

## **TRANSACTIONAL SKILLS TRAINING: ALL ABOUT DUE DILIGENCE**

**DOUGLAS GODFREY\***

### **INTRODUCTION**

Due diligence is a paramount investigation for civil lawyers. Unfortunately, lawyers do not perform due diligence well because we do not have a systematic approach. We do not identify a case plan, methods, or tools, and we are not conscious of our constraints—time and money. Thus, law schools should teach investigation skills to better prepare new lawyers to effectively perform due diligent work. So, what is due diligence, and how can it be incorporated into the law school curriculum?

**CHARLES FOX\*\***

With respect to training due diligence and doing due diligence, there is good news and there is bad news. The good news is that due diligence is something that the new lawyer, fresh out of law school, actually does compared to other skills, such as client counseling and drafting complicated agreements. Typically, a first-year lawyer does not get to do the latter, but when it comes to due diligence, they are sent off to do it from the start. Thus, due diligence is a practical requirement that new lawyers must learn while on the job. The bad news is that invariably the first-year lawyer, no matter how smart, is absolutely unqualified to do this job. The primary purpose of due diligence is to find hidden problems, and by definition, a first-year lawyer is not going to have the experience to identify those types of issues.

When associates are given a due diligence assignment, they are often handed a box of contracts and asked to summarize each one. Typically, they have no idea what to do because they do not know what is important and what is not important. One approach for due diligence training at a law firm includes four segments. First, demystify the whole practice of due diligence. Second, give the associates a strategy for handling their assignment and how best to deal with the fact that they really do not know what they are looking for or what they are doing. Then, provide some

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\* Douglas Godfrey is an Associate Professor of Legal Research and Writing at Chicago-Kent College of Law, J.D., University of Michigan Law School; M.A. University of Illinois at Urbana-Champaign; B.A., University of Illinois at Urbana-Champaign. He may be reached at [dgodfrey@kentlaw.edu](mailto:dgodfrey@kentlaw.edu).

\*\* Mr. Fox is a former partner at Skadden, Arps, Slate, Meagher & Flom LLP, founder of Fox Professional Development L.L.C., and Adjunct Professor at Pace Law School, J.D., Rutgers Law School; B.A., Queens College, CUNY. He may be reached at [cfox@foxprof.com](mailto:cfox@foxprof.com).

specific due diligence issues for certain specific transactions. And last, have the lawyers, in teams, do an exercise. For the exercise, they receive a packet that includes the fact pattern, the specifics of the deal, and set of corporate documents such as a charter, bylaws, board minutes, and contracts. Instruct the lawyers to look through various documents and be prepared to discuss where they see problems and how to fix these problems, and discuss any indicators that other information is needed.

## I. DUE DILIGENCE: THE DEFINITION & PROCESS

### A. Defining Due Diligence

The first step in demystifying the process is to define due diligence. Due diligence is not what most young lawyers think it is. It is not searching for the needle in the haystack, a wild good chase, or simply looking for red flags. Rather, due diligence is very simple because we all do it every day. Due diligence is analogous to buyers inspecting merchandise before they buy. Every business deal involves due diligence because the parties are concerned about factual issues relating to their decision to enter into the transaction and about the terms on which they are willing to do the transaction—this is the simple definition of due diligence.

Due diligence, as well as the negotiation of representations and warranties, flows from a very basic principle of our economic and legal system—the principle of *caveat emptor* or “let the buyer beware.” In most transactions, no party has an obligation to disclose information to the other party, except in certain areas like securities transaction. Young lawyers need to understand that due diligence is done to protect their client against potentially adverse facts.

Due diligence may be very broad or very narrow. The broadest types of due diligence exercises are those done in connection with security offerings or acquisitions. A buyer of a company wants to know everything significant about that company. In the context of doing a securities offering, the issuer or the underwriter, and others face potential liability if they fail to disclose all the material and relevant information regarding the issuer and the security in the offering documents. Thus, in the due diligence exercises you want to find everything that is material, and that is a very difficult task to give to a junior lawyer because they do not know what is material. Narrower types of due diligence assignments typically are related to negotiating specific reps and warranties, or giving specific legal opinions. When firms give a legal opinion that the execution, delivery, and performance of a new agreement does not conflict with any of the company’s existing agreements, that is a much narrower due diligence exercise. Essentially, the lawyer is reading the company’s existing contracts to determine whether there are any conflicts.

