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THE DUE DILIGENCE PROCESS AND ITS IMPACT ON THE DEAL: A PRIMER ON BAYONETING THE WOUNDED

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A. Introduction

Early in their career, all natural resources transactional attorneys are faced with their first due diligence assignment. A partner typically calls a green associate to his office, where the associate finds a box of documents sitting on the floor. “I want you to conduct due diligence on the documents in this box,” states the imposing partner. “What exactly am I looking for?” asks the eager, yet nervous, associate. “You’ll know when you find it,” the partner says with a grin.²

In times of more rationale schedules, reasonable billing rates and less client scrutiny of bills and efficiency, an associate could learn diligence by actually doing it, with the partner looking over her shoulder offering wisdom and encouragement until she did know what she was looking for. Although times have changed, many young lawyers reading this paper today likely recall a similar experience, except that the partner today likely would direct the young associate towards a folder containing documents in an electronic data room.

The stresses, tensions and risks associated with due diligence multiply in the context of the big deal – the high-stakes, all-asset, equity and merger transactions. This paper focuses on the due diligence process, particularly in the big deal, where the process can be the difference between a successful and unsuccessful acquisition.³ After introducing changes in the way technology has impacted the due diligence process, this paper provides strategies to navigate the various phases of due diligence: (1) planning, (2) information gathering and review, and (3) documentation and reporting. Before entering law school and undertaking the practice of natural resources law, one of the authors of this paper was an independent auditor.⁴ As experience necessarily influences an attorney’s practice, much of this paper discusses standards and practices applicable to financial statement auditing and how those standards and practices apply to the transactional due diligence process.

² This story is retold to new associates in the Energy and Natural Resources Group at Holme Roberts & Owen LLP, and is based upon the apparent method of a former partner to indoctrinate young associates to oil and gas title due diligence.

³ See Alexandra Reed Lajoux & Charles M. Elson, *The Art of M&A Due Diligence: Navigating Critical Steps and Uncovering Crucial Data*, 1 (The McGraw-Hill Companies, Inc. 2000).

⁴ Alex Ritchie practiced as a public accountant in the Washington D.C. office of KPMG (formerly KPMG Peat Marwick) from 1993 through 1996.

B. The Acquisition & Divestiture Process in the Twenty First Century

1. The Need for Speed

This Special Institute on Due Diligence was inspired by a presentation of the Landmen's Section at the 39th Annual Rocky Mountain Mineral Law Institute in 1993 that the Foundation published in a separate bound pamphlet. Since that presentation, the speed at which information travels has dramatically increased the speed of transactions and, by necessity, the speed at which due diligence is completed.⁵ Virtual data rooms have made information immediately accessible upon the execution of a letter of intent (or in some cases, upon little more than an expression of an interest). Brokers and business development executives are incentivized to close a deal quickly before the deal dies as a result of cold feet, better bids from competitors, re-trading of the purchase price, overstress on the existing business or operations, market criticism, or the much maligned "deal killer," which can be an unacceptable deal term demanded or refused by the other party or, in some cases, an issue discovered in due diligence. Admittedly, greater care and thoroughness in due diligence has seen a resurgence in response to the U.S. banking crisis,⁶ but the potential liability for inadequate due diligence has never been greater.⁷

2. The Auction Type Bidding Process

The use of an investment banker and an electronic data room in an auction type bidding process has become more prevalent in recent years as companies seek to maximize bid values when divesting of assets or businesses. When representing companies planning a divestiture, the authors have sat through a number of "kick-off" meetings with an investment banker who distributes its standard data room information checklist. This checklist may require land, reserve, production, engineering, and operational data, and may even require the provision of an ARIES database that will allow a potential bidder's engineers and analysts to run their own projected cash flow models. Once collected and provided by the seller to the investment banker, these "evaluation" materials and data are used by the investment banker to prepare an offering

⁵ See Bank of America Business Capital, *Why the Due Diligence Process May be Getting Short Shift* (July/August, 2007), available at www.corp.bankofamerica.com (citing a survey commissioned by accounting firm J.H. Cohen, concluding that the hot M&A market might be causing some to take short cuts with due diligence, while other dealmakers say the process is still strong, but is being done at a faster pace and in less depth than in years past).

⁶ See Bank of America Business Capital, *Seller Due Diligence* (March/April, 2010), available at www.corp.bankofamerica.com, quoting Hector Cuellar, president of McGladrey Capital Markets LLC ("When the economy plummeted in 2009, the M&A landscape changed quite dramatically. . . due diligence data requests skyrocketed. . . . Our average days to close a deal [from letter of intent signing to deal close] increased from 95 days in 2008 to 125 days in April 2009.").

⁷ On February 4, 2010, Andrew W. Cuomo, Attorney General for the State of New York, filed suit against Bank of America in connection with its acquisition of Merrill Lynch for stock worth \$50 billion, stating: "[A]fter barely a day of due diligence, BofA agreed to buy the vast, immensely complex and dangerously weakened Merrill Lynch. . . . The subsequent collapse of Merrill's assets demonstrates the insufficiency of the diligence." See *New York v. Bank of America Corporation* (complaint filed February 4, 2010 in the Supreme Court of the State of New York, County of New York).

document and to populate an electronic data room. The electronic data room may also contain a proposed purchase agreement drafted by seller's counsel and reflecting the comments of the seller and the investment banker. In the authors' experience, the purchase and sale agreement drafted by seller's counsel likely will be more aggressively seller-favorable than desired by the investment banker. The investment banker will argue that the draft agreement is not "market," and the lawyer will argue that it *will* be market, after the bidders and their counsel provide their comments.

After distribution of the offering document, bidders that execute a confidentiality agreement usually are then permitted to access the "evaluation" materials and data to prepare their bids. Once bids are submitted with a markup of the draft purchase agreement, the seller evaluates the bids with input from the investment banker and its counsel. Although the investment banker and the business development executives will emphasize price and speed to closing, other executives and seller's counsel may attempt to redirect at least some focus of the evaluation on other factors, such as accuracy and completeness of the assets listed, liabilities to be assumed or retained, the financial strength of the bidder and the bidder's plans for the seller's employees.

Assuming the investment banker has properly eliminated from the process those bidders that are on "fishing expeditions" without a clear investment motive or management buy-in to proceed, the seller and the winning bidder may execute a letter of intent. In the modern era, the parties alternatively may proceed immediately to the execution of a purchase agreement, in which case the seller will attempt to hold the winning bidder to its markup draft of the purchase agreement. The seller knows that serious bidders likely were encouraged by their investment banker and business development executive to provide a light markup of the purchase agreement in hopes of presenting the winning bid. Although price usually is the dominant driver, the difference between two bids that are close in price can be the degree of restraint exercised by a bidder in its purchase agreement markup. The battle then begins, as the winning bidder tries to squeeze in as much due diligence as possible in the shortest amount of time before the parties complete their compromise on the terms of a purchase agreement.

