



# DUE DILIGENCE INVESTIGATIONS

REASONABLE STEPS TAKEN BY A PERSON TO SATISFY A LEGAL REQUIREMENT, OR IDENTIFY RISK, ESPECIALLY IN BUYING OR SELLING.

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*This guide is published for general information purposes and is not intended to constitute legal advice. Our specialist legal advice should always be sought in relation to any particular situation.*

*This chapter is intended as a high-level legal overview of Due Diligence Investigations in South Africa. Please feel free to contact us if you require more recent or detailed information regarding this particular area of law. ©*

# INTRODUCTION

The importance and value of a due diligence investigation has become increasingly apparent in recent years.

In relation to mergers and acquisitions, and whether a transaction is a share (stock) acquisition or an acquisition of assets, the purpose of, and approach to, due diligence investigations in South Africa is much the same as in other countries.

## PURPOSE OF DUE DILIGENCE INVESTIGATIONS

*From the perspective of the acquiring party:*

The purpose of a due diligence investigation, when viewed from the perspective of the acquirer, is to enable the acquirer:

- to identify and evaluate risks associated with the target (whether the target is an entity such as a company, or, for example, an enterprise comprising assets, personnel, contracts and certain liabilities) in all relevant material spheres, including legal, tax, financial, environmental, liabilities, competition (anti-trust) and employee risks;
- to determine the condition of assets;
- to evaluate the worth of the target in the context of determining price;

- to shape the representations, warranties and indemnities it requires from the party disposing of the target (the seller);
- to determine the extent to which it will be willing to limit the liability of the seller for breach of the applicable agreement(s), including a breach of representations and warranties; and
- to plan efficiently and properly for the integration of the target into the acquirer's operations.

*From the perspective of the seller:*

A due diligence investigation can be (and often is) also beneficial when viewed from the perspective of the seller. Sellers will hope to qualify and limit the extent of their representations and warranties by virtue of the fact that the acquiring party is being afforded an opportunity to conduct a due diligence investigation. The extent of such qualifications and limitations is a matter of negotiation between the parties and is dependent on the strength of their respective negotiating positions.



# THE INVESTIGATION

The due diligence process should occur as early as possible in the transaction as it enables the proposed acquirer of a business or company to determine appropriate tactics and strategies for the negotiation of the transaction.

## TIMING

The timing of a due diligence investigation can and does vary from transaction to transaction. In some instances the investigation is carried out before the proverbial CEO handshake or the finalisation of the term sheet (letter of intent). In other instances it is carried out at a later stage and even after the signing of the definitive acquisition agreement. In the latter instance, provision may be made for the acquiring party to walk away or for a price adjustment if it is dissatisfied (either subjectively or objectively) with the outcome of the investigation, depending on the nature and extent of such dissatisfaction.

The advantages or disadvantages associated with the timing of a due diligence investigation vary depending on a number of factors, such as confidentiality, the need to maintain employee stability and commitment, the avoidance or minimisation of disruption to business operations, the structuring of the transaction and exclusivity, and so on. Thus, the timing of each due diligence investigation needs to be considered in the context of each transaction.

## THE DUE DILIGENCE TEAM

Assembling the correct due diligence team is obviously important. It is crucial that the team members are sufficiently experienced and properly qualified to:

- determine how best to conduct the investigation;
- identify the matters to be investigated;
- evaluate and interpret the information gathered during the investigation; and
- produce a meaningful due diligence report.

# THE INVESTIGATION/ *continued*

## MATTERS TO BE INVESTIGATED

While a typical due diligence investigation checklist or template can serve as a useful starting point (to identify the information to be sought and investigated), such a checklist or template should not be followed slavishly and should be used with caution. A checklist should be tailor-made for each specific transaction.

The matters to be investigated will vary from transaction to transaction but will generally cover some or all of the following:

- the organisational structure of the target;
- the relevant authorities required for the purpose of effecting the disposal;
- organisational restrictions or limitations such as protections for minority shareholders and rights of pre-emption;
- employment issues, such as identifying key employees, determining and evaluating the exposure of the target to employees, employee benefits, non-citizen employees and non-compete protections;
- contractual rights and obligations;
- title to assets;
- insurance cover;
- liabilities, including in relation to tax and environmental matters;
- accounting records and compliance with accounting standards;
- litigation;
- real estate rights;
- intellectual property rights and exposures;
- information technology systems and risks;
- competition (anti-trust) risks; and
- the value of the target and the basis on which such value is determined.

## THE DUE DILIGENCE INVESTIGATION REPORT

The report is the culmination of the due diligence investigation and needs to be properly written and presented in a manner that will serve its purpose, not only for the management of the acquirer, but also for the advisers charged with drafting and settling the definitive agreements.

The due diligence investigation report is significant in three particular aspects:

- placing management of the acquirer in a position to make decisions on whether or not to proceed with the acquisition; pricing; the extent of representations, warranties and indemnities; and (possibly) escrow arrangements;
- serving as evidence of the disclosures made by the seller (although if a virtual data room is used, the processes involved in such use would also provide such evidence); and
- assisting the advisers of the acquirer in the drafting and settling of the acquisition agreement(s).

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