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Chapter 3

Due Diligence

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Sumario:

1. INTRODUCTION TO LEGAL DUE DILIGENCE

1.1. LEGAL DUE DILIGENCE: MEANING AND RELEVANCE

The term *due diligence* may have its origin in relation to business acquisitions in Section 11 (b) (3) of the U.S. Securities Act of 1933[1)]. However, this is often debated. Whatever the origin of the term, it is widely used internationally to include any type of investigation of the risks or contingencies relating to the acquisitions of companies or their assets, financing and pre-contractual investigations in general. In other words, due diligence is the investigation process required before parties agree to or enter into any type of commitment or financial investment. As it relates to the acquisition of a private company, it is the process carried out by the buyer to gather information at the outset of the negotiation stage[2)] for the purpose of assessing the risks of the target company and its economic and financial health.

As a result of political changes in Central and Eastern Europe during the 1990's and the early 21st century, and of the increase in direct investments in those regions and in the Southeast Asian countries breaking free from controlled and restricted economies, it is possible to say that most legal systems worldwide have now accepted the principles of contractual freedom and «Let the buyer be aware» [*caveat emptor*][3)]. This has introduced the due diligence process into a variety of fields in which it is increasingly relevant to assess the potential risks associated with business transactions and, as a result, a large number of professionals and experts are now involved in the process. Due to its scope and importance, the due diligence process may often take much more time than the preparation of the acquisition agreement and ancillary documents.

Typically, transactions to transfer assets involve various risks. For example, it is important to be aware of the political risks associated with the country where the target company is located. There may also be uncertainty about different aspects of the target company; the status of past accounts or financial statements, whether assets are free of liens and encumbrances, if their value is the one assigned or if liabilities may appear in the future and reduce the value or potential use of the assets and/or negatively affect the business. Another relevant issue is the likelihood that key employees, suppliers and customers will remain after the acquisition. Risk may also increase if investments are made in a foreign country given that other factors come into play: monetary and economic, legal and governmental, infrastructure, geographic, labour, tax or financing issues.

Without doubt, due diligence is necessary to investigate and assess these risks. This process, and in particular legal due diligence, is essential to gather information about the various legal aspects of the target company and to understand the various factors that should be considered in any purchase operation or investment. For example, due diligence allows the buyer to confirm their assumptions and the representations made by the seller about the target company such as termination of customer contracts; verify agreements between the target and third parties that might be affected; evaluate the target as a whole; review its operations; and assess the need for indemnification in certain cases. In addition, once the sale and purchase operation is closed, the information gathered during the due diligence process may be a valuable tool to manage the company and ensure its continuity. The cost of the due diligence process may be offset by savings that it generates in the long-term.

Although due diligence is often performed and paid for by the buyer, it can also provide benefits for the seller. It is important to note that the due diligence process is not exclusive to the buyer; it may also be requested by the seller in order to have better information about the company they intend to sell. It can undoubtedly be valuable for the seller to invest time in preparing the business in order to both enhance its value and reduce the risks. Such a process may increase the value of the company considerably and improve the chances of a successful transaction, given that it may reduce the possibility of the buyer breaking off the negotiation sometimes at an advanced stage if certain negative issues surface. However, it is worth noting that the seller may not wish to have an accurate investigation of any negative issues relating to the target, especially if the directors or those in charge of the business could be held liable for a lack of diligence in the past.

There are various types and levels of due diligence that relate to different types of business transactions. For example, due diligence undertaken before company acquisitions is usually more extensive than that required by the party who intends to join a joint venture and seeks to collect information on the potential partners and/or about the company that they have established. While a person interested in acquiring shares will want to gather information to assess the assets of the target company, to verify the productivity of resources and to identify liabilities; a potential partner in a joint venture will want a deep assessment of the credibility of the other partners and may require only a superficial assessment of the venture if it has been recently formed. In addition, it may be necessary to adapt the environment and degree of the due diligence process on the basis of the size and importance of the transaction and to the human resources available to each party. It is also wise to consider that various legal issues relating to acquisition or investment operations may be analysed differently across countries.

So, for the purpose of defining due diligence and the evaluation process that it entails, this chapter will explore the due diligence process; i.e. the various types, strategies and mechanics, with a particular focus on the legal due diligence. The analysis will also focus on asset and share acquisitions, rather than other types of takeovers[4].

1.2. TIMING AND PRELIMINARY COMMITMENTS

The due diligence process should be carried out as early as possible in the negotiation stage given that it may reduce problems arising from the identified risks. The sooner the various issues are analysed and communicated to the negotiation teams, the sooner the buyer will benefit in the negotiation process, given that the seller holds an inherent advantage by being the only one who knows the true nature of the target company —at least in theory—.

However, due diligence only starts after the parties have agreed to the general terms and have defined the general conditions of the operation, especially if the due diligence is done by the buyer, or sometimes after a serious offer is made. Once counterparty is selected from among the multiple interested parties, the potential buyer and seller usually sign a letter of intent setting out the main lines of the agreement. Due diligence is generally only accelerated if the buyer needs to gather detailed information in advance about business issues requiring legal analysis, e.g. contracts with key customers or real estate assets, or in case there is an invitation to tender given to a number of interested parties.

The seller often requires the buyer to sign a confidentiality agreement concerning the information disclosed in this process before any due diligence starts, while the buyer may require the seller to agree not to enter into any dealings, sale and purchase operations, or similar transactions with third parties during a specific period of exclusivity. Such agreements may be included in the letter of intent, which are examined in Chapter 2 of this book. In addition, Annexes 1 and 2 provide sample confidentiality and exclusivity agreements to give the reader a general idea of the content or wording as they relate to the due diligence process. Please note that these examples must be adapted to specific cases.

Regarding confidentiality, it is worth noting that, in addition to the buyer's obligation to maintain the confidentiality of the information made available to it in order to carry out the due diligence process, the parties may want to preserve the confidentiality of the negotiation itself.

By the time due diligence starts, the seller should have identified the employees of the target company who will be responsible for responding to questions from the buyer's teams of professionals. As discussed later in this chapter, documents gathered and prepared for examination will be analysed by different teams (staff, auditors or accountants, attorneys, experts, as the case may be) in the physical or virtual «data rooms». It may also be possible to submit documents and information or copies to the buyer or its various teams for analysis and assessment at their own offices.

As noted previously, as a general practice, in most business operations due diligence is performed before the signing of the various agreements. However, certain exceptions may apply if, for example, the seller cannot wait and needs to execute the transaction urgently. Under such circumstances, the parties may sign and enter into an agreement on condition that the buyer is satisfied with the results of the subsequent due diligence to be performed within a specific time period. This puts the seller in a less favourable position, given that the buyer has a wide range of possibilities to terminate the agreement. In spite of the duty to act in good faith and the clauses included to set out minimum obligations, these may be easily evaded by the buyer with the result that this type of contract effectively grants the buyer an exclusive purchase option to acquire the target company within a specific period.

1.3. MEANING OF DUE DILIGENCE IN CONNECTION WITH REPRESENTATIONS AND WARRANTIES

For the purpose of cost-saving, a buyer may ask that the seller's representations and warranties and their indemnity obligations jointly substitute and cover most of the areas to be examined during the due diligence process.

This strategy is not advisable for a number of reasons:

- The scope of the representations and warranties and the indemnity obligation may be reduced just before the agreement is signed or the transaction is closed, when there may not be enough time to investigate further.

- In general, it is easier for the buyer to interact with the seller before the closing. Typically, a seller will want to close the deal and show a responsive attitude towards the buyer. However, after the closing sellers usually reject claims raised by buyers, even if well supported.

- Representations and warranties are usually qualified by including expressions such as «materially», «substantially», «to the seller's knowledge», etc.; all of which may lead to various different interpretations.

- Representations and warranties, as well as the seller's promise to compensate for damages, are usually valid for a limited period. Indeed, some claims may arise after the specified term, as in environmental claims, for example.

- Warranties may also contain liability limits (a «cap»), waivers and exemptions relating to each claim.

- The indemnity provisions may often not cover damages fully, given that the courts may not consider claims or that damages may be assessed under different criteria, and the fact that some damages cannot be repaired in terms of

monetary compensation; e.g. damage to the reputation or prestige of a trade mark. Some damages are difficult to quantify and compensate, particularly if the plaintiff believes that monetary payment is not the proper remedy.

- The seller might only be held liable if all of the requirements to raise the claim are met.

- Claims for liability are more expensive and time-consuming than foreseeing and negotiating risks, even if claims are not disputed.

- Favourable decisions for the buyer may be difficult to enforce. For example, the guarantor may not be able to meet financial liabilities if solvency or liquidity has been reduced considerably or has disappeared by the time the claim is raised.

- Certain liabilities should be measured upon the closing so that damage can be quantified on that date. However, this does not help to cover subsequent damages. For example, contaminants in a canal may be contributing to a build-up of toxicity. Therefore, the degree of causality used to determine the seller's liability would need to be assessed on the closing date. In addition, the degree of liability can only be quantified if the corresponding tests have been performed on that date. Measurements taken after closing do not help to determine to what point the seller is accountable for the cause of the toxicity, so the seller's liability may not be capable of being assessed appropriately.

Even if the seller agrees to make «representations and warranties» that provide security for the various issues often covered by due diligence, the buyer or investor should carry out their own confirmation processes. Checking information and facts well in advance without necessarily ignoring the seller's «representations and warranties» in the agreement reduces the possibility of disputes by identifying problems in due time. In addition, in some cases the seller or the target company may not be fully aware of a problem until it is identified by the buyer during the due diligence process. The medical principle of *«To guard is better than to heal»* applies equally to the due diligence process.

Ideally, the buyer will try to conduct a thorough due diligence process at the lowest cost possible and with the greatest representations and warranties made by the seller. The seller however, will want just the opposite. Although some sellers may seek to avoid making representations and warranties on issues disclosed or confirmed throughout the investigation or analysis, buyers will often want to ensure the certainty of such results.

When defining the preliminary verification approach (in addition to the representations and warranties included in the agreement, if applicable) it is worth considering that the cost of the due diligence process may be greater than its potential benefits, mainly if transactions are not large or complex. On the other hand, the buyer's right to claim for representations and warranties may be affected if it got to know about the issue as a result of the due diligence conducted. Indeed, the corresponding indemnity obligation may be affected if a specific aspect was known by the buyer, even if it does not derive clearly from the representations and warranties but may be inferred therefrom or evidenced by the seller in any way. Thus, it is advisable that such a contingency is described and acknowledged in a separate clause that sets out the seller's corresponding indemnity obligation, so that this information is provided on a separate basis from the remaining representations and warranties in the agreement.

Whatever the case, any due diligence process is limited in terms of the amount and quality of the information and data provided by or on behalf of the seller. Thus, the buyer runs the risk of not obtaining complete information upon request or gathering information which may lead to false representations. Thus, in view of the limitations of the due diligence process, it is advisable for the buyer to request the seller to give representations and warranties and the corresponding indemnity obligation in the sale and purchase agreement notwithstanding the seller's duty of good faith as examined below. Such representations, warranties and indemnity obligations may support the results of the due diligence conducted if possible or in the event of aspects which can not be confirmed by the buyer. Typically, the buyer may wish to include representations and warranties stating that the information and/or documents provided by the seller are true, accurate and entire and do not lead to errors, although they refer to the content set out in the various representations and warranties rather than every type of information on the company.

