WHITE PAPER

OVERVIEW OF THE PRACTICE OF TRANSACTIONAL DUE DILIGENCE

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INTRODUCTION

The term "practice" refers to that which is "usually or regularly done."[1] In the case of due diligence and reliance, practice refers to the processes and practices that are generally accepted in the industry as being reasonable. Thus, practices are those activities commonly understood as meeting the accepted standards of the industry. An essential element in understanding the practice of due diligence and related reliance, therefore, is what others in similar circumstances are doing during the time in question (the temporal context). While following the practices common in the industry is not a guarantee of legal reasonableness, an investigation that conforms to such customary practice and standards is generally considered reasonable in the industry and may enhance the likelihood that the conduct will be considered reasonable by the court or trier of fact in applying the law.

Special Report: Due Diligence Seminars, published by the NASD (the predecessor of FINRA) in 1981, described these conduct-based industry standards as the "standards of the street" and explained the concept as follows:

> "The standard of reasonableness under Section 11 is, in a sense, a 'standard of the street.' In considering whether an underwriter has conducted a reasonable investigation, therefore, one must realize that the standard of reasonableness is not an absolute standard that never changes. Rather, 'due diligence' may be construed as a standard that depends to some extent on what constitutes commonly accepted commercial practice. If you can establish that the steps taken meet the standard of the trade as it presently exists, a court should not, in applying the Section 11(c) standard, hold you liable for not being duly diligent despite the fact that you missed something and there was a material omission in the registration statement. What other underwriters are doing and the due diligence standards that are followed on the street are highly relevant in establishing one's defense.
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> Since the prudent man standard may be construed as a 'standard of the street,' one is very reluctant to do anything that varies from street practice because that may weigh heavily in establishing liability. If every other underwriter uses a particular procedure, anyone who varies from that procedure is inviting trouble.
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> It is important, then, to be aware of what other people are doing in similar transactions. This does not mean that that is as far as one should go, but if one does not go as far as the standard of the street, he may be exposing himself to potential liability."[2]

[1] http://dictionary.cambridge.org/us/dictionary/english/practice.

[2] NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC., SPECIAL REPORT: DUE DILIGENCE SEMINARS (July 1981) at 6.

The notion that the "standards of the street" are relevant considerations in assessing the practice of due diligence conduct also applies to other legal areas such as torts: "[O]ne should be entitled to cite 'the usual and customary conduct of others under similar circumstances..., as an indication of what the community regards as proper' and as 'a composite judgment as to the risks of the situation and the precautions required to meet them.'"[3]

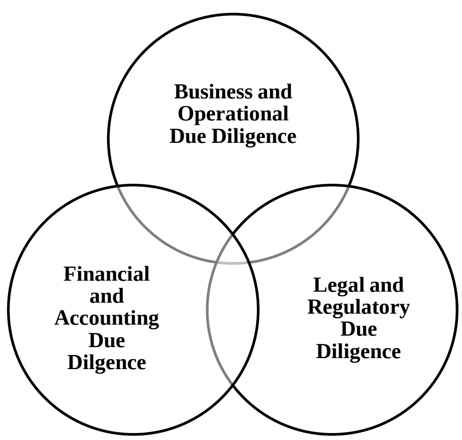
This white paper briefly examines the practice of due diligence in different transactional contexts and the relevance of the standards of the street in considering the reasonableness of a practitioner's conduct.

"SILOS" OF DUE DILIGENCE PRACTICE

In considering the practice of due diligence, it is helpful to establish a basic conceptual framework. For purposes of this white paper, the conceptual framework for due diligence consists of "silos." As explained below, in securities offerings and negotiated transactions, there are three silos of investigative or reliance-based activity: business and operational, legal and regulatory, and financial and accounting. In the case of investment financial services, there are two such silos: investment strategy and operational due diligence.

