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The Down Economy: Special Negotiating and Diligence Items to Consider

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A down economy presents unique challenges to buyers and sellers in an M&A deal, from identifying the right target and price to getting the transaction to close. This article presents some issues for both sides to consider when investigating and negotiating an M&A transaction in lean economic times. This article was drafted with private-target transactions in mind, but many of the issues presented below are equally applicable in a public-target transaction. While the tips outlined below are applicable regardless of the state of the economy, they are particularly relevant in a downturn or when a downturn is expected.

Issues for the Buyer

1. Valuation

Valuation is central to any transaction and potential fluctuations in target value due to macroeconomic conditions should be considered during the diligence phase. A buyer should specifically consider whether an economic downturn will affect the multiple at which the target is valued. For example, in the wake of the 2008 economic crisis, buyers saw value erode simply through application of lower valuation multiples across industries.

The buyer also must pay attention to the valuation of individual assets or classes of assets that may be prone to value fluctuation in a volatile market. In a transaction involving a particularly valuable asset (even where the focus of the transaction is not that asset), the buyer should watch for warning signs of a bursting bubble with respect to that asset's market. The most obvious example is real estate. When the real estate bubble burst in 2008, many buyers were left owning acquisition targets with market values far below purchase price because real estate prices plummeted, even where the target's focus was not real estate. Other particular types of assets that may be particularly prone to valuation fluctuation include commercial paper and marketable securities, equipment and tooling, intellectual property, inventory and accounts receivable.

When a significant component of purchase price rests on the valuation of a particular asset, such as with respect to an inventory or equipment valuation, the buyer should negotiate for valuation subject to GAAP or other clear principles, and specify that valuation is at the lower of cost of fair market value. That way, the seller bears the risk of fluctuation in the value of the particular asset.

[1] The views expressed in this article are those of the authors and not necessarily those of Jones Day or any of its clients.

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Failure to take outside economic conditions into consideration prior to signing a deal may have consequences post-closing. Lower valuation multiples of an acquired target could breach leverage covenants and trigger defaults under the buyer's credit facilities and could, in certain circumstances, result in shareholder dissatisfaction and assertions that the buyer's board overpaid for a target.

2. Business Issues: Supply Chain and Customers

When the economy turns south, vendors and customers may disappear. In addition, if a particular contract has become disadvantageous to a counterparty because of the prevailing economic climate, the counterparty may more aggressively pursue termination or other rights in the event of a prohibited change of control or assignment. Thus, from a business perspective, the buyer should conduct due diligence on whether the business can survive the loss of particular customers or suppliers and whether any material contracts are below market from the counterparty's perspective. In addition, the buyer's counsel should determine whether any default provisions will be triggered as a result of the transaction.

On the business side, the buyer also should pay particular attention to the expected needs of the target's customers in the post-closing period. The buyer should ask itself whether the target's pricing models will hold up if the target's products have to be sold into a soft market.

A buyer also should confirm whether any of the target's contracts with suppliers contain take-or-pay obligations that would cause the target to pay for supplies or services that are not needed if the business slows. A buyer could find itself in a situation where the target has lost its customers, but it is obligated to pay for services and supplies it cannot use.

3. Third Party Issues

Buyers need to make sure that assets (including assets of the target in a stock deal) are owned by the seller (or target) and free and clear of liens at closing. When the economy starts to sour, collection activities will increase and third parties, including the seller's lenders and tax authorities, will be more likely to enforce claims against the seller's assets. Therefore, the buyer should make sure that the target's assets are free of liens by performing a lien search immediately prior to closing. Buyers should generally obtain lien searches in the states in which the target has significant property, the state of the target's incorporation and the county in which real estate is located.