It is worth mentioning some of the considerations analysed in Chapter V of this book on insufficient legal guarantees with regard to the transfer of shares. It may be advisable to include the corresponding representations and warranties in the sale and purchase agreement in question.

As discussed in Chapter V, the seller guarantees that the shares transferred exclude hidden defects. However, physical assets of the company sold are not included by this legal guarantee as the company's assets are not the object of the transaction. The various contingencies or problems affecting these assets do not affect the shares sold as far as hidden defects is concerned, unless they effectively create a hidden encumbrance over the shares or a significant decrease in their value. As further analysed in Chapter V, if the object of the transfer is shares rather than physical assets, the purpose of the representations and warranties included in the sale and purchase agreement is to extend the seller's liability to cover specific contingencies, damages or risks which would otherwise fall within the scope of the buyer. When the parties define the list of events and contingencies to be acknowledged by the seller as true statements, the seller further states that such representations are true and agrees to be held liable for them. Thus, it should be understood that representations and warranties included in the agreement allocate risks and are especially relevant in transfers of shares.

This should however not affect liability for fraud which may be claimed if the seller has hidden, changed or in any other way manipulated such information with malicious intent. Therefore, any such exclusion of liability would turn out to be void.

1.4. DUTY OF THE SELLER TO PROVIDE INFORMATION

As explained above, although each of the parties to a commercial transaction of this kind will seek to protect its own interests, the seller may not, with fraudulent intent, hide or change information provided in the due diligence process without serious consequences.

First, we should not forget the importance given by the Spanish legal system to the principle of protection of trust and good faith and its relevance as elements that precede contractual obligations. Article 1258 of the Civil Code sets out that «Agreements are executed by the mere consent of the parties and, as such, bind the parties to the fulfilment of the content thereof and are held liable for consequences of good faith, use and the law, as the case may be».

In Spanish statute law, good faith is a source of objective rules with no specific express wording that aims at governing legal relations, the exercise of law and compliance of obligations are carried out pursuant to a set of principles deemed necessary by society although they are not expressed in laws or agreements[5)]. Accordingly, in terms of contractual relations, good faith helps to determine the scope of contractual obligations and their fulfilment, and creates accessory requirements to the main obligation. Conduct contrary to good faith in the exercise of the rights would be unlawful as provided for in Article 7.1 of the Civil Code. Therefore, each of the parties may expect the other in a legal relationship to behave in accordance with the principles of good faith. Article 1258 of the Civil Code applies the general rule of Article 7.1 of the Civil Code to agreements.

It is advisable to include an express contractual provision that sets out the obligation of acting in good faith and the specific representations and warranties of the seller guaranteeing that the information so provided is complete, accurate and true, and that no information is hidden that may lead to misunderstandings. Nevertheless, the general principle of good faith may also precede commercial transactions as those examined in this chapter. Thus, the seller's actions may not only be governed by express statements in the representations and warranties, but also by the binding principle of good faith under which they provide all information in the due diligence process in a complete and accurate way, avoiding any type of misunderstanding or confusion. However, in spite of such an obligation, the problem would be to show evidence of inaccurate information or omission contrary to good faith. The due diligence process lacks sufficient guarantees; information is often provided orally or is not certified, and the seller is protected by the presumption of the principle of good faith. In addition, the seller may sometimes intend to limit liability for the information provided in this process by trying to include statements such as the following in initial documents signed at an early stage of this process:

> «The information provided has not been verified independently by us and is provided to you with no representations or warranties in terms of accuracy, entirety or any other characteristic. We therefore do not assume any type of liability against you or your representatives deriving from or in relation to the information so provided».

It is worth noting that in the case of fraudulent intent, certain clauses or representations by the seller may make the entire agreement null and void, if such intent is deemed material.

Article 1101 of the Civil Code on contractual liability sets out the following:

> «He who fulfils obligations with fraudulent intent, negligence or delay and those involved in infringing the degree thereof shall be held liable and shall compensate for resulting losses and damages».

Although this issue is related to the representations and warranties, we should analyse it under the light of the due diligence, especially as the fraudulent intent that may affect representations or documents provided in this process as well. When assessing the existence of fraudulent intent in the due diligence process we are certainly examining interpretations and evidence which may be difficult to assess or determine; especially if we consider what we have already discussed in terms of the lack of sufficient guarantee and the information that is provided to the buyer orally or is not certified.

The due diligence process may give rise to claims and is a source of conflicts given that it does not only include actions or positive facts (e.g. representations made or documents provided), but also omissions. When the Civil Code refers to «insidious words or plots» it seems to include positive behaviour rather than the intentional omission or intentional failure to state material facts (i.e. leading to deceit because a party to the contract has not disclosed information to the other on events or facts which the former should have known and if so, the party would not have entered into the agreement). However, the importance of omissions should not be ignored on the basis of the presumption of good faith whereby one of the parties should provide information to the other on the events or facts leading to a successful agreement. On the other hand, the burden of proof is a complex issue in this regard. As will be examined below in relation to representations and warranties, such intentional omission may be attenuated if the buyer » was able to» know and analyse the company through the due diligence process.

It is difficult to identify what the buyer could or could not know and confirm on the basis of what information the seller provided or failed to provide. It is even more complex to prove that the lack of true information (in representations and warranties or data provided in the due diligence process) constitutes fraud and a serious cause of action whereby the agreement may be annulled (even if the buyer prefers the «incidental fraud» classification under Article 1270 of the Spanish Civil Code and claim corresponding losses and damages).

However, the presumption of good faith is essential both before entering into agreements and prior to any negotiation —even if agreements are not finalised—. If a party is damaged by the other party's failure to comply with the duty of good faith at the negotiation stage (e.g. broken negotiations as a result of the seller changing information aimed at the buyer intentionally), the potential seller should also compensate the potential buyer for damages caused given it may be a case of liability in tort as set out in Article 1902 of the Civil Code[6].

In spite of the duty of good faith it will be difficult to prove fraud or lack of the presumed good faith. A possible solution to this problem may be to conduct a written due diligence process so that information is always provided in writing and documents are included in a list and signed by the persons authorised by the parties to such effect; i.e. similar to the procedure whereby information is provided in data rooms as will be examined below. This is especially important if there are multiple potential buyers. The seller or the target company should ensure all are provided with the same information. However, if the transaction is not large or complex practice is often different in Spain, probably due to the costs involved, amongst other reasons. Thus, the buyer would be lucky if the seller or any representative answered all the questions and requests in any way, even orally.

Notwithstanding these complexities and for the purposes of this section, it is important to consider what approach should be followed and what civil law provisions apply if the seller fails to comply with the duty of good faith; does not provide, or changes or provides false information. Thus, Articles 1101 and 1902 of the Civil Code apply in claims for losses and damages or annulment of contract as explained above, Article 1484 of the Civil Code governs acquisitions of items with hidden defects and Article 1124[7] of the Civil Code sets out termination of the contract if a party fails to comply with its obligations.

These articles usually apply in relation to representations and warranties included in the agreement, mainly due to reasons of proof as explained above. However, they should also apply to the information provided to the buyer by the seller throughout the due diligence process.

As discussed above, it is also worth highlighting that representations and warranties included in the agreement allocate risk especially in transfers of shares. Thus, it is important to note that if shares are transferred the seller's obligation to disclose information in the due diligence process does not imply providing specific information on all of the assets of the company. The seller should only provide information requested by the buyer in the due diligence process. If the seller has not been able to provide such information, or the buyer has not been able to gather it, the buyer should ask the seller to make the corresponding representations and warranties on this issue given that it will be the best way to prove such information was of relevance and requested. It is clear that the seller is not able to foresee all of the information the buyer may deem to be of interest or importance.

We have already discussed the direct relationship between contingencies and the term or depth of the due diligence process; i.e. how relevant a specific contingency is for the buyer and the corresponding interest and time devoted in the due diligence process and the list of contingencies covered by representations and warranties. Each event should be analysed on a separate basis. However, it is possible to state a common scenario: one reason why a due diligence process may not cover a specific event is that the buyer's advantage in knowing the information may be less beneficial than the cost of the process. Therefore, the buyer could choose to bear the risk in this regard.

1.5. CONSIDERATIONS ON THE INFORMATION PROVIDED BY THE SELLER

We have already discussed the obligation of the seller to provide true, entire and accurate information in a way that does not lead to misunderstanding or confusion. However, it is worth mentioning this action is of utmost importance to build confidence with the buyer although detailed control of data is advisable. Accordingly, other aspects should also be considered. Let us analyse below a number of issues to be taken into account by sellers at this stage of the process.

As mentioned above, it is important to build confidence. The buyer may become worried if given the impression that the seller does not disclose all of the data or provides false information. Such an event would lead to a stronger due diligence and longer negotiations. It is important that the seller gives clear orders to advisors and internal personnel in this regard.

It is also essential to provide a consistent image of the target company. The ideal situation would be to present the target company as a highly efficient entity with a high level of professionalism although there is no reason to lead the buyer into a wrong or distorted view of the company. The seller's best option would be consistency; i.e. the seller should discuss the real image of the target company with the persons in charge of disclosing information, reach an agreement, and provide such information to external advisors.

On the other hand, at this stage where information is disclosed, the seller should manage and properly identify what employees in the target company are to be contacted by the various professionals involved in the due diligence process.

In addition, it is necessary to agree on a rationalised or limited scheme relating to the information requested or the questions received from the buyer or its advisors. Accordingly, the seller should not provide more information than what is necessary. Therefore, certain measures should be adopted in relation to confidential information and data should be presented in the best professional way possible.

When a specific reply requires more time than is usual, it is better to provide incomplete information so as not to lead the buyer into thinking that the seller intends to hide information on a specific issue, and to avoid creating tensions.

Typically, the seller may want to qualify the information it provides as well as subsequent representations and warranties mainly if submitted in writing (e.g. answers written in a virtual data room or emails) by adding expressions such as *«to the seller's best knowledge»* —both when the seller is not sure or when costly and lengthy professional counsel may be required to provide certain information for example, to state there is no environmental pollution—. This type of qualification is often not accepted by the buyer if the situation should have already been analysed by a professional or the information could be easily gathered at a reasonable price; e.g. the statement on proper book keeping.

These qualifications are also usual in representations relating to future facts which are under the buyer's control or beyond the control of the seller; e.g. a statement that suppliers or customers shall not cancel operations with the target company as a result of the transaction.

If the seller does not accept the exclusion of the qualifications, the buyer might a request fuller statement; e.g. «in the seller's best reasonable knowledge by having made due investigation in view of the circumstances in question».

However, discussions about this type of qualification or statements most often arise when preparing and drafting the content of representations and warranties rather the time when the seller provides information in the due diligence process given that they usually try to exclude responsibility by providing oral information or not explaining documents which are unclear.

