligence”.⁵

Following from the circumstance that transactions obtained very international character, the notion of Due Diligence was transferred from American law into German legal practice.⁶ American entrepreneurs appeared on German market in great number and brought their ideas on entrepreneurial relations, especially on *M&A* (acquisition and merger of enterprises) translations.⁷ American origin of the notion Due Diligence and domination of Anglo- American legal culture has its advantages too, but, at the same time, it is accompanied by unconditional transfer of traditions, characteristic for Anglo- American law, which are often unnecessary or illegal according to the national legislation.⁸ Naturally, development of the business world and high level of globalization is followed by partial amalgamation of various legal cultures, but referencing needs great attention and analysis so that specific norm or legal tradition does not become artificial outgrowth in the law.

Due Diligence plays important role in *M&A* translations, but there is an opinion that successful company shall use it in certain periodicity⁹ to underline the profitability of the company.¹⁰

Although Due Diligence is not a new discovery, its unambiguous definition does not exist till present. As it was mentioned above, literally, *Due Diligence* means “the required, relevant and proportional diligence”; nevertheless, it expresses not one action, but rather unity of actions.¹¹ And literal translation does not express its present-day essence. Although *Due Diligence* has formed as general principle of trade law, presently it is referred

² Schmitz C., *Due Diligence beim Unternehmenskauf: eine Betrachtung ihrer sekundärrechtlichen Auswirkungen nach deutschem Recht sowie ihrer bürgerlichrechtlichen Bezugspunkte*, Cuvillier Verlag Göttingen, 2002, 2.

³ Ibid, 29.

⁴ Krömker M., *Die Due Diligence im Spannungsfeld zwischen Gesellschafts- und Aktionärsinteressen, Ein Beitrag zur Offenbarungsbefugnis des Vorstand und zum Offenbarungsanspruch eines Paketaktionärs zum Zwecke der Due Diligence vor einem Unternehmenskauf*, Europäische Hochschulschriften, Reihe II, Rechtswissenschaft, Bd./Vol. 3537, Peter Lang, 2002, 4.

⁵ Ibid, 3-4.

⁶ Ibid, 31.

⁷ Ibid, 4.

⁸ Ibid, 31.

⁹ Schmitz C., *Due Diligence beim Unternehmenskauf: eine Betrachtung ihrer sekundärrechtlichen Auswirkungen nach deutschem Recht sowie ihrer bürgerlichrechtlichen Bezugspunkte*, Cuvillier Verlag Göttingen, 2002, 5.

¹⁰ This opinion is particularly applicable to the companies, shares of which are traded on stock exchanges.

¹¹ Knöfler K., *Rechtliche Auswirkungen der Due Diligence bei Unternehmensakquisitionen*, Europäische Hochschulschriften, Reihe II, Rechtswissenschaft, Bd./Vol. 3240, Peter Lang, 2001, 23.

to as an addition to the translation of merger and acquisition of enterprises.¹² It shall also be mentioned that due to the lack of unambiguous definition of the term, it is established in foreign languages not through the relevant translation, but in the form of English term directly. It is not the shortcoming of Georgian legal terminology only; even in the countries, where finding of the relevant meanings and establishment of terms in this form is attached great importance (e.g. in Germany), Due Diligence has not been translated.

3. Due Diligence – in the Case of Merger and Acquisition of Enterprises

3.1. Due Diligence in the Service of Transaction of Merger and Acquisition of Enterprises

Although *Due Diligence* has Anglo- American origin, in the framework of practice *M&A*, the countries of Anglo- American law, historically, made less contribution in its development.¹³ In many developed countries (e.g. in Germany) the entrepreneurs arrived to the opinion that before selling, the enterprise should be comprehensively inspected as early as in middle of the 20th century.¹⁴ Although the institute of inspection of enterprises existed, the terms *Due Diligence* for the purposes of *M&A* established in 90-ies.¹⁵

M&A transaction is always accompanied by certain risk. How this risk turns out, depends on conformity of the information, having by the purchaser about the enterprise, with the reality. *Due Diligence*, which is implemented on the pre-contract stage, more exactly, after achievement of *preliminary agreement*, before signing the *binding contract*, serves just for obtaining of full-value information and insurance of the potential purchaser.¹⁶ As a rule, the purchaser does not have much information about the object; he needs it all for determination of the price, reduction of risks, decision-making, etc. And for the counter-part – the vendor - the information is available and implementation of *Due Diligence* is the expression of his preparedness to hand over the knowledge, existing in his ownership, to the potential purchaser.

