



KOHNEN & PATTON

# DUE DILIGENCE CONSIDERATIONS FOR ETA BUYERS

by

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## Introduction

Buying a house without an inspection is a risk. The place might look perfect with fresh paint, nice staging, and coordinated lighting. Later, however, a naïve buyer may discover a cracked foundation, mold behind the walls, or outdated wiring. The due diligence of a home inspector ensures there are no surprise problems or unexpected expenses after purchase.

Legal due diligence in the acquisition of a business is no different because it pulls back the curtain and inspects the business for liabilities. Due diligence is simultaneously backward and forward looking: Good due diligence confirms the business is how it was represented to be while also influencing what adjustments may be needed to finalize the acquisition. In simple terms, due diligence confirms to the buyer that the acquisition is worth making because it lends confidence that there will be steady operations after the transaction closes, unhindered by risk and unexpected burdens and hurdles.

While financial diligence, such as review of earnings and expenditures, is often the primary focus of the buyer, legal diligence is critical to ensure the buyer's investment in purchasing the business is well spent. A person seeing to become an entrepreneur through acquisition is committing to a personal guarantee with millions of dollars at stake. Investing time early in the acquisition process to ask the right questions and be diligent is a wise decision. This article examines several general categories of legal diligence key to most acquisitions.

## Corporate Structure & Encumbrances

A clear corporate structure and proof of ownership is essential for any transaction. The buyer deserves assurance that the seller, or the person approving the transaction on its behalf, has the authority to do so. The seller should provide documented ownership records and a chart of any subsidiaries to confirm who holds interest and control. In addition, the seller should deliver key organizational documents, such as formation documents, bylaws or operating agreements, and any amendments, along with stock ledgers or capitalization tables that reflect current ownership and any outstanding equity interests.

Diligence should also confirm that proper approvals have been or can be obtained, including board and shareholder consents, and should identify any transfer restrictions or voting arrangements that could affect authority. Reviewing these materials helps uncover risks such as inconsistent records or ownership disputes and allows issues to be addressed before closing, reducing delays and strengthening the enforceability of the acquisition.

Further, the buyer should ensure the seller's assets acquired in the purchase are free of liens. A lien is a legal claim or security interest in property granted to a creditor to secure payment of a debt or performance of an obligation. If the obligation is not satisfied, the creditor may have the right to seize or sell the property to recover what is owed. Assets encumbered by a lien cannot be freely transferred in an acquisition. Legal due diligence involves utilizing paid and public services, such as state Uniform Commercial Code ("UCC") databases, to identify any liens against the property of the business. Such liens should either be satisfied prior to the closing of the acquisition or the transaction should be adjusted to account for the liens remaining after the closing, including a possible adjustment to the purchase price.

## Material Contracts

Material contracts are agreements that are key to the operations of the business, such as supplier and distributor agreements, customer agreements, leases, and payroll and other third-party business services agreements. Certain provisions within material contracts must be identified and reviewed because they could materially affect the transaction.

In asset acquisitions, attention should be paid to assignment provisions, which are contract clauses that govern whether and how a party may transfer its

rights or obligations to a third party, often requiring prior written consent. In equity or membership interest transactions, change-of-control provisions require notice or prior written consent if ownership or control of a contracting party shifts, potentially triggering termination or renegotiation. Assignment and change of control provisions are especially common in leases, where landlords will often condition consent on the incoming tenant's creditworthiness.

## Employment Matters

Employment diligence is essential for evaluating and understanding the target company's employment policies, contracts, compensation and benefits packages, and workers' compensation history. From the buyer's standpoint, uncertainty surrounding employment matters can impact workflow and productivity, which can impact an acquisition's success post-closing.

A way to avoid potential employment impacts is to evaluate and identify early on any issues involving misclassified employees (W2 vs. 1099), compensation and benefit liabilities, insurance policies, and workers' compensation reports. The importance of these evaluations can ensure the satisfaction of employees post-acquisition, that any key man insurance policies are effectively dealt with, and that the buyer is aware of any 'risky' claims that may result in higher insurance premiums. This in-depth look at the target company's past, current, and future employment status is essential to determining possible liabilities and workforce issues.

## Litigation

Litigation is the legal process of resolving disputes by either filing legal documentation with the public court system or negotiating claims privately outside of the court system. Both of these types of resolutions can impact an acquisition and should be disclosed through the diligence process.

Litigation diligence is a systematic investigation of all legal risks and exposures that could affect the acquisition's value and the buyer's liabilities post-closing. The investigation that is commonly conducted requires searching state and federal court dockets, inquiring with the target company, and sometimes requesting third-party searches for judgments and liens. By requesting such disclosures from the target company and acquiring supporting documentation from the docket and database searches, the buyer can be fully informed regarding any outstanding liabilities or interests of the

target company. The snapshot that is produced as an end product informs the buyer of its inherited legal exposure for the target company's past claims, outstanding liabilities, and future or habitual claims.