1.6. CONFIDENTIALITY OF THE INFORMATION PROVIDED

The seller may reasonably want to secure information provided to the potential buyer, especially if it is valuable and confidential, given that the transaction may not conclude and the buyer may have received very valuable commercial information of the target company, e.g. a list of customers or trade secrets. Thus, a prudent seller will require the buyer and its advisors to enter into a confidentiality agreement in the first stage of the transaction, usually before the due diligence process starts (e.g. in the Letter of Intent), even if the protection and compensation for losses and damages that the seller may ultimately receive upon the buyer's breach of the confidentiality obligation may not be sufficient and compensate what such action effectively implies. In other words, the seller and/or the target company should pay special attention when providing this type of information.

Such criteria to secure confidential information should be extended to the increasing use of virtual data rooms. It is important to gather early information on security measures to access them.

Annex 2 provides a model of a possible confidentiality agreement.

However, in addition to the seller's desire to bind the buyer to secure the confidential information received during the due diligence process, it is important to assess other reasons properly as they may relate to the confidentiality required for certain data which may or may not be provided; e.g. legal or contractual confidentiality obligations or legal counsel documents relating to lawsuits.

Accordingly, the Anglo-Saxon approach[8)] recommends considering two main factors when determining what information is required in the due diligence process to provide to the buyer. These factors often lead to problems and are not normally taken into account appropriately:

a) Confidentiality obligations with third parties; and

b) Legal privilege (as known in the Anglo-Saxon system) examined below.

A. Confidentiality obligations with third parties

Some agreements include confidentiality clauses preventing third parties from obtaining copies without the other party's prior authorisation. Therefore, it may not be possible to provide information to the buyer on the existence and content of such agreements. Thus, it is important that the seller identifies early in the process all of the agreements whereby this type of obligation may be required. In addition, such authorisation may not be practicable if there are time constraints. And sometimes the seller will prefer not to be given such authorisation as it may not wish to notify the other party of the reasons behind any exceptions.

A possible solution, for example, may be to delete or erase confidential information in the documents relating to the agreements in question before submitting them to the buyer. However, given that confidentiality clauses may be drafted in different ways, each case should be analysed on a separate basis under their specific scenario to determine if this procedure does not breach the agreement.

B. Legal privilege

This section analyses the legal privilege of some documents prepared to provide legal advice and not be disclosed to the other party throughout the acquisition negotiation process. For example, documents relating to litigation may only be provided to the potential buyer if not privileged.

This note is important given that if the seller or the company drafts a document to provide information on a litigation and submits it to the buyer as a consequence of the due diligence process, the content in such document will not be covered by such legal privilege and may be prejudicial. No privilege will apply to a previously privileged document if it is used for a purpose other than the reason why its confidentiality was required (i.e. the litigation); e.g. when made available to the potential buyer of the target company.

It is important that sellers consider this factor when providing information throughout the due diligence process.

2. DUE DILIGENCE QUESTIONNAIRE

2.1. GENERAL CONSIDERATIONS

Following the first meeting or after assigning the functions or tasks to the personnel in question and setting the guidelines on engagement and performance, the main step forward in the due diligence process is to prepare questionnaires; i.e. the legal due diligence questionnaire. Accordingly, a first document is normally submitted with the «Preliminary Questions» or «Preliminary Questionnaire» that is prepared (usually by lawyers) by considering specific circumstances of the transaction under the restricted information obtained by the lawyers. The Preliminary Questions or Preliminary Questionnaire should focus on the key assets the buyer intends to acquire and the most significant liabilities in question.

Typically, this Preliminary Questionnaire is drafted by the lawyers for the buyer as it is the party who normally starts the due diligence process. However, as explained above, this first step may also be taken by the seller if it wants to prepare the company before it is transferred or —if there are multiple potential buyers— the elected method could be a tender and the presentation of information on the target company in the so-called data room, as will be explained below. Therefore, the seller or its lawyers will prepare the first questionnaire in these circumstances, but the buyer or its lawyers will also draft a questionnaire by including a list of documents and/or information it wishes to find in the data room for legal auditing purposes.

It is important to consider that whilst the target company is subject to due diligence by lawyers, other professionals may also be involved and carry out acts in their fields. Therefore, it is advisable to coordinate actions to avoid requesting the same information several times which may be disruptive for the target company. Although it may be difficult in practice given the time constraints and efforts involved, it may also be advisable that the buyer's internal personnel review the Preliminary Questionnaire to check that questions included are indeed relevant and include additional issues which may be of particular interest in a specific field.

Next, the Preliminary Questionnaire can be filled in when the various aspects are analysed. If possible, it is advisable to group issues or questions into the lowest number of questionnaires and then analyse and request the corresponding answers and clarifications. The seller and target company's personnel often complain about frequent interruptions to their daily work as a result of separate requests. This should be avoided as it may lead to tensions; although it is important to reinforce that all information requested and deemed reasonably necessary should be submitted to the other party.

It is advisable to impose deadlines; i.e. a term during which the buyer may request information and submit questionnaire(s) and a term during which the seller needs to provide the requested information and make due representations.

2.2. SUBJECT AREAS TO ANALYSE

A due diligence preliminary questionnaire should be used to request information on each area to be examined. The most common areas are:

- Company secretarial information.
- Assets (movable and immovable assets, including intellectual property).
- Contracts (including insurance policy and financial contracts).
- Labour issues.
- Administrative or management issues.
- Tax issues.
- Litigation.
- Competition law considerations.
- Environment and urban planning.

Annex 5 in this book includes a sample preliminary questionnaire that serves as a model to structure the preliminary

questionnaire pursuant to the specific case, area and type of transaction as discussed below. It is important to note that the lists in the sample questionnaire are not exhaustive and should only be used as a guideline for the most frequent issues. This model (which is only restricted to due diligence) should be contrasted with other questionnaires used by the buyer or their advisors in other professional fields (e.g. accountants, engineers, etc.) to avoid requesting information twice or missing material data.

As can be seen, the sample questionnaire identifies areas to be analysed during the due diligence process and includes a list of questions to be answered or information to be provided by the seller. The questionnaire should start by identifying and explaining certain issues relating to substantial agreements (e.g. value and duration of the agreements).

2.3. ADAPTING ITEMS TO EACH SPECIFIC CASE OF THE QUESTIONNAIRE

It is important to consider at the initial stage of the first list or Preliminary Questionnaire that each business or industrial area may submit its own specific issues relating to the various aspects to be investigated and analysed in the due diligence process on the basis of each particular case in question. For example, if the target company manufactures food products, a number of issues relating to this industry should be taken into account such as health regulatory requirements, labelling requirements, information to be provided to consumers, etc. Therefore, it is essential at this stage to examine and analyse in detail the requirements to which the target company is subject under the field or business in question given that there are often specific regulations relating to each industrial field. The attached Preliminary Questionnaire (Annex 5) includes general questions or documents often requested during due diligence, but this should be filled in and reconsidered under the specific legislation applicable to the field in question.

Another issue involved in the transaction is the subsidiaries of the target company, if any, which may also be foreign. They should also be subject to the same type of questionnaire although it should be adapted to the specific characteristics and relevance of the subsidiary in each specific case and the culture, characteristics, rulings and customs of the country in question if located abroad.

The due diligence process may not be conducted in the same way in joint venture transactions. Although the interest here is also to gather information on the partners in question, the joint venture target company will often be recently established and so a thorough due diligence process will not normally be necessary.

In addition, it is important to classify items in the questionnaire in accordance with the type of operation as some issues may be ignored or not analysed deeply. Let us focus on the examples below:

- Transfers of assets or business are of a specific nature, so the target company may not agree to provide information on some aspects or litigation not related to the assets or business in question and may require that the due diligence be restricted to the specific transfer.

- Because asset transfers are not performed by means of a single share transfer agreement, typically, it is important to analyse and consider how the various assets should be transferred. Accordingly, the transfer of certain assets such as equipment may be performed by a mere private transfer agreement, but others such as real property or administrative licences may require a public document.

- In transfers of shares it is essential to analyse «takeover» or «change of control» clauses when examining contracts, given that certain clauses may prohibit acquisitions or transfer of ownership in the transfer of assets, or have other important consequences.

Clauses on potential takeovers often set out the rights of the other party to terminate the agreement if, for example, the shareholder or the various shareholders who hold the greatest number of shares or effective control of the company no longer do so. If there is such a clause, the buyer would need to consider carefully at this stage if the other party's consent will be required for the transfer of shares or if the consent could be a condition precedent for closing the operation. It may be wise to consider why this type of clause is included and it is worth taking into account they are often found in agreements where personal relationships between the parties are a key or determining factor to the agreement. To ease the job of finding these clauses, it is possible to state as a guideline that they are most often included in contracts with customers or clients, supply contracts, distribution and agency contracts, franchise contracts, insurance policies, joint venture agreements, real estate lease agreements, financing and guarantee agreements, among others.

However, in asset transfers the buyer will examine if agreements, obligations and rights may be transferred with or without the other party's consent. In principle, the other party's consent is required as the general legal regime applicable to reciprocal agreements (i.e. agreements by two parties whereby one is a debtor and the other a creditor) if no specific provisions are included in the agreement. Thus, if the authorisation is not provided, the other party is not bound to accept the new party. However, it is worth considering tacit authorisations to continue contractual relationships. Article 1205 of the Civil Code should be considered to such effect: «novation whereby a new debtor is substituted for a previous one does not require the latter's consent but the consent of the creditor». Accordingly, the other party's consent is essential in agreements with this type of clause.

3. PERSONNEL ENGAGED IN THE INVESTIGATION AND INFORMATION DISCLOSED

3.1. PERSONNEL ENGAGED IN THE DUE DILIGENCE AND ORGANISATION PROCESS

One of the parties' first steps at this stage is to appoint internal and external personnel to conduct the due diligence.

The due diligence teams of both parties should be made up of persons capable of understanding, communicating and supervising the activities of professional advisors who will be in charge of providing them with due information. The more sophisticated the due diligence process is, the greater the expertise required from the personnel involved. However, it is worth noting that in every transaction of this type it is advisable to include at least the internal operations personnel of the target company, accountants or auditors, insurance brokers or agents if applicable, lawyers and even environmental advisors if the companies involved present this type of potential contingency. In complex and large transactions it may also be necessary to set up internal and/or external teams to deal with certain issues such as strategic management, coordination and communication, use and search of information, risk analysis and remedies, linguists, engineers and labour issues, liability for defective products, real assets and urban issues. It is important to define the function of each team clearly, mainly in relation to lawyers who will be in charge of conducting the specific due diligence process. The particular areas or aspects should be defined clearly given that some issues may be excluded due to the engagement of other professionals; e.g. insurance, environmental and even tax related issues. To such effect, the rules of engagement may be included and are deemed relevant in large transactions. Typically, they contain the following information:

- Term of the due diligence process.

- Seller or target company's deadline to provide or correct information.

- Type of access to information (whether limited or not).

- Confidential information, if any.

- Data room or direct contacts with the target company, if any.

- How to submit questionnaires or questions to the target company or transferor.

- Protocol rules, if any.

- Persons in charge of gathering and grouping information on the target company and coordinators of the various sections, as the case may be.

- Contacts in each team.

- Areas to be analysed by the various teams.

- Date by which the information shall be provided and updated prior to closing.

- Possibility of gathering additional information on the target company from public registries or authorities and official entities.

- Impact of the due diligence on representations and warranties that the buyer intends to get from the seller.

Annex 3 includes a draft document that may serve as a model or reference to define this type of rules.

