

# Poor vendor due diligence – a good way to wreck a deal

Good vendor due diligence before starting a sale process will enhance the likelihood of a successful transaction.

Any lawyer who has been involved in corporate M&A for a period of time will be familiar with the process known as due diligence (DD). Most M&A lawyers will have been involved in conducting the legal DD for a prospective purchaser of either the shares or the assets of a target company. In a purchaser DD process<sup>1</sup>, the purchaser and its professional advisors will undertake a structured process designed to seek information regarding the target, with a view to discovering the strengths, weaknesses, opportunities and threats possessed by or faced by the target. Depending upon the parties involved, the risk appetite of the purchaser and the size and general complexity of the potential transaction, the level of DD may be relatively limited or may be highly detailed and complex.

In general terms, DD will be conducted in at least three categories namely legal DD, financial DD and operational DD. This article deals with legal DD.

Purchasers and their M&A lawyers understand the importance and value of thorough DD. In our experience, the value to vendors of DD conducted on themselves (vendor DD) before going to market is less well appreciated. This article summarises the valuable contribution that sound vendor DD can contribute to a transaction from the perspective of both a vendor and a purchaser and on the other hand, the problems, sometimes very serious or fatal problems for a potential transaction, that can occur as a result of inadequate vendor DD.

By vendor DD, we mean the process in which a vendor of a company's shares or assets and the vendor's professional advisors will inquire into and examine the affairs and circumstances of the company and the sale assets in preparation for a sale process. In a vendor DD process, the vendor will examine itself and the assets for sale to assess whether there are any factors that may be unattractive to potential purchasers or potential impediments to a successful sale transaction. Discovering any such impediments prior to the commencement of the sale process will give the vendor the opportunity to repair or obviate such impediments, thus enhancing the attractiveness of the sale offering. As part of that vendor DD process, the vendor will seek to anticipate all of the questions or issues that may be raised by potential purchasers. In effect, the vendor will conduct on itself, the DD that it can expect potential buyers will conduct on it.

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<sup>1</sup>DD is referred to in different jurisdictions as seller and buyer DD or vendor and purchaser DD. In this paper, we will refer to vendor and purchaser DD.

## Vendor DD – the problem

We have been involved in numerous M&A transactions where a vendor has gone to the market without first having conducted any or any adequate vendor DD process. We have heard many reasons why vendors resist DD at an early stage including:

- it will take too much time, cost too much and divert management's attention from running the business
- the purchasers will tell us what information they want
- let's test the market before we devote the resources and see whether there is a likely purchaser
- we don't want to ask a whole lot of questions or get people looking for documents and send out management questionnaires or we will tip off our people that something is going on
- we don't want our intended sale to leak to the market
- if we give out information and no deal happens, our competitors will have our crown jewels

A thorough vendor DD process will certainly involve work by the vendor's personnel and advisors. The vendor's personnel involved in the process will have some level of their attention diverted from the vendor's day to day operations. Cost will be involved. Where confidentiality is important, there will need to be steps undertaken to preserve confidentiality. In deciding whether and to what extent to conduct vendor DD, there is a cost versus benefit assessment to be made. Invariably, the weight for vendor DD will be on the benefit side.

The vendor's external corporate advisors might be saying that "now is the time to get to market so don't delay things with DD – we can sort that out in the context of a purchaser's DD". A variation on that objection to early vendor DD may be that if the vendor will proceed via a call for expressions of interest or by a potential purchaser shortlisting process, further vendor DD can be conducted once the potential purchaser market has been assessed and qualified.

These may all be genuine points of concern. Careful thought and detailed mapping out of the process ahead of time will be important. It also will be important for the vendor's staff advising management and for external advisors that they understand and can clearly articulate the value to a vendor in conducting effective vendor DD as part of a sale process.

## Sales process and data

There are a wide variety of ways by which a company may initiate a sale process including a request for expressions of interest, shortlisting of potential purchasers or "straight to market" sale processes.<sup>2</sup>

Smaller sales transactions may take place in a one step process. The vendor may know the likely relevant purchaser market and may directly approach potential purchasers. Alternatively, the vendor may engage a business broker or professional adviser to assist with locating and identifying potential purchasers.

In these smaller transactions, the vendor or the vendor's agent may prepare an information memorandum (IM). Typically, the IM and potentially additional information, will be provided to the potential purchaser/s. In a one step process, a substantial amount of vendor information will be made available to the potential purchaser/s.

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<sup>2</sup> Alternatively, a target may receive an unsolicited offer from a prospective purchaser. See below the comments about a target having in place good document and information management systems that enable the target to respond quickly and effectively in such a case.

In these types of transactions, the level of both vendor DD and purchaser DD is often somewhat truncated. Speed and efficiency in terms of time, personnel effort and cost are highly important. Vendors are well advised to anticipate and to prepare and provide the information that potential purchasers will seek.