Likewise, when the parties negotiate representations (reps) and warranties, the results are documented in disclosure schedules that are completed through a due diligence process of all the relevant facts. But, for young associates it helps to demystify the process by showing them that due diligence on a larger scale can be a huge process. In a typical acquisition, the due diligence process is not simply first-year lawyers looking through boxes of documents. The process also includes experts in various areas looking at any subject that the buyer, in the case of an acquisition, is interested in. For example, if your client is looking at an acquisition of a pharmaceutical company, and the company has patents, probably some patent lawyers or patent experts will look specifically at that area. Thus, the due diligence process as a whole covers any issue that a buyer or an investor would possibly care about. Accountants, environmental experts, litigators, and others will be involved in different aspects with one person at the top, usually a senior lawyer, who is responsible for organizing the entire process.

The junior lawyer's role in due diligence is much narrower. Typically, associates review corporate documents—charters, bylaws, board minutes, and stock transfer books—and contracts. With respect to contracts, the most important concern is potential conflicts between the contracts pertaining to the deal and the company's existing contracts. Representations in most agreements require the parties to represent that by signing the deal contract, they are not violating existing contracts. This is a completely different conclusion from the conclusion that the company is generally in compliance with all its agreements, for which it is almost impossible to provide a legal opinion. You would not only need to review their contracts and know all of the facts, but you would also need to know all the company's activities since the inception of the contract to determine whether they have complied since its inception.

To illustrate a contract conflict, consider that Party A and Party B have an agreement with a covenant that requires Party A to do X. Then, Party A begins to negotiate an agreement with Party C in which Party C wants Party A to agree not to do X—a potential conflict. Young lawyers who are asked to do due diligence often have difficulty figuring out whether a conflict exists because they are not skilled at reading contracts and typically do not know what is going on in the second deal. They may know that Party A is selling a business to Party C. But, they may not know whether it is a stock transaction or an asset transaction. They may not know what ancillary obligations Party A might have under that agreement, and in fact, the due diligence is often done before the deal really takes shape and before you know exactly what Party A's performance obligations are under the contract with Party C. Thus, it is impossible to do a proper analysis as to whether performance of those obligations is going to breach any of their preexisting obligations in their deal with Party B.

### **B. Discovering Conflicts**

So why are conflicts such a big issue? The subject of conflicts can be almost anything, including whether the party can grant liens, incur debt, sell assets, merge, sell or issue stock, make investments, create subsidiaries, engage in cash and non-cash transfers among related parties, or conduct transactions with affiliates. As an example, assume your client, a manufacturer, is considering a debt financing in which it is required to pledge all their assets to secure the debt. But, the due diligence reveals that a number of leases prohibit the client from granting a security interest in equipment located at those premises. That is a classic conflict. If you allow the client to enter into the new transaction with a lien on the equipment in violation of the leases, there will be significant consequences.

What are the options for the manufacturer? One solution is to obtain a waiver from the landlord with respect to the pledge or security interest in the equipment. Alternatively, the manufacturer must inform the lenders in the secured financing that it is unable to grant a security interest in the particular equipment. As a third option, the manufacturer could terminate the leases. This example illustrates how critical due diligence can be and how it gives rise to significant impact on the transaction. In fact, due diligence reviews might reveal issues that could blow up the deal or make it unattractive from a client's standpoint. Thus, we see the criticality of the due diligence process and identifying any potential conflicts.

There are several issues that arise from contractual conflicts. First, in the scenario with the three parties we previous discussed, Party B, the first contracting party with Party A, will have a claim for tortious interference against Party C. As an example, twenty years ago Texaco was forced into bankruptcy because they signed a contract with Getty Oil to acquire Getty after Getty had a binding contract for its sale to Pennzoil.<sup>1</sup> Pennzoil sued Texaco and received a \$10 billion judgment from Texaco, and Texaco, unable to obtain a supersedeas, was forced into bankruptcy.<sup>2</sup> So, tortious interference is a real issue.