3. The Impact of the Modern Era – Preparing for Due Diligence Before It Begins

In the Twenty First Century, the lawyer and her team must be prepared to conduct due diligence before it actually commences. Preparedness requires that the lawyer (1) understand the industry, the market generally and the specific markets being targeted by the lawyer's client, (2) understand the key objectives generally applicable to all acquisition transaction due diligence reviews, and (3) have due diligence teams, processes and tools already in place when the phone rings (or when the hand-held device buzzes, beeps or announces the client, as usually happens in today's world). As this paper is about the due diligence process, information about industries and markets is beyond its scope. We explore the critical objectives of due diligence below. Teams and tools are discussed in the context of the planning and information phases.

C. Objectives of Due Diligence

The purchaser's primary objectives of due diligence usually are: (1) to validate or invalidate the purchaser's proposed bid valuation of the acquisition, (2) to inform the process of fulfilling the purchaser's post-acquisition plans for the assets, operations, personnel and systems of the seller or target (which likely will include integration of some, but not all, of these items), and (3) to identify issues that potentially require changes in the terms of the deal itself. These three objectives often overlap. For example, assumptions about the purchaser's ability to carry out post-acquisition plans likely were taken into account by the purchaser in determining its bid. Further, issues discovered in due diligence that impact value may also impact the terms of the deal.

Lawyers (especially young lawyers) tend in all areas of their practice to make big issues out of trifles – an especially dangerous tendency in the context of due diligence. Clearly focusing on the objectives of the due diligence helps the lawyer avoid this tendency. If the lawyer lacks this focus, she risks alienating both her client (the purchaser) and the seller, or worse, missing the big issue in the midst of the weeds.

1. Assumptions Underlying Bid Values

The most important objective of the due diligence process is the validation or invalidation of the purchaser's proposed bid. To contribute to this objective, the lawyer should have at least a general understanding of the purchaser's underlying bid assumptions before it begins its due diligence. For example, if the purchaser ascribed little to no value to a large group of assets and significant value to a small subset of assets, then title and other issues affecting that small subset likely will be proportionately more important to the purchaser.

Regardless of the precision applied by the purchaser's engineers and financial experts, the bid value always will be based on a number of subjective assumptions unique to the purchaser. In the context of a large transaction, the purchaser's bid or initial purchase price does not represent the "fair value" or "fair market value" of the target business or assets. Consider, for example, the definition of "fair value" for U.S. accounting purposes. The Financial Accounting Standards Board has defined "fair value" as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date."⁸ This definition assumes a hypothetical transaction that occurs in the principal (or most advantageous) market for the asset or liability, assuming the highest and best use, with a knowledgeable purchaser and seller, and a purchaser that is able and willing to transact for the asset or liability.⁹

As should be apparent, a hypothetical concept of "fair value" or "fair market value" has little application to an actual transaction, where there may be valid reasons that the value (often

⁸ Financial Accounting Standards Board ("FASB"), Accounting Standards Codification,TM Topic 820-10-35, available at www.fasb.org ("FASBASC") (codifying Statement of Financial Accounting Standards No. 157, Fair Value Measurements (2006)).

⁹ *Id.*

referred to by business appraisers as the “investment value”) to one purchaser of a group of assets or business differs significantly from the value to another purchaser of the same group of assets or business.¹⁰ These differences may include synergies with other operations or assets, differing estimates of future earning power or perceptions of risk, differences in aversion to or willingness to accept risk, and even income tax status.¹¹ The purchaser’s lawyer should understand these dynamics as they apply to the purchaser and its bid.

The discounted cash flow method is the most common valuation method used by a purchaser in a transaction, where future expected cash flows are discounted at a rate equal to the purchaser’s opportunity cost of capital.¹² While it may seem empirical, use of this method requires a number of assumptions and judgments regarding available reserves and volumes, future prices, the cost of capital particular to the purchaser, and risk factors as to the purchaser’s future ability to discover, recover, mine, produce, refine, market, transport and sell products. Those assumptions and judgments should be tested by and through the due diligence process.

In addition to those assumptions that increase value, the lawyer must understand the liability assumptions made by its client in calculating its bid. Although the word “liability” means different things to different people, a “liability” of an entity is a present economic obligation for which the entity is the obligor.¹³ Applying the discounted cash flow method, liabilities represent future costs that decrease value. In some cases, those future costs actually may exceed the value of the assets purchased and that are available to satisfy those costs.¹⁴ As already discussed, bids in the modern era often are based upon little due diligence other than minimal “evaluation material” in an electronic data room, due in part to the increased prevalence of the auction-type bidding process. While “evaluation material” likely contains land, reserve, production, engineering and operational information, it rarely includes adequate information regarding fixed and contingent liabilities. Although a sophisticated purchaser may have discounted its bid for material known liabilities or by a contingency for unknown liabilities (or a

¹⁰ Shannon Pratt, *The Lawyer’s Business Valuation Handbook*, 2000 A. B. A. Section of Family Law, General Practice, Solo and Small Firm Section, 8. (hereinafter “Pratt”).

¹¹ *Id.*

¹² *Id.* at 105.

¹³ This definition is the current definition of “liability” under continued consideration by the Joint Financial Accounting Standards Board and International Accounting Standards Board Conceptual Framework Project. See Project Update, Conceptual Framework—Elements and Recognition (updated March 15, 2010), available at www.fasb.org. The term “liability” is not currently defined in Generally Accepted Accounting Principles.

¹⁴ See Milam Randolph Pharo, *Due Diligence Review in Oil and Gas Acquisitions Or “I Don’t Care—Did I Get the Deal I Bid On?”* 39 Rocky Mt. Min. L. Inst. Landmen’s Section Due Diligence Presentation, ¶ 8 (Rocky Mt. Min. L. Fdn. 1993) (“Our experience has often been that the low value properties have a hidden downside. Often liability issues are tucked into these properties which far exceed their allocated value. These are the properties which have received the least attention and maintenance, thus acting like well camouflaged incendiary devices waiting for the unwary.”).

combination of both), the lawyer simply will not know when planning her due diligence unless she first asks her client.

2. The Purchaser's Future Plans

Any material plans of the purchaser to liquidate assets, to shut down, decrease or expand exploration programs, drilling programs or other operations, to retain or terminate management and other employees, to maintain employee benefit plans or bring employees under the purchaser's plans, to integrate operations or information systems with existing operations or information systems, to cancel, extend, terminate or assume contracts, and other purchaser plans, should influence greatly the entire due diligence process.

One of the authors can relate from experience the importance of understanding the purchaser's future plans. This lawyer was asked to draft a purchase agreement for the acquisition of a non-energy related retail business pursuant to a term sheet that provided for "standard" representations and warranties. After spending more than 20 hours on the first draft of the acquisition agreement, the client informed the lawyer that immediately after closing the client intended to terminate the employees, sell the personal property for scrap, level the building and build a new hotel. The lawyer thanked the client for the information, threw away the purchase agreement, wrote off all of his time to date, and proceeded to draft a new real estate purchase agreement, eliminating needless representations and warranties and due diligence regarding such matters as product sales and the condition of the personal property.