However, in addition to the above rules, an engagement letter may also be entered into with some of these professionals; e.g. accountants, lawyers. This document is often drafted or signed by these professionals upon request of the client after the main terms are agreed in accordance with the specific services to be provided. This document was not normally required in Spain some time ago, save for due diligence processes relating to significant or large transactions. However, its use in Spain has increased gradually due to Anglo-Saxon influence and the growth of cross-border transactions. Among other information, engagement letters identify the persons involved in the transaction, assign tasks, specify investigation areas, restrict liabilities, set fees or limits for the various professionals and estimate expenses and fees, exclude specific aspects from the study, set deadlines for reports or drafts for each case in particular and help to avoid repeated or missing information.

Typically, the buyer contracts the services of lawyers (usually external) to conduct the legal due diligence process even if both —buyer and seller— contract services for advice on the agreements and closing. In relation to the legal due diligence, sellers often resort to their own internal personnel in transactions other than large or complex, although sometimes they may want to conduct more complete due diligence to prepare the company better, and well in advance as explained above. On the other hand, the legal due diligence process for buyers is often more demanding and it may also wish to be covered by the liability assumed by the external firm providing advice.

Areas or aspects often analysed in the legal due diligence process by the buyer's lawyers are under constant change. Let us examine below the issues most frequently analysed.

The legal due diligence process may often need to be coordinated and/or supplemented with the information or analysis provided by other experts or professionals on the basis of the nature and type of each target company. For example, if environmental issues are present, an environmental expert should identify specific risks or contingencies and the lawyer will

only provide advice on the resulting legal consequences or on issues such as health and safety and product liability.

It is essential that lawyers engage in the transaction as early as possible to provide advice on the structure of the operation and to avoid problem areas arising unexpectedly during advanced negotiations, given that incorrectly founded transactions will need to be partially or even entirely reconsidered.

3.2. INFORMATION PROVIDED BY THE TRANSFEROR FOR THE PURPOSES OF THE LEGAL DUE DILIGENCE: APPROACHES

There are two broad types of information that the seller provides to the buyer:

a) Information predefined by the seller.

b) Information provided by the seller upon the buyer's requests.

A. Information predefined by the seller

In this case, the seller groups the entire information to provide to the buyer before negotiations and allows the buyer to review the corresponding documents to such effect, usually in the so-called data room. However, as explained above, the seller may also agree that the buyer submits a questionnaire with a list of documents and/or information to be provided. This system or approach is often used in the event of tenders involving multiple potential buyers or when the target company does not want the buyer's advisors to move to its offices or disrupt daily work of employees on a constant basis, especially in large transactions. Typically, data rooms are operated under conditions of maximum security. A significant problem for a buyer when physical data rooms are used is that data are merely documents, rather than statements of facts or specific answers to questions made by the buyer in relation to the target company. The buyer will most often be interested in receiving answers to specific questions, and will usually be much more interested in gathering them in writing. However, this issue is resolved by means of the Q&A approach used in virtual data rooms.

When sellers predefine information, they centralise and control information disclosure in a better way, reduce interruptions to the target company's personnel, secure confidential information better, avoid discussions on what information has been disclosed or not and even guarantee equal treatment to all potential buyers in a tender in relation to the information provided. It is possible to use a number of physical data rooms at the same time —one per each potential buyer—. In this case, it is important to keep written lists to include the name of the documents provided in each data room (even in the case of only one data room) so that all potential buyers receive the same treatment[9]. It is also possible that the same data room is used over the time on a consecutive basis for the same length by the various potential buyers. If so, if it is possible to ask questions in writing in these data rooms, it is important to set a system whereby answers are shared with all of the potential buyers on an equal basis. However, the data room system gives rise to certain problems for sellers as it involves greater costs and discipline; data may be outdated in a short period of time and may lead to fruitless efforts if none of the potential buyers ultimately show any real interest in the acquisition. As explained above, in practice, most of these contingencies are overcome or attenuated with virtual data rooms.

In contrast, this approach carries lower costs for the buyer and avoids discussions on the information made available to them. However, it is also an important restricting factor given that no further information may be gathered at least at this stage, and copying data or documents is often prohibited when physical data rooms are used.

The main reasons why data rooms of this type are chosen are as follows:

- Confidentiality both internal within the target company, and externally (information analysed by the potential buyer);

- Less disruption in the business of the target company and its personnel;

- Convenience to avoid mass documentation and multiple copies; and

- Negotiating advantage given the restricted period of time in which potential buyers can find negative aspects or contingencies that make them not proceed with the transaction or may impact on the terms of the transaction.

It is advisable to draft a document with the rules to consider if this system is chosen and —particularly— if a data room is used as well. Annex 4 includes a draft document that could serve as a model to prepare this type of document for a physical data room, although it will be necessary to adapt it to the case or transaction in question or if a virtual data room is used. The information on this draft document may not be deemed entire, exhaustive or valid for any one type of event. It sets out rules not often used as they may be unnecessary or discouraged on the basis of the transaction in question or inapplicable as in the case of virtual data rooms. Let us examine some aspects of this annex which may help us to understand and make best use of the information available.

It is important to define clearly in the rules if documents made available to the buyer may be photocopied or otherwise copied or printed in the event of virtual data rooms given the significance the content may have for the seller in certain cases. Sometimes the list of documents that may be reviewed in a physical data room specifies what information may be photocopied by including statements below documents or charts. As can be seen in Annex 4 it is also possible to include sheets, forms or printouts to request the copy/printing of certain documents —which is also a way to guarantee equal treatment to all potential

buyers—.

Another important issue is to control the access to the data room (not only to identify or limit the number of authorised people and to record entry and exit times, but also to request in advance the names of those who will represent each potential buyer in the data room). It is also essential to define the Q&A procedure, as mentioned above, and the use of sheets, forms or printouts as those included in Annex 4. This procedure may be adapted to virtual data rooms, as the case may be.

It is worth mentioning that Annex 4 reminds us of the confidentiality undertaking by reference to a separate document[10]. However, it can also be repeated or expressly stated in such a document together with the rules governing the use of data rooms mainly in the absence of a document setting out the confidentiality requirement when rules were defined. In fact, the sheet used for access control purposes, often signed by each person who accesses the data room, may be the best document to certify in writing that the person in question acknowledges the confidentiality requirement. To such effect, if virtual data rooms are used in turn, emails or notices are often required to be sent to persons when obtaining the authorisation or accessing information.

In addition, questions or requests for clarification are often considered between potential buyers and the seller. Accordingly, it is both important and advisable to appoint representatives in charge of communications and also that the seller subcontracts the services of an external advisor in charge of other issues; e.g. in large transactions. These contingencies are better dealt with in virtual data rooms.

Last but not least, it is worth mentioning the growing use of virtual data rooms which can be accessed by entering passwords on the Internet. Although they have become a useful tool in large or cross-border transactions involving a large number of agents, their use has become widespread for all types of transaction. Some of the many advantages —such as confidentiality, cost-saving benefits and securing and restricting information (even by denying copies or prints of uploaded documents)— contribute to the significant benefits of the due diligence process.

B. Information provided by the seller upon the buyer's requests

This information is provided upon the buyer's request —sometimes, at a later time based on the representations and warranties and/or their exceptions which are intended to be included in the agreement—.

The buyer often submits the preliminary questionnaire to the seller as examined above. It allows the seller to gain a better position in that it may hide some negative aspects and take advantage of the presumption of good faith in its behaviour at this first stage; assume lower costs in relation to professional fees, and make savings if the acquisition is not completed. However, it often allows the buyer to gather further information, especially on negative aspects.

It is important to highlight there are two instances when information may be provided by the seller:

- At an early stage upon the buyer's request based on their first list or questionnaire or additional questionnaires or questions; and

- At a later stage when the due diligence process is often concluded given that the seller provides new information at the time representations and warranties and their exceptions are drafted.

As will be analysed below, it is advisable to follow a broad approach early at the preliminary questionnaire stage to include and make the seller consider any relevant aspect, define rules of engagement or performance, and include deadlines both for the buyer and seller (in relation to the term during which information may be requested or the due diligence process may be conducted and the term during which information should be provided —mainly in relation to data affecting representations and warranties and exceptions thereto—. Clearly, in spite of the good faith required of the seller's behaviour under which it should provide all the information reasonably deemed relevant for the buyer, the seller may often try to benefit from the presumption of good faith. In essence, deadlines and questionnaires covering a wide range of issues may help to prevent the seller from not providing information in due time except if it is clear they are not acting in good faith.

4. DUE DILIGENCE APPROACH

At a first stage of the process the seller is better positioned than the buyer if we consider the information it has about the target company. In trying to balance this unfavourable position the buyer may, for example, intend to conduct most thorough due diligence process possible and to use the resulting information to improve the terms of the transaction and identify factors which may reduce the value of the target company.

However, the approach or criteria to follow in terms of strategy should be defined in advance. In essence, the buyer should consider a number of events and aspects, for example key risks to which the target company and the seller may be exposed. Some industries involve risks which may give rise to serious consequences so due diligence should be conducted at a greater level of detail, for example in the event of chemical industries. It is also possible that a price or a limit of the price has been agreed at a first stage considering a significant reduction to be offset by the fact that subsequent due diligence will not be exhaustive. On the other hand, it may be possible to know or have an idea on why the seller has decided to sell. Otherwise,

reasons should be identified out of the due diligence process and a deeper analysis will be needed.

In addition, a number of factors may considerably influence the approach used in the due diligence process. Let us examine some of them:

- Previous relationship between buyer and seller; e.g. if they belong to the same group;

- The seller's capacity to indemnify the other party, if applicable; the seller's history in this type of situations; or a tendency for litigation;

- Whether there is a deadline to complete the due diligence; and

- Proximity to the date of closing.

It is also important to consider certain factors at this first stage of the transaction; e.g. if an exhaustive due diligence process allows the seller to demand fewer representations and warranties; the buyer's typical attitude and policy towards the risk; and the price the buyer intends to pay.

It is advisable to identify early which factors may be of upmost importance at the time of the auditing and to decide how and what aspects should be addressed in particular. In addition, it is advisable to define certain rules of engagement, identify key assets and the intended use thereof, determine the reasons why the target company is being transferred, consider what factors may cancel the transaction (e.g. clauses on takeovers in a specific key agreement) and to identify what areas should be examined more in detail.

At the time this decision is made, it is important to know that any information provided by the seller will often be part of the representations and warranties or the exceptions thereto. It may be helpful to negotiate a lower price or other terms of the agreement, although this may not be always the case. In summary, the buyer should be aware of the fact that deeper investigation may also imply less protection. Therefore, the first issue to bear in mind is (a) if the buyer prefers greater certainty and lower risks by having information on what is acquired on early on, or (b) if the buyer prefers to run the risk by being protected only by representations and warranties and then claiming on that basis, if necessary.

The buyer should also define minimum levels in relation to the information or amounts it may be interested in. Typically, it may not wish to consider certain aspects if they are lowered than a certain amount based on a profitability basis. For example, the buyer may instruct their lawyers not to consider or analyse contracts with customers below a specific amount or with a term shorter than a certain length of time.

