

BARGAIN HUNTING WITH A VIEW UNDER THE HOOD: BUSINESS COMBINATIONS AND ACQUISITIONS IN UNCERTAIN ECONOMIC TIMES

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Until relatively recently, “slow,” “slumping” and “sluggish” were among the terms pundits used to describe the economy (and those were the optimists). The crises in the stock and credit markets have made bad matters worse and even the optimists are using the word “recession” with increasing frequency. As an inspirational desk calendar will remind you, with challenge comes opportunity. Some financial buyers thrive on economic downturns, surveying the market for distressed companies, mature product lines that might do better with a fresh management team, nascent technologies that will never be adequately funded in their current home, and other opportunities sometimes more acutely fleshed out in a downturn. Strategic buyers are looking at some of those same opportunities, although their lens and long-term goals are likely quite different from the financial buyers. (And there are a lot of strategic buyers out there that wouldn’t typically think of themselves as “acquirors,” but the right confluence of events puts them face to face with a we-can’t-pass-this-up decision.)

In a combination or acquisition scenario, whether you’re making an economic investment, an investment in your current business or an investment in what you think your business could be, you’ll be doing some amount of due diligence (or looking under the hood). The scope and focus of your diligence process will depend on a number of things, including your ultimate business objectives, the bandwidth of your own personnel to participate in the deal process, what you’re willing to pay the seller and how much you’re willing to spend to do the deal. Particularly when a buyer is in bargain hunting mode, you’ll likely be spending some time early hunting for those “deal killers” that allow you to assess whether what’s under the hood matches what’s been advertised, and potentially change course if the two don’t matchup.

With that abridged backdrop, and in the interest of providing some high-level, preliminary hunting points for when the credit markets loosen, here are 10 things to consider as you look at new combination and acquisition opportunities in these “interesting” times:

1. *How’s the cash?* There’s the obvious question of how much cash a seller has in the bank; while cash on hand (and for that matter, cash trends) will not contribute to direct economic value in some deal structures, it may still have an indirect effect on the transaction (see item 9 below). In addition to cash on hand, does the seller still have a willing lender (and if not, why)? If the seller’s existing or prior lenders are unable or unwilling to lend, will yours?
2. *Is the seller getting paid, and paying?* With an eye on historic accounts information, consider whether the seller’s customers have been paying, and are continuing to pay, on a timely basis (and whether the customer base that’s been represented is likely to stick around post-transaction). On the other end, you will want to understand the seller’s current and past practices with regard to accounts payable. Is the seller sitting on invoices longer than usual in an effort to make things look better with regard to cash on hand?

3. *Are there any “extraordinary” liabilities looming?* A prime example is threatened or pending litigation. While some litigation may be relatively innocuous given a seller’s business, other litigation may carry with it the possibility of hefty financial judgments, restrictions on the business going forward and/or reputational “black eyes.”

4. *Did they already give the value away?* You will want to take a careful look at the relevant agreements the seller has with customers and other third parties to determine whether important rights have been contracted away, unusual or unexpected obligations have been assumed and/or profit margins have been compromised, particularly where a company has fallen on hard times and/or lost key personnel (and institutional knowledge) in the period leading up to the deal. Key contractual provisions will include the representations and warranties the seller has made to third parties, and the indemnification obligations the seller has agreed to assume. For certain companies, ownership of intellectual property and licensing provisions will also be critical to your analysis.

5. *Did they never have the value to begin with?* Of course, the point of the business and legal due diligence process is to, fundamentally, answer this question. But there are a few points that we want to highlight for technology companies in particular. There are legal formalities that must be followed to assure a company’s ownership of the intellectual property it thinks it owns (e.g., written assignments of works created for the company, adequate controls around the availability and confidentiality of information it considers trade secret). Some of these formalities, and the company policies and programs that support them, can erode when company personnel and resources are stretched thin or have disappeared.

6. *Will the people stay?* It probably will not be difficult through discussions with management and other seller employees to assess the likelihood (or not) that employees will stay with a business following its sale. Some may view a sale as a positive and be excited at the prospect of continuing on with the business, or with helping to move the business in new or different directions. Others may choose to leave at the first signs of a sale (and/or may already be actively looking if they have a sense the company is in distress). The obvious corollary: Do you want the employees to stay? In both cases you’ll want to consider what types of change-of-control and severance arrangements are in place for existing personnel.

7. *Have the people gotten what they were entitled to?* Is the seller still paying payroll when due? Are appropriate deductions from wages being made for benefits? Are benefits elections being honored? Is the seller properly managing its 401(k) and other benefits plans? Working through negative answers to these questions is far beyond the scope of this list, but even initial responses from a seller to these questions may identify some threshold items for you to consider before moving further.

8. *Who owns it?* It sounds like a simple question – who owns the company? As budgets are stretched thin, however, sometimes the “general and administrative” personnel are the first to go. Of course, those are typically the same folks that make sure the corporate records are kept properly, and that the right approvals (e.g., board of directors, stockholders) happen when they need to happen. Asking for a capitalization table is an easy first step; making sure you can prove

it out against the corporate records would follow (as would an assessment of the rights of the company's owners, especially with regard to any sale transaction).

9. *Is there runway left?* Is there enough cash left to pay the vendors, pay the employees and keep the doors open long enough for a deal to be vetted, negotiated and closed? Are key employees needed to answer some of the above still around? Will management stick around to ensure the deal you want to do actually happens?

10. *Is it worth the costs?* There's the obvious expense of the purchase price/deal consideration, but also the transaction costs associated with actually doing the deal (e.g., fees payable to lawyers, accountants, brokers and investment bankers). Particularly with a "bargain" purchase, the transaction costs could end up being a high percentage of the economic value of the deal. And what about post-closing integration? Do you have the management bandwidth and other support resources to ensure a successful (or at least stable) first six months, and beyond?

Obviously these issues are the tip of the iceberg, and their relative importance in connection with an overall due diligence effort will depend on, among other things, the type of company, its stage of life, the related industry and nature of the transaction. We are available and happy to help you work through your opportunity analyses.

If you are considering a business combination or acquisition, or have other business or technology transactional needs, please contact Brian Cyr (bcyr@rosenbergmartin.com) or another attorney in our corporate group:

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