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# **Mergers and Acquisitions of Small Businesses in a Troubled Economy**

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## **Abstract**

The lack of funding available for small businesses to acquire new businesses and the lack of attractiveness of businesses to be acquired has limited the number of small business acquisitions. Those with cash, financing or value in their current business are in a position to move forward in acquiring or merging with another small business. The purchasing business can, because of the troubled economy, usually obtain the target business at a discounted value. This is the case whether the target is a troubled business or is not a troubled business.

Successful businesses may also wish to examine target companies that are carrying net operating losses so they can take advantage of the post acquisition tax benefit provided by IRC Section 172, Net Operating Loss Deduction. Advisors to a buyer in these circumstances must also be aware of IRC Section 382, Limitation on Net Operating Loss Carryforwards. Section 382 limits certain built-in losses following ownership change. Purchasers must be on the lookout for diminished assets on the balance sheet that are worth less than the value on the tax basis balance sheet.

This article will address issues that must be addressed by a prudent buyer during and negotiation or due diligence review. Attorneys advising buyers should be aware of the pitfalls and present alternative planning possibilities to protect their client. While it is almost impossible to present an all-inclusive checklist of potential risks, the article discusses some of the more obvious disasters and what can be done about them.

**Keywords:** Mergers, Acquisitions, Small Business, Buyer, Seller, Due Diligence

## **Mergers and Acquisitions of Small Businesses in a Troubled Economy**

### **Introduction**

Acquiring a small business during times of economic hardship offers opportunity for those with cash and value to purchase those businesses. Lenders have been cautious with providing funds for small businesses and prospective acquirers must be vigilant in their due diligence. This is the case regardless if the client is seeking funds from a lender or using their own capital.

I will review some of the areas of the target companies that must be examined and investigated to protect lenders and clients. The major areas discussed in this article are:

1. Receivables
2. Debt
3. Investments
4. Inventory
5. Equipment
6. Real Property
7. Intellectual Property
8. Warranties

### **Receivables**

While the current economy has discounted the price of many of the current small businesses on the market, much care must be taken to insure the value for a prospective buyer. One of the major focuses should be on Accounts Receivable. The Net Receivables on the books may have little to do with the ability to collect those receivables. There is a domino effect of a troubled economy and one of the reasons a current seller is ready to dispose of his business may be because of trouble collecting the firms receivables and a diminished cash flow that will accompany the slow collection of receivables.

A detailed aging of the accounts receivable is a starting point for analysis of their value. The aging should be examined along with a schedule of bad debts that have been written off and the change of percentage of receivables being deemed uncollectable must be reviewed to determine any negative trends in receivable collection.

A more thorough evaluation of collectability must be undertaken after the initial analysis. Customers with large delinquent balances must be contacted to determine the collectability of their balances. This of course would be done after consent by the seller in the normal course of a non-disclosure due diligence agreement. Reliance on the customer is just the first step in helping the client evaluate the value of the receivables. A search of the bankruptcy filings in the Federal District Court for any of the targets customers would also be in order along with a review of Dun and Bradstreet for any negative comments and reports.

Another potential trap that needs thorough investigation is the possibility of preference claims made by the target's customers during the customers' bankruptcy. (Bankruptcy Code § 547) The bankruptcy code provides for a preference claim which can have payments made by a debtor pulled back into the bankruptcy estate. There are defenses to the preference claims which would protect the target or the buyer should customers file for bankruptcy.

One of the defenses can be made if the payments were made in the ordinary course of business between the creditor (target) and the debtor (customer). (Bankruptcy Code § 547(c)(2)) This defense also includes payments made according to terms that are customary in the industry of the target. Another defense is the contemporaneous exchange for new value. (Bankruptcy Code § 547(c)(1)) This defense is raised when the debtor and creditor intended the exchange for new value to be contemporaneous. Care must be taken to demonstrate that the payments are not being applied to aging receivables. It would also be wise if the target would take a purchase money security interest in the goods being transferred to its customers. (Bankruptcy Code § 547(c)(3)) This strategy would give rise to the enabling loan exception defense. As with all the defenses, there are timing issues and other requirements that must be followed to be successful raising these defenses to a preference claim.

Having this information will help the client discount the value of the receivables in both setting the price for the business and in determining the correct book value of those receivables. If there is doubt about the collectability or uncertainty about successfully defending any preference claims, the buyer should seek to have the seller bear a burden for un-collectability by reducing the purchase price of the target based on unpaid receivables or successful preference claims.

