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Due Diligence

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Building Change Trust

Due Diligence

Contents

How this guidance note can help

The following Guidance Note has been developed by CollaborationNI to help voluntary and community organisations understand what is meant by the term 'due diligence'.

It has been devised to assist organisations considering merger or joint tendering to understand what is involved in the process of appropriate risk assessment when considering working collaboratively.

CollaborationNI does not provide legal advice to organisations and it is important to note that this Guide is not intended to be relied upon as legal advice.

1. What is due diligence?

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

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

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

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

2. Areas for investigation

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

- Legal
- Financial
- Commercial or operational

2.1 Legal

Legal due diligence will focus on legal issues such as:

- the constitution of the organisation
- its powers and objects
- freehold or leasehold property
- contracts of employment

Although the areas of investigation for due diligence can be approached in any order, or simultaneously, it is advisable to begin by looking at the constitutions of the organisations involved. The charitable objects of the merging organisations must be compatible. For example, the investigation should establish whether there is a power in the constitution to allow for the merger of the organisations and ensure that the merger can occur. There may also be issues in relation to the rules for appointing trustees to the newly merged body which may need to be checked and considered.

When considering the constitution, the investigation should also examine whether or not the organisation is being run according to its constitution and therefore whether or not the constitution needs to be amended to reflect the current running of the organisation.

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

Contracts of employment should be reviewed and information relating to employees should be shared. This includes details such as:

- how many are, or will be, employed by the new organisation
- whether the terms and conditions are compatible for transferring employees

The Transfer of Undertakings (Protection of Employment) Regulations 2006 and the Service Provision Change (Protection of Employment) Regulations (NI) 2006 (collectively known as "TUPE") need to be taken into consideration.

For further information on TUPE see the CollaborationNI Guidance Note of the same name available at: www.collaborationni.org

2.2 Financial

Financial due diligence will focus on an organisation's financial affairs and will identify any financial risks and financial opportunities arising from the merger. Financial due diligence will typically set out the organisation's financial history, and include copies of accounts going back over the last three financial years. It may also include:

- financial results and forecasting
- accounting policies
- taxation
- assets and liabilities
- pensions
- management information
- accounting systems information

It should be noted that all accounts must be looked at within the current financial landscape.

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

2.3 Commercial/Operational

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

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

3. What to consider when carrying out the due diligence exercise?

When carrying out a due diligence exercise there are a number of factors that a board should consider.

3.1 Who carries out due diligence?

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

Due diligence can be carried out by the organisations' trustees and it is the trustees who should decide whether external professional assistance is required. The advantage of engaging a professional to undertake due diligence is:

- they will have the necessary specialist skills and experience for the task
- they will have the ability to ask challenging questions
- they will have the ability to act independently and objectively

Bear in mind if pursuing this option that thought should be given to the cost implications if more than one external advisor is appointed (eg if there is one for each party).

In deciding whether or not to carry out the due diligence process in-house, trustees should consider the following:

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

3.2 Proportionality

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

3.3 Timing

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

3.4 Pre-merger confidentiality

It is beneficial to agree the scope of the due diligence work for each partnering organisation and external professional advisor before it commences. A Memorandum of Intent and Confidentiality Agreements should be exchanged before the due diligence is started. The Memorandum of Intent sets out:

- the preliminary intention of organisations to merge
- the reasoning behind the decision to pursue a merger
- intention to formalise a definitive Merger Agreement
- how transaction costs will be divided between the organisations
- an agreement that the Expression of Intent does not form any legal obligation unless and until a definitive Merger Agreement is executed

This Memorandum of Intent should also contain agreement by the organisations that they will not negotiate or consider any other organisations' proposal to merge. It is vital that the confidentiality obligations are made binding.

3.5 Charity Commission for Northern Ireland

In a merger the Charity Commission for Northern Ireland (CCNI) will need to be notified so that the Register of Mergers can be updated. Please note that in most cases a merger of charities will not require the consent of CCNI, however if you do not have the appropriate power then you can request consent from CCNI. The charity's governing document may include trustees' power to merge with other charities, but this should be carefully checked in each case and professional advice obtained. CCNI are adding new information and resources to their website regularly.

For more information on how the Charity Commission for Northern Ireland will manage mergers follow this link:

https://www.charitycommissionni.org.uk/Manage_your_charity/Merge_or_close_index.aspx?Type=PAGE#).

4. Due diligence outcomes

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

- The due diligence process may not have uncovered anything of serious concern and therefore the merger can go ahead as planned
- There may be some discrepancies highlighted following due diligence which will require clarification; as a result the merger and its timeline may be delayed in order to discuss these issues or to renegotiate the terms of the merger

And finally…

Always remember you do not have to merge!

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

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

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CollaborationNI provides a range of practical resources to groups within the voluntary and community sector that are, or wish to be, working collaboratively. Launched in 2011, it is funded by the Building Change Trust and delivered in partnership between NICVA, CO3 and Stellar Leadership. For further information go to: www.collborationni.org

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June 2014