



Legal Vendor Due Diligence: Staging a Successful Sale

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As anyone who has sold a house knows, the housing market can be an incredibly competitive one. Home sellers take such steps to maximize the value of their properties as home staging, hosting open houses and providing potential buyers with pre-sale home inspections. Real estate agents routinely recommend that home sellers commission, at their own cost, a pre-sale home inspection from reputable inspectors to provide to potential buyers. Such pre-sale inspections are aimed at setting the stage for a competitive auction by providing more information at little to no cost to the bidders. The purpose of performing such diligence is to help dispel fears about unknown risks in the interest of increasing the number of bidders and the prices at which they bid. Innovative deal teams in Europe have been applying these same principles to selling businesses as well.

In Canada, legal due diligence in an M&A transaction is traditionally a buyer-driven process. In a typical merger or acquisition, a due diligence review of documentation provided by the seller or the target company is conducted solely by the potential buyers and their advisers. However, European sellers' counsel, much like home inspectors, frequently perform the legal due diligence investigation in advance of a sale and produce what is commonly known as a vendor due diligence (VDD) report. The VDD report is, subject to confidentiality restrictions, provided to bidders and may ultimately be relied on by the successful buyer.

In the context of private equity and auction sales, VDD reports have been widespread and routine in European jurisdictions for several years. They are now becoming less of an anomaly in the United States and have made an exceptional appearance in a small number of Canadian transactions. While the desire to maximize value is not new, sellers are increasingly looking to achieve the highest possible bid prices in combination with short timeframes and tight turnarounds. VDD reports can help curtail the amount of time that typical due diligence reviews and transaction negotiations take. In a buyers' market, in particular where experienced multi-national buyers are involved, legal VDD in Canada could become as customary as pre-sale home inspections.

VENDOR DUE DILIGENCE PROCESS

The VDD approach involves a seller engaging third parties to conduct due diligence and prepare a report in the early stages of a sale process. Financial and tax VDD has been common in competitive bids as has environmental and real estate VDD in certain industries. Similarly, legal due diligence focuses on the risk profile of the target assets or business to be sold.

The seller will pay some or, most likely, all of the costs of preparing the VDD report. The VDD report is prepared on the basis that the third party adviser's mandate is to investigate and disclose all issues that would be material to a potential buyer. The VDD report will then typically be provided on a "reliance" basis only to the client, being the seller, which may rely on the information in the VDD report.

The VDD report is normally provided to prospective buyers during the earlier phases of a sale process, generally as a supplement to a confidential information memorandum. A copy of the VDD report will usually be released to a bidder only once it has signed a non-reliance letter whereby it acknowledges that it is not entitled to rely on the VDD report. By signing the non-reliance letter, the bidder will also agree not to disclose any information in the VDD report to third parties and to use the VDD report for the sole purpose of assessing the relevant transaction. Even with a non-reliance letter in place, there is the risk that a Canadian law society may take the view that a recipient of the VDD report is a client and that the non-reliance covenant is consequently unenforceable. Where strategic market participants are involved in the auction, redactions of competitively sensitive information may be required, at least in the early stages of the sale process.

As with a traditional due diligence report, the VDD report will include an executive summary highlighting material findings and legal issues. It will also provide a list of the documents reviewed and the information made available by the seller or target business, any outstanding requests and queries for the seller, the basis and assumptions on which the VDD report was prepared as well as any other limitations or qualifications to the report. Potential buyers will be provided with access to the underlying documents used to prepare the VDD report and may conduct confirmatory and limited followup due diligence, including documentary requests and due diligence calls with the authors of the VDD report.

With a comprehensive VDD report, any confirmatory or followup due diligence is likely to require less time and incur lower costs than a full due diligence review by multiple bidders. Certain potential buyers may even elect not to retain their own counsel at earlier stages of the sale process and may only do so once they have been selected to move into the advanced rounds of an auction.

In Europe, the usual practice is for the VDD report providers and the ultimate buyer to enter into an agreement prior to or simultaneous with the signing of the final acquisition agreement pursuant to which the buyer is permitted to rely on the VDD report, subject to terms and

conditions set out in a reliance agreement. In certain European countries, law firms are permitted to contractually limit their liability and obtain insurance to provide coverage for a large part of that exposure.

However, as is also generally the case in the United States, under Canadian law society rules, law firms are not permitted to limit or cap their liability, at least in respect of their clients. Major Canadian and U.S.-based law firms have thus far been unwilling to provide reliance in respect of their work product to any party other than their own clients. For example, the standard transaction legal opinions of all major law firms include strict anti-third-party reliance language. North American law firms providing reliance in respect of VDD reports would be a significant departure from past practice. Nevertheless, VDD reports can and have been distributed on a non-reliance basis and bidders still find them effective in evaluating and assessing the risks associated with a target business.

POTENTIAL ADVANTAGES

Legal VDD offers advantages to both buyers and sellers in complex transactions, particularly auction sales. Sellers are able to achieve a sale process that is efficient while optimizing value and purchase price. Meanwhile, potential buyers are able to avoid incurring high costs at the initial stages of a transaction while becoming better able to anticipate the potential risks of and benefits for integration. Such benefits can help to not only attract more bidders but to also keep more bidders interested in the early stages of the process. Efficiency is gained if sellers and bidders avoid the duplication of core work and multiple parties paying legal fees for similar services.