The above provided definition, the process of its formation does not greatly differ from *Due Diligence*, which is implemented in the case of merger and acquisition of enterprises. Generally, it could be understood as analysis and assessment of the object with particular diligence in the course of business transaction.¹⁷ However, this general statement shall be further specified. In the cases, the object is the enterprise and the enterprise required study and analysis. As far as each object substantially differs from others, only as a result of its detailed examination the purchaser can require exact guaranteed from the vendor.¹⁸ It shall also be mentioned that the exact recipe of implementation of *Due Diligence* does not exist, as the entrepreneurs' approach and the information, interesting for them about the target object changes in each particular case.¹⁹

In the sense of corporate law, *Due Diligence* means the level of diligence, which the relevant officials of the enterprise shall use in the course of fulfillment of their obligations.²⁰

¹² Löffler C., Tax Due Diligence beim Unternehmenskauf, Analyse und Berücksichtigung Steuerlicher Risiken und Chancen, IDW-Verlag GmbH, Düsseldorf 2002, 10.

¹³ Fatemi A., Die Obliegenheit zur Due Diligence beim Unternehmenskauf, Eine Rekapitulation der Fahrlässigkeit, Düsseldorf Rechtswissenschaftliche Schriften, Nomos, 2009, 16.

¹⁴ Ibid, 16.

¹⁵ Wegmann J., Koch W., Due Diligence - Unternehmensanalyse durch externe Gutachter - Ablauf und Technik, Folge-Due-Diligence als neuer Analysestandard, DStR, Verlag C.H. Beck, 2000, 1028.

¹⁶ Bing G., Due Diligence, Planning, Questions, Issues, Praeger, 2008, 1.

¹⁷ Elfring C., Legal Due Diligence Reports, JuS-Beil, Heft 5/2007, Verlag C.H. Beck, 2007, 4.

¹⁸ Klie M.A., Die Zulässigkeit einer Due Diligence im Rahmen des Erwerbs von börsennotierten Gesellschaften nach Inkrafttreten des Anlegerschutzverbesserungsgesetzes (AnSVG), Schriften zum Unternehmensrecht, Band II, Peter Lang, 2007, 28.

¹⁹ Wegmann J., Koch W., Due Diligence - Unternehmensanalyse durch externe Gutachter - Ablauf und Technik, Folge-Due-Diligence als neuer Analysestandard, DStR, Verlag C.H. Beck, 2000, 1029.

²⁰ Schmitz C., Due Diligence beim Unternehmenskauf: eine Betrachtung ihrer sekundärrechtlichen Auswirkungen nach deutschem Recht sowie ihrer bürgerlichrechtlichen Bezugspunkte, Cuvillier Verlag Göttingen, 2002, 2.

In the cross-section of merger and acquisition of enterprises, *Due Diligence* does not only mean analysis and inspection of the object, as the object of transaction, but the inspection reaches to the goals of the related contract.²¹ Whether or not the potential purchaser acquires or merges the enterprise depends on many factors. *Due Diligence*, as the collective noun, covers many tasks and works towards this way.²² During transactions, not only the potential purchaser is interested in maximum inspection of the target object, but the vendor as well. The vendor, on the basis of demonstration of free will, may order the implementation of *Due Diligence* to the professionals and present it as additional documentation (Vendor Due Diligence).²³ By such step, potential purchaser will save both time and money. Implementation of Due Diligence check requires such a lot of time and funds that, if the vendor and the purchaser trust each other and the inspection is already conducted, the purchaser shall even be glad.²⁴ The value of *Due Diligence* shall not be equaled to the value of the transaction, and often it is not determined what percentage share of the transaction value can be used for *Due Diligence* check in the worst case. According to research, mean value of *Due Diligence*, usually, does not exceed 1,08 % of the transaction value.²⁵ In addition to the amount, the time factor shall also be taken into account, which plays important role in business relations. The potential purchaser shall manage to obtain the information, required for him, in quite short period of time not to hinder the workflow of the company and, at the same time, be the first in the environment of competition and not to concede the object, interesting for him.²⁶ In *M&A* transactions, the speed of decision-making is particularly valuable; the entrepreneur competes not only with other entrepreneurs, but with the time too.

In practice, the reliability of the information is determined on the basis of three criteria. These criteria are Need to know (obligatory information), Deal Killer (information, lack of which will fail the deal) and Nice to have (desirable, but not substantially necessary information).²⁷ According to these criteria, the auditors make up a list (Due Diligence Checklist) of what shall be inspected by them.

3.2. Development of Due Diligence up to the Present Standards in the Aspect of Acquisition and Merger of Enterprises

In 80-ies- 90-ies of the 20th century, *Due Diligence* established in M&A transaction as internationally recognized standard. The wave of *M&A* transaction of that period developed the market of sale of enterprises. Since then, *M&A* transactions, actually, became essential constituent element of activities of the enterprises; the enterprises used *Due Diligence* check almost inevitably.²⁸

The group of the investors of new generation also greatly contributed to the development of *Due Diligence*. In the middle of 80-ies investors (mostly, the so-called Private Equity Funds) appeared on the market, which invested funds in enterprises for relatively short period (3-7 years), but with the expectation of greater profit in

²¹ Schmitz C, *Due Diligence beim Unternehmenskauf: eine Betrachtung ihrer sekundärrechtlichen Auswirkungen nach deutschem Recht sowie ihrer bürgerlichrechtlichen Bezugspunkte*, Cuvillier Verlag Göttingen, 2002, 6.

