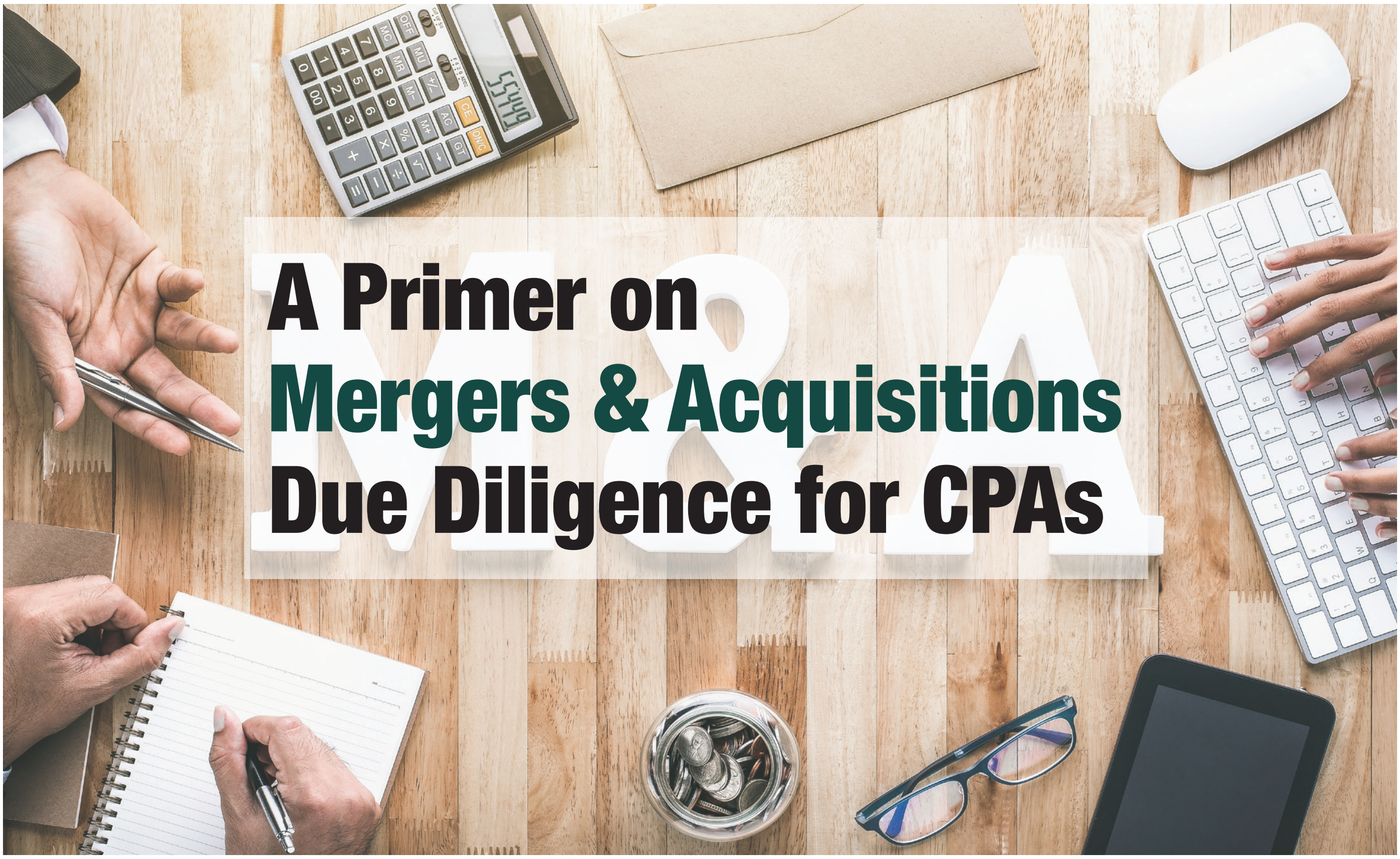
A Primer on Mergers & Acquisitions Due Diligence for CPAs



By David R. Johanson, J.D., Michael W. Thicksten, J.D., and Teresa Y. Huang, J.D.