If the target company operates in other countries, due diligence usually takes much longer and is much more complex. Typically, in the event of significant cross-border businesses, the services of lawyers or other professionals in such jurisdictions are also hired if applicable. It is also advisable to set reference terms and guidelines on an initial basis and to conduct the due diligence process as consistently as possible. However, the buyer should adapt to the local terms and customs of each jurisdiction following usual practices to conduct due diligence in the countries in question and avoid acting in invasive or even offensive ways which may damage the target company or seller's integrity and reputation.

If the cross-border business is more limited (e.g. if only certain agreements are subject to foreign legislation), it may be wise to hire lawyers of the corresponding jurisdiction for their revision although the due diligence process on the foreign company may not be conducted entirely or exhaustively.

5. CONFIRMATIONS. NON-REGISTERED INFORMATION. CONFIRMATION OR INFORMATION FROM REGISTRIES OR OTHER PUBLIC ENTITIES

Once the buyer analyses the information provided by the seller, further questions or requests are often submitted on documents referred to therein which have not been provided to the buyer or/and facts, events or confirmation which are not at all clear. As explained above, deadlines are often set for both buyer and seller to such effect. In addition, it may be difficult to evidence whether the buyer has received the seller's replies to its initial or additional questions or questionnaires if given orally, as is often the case. Under these circumstances, lawyers or professionals in charge of the due diligence process should make it clear such information was only provided orally and each one party should assess the need or interest of the answers being part of the representations and warranties or exceptions thereof.

Further to this information, confirmation and additional documents provided by the seller, the parties may agree that the buyer be entitled to gather other information by themselves or with the contribution of the target company or seller if applicable. Let us analyse this information below.

5.1. INFORMATION FROM THE CORRESPONDING COMMERCIAL REGISTRY OR THE LAND REGISTRY

This section refers to the information requested on the company (usually a non-certified property extract) to the Commercial Registry relating to its registered office, and the information on its real assets or land requested at the Land Registry where they are located. The non-certified extract is not as accurate as a deed or notarised document, and does not certify information

relating to the company's records. However, it may be useful for legal audits, mainly to compare it with the information and documents provided by the seller or target company[11]. The content requested by means of non-certified extracts may include all or part of the information in the records in the Registry and is often sent electronically. Registries require some time to submit the extracts given that it depends on their workload, but a deadline is often set out by law. Some Registries do not render the extracts on matters of urgency, even if the buyer is willing to bear the costs; e.g. express courier —cash on delivery —. Therefore, significant delays should be taken into account if a fast due diligence process is required on the basis of the buyer's time constraints. It is nowadays possible to access a number of Registries online to gather essential and relevant information in real time; e.g. incorporation of the company, ID data, share capital, bodies, termination of posts and new appointments, auditors, account deposits, etc. which speeds up the gathering of the information.

In addition to the above and depending on the engagement level requested from the lawyers in the legal due diligence as well as other aspects under their analysis, Commercial Registries are often requested to provide a copy of the deposit of annual accounts for the last four fiscal years if the company is not able to provide them.

By gathering this information, the buyer is able to contrast data which would have been provided by the seller or the target company to assess credibility and confirm if it is complete, true and accurate.

5.2. INFORMATION ON INDUSTRIAL PROPERTY RIGHTS

It is also possible to request and gather information on the different intellectual property rights of the target company if any to the Spanish Patent and Trade Mark Office, usually online or by means of intellectual property agents, and licences or other types of rights which could have been requested, granted and recorded (as the case may be) in the company's name both at a community or cross-border level.

5.3. CERTIFICATES OR INFORMATION FROM THE MINISTRY OF ECONOMY AND FINANCE

In addition, a party may request a certificate from the Ministry of Economy and Finance to confirm that the company is not pending payment for any expired debts. Information on local taxes (e.g. real estate tax) may be requested from the collections department of the corresponding City Council. In essence, in the event of asset transfers including any real estate property, the Public Notary will request proof of the last payment of this tax when formalising the transaction.

5.4. CERTIFICATES FROM THE GENERAL TREASURY OF THE SOCIAL SECURITY

Certificates from the General Treasury of the Social Security show whether there are outstanding payments owed by the company or claims filed by this entity.

5.5. INFORMATION ON URBAN PLANNING

Typically, the City Council keeps records of the urban classification of the land corresponding to premises of the target company or the licences granted for works therein.

5.6. ADMINISTRATIVE INFORMATION

It is also possible to request information or confirmation from the corresponding City Council or Department within the Autonomous Community in question (e.g. the Department for Environment of the City Council, if any; Department of Industry, Fisheries and Food, etc.) in connection with other types of licences or administrative permits (environmental status of the land and type of business; licences granted to perform disturbing, unhealthy, noxious or hazardous acts; licences to open and operate a business; registration in the Industrial Registry or other, as the case may be).

Local authorities often do not provide information or confirmation on this matter in writing, especially if requested on matters of urgency. However, a visit to the corresponding entities or persons in charge may help to know the real situation and estimations.

5.7. INFORMATION FROM OTHER TYPES OF REGISTRIES OR ENTITIES, AS THE CASE MAY BE

It is advisable to request information from other types of registries if there are reasons to believe other registrations have also been made and information may be requested by third parties (e.g. sales agreement to acquire real estate in instalments, franchises, foreign investments, etc.) It helps to confirm, at least, that the seller or the target company complies with the corresponding regulations. Sometimes a mere telephone call or a visit is sufficient to request information.

6. ISSUES TO BE CONSIDERED AND VERIFIED IN RELATION TO DOCUMENTS PROVIDED FOR LEGAL DUE DILIGENCE PURPOSES

Although the due diligence process focuses on the target company whose shares or assets are to be transferred, the seller may

also be identified along with relevant data about their business (e.g. solvency, competing businesses units, the structure of the group, etc.). This chapter includes a breakdown of some, but not all, of the most significant aspects that are considered and analysed in the documents provided throughout the legal due diligence process.

In addition to the different points discussed below, it is important to note that certain considerations vary depending on the subject matter of acquisition; i.e. shares or assets. In the latter case, the liabilities and obligations of the company are not transferred with the assets, with some exceptions such as labour or tax liabilities.

The buyer's most frequent concern is often the limitation period for each type of liability relating to the contingencies identified. Therefore, as a prelude to our analysis, it is worth exploring the various limitation periods in question, which may be classified in three categories; civil, administrative and criminal.

Article 1968 of the Civil Code applies as the general rule in civil liability cases, notwithstanding the multiple exceptions in a number of cases[12]. Thus, any action to claim civil liability in relation to fault or negligence as set out in Article 1902 must commence within one year of the event which gives rise to the issue in question.

Alternatively, administrative liability claims are governed by Article 132 of the Regulation of Public Administrations and General Administrative Procedure Act and the limitation period for infractions and penalties is provided by the corresponding laws. However if legislation is silent with regard to the issue, the following applies:

- Serious offences in the first degree and related penalties expire after three years.

- Serious offences in the second degree and related penalties expire after two years.

- Minor offences: six months. Related penalties: one year.

Additionally, whilst the limitation period for offences shall commence as of the date that infraction has been committed; expiry of penalties commences as of the judicial ruling in question.

Finally, Articles 131 to 135 of the Criminal Code set out the limitations for crimes and offences as well as for penalties and bail conditions in criminal liability claims.

Notwithstanding the fact that any individual held criminally liable for a crime or offence may also be held civilly liable for resulting losses and damages, no one shall be tried twice for the same offence as a general principle of law and its effects [*non bis in idem*][13].

6.1. CORPORATE ASPECTS

The Certificate of Incorporation is a public document that certifies that a company is duly registered and is always included in the original version of the company's Statutes. Any amendments must also be documented in a separate deed of amendment. In addition to any amendments agreed to by shareholders or partners, either voluntarily or due to legal obligation (e.g. company name, purpose, registered office or share capital), the Company's statutes may also need to be reviewed and amended if there are changes in applicable commercial laws.

Generally speaking, the Statutes (and their amendments as documented in a public deed or issued in a non-certified extract from the Commercial Registry) contain information relating to the company name, registered office, term of existence, purpose, share capital, limitations to free transfer, structure and operation of the governing bodies and term of the fiscal year.

Any limits on free transfer should be evaluated before the closing so that all related requirements can be fulfilled in due time and form. The buyer may also want to amend these clauses depending on the circumstances that exist after closing. Typically, if the company is to be formed with only one shareholder or partner, the buyer may want to simplify procedures or eliminate this type of clause. However, in the event of a joint venture, these limits will be of utmost importance.

The certified copies of the documents executed by the company and filed with the Commercial Registry contain information on its registration. However, it is important to verify this information with the non-certified extract provided by the Commercial Registry.

General powers of attorneys and other documents that grant powers, along with any amendments, revocations or substitutions, must be filed with the Commercial Registry. However, special attention should be paid to powers of attorney granted to act in claims or those granted to perform specific acts[14] given that there are no filing requirements in these cases. The buyer may wish to revoke or amend some of these powers upon closing.

In relation to governing bodies, it is important to review the various operating rules, whether directors have been duly appointed, if appointments have been registered, if the positions are paid and in effect, particularly given the provisional limitations set out for corporations by Article 221 of the Companies Act. It is also advisable to identify *de facto* directors, if any. The existing governing body or directors should be known especially if there is an intention to make changes upon closing, which is often the case.

In terms of share capital, although the amount is reflected in the Company's statutes or any amendments (which should also be

filed with the Commercial Registry), the share structure may be different from the one specified in the Certificate of Incorporation or other documents registering the increase or decrease of share capital that are filed with the Commercial Registry. Transfers of shares are not recorded in the Registry but they may be reflected in public documents (deeds or policies), private documents or even a simple endorsement in some cases. Therefore, it is advisable to examine these documents carefully when analysing the share structure or ownership of the share capital. To this end, the entries in the book of registered partners or registered shareholders may be a valuable resource in the case of limited liability companies or corporations with registered shares. Certificates, if issued, should also be verified. This is of the utmost importance in a share transfer given that the subject matter of the transaction is the shares and the title must be true and certain.

In a share transfer, it is also important to identify the shareholders or current partners as part of the due diligence process given that they will act as sellers. Not only is it important to review the share transfers whereby the sellers became shareholders, but also all of the transfers after the date that the company was incorporated.

Charges, encumbrances or third party rights (e.g. options to purchase) that may affect shares should also be taken into consideration. It is important to analyse information relating to any current options on shares, warranties or convertible debentures as well as any other documents involving debentures or shares issued or reimbursed by the company, and to review the legality pursuant to current legislation.

In the event of a single shareholder company, it is important to verify if the company has fulfilled its obligations to file certain information with the Commercial Registry such as its incorporation as a company with a single shareholder or partner, the change of share structure that has given rise to the current status, the change of single shareholder status or a change of the sole partner or shareholder. It is often important to confirm that single owner status has been set out in all documents, emails, purchase orders, invoices and notices published in accordance with legal provisions or the Company's statutes[15)].

If the company is required to appoint auditors[16)], it is important to verify whether the appointment has been duly made and if both the appointment and the auditors' agreement have been duly filed with the Commercial Registry. In addition, the analysis of the Annual Accounts may help to confirm certain data, such as that the company is not under a proceeding which would oblige it to reduce its share capital or could cause bankruptcy. It may also provide the opportunity to check if it has sufficient reserves and provisions or to review data relating to competition rights, etc.