Consider another example in the natural resources context where the purchaser of certain oil and gas properties asked its lawyer to review the seller's gas marketing contracts in connection with the acquisition of those properties. The lawyer did not know (because he did not ask his client) that the purchaser intended to market gas from the acquired properties under one of its existing marketing arrangements. Had the lawyer inquired, he should have first noticed that each contract permitted termination for convenience upon 30 days' notice. Instead, the lawyer placed a panicked call to the client to report that the gas marketing contracts required notice and written consent to assign.

Also carefully consider the purchaser's integration plans and how those plans affect due diligence. For example, a purchaser who intends to use the seller's land, marketing and accounting information software and systems should understand in detail user's manuals, disaster recovery plans, licensing arrangements and technical specifications, while a purchaser who intends to transfer data onto its own systems should focus on data formatting and transfer requirements and restrictions. As with the purchaser's value and liability assumptions, the lawyer needs to confer with the client before planning her due diligence to clearly understand the client's plans.

3. Issues that Affect Deal Terms

A lawyer leading a due diligence review in a large transaction obviously must understand the legal issues particular to the client, the seller, the industry, the relevant jurisdictions and the transaction and how those legal issues may affect the deal terms. While an in-depth discussion of those issues is beyond the scope of this paper, some common examples include:

- approval of anti-trust regulators under the Hart-Scott-Rodino Antitrust Improvements Act of 1976¹⁵ or foreign anti-trust regulations;
- notices of a “plant closing” or “mass layoff” under the Worker Adjustment and Retraining Notification Act of 1988;¹⁶
- requirements to replace bonds or surety arrangements under environmental and operational statutes or regulations;¹⁷
- requirements for the transfer or replacement of exploration, drilling, mining, environmental and other permits;
- Federal and State processes and requirements for assignment and transfer of leases, licenses, rights-of-way and other assets;
- jurisdiction-specific issues, such as the manner in which property and production is taxed by state and local taxing authorities; and
- shareholder approval requirements under securities exchange listing rules, securities statutes and regulations and state corporate statutes and regulations.¹⁸

There may also be important, client-specific sensitivities to issues that arise in due diligence and that may affect deal terms. For example, the client or the seller may have important reasons that closing cannot extend past a certain date, including internal commitments, the satisfaction of debt covenants or financial ratios, and market perceptions. The client may have received board approval for a specific-type of transaction that is not subject to change. While the client may not be willing to share with the lawyer all of the reasons why, the lawyer conducting due diligence should understand the “deal killer” terms that are important to the client and other terms for which the client is particularly sensitive.

¹⁵ 15 U.S.C. § 18a (2010); Pub. L. 94-435

¹⁶ 29 U.S.C. §§ 2101 to 2109 (2010).

¹⁷ *See, e.g.*, Colorado Oil and Gas Conservation Commission, Rules and Regulations, 2 Code Colo. Reg. 404-1 §§ 702, 709 (2010); Utah Oil and Gas Conservation General Rules, Utah Admin. Code R649-3-1 (2010); Office of Surface Mining Reclamation and Enforcement, Department of The Interior, 30 C.F.R 800.1-800.40 (2010).

¹⁸ *See, e.g.*, NYSE, Inc., Listed Company Manual § 312.03 (2005) (addressing shareholder approval requirements where transaction calls for stock issuance); Model Bus. Corp. Act §§ 11.04(b), 12.02(a), 6.21(f) (2002) (addressing shareholder approval requirements for merger transactions, asset purchase transactions, and where transaction calls for stock issuance, respectively).

D. The Planning Phase

1. The Client Meeting – Considerations in Planning Due Diligence

The first step in planning the diligence process is not the collection of data and information. Before allocating responsibilities and requesting information that is not already available, the lawyer should have an in-depth, in-person (if possible) meeting with her client. Among the issues to be discussed, the lawyer should consider the following:

- how the client determined its bid value, the plans of the client, particular assets and deal terms that are important to the client, and other specific objectives of the client;
- the client's views on materiality for purposes of the due diligence;
- a review of recent seller financial statements (if available) or publicly available documents to identify risks relevant to the due diligence;
- the names and contact information of each individual team member in the due diligence process (including individual lawyers, client officers and employees, landmen, accountants, financial advisors, environmental and other consultants), and the name of the team leader or responsible person at each company or firm;
- the need for additional expertise (or warm bodies) to timely complete the due diligence;
- any agreements or conceptual understandings regarding the terms of the transaction, including the terms as they stand in the purchase agreement, letter of intent or similar documents;
- confidentiality and access rights and limitations; and
- sensitive disclosures that may be prohibited under anti-trust laws and regulations.¹⁹

After taking into account the above considerations, the lawyer and the client should agree on the scope of the due diligence to be conducted by the lawyer and the other members of the diligence team, together with a timeline for the due diligence process and how the timeline relates to the timeline for the transaction as a whole.

¹⁹ See Sherman Antitrust Act §§ 1, 2, 15 U.S.C.S. §§ 1-7 (2010), (providing for criminal penalty for acts restraining trade or commerce or monopolizing any part of trade or commerce among the States).

2. Financial Statement Review

Before plowing through a checklist (or worse, requesting documents), review the financial statements of the seller or the target to be acquired. If the seller is a public company, also review its recent periodic reports filed under the Securities Exchange Act of 1934.²⁰ Earlier in this paper we discussed assumptions that underlie bid value. For those uninitiated in the ways of accountants, under Generally Accepted Accounting Principles²¹ (GAAP), the net worth (or owner's equity) in a business equals its assets minus its liabilities.²² The new accounting student learns quickly, however, that most long-term assets²³ on a GAAP balance sheet are presented at their historical costs, not their "fair market value" or "fair value." While the recorded book value of the seller's assets may be rather meaningless in the context of a negotiated transaction, just having a list of assets eases the planning process.

More important, the balance sheet also provides a list of amounts accrued by the seller or the target as liabilities. If the balance sheet reflects an amount accrued as a liability, the seller believes the liability is both probable and subject to estimation.²⁴ Nobody understands the seller's business better than the seller and its accountants. If the purchaser is willing to assume the liability in connection with the transaction, the liability most certainly will be payable, and if not previously taken into account, will most certainly reduce the value of the transaction to the purchaser.

What about other liabilities? GAAP does not currently require balance sheet accrual of contingent liabilities that are not both probable and subject to estimation²⁵ (although it is moving

²⁰ 15 U.S.C. §§ 78a-78oo (2010).