The U.S. stock market experienced phenomenal growth in 2017, with overall gains for the Dow Jones Industrial Average of approximately 25 percent and for the S&P 500 of approximately 19 percent.[i] Despite losses in the Dow Jones earlier this year due to concerns of a potential global trade war prompted by tariffs on China[ii], institutions such as Goldman Sachs and Wells Fargo project mergers and acquisitions activity to rise in 2018.[iii] The combination of economic growth throughout the world, U.S. corporate tax cuts and repatriation of offshore profits attributable to the Tax Cuts and Jobs Act of 2017 (Pub. L. 115-97), and renewed interest in growth stocks may result in a remarkable year for mergers and acquisitions.[iv]

With the growing number of potential deals, CPAs may best serve their clients and themselves if they are well prepared for the anticipated increase in the volume of mergers and acquisitions and more involvement in the overall transaction process. Our country has anticipated a major boom in mergers and acquisitions activity since the Great Recession dating back to 2008. It appears that the time for a significant uptick in sales of businesses is finally on the horizon.

Companies continuously attempt to increase earnings by more efficiently controlling overhead and developing top-line growth with effective marketing and sales. Global market pressures increasingly require boards of directors, officers and executive management to consider mergers and acquisitions as a means for growth in revenues and market share, a reasonable return on shareholders' investments, and/or an exit strategy for a struggling business or a more mature profitable business with no viable management successors.

Conducting such transactions is normally a complex endeavor that requires advance consideration of the short-term and long-term business objectives, a thorough due diligence process and a well-crafted integration plan (for surviving corporate entities). When executed successfully, mergers and acquisitions facilitate:

- Growing market share by establishing new distribution channels,
- Increasing the potential to cross-sell goods or services to new markets, improving access to technology,
- Adding talent,
- Increasing efficiency and profits by realizing greater economy of scale,
- Better positioning in the value chain for the acquirers and
- Creating an orderly disposition of business assets and liabilities for an acceptable price for sellers.

Importance of the Due Diligence Process

Proactive due diligence efforts remain vital to any company anticipating a sale, irrespective of whether the company is an acquirer or target company. Every stage of a merger or acquisition transaction involves the diversion of corporate resources (human and otherwise) away from revenue generating and expense controlling matters. Companies that are doing well may receive frequent expressions of interest; however, very few offers may be worth pursuing.

Proactive due diligence efforts remain vital to any company anticipating a sale, irrespective of whether the company is an acquirer or target company.

Conducting a due diligence review in advance may help sellers evaluate whether any unsolicited offers are bona fide offers and thus help sellers avoid wasting resources on non-viable offers. Selling companies that make the investment in due diligence prior to engaging in substantive negotiations with potential buyers may also realize greater purchase prices and improved odds of closing a transaction. Early investment in due diligence affords the selling company the opportunity to assess underlying risks and take corrective action before a buyer uses them as bargaining chips to reduce the purchase price or other consideration to be paid at closing.

If a company is in the preliminary stages of a transaction, initial due diligence may facilitate the process of marketing the firm (directly, through investment bankers on a blind or fully disclosed business, or through other business contacts). Providing a professionally assembled presentation, "deal book," or packet of financial information with respect to a selling company to strategic and financial buyers may help justify a premium purchase price and allay concerns about operations.

An acquiring company determines a target company's proper value through an objective and meticulous due diligence process. Thorough typically includes legal, financial and operational analyses of the target company, in large part to validate the buyer's assumptions and/or preliminary impressions of the target company against factual data. A prudent process should cover more than an evaluation of the target company's balance sheet and profit and loss statements. It should also evaluate information about every aspect of the selling company and its business operations, including without limitation, the following:

- Business strategy,
- Operations,
- Working capital requirements,
- Taxes,
- Competitors,
- Consolidation in the industry (if any),
- Labor disputes,
- Litigation (ongoing, pending, threatened or potential lawsuits, and other contingent liabilities) and
- Other factors that may impact the valuation of the selling company.

