Why U.S. Private Equity Funds Should Adopt Sell-Side (Vendor) Due Diligence with a Twist

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As a busy U.S. sell-side lawyer, I am finding that private equity buyers and sellers are becoming extremely fatigued with the buyer due diligence process. Repetitive buyer due diligence requests and management meetings are taking too much time and effort, distracting management from running the business and slowing the sale process (with every day of delay increasing the chances that customers, suppliers and employees will learn of the deal). Furthermore, buyers sometimes use the due diligence process to negotiate down the purchase price after a "winning" bid based upon due diligence uncovered later in the buy-side process (increasing the risk of a busted deal). If a seller can expedite and control the due diligence process, then there is a better probability of accomplishing the primary seller goals of increasing the likelihood that a deal will close quickly and confidentially and on the price and terms contemplated by the letter of intent, while reducing overall professional fees and transaction costs.

In Europe, the seller (vendor), prior to going to market, retains legal, accounting, and other relevant advisors to prepare the vendor due diligence reports (VDDR). In this process, the seller can get ahead of any issues that might result in the lowering of a bid or even having a bidder walk away from the bidding process. Having worked on European VDDR concerning U.S. legal, regulatory, and political risks, it seems appropriate that U.S. private equity funds should consider utilizing a sell-side process in which all prospective buyers are presented with a VDDR (subject to a twist as suggested below) and given a more limited period of time to buyers to conduct their due diligence.

ADVANTAGES OF VENDOR DUE DILIGENCE

Vendor due diligence has advantages to the sellers and the buyers.

Advantages to vendor due diligence to the seller include:

1. The due diligence process would be much more efficient if all prospective buyers receive the exact same information packaged in one report and group informational answer sessions can be set up.
2. Buyers' ability to conduct an initial due diligence analysis would be accelerated by the VDDR. Shortening the due diligence timeline reduces the seller's professional fees as the process becomes much more streamlined and efficient. Sellers may require written questions to the VDDR. Sellers can then respond at one time to major issues that may arise to one or all parties.
3. Having fewer advisors involved reduces the risk that news of a confidential sales process could be leaked.

4. Post-bid price reductions are reduced, as there are fewer due diligence concerns popping up later in the due diligence process.
5. With less uncertainty as to unknown risks, buyers may be more likely to make higher bids rather than building in reduced pricing due to unknown or undisclosed risks.

Advantages of vendor due diligence to the buyer include:

1. Reduced initial due diligence costs as the seller has incurred the initial costs. With less upfront costs, buyers may be more inclined to look at the seller as a potential target.
2. Buyers can focus their advisors on major issues which should reduce costs in terms of having a VDDR reviewed as opposed to prepared de novo.
3. European buyers will be attracted to U.S. sellers with the foresight to utilize a VDDR.

DOWNSIDES TO VENDOR DUE DILIGENCE

There are certain potential negatives in vendor due diligence. For example, from the seller's perspective, potential disadvantages largely consist of (i) increased upfront time and associated (and potentially significant) cost involved in having outside advisors prepare the VDDR, (ii) the prospect that the items disclosed will affect negatively the sales price, (iii) concerns, in the case of disclosures about pending or threatened litigation and/or governmental investigations and proceedings, of waivers of attorney-client privilege, (iv) the prospect that, notwithstanding the seller's best efforts, it will still be forced to respond to multiple, conflicting and time-consuming requests for follow up diligence and meetings, and (v) the risk that there will not be any tangible benefit to it in terms of an increased sales price and/or more favorable indemnification terms than it would otherwise have achieved had it simply left each bidder to its own device in carrying out diligence.*

PROFESSIONAL LIABILITY ISSUE

In Europe, it is standard practice is to provide the recipients of VDDR final reports the right to rely on the report subject to certain caveats, such as a cap on liability. U.S. advisors either cannot or will not want to create an attorney-client or professional service client relationship with an unknown third party. Thus, a non-reliance letter, in the context of a legal due diligence report, serves primarily to record the recipient's acknowledgment that delivery of the report does not establish an attorney-client relationship between the law firm and the recipient of the report. It also contains disclaimers to the effect that the preparing firm has not consulted with the recipient in connection with defining the scope of the report and, as a result, it is possible that the recipient may have different interests and views of materiality from those expressed by the preparer of the report. Finally, the non-reliance letter contains a waiver and release by the recipient of any and all claims it may have against the preparing firm with respect to the report. Thus, the recipient uses the report at its own risk and the provider takes no responsibility for its contents and disclaims any responsibility to update the report. However, it is generally much easier and cheaper to confirm a VDDR report than to prepare one de novo.

A HYBRID APPROACH TO U.S. VENDOR DUE DILIGENCE

I would suggest that the private equity funds also consider modifying the European style of VDDR to include a quality of earnings analysis as well as a tax analysis, which could include deal structure issues, confirmation of payment of U.S. state and local taxes and foreign taxes (as applicable), support for projections and EBITDA or adjusted EBITDA, verification of tax elections, etc. In addition, cybersecurity and technology risks could also be added to the U.S. VDDR disclosures.

Furthermore, U.S. professional service firms will prefer non-reliance language which should help keep the cost down on the projects. In today's competitive sales market, this hybrid approach should be very attractive to both sellers and buyers. As to the acceptance of non-reliance language in the VDDR, this author's opinion is that buyers can understand the risks and make their own determination what their own professional advisor need to focus on.

Lastly, the primary goals of an efficient sell-side process are: (i) closing quickly, confidentially and efficiently, and (ii) maximizing after tax and claims consideration. A VDDR or other front-end loaded process accomplishes both goals. Thus, even if the VDDR process is not followed exactly, the aforesaid goals are much more likely to be accomplished if the seller proactively takes the front-end actions discussed above (e.g., sell-side quality of earnings, sell-side diligence, etc.) and perhaps also sends out a proposed purchase agreement with complete schedules.

** United States: Vendor Due Diligence Reports: A Tale Of Two Markets, by Jeremy W. Dickens, Esq., Mondaq and previously published in The International Comparative Legal Guide to: Private Equity 2015.*

Please contact Ted D. Rosen, Esq. at ted.rosen@akerman.com or 212.259.8711 if you have any questions regarding this article. Special thanks to Carl D. Roston, Co-Chair, Corporate Practice Group at Akerman LLP for his insightful comments to this article. This article is intended for discussion purposes only and should not be relied on without obtaining legal counsel.