²¹ The GAAP hierarchy recently was defined and in then redefined. In June 2009, FASB issued the last FASB Statement referenced in that form: FASB Statement No. 168, The FASB Accounting Standards Codification™ ("FASBASC") and the Hierarchy of Generally Accepted Accounting Principles—a replacement of FASB Statement No. 162. This standard establishes FASBASC as the source of authoritative U.S. accounting and reporting standards for nongovernmental entities, in addition to guidance issued by the SEC, and is effective for financial statements issued for interim and annual periods ending after September 15, 2009.

²² "Equity, sometimes referred to as net assets, is the residual interest in the assets of an entity that remains after deducting its liabilities." FASBASC, Topic 505-10-05-3.

²³ By "long-term assets," the authors mean assets other than "current assets." Current assets are used to identify cash and other resources commonly identified as those that are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business. *Id.* at Topic 210-10-20.

²⁴ *See* FASBC, Topic 450-20-25-2 (codifying Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 5, Contingent Liabilities (1975) (hereinafter "FASB 5").

²⁵ *Id.*

in that direction).²⁶ GAAP does require, however, financial statement disclosure in the footnotes of contingent liabilities that are reasonably possible to occur, and permits disclosure of contingent liabilities that are even less certain.²⁷ Further, footnote disclosures are not limited to contingent liabilities. With each passing year, revisions in GAAP increase the extent of disclosures required in financial statement footnotes regarding various aspects of a company's business, how amounts are recorded in the financial statements, and even risks regarding the company's future, such as whether there is a short-term risk that it will be able to continue as a going concern.²⁸

The lesson is that a quick review of financial statements in the planning process should help focus the diligence on certain areas that would otherwise seem insignificant, and lessen the extent of diligence in other areas. For example, the client may decide after a review of audited financial statements to rely on the seller's estimate of its plugging and abandonment liability and forego further diligence procedures. Alternatively, an unfunded pension liability on the balance sheet may trigger an in-depth review, and even a change in the deal. Even if financial statements are not audited, they provide an invaluable source of planning material as representing the view of the seller's or target's management as to its financial position, results of operations and cash flows.²⁹

What about the asset transaction involving less than all assets? How about the sale of a division where the seller does not prepare financial statements? An obstinate seller will argue that stand-alone financial statements simply cannot be prepared without undue effort.³⁰

²⁶ FASB issued an Exposure Draft, Disclosure of Certain Loss Contingencies, on June 5, 2008, that would amend FASB 5 to mandate more frequent accrual and disclosure of loss contingencies. Although such amendments likely would assist a lawyer planning its due diligence, The American Bar Association strongly objected to the Exposure Draft based on the apparent requirement to disclose litigation risks and contingencies and privileged attorney-client communications. See Comments of The American Bar Association on The Financial Accounting Standards Board Exposure Draft Titled "Disclosure of Certain Loss Contingencies: An Amendment of FASB Statements 5 And 141(R)," available at http://www.abanet.org/poladv/priorities/privilegewaiver/2008aug5_privwaiv_fasb_1.pdf. Based on these and similar comments, on September 24, 2008, FASB decided to redeliberate on its Exposure Draft.

²⁷ FASBC, Topic 450-20-50-3, 50-5 – 50-8.

²⁸ American Institute of Certified Public Accountants ("AICPA"), Codification of Statements on Auditing Standards ("AU") §341, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, requires the auditor to include an explanatory paragraph in its audit opinion if the auditor determines there is substantial doubt about its audit client's ability to continue as a going concern. FASB has issued proposed Statement of Financial Accounting Standards, *Going Concern* that would require financial statement disclosure of this doubt that would amend FASBASC by inserting subtopic 30 to topic 205.

²⁹ See AU § 508, *Reports on Audited Financial Statements*, ¶ .08.

³⁰ See Paul Hammes and William Kierse, *Carve-Out Financial Statements* (EYGM Limited 2009), for a discussion on the preparation of carve-out or stand-alone financial statements for divestment purposes.

Admittedly, in a small asset acquisition even the request for a one-off balance sheet may be unreasonable. For larger transactions, regardless of the structure as an equity or an asset deal, the sympathy to this argument displayed by purchaser clients repeatedly baffles the authors. The Securities and Exchange Commission protects investors in public companies by requiring the disclosure of financial information about the target in connection with the acquisition of a significant amount of assets.³¹ While obtaining a quick audit may be difficult, why should the purchaser in a large negotiated transaction not, at the very least, be entitled to a balance sheet? We live in a century where complex accounting software presents data on an asset-by-asset and related liability basis. A balance sheet likely is the most important document that will be reviewed by the client, its accountants, engineers, consultants and lawyers conducting due diligence.

3. Establishing Materiality

An independent auditor's opinion on financial statements does not guarantee a complete and accurate financial picture, but only assures a fair presentation of the financial statements in all *material* respects.³² Similarly, a lawyer's due diligence should be planned and performed to identify issues and risks that are *material* to the objectives of the due diligence. Unimportant questions and findings not only escalate transaction costs, but frustrate both the seller and the purchaser.

For accounting purposes, "materiality" has been defined by the Financial Accounting Statements Board as a fact or circumstance that would change or influence a reasonable person relying on the information.³³ The Supreme Court has defined a fact as material if there is "a substantial likelihood that the . . . fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available."³⁴ SEC guidance has echoed accounting standards, making clear that materiality concerns both quantitative and qualitative factors, and that "no general standards of materiality could be formulated to take into account all the considerations that enter into an experienced human judgment."³⁵

A transactional lawyer is wise to understand accounting concepts of materiality, but the client ultimately determines materiality in the context of transactional due diligence. Bid

³¹ See Securities and Exchange Commission, Form 8-K, 17 C.F.R. § 239.308, Item 2.01, *Completion of Acquisition or Disposition of Assets*, and Item 9.01, *Financial Statements and Exhibits* (2010), for the financial statement disclosure and filing requirements in connection with acquisitions or dispositions by public reporting companies of a significant amount of assets, otherwise than in the ordinary course of business.

³² AU § 508, ¶ .08.

³³ FASB Statement of Financial Accounting Concepts No. 2, *Qualitative Characteristics of Accounting Information*, 132 (1980).

³⁴ *TSC Industries v. Northway, Inc.*, 426 U.S. 438, 229 (1976).

³⁵ SEC Staff Accounting Bulletin: No. 99 – Materiality, 17 C.F.R. Part 211 (August 12, 1999).

assumptions, seller financial statements, market risk, industry risk, outside factors (including lender requirements in the case of financed transactions), and client risk tolerance all factor into the client's materiality determination. Although intuitively most professionals understand that a \$20,000 problem in the context of a billion dollar transaction is not material, ask the client if it has a dollar threshold or range that it considers material for purposes of due diligence. Also ask the client whether it has identified specific matters or issues particular to the seller, the transaction or the client itself that it considers material regardless of the dollar impact (such as matters that impact the timing of the transaction).