From the buyer's perspective, a detailed due diligence review will reveal any hidden issues, such as pending litigation or a previously undisclosed downturn in the selling company's financial performance. Unexpected discoveries can serve as compelling reasons for buyers to modify the deal terms or, in extreme cases, findings of sufficient risk may warrant walking away from the deal entirely. Buyers should also determine whether the target company has made prior efforts to sell. Multiple unsuccessful divestment attempts could signal substantial valuation, operational or risk concerns.

Throughout the assessment, the acquiring company's representative(s) should advise the acquirer of the advantages and disadvantages of the proposed structure of the transaction and the feasibility of the target company as a going concern, and assist the buyer with an assessment of the cash flow and financing alternatives required to acquire the target company. The aim should be to provide sufficient information to the buyer so that it may determine whether the acquisition will satisfy all of the buyer's business objectives without presenting a level of financial, business and legal risk that the buyer finds unacceptable. An assessment of the acquiring company's goals should include an analysis of growth strategies balanced with the buyer's overall corporate strategy. Understanding the business objectives of the acquisition helps the buyer's advisors prioritize the due diligence efforts and decide what data is relevant.

Start of the Process

While the buyer and seller should initiate the due diligence process as soon as practicable to allow for sufficient time to analyze data, in an ideal situation, both parties will have entered into a letter of intent (LOI) or offering memorandum (offer memo) before undertaking an exhaustive due diligence and document review. Agreement in an LOI or offer memo should review the structure of the transaction and other important matters, including without limitation, confidentiality, whether an exclusivity period applies, which party will bear the costs of the transaction, a mutually acceptable period for conducting the due diligence review and negotiations for the definitive sale and purchase agreement, the consequences to either or both parties if the transaction fails to close successfully, and indemnification baskets and caps. This narrows the objectives of the transaction, and avoids confusion and premature disclosure of sensitive information.

Furthermore, the identification of the transaction structure (whether an asset purchase or stock purchase) and the applicable representations and warranties of the parties will serve as a guideline for the particular due diligence documents that the selling company should provide, and the buyer should obtain and review.

Types of Due Diligence Documents

A robust due diligence process should cover the following, without limitation:

- Evaluation of the target company's owners and employees,
- Assets,
- Clients and customers (both in terms of revenue, as well as concentration risks),
- Employee benefits,
- Company policies and procedures,
- Potential and pending litigation,
- Regulatory reviews and investigations,
- Tax considerations,
- Other sources of potential liabilities (i.e., labor and employment, environmental hazards, real property concerns, etc.),
- Information technology structure and
- Intellectual property rights.

Adequate due diligence also includes a thorough analysis of competitors and competitive markets in the same industry. CPAs may guess correctly that the target company's financial statements, whether prepared internally, reviewed, audited or compiled, constitute one

continued on next page

"PROACTIVE DUE DILIGENCE EFFORTS REMAIN VITAL TO ANY COMPANY ANTICIPATING A SALE, IRRESPECTIVE OF WHETHER THE COMPANY IS AN ACQUIRER OR TARGET COMPANY."

of the primary types of due diligence documents that a buyer should review prior to closing a transaction. In preparing compiled, reviewed or audited financial statements, CPAs are limited to determining if the target's historical financial statements are an accurate representation of the company's operations. In the context of a pending transaction, however, the due diligence process may also require a financial forecast from the target company as part of the purchase price negotiations and the buyer's review of such financial projections for reasonableness.

In certain transactions, particularly those involving companies whose stocks or securities are not traded on an established securities market such as NASDAQ or the NYSE, which is true with all closely held companies, the buyer may need to commission an independent business or stock valuation from an independent appraiser and financial advisor. Financial forecasts and the reasonableness of such projects are particularly important in such valuations. Even in transactions that do not require a separate valuation, buyers may rely upon CPAs for assistance in evaluating the target company's cash flow, earnings, growth potential, reasonableness of debt to equity ratio, appropriateness of accounts receivables and accounts payables, and other financial metrics.