Additionally, if there is a conflict that is not discovered and addressed, the second contract is likely to be in default from the beginning. Almost invariably, there is a representation in the second contract that states that there are no conflicts. The first contract may also be breached as a result of the conflict, particularly if there

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<sup>1</sup> See E. Allan Farnsworth, *Development in Contract Law during the 1980's: The Top Ten*, 41 CASE W. RES. L. REV., 203, 210-11 (1990).

<sup>2</sup> See *id.*

are similar representations in the first contract that have to be brought down periodically.

Another risk with conflicts is that the second contract may be unenforceable in whole or in part. Even sophisticated lawyers fail to consider this effect and, although aware of the conflict, accept the risk of the conflict and suggest that the no-conflict legal opinion will carve out the conflict issue. The result is a much broader issue of enforceability. Case law, which is summarized in section 194 of the *Restatement (Second) of Contracts*, provides that provisions in a new contract that are in conflict with an existing contract are unenforceable.<sup>3</sup> In fact, the entire new contract might be unenforceable. Of course, if the attorneys agree to carve out the conflict issue in the no-conflicts opinion and give a clean enforceability opinion, the opinion is likely incorrect. Furthermore, to the extent any of the companies involved in the transaction are public companies, their failure to disclose the risks may be a violation of securities law.

### C. Strategizing Due Diligence Assignments

Accordingly, young lawyers need to understand how important their contract reviews are in the due diligence process. If the lawyers are told to just summarize agreements, they must keep their eye on potential issues. However, associates need a strategy when completing their assignment. They typically receive little to no guidance by the senior lawyer who has given them the assignment.

Instead, the associates must be proactive and force the senior person to explain the situation. To do due diligence properly, associates must understand the company, the transaction, and their particular assignment. Also, associates need to be able to visualize issues to look for during their review. But, associates have to proactively seek information. An associate sitting in a partner's office getting a due diligence assignment, or any assignment, should ask if the partner has any other materials that might show the structure of the transaction, describe the company, or provide other relevant background information. If associates are forceful and proactive in trying to understand what is going on, they will be better able to do the job.

At the end of the day, no matter how smart they are or how much training they have, associates are still much less qualified than they need to be because they lack the level of experience, judgment, and intuition necessary to discover all the problems. That unfortunately is a fact of life.

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<sup>3</sup> RESTATEMENT (SECOND) OF CONTRACTS § 194 (1981).

**EDWARD C. HARRIS\***

### **I. TEACHING DUE DILIGENCE TO LAW STUDENTS**

It is useful to first focus on the words in the definition of due diligence to help the student think about the concept. So, what does due diligence mean? “Diligent inquiry is such inquiry as a diligent [person], intent upon ascertaining a fact, would ordinarily make . . . [and] [i]t is [an] inquiry made with diligence and good faith to ascertain the truth . . . [and] must be an inquiry as full as the circumstances of the situation will permit.”<sup>4</sup>

For a lawyer to perform due diligence competently requires a diligent attention to detail, ability to think creatively, flexibility to fit the particular situation, and the ability to use methodological approaches to discover all relevant information. In essence, due diligence requires a thoroughness and the ability to take the discoveries and convert them into language that protects the client’s interest.

Due diligence is an important function that almost every transactional lawyer will engage in at some point in their career, and most likely, towards the beginning of that career. However, litigators should also understand the concepts and methods of due diligence. If we are to create competent lawyers, they should be introduced to these concepts and how to develop a flexible and methodological approach to due diligence before practicing in real life, where the stakes are very high. An introduction to due diligence will give lawyers a sense of the level of detail necessary to perform these tasks competently.

From a pedagogical perspective, due diligence is best taught as a collaborative process with emphasis on experiential learning through a collaborative exercise. Due diligence is essentially a collaborative process. For any acquisition or deal, a due diligence team with several lawyers will be assigned to review the data files or look through the data room that has been set up for the deal. The lawyers must also collaborate with their boss. Thus, the professor could play the role of the partner in the firm, assigning the tasks and telling the groups of young lawyers to find the information and issues. A collaborative exercise will likely be more engaging, fun, and interesting for the students and the professor.

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\* Edward Harris is a Visiting Associate Professor of Law for the International LL.M. Programs at Chicago-Kent College of Law, J.D., Chicago-Kent College of Law, 2001; B.A., Loyola University Chicago. He may be reached at eharris@kentlaw.edu.