In larger transactions<sup>3</sup>, it is commonplace to see a multi-stage process. This may occur both if the vendor puts itself or its assets up for sale or if a prospective purchaser approaches a target with an unsolicited offer. In the case of an unsolicited offer, the target may decide to test the market by canvassing for other potential purchasers.

In a multi-stage process, the vendor and its advisors typically will prepare an IM tailored to the size and complexity of the offering<sup>4</sup>. In undertaking that step, the vendor will be well advised to conduct thorough vendor DD. The vendor will need to be assured that the information provided to potential purchasers is sufficiently detailed and is accurate and not misleading by inclusion or omission.

In most transactions we see, the vendor or the vendor's advisors will set up an electronic data room. In smaller transactions involving fewer documents, the data room may be in the form of a Dropbox or file sharing arrangement. In larger transactions, the vendor will frequently engage a third-party professional data room supplier. The data room will be populated with the documents and information that potential purchasers can be anticipated to require in conducting their purchaser DD. Logical and efficient organization and indexing of data room contents will assist in facilitating an efficient DD process. On the contrary, random or haphazard population of a data room will slow down purchasers' DD, will lead to increased purchaser requests for information and for longer DD periods and will add cost for both potential purchasers and the vendor.

Frequently, a vendor will invite potential purchasers to submit a non-binding purchase offer in the form of an expression of interest (EOI) or a non-binding indicative offer (NBIO). Typically, an EOI or NBIO does not constitute a binding purchase offer by the purchaser. In order to solicit EOIs or NBIOs, the vendor will give potential purchaser/s access to enough information in the data room as is calculated to allow potential purchasers to realistically assess the opportunity and to submit sensible purchase offers. The vendor will then review submitted offers with a view to selecting the party or parties (if any) with which the vendor will continue negotiations. In this step, potential purchasers are likely not to be given access to highly confidential or commercially sensitive vendor information, on the basis that if a transaction does not proceed, the vendor does not want third parties to have that key information.<sup>5</sup>

In the next step of the process, the vendor would select a preferred potential purchaser/s with which to go forward. If parties were not given access to all data room information at the EOI/NBIO round, full access would now be given. The parties would negotiate formal transaction documents, particularly a share or asset sale and purchase agreement.

In some processes, potential purchasers may be asked to submit a firm or binding offer as distinct from an EOI or NBIO. In that circumstance, it would be a term of the potential purchaser being invited to participate that if it was selected as the preferred purchaser, it will be obligated to proceed with a purchase at its submitted price unless the second, detailed stage of DD disclosed some material adverse event or material adverse change that was not disclosed by the first round of DD.

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<sup>3</sup>Publicly traded or stock exchange listed companies will have listing rules and other compliance obligations, including continuous disclosure obligations, that are likely to affect a sale process. This paper does not address those obligations and their impact on a sale process.

<sup>4</sup>There are of course many steps leading to and involved in a sale process. This paper is limited to a general outline of steps related to the vendor DD process.

<sup>5</sup>This is likely the case even when, in accordance with usual practice, potential purchasers have executed an NDA as a condition of being granted access to the data room.

What constitutes a material adverse event or a material adverse change will be defined. With this process, it will be necessary that the data provided to potential purchasers during the first stage is sufficient to allow potential purchasers to submit binding offers and is accurate so as to reduce or obviate the risk of potential purchasers walking away or being able to escape from a binding offer because further, adverse information is discovered during the second stage of the process<sup>6</sup>. This demands that prior to commencement of the process, the vendor will have conducted a substantial level of vendor DD. The risk for a vendor in not conducting thorough vendor DD prior to the start of the process is that potential purchasers, notwithstanding that they have submitted an offer, either walk away or seek to reduce their offer because in the course of further purchaser DD, they discover material adverse information about the vendor, perhaps information of which the vendor was unaware.

The question arises – how does one define what constitutes a material adverse event (MAE) or a material adverse change (MAC)? The most usual approach we see is to define an MAE or MAC by reference to the impact that the event or change has on the target's profit and loss statement or balance sheet. The quantum of impact will typically be proportionate to the size of the target and the value of the proposed transaction. This may form part of a purchaser's assessment of what constitutes materiality more generally<sup>7</sup>.

Frequently in going to market, a vendor or the vendor's corporate advisor will prepare a glossy IM that includes forecasts, broad statements about the size of the target's potential market, all the opportunities that the target has etc. – generally a sales document. The IM will set the expectations of potential purchasers. We have seen several examples where subsequent purchaser DD has disclosed a major gap between what is stated in the IM and what can be substantiated by the vendor or worse, discloses a position that is contrary to statements in the IM. Such a lack of alignment between what is promoted and what can be substantiated can be very detrimental to a sales process. There is no excuse for a vendor allowing this lack of alignment to arise. Thorough vendor DD should prevent this danger. Vendors should not rush to market before they have properly prepared and ensured that they can substantiate statements made to the market.