²² Ibid, 6.

²³ Ibid, 7.

²⁴ As implementation of full-value inspection requires great expenses (in the form of time, as well as amount), the interested party chooses the segment, interesting for him and conducts inspection in that direction. It could be legal, tax, economic or environmental Due Diligence. The entrepreneur shall understand that the enterprise is a complex organism and even the owner may not know all details about it.

²⁵ Fatemi A., *Die Obliegenheit zur Due Diligence beim Unternehmenskauf, Eine Rekapitulation der Fahrlässigkeit*, Düsseldorf Rechtswissenschaftliche Schriften, Nomos, 2009, 18.

²⁶ Ibid, 18.

²⁷ Ibid, 18-19.

²⁸ Liekefett K H., *Due Diligence bei M&A Transaktionen, Voraussetzungen und Grenzen bei Börsengängen, Fusionen, Übernahmen, Beteiligungskäufen, Private Equity und Joint Ventures*, Duncker und Humblot Berlin, 2005, 26.

the case of sale of the enterprise (leveraged buyout).²⁹ Investors of this type made their decision just based on the information, obtained as a result of implementation of *Due Diligence*, which included detailed analysis of the enterprise. In 90-ies, *Due Diligence* established even in Germany - the country with quite conservative law and presently it stands on quite high stage of development.

4. The Purposes of Due Diligence

In the course of acquisition of the enterprise, the main problem is the lack of information.³⁰ The share of failed deals is still quite big in the transactions of merger and acquisition of enterprises. Each case is individual and, accordingly, the causes of failure are diverse. However, the causes may be generated and on the long list, having erroneous or incomplete information against the background of improperly conducted *Due Diligence* is on the first place.³¹ Resolution of problems, detected after completion of transaction requires a lot of time and funds, which is not profitable for the entrepreneur. Successfully conducted *Due Diligence* cannot completely resolve problems, but shall ensure their reduction and prediction.

Briefly, *Due Diligence* has the function of assistance in decision making on pre-acquisition stage, strategy planning, structuring and arrangement, determination of the price of acquisition, insurance and guarantee, evidence, facilitation of formalizing the deal.³² Fulfillment of these functions is the purpose of conducting of *Due Diligence*.³³ Each of the above-specified functions is performed by *Due Diligence* on different stages of deal; some of them are substantial on pre-transaction period, and some – after completion of transaction.

4.1. Detection of Risks

Prior to concluding of agreement, in all cases, certain asymmetry of information exists between the parties³⁴. One has more information than the other. Potential purchaser, for obtaining of information, primarily, applies to the public sources of information like Public Register, published annual reports, voluntarily published other reports, etc.; but the events inside the company and important documentation remains unavailable. Many nuances may emerge in legal, financial, tax or many other aspects, which may make the deal unreasonable for the potential purchaser. Certainly, it is possible to formalize a deal without implementation of *Due Diligence*, but in such case, the vendor shall provide many guarantees to the purchaser and the detected shortcoming shall later be eliminated on the basis of these guarantees so that the purchaser's damage is minimized. It seldom happens, but when both parties are in hurry to make a deal, such agreement is possible.³⁵ Inspection of all types of documentation and their maximum study allows detection of the risks, related to the company and makes it possible to insure them, so detection of risks can be considered as the central goal of *Due Diligence*.

²⁹ *Liekefett K H.*, *Due Diligence bei M&A Transaktionen, Voraussetzungen und Grenzen bei Börsengängen, Fusionen, Übernahmen, Beteiligungskäufen, Private Equity und Joint Ventures*, Duncker und Humblot Berlin, 2005, 26.

³⁰ *Fatemi A.*, *Die Obliegenheit zur Due Diligence beim Unternehmenskauf, Eine Rekapitulation der Fahrlässigkeit*, Düsseldorf Rechtswissenschaftliche Schriften, Nomos, 2009, 21.

³¹ *Ibid*, 21.

³² *Kusche M.S.*, *Die aktienrechtliche Zulässigkeit der Durchführung einer Due Diligence anlässlich eines Unternehmenskaufs, Mit Due Diligence-Checkliste für die Zielgesellschaft*, Studien zum deutschen und europäischen Gesellschafts- und Wirtschaftsrecht, Peter Lang, Herausgegeben von Ulrich Ehrlicke, Band 2, 2005, 34.

³³ *Kneip C., Jänisch C.*, *Tax Due Diligence, Steuerrisiken und Steuergestaltung beim Unternehmenskauf*, Verlag C. H. Beck München, 2005, Hogh, 8.

³⁴ Despite the attempts, full resolution of the problem of asymmetry is a utopic intention and potential purchaser shall take this risk into account too. See *Klie M.A.*, *Die Zulässigkeit einer Due Diligence im Rahmen des Erwerbs von börsennotierten Gesellschaften nach Inkrafttreten des Anlegerschutzverbesserungsgesetzes (AnSVG)*, Schriften zum Unternehmensrecht, Band II, Peter Lang, 2007, 44.