In addition, the buyer should make sure it has clear evidence of the chain of title where appropriate. For example, where the target recently acquired a valuable asset, such as a significant piece of manufacturing equipment, the buyer should make sure that the seller has obtained a clean bill of sale from the original seller to avoid any title disputes relating to, for example, the target's failure to pay the applicable purchase price. The seller should also seek releases at closing for any liens known to encumber the applicable assets. In tough economic times, it is possible that a creditor's successor (and not the creditor) pursues recovery, either because the creditor sold the right to pursue the obligation or through foreclosure or similar proceeding. The assignee will not be familiar with the historical relationship and may have different motives and interests than the assignor. Thus, clear documentation of any lien releases, transfer of title or release of other claims should be obtained prior to closing.

The Buyer should also pay careful attention to the target's compliance with laws and permits because governmental agencies may be more likely to actively pursue fines for violations of law when tax revenue from business activity decreases. Accordingly, buyers should pay attention to seemingly dormant, but unresolved, tax and environmental issues that may again present themselves.

4. Working Capital: Accounts Receivable History and Collectability

While always relevant, collectability of accounts receivable is particularly pertinent in lean economic times. Prior to signing a deal, the buyer should assess the credit risk presented by the target's debtors and whether the target has a sufficient bad debt allowance. Occasionally, parties agree to a post-closing bad debt adjustment that may provide for a credit to the buyer for pre-closing accounts receivable remaining unpaid as of a certain date. Such adjustment is typically dollar-for-dollar and not subject to baskets or caps that would be applicable to a representation with respect to accounts receivable.

Where a bad debt adjustment is employed, the buyer should resist burdensome covenants regarding collection of outstanding receivables and application of payment from the account debtors. For example, the buyer should try to avoid agreeing that oldest invoices will be deemed to be paid first, regardless of how the debtor designates payment. The target's customer may pay a post-closing invoice, but leave an old invoice open due to a claim of defective merchandise. Because the old receivable is deemed to have been satisfied for purposes of the bad debt adjustment when the customer actually intended to pay the more recent invoice, the buyer is no longer able to utilize the bad debt adjustment to recoup the amount under the old invoice from the seller. While the buyer may have an indemnity claim for a breach of a representation, such a claim may be subject to limitations like baskets and de minimis claim thresholds that would be inapplicable to a bad debt adjustment.

The buyer should also be careful that prior collections from the target's debtors were done in the ordinary course of business because, as the economy sours, it is more likely that, due to an outside economic event, some of the target's customers will become subject to bankruptcy or other insolvency proceedings and the target may face statutory avoidance actions (preference actions and fraudulent conveyance actions) from the insolvent customers' estates. Establishing that prior payments were in the ordinary course of business or for adequate consideration may be an effective affirmative defense to such an action.

5. Working Capital Needs

The buyer should pay particular attention to working capital needs in the post-closing period because tighter credit terms and slow paying customers in an economic downturn may strain the target's working capital flow. If cash flow will be slow, the buyer may need to invest capital at or after closing. In addition, if the transaction involves a working capital adjustment targeted off a pegged value, the buyer may try to negotiate a target value that takes into consideration expected working capital needs of the business, not just historical values. While the working capital level of the business may have been consistent for a period pre-close, anticipated changes to the economy may be considered when the parties are negotiating the working capital target.

6. Sales History—Propping Up the Business

As the economy faces a downward turn, some sellers may be incented to demonstrate recent, improved performance in order to soften the results of a sliding business. For example, the seller may push customers into buying more product right before the deal is signed to increase sales volume at the expense of future sales. Thus, the buyer needs to be especially tuned in to recent performance to be sure that reported results are accurate and to confirm the quality of sales reported. The buyer should be careful to consider whether sales are the result of unusual discounts or promotions or other unusual activity, such as selling new stock before older stock. The buyer should consider including inventory quality and age (either specifically or through a reference to GAAP accounting) in the working capital adjustment in order to mitigate the latter risk.

7. Indemnity

One of the most apparent risks in an M&A transaction when the general economy is suffering is the ability of the seller to satisfy a post-closing indemnity claim. Therefore, the buyer should be careful to evaluate the financial strength of the seller and, if necessary, seek an indemnity escrow, purchase price hold back or guarantee from an affiliate or parent of the seller.