Regardless of the sale process, a key element for a vendor in its DD is to identify issues with the company or the sale assets that may be seen as detrimental by potential purchasers and to address and rectify those issues before the sale process commences and certainly before those issues are pointed out by a potential purchaser. A purchaser pointing out problem issues not identified and addressed by the vendor is a primary reason for delays and additional costs and crucially, for reductions in the purchase price proposed by purchaser (in the vernacular, "chiseling").


## The data room

Vendors should anticipate how purchasers will go about purchaser DD. A vendor should ensure that its data room is properly structured and populated with the information that it can anticipate purchasers will require. A poorly organized data room will be a negative in terms of a sale process. At the least, a data room that is poorly organized or that does not include all of the documents and information the vendor should anticipate potential purchasers will require, will make prospective purchasers and their advisers grumpy. It will delay the process and is likely to result in both requests for extensions of the DD timeframe and an increased number of requests for information from purchasers and their advisers, all of which increases costs for both the vendor and the purchaser.

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<sup>6</sup> In practice, while purchaser offers may be expressed to be binding, if a purchaser wants to escape after submitting its offer, contractually and commercially, there are a number of ways that can happen.

<sup>7</sup> When conducting purchaser DD, the purchaser will set materiality thresholds so that matters that the purchaser may consider are adverse or disadvantageous with respect to the target's affairs but that are likely to have a monetary impact below a stated materiality threshold need not be reported in the DD report by its advisers that will be provided to the purchaser in the course of the purchaser DD process. This paper is not considering purchaser DD issues.



A badly structured or deficiently populated data room reflects the vendor's business organisation and will likely lead potential purchasers to think that the state of the data room is consistent with the vendor's business practices. This may lead potential purchasers not to proceed with a purchase offer or to discount their purchase offer because of concern about the status of the vendor and its business practices. Poor DD diminishes the vendor's credibility and deal "good will". It is likely to increase the purchaser requirements for warranties, hold backs, earn outs and potentially, will increase the likelihood that purchasers will require that representations and warranties insurance be put in place at the vendor's cost.<sup>8</sup>

For any transaction where a reasonable volume of documents will be required for due diligence, our view is that establishing a data room through an experienced data room services vendor is a worthwhile exercise. Those data rooms enable a vendor or its advisors to control the documents in the data room and who has access to those documents. Vendors are often able to see what documents are receiving most attention from potential purchasers, which can be a very useful source of information for vendors, since they will know what matters are likely to be of most interest or concern to potential purchasers. These data rooms incorporate facilities that enable potential purchasers to log requests for further information and for vendors to respond to those requests, with those RFIs and responses being properly documented.

In transactions where probity<sup>9</sup> is an important consideration, well organized data rooms facilitate transparency about information provided to bidders or potential purchasers, including additional information provided in response to purchaser RFIs.

A further important benefit of a well-organized and operated data room relates to the representations and warranties that a vendor will be asked to give in a sale and purchase agreement (SPA). Invariably, in an SPA the vendor will be required to give a range of representations and warranties. Those representations and warranties typically will be qualified by information that the vendor has fully and fairly disclosed to the purchaser in the due diligence process.

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<sup>8</sup> Insurers, before agreeing to provide reps and warranties insurance will invariably conduct thorough DD on the target. A target being able to demonstrate to an insurer that it has its house in order will be a significant component in an insurer agreeing to provide cover and the cost of that cover.

<sup>9</sup> In tenders called by large corporations, government departments or instrumentalities, probity with respect to the conduct of the tender process very frequently will be a key consideration.

The better the quality of the vendor disclosure, the better the chance that the vendor will be able to negotiate less demanding warranties. A well-structured data room will enable the vendor to easily produce a list of all documents provided in the data room and a list of all RFIs and answers. This information can be supplied as an attachment to the SPA by way of disclosure qualification against representations and warranties.

## Considerations

A vendor undertaking a vendor DD process will assist the vendor to assess how well its own document management system works and to identify gaps in its document management and even more importantly, issues in its business that potential purchasers are likely to find and that could give rise to risks that a transaction may not get done. The vendor's ability to respond to and collate information based on a vendor DD checklist provided by the vendor's advisors may show a vendor just how well its information is organized or alternatively, may point out to a vendor just how badly its management of contracts and key documents is organized. Vendors will discover how quickly their management systems enable them to identify and find documents, how well documents and other information are stored and sorted for materiality and security and whether they have adequate document capture, retention and management structures in place.

