



Are the due diligence reports “in form and substance satisfactory to Lenders”?

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Receipt of due diligence reports in “form and substance satisfactory” to Lenders is usually a Condition Precedent in project finance loan agreements. Not only is this protection required to assure Lenders that the project they are lending to meets their credit requirements, but these reports are also needed to sell down the loan to participant banks.

When I first started working on project finance transactions, it was customary for banks to appoint their own “independent” consultants. The project owners paid for the reports, but Lenders had a direct relationship with their due diligence consultants. The consultant’s reports were often backed by substantial levels of Professional Indemnity Insurance cover. The consultant’s primary duty of care was to the Lenders.

Competitive forces eventually forced Lenders to agree to rely largely or wholly on reports prepared by due diligence consultants for equity investors and project owners to avoid “doubling up on costs”. Along with this came substantial reductions in the level of Professional Indemnity Insurance cover offered by due diligence consultants. The levels of cover now offered do little to protect banks against the possible financial impacts of a material error in the reports. At best the only protection Lenders get is that there is some incentive on the consultants to get it right because of the risk of reputational damage and increased insurance premiums if a claim is made under these PI Insurance contracts. The primary relationship of the consultants is with the project owners and there is also often a relationship with the Financial Adviser who can be instrumental in generating repeat business. There is substantial potential for conflicts of interest.

Unfortunately, it does not stop there. A further dilution in the usefulness of these reports occurs if consultants add additional caveats in the “reliance language” that prefaces these reports. Some of these caveats the author has come across include:

- Limitation of the scope of the report to the specific instructions given by the client, including any predetermined materiality thresholds, as outlined in the underlying due diligence report and without regard to any potential additional areas of concern of the third parties to whom the report is being provided.
- Limitation on the timeliness of the report to the date provided, with no duty to update beyond such date.
- Limitation on the extent of reliance by such third party to reliance only for purposes related to the underlying transaction and a limitation of the duty owed by the due diligence firm to the third party to a duty no different from, and no greater than, the duty owed by the firm to its client.
- Statement that the due diligence firm reviewed only the material provided and undertook no additional factual investigation (desk top review).
- Disclaimer that the due diligence firm limited its diligence review to matters of a legal/technical/regulatory nature expressly excluding review of certain specified areas, and without undertaking to provide an analysis of the commercial nature of the acquisition.
- Disclaimer that the due diligence firm undertook no independent verification of the information provided and that it assumed the validity, completeness accuracy and accuracy of the information provided.
- Inclusion of a cap on the liability of the firm to the third party or a cap on the aggregate liability owed by the firm to both the client and the third party, in each case either in the form of an absolute amount or in the amount of the transaction value.

As they say, "caveat emptor".

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