

Critical Corporate Housekeeping and Due Diligence

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Brian Carnevale: Welcome to the episode. My name is Brian Carnevale from Harris Beach and I'm your host today. I'm joined by Dave Clar, leader of the Harris Beach Corporate Practice Group and John Buhrman, Harris Beach Partner and Corporate team member. Today we're discussing legal housekeeping and due diligence and Dave and John will discuss their experience in this area of law supporting clients of all sizes. Dave and John welcome, thanks for joining us. Dave I'll start with you. What are the elements of legal housekeeping and due diligence and what typically prompts a company to explore these steps?

Dave Clar: Thanks Brian. Let me take the second part of that question first. In terms of what prompts a company to explore these steps, usually there's some sort of triggering event. A change of control transaction is contemplated, maybe you have a new shareholder coming on board or a shareholder leaving, or it could be a new financing being undertaken by the company, maybe some succession planning. Often times it's as simple as a change in personnel. You bring in a new CFO, a new CEO, they have some questions, they're looking for some documentation and all of the sudden you're sort of into a diligence exercise. So, John if you want to add anything to that; but lots of different ways that you sort of find yourself engaged in diligence of some sort.

John Buhrman: Yeah, I would agree with that Dave. You know, I think sometimes there's a tendency for businesses, especially if they're on the smaller side or if they're fairly new, to delay taking proper documentation and getting prepared for a significant event until there is change of personnel, a big transaction coming up that prompts someone to take a closer look at things or be prepared to sort of open their books. Ideally, there would be practice steps taken but that's not always the case.

Dave Clar: I would agree, and I think the first part of your question Brian, what are the elements, really expands the gamut from the organization and structure of the company itself to issues related to tax, intellectual property, financial transactions, set instruments, contracts, environmental, literally across the board and you know if we are involved in sort of a comprehensive diligence exercise we will typically hitting many if not all of those areas.

**Brian
Carnevale:**

I imagine that maybe no two exercises are the same so where might an organization face a particular challenge or where might those pieces pop up during that exercise?

Dave Clar:

Great question, and again a lot of times it depends on why and how you got into the diligence process. If it's for example, a tax or a department of labor audit, obviously you'll be focused on certain things and your HR practices in the context of a labor audit may be front and center. Stepping back sort of more globally, you know, where do problems exist, often times it's as simple as documentation doesn't exist, documentation can't be located, you've got inconsistent or inaccurate record keeping, especially if we're talking small closely held businesses in and around the startup phase. Often times the CEO was also the guy that came up with the idea, maybe he's a very good business man/entrepreneur, maybe he's not great with the tax and accounting, maybe he's just not sort of a dotting I's crossing T's kind of individual and often times one of the issues you have in any process is, is the documentation readily available, is it accurate, certainly at a high level. John, I don't know if you want to talk about more specific examples...

**John
Buhrman:**

Yeah I mean I think often times when it comes to documentation it's sort of not followed all the way through. There is an intention to change ownership, there is an intention to document perhaps a transaction between parties who are closely related, an affiliate, or something like that and there's not an issue right now and the business wants to get right to what they do best, which is actually producing the good or service or what have you and it's just going to often times fall by the wayside because it's not an immediate concern even though down the line it could cause an issue.

**Brian
Carnevale:**

And you had touched on a couple of those typical areas that are reviewed and some of those issues in your last answer you mentioned tax issues, you mentioned labor issues. John, do you want to kind of just provide the gamut of possibilities and what are those typical areas that are reviewed during the due diligence exercise?

**John
Buhrman:**

Yeah I think probably a good way to sort of cover a lot of different areas is to talk about an example where there's a company that's perhaps sell its business or take on a major investor and so they're really going to be asked to completely open their books in a wide variety of areas. We could be talking about showing their organizational documents, the Constitution if you will, the Certificate of Incorporation, the Charter, the creation of Bylaws, or Operating Agreements for an LLC. Showing the capitalization table, showing the stock ownership, things like that. Are there prior investors, what are the relationships between main entity and perhaps the landlord who might be, you know, an entity that is owned by the owners of the business itself. Intellectual property employment is where general issues, litigation and tax and to get into sort of more specific examples

starting with organizational documents, one of the first issues is making sure you have up to date information. Sometimes someone has a record and doesn't realize, oh we passed an amendment to that Charter that we don't have, or there's an Operating Agreement that shows ownership that is out of date, maybe family members have been brought on or there have been some other changes. Sometimes with prior investments, there is not all the securities filings that you need to have or you don't have the signed documents or final documents or things like that. Sometimes when you have related parties, getting into that example, you don't have the lease documented between the main business, for example, and the real estate entity. The owner maybe lent money to the business but there isn't a promissory note documenting that.

For intellectual property issues a frequent thing we find is it's not clear who actually owns the intellectual property, if whether the employee maybe created the intellectual property and really it should be the company's but they haven't documented the transfer. That especially can be an issue with anything that's patentable, an invention of some sort. Employment issues, are the employees properly classified, should they be paid hourly but they're being paid with a salary or there are overtime issues, things like that. And certainly tax issues, I think especially in this world where you're not just selling your goods or services where you are but you're selling it across the country and across the world, are you properly paying taxes for that, are you registered in the right places, things like that. There's any number of different issues that can come up and no two companies are the same but you're certainly going to see some patterns there.