A company that has detailed and well structured document and information management systems will be far better able to assess the attractiveness or otherwise of an unsolicited offer and to respond to that offer quickly and effectively.

The discipline imposed by undertaking a vendor DD process will also assist a vendor to consider and manage information flows that will be relevant in the context of a transaction. For example, a vendor will be prompted to consider what information has what degree of confidentiality and to whom and when can information be disclosed? If the vendor's financiers need to be consulted – commonly the case in the context of a transaction - can the vendor readily provide the information that its financiers will require in order for the transaction to be effected? The vendor DD process may also assist the vendor to consider what information should be released to customers and the market generally and when that information should be released.

## Vendor DD on potential purchasers

The aspect of vendor DD that is not so frequently considered is the DD that vendors should conduct on potential purchasers.

If the consideration to be paid to the vendor consists of or includes securities in the purchaser, the vendor should assure itself of the value of the purchaser's securities.<sup>10</sup> The vendor should consider the extent to which it should conduct "purchaser DD" on the purchaser.

If a vendor is going to sell the whole or a substantial part of its business, is the transaction only about the price (what the vendor can take off the table)? For many vendors, perhaps the predominant answer in the end, is yes.

Vendors want to maximize the purchase price. Purchasers want to ensure that they are getting everything for which they are paying. A common way that these two potentially competing aims may be reconciled is via an earnout.

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<sup>10</sup> Where the purchaser is a listed entity, reference to the quoted price and trading history of the purchaser's securities will go a long way.

Typically, the purchaser will pay a substantial percentage of the total maximum purchase price at completion (closing) and will then pay to the vendor a potential further amount, calculated by reference to a range of factors that relate to the success of the transition of the business or the retention of the business post-completion.

This latter payment is referred to as an earn out. An SPA may provide that in addition to the amount payable by the purchaser at completion, further amounts will be payable to the vendor based on the degree to which key performance measures are achieved in (typically) one or two years after completion. Those measures often include whether the target business achieves a specified level of revenue or profit, or the number of customers retained or new business that is developed.<sup>11</sup>

The drafting of earn out clauses in SPAs is critical for a vendor. Where the degree to which an earn out is earned is dependent on the performance of the business post-completion, a key consideration for a vendor is what degree of control or influence does the vendor have on the performance of the business after completion. If the control of the business and its performance post-completion will largely or entirely reside with the purchaser, then the vendor will need to undertake very careful consideration of the purchaser, the purchaser's capacity to run the business, the purchaser's willingness to devote the capital and other resources promised by the purchaser pre-completion or that may be otherwise required for the business to flourish after completion. Where an earn out is calculated by reference to accounting practice sensitive matters such as achievement of net profit targets, the vendor will need to consider the propensity for the purchaser to manipulate the accounts of the business post-completion so as to reduce net profit figures.

As mentioned above, it will be important for a vendor to understand whether a purchaser has the intent, the resource capacity (financial, personnel, markets) and strategy to see the business thrive post-completion. Where the target is to be integrated into the purchaser's organization and the vendor and or vendor personnel will be involved, it will be relevant for the vendor to understand what the purchaser's integration plan is.

Vendors having satisfied themselves about these matters will have a much better story to tell their personnel and at the right time, the market.

Another factor relevant for the vendor's DD on a purchaser will relate to the vendor's personnel. Are the vendor's employees staying in the business after the transaction is done? Will the personnel be working essentially for the same management or will they have a new boss? How will the purchaser treat the vendor's personnel? Does the vendor really care? Will the vendor (e.g. a founder or leader of the target) be staying in the business post-completion. Apart from the earn out issue above, the vendor will have a new boss. Vendors need to understand who they will be working for and potentially, ultimately reporting to. Vendors need to prepare themselves for the transition from being the boss to the "not boss". How will the vendor feel about working for a new owner?

In a transaction, is the purchaser saying that it will make a range of post-completion improvements, restructuring, providing key personnel, finance or other resource commitments, providing marketing plans and good homes for the vendor's personnel? Vendors need to ensure that these purchaser commitments are properly documented in the transaction documents. We very rarely see these matters included in what are typically very limited purchaser warranties set out in SPAs. Vendors should consider whether a post-completion business plan is included as an annexure to an SPA.

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<sup>11</sup> In many IMs, statements will be made about the "blue sky" opportunities that the target offers to purchasers. The degree to which this blue sky is achieved post-completion may well be a factor in determining the extent of earn outs paid.

A thorough vendor DD process carried out on a purchaser is likely to improve not just expectations regarding earn outs but also to improve post-completion transition and integration and reduce the risk of value diminution.<sup>12</sup>

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<sup>12</sup> This article is an extract of a paper that formed the basis of a presentation by the author at the International Client Seminar presented by ALFA International in Puerto Rico in by March 2024.

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