4. The Due Diligence Checklist and Request List

In conjunction with this paper and in collaboration with the author of the paper on Environmental Due Diligence, the authors have provided the 2010 Oil and Gas and Mining Due Diligence Special Institute participants with over 100 pages of sample due diligence checklists and checklist supplements. In opening the packet, the reader will first notice that the checklists are long and detailed. Before happily transmitting an exhaustingly long checklist to opposing counsel, the authors sternly warn the reader to heed the difference between a checklist and a request list. A due diligence checklist provides a comprehensive list of matters to consider in planning and preparing for due diligence. A due diligence request list is a list of documents that the lawyer (on behalf of the client) requests from the seller and its counsel.

Please do not consider sending an unedited version of one of the attached checklists to the seller or its counsel unless the transaction either involves hundreds of millions of dollars or you have an innate desire to be lambasted as to the unreasonableness of your request. A checklist should be closely tailored to the particular circumstances of the transaction well before it ever becomes a request list. If using a long and detailed checklist, first meet with your client to carefully go through the checklist and discuss the various items that will be requested from the seller. Then eliminate unnecessary items and insert items particular to the business or the transaction applying a high degree of self-criticism. Finally, with a revised (and hopefully shorter) request list ready for transmission, file away in a safe place your checklist notes indicating those requests that were mutually agreed with the client as being immaterial or unnecessary, and keeping in mind that each item of information deleted from the checklist in preparing the request list is a limitation on the scope of your due diligence. Clients may have short memories; the marked copy of the checklist may become useful if a request the client agreed should be deleted turns out to be the information that would have crushed the deal and now crushes the client.

5. Expertise and Team Resources

In a large transaction, the due diligence team at a minimum includes purchaser internal and external counsel, purchaser management, and other employees of purchaser, including members of the land, human resources, tax, engineering and accounting functions. Lawyers at large firms usually draw on the resources of their colleagues that specialize in particular areas,

including environmental, tax, land and mineral title, employee benefits and water experts.³⁶ That said, the client and the lawyer should both carefully consider the billable fees for a lawyer to review land title documents that could be reviewed by a landman, environmental reports that could be reviewed by a consultant, financial data that could be reviewed and analyzed by an accountant, and so on. While a large due diligence review can mean a big pay day for a law firm, the client may resent the partner's new addition to his mountain home when reasonable alternatives are available.

Contrast that with the small transaction, where one or a few lawyers may be asked to conduct due diligence for which they are not really qualified. The properties may be located in a state where the lawyer is not licensed. The generalist may be asked to review environmental disclosures, financial reports, tax information and employment data. In all such cases the lawyer must inform the client of the limitations of his or her competence.³⁷ What if the client has been fully informed of the lawyer's limitations, does not want to pay for a team of specialists and is unable to engage another lawyer who has mastered every area of law applicable to the due diligence review? In the case of a small, less risky transaction, where the client's cost-benefit analysis determines that a lawyer should provide some due diligence in areas outside his expertise, and where the client understands the limitations on the lawyer's competence and that any conclusions in areas outside of the lawyer's expertise are based on practical, and not legal, advice, the authors will not say that the lawyer should not proceed – but he should proceed with caution. If the client does not clearly understand the limitations on the lawyer's ability, the lawyer could subject himself to malpractice claims and allegations of ethical misconduct.³⁸

6. Deal Terms

Other authors at this Special Institute plan to address the impact of the deal on due diligence. Suffice it to say, deal terms that have already been agreed to before the conduct of due diligence should be carefully considered in the planning process. These deal terms may include a written indicative offer letter, letter of intent or formal purchase agreement, or simply an informal understanding as to structure, price or other terms.

7. Confidentiality and Access

Again, other authors at this Special Institute intend to more fully address issues of confidentiality in due diligence. Relating to confidentiality, the lawyer should closely consider the rights and restrictions of its client to access the data and information required to conduct the due diligence review. Rights and limitations on access may be formal or informal. In either case, limitations on access compromise the purchaser's ability to conduct due diligence.

³⁶ Subcommittee on Acquisition Review, Committee on Negotiated Acquisitions, *Manual on Acquisition Review*, 1995 A.B.A. Section of Business Law, at x (hereinafter "ABA Manual on Acquisition Review").

³⁷ *See id.*

³⁸ *See id.*

Informal access limitations arise when, for retention, confidentiality or other reasons, the seller's executives decide to limit internal communications regarding the transaction to a select group of employees and staff. For example, it is difficult to interview the seller's engineer responsible for managing water rights or to obtain the water documents in her control if she is not permitted to know about the transaction. Informal access limitations also tend to arise when the seller's personnel are overworked or annoyed by having to compile documents while simultaneously performing their regular work duties. In any case, the client's executives should discuss these sensitive issues with the seller's executives up front to avoid unnecessary misunderstandings.

Formal access rights and restrictions should be memorialized in a letter of intent, confidentiality agreement or other agreement executed before due diligence commences. Absent a formal agreement, the purchaser should not expect much cooperation, especially if it intends to conduct invasive due diligence, such as downloading of electronic data or Phase II environmental samples.

In determining the extent to which access is granted, the purchaser should be willing to provide some form of indemnity to the seller for damages arising from on-site access to properties. In addition, the seller should object to providing information that is subject to an obligation of confidentiality or non-disclosure, or that is protected by the attorney-client privilege or work product doctrine. In that case, and without breaching the confidentiality obligation or compromising the privileged nature of the restricted or protected documents, the purchaser should at least be made aware that such documents exist and the extent to which they might be material to the transaction or the seller. In the case of documents that are protected by confidentiality, the purchaser and the seller jointly should decide whether to approach the counterparty to obtain a waiver of the restriction. In the case of privileged documents, the seller and the purchaser should consider whether they have a sufficient common interest under the laws of the applicable jurisdiction to satisfy the legal requirements to execute an enforceable joint privilege agreement.

The following is a sample access provision from an oil and gas purchase agreement (with defined terms omitted):

Sample Due Diligence Access Provision

4. Due Diligence; Access.

(a) From the Execution Date until the Closing Date, Seller shall provide Purchaser and its Representatives with access in accordance with this Section 4 to all information in Seller's possession or control relating to the Acquired Assets or the Assumed Liabilities, including any related Records, Permits, Contracts, reports, assessments and other documents, and shall use Commercially Reasonable Efforts to make available to Purchaser those Representatives of Seller who would reasonably be expected to have material knowledge or material information regarding the Acquired Assets or the Assumed Liabilities or the status or condition thereof (including the

environmental status or condition thereof), to permit Purchaser to perform a due diligence investigation and review (the "Due Diligence Review").

(b) Records, Permits, Contracts, reports, assessments and other documents shall be made available to Purchaser at the principal office of Seller during Seller's normal business hours or as otherwise reasonably requested by Purchaser to complete its Due Diligence Review; *provided, however*, that any obligation of Seller under this Agreement to make any information available to Purchaser shall be: (i) only to the extent that doing so does not violate any confidentiality or non-disclosure obligation under any contract or agreement of Seller or any of its Affiliates to any third party; and (ii) only to the extent such information is not protected by the attorney-client privilege or work product doctrine.