³⁵ See *Kusche M.S.*, *Die aktienrechtliche Zulässigkeit der Durchführung einer Due Diligence anlässlich eines Unternehmenskaufs, Mit Due Diligence-Checkliste für die Zielgesellschaft*, Studien zum deutschen und europäischen Gesellschafts- und Wirtschaftsrecht, Peter Lang, Band 2, 2005, 36.

4.2. Determination of the Value and the Sale Price

Determination of real value of the enterprise and agreement of the sale price has substantial significance for the investor, due to understandable reasons.³⁶ Real value of the company not always coincide with the sale price.³⁷ Determination of the deal price depends on many criteria and is subject to agreement between the purchaser and the vendor.³⁸ Nevertheless, real price of the company identified and the risks detected as a result of implementation of *Due Diligence*. So, one of the important purposes of implementation of *Due Diligence* is determination of the sale price in the course of *Due Diligence* check, clarification of the real value and agreement of favorable price with consideration of other factors (risks, guarantees).

4.3. Guarantees

The catalogue of guarantees is individual for each case and it depends on the detected risks and heir analysis. Often, legislative norms (dispositional and not imperative) of guarantees of specific country are not applied and the guarantee obligations, undertaken by the parties, fully depend on the results of *Due Diligence*.^{39,40} In this case, the parties are driven by different interests; the vendor wants to provide as few guarantees as possible and receive as big amount as possible, and the purchaser – vice versa – pay less amount and receive more guarantees. For this reason, after implementation of *Due Diligence* it is the subject of negotiations and agreement. And both parties want to achieve the best results in the course of negotiations on the basis of the existing documentation at their disposal and *Due Diligence* report. The parties have to come to terms and it is natural, as the faultless company, as well as the purchaser with unlimited financial resources, does not exist.

4.4. Obtaining of Evidences

To avoid future misunderstandings and disputes, in close linkage with the guarantee obligations, all important documents shall be recorded so that they have the power of evidence is required.⁴¹ Registration and documenting of the future evidences shall be performed prior to concluding the agreement. In addition to the purchaser, this action may prove to be useful for the vendor in specific case, to prove information of what level was at the purchaser's disposal before concluding the contract.⁴²

³⁶ *Kusche M.S.*, Die aktienrechtliche Zulässigkeit der Durchführung einer Due Diligence anlässlich eines Unternehmenskaufs, Mit Due Diligence-Checkliste für die Zielgesellschaft, Studien zum deutschen und europäischen Gesellschafts- und Wirtschaftsrecht, Peter Lang, Band 2, 2005, 37.

³⁷ "Price is what you pay. Value is what you get." See *Klie M.A.*, Die Zulässigkeit einer Due Diligence im Rahmen des Erwerbs von börsennotierten Gesellschaften nach Inkrafttreten des Anlegerschutzverbesserungsgesetzes (AnSVG), Schriften zum Unternehmensrecht, Band II, Peter Lang, 2007, 45.

³⁸ *Kusche M.S.*, Die aktienrechtliche Zulässigkeit der Durchführung einer Due Diligence anlässlich eines Unternehmenskaufs, Mit Due Diligence-Checkliste für die Zielgesellschaft, Studien zum deutschen und europäischen Gesellschafts- und Wirtschaftsrecht, Peter Lang, Band 2, 2005, 37.

³⁹ *Ibid.*, 38.

⁴⁰ In the paper the case is discussed, when vendor acts as Due Diligence implementer and one of the bases because failure of further issuance of many guarantees. And its basis is timely detection of risks and optimization, as far as possible. Issuance of many guarantees may cause damage to the vendor and make the transaction in attractive for him.

⁴¹ *Kusche M.S.*, Die aktienrechtliche Zulässigkeit der Durchführung einer Due Diligence anlässlich eines Unternehmenskaufs, Mit Due Diligence-Checkliste für die Zielgesellschaft, Studien zum deutschen und europäischen Gesellschafts- und Wirtschaftsrecht, Peter Lang, Band 2, 2005, 39.

⁴² *Ibid.*, 39.

5. Types of Due Diligence

5.1. General Overview

Complication of business transactions refined and diversified *Due Diligence* step-by-step. Different goals are driving entrepreneur in the case of acquisition and merger of enterprises; consequently, they have different goals when conducting *Due Diligence*. Following from these goals, the presently existing types of *Due Diligence* formed. Obviously, the list will not be comprehensive and emergence of new types is an ongoing process. Nevertheless, this paper will cover the most widely spread types of *Due Diligence*. These are legal, tax, commercial, technical, financial and environmental *Due Diligence*-o.⁴³ The above listed types of *Due Diligence* may be considered the most demanded types of *Due Diligence*, although there also are researches of strategic, human resources, organizational,⁴⁴ cultural, real estate, insurance⁴⁵ and other types of *Due Diligence*.