Along with the financial statements and related assessments, buyers and/or sellers may request their respective accountants to assist with the evaluation of the potential tax implications of completing the transaction. If the transaction involves a corporate reorganization, accountants may need to evaluate whether such transaction structure complies with the requirements for tax-deferred treatment under Section 351, et seq. of the Internal Revenue Code of 1986, as amended (the Code). Under Section 338 of the Code, certain stock purchases are treated as asset acquisitions and an election under Section 338(h)(10) of the Code permits an acquirer to purchase a target's stock and, for tax purposes, acquire the target's assets, resulting in a stepped-up basis in the assets. Both the buyer and the seller must make the election under Section 338(h)(10) of the Code.

It may also be helpful to consider other tax-deferral opportunities – such as a qualifying sale of employer securities to an employee stock ownership plan and trust (as defined in Section 4975(e)(7) of the Code) along with the selling shareholder's election to defer recognition of capital gains taxes under Section 1042 of the Code. Also, potential tax liabilities, such as transfer taxes, may impact the decision to structure the transaction as a stock or asset purchase. Employee Stock Ownership/ Option Plan (ESOP) transactions can also be funded with pre-tax contributions under certain circumstances and potentially involve a great means of sharing equity on a broad basis with employees. CPAs who conduct an appropriate review will position themselves to help their clients determine how best to structure the transaction from a tax savings perspective.

Additional due diligence consideration should include a thorough review of whether the target company has timely filed all of its income and sales tax (and other reporting and information) returns. This is of particular concern in stock acquisition transactions, where the buyer essentially assumes all of the liabilities of the target company.

If the target company has failed to file their sales and income tax returns in a timely manner and make corresponding tax payments (income, employment or other taxes) on a timely basis to federal and state agencies, the buyer may be faced with the burden of addressing such tax deficiencies following the close of the transaction. Any such tax deficiencies identified during the due diligence period will have a negative effect on the consideration that the buyer is willing to offer for the acquisition, so the seller has a vested interest in proactively addressing any such tax deficiencies.

While it may seem obvious, making a careful review of prior tax returns and making sure that they have been timely filed pays off in dividends to limit exposure to risk down the line. Typical document requests will include the target company's tax returns for the taxable years open to assessment under the Code, documents relating to any governmental tax audits and correspondence with taxing authorities pertaining to potential tax issues. Generally under Section 6501 of the Code, the statute of limitations for the Internal Revenue Service (IRS) to assess taxes is within three years following the filing of a tax return, unless extended with the taxpayer's voluntary agreement or if the taxpayer has failed to file a tax return at all or committed fraud.

Beyond the familiar areas of corporate financial statements and tax returns, CPAs should be aware of other potential areas that may require further scrutiny. Review of a thorough organization structure chart identifies subsidiaries, ownership, parent company relationship and the state(s) of incorporation. The organization chart reveals often overlooked minority shareholders and the complexity of the target company. Companies with a complex corporate structure or new or multiple product lines or types of services offered to customers tend to be more challenging to incorporate into existing business lines and/ or further develop. If buyers intend to diversify their business, they will need to familiarize themselves with standards and regulations applicable to the new industry or line of business, which may require advice from experienced legal counsel.

Standard representations and warranties also address whether the parties have the authority to enter into the transaction, if the seller has legal title to the assets or the shares free and clear, if there are any outstanding liens that need to be addressed and whether the target company has operated in the ordinary course of business during the negotiations period. Buyers and sellers should also ensure that there are no change of control provisions in prior contractual agreements that trigger upon the sale; e.g., do landlords, lenders and other contracting parties have claims against the seller and/or buyer downstream? An

Post-Closing

Even if the business parties have established document retention policies, the parties to the transaction (or their advisors) may find it procedurally prudent to circulate a complete record of the due diligence document requests and responses (the due diligence records) contemporaneously with the formal closing binder (which contains the executed transaction documents and any related ancillary documents) on a post-closing basis.