Securities Offerings and Negotiated Transactions

Conceptually, securities offering and negotiated transaction due diligence may be thought of as having three silos—business/operational, legal/regulatory and financial/accounting. There are no bright lines of demarcation between and among these three general areas of investigation. Each silo, and the investigative or reliance-based efforts of the various members of the multi-disciplinary team functioning within and among them, are akin to overlapping circles in a Venn diagram.[4]



As is evident from the Venn diagram, due diligence is not conducted in a vacuum. While each member of the multidisciplinary team conducts its own due diligence, and makes its own reliance-based decisions, his or her activities in this regard may be relevant to work and reliance of others. Therefore, it is important that the team adopt effective

[3] KEETON ET AL., PROSSER AND KEETON ON THE LAW OF TORTS § 33, at 193 (West, 5th ed. 1984).

[4] "A Venn diagram is a diagram that uses circles to illustrate the relationships among sets." http://www.icoachmath.com/math_dictionary/venn_diagram.html.

communication and documentation protocols to facilitate cross-pollination and sharing of information.

Silo One: Business and Operational Due Diligence

Business and operational due diligence is most apparent in negotiated transactions, but is also typically a part of securities offerings due diligence as well.

In a negotiated transaction, the buyer invests money or other consideration today in hopes of generating favorable future returns. Therefore, the buyer is interested in many business and operational aspects of the target company, though sellers also have an interest in conducting due diligence with respect to matters such as the material accuracy of representations and warranties they make in definitive agreements and assessing any non-cash components of consideration, among other things.

In a securities offering, the underwriters and other involved parties are not acquiring control of the issuer, however many participants may be held liable for material misstatements or omissions in the offering documents. Therefore, securities offering participants also typically are interested in some of the business and operational aspects of the issuer, at least to the extent they are discussed in the offering materials.[5]

While there is no definitive or comprehensive list that applies in all contexts, business and operational due diligence may include:[6]

- Industry and sector related concerns
- Strategic positioning of the target
- Revenue and profit performance compared to the industry
- Operating budgets
- Revenue, income and other financial projections
- Selected business and financial trends
- Management and personnel
- Facilities (such as manufacturing plants)
- Tangible and intangible property
- Employee relations and human resources and
- Similar operational and related areas

Thus, business and operational due diligence typically encompasses the areas of commercial, operational and to some extent financial concern most relevant to a business person who will be operating the business post-closing (in negotiated transactions) or who has an interest in ensuring the accuracy of the related statements made to potential investors in the offering documents (in securities offerings).

Silo Two: Legal and Regulatory Due Diligence

As the name implies, legal and regulatory due diligence focuses on legal and regulatory concerns. Therefore, it typically is conducted by attorneys, other relevant subject matter

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[5] However, contrast this with an offering of asset backed securities where the value of the securities may be largely unrelated to the issuer.

[6] *See generally*, VALERIE FORD JACOB & STEPHANIE J. GOLDSTEIN, CONDUCTING DUE DILIGENCE IN A SECURITIES OFFERING (Practising Law Institute, 2009) [hereinafter "Jacob and Goldstein Treatise"].

specialists and/or by other appropriate parties upon whom they rely. Where non-attorney legal and regulatory subject matter specialists are involved (such as an environmental auditing firm or an intellectual property specialist, for example), those specialists commonly work under the supervision of attorneys and are considered part of the legal and regulatory effort.

In an underwritten securities offering, responsibility for legal and operational due diligence is typically shared among the issuer's counsel, the underwriters' counsel and any subject matter experts (and the parties upon whom they reasonably rely). This shared responsibility necessitates a degree of interaction and cross-pollination among the diligence team. In a private placement, responsibility for legal and regulatory due diligence typically is shared between the participating broker-dealer's counsel, the issuer's counsel and any subject matter experts (and the parties upon whom they reasonably rely), who also have an interest in sharing the results of their investigation and reliance.

In a negotiated transaction, legal and regulatory due diligence often is primarily the responsibility of buy-side counsel,[7] though seller's counsel may conduct some level of due diligence, for example when it related to confirming the accuracy of the seller's representations and warranties in the definitive agreements, or assessing the value and other relevant attributes of any portion of the purchase price that is paid with a currency other than cash (such as shares of stock in the buyer or a promissory note). While negotiated transactions are typically thought of in the context of a purchase and sale or joint venture, this term also encompasses lending transactions. In a lending transaction, legal and regulatory due diligence is most commonly conducted by the lender and its counsel, as well as any relevant subject matter experts.[8] However, borrowers and borrower's counsel may also conduct some level of legal and regulatory due diligence regarding matters such as the accuracy of the borrower's representations and warranties in the loan agreements and the lender's capacity to fund the loan.

