Due Diligence

What is it?

In a merger, due diligence is the process of investigation which each organisation undertakes in order to obtain a better picture of the other organisations involved including their assets and liabilities. This process investigates the records of the other organisation(s) to find out whether there are matters of concern or matters which require further information. Due diligence provides comfort that collaborating or merging is in the best interests of both the organisation and its beneficiaries and the process can be supported by warranties and indemnities in the Acquisition Agreement.

When working together collaboratively or merging, an organisation is exposed to various risks and liabilities. All potential risks should be identified before entering into an agreement to merge or work collaboratively. Due diligence should expose all potential risks, including liabilities, which could arise as a consequence of the merger - and therefore there will be no post-merger surprises.

Trustees of a charity must comply with their legal duty to act prudently and in the best interests of the charity. They should ensure that any potential risk to their organisation has been identified and managed appropriately. The cost of due diligence is a proper use of charity funds and can create and build trust and confidence which in turn will increase the likelihood of a successful merger. However, it would be appropriate to arrange regular reviews of the cost of due diligence so as to ensure its continuing proportionality to the risks involved.

There is more in depth analysis of due diligence and the areas to be covered by a due diligence process on the Charity Commission for England and Wales (CCEW) website entitled 'Collaborative working and mergers: an introduction (CC34)' and charities may also find the CCEW due diligence checklist useful.

Areas for Review

The three main areas which are typically included in the due diligence process are:

- Financial
- Legal
- Commercial or operational

Financial

Financial due diligence will focus on an organisation's financial affairs and will identify any financial risks and financial opportunities arising from the merger. Financial due diligence will typically set out the organisation's financial history, and include copies of accounts going back over the last three financial years. It may also include financial results and forecasting accounting policies, taxation, assets and liabilities, pensions, management information and accounting systems information. It should be noted that all accounts must be looked at with the current financial landscape in mind.

Financial due diligence can also help to determine what legal structure may be best suited to the merger.

Financial due diligence is extremely important as it can also help determine what legal structure is best suited for the merger. This financial investigation should also highlight whether any arrangements with banks or funders are subject to any claw back conditions or change of control provisions. These restrictions can increase the transactional cost of a merger significantly. The charity trustees should be alive to these issues particularly the transfer of any pension deficit.

Legal

Legal due diligence will focus on legal issues such as the constitution of the organisation, its powers and objects. The charitable objects of the merging organisations must be compatible. For example, the review should establish whether there is a power in the constitution to allow for the merger of the organisations and ensure that the merger can occur. There may also be issues in relation to the rules for appointing trustees to the newly merged body which may need to be checked and considered. When considering the constitution, the process may also examine whether or not the organisation is being run according to its constitution and therefore whether or not the constitution needs to be amended to reflect the current running of the organisation.

Legal due diligence should also look into whether the organisation holds any freehold or leasehold property and consider any issues relating to such deeds or leases – for example the full details of any properties and whether there are any onerous clauses, for example, repair obligations, charges such as rates or service charges. Any leases should be considered in detail and this may uncover issues such as landlord's consent required for transfer of a lease.

Contracts of employment should be reviewed and information relating to employees should be shared. This includes details such as how many are or will be employed

by the new organisation and whether the terms and conditions are compatible for transferring employees. The Transfer of Undertakings (Protection of Employment) Regulations 2006 and the Service Provision Change (Protection of Employment) Regulations (NI) 2006 (collectively known as "TUPE") needs to be taken into consideration.

Commercial/Operational

Commercial due diligence involves agreeing the extent of the work of the organisation and, for example, conducting a SWOT analysis (strength, weaknesses, opportunities and threats). It would also be beneficial to review the risk register and any appropriate minutes. If the organisations merge there may be issues that need to be considered with regard to funders/donors. An assessment will need to be made as to whether or not funders will continue to support and fund the merged charity. As outlined previously, some banking and funding arrangements contain restrictions on change of control and claw back conditions.

Other charities with similar objectives should be identified in order to assess whether there is potential for too much competition in the relevant area of service provision or geographical area and whether the merged charities would be able to achieve their charitable objectives as a result.

How to carry out the due diligence exercise?

Who carries out due diligence?

It is important to be aware that there are no conventions for the best process to follow in a charity merger unlike in commercial mergers; due diligence exercises vary in scope and depth from one charity merger to another. The process can be quite intensive and demanding so organisations will need to ensure that they apply appropriate resources, finances and time commitment to the exercise.

Due diligence can be carried out by the organisations' trustees and it is the trustees who should decide whether external professional assistance is required. The advantage of engaging a professional to undertake due diligence is that they will have the necessary specialist skills and experience for the task as well as the ability to ask challenging questions and the ability to act independently and objectively. In deciding whether or not to carry out the due diligence process in-house, trustees should consider the following:

- Do the trustees have necessary experience?
- Are the trustees able to act with sufficient independence and objectivity?
- Do they have the available time to be able to take on a due diligence exercise?
- Are the trustees able to ask difficult questions without affecting the relationship between the partner organisations?

Trustees should be aware that they have ultimate responsibility for the decision on whether to proceed with a merger once they have seen the outcome of the due diligence exercise.

Thought should be given to the cost implications if more than one external adviser is appointed (for example if there is one for each party).

Proportionality

Any due diligence exercise should be proportionate to the size and nature of the organisations, the proposed project, the finances and funding involved, the nature of the activities involved and any risks.

Timing

Due diligence should be commenced quite promptly once the parties have agreed to merge; this allows the identification of any problems early on in the process so that they can be worked through in a timely manner without disrupting the merger timetable.

Pre-merger confidentiality

It is beneficial to agree the scope of the due diligence work for each partnering organisation and external professional advisor before it commences. A Memorandum of Intent and Confidentiality Agreements should be exchanged before the due diligence is started. The Memorandum of Intent sets out the preliminary intention of organisations to merge, the reasoning behind the decision to pursue a merger, intention to formalise a definitive Merger Agreement, how transaction costs will be divided between the organisations and an agreement that the Expression of Intent does not form any legal obligation unless and until a definitive Merger Agreement is executed. This Memorandum of Intent should also contain agreement by the organisations that they will not negotiate or consider any other organisations' proposal to merge. It is vital that the confidentiality obligations are made binding.

Charity Commission for Northern Ireland

Consider whether the Charity Commission for Northern Ireland (CCNI) needs to be informed or involved. Please note that in most cases a merger of charities will not require the consent of CCNI as the charity's governing document may include

trustees' power to merge with other charities but this should be carefully checked in each case and professional advice obtained. There are some statutory mechanisms for "merging" charities as well.

For more information on how the Charity Commission for Northern Ireland will manage mergers follow this link: https://www.charitycommissionni.org.uk/Manage_your_charity/Merge_or_close_index.aspx?Type=PAGE#).

Due diligence outcomes

Once the due diligence exercise is complete, it should provide the trustees with a detailed and comprehensive picture of the organisation's prospective merger partner(s). It should also increase the levels of trust between all the organisations. There are however various possible outcomes to a due diligence process:

- The due diligence process may not have uncovered anything of serious concern and therefore the merger can go ahead as planned

- There may be some discrepancies highlighted following due diligence which will require clarification; as a result the merger and its timeline may be delayed in order to discuss these issues or to renegotiate the terms of the merger

Always remember you do not have to merge!

Once the due diligence process is complete, the board may resolve not to continue with the merger. This can be a difficult decision for a board, particularly after spending time, effort and money on the merger process generally and on due diligence in particular. If the board has serious concerns however, it is right that the decision to merge should be reconsidered and, if necessary, abandoned.