VDD allows for overall transaction risk to be minimized as any potential deal-breakers are identified and potentially addressed early in the sale process. The seller can ascertain where there are risks and liabilities that may be mitigated before commencing the sale process, such as obtaining approvals or remedying deficiencies in agreements, corporate records or licences. Where there are risks or liabilities that cannot be mitigated or remedied, the seller can prepare for negotiations in advance rather than having such issues spotted at a later stage when they could potentially derail a transaction or have a downward impact on the purchase price.

If defects and deficiencies are voluntarily disclosed, transaction documentation can be drafted to take them into account. The purchase and sale agreement and disclosure schedules can be prepared with material risks and liabilities already carved out of the representations, warranties and indemnities. At the same time, the impact of unknown risks in pricing models can be mitigated.

In providing a VDD report, competition in a bid scenario is increased as all potential bidders approach the transaction on an even playing field with the same level of knowledge. By disclosing risks and liabilities at



the outset, prospective buyers are less likely to submit initially high bids only to subsequently negotiate lower prices based on their own due diligence. Potential buyers may also become comfortable enough to enter bids with limited conditionality.

With the benefit of an existing VDD report, the potential buyer can focus on supplementary or confirmatory diligence specific to its needs. Comprehensive VDD reports decrease the necessity for additional diligence information requests or queries, which should be limited to a bidder's particular areas of concern. Such limited followup enables the more efficient use of time for the seller and bidder, particularly during an exclusivity period. Any additional queries and requests can be addressed more efficiently as the information is likely to have already been reviewed and be readily available. As a result, a streamlined due diligence process allows target management to focus on day-to-day operations.

POTENTIAL DISADVANTAGES

The initial drawback to the VDD approach is the upfront costs borne by sellers or target companies for engaging a law firm to prepare the VDD report. Although the overall due diligence timeline may be truncated, the lead time required for the preparation of the VDD report may be less ideal for eager sellers looking to expedite the launch of a sale process. Depending on the breadth and depth of the VDD report that is prepared, the cost to the seller or target may be significant.

On the other hand, if the VDD report is not sufficiently comprehensive, the potential buyer may not be reasonably satisfied and may prefer to conduct more extensive confirmatory or followup due diligence. This would, in part, defeat the purpose of the VDD report. In any event, there is no guarantee that a bidder will not seek to have its own advisers undertake a full due diligence review if it does not wish to rely on the VDD report as the sole or primary source of information in respect of the target.

Furthermore, as the VDD report will be prepared on instructions from the seller, it may not necessarily deal with each prospective buyer's primary concerns. Such concerns may require further diligence to address specific areas of interest to a particular bidder.

A key consideration for all parties to be aware of is that there is an inherent tension underlying the very purpose of the VDD report, which is to provide substantive disclosure of material issues to potential buyers while balancing the desire of the seller to market the assets it is selling in the best possible light. If this balance teeters too much on one side or the other, the process is more likely to fall short of the objectives of maximizing value within a tight timeframe.

The acceptance by potential buyers of VDD reports in place of their own comprehensive due diligence is dependent on the level of trust between the parties. The degree to which a potential buyer is comfortable with the VDD report will be determined by whether they trust that the description of the material risks is robust and complete despite the fact that it has been prepared based on instructions from the seller, with whom their interests are not aligned. The tension regarding a VDD report can be mitigated by the seller ensuring that the law firm providing the VDD report is notable and has a strong reputation for integrity.

Another important consideration relates to solicitor-client privilege. The distribution of a VDD report that contains any legal advice will almost certainly constitute a waiver of solicitor-client privilege in respect of that advice. Due to the delivery of the report to multiple bidders, the waiver would not be subject to the common interest exception that is often relied on in the context of a bilateral M&A transaction between two parties. Accordingly, a law firm providing a VDD report in Canada must be careful to circumscribe the scope of the report such that it includes a summary of documents and facts and not legal advice in respect of which the target would not want to waive solicitor-client privilege.

Alternatively, a well-informed client may decide that it is prepared to waive solicitor-client privilege where the matters involved are not significant in the context of the overall transaction value. Further, a decision may be made to redact certain legal advice in the VDD report to attempt to maintain solicitor-client privilege until there is one prospective purchaser; however, there is no guarantee that a court would not view the provision of partially redacted language as a waiver of solicitor-client privilege.

LOOKING FORWARD

Whether or not legal VDD becomes a disruptive force in Canada remains to be seen and will depend not only on what bidders expect but also on the desire of sellers and their advisers to undertake the necessary preparation. Setting the stage with such an approach will require more work upfront, but could potentially yield greater results given the more comprehensive divestment process.

Deployed as a mechanism for transaction risk management, VDD can be favourable for both sellers and bidders alike as VDD reports identify key issues at the outset and establish the grounds for negotiation, saving both time and money. Although it is unknown if VDD reports will become as prevalent as pre-sale home inspections, with bidders' expectations for efficient transactions growing and sellers becoming savvier in presenting attractive targets, legal VDD may not remain exceptional for long.

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