

Due Diligence in Mergers - Two Areas to Consider – A Blog Post by David Goldenberg

Acquiring or combining with another company is a complex transaction with many areas to review and consider. Below is a review of two important areas typically covered in any acquisition.

When two companies consider a merger, both companies should be engaging in due diligence. Particularly when private companies are involved, due diligence starts with detailed inquiries, and important, prying questions must be asked, and answered. Unlike public companies, which are required to share detailed information publicly on a regular basis, private companies generally do not need to share information. The only way to learn important information about your potential merger partner is typically through the diligence done in the merger process.

The following is a discussion of two of the many areas which should be the subject of inquiry and robust discussion prior to any merger.

Existing Contracts

Every company has contracts, from real estate leases to supplier contracts. Before considering a merger, examining existing contracts is critical to get a better view of how the company is situated. The types of contracts which may exist depend in part on the nature of the business. However, some common contractual commitments include:

- Employment agreements;
- Collective bargaining agreements / union contracts;
- Non-compete clauses;
- Exclusivity agreements;
- Distribution agreements;
- Advertising commitments;
- Franchise agreements;
- Licensing agreements;
- Equipment leases;
- Real estate leases;

- Customer contracts;
- Supplier contracts;
- Loans; and
- Credit agreements.

A potential buyer should also be mindful of and carefully consider any contracts in existence which, if terminated, could have an adverse effect on the buyer's ability to continue to operate the target's business or on the profitability of that business.

Note also that in today's world of online business, many of a company's most important agreements may not have physically signed copies, but may exist only online. It is important that each company understand and get copies of the other party's online agreements, including SaaS and other services the other party uses.

Employee Issues and Management Issues

When merging with another company, understanding the roles of employees and management structure is critical to the future success of the combined company. Acquiring companies should begin by examining the organizational chart of the target. In addition to a hierarchy of roles, biographical information of those filling the roles should be reviewed. If there are consultants critical to the company's success, their qualifications, as well as their consulting agreements, should also be reviewed. Consider doing detailed background checks of key personnel.

Employee compensation should be carefully reviewed. Compensation is often not just salary and bonuses, but can also involve important non-cash compensation (such as employee vehicles, use of company owned season tickets, etc.). Ideally, this review should go back at least three years for officers and key employees. Further, each party should review all employee benefits offered by the other party, including profit sharing, deferred compensation, pension plans, and retirement plans, to determine if there are significant mismatches. With companies that offer stock options, also review evidence of IRC Section 409A compliance. If the company offers separate management incentive or bonus plans, review these plans – both the policy governing the incentives, and how those incentives or bonuses are implemented in practice.

Finally, investigate the possibility of any labor disputes within the company. It is reasonable to ask for summaries of past labor disputes as well as ongoing labor disputes, which can serve as an indicator of larger issues.

Compensation is often key to the success of a merger and should be carefully considered. For key employees, has seller implemented any agreement to retain the employees through the merger? Will

buyer offer any bonuses post-merger? Have key employees been identified? What discussions, if any, have taken place to ensure employees are interested in and willing to stay post-merger? How will these payments and employees be integrated into buyer's existing compensation systems?

Will layoffs be an issue or a potential issue? Buyers should be aware that there are laws restricting a company's ability to lay off large groups of people and plan accordingly. How much will severance costs amount to? Will buyer or seller be responsible for compensating employees who will not move to the post-merger company? Is there a collective bargaining agreement or union contract which governs severance costs? In evaluating layoff costs, don't forget to include vacation pay and any other transition assistance (such as education assistance).