<sup>4</sup> Liepelt v. Baird, 161 N.E.2d 854, 857-58 (Ill. 1959).

A due diligence exercise will also be experiential learning. The students learn by doing through these simulation exercises. The students are given a due diligence task under simulated conditions and prepare work product based on a set of facts and the findings of the due diligence investigation. Then, the professor can review and critique the work product and provide feedback on the reasoning process and identify any adjustments that need to be made to put the student on the proper path.

## II. HOW TO IMPLEMENT DUE DILIGENCE IN THE CLASSROOM

### A. Drafting Exercises

There are a number of ways to implement teaching due diligence. First, due diligence concepts could be taught in a straight drafting exercise. This would involve the professor providing a set of facts, including items discovered through due diligence, and having the students draft an agreement (or a few provisions of an agreement) that incorporates the findings in a manner that protects the client's interests. The professor could have the students either start from scratch in drafting language or give them some boilerplate language for them to adapt to the specific discovery. Thus, the straight drafting exercise is quite simple and, with a minimum investment of time, exposes the student to due diligence and converting a due diligence discovery into drafted work product.

The drafting exercise could be expanded into a research plus drafting exercise, whereby the students research a provision of law to identify the kind of language necessary to protect the client's interest. For example, a relatively focused exercise would involve having the students determine whether the restrictions discovered on the back of share certificates for a company are legal and enforceable under the state's corporation act. Thus, the student must research the law and draft work product that reflects and explains their research findings and conclusions (and perhaps further explains these findings in a short memo excerpt to the partner or client).

### B. Negotiation Exercises

Alternatively, due diligence could be taught in connection with negotiation exercises. Information that is discovered through due diligence often affects the bargaining positions of the parties, the negotiations, and the legal language of the agreement.

For the negotiation exercise, the class could be split into two groups, one group representing the buyer and the other group the seller. Then, the students would be further paired with students from the other side. The student representing

the seller would be assigned the task of drafting the documents, and the student representing the purchaser would be provided with information that was discovered through due diligence. Then, the students negotiate the effects of the information on the deal—the value of the deal and the price of the acquisition. The student charged with drafting the document would incorporate the effect of the negotiations into the provisions. The roles could be switched to give each student drafting experience using new or additional facts.

### **C. Client Counseling Exercises**

A third type of exercise in which due diligence can be incorporated is a client counseling exercise. Young lawyers may be required to draft a client counseling letter for a partner. The challenge is to take sophisticated legal concepts and convert them into user-friendly language so that the client can understand. For the client counseling exercise the student would convert a due diligence discovery into proposed contractual language and then communicate to the client the findings, the legal implications, and how the language they have drafted protects the client's interests.

## **III. INCORPORATING DUE DILIGENCE INTO THE CURRICULUM**

The next challenge in teaching due diligence in law school is where to incorporate it into the curriculum. Courses in the current curriculum—first-year legal writing and upper division legal writing courses—are already likely packed, making it difficult to incorporate one more thing into the syllabi. A due diligence exercise, though, is most productive where the students have had an introduction to contracts, but they do not necessarily need to have completed the entire first-year course. Thus, due diligence could be incorporated into legal writing courses (end of first-year or in upper division writing courses if offered), but need not be placed exclusively here. This important training could also be provided in courses covering corporate transactions, real estate transactions, commercial law, or international business transactions.

### **DOUGLAS GODFREY**

Additional considerations for professors teaching due diligence in law schools include:

- Acknowledge and adjust for inexperience and lack of knowledge of the students;
- Provide a lecture upfront to train students on what due diligence is;



- Incorporate feedback mechanisms or discussions with students on the exercises and grade accordingly once the students have the experience and knowledge;
- Keep topics and tasks of due diligence exercises limited and focused;
- Provide an informational package to students to include, for example:
  - Background of the business and parties involved;
  - Knowledge about the transaction;
  - Specific issues to be addressed;
  - Correspondence pertaining to the transaction and issue; and
  - A checklist of items the students should address or consider; and
- Reinforce student's responsibility to learn about the transaction, the business, and the laws to perform the due diligence exercise.

Remember, a valuable result of due diligence and other transaction exercises is that students learn what lawyers really do.