In addition, it is important to verify that any deposit of the Accounts in the Commercial Registry[17)] when necessary was made in due time and form, or to check if the Registry has been requested to appoint the auditor by the minority shareholders[18)].

During this part of due diligence it is useful to verify that the company has duly kept and recorded the following corporate books:

- The Minute book for the General Partners' or Shareholders' Meetings[19)].

- The Minute book for the Board of Directors' Meetings, if such is the case[20)].

- Record book of registered shares or partners, as the case may be[21)].

- Record book of contracts between the sole shareholder or partner and the company, in the event of single-member companies[22)].

Whilst it is not required that agreements between shareholders and partners be recorded in public documents or be filed with the Commercial Registry, it is advisable to review them given that they bind the partners (even though these do not bind the company).

Company liability in relation to these issues may not only be civil or administrative but also criminal. In addition, the potential liability of directors (which may also be criminal) should also be considered[23)]. It is also advisable to analyse the possible liability of any *de facto* directors. Such liabilities should be assessed throughout the due diligence process, however it may be difficult to gather such information given that the directors, who are often in charge of providing the information requested by the buyer (or at least supervising the task), will normally try to exclude or hide negative information relating to their position or performance.

Information that may be gathered in connection with any subsidiaries, companies, associations, stake holdings, branches or joint ventures, is significant at the early stage of the negotiation process given that it may imply that similar due diligence processes are initiated in those entities.

Finally, the analysis of the company's capital and of loans and/or guarantees granted to or received from subsidiaries, partners or directors is closely related to Article 134 et seq. of the Companies Act and to prohibitions or limitations therein.

6.2. ASSETS OF THE COMPANY

The definition provided in Article 334 of the Civil Code may be helpful to differentiate real property from personal property. Ownership of real property (or real estate) or the corresponding rights *in rem* are often documented in public deeds, although they may have been formalised in private documents. This latter situation often gives rise to problems relating to the lack of

records in the Registry and the resulting ineffectiveness as against third parties. Accordingly, Article 1280 of the Civil Code sets out that every and all acts and agreements whose purpose is to create, transfer, change or extinguish rights *in rem* on real estate shall be documented in public deed. However, Article 1280 of the Civil Code does not intend to create a certificate of the public documentation of such acts and agreements, but to facilitate proof. Article 609 of the Civil Code states clearly that property and other rights *in rem «are acquired and transferred by operation of law, by gift, testamentary or intestate succession and as a result of certain agreements by the transfer of title to goods (...)»* , Article 606 of the Civil Code that clarifies that «title deeds or title to other rights in rem on real assets not duly registered in the Property Registry shall not prejudice third parties», and the protection of the third party «acquirer» in good faith as provided by Article 34 of the Mortgage Act. In every case, it is important to analyse the documents provided and verify that the rights (ownership or other rights *in rem*) have been duly acquired by means of a certificate and procedure but considering there are certain cases whereby the provision of public document and its filing before the Property Registry is a certificate of the right in question (e.g. mortgage)[24].

The first authorised copies of the various public deeds filed with the Property Registry contain information on its incorporation. However, it is important to confirm these data with the non-certified extract from the Property Registry.

In addition to property rights of possession (e.g. enjoyment, use, legal or voluntary easement, etc.) and encumbrances that may exist (e.g. mortgages), it is important to analyse personal rights that may affect rights *in rem* (e.g. rent, options to purchase, pre-emptive and redemption rights, etc.) as well as notices of current new works or those which should have been made, although this latter event could be analysed as an administrative factor in the due diligence process. A visit to the facilities may be helpful to identify certain rights. For example, pipes o pathways across premises may evidence some easements.

Expenses and other substantive agreements relating to the provision of utilities for the property (e.g. electricity, water, etc.) may be analysed in the contracts section of this investigation.

The company's real estate valuations and location may be substantial in transfers of shares when analysing application or exemption of the Taxes on Property Conveyances («stamp duty») and Documented Legal Acts (document tax) and any Value Added Tax on the transfer of this type of instruments upon closing. Article 108 of the Securities Market Law sets out in general the exemption of this type of operations save for *«transfer of securities made in secondary markets which may not be traded in official secondary markets shall be levied by the corresponding tax as an onerous transfer of real property when by means of such transfer of securities the person intended to avoid payment of taxes that would have been levied on the transfer of real estate owned by the entities to which such securities belong.»* Such article also includes some rebuttable presumptions [*iuris tantum*] of circumstances whereby it is assumed that such avoidance is sought, for example when at least 50% of the assets of the company are real estate located in Spain and are not used for business or professional activities.

With reference to movable assets, the Civil Code provides a definition in Articles 335 et seq. which may also be a helpful starting point in this type of investigation. Typically, this includes an inventory of permanent facilities, equipment, vehicles and equipment and raw materials. It is important to consider the requests and the intention of the buyer when determining information to request and the degree of detail of the investigation. Typically, the potential buyer may be willing to accept lists or accounting inventories, and it may often be difficult to obtain documentation of legal ownership.

Whatever the case, it is important to verify title, and whether there are charges, encumbrances or other type of third party rights that may restrict or affect them. Likewise, it is crucial to consider the effects of any transfer restrictions. It is also important to analyse other contracts such as renting, leasing, or hire purchase agreements.

Although it may be possible to verify the information provided by the seller or target company on assets and their charges, encumbrances or limits, based on the information provided by public registries (e.g. Industrial Registry, Registry of the Sale of Personal Property in Instalments), other times the buyer may only rely on the information provided by the seller on this type of assets as being true, accurate and complete.

This section or that relating to urban or administrative aspects may also analyse licences or permits (to set equipment, perform works, etc.) that may be required in relation to the various assets of the company, as well as fulfilment of urban planning laws in effect and the real situation. It is advisable to resort to the guidelines in this chapter in this regard. Provided that the company so authorises, this investigation may be completed with enquiries to corresponding entities or authorities which should be local or belong to communities (City Council, Department of Industry in the Autonomous Community in question, etc.).

«Industrial and intellectual property» rights may be considered as a subset of the movable assets of the company. Industrial property rights include patents, trademarks, brands, logos, designs, models and drawings. Confusingly, «Intellectual property» [*propiedad intelectual*] in Spanish legislation, unlike in English legal parlance, refers solely to copyright.

With reference to the latter, it is usual to investigate the use of software and related licences the company may hold. Indeed, when this type of right is referred to, the seller will often think immediately of the software which has been used. However, it is advisable to consider other issues; for example, possible copyright of employees or subcontractors in software created by them. The buyer intends to ensure business can continue and may continue using the same programmes and equipment used prior to the closing and, thus, in the due diligence process the following minimum information should be analysed:

- List of all the software (including operating systems) licensed to the company or developed by the company or used by

the company.

- Contracts and documents relating to such software.

- Licences granted by the company to third parties in relation to the software.

- Possible change of ownership or takeover and potential effects on the software used.

Another aspect to consider is domain names owned by the target company, their registration, and compliance with the corresponding laws.

Analysing industrial property rights in a legal due diligence process helps to verify information as industrial property rights applied for or granted are recorded at the Spanish Patent and Trade Mark Office or the corresponding community or foreign registries. However, it should be noted that —at least in Spain— such recording does not give rise to the right and the lack of recording does not *per se* affect third party buyers acting in good faith.

The assessment of industrial and intellectual property rights includes the followings as the most relevant issues to consider:

- Identification of the rights in question.

- Ownership and scope (some rights —for example patents— are subject to a maximum term whilst others such as trademarks can be renewed on a periodic basis).

- Possible licences granted in relation to the rights or obtained from a third party.

- Possible litigation or disputes in relation to these rights. It is important to consider not only possible infringements of the rights of the company by third parties, but also infringements of third party rights by the company itself, including the possible criminal liability of the company[25)].

As explained above, this type of investigation may require the services of industrial property agencies (also known as patent and trade mark agents). However, if these agents are contracted, their scope is normally restricted to the country of the target company. The assessment of these rights at the community or cross-border level should be considered and determined by the buyer on the basis of the costs involved, and the engagement of these professionals from the foreign countries in question. Typically, cross-border investigation is restricted to rights of special interest.

Another item of the movable assets section is any shareholding in other companies owned by the target company or in relation to which the target company holds other types of rights. It is important to assess whether the current regulation is complied with, and to take into account provisions made on share capital, ownership or restrictions thereto. It is worth restating that acquisitions of shares and rights are not recorded in any public registry and may be evidenced by public documents (notarised documents or policies), private documents or mere endorsement in certain cases. Therefore, these documents should be analysed in detail when assessing ownership of such shares. Finally, the entries in the book of registered partners or registered shareholders may be a valuable resource in the case of limited liabilities companies or corporations with registered shares.

6.3. CONTRACTS

It is important to highlight in this chapter the possible existence of oral contracts or contractual relations (e.g. agency or distribution agreements) and to study possible consequences or legal obligations resulting therefrom even though there are no written provisions. It is also important not to forget that standard terms and conditions may also apply.

One of the essential assets any buyer typically intends to acquire is the ongoing business of the target company, so liabilities and/or obligations relating to this business should also be analysed. On the other hand, at the beginning of the due diligence process it is necessary to identify where the various businesses are located and, if operating abroad and deemed substantial they may require a separate due diligence investigation in the country in question. The target company should be pressurised to identify any type of cross-border business, however small; It is easy to forget information on other agents or representatives abroad that may create a potential liability in the future.

Some of the aspects worth considering in the various types of contracts are:

- Date, parties and other identification data in the contracts (e.g. fiscal reference number).

- Subject matter of the agreement.

- Term of the agreement.

- Price and method of payment, if applicable.

- Obligations of each party (e.g. price offers that may be binding for a period of time remembering that some may result by operation of law).

- Termination provisions.

- Transfer or takeover provisions. As discussed above, the transfer of contracts depends on the subject matter of the acquisition. If shares are transferred, the company will continue to be the same, so no subrogation will be required although clauses on a potential takeover should be analysed in detail. However, if only assets are transferred, the study should focus on the way the subrogation will be performed. We refer to the notes already made in this regard.

- Notice provisions.

- Law and jurisdiction clauses.

- Survivorship clauses: possible nullity of some clauses, or the contract in general.

- Possible need for a specific seal, stamp or other formality to ensure effectiveness or execution.

If numerous, it may be advisable to group contracts by type and to explain together the main characteristics common to all of them. It is not unusual to study financial and banking contracts and insurance policies in separate chapters if these are of special importance.

A. Financing and banking contracts

The due diligence investigation may include the following:

- Specification of every type of loans to third parties and guarantees or security in relation thereto and separate identification of loans to employees (in any way, e.g. transport vouchers) or to shareholders or companies within the same group or to directors.

- Identification of bank accounts and other type of information provided by banks, including statement of balances, debits, pending instructions to be formalised, registered signatures of authorised signatories, etc.

- Identification of all loans granted by third parties and guarantees or security in relation thereto and a study of the main provisions and effectiveness.

- Identification of loans provided by other companies within the group, or directors, employees or shareholders. These should probably be cancelled prior to closing.

- A review and study of any potential default that may exist or could arise in relation to the loans mentioned above and the documentation or notices received in this regard.

- The study of the existent security in relation to the various loans will include the analysis of scope and preference and any notices or other facts giving rise to foreclosure.

