Representing a Buyer in an Uncertain Economy

MITIGATING THE RISK

By Melinda Davis Lux

Introduction

Both the current uncertainty in the economy and the tightening in the credit markets have caused a slowdown in recent merger and acquisition activity. The deterioration of the economy, however, has created a buyer's market. Buyers with cash or available financing have the opportunity to purchase businesses at favorable valuations. In addition, seller financing is more likely to be available in today's economy.

Buying a business in the current economic climate, however, is generally riskier than buying a business when the economy is stable and healthy. Transactional attorneys who represent buyers should advise their clients of the heightened risks presented by the current economic climate and suggest strategies for lessening those risks. This article describes some of those risks and strategies.

This article assumes that the seller has not filed for bankruptcy protection and is not conducting an auction. In addition, this article addresses risks and strategies that apply generally to most business acquisitions and does not address risks that are industry specific. In this article, references to "seller" usually refer to a seller of assets. If the transaction is a stock purchase or a merger, references to the "seller" should generally be read to refer to the target company.

Investigate the seller's accounts receivable

During a downturn in the economy, some of the seller's customers may be facing cash flow and other financial challenges. As part of its due diligence, the buyer should pay particular attention to the seller's accounts receivable, reserve for doubtful accounts and historical collection data.

The buyer's due diligence review may reveal that some of the seller's customers are slowing their payments. If that is the case, the seller may collect fewer of its accounts receivable than it has in the past. The seller may or may not have created a reserve for doubtful accounts that, in the buyer's view, adequately addresses this risk.

If the buyer is purchasing accounts receivable, the purchase price includes a value for those accounts receivable. The buyer should view the value of the accounts receivable on the seller's balance sheet with skepticism. To address collection risk, buyers often apply a discount to accounts receivable, with old accounts typically discounted more than new accounts. In the current economic climate, a buyer should generally apply a greater discount to the seller's accounts receivable. The buyer may also heavily discount specific accounts, and may be unwilling to pay for some accounts. If the buyer and the seller disagree about the collectibility of particular accounts, one solution is to exclude those accounts from the purchase.

Even if the buyer is not purchasing accounts receivable, the buyer should carefully analyze the seller's historical collection data. Buyers commonly value a business by taking the average annual earnings of the business over a period of time and applying a multiple. Using a historical approach to value a business is risky when the economy is deteriorating. If some of the seller's customers are experiencing financial stress, future revenues from those customers are uncertain. Those revenues may not be replaced in the short term. The buyer should lower its valuation of the seller's business, and consequently the purchase price, to reflect the potential loss of those revenues.

ILLUSTRATION BY STEVEN WHETSTONE

Obtain representations regarding the seller's accounts receivable

To further address collection risk, the acquisition agreement can include provisions that have the effect of transferring the collection risk to the seller.

The seller can guaranty collection of its accounts receivable by representing in the acquisition agreement that its accounts receivable are collectible, net of reserves, and that each account receivable will be collected, net of reserves, within 90 days from the date on which the account becomes due and payable. This representation would be backed by the seller's indemnification obligation. For full protection, the seller's indemnification obligation with respect to this representation should not contain a threshold that must be achieved before indemnification is owed.

The acquisition agreement can also require that the seller repurchase all pre-closing accounts receivable that are not paid within 90 days after the closing. This provision can be included as an alternative to a collection representation or in addition to a collection representation.

If the buyer negotiates to transfer the collection risk to the seller, the seller may argue that the purchase price for the accounts receivable should not reflect any discount. The buyer should accept this argument only if the buyer is confident that the seller will be solvent after the closing and will fulfill its obligations under the acquisition agreement. Alternatively, an escrow account can be used to satisfy concerns about the seller's financial ability to meet its obligations with respect to accounts receivable.