(c) Upon reasonable advance notice to Seller, Seller shall allow Purchaser to conduct, at Purchaser's sole risk, Liability and expense, one or more on-site inspections and an environmental assessment and compliance audit of the Acquired Assets (an "Environmental Assessment"). In connection with any such on-site inspections or Environmental Assessment:

(i) Purchaser shall not interfere with the normal Operations of any Acquired Assets in any material respect and shall comply with all requirements and safety policies and procedures of the operator of such Acquired Assets;

(ii) Purchaser shall provide Seller with prior written notice of any activities with respect to any such Environmental Assessment, and shall provide Seller with the opportunity to participate in all such activities;

(iii) any contractor engaged to perform all or any portion of such inspections or Environmental Assessment shall execute and deliver to Seller a confidentiality agreement in a form acceptable to Seller;

(iv) Purchaser shall not conduct, authorize or permit any test drilling, sampling or other on-site activities without prior written notice to Seller, and the prior written consent of Seller, which consent shall not be unreasonably withheld or delayed; and

(v) Purchaser shall provide to Seller promptly (and in any event, within three Business Days) after receipt, at no cost to Seller, all draft and final reports, results, data, analyses of site visits, Remediation cost estimates, and any other portion of any Environmental Assessment, all of which shall be subject to the confidentiality provisions in [the Confidentiality Agreement][Section ___].

(d) In connection with the granting of any access to the Acquired Assets and any Environmental Assessment, Purchaser represents and warrants to Seller that Purchaser and each of its agents and contractors that conducts any such Environmental Assessment or otherwise enters onto any of the Acquired Assets are adequately insured. Except to the extent caused by Seller's negligence or willful misconduct, Purchaser waives and releases, and agrees to indemnify, defend and hold Seller harmless from and against any and all Claims of any Person for injury to, or death of, any natural person or for Losses incurred by any Person arising out of the access afforded to Purchaser, or any of its agents or contractors, in connection with Purchaser's Due Diligence Review. This Section 4(d) shall survive the termination of this Agreement.

8. Agreement on the Scope of the Review and Timeline

After a thorough discussion of the preliminary issues discussed above, the client and the lawyer should agree upon the scope of the due diligence review to be conducted by the lawyer and the other participants in the due diligence process. This “agreement” should be based on the client’s direction after consultation from the lawyer. In addition to the factors discussed above, other factors that may influence the client’s direction as to the breadth and depth of the review include:

- the nature of the controls and sophistication of the business being acquired;³⁹
- the client’s judgment regarding the benefit of certain due diligence procedures, or time constraints resulting from business needs, such as the desire to close quickly,
- the extent to which the client intends to rely on the representations and warranties and indemnifications in the purchase agreement; and
- just how much due diligence the seller actually can tolerate.⁴⁰

When the roles and responsibilities of each participant in the due diligence process have been agreed, a responsibility matrix (also referred to as a work program or a work plan) should be prepared and distributed to all due diligence participants. Such a matrix or work plan not only is the best way to ensure that all participants understand their responsibilities and that the work is timely and properly completed, but the work plan also tends to reduce instances of selective memory among the diligence participants when problems magically appear after the closing that were not highlighted in the diligence process. Although we considered providing a sample form of a responsibility matrix, we decided that it should be so specifically tailored to each transaction that a form would be of little value. To provide the reader some idea as to the content of a responsibility matrix, below is a sample of a portion of a responsibility matrix relating only to land due diligence to be conducted for an oil and gas asset acquisition.⁴¹

³⁹ For example, a large sophisticated business may have audited financial statements, significant internal controls, detailed safety and environmental policies and procedures, internal counsel and an internal audit function, all of which can expedite or distribute the burden of the due diligence. By contrast, the small, family owned oil and gas company that has never received a financial statement audit may require proportionately more due diligence.

⁴⁰ See ABA Manual of Acquisition Review, at viii-ix.

⁴¹ For an example of a more comprehensive responsibility matrix relating to a technology company, see, e.g., the “Hypothetical Work Program for an Acquisition Review” in ABA Manual on Acquisition Review, at 6.

PROJECT BIG DEAL

DUE DILIGENCE RESPONSIBILITY MATRIX

LEGEND

Abbreviation

Name

OGPC	Oil and Gas Purchaser Corporation
OSLF	Outside Law Firm LLP
LTI	Landman Title Company Inc.
PSC	Petroleum Seller Corporation
SBLC	Seller Big Firm Legal Counsel P.C.

<u>DEADLINE</u>	<u>TASK</u>	<u>RESPONSIBLE PERSONS</u>
A. LAND		
Ongoing	Internal management reporting.	OGPC Senior VP Land, John Smith
March 1, 2010	Coordinate and conduct interviews of PSC land staff to gain general understanding of land positions. Communicate results of interviews to responsible persons.	OGPC Senior VP Land, John Smith
March 1, 2010	Copy maps and land summary documents and distribute to all responsible persons for informational background purposes.	OSLF, Susan Dewey, Associate
Within 24 hours after receipt	Log and track documents responsive to due diligence requests (other than title documents made generally available in title review).	OSLF, Susan Dewey, Associate
Within 24 hours after receipt	Distribute responsive documents to responsible parties. Coordinate additional document requests and due diligence inquiries.	OGPC Senior VP Land, John Smith
March 10, 2010	Review leases, joint operating agreements and other contracts with consent requirements and preferential right provisions and coordinate with SBLC preferential rights notices and consent letters.	OSLF, Susan Dewey, Associate Copies to OGPC Senior VP Land, John Smith
March 30, 2010	Review and report on material land agreements, including farmout, farmin, development, participation, area of mutual interest, spacing, pooling and communitization agreements.	OSLF, Harry Cheatum, Partner Copies to OGPC Senior VP Land, John Smith

<u>DEADLINE</u>	<u>TASK</u>	<u>RESPONSIBLE PERSONS</u>
March 30, 2010	Review and report on surface use, surface access, and surface damage agreements, and rights-of-way and easements for surface, access, roads, pipelines, utilities and other purposes.	LTI, Ted Defectfinder, Landman OGPC Land Staff
March 30, 2010	Review documents relating to owned and leased surface real property (other than oil and gas). Coordinate whether and to what extent to obtain title commitments and surveys.	OSLF, Susan Dewey, Associate OGPC Senior VP Land, John Smith
April 30, 2010	Comprehensive review of title PSC title files, comparing land and lease positions, well and undeveloped location NRIs and WIs to purchase agreement exhibits, taking into account before and after payout interests.	LTI, Ted Defectfinder, Landman OGPC Land Staff
April 30, 2010	Update acquisition title opinion dated November 30, 2007, prepared by Title Law Firm P.C. in connection with D-J Basin acquisition by PSC.	OSLF, Harry Cheatum, Partner
May 5, 2010	Coordinate draft of final report of land due diligence findings and prepare draft report.	OSLF, Harry Cheatum, Partner OGPC Senior VP Land, John Smith
May 7, 2010	Summarize findings for Board presentation.	OGPC Senior VP Land, John Smith
May 10, 2010	Prepare and transmit title defect notices.	OSLF, Harry Cheatum, Partner

E. The Information Gathering and Review Phase

1. The Process Manager and Team Leaders

Every successful large project has a specific person designated to “own” the project. In a large due diligence project, typically one lawyer (which may be internal or external counsel) should be tasked with managing the entire due diligence process. We refer to that person as the “Process Manager.” As a transaction grows in size, the amount of detailed substantive review conducted by the Process Manager decreases. In a very large transaction, the Process Manager focuses solely on gathering, organizing and disseminating information, organizing reports and making communications.