5.1.1. Legal Due Diligence

The goal of legal due diligence is to understand the legal relations of the target object and assess them. Consequently, the subject of such inspection, primarily, is: foundational agreement (each detail since the day of establishment of the enterprise shall be checked, how correctly it was registered, are all legal requirements, related to establishment, met, etc.), the Charter, contracts between the company and directors, rental and leasing contracts, documentation, regulating relations between the clients and suppliers, labor legal relations, the existing of future disputes, public legal relations (licenses, permits), contractual relations, obligations in regard to environment protection. If the company has daughter companies, documentation, related to them shall also be checked (when it comes to the international company, or the company, which has daughter companies abroad, the inspection complicates, as the auditors have to understand several legal systems and make the relevant conclusions).⁴⁶

According to the country, where the enterprise is being acquired and the legislation the purchaser and the vendor have to obey, the structure of the sale contract itself shall be studied – what elements are included in it.⁴⁷ The subject of legal *Due Diligence* may also be study of cartel agreement on the market, as this information is no less important for the future activities. In the aspect of property relations, the function of legal *Due Diligence* is limited by checking the correctness of accounting of the enterprise's assets and liabilities.⁴⁸

5.1.2. Tax Due Diligence

The goal of the tax *Due Diligence* is identification of the tax risks of the target object; e.g. are the assets underestimated, or, on the contrary, are the liabilities over-estimated⁴⁹; the issue of hidden incomes; whether the

⁴³ In the case of acquisition and merger transaction 94% conducts financial inspection, and alongside with financial *Due Diligence*, 82% also conducts legal and 78% - tax inspection, see: *Vogt G.*, *Die Due Diligence - einzentrales Element bei der Durchführung von Mergers & Acquisitions*, DStR, Verlag C.H. Beck, 2001, 2028.

⁴⁴ *Kusche M.S.*, *Die aktienrechtliche Zulässigkeit der Durchführung einer Due Diligence anlässlich eines Unternehmenskaufs, Mit Due Diligence-Checkliste für die Zielgesellschaft*, Studien zum deutschen und europäischen Gesellschafts- und Wirtschaftsrecht, Peter Lang, Band 2, 2005, 44.

⁴⁵ *Vogt G.*, *Die Due Diligence - ein zentrales Element bei der Durchführung von Mergers & Acquisitions*, DStR, Verlag C.H. Beck, 2001, 2028.

⁴⁶ *Wegmann J., Koch W.*, *Due Diligence - Unternehmensanalyse durch externe Gutachter - Ablauf und Technik, Folge-Due-Diligence als neuer Analysestandard*, DStR, Verlag C.H. Beck, 2000, 1028.

⁴⁷ *Kneip C., Jänisch C.*, *Tax Due Diligence, Steuerrisiken und Steuergestaltung beim Unternehmenskauf*, Verlag C. H. Beck München, 2005, 16.

⁴⁸ *Wegmann J., Koch W.*, *Due Diligence - Unternehmensanalyse durch externe Gutachter - Ablauf und Technik, Folge-Due-Diligence als neuer Analysestandard*, DStR, Verlag C.H. Beck, 2000, 1031.

⁴⁹ *Ibid*, 1032.

company enjoys and special tax or customs privileges or, on the contrary, whether there is a risk of increase of expenses in this aspect, etc. In practice, tax *Due Diligence* is often complementary to the legal *Due Diligence* and they are implemented together.⁵⁰

5.1.3. Commercial Due Diligence

Commercial *Due Diligence* is mainly directed towards study of capability of the object in economic relations. To achieve this goal, the present market position of the object, production and the ways of sales, as well as the activities of other entrepreneurs, operating in the same direction, shall be examined. Primarily, analysis of the market structure and its players shall be conducted to plan the future changes.⁵¹

In addition to the information, which can be obtained from the management, external sources of information are important, like press, consumers, reports of various organizations on operation of the target object, Internet, etc. Naturally, the information sources shall be differentiated based on the reliability.

In the case of merger of enterprises, commercial *Due Diligence* provides information on the effect of synergy.

There effects are expected in the following spheres:

Research and development: reduction of expended and transfer of know-how;

In the case of acquisition: optimization of logistics, equalization of price;

Goods/ services: optimization of standards, distribution of work, consumer contacts;

Marketing: improvement of supply structure;

Shipment: optimization of logistics;

Management: reduction of expenses through centralization.⁵²

5.1.4. Technical Due Diligence

Technical *Due Diligence* is used in regard to the enterprises, which produce any kind of goods. It shall be assessed how much the technical equipment, used in production, fits modern standards; how efficient it is, etc. The expenses of supply, personnel are added to the production costs and all together, allow to assess how effective the production is. The goal of technical *Due Diligence* clarification of modernity, innovativeness of equipment, and, on its basis, prediction of future, understanding of the possibility of transfer to production of other goods, advancement of the issue of risks and responsibility, research and development.⁵³

In the case of such check, all the equipment, participating in production, as well as the related permits and licenses, are subject to inspection.⁵⁴

As the technical aspect of production greatly depends on environmental issues, technical *Due Diligence* and environmental *Due Diligence* are close to each other.

