

Due diligence as an indispensable stage of capital investments

The conference on preparation for capital investments was held on 3 February 2017 as a part of the conference series organised by KRS Attorneys-at-Law. Investors and advisors reported on their practical experiences relating to preparation for capital investments at the successful conference with the participation of nearly 50 investors and SME's. To read our report in Hungarian on the conference [click here](#), and you can find below our interview made with the expert of KRS Attorneys-at-Law:

What is the purpose of due diligence?

In preparation for investments, investors already have an opportunity to get to know the beneficiary of the prospective investment (commonly referred to as the target company); however, all legal risks cannot obviously be detected. During the due diligence, the task of the attorney responsible for the due diligence is to identify the relevant legal risks of the investment, namely, to examine the structure and the operation of the target company and to inform the investor regarding the legal facts, circumstances that may endanger the return of the investment.

When does a due diligence take place?

Preparation for capital investments is generally a long process, which can last several months. Due diligence usually takes place following the execution of the non-binding agreement, namely the term sheet, which sets out the fundamental conditions of the planned investment but before the investment agreement and the disbursement of the investment.

What does the attorney examine during the due diligence?

The most essential fields of due diligence regarding its content can be summarised as follows:

- In examining the company law structure and the owners of the target company, general company law data of the target company is firstly investigated, including the review of the supreme body's resolutions, the Articles of Association as well as the agreements made between the Parties, or between the Parties and the target company regarding the organisation and operation of the target company.
- In general, the attorney in due diligence only examines the standard contracts attached to certain jobs in respect of the work organisation, excluding of course the contracts of the



management and the so-called key employees, which is always a particularly important aspect in the investigation.

- Due to its significant value, the real estates of the target company are always subject of the investigation, whereas in case of movable properties, only the ones of higher value or in larger volume are of importance.
- It is essential to emphasise that not only own real estates but also the ones leased, or used by tenancy at will or under other legal titles (movable properties of higher value) are subjects of the due diligence. Intellectual property is always an essential object of the due diligence. Mainly, know-hows, IPs or patents are the intellectual property rights which usually exit in seeds and, the investigation of which from a legal point of view is indispensable due to its profit—making capacity in the future. Let us look at the significant degree of risk that an IP-related legal dispute (mainly, if the IP is the only income-generating tool of the target company) can involve if the case is lost.

The list could be continued but it is enough to set out as a rule of thumb that the attorney providing due diligence must investigate all relevant facts and data that may influence the decision of the investor.

What statement does the attorney in due diligence have?

The attorney in due diligence may of course make any statement of any nature; his/her professional opinion cannot be limited. Three types of statements can be usually made in practice, depending on the degree of the legal risk that endangers the return on investment of the investor. The most serious risks include the ones which cannot be managed (e.g. if another contract is made) and endanger the return of the investor to such an extent, which is very likely to exclude the granting of the investment. Legal risks falling within the next but milder category are the ones which should be managed before the investment but do not give a reason for exclusion (the conclusion of missing management contracts is a typical example). Finally, the proposals can be classified into the third category the management of which is not indispensable but can contribute to the proper or regulated and transparent functioning (or possible future sale) of the target company to a great extent. It could be for example an organisational and operational regulations (SZMSZ) or rules of procedure of the board.



The expert of KRS Attorneys-at-Law, dr. Attila Pintér suggests by way of conclusion that if possible, associations must be prepared for a possible raising of capital, which can significantly accelerate the process of the due diligence, therefore it is practical to continually update the collection of resolutions, to keep records of contracts, or to summarize the portfolio of real estates of the target company in a cadastral register.