Obtain protection against preference claims

In a worsening business climate, one or more of a seller's customers may have filed or may be considering filing for bankruptcy protection. One risk of customer bankruptcies that is often overlooked is the risk of preference claims. Under the preference claim provision of the bankruptcy code, a debtor that has filed for bankruptcy can attempt to "claw back" many of the payments that it made to non-insider creditors during the 90 days prior to its bankruptcy petition. The look-back period is one year if the creditor is an "insider." Two common defenses to preference claims are that the payments at issue were made (a) in the ordinary course of business between the debtor and creditor or (b) in accordance with ordinary business terms for the industry.

To assess the risk of preference claims, the buyer should examine the seller's current customer list and a list of the seller's customers over the past several years. The buyer should determine whether any of those customers have filed or are likely to file for bankruptcy protection. The goal is to determine whether the seller has received or is likely to receive payments within the 90-day or one-year period prior to a customer bankruptcy. If any such payments have occurred or are likely to occur, the buyer should assess whether the ordinary course of business or ordinary business terms defenses are available. This will involve determining if the seller deviated in any significant way from its ordinary course of dealing with the customer, or if the payments at issue departed from industry norms.

In most acquisitions, the seller agrees to indemnify the buyer from liabilities, other than liabilities specifically assumed by the buyer, arising from the conduct of the business prior to the closing. Preference claim risk should fall within this general indemnification obligation. If the buyer identifies specific preference claim risk, however, the safer course is to specifically provide in the acquisition agreement that the seller will indemnify the buyer against preference claims. The inclusion of a specific indemnification obligation should reduce the risk that the seller will dispute its obligation to provide a defense for preference claims. When the transaction is structured as an asset acquisition, the buyer can minimize preference claim exposure with respect to unpaid accounts by excluding the identified at-risk accounts from the purchase and adjusting the purchase price.

To provide further protection, the buyer's counsel should include representations in the acquisition agreement that the seller has collected its accounts receivable in the ordinary course consistent with past practice, that it has not materially changed its collection efforts generally or with respect to any specific accounts, and that it has not received payments under circumstances that depart from industry norms. These representations would be backed by the seller's indemnification obligations.

Investigate significant third party relationships

The seller's customers are probably not the only parties with whom the seller does business that are experiencing financial stress. The seller's vendors, distributors, equipment lessors, landlords and other third party providers may also be under financial stress.

As part of its due diligence, the buyer should identify whether any party with whom the seller does business may be likely to shut down its operations or file bankruptcy and then reject its executory contracts. If that were to occur and the seller's business would be interrupted or a replacement provider would be significantly more costly, the buyer can seek indemnification or other concessions from the seller to address that risk.

Obtain consents for valuable agreements

The recent uncertainty in the economy has been accompanied by volatile energy, transportation and other costs. Because of this volatility, the seller may have fixed supply agreements, purchase agreements, distributor agreements or other contracts that are valuable to the seller and may not be profitable for the counterparty.

The seller may be required under these contracts to obtain the consent of the counterparty in connection with the acquisition. The danger with these contracts is that the counterparties may be looking for a reason to terminate the contracts. Under the contracts, if consent is required and is not obtained, the counterparties will likely have the right to terminate the contracts.

If the buyer identifies valuable contracts of the seller that cannot easily be replaced on similar terms, the buyer's counsel should make sure that the seller delivers all required consents. If the seller fails to deliver any required consents, the buyer should seek indemnification or other concessions from the seller before it closes the transaction.

Ensure compliance with loan documents

In today's economic climate, some lenders may require stricter compliance with loan covenants than they have in the past. In addition, there may be some situations in which a lender has an economic incentive to declare a default on a loan and require the debtor to refinance.

If the buyer has financing arrangements, the buyer's counsel should make sure that the buyer informs its lender of the proposed acquisition and obtains any required consent. The buyer's counsel should also make sure that the buyer will be in compliance with all loan provisions after the closing.