In addition, one person ultimately should be responsible for each category of information identified in the applicable checklist. We refer to that person as a “Team Leader.” Depending on the size of the due diligence, the Team Leader may be responsible for one or multiple categories, may conduct the entire review of information in that category herself, or may have an entire team of professionals (including outside consultants and others) reviewing information in that category. The Team Leader tracks information disseminated to her team, coordinates the review of responsive information applicable to the assigned category, interviews seller personnel regarding issues relating to her assigned category, works directly with designated client

personnel assigned to the same category or that work in the related functional area, and summarizes responsive information for reports and other communications.

The senior partner with the client relationship has a critical role in the planning phase and the documentation and reporting phase, and continually should be available to answer questions. In our experience, however, he should not be the Process Manager. Even ignoring that the senior partner regularly loses documents without his assistant (and the due diligence response likely includes thousands of documents), his billable rate likely does not support herding cats. If the senior partner wisely tasks a resourceful, organized, Type A associate or junior partner as the Process Manager, then specialists designated as Team Leaders may be significantly more senior by law firm rank than the Process Manager. If the process functions properly, Team Leaders subordinate their rank to the Process Manager's directions. Those that do not risk losing critical information or missing deadlines.

2. Collecting and Organizing Information

This paper previously discussed the temptation to jump into a review without proper planning. Most lawyers equally are tempted to promptly download and print information from a data site without an organization system. The following are just some of the billable tasks where timing may demand and clients greatly appreciate a high degree of efficiency in the large transaction due diligence:

- determining which documents are responsive to what requests, and whether requests remain unanswered or only partially answered;
- collecting and logging documents and information using a system consistent with what is already used by the seller and its counsel to respond to due diligence requests and provide documents and information (as opposed to entirely different categories of information, likely in the form of the lawyer's favorite checklist);
- procedures to avoid duplicative review of documents;
- requests for follow-up information and information that already has been requested; and
- timely dissemination of documents to appropriate participants in the due diligence process.

Some of the tasks described above are best performed in cooperation with the seller. The forms provided with this paper include a letter of instructions to accompany the request list provided to the seller and its counsel (assuming one of the checklists is properly revised into a request list). The instructions request of the seller when providing documents, to

please return the most recent copy of the request list, with the applicable box checked under "Item Status" and as much background information as possible in the "Comments" box, especially in the case that a document is only partially responsive to a request.

The “Item Status” column corresponding to each item request on the sample checklists contains options permitting the seller to check whether responsive information (1) has already been provided or already is in the data room, (2) is provided with the returned copy of the request list, (3) is to be provided later, (4) is being provided, but additional information remains to be provided, or (4) does not exist or is not applicable. The instructions also request of the seller:

As you are in a much better position to determine where a document is responsive to a request, please write in pencil or by electronic stamp (if provided electronically) in the upper right-hand corner of each document provided the item number (or numbers) on the request list corresponding to the document.

All too often, the seller assigns an employee to pull information responsive to a request, the employee forwards the information to the seller’s lawyer, and the seller’s lawyer forwards the information to the purchaser’s lawyer, in each case without any indication as to how the information corresponds to any particular due diligence request. The authors humbly request that lawyers representing the seller encourage and assist the seller in tracking and coding information. While the checklists we have provided are meant only as an example of a system, the purchaser will appreciate any assistance.

Assume now that the highest bidder has been identified to conduct more detailed due diligence, the data room exists and is full of “evaluation material,” and the seller intends to continue to provide responsive diligence information through the data room. Data rooms offer tremendous advantages, including fast electronic delivery of information and tracking individual use of the data room, but, as previously discussed, investment bankers often control the data room process before lawyers become involved. As a result, data often falls into folders defined by narrow categories that are interesting to investment bankers and business executives (e.g. folders labeled “land,” “engineering” and “operations”), with every other document falling into a folder labeled “other”. The lawyer representing the purchaser may ask the seller to reorganize its information based on the categories in the purchaser’s form request list, but the authors have never seen that actually occur. Instead, consider meeting half way. One compromise approach involves the purchaser beginning its request list with the narrow categories already present in the data room, and the seller allocating information in the “other” category to more narrow categories identified by the purchaser in its request list (e.g. environmental, intellectual property, taxes, etc.).

Data rooms have become so advanced that many are capable of sending an email to users that new information has become available. Unfortunately, much of this new information is annoyingly lumped into one folder entitled “new” or “added” information. The purchaser and its counsel then spin their wheels to determine whether the new information is an environmental report, a financial statement or a joint venture agreement. To address this issue, seek data providers that put new information in the category where it belongs, that simultaneously inform users of new information and its category, and that keep a comprehensive list updated of all information, when it was added to the datasite, and where it was added.

3. Due Diligence Evidence

When conducting due diligence, an effective and efficient process requires more than a review of responsive documents and information. Obviously the lawyer should carefully review important documents such as deeds of trust, critical product marketing and smelting agreements, and material participation agreements; but, he should also consider other sources of evidence. Seller management and staff interviews provide valuable context for, and may even contradict, written documents.⁴² UCC filings, court filings, county records, oil and gas commission records, Bureau of Land Management records and other publicly available documents may provide significant information regarding risks that may not be available in the seller's documents or may even be unknown to the seller.

Instead of focusing solely on documents provided by the seller, in the information gathering and review phase consider the different types of evidence that auditors review in a financial statement audit. In addition to specific financial procedures (including recalculating math and re-performing controls) and analytical procedures like scanning a transaction listing, audit evidence includes:

- inspection of records or documents – the typical focus of lawyer due diligence;
- inspection of tangible assets – to provide evidence of the existence and condition of assets;
- observation of processes and procedures – mining of minerals, drilling of a well, etc.;
- inquiry – seeking information from knowledgeable persons, both inside and outside the entity, including vendors, suppliers and purchasers; and
- confirmation – the process of obtaining a representation of information or of an existing condition directly from a third party, such as an estoppel certificate.⁴³

F. The Documentation and Reporting Phase

1. Standards of Documentation

When performing due diligence, consider whether or not the documentation compiled by your team is sufficient to satisfy the standards applicable to auditors:

The auditor must prepare audit documentation in connection with each engagement in sufficient detail to provide a clear understanding of the work performed (including the nature, timing, extent, and results of audit procedures

⁴² How often have you heard a seller say something like: “We never intended for title to be in that entity. It was a mistake. We just never got around to fixing it.”

