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Third-party reliance on due diligence common in U.K.

This practice can present U.S. M&A law firms with a quandary.

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Suppose an overseas company is about to complete its first major multinational acquisition. The deal is in its final stages—the closing process has reached a frenzied pace, and the various agreements are in final form.

Amid a wave of other last-minute communications, a partner at the company's U.S. law firm receives a call from the United Kingdom co-counsel asking when the U.K. co-counsel will receive the U.S. law firm's reliance letter addressed to the buyer's lenders so that they can use and rely on the U.S. law firm's due diligence report. When the U.S. lawyer replies that his firm has a policy against allowing third parties to rely on its due diligence reports, not only is the U.K. counterpart quite surprised, but he is also quite concerned that the U.S. law firm's refusal will prevent a timely closing and could lead to loss of the deal.

The working group is advised of the U.S. law firm's position, and shortly thereafter, the U.S. lawyer receives the inevitable call from the client. After a series of conversations, the ultimatum is given: The U.S. law firm's refusal to provide this "common" reliance letter is not only jeopardizing the client's ability to get this deal completed, but does not bode well for the long-term prospects of the U.S. firm's relationship with this client.

This scenario is increasingly faced by U.S. law firms acting as co-counsel on U.K.-based transactions, and in other contexts. The tension arises from the relatively established practice among U.K. law firms to allow third-party lenders to rely upon the legal and factual analysis presented in the due diligence reports prepared for their clients. This practice is now threatening to spread beyond U.K. borders as U.K. counsel and lenders increasingly request that co-counsel in other countries provide similar reliance letters for the results of due diligence conducted in their native country.

The potential benefits of this approach are clear. The seller experiences less disruption to its business and retains greater control over the sale and financing process. This practice may also reduce the risk that a confidential sale process is leaked to the public, as fewer individuals need be involved in the due diligence process. In addition, and perhaps most importantly, allowing third-party reliance should result in significant cost savings directly by the third-party lenders (and indirectly by the buyer/borrower who usually bears those costs) since it may not then be necessary for the lenders to conduct their own separate due diligence review of the target corporation.

The practice of allowing third parties to rely on legal due diligence reports appears to be a close relative to the growing European practice of creating what are known as vendor due diligence reports. For many of the same reasons, it is relatively common for sellers in European auctions to hire an outside law firm, accounting firm and other third-party consultants (most commonly environmental consultants) to develop a vendor due diligence report based on a review of the target company. That vendor report then serves as a substitute for due diligence by the potential purchasers and their financing sources.

During the auction process, the vendor report providers require the prospective purchasers to execute release letters accepting the engagement terms of the providers and releasing the providers from any liability to the recipients regarding the contents of the report. At the time the purchase agreement is executed, the vendor report providers often address a reliance letter to the winning bidder allowing reliance upon the contents of the report and expressly assuming liability up to a prescribed cap. This practice appears to be growing in Europe, with the European offices of the Big Four accounting firms now promoting the benefits of vendor reports.

U.S. firms would face risks

Not surprisingly, U.S. law firms are apprehensive about the prospect of allowing lenders (or others) to rely on due diligence reports prepared for their buyer clients. While it is not unheard of for U.S. advisors to allow third-party reliance on their reports (e.g., accounting firms permit reliance upon their audits, reviews and other reports; environmental consultants allow lenders to rely on environmental site assessments of the underlying property, etc.), legal memorandums like due diligence reports have historically been prepared for the sole use and

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reliance by the client. Due diligence reports are occasionally shared with third parties in limited contexts, but under those circumstances, most firms will insist that the recipient execute a nonreliance letter absolving the firm of any responsibility or liability for the contents of the report, and clarifying that the firm owes no duties to the recipient.

Accordingly, if a formal due diligence report is prepared by U.S. counsel, it will more often than not include language that specifically prohibits reliance by any party other than the client for whom the report was initially prepared. Even then, the report will usually allow reliance by such client only in connection with the specific purpose for which the report was created. By expressly permitting a person other than its client to use and rely upon a due diligence report, the law firm risks extending its duties to this third party, and may also expand its upper limit of liability.

For example, a client for whom a due diligence report was initially prepared could sue based upon misinformation or faulty analysis contained in the report for damages based on the difference between what the client would have paid for the target company had it received accurate information and what was actually paid based upon the inaccurate report. In contrast, if a third-party reliance letter is provided to a lending institution, the amount of damages could be expanded to include not only the damages suffered by the client but also to potentially include the entire amount of the loan extended to the client for the transaction.

In this context, it is also worth noting that information contained in a due diligence report prepared for a client may be entitled to attorney-client privilege protections. Providing the due diligence report to a third party could constitute a waiver of the privilege with respect to the report and conceivably also to matters in the same subject as the report. The privilege is apt to be waived by the act of disclosure and normally does not depend on whether the third party is allowed to rely on the report. Consequently, before providing any due diligence report to a third party, firms will usually obtain the consent of the client, ensuring that the client understands the risk of loss of privilege. A natural byproduct of potential liability exposure or loss of attorney-client privilege may be the omission from the report of certain sensitive but important information and conclusions, which could reduce the value of the due diligence report for the client.

Disclaimers in U.K. firm reports

Subject to variations in local law, many of the same considerations are faced by U.K. firms when they allow third parties to rely on their due diligence reports. As a result, the practice of including lengthy opinionlike disclaimers and qualifications in due diligence reports has already been adopted by law firms in the United Kingdom that are providing such third-party reliance letters. Common qualifications, carve-outs and limits 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 purchase transaction and a limitation of the duty owed by the law firm to the third party to a duty no different from, and no greater than, the duty owed by the law firm to its client.

■ Statement that the law firm reviewed only the material provided, and undertook no additional factual investigation of the company.

■ Disclaimer that the law firm limited its diligence review to matters of a legal nature pursuant to local law, expressly excluding review of certain specified areas, and without undertaking to provide an analysis of the commercial nature of the acquisition.

■ Disclaimer that the law firm undertook no independent verification of the information provided and that it assumed the validity, due authorization, completeness, accuracy and enforceability of the information provided.

■ An attempt to claim that the contents of the report are confidential and subject to attorney-client privilege even though disclosed to the third party.

■ 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.

For now, most U.S. law firms appear to be resisting these requests for third-party reliance on the basis that it is not the norm in the United States to allow third-party reliance on due diligence reports. However, it is presumably somewhat awkward for a U.S. firm with an office in the United Kingdom to resist such a request.

Consequently, it is becoming more common for those firms to conduct due diligence on the U.S. target entities and then have their U.K. office issue the third-party reliance letter so that any dispute related to such third-party reliance letter would be governed by English law and would have the benefit of any interpretations and understandings with respect to third-party reliance letters that may have been established in the United Kingdom.

As legal costs continue to escalate, and as clients continue to look for ways to expedite the transaction process, it would not be surprising to see market pressures build to allow this type of reliance in the United States as well. When, and if, that happens, U.S. law firms will no doubt be deliberate in their approach and preparation. Internal opinion committees will presumably develop lengthy disclaimers and limitations to be included in any reliance letters, and the process of issuing what is today a somewhat informal document, may take on the formality associated with issuing an opinion. Whether that will ultimately benefit anyone will remain to be seen. NLJ