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How to Evaluate Legal Risk in Aquisitions

by James Shields

You have identified a company for acquisition or investment and begun your risk assessment. While completing the assessment, you discover the company has pending litigation. You don't want to let a potentially great investment slip through your fingers, but you also don't want to be stuck in a bad situation if the litigation is material. What do you do? How do you assess the legal risk?

In today's litigious society, it is nearly impossible to find a company not involved in some sort of litigation. You can no longer afford to only evaluate companies on the management team's talent, available cash flow, and the product's market penetration. You also need to assess the effect the litigation will have on your investment. Bottom line – you want to make money with the least amount of risk possible.

Expert assistance is of strategic importance, yet attorneys are costly and not naturally accustomed to aligning their efforts with an investor's goals and budgets. Investors and companies are turning to a new breed of litigation management experts to complete these risk assessments quickly and efficiently. Litigation managers are attorneys with significant business backgrounds who work with investors and executives to evaluate the legal risk in potential investments.

"It is not unusual for potential legal risk relating to a business' past or current activities to cause an investor to shun what could have been a valuable investment. The ability to accurately quantify and qualify legal risk is essential in making any investment decision," said Scott Troeller, Partner, Veronis Suhler Stevenson.

Three important criteria to evaluate when assessing a company's legal risk are:

- Materiality of the litigation
- Potential for future suits
- Connection between the litigation and the business plan

When evaluating a company's pending litigation, it is imperative to compare the cost and timeline of the litigation with available funds. If the litigation will cost the company more than they can afford, it will bankrupt the company. It is also important to determine the potential of a bad result and the costs associated with it. If it is likely that litigation will end in a bad result for the company, investors and executives need to know if the company can handle the financial repercussions.

For example, a large bank sought to acquire a title company in order to facilitate its real estate lending practice. The title company had several pending lawsuits, claiming faulty underwriting. The bank sought to evaluate the legal risk, damage model, resolution time and the potential for future litigation. The litigation model of the general counsel was also assessed because there was a conflict of interest as they were also directly involved with closing documents in question in the litigation. With the litigation manager's advice, the acquisition was successfully completed, the litigation was resolved, and the business model was corrected to eliminate the risk of future conflict.

The assessment on whether other suits may spawn from the issues being litigated will also have an impact on any investment decision. Other parties involved in the company may be sued later. There could also be other potential plaintiffs who may sue based on the same or a similar set of facts or claims in the current litigation.

Investors and C-level executives need to know the possibilities of future litigation that will affect the profitability of the company.

“When looking at a potential company to invest in, I want to be advised that the legal process for pending litigation is aligned with the goals of my company to achieve the best possible results,” said John Pappanastos, CEO, EFG Companies. “In my experience of working with a litigation manager, I have been secure in my decisions, knowing that I am fully informed about all the variables that can affect my company’s future.”

Traditional attorneys tend to only focus on the materiality of the litigation and the potential for further suits. Litigation managers also answer the question, does the lawsuit expose a problem with the company’s business model. The litigation may be a one-time anomaly, but if it is due to a process or action addressed in the company’s business plan, there is potential for more suits.

For example, if there was a case involving two different states declaring that the practices of the company violated state laws and directed it to no longer conduct business in those states, the company clearly has promoted processes in its business plan that are adverse to conducting lawful business and more suits will follow.

Litigation does not have to be an uncontrollable factor in the valuation of any business. By properly evaluating the potential for materiality and future litigation, and the connection between the litigation and the business plan, investors can make informed decisions, with a full understanding of the legal risk associated with a potential company.

How a Residential & Commercial Brokerage Firm Sized up the Risk of an Acquisition

A large regional residential and commercial brokerage firm was in the process of acquiring another real estate company. The company to be acquired had several open, active litigation matters that included claims of fraud and misrepresentation regarding the manner in which the company presented properties for sale. Because the sale involved was a stock purchase for tax purposes, any current liability or claims asserted against the company to be acquired would be assumed by the acquiring company.

In addition to evaluating the immediate risk of the pending litigation matters, evaluation was conducted of the current business model and training practices of the company to be acquired to determine if there was a systemic problem by management that encouraged aggressive, ill-founded marketing practices in order to increase sales.

It was also necessary to determine whether the prior litigation matters were concentrated in the hands of a few salespersons, critical to the ongoing success of the company to be acquired, as well as management’s response not only to the litigation but also to the policies and procedures of the company.

Finally, because of the claims made in the pending litigation, evaluation was made on whether a successful integration of the sales and marketing team into the acquiring company’s business model could be made, given an apparent difference in the sales culture between the two companies based upon the litigation claims.

The litigation manager determined that the pending litigation matters were more of an anomaly rather than a systemic practice and that the claims were not localized to a specific salesperson or attributable to an aggressive sales strategy. The litigation matters were successfully resolved within approximately six months of closing on the purchase.

James Shields

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