As with business and operational due diligence, there is no definitive list of issues to be investigated in all contexts. However, legal and regulatory diligence may focus on items such as:[9]

- Charter
- Bylaws
- Records of material entity action or meetings
- Entity organizational charts
- Employment agreements
- Benefit plans
- Related party transactions
- Disputes and litigation
- Statutes, rules and regulations applicable to the target's business
- Relevant regulatory bodies and compliance and

[7] Negotiated transaction due diligence has a "buy side" (the buyer, lender, etc.) and a "sell side" (the seller, borrower, etc.).

[8] However, as noted, all parties to a business transaction typically have some level of interest in appropriate due diligence.

[9] *See generally*, Jacob and Goldstein Treatise.

- Other similar legal or regulatory matters

Thus, the primary focus of this silo of due diligence and reliance practice is legal and regulatory matters, and the investigation typically is conducted by or in coordination with attorneys.

Silo Three: Financial and Accounting Due Diligence

Whether in the context of a securities offering or a negotiated transaction, financial and accounting due diligence typically involves one or more accounting or financial firms that are expert in the area and, in the case of accountants and other regulated professionals, licensed to practice in it. As with the other two silos, other investigators often rely on the work of these professionals with respect to matters such as audited and unaudited financial information[10] as opposed to conducting their own extensive independent investigations.

Here too, there is no definitive list of financial and accounting issues to be investigated in all contexts. However, areas of focus may include:[11]

- Target company's financial statements (audited and unaudited)
- Margins
- Ratios
- Internal controls
- Auditor's reports to management
- Management letters
- Working capital
- Prior and current period financial performance analyses and
- Reliable data regarding budgets, projections, and similar accounting or financial matters

Thus, the primary focus of this silo is financial and accounting matters, and the related investigations are conducted by firms and/or individuals with appropriate skills in these areas.

Financial Services Due Diligence

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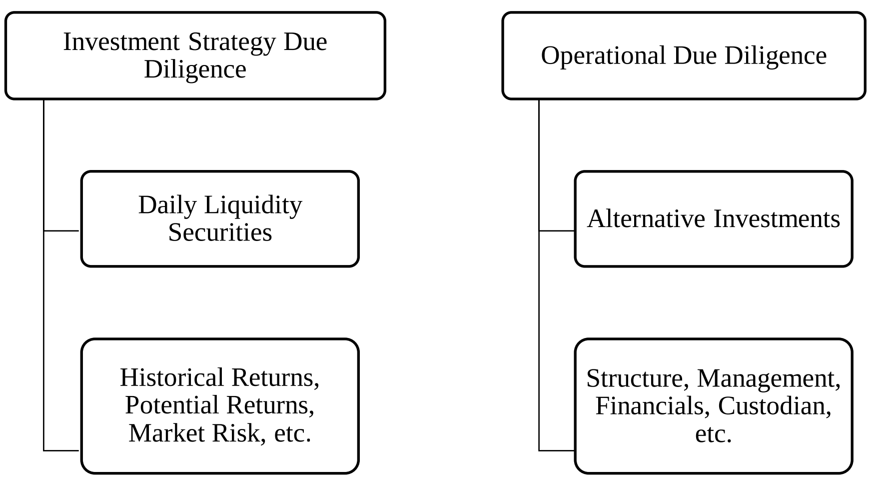
[10] However, note that in the WorldCom case, Judge Cote ruled that for purposes of the "reliance defense" investigators are not entitled to rely on auditor comfort letters to the extent they address interim financial information that has not been audited (and therefore is not expertise material). In re: WorldCom Sec. Litig., 346 F. Supp. 2d at 628, 666. Note also that SEC Rule 436 provides that notwithstanding written consent, 'a report on unaudited interim financial information…by an independent accountant who has conducted a review of such interim financial information shall not be considered a part of a registration statement prepared or certified by an accountant or a report prepared or certified by an accountant within the meaning of sections 7 and 11 of the Securities Act. 17 CFR § 230.436(c). Further, "[a] review of interim financial information does not provide a basis for the expression of such an opinion, because the review does not contemplate a study and evaluation of internal accounting control; tests of accounting records and of responses to inquiries by obtaining corroborating evidential matter through inspection, observation, or confirmation; and certain other procedures ordinarily performed during an audit. A review may bring to the accountant's attention significant matters affecting the interim financial information, but it does not provide assurance that the accountant will become aware of all significant matters that would be disclosed in an audit." *Id*. However, reliance on such information is commonly part of an underwriter's reasonable investigation.