B. Insurance policies

One of the first aspects to consider in relation to insurance policies is if the parties intend the buyer to continue enjoying the benefits of current policies in effect. If so, it is important to analyse in detail all of the current agreements and fulfilment of all obligations on behalf of the target company (e.g. maintenance/continuance of certain insurances) as well as clauses relating to notices, takeover or change of ownership, etc. In this regard, it may be possible that there is an agreement of individual coverage with the company or coverage resulting from a global policy paid by the group to which the company belongs. In this case, it will be necessary to reach a new agreement and it may be possible to consider a change of policy or insurance agencies after assessing prices and risks to be covered. Insurance brokerage the company may have could be a very good source of information in this area.

Another important factor in relation to insurance policies is the labour law requirements (e.g. collective bargaining agreements) or contracts entered into by the company (e.g. employment contracts, mortgages) when contracting insurance cover.

6.4. LABOUR ASPECTS

The labour aspects analysed in the legal due diligence process include assessing employees of the target company, work centres, wages and extra bonuses, length of service and severance payments. An important source to confirm these data is the written contracts or agreements. A deeper analysis should include commencement date of the employment and other previous dates in the same company, status and a brief job description (i.e. tasks or functions), minimum wage and bonus payment, usual date of payment, agreed or estimated wage increases, weekly working hours and treatment of overtime work, corresponding pension plans or other plans or agreements in favour of the employees (vehicle, loans, private insurance, fitness centres, clubs, etc.), disciplinary measures imposed, holidays taken and maternity leave, absences due to sickness or accident, participation in associations or corporate committees.

The different types of contracts or agreements will also be assessed (indefinite term agreements, fixed term contracts, oral contracts, etc.), as well as their significance and consequences.

Applicable collective bargaining agreement(s) are also included in the analysis (and main regulations included therein). It is

important to consider that conditions in individual agreements should not be lower or worse than minimum conditions set out in the collective bargaining agreement(s). It is important to analyse their scope in terms of jurisdiction, function and effective date. These may also help to provide information on current rules relating to wages, revisions, deferred payments, corporate provisional work programs, fixed term contracts, bonuses, additional payments and incentives, pension plans, holidays, extra bonuses, seniority, fees, working hours and work day, overtime work, disability and mobility, amongst other issues.

It may also be important to confirm service contracts with any third parties such as subcontractor non-employees and self-employed individuals.

Another relevant issue is the employees' and trade union's representatives (if applicable) and the considerations that each position entails.

The registrations in the Social Security System of the company and its employees should also be checked. To such effect, it may be useful to verify that the document or card certifying the company has been registered in the corresponding system, as well as TC1 and TC2 (payment forms in Spain) for the last four fiscal years, and a certificate issued by the General Treasury of the Social Security that shows if there are outstanding payments or corresponding administrative claims. However, care should be taken in this regard given that a positive certificate does not entirely guarantee there are no subsequent debts, inspections and/or claims. Liability for Social Security payments and other joint considerations (unemployment, FOGASA [Spanish Wages Guarantee Fund] and professional development) expires four years after the payment deadline.

Other issues may include private insurance; pension plans; any other plans or agreements in favour of the employees; agreements with employees; decisions to improve benefits under the Social Security System and any internal rulings.

Credit benefits granted to employees may be considered to be payments in kind and should not be ignored.

In connection with terminated contracts (due to dismissal or any other grounds), it will be necessary to analyse the termination of contracts or dismissals throughout the previous 12 months. This may be sufficient given that actions arising from employment contracts without a specific term expire one year from the termination date and claims for wrongful dismissals should be filed within 20 business days as of the date of dismissal. In the event of company succession (i.e. if the transfer of assets includes the personnel), labour relationships are not terminated and the new business assumes all the rights and obligations of the previous employer. However, both the former and the new business are jointly and severally liable for a period of three years for any labour issues arising before the transfer which have not been resolved[26].

Unresolved labour claims and other types of labour issues, claims or litigation relating to employees (e.g. due to breach) help to build an idea of past and present litigation in the company (whether resolved or not given that it implies a contingency). To such effect, it is important to consider the various limitation periods. The limitation period for corporate liability is three years, save for some exceptions such as in Social Security matters, for which it is four years. The limitation period in the field of the prevention of labour risks may be one, three or five years depending on the seriousness of the breach in question.

Other contingent labour risks may arise (such as strikes) and should also be analysed in the due diligence process.

The Visitors' Book of the company may help to reveal the frequency of health and safety inspections.

Finally, it is important to assess compliance with regulations on health and safety, risk prevention and any potential criminal liability[27].

6.5. ADMINISTRATIVE ASPECTS

After gathering the information requested on administrative aspects, the legal status of the company will be analysed and confirmed with the corresponding authorities based on those documents. Thus, in addition to any information or documents the company may provide, it is important to analyse the field in question; equipment or other assets used; works done or in progress; type of business etc. and to identify what licences or permits are required; e.g. business licence, registers in the corresponding Industrial Registry, updates, etc. These may also help to identify and confirm equipment or other fixed assets of the company as they are set out in these documents.

The business licence is one of the documents among the various authorisations and licences required to operate the target company, although the granting of a special licence may also be required to perform disruptive, unhealthy, noxious and/or hazardous acts or given the special nature of the business in question. In addition, special permits or licences should have been obtained for works performed or assets used (e.g. certain type of equipment). It is important not to repeat information requested and analysed in other due diligence sections however, to avoid confusion on what is requested and questioned.

Administrative authorisations or permits (e.g. the use of river water) may be analysed in this section of the due diligence process, but takeover issues require special analysis.

Any subsidy or public financial assistance the company may have been granted or may be entitled to could be subject to specific conditions or requirements (on creation of work, investment, etc.) which the potential buyer should know. In addition, if the applicable regulation has been amended, those benefits may no longer exist.

Corresponding administrative proceedings should be verified in the event of a company with foreign investment or a company that has obtained loans from non-residents (e.g. statements/filings or request of verification/authorisation —as the case may be — request of Financial Transaction Number to the Bank of Spain, etc.) It would also be advisable to verify if the Foreign Investment Record has been updated accordingly.

It is also important to examine the regulation on the processing of any individual's automated personal data.

At the same time and in connection with administrative issues, licences, authorisations or statements required upon closing will also be examined to proceed with the corporate change of ownership (if required, as in the case of transfers of assets) or to prepare and submit the corresponding statements or authorisation or verification requests in due time as required by the transaction in question (settlement of foreign investment obligations and/or new foreign investment, intervention by the Bank of Spain, etc.) In principle, these are the buyer's —and not the seller's— responsibility as they relate to acts which have not yet been performed. However, if certain authorisations or consents are required in relation to the industrial field in question, the seller will often use its knowledge in the industry to ensure that the buyer is aware of the requirements, and is taking all due measures well in advance. Nevertheless, the buyer need not rely solely on the information provided by the seller; due advice and confirmation from the buyer's lawyers or other professionals should be obtained.

Finally, criminal liability may arise, for example, in connection with crimes set out in Articles 308 et seq. of the Spanish Criminal Code (i.e. fraud in obtaining subsidies, tax credits or financial assistance).

6.6. TAX ISSUES

Further to the study of tax issues in connection with the transfer of companies and the closing of the operation (as explained later in this book), the legal due diligence process should analyse current tax risks and contingencies of the target company. In essence, the expiration term regarding the duty to pay taxes is four years for national taxes in accordance with Article 66 of the General Tax Law 58/2003 of December 17. However, the specific provisions of the various Autonomous Communities or territories should also be considered.

In connection with this term and on the basis of the documents provided relating to the different types of taxes, it is important to assess if tax returns have been filed in due time and form. It is also advisable to verify any current or future tax examinations or settlements.

Criminal liability may also apply in tax matters and should be considered in detailed[28)].

6.7. LITIGATION

Litigation or arbitration proceedings to which the company is a party, or those which have been settled in the last three years, should be studied and their relevance analysed on the basis of the amounts involved or other factors in addition to the possibility of successful settlement. It is also important to verify if the corresponding accounting provisions have been made.

This analysis will help to provide information on current and past litigation as well as potential conflict areas. It may also be important to analyse likely or forthcoming claims known by the company and usual conflict areas in the field in question.

A relevant subsection of the due diligence process is the analysis of possible liability for defective products which may give rise to both civil and criminal liability.

Another important aspect to consider is the limitation period for possible interruptions with respect to actions on judgment or those not still filed. Title XVIII of Book IV of the Civil Code refers to this issue and provides a wide range of limitations for legal actions directed toward property [*action in rem*] or actions in which judgment is sought against a person [*action in personam*], although special provisions should also be considered for each particular case.

6.8. COMPETITION LAW[29)]

Not only should Spanish legislation be considered in this regard, but EU law as well.

Requested data should be analysed to determine if the company complies with Competition Law, especially in cases of possible abuse of dominant market positions, agreements or practices restricting competition or control of holdings if the company belongs to a group operating significant business in Spain. At the same time, in view of the closing, it may be appropriate to analyse the need for requesting information or notifying the Competition Authorities of any data based on the business in Spain operated by the group to which the company will belong. Such analysis requires considerable time in advance given that economic concentrations may not be carried out until express or implied authorisation form the Administration is granted and effective. Significant penalties and measures can be imposed to ensure effective competition (e.g. corporate unbundling).

Possible criminal liability should also be assessed in these cases[30)].

6.9. URBAN PLANNING AND ENVIRONMENT

The certificate of urban planning for the land where the company is located may help to confirm that the type of business carried out agrees with the permitted uses. If there is no General Urban Planning it may be wise to resort to the applicable regulations. Given the wide range of regulations in this field it is important to confirm or request information on any project aimed at amending current urban planning regulations.

On the other hand, proper environmental management is essential in industrial company transfers given the significant liabilities and contingencies that may arise. It is important to ensure there is no contamination on the land where the business is conducted (of any type, not only environmental pollution) and that adjacent or nearby land is likewise not contaminated. Factors to consider are smoke, dust, noise or sewage of the business operated by the company. If disruptive, unhealthy, noxious and/or hazardous, it is important to identify what corrective measures have been taken or what statements have been made to such effect. It is also important to investigate the possible use of hazardous, noxious or unhealthy substances or materials (lubricants, radioactive substances, etc.) or the existence of asbestos of any type, for example, in buildings or facilities. Another essential factor is possible sources of contamination; e.g. underground storage tanks (whether in use or not) and the type of substance stored. It is also important to consider the application of the Law 16/2002 of 1 July on Integrated Prevention and Pollution Control (developed by Royal Decree 509/2007 of 20 April approving the Regulation for the development and enforcement of such law) and the Integrated Environmental Authorisation for certain activities.

The first main purpose of the legal audit is to verify compliance with environmental regulations, if the company has been granted effective authorisation to such effect, and to study the legal consequences or impact of the various environmental risks or contingencies which may be identified. Therefore, in companies where this area is important, it will be necessary to obtain assistance from other experts (engineers, technicians, etc.) who are able to conduct a technical environmental audit to update, contrast or supplement recently concluded environmental audits. Given the various items in common, the environmental investigation can often be shared or exchanged with the investigation conducted on workplace health and safety issues.

It is essential to know if the Administration has submitted notices or communications, if it has initiated or is likely to initiate penalty proceedings, litigation or claims or if there are any potential third parties claims.

