Make an informed decision

Due diligence is a critical tool when entering into an M&A transaction

INTERVIEWED BY MARK SCOTT

ELIZABETH G. YEARGIN
Partner
Brouse McDowell

(330) 434-4824
eyeargin@brouse.com

WEBSITE: To learn more about the value of due diligence in your company's next M&A transaction, visit www.brouse.com.

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Business owners should take the time to perform thorough and smart due diligence before entering into an M&A transaction, says Elizabeth G. Yeargin, a Partner at Brouse McDowell.

"It is better to spend time and money on the front end of a deal uncovering risks and learning the ins and outs of the potential target than to blindly enter into a deal," Yeargin says. "You may end up spending extensive amounts of money post-closing for liabilities that should have been uncovered during an appropriate due diligence process."

This process enables the buyer to make a more informed decision about whether to move forward with a transaction, but the effort can also be very useful to the seller.

"Due diligence is important to sellers because it gives them the necessary information to determine a realistic valuation for their business so they don't leave money on the table," Yeargin says.

Smart Business spoke with Yeargin about due diligence and what you need to know before finalizing your next M&A transaction.

How informed is the typical buyer going into an M&A transaction?

Two factors that often have the most impact on the approach a buyer takes toward an M&A transaction are the size of the deal and the relationship the buyer has with its legal counsel. Companies will often spend less time and money if it's a smaller transaction because they see the risk as being smaller. But you run into some of the same issues when trying to complete a deal whether you're buying something for $50,000 or $50 million. Regardless of the size of the target, you need to dig into the potential legal and financial risks, uncover potential liabilities and get assurance that the benefits of the deal outweigh the potential dangers. You can then use that information, if you decide to move forward, to determine or adjust the purchase price for the target.

The relationship you have with your legal counsel is another key component. If you work closely with your legal representatives and stay in contact on a regular basis, you're more apt to have that team involved in the M&A process from the beginning to provide information and answer any questions that you might have along the way. If you haven't worked as closely with your legal partners, it makes the process more difficult and creates more risk. The best advice is to take steps to build a stronger partnership with your legal team before you enter into negotiations to buy or merge with another company.

What areas should you focus on as you conduct your due diligence?

Buyers typically are adept at reviewing another company's management team and the big picture financials such as revenue, sales volume and personnel costs. But you also want to review the condition and composition of that company's assets. How much real estate, if any, does the company you're looking to purchase own and are there any environmental issues with that property? What about intellectual property (IP)? What does that company's customer base look like? What supplier or material contracts are in place? You also want to be aware of any litigation or product liability issues that might pertain to that company, as well as matters that involve employee benefits, labor unions, insurance, taxes or potential anti-trust concerns.

How do you address successor liability issues?

As a general rule, sellers prefer equity purchases, while buyers prefer asset purchases. Sellers will usually favor an equity deal because it allows them to completely walk away, often free from any future obligations with respect to the business. With a buyer, the advice is typically to do an asset deal. You pick and choose your assets and you also pick and choose which liabilities you are willing to assume. As an asset purchaser, you're not going to assume litigation that involves the seller or take on debt with the seller's lender.

If you decide to do an equity deal and assume the seller's liabilities, you'll want to keep that in mind as you determine what you're willing to pay for the business. You'll also want to work with your legal team to structure the agreement to include representations from the seller and indemnification against the risks you're choosing to take on in the deal. ●

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