Journal of Finance and Accountancy

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

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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.

Some of the areas of the target companies that must be examined and investigated to

protect lenders and clients will be reviewed. 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.

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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. (Banruptcy 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

Has the total debt of the target been adequately identified 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

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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 targets investments focus on buy-sell

agreements or any other commitments regarding the purchase or sale of any investments.

Finding out about the targets 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 targets 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.

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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 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).

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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 is 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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