[11] *Id*.

Financial services often involve investment advisor and/or investment stewards. The term investment advisor generally refers to a professional who is responsible for providing investment advice and/or managing investment decisions.[12] It includes: (i) investment advisory firms that are registered with the SEC or a state, (ii) individuals associated with such firms (commonly referred to as a registered investment advisor representative or RIA), and (ii) investment managers.[13] Typical examples include wealth managers, financial advisors, trust officers, investment consultants, financial planners and both fiduciary and non-fiduciary advisors engaged in similar activities. The term investment steward refers to persons who have: "the legal responsibility for managing investment decisions, including retirement plan sponsors, trustees, and investment committee members. Typically, an investment steward is not an investment professional, but is responsible for selecting and overseeing investment professionals to act as investment advisors or investment managers for the plan, foundation, endowment, or other entity served by the investment steward."[14]

Conceptually, investment advisor and investment steward due diligence may be thought of as falling into one of two silos—investment strategy due diligence and operational due diligence. Unlike the three silos applicable to securities offerings and negotiated transactions, these two silos do not typically overlap and therefore are displayed differently in a schematic diagram.



[12] The term "adviser" (with an "e") is defined in the 2006 Pension Protection Act, the Investment Advisers Act of 1940, and various state securities laws. A "registered investment adviser" is a firm or individual (a registered investment adviser representative or "RIA") that is registered with the SEC or a state. *See, e.g.*, FI360, CENTER FOR FIDUCIARY STUDIES, PRUDENT PRACTICES FOR INVESTMENT ADVISORS, DEFINING A GLOBAL FIDUCIARY STANDARD OF EXCELLENCE (fi360, 2006-2013) [hereinafter "Prudent Practices for Investment Advisors"]. fi360 "is the leading fiduciary training and resources organization in the United States." *Id*. at 6. Its affiliate, the Center for Fiduciary Studies "is the standards-setting body for fi360 and is supported by a team of experienced investment practitioners, attorneys, educations and other professionals." *Id*. Herein, the term "advisor" is used to describe investment advisors generally (including "advisers"), and the term "adviser" is used with specific reference to the statutes and regulations using that term.

[13] FI360, PRUDENT PRACTICES FOR INVESTMENT STEWARDS, DEFINING A GLOBAL FIDUCIARY STANDARD OF EXCELLENCE (fi360, 2006-2013) [hereinafter "Prudent Practices for Investment Stewards"] at 7.

[14] Prudent Practices for Investment Stewards at 7.

Silo One: Investment Strategy Due Diligence

Investment strategy due diligence is typically conducted by investment advisors and stewards (or by third parties to whom they have delegated such responsibility) with respect to daily liquidity securities, which include publicly traded stocks, bonds, mutual funds and exchange-traded funds. Investment strategy due diligence commonly involves investigating (or relying on others to investigate) areas such as potential returns and market risks, but not the operational aspects of the issuer or fund sponsor. Instead, the investigation takes into consideration, among other things, the kinds of investments being made and how they may compare to other alternatives in terms of short-term, long-term risk adjusted rates of return and similar factors. While there is no definitive list of the components of investment strategy investigation due diligence, areas of focus may include strategy (*e.g.*, what is the risk profile of the investment and how does the risk compare to the projected return and other alternative opportunities in the same sector), execution of the strategy (*e.g.*, are the people involved in executing the strategy experienced and skilled), likelihood that the investment will be successful (*e.g.*, is its management team stable and its strategy consistent) and expected deviation from any relevant benchmark (*e.g.*, how much variation is there from a passive investment in an index fund).[15]