## **Debt**

Have we adequately identified the total debt of the target and how much of it is being assumed by the purchaser? These are two very important questions in a troubled economy. All debt instruments should be reviewed. These include all notes, any debentures, and term loans. Any security agreements, mortgages, deeds of trust, consignment agreements, liens and encumbrances on any assets as well as purchase money security interests created by the target must also be reviewed.

Great care should also be taken in reviewing the targets compliance with any restrictive loan covenants and terms contained in the security instruments. Depending on the terms of the ownership transfer the mere change of business ownership may trigger acceleration clauses in notes or security agreements. These issues should be addressed prior to finalization of the transfer and addressed with the lender.

Any tax deficiencies must also be identified. Were any audits conducted on the target by any taxing authority or are there any notices of planned tax audits? If the target is a multi-state operation, all state income tax returns should be compared to the states where the corporation is qualified and does business.

A big part of the value to your client may be acquiring any loss carryovers from the target. If your client is a successful business, being able to reduce the tax burden is an attractive feature of purchasing a business with federal and state loss carryovers. Great care must be taken in evaluating the carryovers. IRC Section 382 places limitation on the amount of loss the acquiring corporation can take after a change in ownership. One of the restrictions is that the total available losses are written down to the fair value of the corporation at the date of the change in ownership. In an effort to keep the fair value at a maximum amount, owners would make capital contributions to the corporation to maintain its value. Congress, wishing to limit the amount of the loss carryover, in Section 382(l)(1)(A) & (B) provided capital contributions are disregarded if part of a plan to avoid or limit the reductions of Section 382 and any capital

contribution within two years of the ownership change is presumed to be part of a plan to avoid or limit the reductions. (IRC § 382)

Two important points when advising clients are to make sure there were not capital contributions to the target in the last two years and that the annual amount of the loss carryovers will be limited to the amount of the fair value of the target times the long-term tax-exempt rate.

## **Investments**

Does the company have an equity position in any other company? The value of the investment being carried on the books of the target is very important when determining the purchase price or structure of the business combination. Care must be taken to make sure the target has correctly valued the investment. A worthless investment being carried on the books at purchase price or an unrealistic fair value could inflate the consideration requested from the target.

Another consideration when dealing with the target's investments focus on buy-sell agreements or any other commitments regarding the purchase or sale of any investments. Finding out about the target's obligation in a stock purchase subscription after settlement could prove disastrous if the new owners must generate cash to purchase equity of other companies. The terms of any buy-sell agreement could also put the new company in a position of having to liquidate some of its investments at a previously agreed upon price which is lower than fair value or if the company is required to purchase some investments at a price higher than fair value.

## **Inventory**

A very careful physical examination of the target's inventory must be made to determine if any outdated, stale, or useless items are included in the value of the inventory used when computing the price value of the target. Close examination of the work in process inventory and how it is determined must also be undertaken.

Included in the determination of outdated, stale or useless products, an evaluation of seasonal sales cycles, not only for obsolescence, but also for availability of product for current and upcoming cycles must be done. Purchase or combination with a company that is not ready to meet the demand of the next sales cycle may result in a drastically reduce revenue stream.

Further, an analysis of individual inventory item turnover and a comparison to available inventory will reveal the ability to fulfill the demand for popular or fast selling product. Much like the seasonality analysis, the target should have adequate product to meet the immediate demand of the market place.

## **Equipment**

If the target is a manufacturing company, close evaluation of the machinery and equipment must be done. Is the equipment operating efficiently in its production of product? The client must obtain detailed records of operating costs and determine the total cost per product line and item. Comparison to industry data can provide useful information in evaluating efficiency of the machinery and equipment. Maintenance and replacement schedules should also be obtained along with any agreements that relate to either the maintenance or replacement.

Repair, maintenance and productivity analysis should also be done in a comparison with new equipment, trade-in value and operating cost per product. If a new machine is needed, do the targets employees have the technical knowledge to operate the new machinery? Does the target provide for continual training of the production line workers? If the machine is used in the production of product, what is its utilization and what are alternative production methods that would allow the retirement of the machine?