Dave Clar:

Yeah and just to add a couple of thoughts onto that, with respect to intellectual property, we often see consultants engaged to help with creating source code and developing some of the technology and architecture underlying the actual product service, business itself and those aren't always documented in a way that makes clear that those rights have vested in the company. We're also running into a lot of foreign jurisdictional matters. In today's world most companies aren't just domestic, aren't just located in one state or jurisdiction. Often times they do have investors or independent contractors, consultants, contributors, employees in various jurisdictions including overseas, where frankly the laws and regulations can be a little bit different in around the IP issues and that kind of thing. And the other one is sort of cyber security and privacy. There's been obviously a ton of development there, GDPR in the European Union has obviously impacted the company's very material ways. California has a privacy statute, New York has a new privacy statute, other states across the U.S. have some in the works and we think that's only going to become more of an issue moving forward.

**Brian
Carnevale:**

So with instances where there may be a known issue going into due diligence, what's the best approach for addressing that?

Dave Clar:

More often than not I think, you'll have two parties who will want to jointly solve whatever that issue is and whether it is a noncompliance issue or you're dealing with an estranged equity owner or you've got documentation of IP ownership. Oftentimes the parties will sort of collaborate on what that solution is. At the end of the day, if the due diligence is taking place in the context of a transaction, really it's just an allocation of risk exercise. Once you've identified the potential exposure, then the parties can work together to minimize and to mitigate an appropriately assigned risk, so, I do tend to agree that typically transparency is in everyone's best interest. Obviously, if the diligence is undertaken in a different sort of context, for example, if you're being audited by the tax department or the department of labor, you want to be answering only what you have to and be sharing only what you have to. You want to make sure you stay in the confines and don't create an unnecessary exposure but for the most part we have found in our experience if you tackle these things head on, you tend to come to a resolution that everyone can live with and then you move on.

**Brian
Carnevale:**

So when unexpected issues do come up, what happens in those scenarios, could there be a situation when there's an event such as a major investment or full sale. Could a deal potentially fall through with unexpected things arising during diligence?

Dave Clar:

Certainly a possibility and obviously nobody likes to see a deal fall through. If you have a willing buyer and a willing seller and they've reached agreement on terms, you know I think there's a certain excitement, if not an expectation of getting that deal to come to fruition and to consummate the transaction but certainly in diligence there are issues that arise to the point where the deal could be comprised and whether that means the deal does not get done, whether there's an adjustment to the transaction structure, whether there's a modification of the purchase price will depend to a large extent on the materiality of the issue and oftentimes the context of the transaction can drive a resolution of the issue. If you have an unresolved piece of litigation that's been hanging around for a couple of years, now you're looking to sell the company, the buyer doesn't want to jump into that, that's going to sort of maybe drive you to settle litigation that otherwise you may have been willing to let sit a little longer. Some other issues that we've seen that have caused the decision point in a transaction have dealt with things like unfunded pension obligations, noncompliance with industry regulations and standards, I think we've talked again on the IP ownership and going back to some of the undocumented or issues with contracts, we have a lot of companies we represent that are sort of sloppy in their housekeeping and they are asked to disclose all of their contracts and they realize that they haven't done a

good job of actually following through and getting contracts signed, or if they have they can't locate them, you know all issues that have to be worked through with the buyer but to answer your question Brian, yes, I think it does put some strain on the potential transaction.

**John
Buhrman:**

And I think that may cause some sellers to be reluctant to disclose major issues but I think in most circumstances it'd be better for the deal to fall through than for there to be some expensive contentious litigation when the issue actually comes to the buyers attention and I think your ability to have some creative problem solving to address the issue that has come up in the due diligence process is much improved when you are upfront about the issue before the deal closes as opposed to settle a contentious dispute afterwards.

**Brian
Carnevale:**

So I think through this conversation you've certainly cemented for the audience the importance of regular due diligence and housekeeping. How can the two of you and the corporate team statewide support organizations in that effort?

**John
Buhrman:**

One takeaway I want listeners to have here is that there is often going to be an issue, no company is perfect about this, this is more a question of how can we improve, how can the housekeeping be better and be more organized and sort of limit exposure and downside and options later on when it may be a little late to fix some of these issues.

Dave Clar:

Yeah I think two ways in which Harris Beach can really help is similar to the way in which on an annual basis the company will go and meet with their accountant and they will walk through anything from revenue recognition to old A/R to inventory. To have a regular cadence where you meet with your attorney, just to walk through who is managing the contract process for your company, who's in charge, who's monitoring, things like the lease and when is that coming up for renewal. Or if you have an Operating Agreement or a Shareholder Agreement are people periodically looking at that to see if it still makes sense? Do we have enough insurance in place, key man insurance, life insurance, disability insurance? In terms of your employee base, has that shifted, are you using more consultants or independent contractors? Who's contributing to the IP of the company and whether that's some sort of annual checklist or a regular meeting, heedance, the timing, the form is a little bit sort of dependent and specific to the client but there should be some regular thinking about this because the last thing you want to do is go five, ten, twenty years without looking at anything, decide you now want to sell your company and realize at the end of the day you have done nothing to enhance or preserve the value of what you actually have through the failure to maintain these formalities through the years.

**Brian
Carnevale:**

I'd like to thank Dave and John for joining us today. For more information visit www.HarrisBeach.com/corporate. While you're there you can contact Dave and John, sign up for legal alerts and learn more about the statewide team. Make sure you're subscribed to the podcast to catch future episodes related to the challenges and opportunities impacting private and closely held businesses.

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