Circulating the due diligence records in such manner avoids any future claim of any ambiguity with respect to which documents have been furnished to the requesting party in advance of closing and preserves written evidence (which is more reliable than personal recall) in case of any future judicial, administrative or regulatory proceeding.

effective due diligence will mitigate the risk of the parties identifying last-minute surprises that may terminate the deal.

Other areas of concern include, without limitation, workers' compensation claims, and other labor and employment claims, such as ERISA (Employee Retirement Income Security Act of 1974) claims for unfunded pension liabilities that can potentially apply to individuals who own the selling company and may subject the buyer to substantial financial obligations to collectively bargained retirement plans.

Another area of concern is whether the target company owns or leases real property. If the former, then has the target company complied with its obligations as a real property owner? If the latter, does the target company have proper lease or sublease agreements in place? Furthermore, the buyer will need to determine whether the target company or any employee benefit plan that the target company maintains is the subject of any lawsuits, investigation or regulatory proceeding, and whether the target company has sufficient ERISA fiduciary insurance coverage, especially in a stock acquisition with the target company surviving as a subsidiary of the buyer.

In summary, one of the primary purposes of a due diligence review is to ensure that there are no or limited anomalies that the seller needs to disclose in the definitive agreement or mitigate on a pre-closing basis, or that the buyer considers significant in finalizing the consideration that the buyer will pay in the transaction or that the buyer will use as a bargaining tool in crafting some other remedy to minimize the buyer's acquisition risks (such as modifications to a post-closing purchase price adjustment formula, increase in indemnification or other form of holdback amount held in escrow, extension of the escrow period or indemnification period, etc.). It is strongly advisable for the buyer and seller to arrange for their advisors to prepare a formal due diligence report that documents all of these material and significant issues discussed in this article.

Final Remarks

With markets becoming increasingly competitive, companies must find ways to sustain business operations and promote growth. Mergers and acquisitions have many complex facets that involve the intersection of a variety of experienced professionals, including, but not limited to, attorneys, accountants, environmental specialists, information technology experts, marketing teams, human resources, projection management, auditors and consultants.

A professional and thorough due diligence process in which all parties and their respective legal, accounting and tax advisors participate and collaborate minimizes the likelihood of unexpected and unpleasant surprises, and increases the likelihood of reaching a successful closing.

Footnotes

i. Mohamed A. El-Erian, "Markets Benefit from What Didn't Happen in 2017," *Bloomberg*, Jan. 1, 2018, at https://www.bloomberg.com/view/articles/2018-01-02/markets-benefited-from-what-didn-t-happen-in-2017.

ii. Matt Egan, "Dow Plunges 724 Points as Trade War Fears Rock Wall Street," *CNN Money,* March 22, 2018, at http://money.cnn.com/2018/03/22/investing/dow-jones-trade-war-china/index.html.

iii. Joe Ciolli, "Wall Street: more blockbuster mergers are coming," *Business Insider*, Dec. 6, 2017, at http://www.businessinsider.com/wall-street-says-expect-more-mega-mergers-in-2018-2017-12.

iv. Alex Morrell, "2018 has all the makings of a monster year for dealmakers," *Business Insider*, Jan. 11, 2018, at http://www.businessinsider.com/2018-mergers-and-acquisitions-outlook-citi-2018-1.

David R. Johanson, J.D. practices with the law firm of Hawkins, Parnell, Thackston & Young, L.L.P. He is partner-in-charge of the Napa, Calif., office and also has offices in San Francisco, Los Angeles, Dallas and New York. He leads Hawkins Parnell's national ERISA, employee benefits, executive compensation and equity incentives practice and fiduciary litigation practice. He can be contacted at djohanson@hptylaw.com.

Michael W. Thicksten, J.D. practices with the law firm of Hawkins, Parnell, Thackston & Young, L.L.P. He is an associate resident in the Dallas, Texas, office and can be contacted at mthicksten@hptylaw.com.

Teresa Y. Huang, J.D. practices with the law firm of Hawkins, Parnell, Thackston & Young, L.L.P. She is a partner in the Napa office and can be contacted at thuang@hptylaw.com.