Silo Two: Operational Due Diligence

Operational due diligence is typically conducted by investment advisors and stewards (or by third parties to whom they have delegated such responsibility) with respect to alternative investments which lack daily liquidity. Such investments typically include hedge funds, private equity funds and venture capital funds, among others. Alternative investments tend to be offered through unregulated or lightly regulated investment vehicles that aggregate capital from many investors to make collective investments in securities and other assets. Such funds typically are professionally managed and are available exclusively or primarily to institutional and high net worth investors. They commonly are organized as limited partnerships or limited liability companies and therefore "pass through" their net profits and losses to investors. These funds typically are open-ended in that they permit additions or withdrawals to capital accounts by investors, but usually only within specified windows and often subject to notice requirements. Such investments have elements of operational risk that distinguish them from publicly traded stocks, bonds and cash, most notably their lack of daily liquidity. Operational due diligence often is concerned with things such as the business, finances and operations of the fund and/or fund manager.[16]

CONCLUSION

Due diligence typically is conducted by a multi-disciplinary team involving principals, attorneys, accountants, intermediaries and subject matter experts. No one party, no matter how capable or diligent can investigate these areas alone. Thus, the practice of due diligence varies with positional, transactional, temporal and situational context. Moreover, as explained above, in securities offerings and negotiated transactions, there are three silos of investigative or reliance-based activity: business and operational, legal and regulatory, and financial and accounting. In the case of financial services, there are two such silos:

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[15] *See generally*, Prudent Practices for Investment Advisors at §§ 3.1 and 3.3.
[16] *Id*.

investment strategy and operational due diligence. Thus, the investigatory practices differ within these two categories. In each instance, however, a relevant benchmark for assessing the appropriateness of the practices employed is what others in similar circumstances are doing during the time in question.

About the Author

G. M. Lawrence is a prominent transactional and due diligence scholar whose academic work has been cited authoritatively in numerous publications, by the Federal District Court for the Southern District of New York and in pleadings before the Supreme Court of the United States. He also has advised the U.S. Securities and Exchange Commission regarding such matters and has served as a consulting expert in a number of high profile cases.

Professor Lawrence is a member of the adjunct faculty of the Dedman School of Law of Southern Methodist University where he teaches due diligence studies to MBA, JD and LLM candidates, the founder and executive director of the independent Center for Advanced Due Diligence Studies, and managing principal of Applied Research & Analytics, a consulting firm. He also is executive chairman of the investment firm, Pacific Financial Group.

He is the author of the two-volume treatise *Due Diligence in Business Transactions*, a leading work in the field for more than 20 years, and the graduate textbooks *Due Diligence, Reliance and Verification: Law, Standards and Practice*; *Due Diligence: Law, Standards and Practice* and *Due Diligence, a Scholarly Study*. He is co-author of the treatise *Representing High Tech Companies*. Recently, he served as Visiting Due Diligence Scholar in Residence at the University of London.

Professor Lawrence holds a FINRA Series 65 license, a professional certification in Strategic Decision and Risk Management from Stanford University's Center for Professional Development and a J.D. degree from Vanderbilt University Law School.

He is a current or former member of or active in, among others, the Securities Industry and Financial Markets Association Compliance and Legal Society, Investment Management Consultants Association, the National Association of Retirement Plan Advisors, the National Association of Corporate Directors, the Society of Decision Professionals, the Global Association of Risk Professionals, the Society for Judgment and Decision Making, the Academy of Financial Services and the American Securitization Forum, and has been admitted to the state bars of New York, the District of Columbia and Texas.

Previously, Professor Lawrence was a global managing partner with a global law firm where he founded and taught the firm's due diligence training program, managed the firm's investment fund and chaired the technology, media and telecommunications practice. He was a member of the firm's management, strategic planning, compensation and other committees. Professor Lawrence also has served on the board of directors and various committees of public and privately held companies.