8. Workforce Needs and Statutory Requirements

The buyer should carefully review the target's termination history and expected employee needs post-closing to ensure that the WARN Act or other similar state statutes will not be triggered by a post-closing layoff. Generally speaking, and subject to certain exclusions and other requirements, the WARN Act requires employers to give 60 days' prior notice before laying off 50 or more employees over a 30-day period. Failure to comply effectively triggers a severance obligation to the terminated employees. Typically, the seller will bear the cost of statutory implications of layoffs resulting from the transaction itself, but post-closing terminations will typically be the buyer's responsibility. While a seller may represent that it has not caused enough layoffs to trigger statutory liability, the buyer should confirm the exact number of layoffs prior to closing to avoid crossing the threshold post-closing.

9. Transaction Pace

Both parties should consider the pace of the transaction as the economy turns. Buyers want to sign and close rapidly where the downturn shows signs of letting up (before the seller is in a position to extract a higher purchase price) or where upcoming macroeconomic difficulties will create problems for the target with its current ownership structure. For example, the buyer may want to close a transaction quickly if credit markets are expected to tighten such that the target will be unable to obtain short term financing for capital needs without the buyer's support and the inability to obtain credit would impair the target's purchasing power and ability to fulfill significant orders or otherwise strain customer relationships. Of course, sellers may try to speed up a transaction where a downturn is expected to result in a depressed purchase price or where the business is expected to perform poorly.

Issues for the Seller

1. Certainty of Close

Sellers should seek to lock up the purchaser's obligation to close by minimizing closing conditions. Specifically, sellers should seek to avoid financing conditions, especially when the credit market may tighten. The seller is in a stronger negotiating position if the buyer is contractually obligated to close and the seller can seek specific performance to force the buyer to close the deal than if the buyer can simply refuse to close if it fails to obtain financing.

Another condition to consider is the traditional standalone MAC condition. As most deal lawyers would readily acknowledge, it is difficult to convince a court that a material adverse change has occurred. Nevertheless, with specific, objective and quantifiable triggers, a MAC condition can be an effective out. For example, a specific MAC condition might be defined to include any facility shut down longer than a specified period. If a supplier shuts down because of the overall economic condition, the target facility may be forced to temporarily close while an alternative supplier is sought. There, indirectly, the economic climate caused a MAC shut down and the buyer may be able to walk. Sellers should be aware of these types of conditions as stand-alone conditions as well.

Regardless of the state of the economy, sellers should carefully weigh the economic benefit of a higher bid price with multiple contingencies against bids with lower bid prices, but fewer conditions to close.

2. Buyer's Ability to Finance

Notwithstanding the buyer's contractual obligation to close, the seller should be mindful of the buyer's ability to close. Even without a financing out, many buyers do not have cash on hand to close a big deal without outside financing. Because credit markets can become volatile when the economy starts to turn, the seller should diligence the buyer's ability to close without financing. Although commitments from lenders can and should be reasonably relied upon, in extreme circumstances (as during the most recent financial crisis), credit sources may be unable to fulfill a financing commitment or may be willing to assert that conditions to closing have not been satisfied. The seller should consider what to do if such a scenario occurs. A common way to address this circumstance and mitigate some of the damage caused to a seller from a financing failure is to include a reverse break-up fee as part of the transaction architecture.

3. Seller Releases / Indemnity

Sellers should insist on broad releases of liability from the buyer, including with respect to directors, officers, employees and affiliates of the seller and disclaim representations and warranties, other than those set forth in the transaction agreement. In economically troubled times, the buyer may be more likely to assert more tenuous claims against a broader range of defendants to try to recoup an investment that has turned negative. Among the things for the seller to consider are specific releases of affiliates of the seller, specific disclaimers of representations or warranties with respect to forecasts or projections, and clear provisions limiting indemnity claims to those specifically provided for in the transaction document.

The Bottom Line

Keeping these issues in mind when investigating and negotiating a potential transaction may play a part in helping buyers and sellers close successful transactions, even in down or down-turning markets. As in every transaction, both parties need to be aware of the broader market and be willing to adjust deal terms and expectations to match the current environment.