Vendor Due Diligence: Could It Catch On Here?

By Lee J. Potter, Jr.

The due diligence process associated with most prospective M&A transactions here in the United States tends to generally follow a fairly well-worn path. A buyer’s legal and financial advisors will review documentation provided by the seller or the target company and perhaps interview members of its management. Other advisors hired by the buyer, such as environmental consultants, will separately perform inquiries. Thereafter, the advisors will prepare one or more written reports for the client to review. These reports (at least the legal report prepared by the buyer’s counsel) will usually contain language stating that no party other than the client may rely on its contents.

Over the past decade or so, a quite different process has become popular in many European jurisdictions, at least in situations involving auctions. This alternative approach, referred to as “vendor due diligence” or “VDD,” is now fairly common in transactions involving multiple potential buyers. In a typical VDD, the seller, rather than the buyer, will hire financial, legal and/or tax and other advisors to review the relevant documentation of the target company. These advisors will then prepare drafts of written reports that will be provided to prospective buyers to review. Prior to receiving a copy of the draft report, each prospective buyer first must sign a non-reliance letter agreeing that the report provider has no liability to that prospective buyer for any mistakes or omissions that may be contained in such draft reports. Once the non-reliance letters are signed and delivered, the draft VDD reports are then provided to the prospective buyers for review. In addition to reviewing the VDD reports, the seller oftentimes will allow the bidders, or perhaps a select subset of them, access to the underlying documentation of the target for purposes of performing confirmatory due diligence. The time period permitted for such confirmation will vary, depending on numerous factors, such as the amount of documentation, the detail of the VDD reports, and the relative bargaining strength of the seller and buyers. However, the amount of time allotted likely will be less than would have been the case if no draft VDD reports had first been provided and the prospective acquirers instead were performing their own due diligence.

Some VDD processes culminate with the report providers delivering to the ultimate buyer a final copy of the VDD reports at the time the buyer signs the definitive acquisition agreement. The report providers and the buyer will, at the same time, enter into an agreement that permits the buyer to rely on the final reports, subject to the terms and limitations contained in the agreement (these terms usually include a cap on liability).

The VDD process offers some interesting potential advantages when compared to the buyer-led due diligence process with which U.S. dealmakers are familiar. When there are numerous prospective buyers, providing them with draft VDD reports rather than having multiple sets of advisors involved would reduce significantly the burden on the seller to respond to multiple document requests and redundant queries. It would also reduce the amount of time bidders need to obtain a reasonable familiarity with the target company’s businesses, operations, finances and legal issues (depending on the scope and detail of the reports). It would also reduce the cost to prospective buyers, particularly in the initial stages of their inquiry, when they might otherwise need to incur significant legal and other advisory fees to gain a baseline understanding of the target company. These cost savings could result in more prospective buyers remaining in the hunt and might result in a higher purchase price or better sale terms for the seller. In addition, delivering a draft VDD report that describes all known material risks and liabilities of a target company diminishes a prospective bidder’s ability to submit a high initial bid merely to get exclusivity and later negotiate a lower price based on problems subsequently discovered. Lastly, having fewer advisors involved reduces the risk that news of a confidential sales process could be leaked.

The VDD process clearly has some potential disadvantages as well. First, a seller or target company has to incur the costs of hiring legal, accounting, and perhaps other advisors to prepare the VDD reports. These costs could be rather significant if the intent is to provide prospective buyers...
with reasonably comprehensive reports covering most or all material aspects of the target’s businesses, finances, operations, and liabilities. (If the reports are not comprehensive, prospective buyers will reasonably assert that they will need to undertake additional due diligence to fill in the gaps.) Secondly, a buyer may be reluctant to place sole or primary reliance on the contents of the reports, as they are prepared by advisors for the seller, rather than its own advisors. Thirdly, the information in the reports would usually be presented in a very dry and stiff format, with little or none of the insight, advice, or recommendations that a buyer might expect from a report prepared by its own advisors. Lastly, VDD may pose some vexing issues for U.S. law firms involved in such projects.

A U.S. law firm that is invited to participate in a multi-country VDD needs to understand up front the contemplated process and the expectations of the parties, and carefully assess its risk exposure. It is not customary for an American law firm to permit a non-client to rely on a report prepared by it. Most U.S. law firms will not permit a non-client even to see its due diligence report unless the non-client first signs a letter agreeing that it may not rely on its contents. This practice presumably results from liability concerns—malpractice claims against law firms are more commonplace here in the United States than elsewhere. Moreover, ethics rules applicable to lawyers in the United States disallow them from capping or otherwise limiting the amount of their liability for malpractice. A U.S. law firm that contractually permitted a buyer to rely on its due diligence report therefore would be liable, without any limitation, for any losses incurred by the buyer that result from mistakes or omissions contained in its report. Moreover, when preparing the report, the law firm would not yet know the identity of the ultimate buyer, and thus would not have an understanding of that buyer’s particular concerns or focuses. It is difficult to envision a law firm here in the United States agreeing to such an arrangement.

Therefore, before an American lawyer accepts a VDD engagement, he or she should have a clear understanding of the anticipated process, including whether the lead law firm or office (which may be a separate firm in the country of the seller or perhaps a foreign office of the same firm) will be required to deliver a reliance letter to the ultimate buyer, and whether the U.S. firm or office is itself expected to also deliver such a letter. A process that contemplates the U.S. firm itself affirmatively agreeing to permit reliance on its VDD report by the buyer may prove to be too unpalatable for the firm to accept. Alternatively, the foreign lead law firm may decide to include the U.S. information within its own VDD report, under its own name. This approach affords the U.S. firm at least a possibility that any dispute over U.S.-related information in the report would take place between the lead firm and the buyer, with the U.S. firm remaining in the background (albeit with liability over to the lead firm as its subcontractor), and that any resulting liability would be subject to the agreed-upon cap. However, even if the U.S. firm has no direct contact with the buyer, the buyer might nonetheless decide to file a malpractice claim directly against the U.S. firm in an American court. Such a claim would not be subject to any contractual cap, as (1) malpractice is a tort, not a contract-based claim, and (2) applicable ethics rules in the U.S. disallow lawyers from capping their liability in the terms of their engagements.

Because of the differences in the U.S. legal system versus those of European countries, VDD, at least in its most full-some form that permits buyer reliance on the final reports, is not likely to become popular here in the United States. Even so, U.S. lawyers need to be somewhat familiar with this growing European practice, in order to properly address potentially problematic issues that could arise should they be invited to participate in such a project.

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