5.1.5. Environmental Due Diligence

In the course of implementation of environmental *Due Diligence*, the starting point is identification of the risks of damage, which, presently or in the future, may be caused to the environment. Such inspection be-

⁵⁰ Rödder T., Hötzel O., Mueller-Thuns T., Unternehmenskauf Unternehmensverkauf, Zivil- und steuerliche Gestaltungspraxis, Verlag C. H. Beck München 2003, 55.

⁵¹ Ibid, 13.

⁵² Rödder T., Hötzel O., Mueller-Thuns T., Unternehmenskauf Unternehmensverkauf, Zivil- und steuerliche Gestaltungspraxis, Verlag C. H. Beck München 2003, 14.

⁵³ Kneip C., Jänisch C., Tax Due Diligence, Steuerrisiken und Steuergestaltung beim Unternehmenskauf, Verlag C. H. Beck München, 2005, Hogh, 15.

⁵⁴ Wegmann J., Koch W., Due Diligence - Unternehmensanalyse durch externe Gutachter - Ablauf und Technik, Folge-Due-Diligence als neuer Analysestandard, DStR, Verlag C.H. Beck, 2000, 1030.

comes more and more topical due to strengthening of environmental legislation and expensiveness of environment-friendly equipment. Law of the number of developed countries actually obliges potential owner to know all issues, related to the relation of the enterprise and the environment.

Legislation, requirements, related to the protection of environment, soil, water, the impact of the production on natural resources, as well as the method of separation and neutralization of waste shall be studied in the course of implementation of environmental *Due Diligence*.

5.1.6. Financial Due Diligence

Financial *Due Diligence* is often referred to as the starting point for other types of *Due Diligence*.⁵⁵

In the course of implementation of financial *Due Diligence* financial accounts of the target object are subject to inspection, as a rule, those of the last year only. Besides, accounting procedures, balancing shall be studied to analyze financial risks; the existing projects are inspected from financial viewpoint, as well as credit history, liabilities, transactions, etc. Past activities are also studied to compile the future picture with more or less accuracy.⁵⁶

6. Difference of Due Diligence according to the Client

6.1. Vendor Due Diligence

The vendor, through *Due Diligence*, conducted by him, tries to create primary impression about the object of sale before opening the trade. The motives of such action of the vendor may be different. He may want to be the first to detect the risks, related to the enterprise, improve the situation as far as possible and make the enterprise more attractive.⁵⁷ If elimination of the detected problems is impossible, the vendor will be prepared to meet the results of external *Due Diligence*.⁵⁸ There are cases, when the vendor himself does not have full-value information, as he is the investor and does not participate in management of the enterprise.⁵⁹ As a result of inspection, Vendor Due Diligence Report shall be made up, which will be presented to the potential purchaser. In such case, the purchaser can limit only by crosschecking of the presented report and restrain from extra expenses. Often, together with reports, for more reliability, the so-called *Reliance letter* is presented to the purchaser, which contains the guarantee of correctness and perfectness of the presented report.⁶⁰ Obviously, the vendor is not obliged to conduct *Due Diligence* himself, but its implementation increases the purchaser's or the person's, who want to merge, trust towards the vendor.

6.2. Purchaser Due Diligence

According to the established practice, in most cases, *Due Diligence* inspection is implemented by the purchaser. It is kind of repercussion of the principle caveat emptor, when the purchaser buys item under his own

⁵⁵ *Picot G.*, Handbuch Mergers & Acquisitions, Planung Durchführung Integration, Schaffer Poeschel Verlag Stuttgart, 2000, 232.

⁵⁶ *Makharoblishvili G.*, Implementation of Fundamental Changes in the Structure of Capital Companies on the Basis of Corporate-Legal Actions (Acquisition, Merger), Comparative-Legal Analysis, Publishing House of Tbilisi State University, 2014, 186.

⁵⁷ *Elfring C.*, Legal Due Diligence Reports, JuS-Beil, Heft 5/2007, Verlag C.H. Beck, 2007, 4.

⁵⁸ *Spill J.*, Due Diligence - Praxishinweise zur Planung, Durchführung und Berichterstattung, DStR, Verlag C.H. Beck, 1999, 1787.

⁵⁹ *Elfring C.*, Legal Due Diligence Reports, JuS-Beil, Heft 5/2007, Verlag C.H. Beck, 2007, 4.