The seller's financing arrangements are usually paid off at the closing. If the buyer intends to keep the seller's financing outstanding to fund the business after the closing, the buyer should make sure that the seller informs its lender of the acquisition and obtains any required consent. To ensure that there is no basis upon which the seller's lender can declare a default on the loan, the buyer should also make sure that the seller has complied with all loan provisions prior to the closing and that all loan provisions will be complied with after giving effect to the closing.

Obtain solvency representations

To address fraudulent conveyance laws, the acquisition agreement should include representations regarding the seller's solvency. If the seller is experiencing financial difficulty to such a degree that the buyer is concerned about the seller's solvency, the buyer should proceed very cautiously with the acquisition. If that is the case, the buyer's counsel may recommend that the buyer require a solvency opinion from a third party or a third-party appraisal of the seller's assets.

If the seller is nearing insolvency, the issues become complex. The buyer's counsel should consult with attorneys and other specialists with insolvency expertise to determine whether a sale outside of bankruptcy is feasible or advisable.

Update lien searches at closing

It is customary for the buyer's counsel to obtain lien searches as part of the buyer's due diligence investigation of the seller's business. The lien searches usually cover Uniform Commercial Code filings, tax liens, judgment liens, litigation and court records, and bankruptcy filings.

The buyer's counsel should update the lien searches as close to the closing as possible. Lien holders, especially non-institutional lien holders, sometimes do not make filings to perfect their liens until they are contemplating taking action against a debtor. An updated lien search will catch new filings so that they can be addressed prior to the closing.

Include specific closing conditions in the acquisition agreement

In today's economy, a buyer is more likely to encounter unpredictable circumstances that cause it to decide not to go forward with an acquisition. If a buyer signs an acquisition agreement with the intent to close the transaction at a later date, the acquisition agreement should include at a minimum a closing condition that there has been no "material adverse change" in the business, operations, condition, results of operations or prospects of the seller. For added certainty, the acquisition agreement should also include closing conditions that address specific situations that the buyer would consider important enough to warrant not closing the transaction. Those situations may include the loss of key customers, the loss of key employees, the failure

to meet minimum revenue or earnings targets or other financial performance measurements, and significant increases in costs.

If the buyer needs to obtain financing to consummate the acquisition, financing should be included as a closing condition. Sellers often resist this closing condition based on the argument that it effectively gives the buyer an option to purchase the business. While financing is never assured until the lender provides the funding, this is especially true in today's economic climate, and the buyer should insist on a financing condition if financing is needed.

In addition, it will likely take longer for a buyer to secure financing than it has in the past. Because financing is not readily available, most buyers will have to spend more time contacting and negotiating with potential lenders. Lenders that are financing transactions will probably conduct more extensive due diligence regarding potential transactions than they have in the past. Consequently, a buyer should add cushion to the "drop dead" date in the acquisition agreement, which is the date after which either the buyer or the seller can terminate the agreement without cause, to ensure that the buyer has enough time to secure its financing.

Increase likelihood that the seller's indemnification obligations will be satisfied

The seller, and sometimes the seller's shareholders, typically indemnify the buyer against many of the pre-closing liabilities associated with the seller's business. If the seller and the shareholders are experiencing financial difficulties, they may be unable to fulfill their indemnification obligations. Even if the financial capability of the seller and the shareholders is strong at the time of the closing, their financial condition could deteriorate quickly after the closing.

The buyer can insist on various arrangements to increase the likelihood that indemnification claims will be satisfied after the closing. For example, the acquisition agreement can prohibit the seller from distributing the proceeds received pursuant to the acquisition agreement to its shareholders for one or more years after the closing. A portion of the purchase price can be placed in an escrow account for a period of time after the closing. If the seller provides financing for the acquisition, the buyer can negotiate for the right to set off the amount of any indemnification claims against amounts that it owes under the financing arrangement. The buyer can also require that the seller provide collateral as security for its indemnification obligations.

Conclusion

An informed buyer that takes advantages of current opportunities in the market without assuming undue risk may experience significant upside in the long term. The buyer's counsel can help his or her client mitigate some of that risk.

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