## **Tax**

Tax due diligence, in particular, is essential for evaluating potential exposure, confirming the accuracy of the target's tax positions, identifying any outstanding liabilities, and highlighting opportunities to structure the transaction more efficiently from a tax perspective. From the buyer's standpoint, the depth and duration of tax diligence should align with the complexity of the transaction. Asset acquisitions are often more limited in scope and can be completed relatively quickly, whereas stock and interest purchases typically demand more extensive analysis because the buyer may assume historical liabilities.

To support this review, the buyer should request key documents, such as financial statements and recent income and sales tax returns in states where the target has sufficient activity to establish nexus, to verify compliance, identify inconsistent positions, and understand tax-related assumptions. Where applicable, organizational or trust documents may also be reviewed to confirm proper ownership structures. Further, the buyer should ensure the target company is free of tax disputes and liens. Finally, tax clearance certificates from any respective department of taxation or revenue provide assurance of the transferability of assets and good standing of the company with taxing authorities. The certificates can require notable lead time, necessitating tax diligence be an early category addressed in the diligence process. Taken together, tax diligence enables the buyer to price risk accurately and negotiate appropriate protections.

## **Intellectual Property**

Intellectual property ("IP") is a broad and sometimes misunderstood category of assets in a business, encompassing not only obvious items like logos, trade names, and website domains, but also less visible assets such as customer data lists developed by employees. Because IP can exist across multiple systems and databases, it is important to identify and verify ownership early and revisit that diligence regularly to avoid gaps or inconsistencies.

Additionally, some intellectual property may not be owned outright but instead licensed from third parties. Those licenses can carry restrictions, including provisions that make them unassignable,

creating potential complications in transactions or operational transitions. For example, a critical logo used in the target company's branding but owned by a parent company and licensed to the target company is an essential matter to address, one that can only be discovered through solid legal due diligence.

## **Information Technology**

Information technology ("IT") diligence may appear broad and less important depending on the type of acquisition. IT diligence, however, is very important for the buyer to understand as even a 'non-technology' company uses email, information management systems, logging systems, and much more. As a result, IT diligence offers insight into the target company's framework and privacy protections.

A thorough evaluation of the target company's IT framework allows the buyer to understand how the target company's technology is built, operated, maintained, and secured. This evaluation is important to avoid potential hacking incidents and phishing scams, which are becoming more prevalent, and can often be mitigated with cybersecurity insurance, which may require the buyer to satisfy certain obligations. Knowledge of these potential privacy risks pre-closing can help the buyer determine the validity of the investment and assess the compatibility of the framework's integration post-closing. As a result, IT diligence can have a big impact on the acquisition.

## **Regulation & Compliance**

Regulatory diligence provides a snapshot of the potential regulatory risks, liabilities, and compliance gaps that exist for the target company. When conducting this type of diligence, the buyer should be on the lookout for governmental approvals, industry licenses, safety and efficiency data, quality control and compliance records, training materials, written standards of conduct, regulatory investigations, audits and reviews, and remediation plans.

By reviewing the regulatory documentation and policies of the target company, the buyer can establish whether the target company is following the rules, has the proper licenses, and is complying with the law. If the due diligence reveals that an industry-specific license is required, such as in plumbing and HVAC industries, then careful corporate structuring should be considered by the buyer to acquire the license, which may result in there being multiple license holders. As a result, the acquisition of industry-specific licenses and compliance with such regulatory rules will indicate how the target company

navigates compliance challenges and help the buyer understand potential liabilities.

## **Insurance**

Insurance is another key diligence area, requiring a careful review of all policies and their specific terms, including coverage for real estate, equipment, directors and officers (“D&O”), employment matters, workers’ compensation, and general liability. Beyond simply confirming that coverage exists, it is important to understand limits, exclusions, deductibles, and any unusual provisions that could affect risk exposure.

A thorough evaluation should also include the target company’s claim history. Denied or disputed claims can reveal potential coverage gaps or recurring issues. Tail coverage, which is insurance that allows reported claims after a policy ends for incidents that occurred while the policy was active, may be necessary in certain professional service industries. In addition, reviewing correspondence with insurance brokers and carriers can provide valuable context about prior claims, coverage negotiations and denials, and any known areas of concern. Further, any notices from the state worker’s compensation bureau should be reviewed for risk analysis, both financially and regarding labor and safety issues.

## **Conclusion**

For the buyer in an acquisition, proper legal due diligence is the key to avoiding inherited and unknown liabilities. The course of the transaction will be impacted by identifying issues in due diligence, resulting in modifications to the legal structure and documentation. While legal due diligence will not usually kill a transaction, it will play a massive role in how the transaction is structured and the buyer’s long-term satisfaction with the acquisition.

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