⁶⁰ *Ibid*, 4.

responsibility.⁶¹ The purchaser requires from the vendor the desired documentation (Due Diligence Request List) to obtain the understanding in regard to the target object. The vendor will present it physically or in virtually arranged *Data Room*.⁶² In the first case, the documents are copied from original and presented to the auditors, assigned by the potential purchaser, and in the second case, they are scanned and supplied to the interested party via the Internet. The presented documentation will be classified and used accordingly, following from the goals.⁶³ As a rule, the report, generated by the purchaser (Purchaser Due Diligence Report), is not available for the vendor. Naturally, it is the interest of the both parties, especially purchaser, to complete inspection in given time and before formalization of the main contract, so that the due guarantees from vendor are included in the contract. Nevertheless, the practice knows the post-contractual (post-closing DD) *Due Diligence*, which continues after concluding the contract and the purchaser tries to stick to the provided guarantees as much as possible in the case of detection of defect, in order to bear less losses.⁶⁴

The obligation of provision of information may be divided into two points. The first is that all documents, presented by the vendor shall comply with the truth and shall be perfect; and the second is that the vendor shall provide to the purchaser also the information, which was not requested but may have great importance for concluding the contract.⁶⁵ There is an opinion, that if the *Due Diligence*, conducted by the vendor in advance, already exists, the requirement of the second point will not exist anymore, nevertheless, major part of scientists reject this opinion.⁶⁶

7. Stages of Implementation of Due Diligence

7.1 Preparation

After commencement of negotiations, when the parties express their will (one – of sale and the other – of purchase) and the expression of will, more or less, coincides, before starting implementation of *Due Diligence* check, the so-called Letter of Intent is formalized between the parties.⁶⁷ It contains the will of the parties, as well as the list of issues, still requiring clarification and agreement.⁶⁸ This document may already contain the list of the required documentation, which the purchaser needs from the vendor, or it may simply specify there what type of *Due Diligence* will be implemented by the purchaser. The Letter of Intent often also contains the provision, according to which the vendor undertakes not to conduct negotiations with the third party and violation of this provision will lead to the relevant responsibility.⁶⁹

⁶¹ *Elfring C.*, Legal Due Diligence Reports, JuS-Beil, Heft 5/2007, Verlag C.H. Beck, 2007, 4.

⁶² *Ibid.*, 4.

⁶³ Compare: *Makharoblishvili G.*, Implementation of Fundamental Changes in the Structure of Capital Companies on the Basis of Corporate- Legal Actions (Acquisition, Merger), Comparative- Legal Analysis, Publishing House of Tbilisi State University, 2014, 183.

⁶⁴ *Elfring C.*, Legal Due Diligence Reports, JuS-Beil, Heft 5/2007, Verlag C.H. Beck, 2007, 5.

⁶⁵ And according to the explanation of the Supreme Court of Germany, absolute obligation of the vendor to disclose all details of the business to the purchaser doesn't exist, as the purchaser shall make decision himself and elaborate on what the contract will bring to him, i.e. the risk is mostly with the latter.

⁶⁶ *Elfring C.*, Legal Due Diligence Reports, JuS-Beil, Heft 5/2007, Verlag C.H. Beck, 2007, 5.

⁶⁷ *Spill J.*, Due Diligence - Praxishinweise zur Planung, Durchführung und Berichterstattung, DStR, Verlag C.H. Beck, 1999, 1787.

⁶⁸ *Kusche M.S.*, Die aktienrechtliche Zulässigkeit der Durchführung einer Due Diligence anlässlich eines Unternehmenskaufs, Mit Due Diligence-Checkliste für die Zielgesellschaft, Studien zum deutschen und europäischen Gesellschafts- und Wirtschaftsrecht, Peter Lang, Band 2, 2005, 57.

⁶⁹ *Ibid.*, 57.

Following from its importance, *Due Diligence* needs fundamental preparation. On this stage, it is specified what type of information will be inspected and what type of information is to be provided by the other party; negotiations are held. Well-prepared *Due Diligence* is the guarantee of avoidance of excessive spending of financial and human resources. During this period, auditors prepare the list of documentation to be provided to them by the vendor (the so-called *Due Diligence Checklist*). For the purpose of facilitation of the work and avoidance of asking one question several times, it would be appropriate if the implementers of different kinds of *Due Diligence* – legal, financial, etc. – agree the list of the required documentation among themselves and present the uniform list to the vendor.⁷⁰

After presentation of the list, preparatory activities continue on the part of the vendors; they prepare the documentation, required for the purchaser in one space, be it the room or the Internet space.⁷¹ Besides, specific persons shall be assigned for answering the questions and provision of service to the people, sent by the potential purchaser, so prevent the whole workflow from failure.⁷² The Board of the target company shall determine the level of the information, which shall be provided to the potential purchaser; they shall also assess the positive and negative outcomes of disclosure of specific information for the company.⁷³

7.2. The Process of Inspection

After completion of the preparatory period, the process of the basic inspection begins. Following from the size of the enterprise, inspection may last from several days to several weeks. The process does not imply only documentary inspection, but, often, visit- visual inspection of the enterprise and direct interviews with necessary persons.⁷⁴