It may also be advisable to conduct an investigation on the current and past use of the land where the company and its neighbours are located. Environmental controls and restrictions are ruled by current legislation, but the environmental effects which may have been caused by the company before any such laws or controls come into force may remain underlying on the land in question and become a significant source of contingencies.

Waste treatment is another important issue to consider given that its use or discharge is heavily regulated and is subject to authorisation. For example, it may be necessary to assess the type of waste and it is important that the waste treatment manager in charge is duly authorised.

When assessing the limitation period in this field it will be necessary to identify civil, criminal or administrative liability.

One of the most complex issues in civil liability cases (mainly in environmental issues) is to determine the starting date [*dies a quo*].Underlying damage can become apparent long after closing so it is not possible to resolve this issue simply by restricting liability to one year after the closing date.

On the other hand, examples of criminal liability in environmental cases may include crimes against natural resources or the environment as set out in Articles 325 et seq. of the Criminal Code (Chapter III, Title XVI, Book II) and crimes against public health as set out in Articles 359 et seq. of the Criminal Code (Chapter III, Title XVII).

7. LEGAL DUE DILIGENCE REPORT

7.1. PRESENTING INFORMATION

Given the specificity of this book and the legal approach followed in this chapter, we will not analyse how to present the information and conclusions resulting from the various due diligence processes conducted (accounting, environmental, etc.). However, we believe it is important to highlight the need to coordinate or exchange information among the professionals in charge of the due diligence at all times of the process; i.e. at the initial stage where information is requested and gathered, at the intermediary stage, and the last stage where information and results are presented. To such effect, it may not be sufficient to submit a copy of the report prepared by the various groups of professionals (accountants, engineers, lawyers, etc.). They may have not paid due attention or may have not fully understood what is required. It is important to set some communication rules that allow the persons to use the information better and develop solutions and positive strategies. Thus, it is advisable that teams working in similar or complementary areas meet at least once at each stage to discuss and analyse the most important issues.

If the buyer needs to gather information as a matter of urgency, the process may be accelerated upon request. Therefore, the main problems or contingencies are identified in a «preliminary report» and a final report is drafted at a later stage. It is also possible to prepare a number of drafts before the final and definitive report given that its various chapters are concluded at different times, and new information or confirmations are added throughout the process. Typically, the best, easiest and clearest way to present the various drafts to the buyer is by updating previous versions and highlighting the changes added.

We have already discussed when the due diligence process should be conducted. However, it is worth mentioning the importance of the time when the report is presented (initial drafts or final version). The earlier information is gathered in the negotiation process, the better, given that it may be possible to find solutions to the different problems or contingencies identified. With time, when energies and the desire to work flounder, negative reports may lead the parties to break off negotiations.

When preparing the due diligence report, it is important to adhere to the terms of reference defined when setting the rules of engagement.

On the other hand, a report is usually divided into three parts:

1. A brief introduction to the subject matter, scope and purpose of the due diligence and an abstract which allows the buyer to know the main aspects it should consider or focus on.

2. When possible, the body of the report usually includes information by following the same order and titles as the preliminary questionnaire. Each of these chapters may be classified in sections and include the following:

i) Description of the information provided by the seller and target company and identification of the date when it was made available to the buyer.

ii) Description of the information gathered by the buyer on its own or with the help of the target company and identification of the sources of information.

iii) Description of the analysis, facts or events confirmed and the various resulting legal consequences.

iv) Main conclusions and impressions on the aspects analysed in the corresponding chapter.

The last part of the report includes annexes referred to in the body of the report. Typically, it includes data or documents provided by the seller or the target company throughout the due diligence process where direct acknowledgment or confirmation by the seller or the interested person in question is deemed relevant.

Typically, the report is read at the last stage of the transaction and negotiation when the buyer does not have enough time or may not pay full attention. Thus, it is advisable to warn the buyer of the key information of interest in the best possible way for a clear understanding (although it should be borne in mind that the professional in charge of the due diligence process will be required to include all relevant information). Some buyers may think that the purpose of including so much information in the report is to protect the advisors against possible claims for professional negligence, and to justify fees and time spent.

On the other hand, some specific areas of the due diligence process are often analysed by a number of different professionals. Thus, the various professionals in a law firm usually analyse different areas of the law on a separate basis in accordance with the due diligence chapters. Therefore, a common system, methodology and engagement guideline are key to integrate the various chapters in a single document.

Finally, it is worth noting that the due diligence report may be presented to both the seller and to the target company as well. If so, certain care should be taken to avoid damaging the sensitivity of the seller, target company and directors. The buyer may want to submit the report to the seller or the target company so that they can confirm possible errors or misunderstandings. However, this is often not the case given that the seller and the target company may take advantage of the work paid for by the buyer even if the transaction is not ultimately closed. In addition, the seller may use the report to support data provided to the buyer even if they are not included in the representations and warranties.

7.2. CONTENT

The main content of the legal due diligence report and the minimum information which should be provided is a description of the analysis done, the facts or events evidenced, and the different consequences or legal effects resulting therefrom. However, this minimum content may be supplemented with the other parts referred to in this chapter not to justify the time spent in the analysis, but due to systematic reasons and to ease the understanding of the buyer who will have contracted this type of audit. The conclusions section is therefore fundamentally important.

The introduction section of the audit report or its preliminary report may refer only to the negative aspects identified in the company. However, the body of the report should include all relevant information collected about the company and the description or information should be presented in the most objective way possible.

It is important to describe the contingencies or negative aspects (if any) as well as the negative consequences that may result therefrom (sanctions, penalties, dissolution of the company, etc.) but also, whenever possible, the report should include information on how the problem should be faced and the possibilities of overcoming it before closing.

Annex 6 of this book presents a draft document with different summaries that may be included in a legal due diligence report. It does not intend to be exhaustive or valid for every type of transactions, but can be used as a guideline to draft a report of this type.

7.3. USE OF THE INFORMATION IN THE REPORT

The information provided in the legal due diligence report should be used not only by the buyer, but also by the seller and the target company (who will be informed by the buyer about relevant aspects as it is not necessary to submit the entire copy of the report to the seller as explained above). It is surprising, however, to see how negative aspects identified throughout the due diligence process are frequently not dealt with adequately and how the information collected is not used properly by the seller (if obtained at the final stage of the negotiation) or by the buyer (if it ignores the fact that negative aspects continue after acquisition).

Once the relevant negative aspects identified in the due diligence are acknowledged in the negotiation by the buyer, a number of strategies may follow, namely:

- Requesting the seller's solution before or after closing.

- Including the solution to the problem in question and the exclusion of the contingency as a condition precedent to the agreement to close the operation.

- Improving agreements reached in relation to other terms or conditions of the contract (e.g. reduction of price; setting-off with other assets already granted to the seller or which are intended to be negotiated; withholding or deferral of the price or other type of guarantees).

- Including indemnity clauses for the problem in question.

- Restructuring the operation; e.g. acquisition of certain assets instead of the acquisition of shares.

- Breaking off negotiations in the event that the negative aspects cannot be adequately resolved or no protection can be found; if the buyer does not trust the seller and considers that the potential contingencies are excessive; if the relationship between the buyer and the seller is to be preserved and the buyer does not believe negotiations are feasible.

It is worth considering that results from a due diligence process may be an important tool to assess and verify if the price agreed is appropriate on the basis of the what is purchased and paid, and to analyse any other aspects of the agreement in question.

If contingencies are not eliminated (either because measures are not agreed or because contingencies still exist and become evident at a subsequent stage) a number of alternatives may be considered to deal with them. Let us analyse a few examples, although some have already been discussed.

- The most direct solution is a price adjustment provided that the parties can reach an agreement on the real cost and contingency potential.

- Withholding or deferring the price. Typically, the buyer can withhold or defer payment of a portion of the price until confirming a specific liability and/or contingency and the corresponding solution of the seller. It is essential that the relevant clause is clear and leaves no doubt as to the events whereby partial payment may be withheld or deferred (i.e. upon a possible claim which has not been made yet, upon final and binding court judgment etc.).

- Guarantees (e.g. bank guarantees payable on first demand, parent company guarantees, etc.).

- Representations or warranties including statements agreed by both parties in relation to the problem in question, or a separate clause on the negative aspect and possible contingency and the corresponding indemnity obligation if the buyer or the target company is or may be damaged as a result. This latter case often benefits the buyer against the other example given (representations and warranties). In this latter case, as explained above, the seller will seek to take advantage of the presumption of good faith. The buyer's effective knowledge of the fact (even if not included in the representations and warranties or the exceptions) will reduce and may even imply that the protection agreed will not apply in the circumstances described if such knowledge is proved.

It is worth highlighting that the information contained in the legal due diligence report is most often used and considered when drafting the representations and warranties and the possible exceptions (the so-called disclosure letter). In principle, the seller makes the representations and warranties given that it states in the agreement that the information contained in it is true and is consequently responsible for it. However, the buyer's lawyers may have gathered information resulting from the due diligence process and used it to draft a first draft of those representations, warranties and exceptions —which will be made available to the seller for confirmation or changes, as it will be responsible for the final version—. The greatest issue for the seller is to notify the buyer of incorrect representations and warranties; the seller should act in good faith. Although this attitude is presumed, it is worth remembering that some sellers will act otherwise. Therefore, the buyer should cover this risk by adding a statement in the agreement such as the following:

> «These representations and warranties, the exceptions thereof and each annex attached to this agreement are true, accurate and entire with regard to all relevant issues contained therein. This agreement, attached annexes and all related documents and instruments executed do not include false or erroneous representations or warranties by the seller(s) or the company and do not exclude any statement of a relevant fact or event to avoid that a representation or warranty by the seller(s) or the company may be incomplete, inaccurate or lead to misunderstandings».

The first part of this statement is often found in every sale and purchase agreement. However, the seller may try to avoid the second part.

Another clause the buyer may try to include in the agreement is:

> «For the purpose of identifying the buyer's rights/remedies/actions upon the seller's failure to comply with the representations and warranties made and contained herein, even if the buyer was notified of or knew about any error or inaccuracy of such representations and warranties before closing, the buyer shall have the same rights/remedies/actions as those they would have had in the event of not being notified of or not knowing about such circumstance».

In turn, the buyer may not comply with its duty of good faith and may not notify the seller of facts discovered during the due diligence process. A prudent seller may therefore want to include certain statements in the agreement such as the one below:

> «The buyer states that, by the time this agreement is entered into, it has not known of any aspect or fact inconsistent with or contradicting the representations and warranties and exceptions thereof made by the seller in this agreement».

However, once the operation is closed, the buyer should analyse the due diligence report once again and consider possible solutions to the problems or contingencies identified but not resolved before closing. Sometimes the buyer may conduct an audit after the closing to confirm the accuracy of the information and data provided throughout the due diligence process. This is highly recommended given the typical time restrictions and the applicable limitation period for potential claims for alleged breaches of the representations and warranties included in the agreement.

As a final note in connection with the benefits of carrying out due diligence it is worth mentioning that this process will allow the buyer to improve the way in which it is able to manage, operate and plan the business after closing. As can be seen, this is yet another persuasive reason to carry out the due diligence process in every transaction of this type.

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Fuentes