⁴³ See AU §§326.20 – 326.41.

performed), the audit evidence obtained and its source, and the conclusions reached.⁴⁴

Memoranda should be prepared that document interviews with seller personnel, including the persons involved and the time of the interviews. Summaries of documents should not only be informative, but also concise. When documenting the evidence of due diligence, also consider materiality and the objectives of the due diligence as discussed above. A summary of a 20 page contract should not be 10 pages. Thoughtfully summarize the important provisions of a contract or other document.

2. Informal Reports of Findings

At the end of each week or other rational period, the client should be presented with an informal update of the status of the due diligence. At the request of the client, and taking into account the timing of the transaction, the status update may be either written or oral. In the case of a written status report, both the client and the lawyer should keep in mind that lawyers are wordsmiths, and frequent written reports distract from the process of collecting and reviewing information. Status reports should include:

- a discussion of material findings that affect the objectives of the due diligence, including the proposed price, the client's future plans and the terms of the transaction;
- an update regarding changes in or resolution of material findings from prior updates; and
- a discussion of material open issues (including material holes in relevant information).

To prepare for the presentation of updates in the large due diligence, the Process Manager must collect material findings, updates and a list of material open issues from each Team Leader. Accordingly, consider adopting a standard format for written internal documentation of these material matters, also referred to as an "issues list." If the status report is conveyed to the client verbally, Team Leaders who have identified material issues should be available to answer client questions. In any case, before discussion of the general findings with client management, Team Leaders, the Process Manager and the senior relationship partner should meet to discuss their respective issues lists to identify problems and issues that cross multiple disciplines, and to mutually make determinations as to materiality. Ultimately, the relationship partner should determine which items are material and non-material for presentation to the client based on the planning process and changes in the scope of the due diligence as the process progresses.

⁴⁴ AU §339.03. The person standard for who should have the clear understanding by reviewing the audit documentation is an experienced auditor with no previous connection to the audit. *See* AU §339.10.

3. Real Time Reports of Material Findings

Notwithstanding that periodic status reports are scheduled, significantly material issues and risks should be communicated to the client within hours of discovery, with input from the client relationship senior partner. In addition, even if the transaction document team and the due diligence team are from different law firms, they should have a constant and continuous open line of communication. The due diligence team should know the status of purchase agreement drafts so that issues discovered in due diligence can be incorporated into comments before the next turn.

4. Formal Due Diligence Reports

As the speed of transactions continually increases, formal, written due diligence reports are becoming more rare. The positive result of this development is that it is difficult for a lawyer to omit something from a report that is never provided to the client. The negative aspect is the lack of any evidence that the client was ever informed of material findings.

If a formal diligence report is required, time constraints often require the delivery to the client of a draft of the report before completion of the entire due diligence. If the lawyer has delivered a draft report, soon thereafter he should finalize a report that resolves any open issues existing at the time of the draft report. The final or draft report usually will be scaled down by the client into 10 or fewer slides for presentation to its board of directors. Because decisions may be made on the basis of the report, any material open issues at the time a draft report is presented must clearly be identified. Out of caution, the lawyer should be careful not to draw conclusions in a draft report regarding open issues. Even better, material open issues should be resolved before the draft is delivered. The seller might have a very good explanation for something that appears in a draft report to be a material risk. The lawyer would be advised not to be responsible for a material business decision based on an erroneous assumption.

As with other documents, a lawyer tends to bury important issues among a sea of information in formal reports. Consider that most corporate communications have evolved into power points and bullet lists. Clients have become very accustomed to reading information in a highly summarized form. As such, an executive summary is the most important part of the formal due diligence report for the client. The lawyer should use special care to ensure the executive summary is concise, clear and in plain English.

For the lawyer, the most important part of the formal due diligence report is the introduction. Legal organizations have issued extensive guidance to lawyers as to the issuance of legal opinions,⁴⁵ but to our knowledge, no similar formal guidance has been provided for due diligence reports. Given the risks involved in the failure to discover and report material issues in connection with due diligence, this guidance would be a welcome addition to the academic legal landscape. In the meantime, the authors have included in their forms provided to participants in the Special Institute some sample language that may be incorporated into a due diligence report introduction. The most important provisions of the introduction:

⁴⁵ See *e.g.*, Third Party “Closing” Opinions, A Report of the TriBar Opinion Committee (TriBar Opinion Committee 1998).

- limit the scope of the due diligence to the items in the responsibility matrix or other matters agreed between the client and the lawyer;
- attach a copy of the due diligence request list identifying items that never were provided by the seller;
- assume the authenticity of the documents provided;
- assume oral responses are true, complete and correct;
- indicate whether any confirmations have been received from third parties;
- exclude review of any financial, commercial and technical information;
- limit the legal basis of the review to the laws of the states where partners in the law firm are licensed to practice;
- include the disclaimers required by relevant United States Treasury Regulations that the report does not constitute a formal tax opinion; and
- disclaim any obligation to update the report past its effective date.

G. The Impact of Due Diligence on the Deal

We previously stated that one of the primary objectives of due diligence is to validate or invalidate the purchaser's bid value. In reality, a properly conducted due diligence rarely validates the bid value. Bid values usually go in one direction after due diligence. After the seller spends weeks or months looking for an acceptable deal or bidder and the parties conduct bloody negotiations over a term sheet or purchase agreement, the lawyer conducting due diligence is tasked with undoing the deal by finding material issues to re-negotiate. In that way, the lawyer conducting due diligence resembles the old adage about the auditor as the person who arrives after the battle and bayonets the wounded.⁴⁶ On rare occasion, the due diligence process reveals a particular benefit to all parties, with special emphasis on the word "rare."⁴⁷ More often, the "successful" due diligence process highlights deal killers, justifies price adjustments or simply raises blood pressures. Success is measured by the degree to which the lawyer and his team thoroughly, timely, efficiently and professionally completes this unenviable task. Such success likely will be denied the deserved kudos, but a sophisticated client nevertheless may appreciate their efforts by rewarding the next deal.⁴⁸

⁴⁶ Unknown author.

⁴⁷ For example, due diligence may reveal that a particular structure might preserve a tax asset without a material corresponding increase in the risk of the change in structure to either party. As a result, the purchaser may be willing to increase the purchase price.

⁴⁸ Kendor P. Jones, *Due Diligence and Closing Issues*, Oil and Gas Acquisitions Special Institute, ¶ 4 (Rocky Mt. Min. L. Fdn. 1995).

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