After completion of the above-mentioned activities meeting is held with the vendor (directors of the enterprise; shareholders may also be represented) and their advisors to discuss critical questions once again. It gives the issuers the chance to express their opinion on problematic issues and find the ways out, until these problems are documented in the final report. As a rule, the discussion and presentation of documentation is followed by issuance of the Statement of Perfectness the vendors, which means that they take responsibility, that they provided truthful answers to all questions and provided all required information to the interested party.⁷⁵

7.3. Assessment

Assessment is the final part of *Due Diligence*, the goal of which is to reflect the conducted activities clearly and arrive to the relevant conclusions. It is desirable that the conclusions are followed by the recommendations of further actions. Elaboration of the final report is quite labor consuming; the expectation of the clients shall be taken into account and besides, it shall be as detailed as possible.⁷⁶ Final report of *Due Diligence* may fail or delay the agreed date of translation, so it shall be prepared with special attention.

⁷⁰ Müller W., Rödder T. (Hrsg), Beck'sches Handbuch der AG, gesellschaftsrecht, Steuerrecht, Börsengang, 2. vollständig überarbeitete und ergänzte Auflage, Verlag C.H. Beck München, 2009, Göckeler, Rn. 198.

⁷¹ Ibid., Rn. 199.

⁷² Wegmann J., Koch W., Due Diligence - Unternehmensanalyse durch externe Gutachter - Ablauf und Technik, Folge-Due Diligence als neuer Analysestandard, DStR, Verlag C.H. Beck, 2000, 1029.

⁷³ Makharoblishvili G., Implementation of Fundamental Changes in the Structure of Capital Companies on the Basis of Corporate- Legal Actions (Acquisition, Merger), Comparative- Legal Analysis, Publishing House of Tbilisi State University, 2014, 181.

⁷⁴ Müller W., Rödder T. (Hrsg), Beck'sches Handbuch der AG, gesellschaftsrecht, Steuerrecht, Börsengang, 2. vollständig überarbeitete und ergänzte Auflage, Verlag C.H. Beck München, 2009, Göckeler, Rn. 200.

⁷⁵ Ibid., 202.

⁷⁶ Spill J., Due Diligence - Praxishinweise zur Planung, Durchführung und Berichterstattung, DStR, Verlag C.H. Beck, 1999, 1791.

Final report may be produced in several forms; these are: debriefing, brief presentation, comprehensive presentation and report (the same as conclusion). Debriefing shall be held shortly after completion of inspection; it is presented verbally or in the form of brief notes.⁷⁷ Short presentation is structured around the most important issues and is a good method of demonstration of problematic and important issues in short time. Long presentation and report are actually similar; the only difference is that in the report narration is on the first place.⁷⁸

8. Conclusion

Due Diligence is a very wide and comprehensive term, unambiguous definition of which, in spite of many attempts, does not exist up to present. Neither there exists its translation into many languages, which is mostly caused by the absence of definition. The process, implied under the term Due Diligence has significant impact on following modern business interests and the “fate” of many future companies depends on its proper and reasonable implementation. For this very reason, the scientists and practitioner lawyers, auditors actively work in this aspect during the last two decades, which led to the refinement of this issue and took it to the higher level.

Discussion of the goals of *Due Diligence* clarified the need of its implementation in the course of important transactions. Many type of *Due Diligence* allow us say that they are the achievement of developed countries. For example, there will be no need of implementation of environmental *Due Diligence* in the countries, where less attention is paid to the environment. The same applies to the human resources and many other types of Due Diligence.

Implementation of *Due Diligence* is such a labor-consuming, expensive and time-consuming process that its proper planning has substantial significance for its successful implementation. The expenses, related to its implementation, greatly determine limited choice of entrepreneurs – which type of *Due Diligence* is better to implement for obtaining more profit, detection of risks and successful finalization of the deal. The time factor cannot be neglected. In the accelerated pace of modern business each day is important and thus, quick decision-making is highly valued; although, naturally, more mistakes may be made in haste. The properly planned *Due Diligence* does not exclude the possibility of making wrong decision, although, at least, minimizes it in the part, which, generally, follows from the goals of Due Diligence in general.

Business in Georgia is not developed yet to the level, where the acquisition and merger of enterprises is the main occupation of the companies. It, obviously, required great financial resources and the relevant market. In the Association Agreement, concluded between Georgia and EU there are many provisions, which directly envisage development of Georgian corporate law, and, most importantly, Georgian economy at the expense of proper steps, made by the government and certain support from EU. It give us the hope that development of economy willlead to advancement of the need of Due Diligence from time to time. Interesting *M&A* transactions and, consequently, *Due Diligence* inspections have already been registered on Georgian market. It is very appreciated and interesting topic for future research. As this trend has already emerged, development of economy and increase of scale of Georgian market will facilitate its continuation and, at the same time, will lead to its further development.

⁷⁷ *Spill J.*, *Due Diligence - Praxishinweise zur Planung, Durchführung und Berichterstattung*, DStR, Verlag C.H. Beck, 1999, 1791.

⁷⁸ *Ibid*, 1792.