Is due diligence getting out of control?

Recent newspaper publicity has focused on the high fees being charged by solicitors, accountants and others involved in the preparation of prospectuses. Alan Davies asks whether the due diligence process is simply a way to make fast money for accountants, taxation advisers, lawyers and any other consultants who can get in on the act. The answer seems to be both yes and no. The performance of due diligence procedures is vital for the protection of all interested parties. However, the procedures can be conducted in a way that maximises the value while minimising the risks and costs.

Due diligence procedures are driven by the prohibited conduct and civil liability defence provisions of the Corporations Law. Section 996(1) makes it an offence to authorise or cause the issue of a prospectus which contains a statement that is false or misleading or from which there is a material omission. Section 1005 allows any person who suffers loss or damage by the conduct of another person that was in contravention of a provision of Part 7.11 (Conduct in Relation to Securities) or Part 7.12 (Offering Securities for Subscription or Purchase) to recover the amount of loss or damage by action against another person.

These are very strong but also very general sections. The defence for these sections is outlined in Section 996(2) which states: "It is a defence if it is proved that the defendant, after making such inquiries as was reasonable, had reasonable grounds to believe, and did until the time of the issue of the prospectus believe, that the statement was true and not misleading or the omission was not material or that any omission was inadvertent."

This defence also is couched in very general terms. What constitutes reasonable inquiries? This question is made more difficult by Section 1002, which states that a prospectus should contain all such information as investors and their professional advisers would reasonably require, and reasonably expect to find in the prospectus.

So far there is no established case law dealing with these issues. Therefore what constitutes reasonable inquiries and reasonable information must be determined by the parties involved in the due diligence process. The response to this challenge should not be panic and the "overkill" that results in excessive investigation and unnecessary cost. In contrast, the most effective response is the performance of well-controlled and coordinated due diligence procedures.

The Securities Institute of Australia has attempted to provide some structure and guidance to the due diligence process in its Due Diligence Guide. The checklist gives the user guidance on the legal and procedural requirements of the due diligence process. It also provides a list of questions covering the various key areas of an organisation which may be relevant when conducting the due diligence process. However, the limitations of a checklist are clearly outlined in the Due Diligence Guide itself, which states: "The attached checklist therefore is not a document that can be followed blindly with the sole intention of fulfilling legal responsibilities. Its purpose is to serve as an aide-

Alan Davies is an audit partner in the Sydney office of Arthur Andersen.
At some point, the trade-off between value and cost has to be considered. A practical approach is necessary, since it is inappropriate and impractical to eliminate all risks.