The public records at the county courthouse and with the Secretary of State in the County and states where the company operates must be checked for Uniform Commercial Code (UCC) filings as well as recorded liens or judgments against the target. Secured transactions impairing any inventory, equipment, machinery and fixtures must be reviewed to insure the target can transfer title to the purchaser. (UCC § 9-103)

## **Real Property**

If the business purchase includes real property, great care must be taken to assess the value of the property and any possible claims against the property. A title search of all properties included in the deal must be done to identify the owners of record and if there are any filings raising an issue of ownership. In addition to any filed security interests, mortgages or deeds of trust, any filed easements, restrictions of record and any recorded leases should be identified and examined to avoid conflict or restriction on the business operation.

Filed plats or surveys should be obtained from target or county and physical inspection of the property should be undertaken looking for encroachments onto adjacent property or encroachments from adjacent properties onto target property. In addition to encroachments, violations of setback and zoning requirements must also be undertaken and it must be determined, if any exist, whether appropriate variances were issued by the appropriate governmental body.

If the property is going to be developed, with construction of a building or through subdivision, identification and availability of phone, electric, water, sewer and all other necessary services must be ensured. The client must also find out if any adjacent or properties within close vicinity are planning for development or if improvements are being planned.

If a Phase I environmental report has been completed on the property, it should be reviewed with an eye toward additional costs, if any, to be borne by the buyer. Sale or transfer of commercial property is a triggering event for a Phase I report. In addition, the target should complete an environmental questionnaire on all parcels being transferred in the current deal.

Does the Federal Emergency Management Agency identify this property as being in the flood plain and if so, does any mortgagee require an engineering certificate or federal flood insurance prior to closing? The client must also determine if being in the flood plain will jeopardize the planned use of the property and to what degree it might reduce potential return from the business. (FEMA, Flood Insurance Rate Maps)

If the client is purchasing real property in an asset sale, care must be taken if a seller is foreign entity and a Foreign Investors Real Property Tax Act (FIRPTA) certificate should be obtained and appropriate taxes allowed for at the settlement. It is the responsibility of the buyer (transferee) to determine if the transferor is a "foreign person" and subject to tax withholding on the transfer. The transferee is the agent and if they fail to withhold the tax, they may be held liable for the tax. (FIRPTA; IRC at 26 U.S.C. § 897, 26 U.S.C. § 1445, and 26 U.S.C. § 6039C)

## **Intellectual Property**

Client must verify ownership of Intellectual Property being conveyed in the transfer. All patents, trademarks, service marks, trade names, copyrights, trade secrets, licenses, and consent agreements and any related applications for the above mentioned intellectual property of the target must be obtained. Care must also be taken with target employees and their employment contacts, insuring non-competition and confidentiality provisions. In addition, the provisions that assign any patent or ownership rights of the employee to the company must be verified.

In considering any future litigation or liability costs, the target must provide all notices given by the target and all notices of infringements received by the target company. The client must evaluate these intellectual property issues relative to their costs, if they are assets on the balance sheet, the amortization method and the remaining useful life of each.

## **Warranties**

All warranties given by the target must be reviewed along with the estimated warranty expense and claims history for each product manufactured or sold by the target. Detail information from the warranty claims made against the target and whether those claims are for alleged or admitted defects in material, workmanship or design must be reviewed and the amount of liability must be determined.

Is there any litigation pending involving the targets products? The results of all testing used to measure product integrity, whether these tests were done internally or from an outside testing firm, must be analyzed. The measures that the target has implemented regarding quality control must also be reviewed and observed to guarantee compliance with the quality control procedures.

## **Conclusion**

An exit strategy should always be included in any acquisition agreement. If an agreement has been reached and signed with a closing date established, a failsafe provision allowing the buyer to cancel the purchase should be provided for. This provision would provide for a "material change" in any number of conditions of the target. The more specific the qualifying condition is the better. A material change should include the resignation of key employees, loss of key customers, failure to obtain minimum revenue or profit targets, significant increase in expenses or costs and any other conditions considered mandatory for the closing to take place.

An other mandatory contingency is the buyer's ability to obtain financing to close the acquisition. Securing financing will no doubt take longer than in the past and is never assured until the lender provides the money to the buyer. With this in mind, the buyer should try to extend the date the agreement can be terminated.

The buyer and their counsel should make every effort to mitigate the risk associated with the acquisition of a small business in our current troubled economic situation. With a close examination of the issues raised herein the buyer's counsel can help the buyer do just that, mitigate the risk.

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