Holland & Hart

Timothy Crisp

Partner
303.295.8000
Denver, Salt Lake City, Santa Fe
TSCrisp@hollandhart.com

Is Now a Good Time to Acquire a Business? Opportunities and Risks for Buyers in the Era of COVID-19

Insight — July 29, 2020

The long seller's market may be over, which is welcome news for many companies that are eager and able to acquire or expand a business.

Many businesses and business owners have struggled mightily under the COVID-19 pandemic, and their financial condition, liquidity, and prospects have sharply deteriorated. However, if your company has liquidity sources and your business would benefit from expansion, but it has lost out in past bidding wars, shied away from excessive valuations and multiples, or been wary of sellers' high negotiation leverage, now may be an excellent time to go shopping.

Consider these economic factors that have created a positive purchase environment:

- Recently released surveys indicate a significantly lower volume of completed and announced deals and more abandoned deals.[1]
- Many companies and private equity firms have hit the “pause button” on new investments, meaning that there are often fewer companies able or willing to bid for new deals.
- Lower deal volume and fewer bidders have resulted in lower transaction prices, calculated as a multiple of prior period earnings.
- Buyers now often have a greater ability to negotiate a lower purchase price and more favorable transaction terms than they have had in years.
- Many businesses and their owners have lost their sources of revenue and liquidity and are unable or unwilling to continue to fund the business while staggering losses are accruing. They may be highly incentivized to sell.
- Acquisition loans are still available for well capitalized companies. Unlike the 2008 financial crisis, banks are generally better capitalized and are not facing liquidity concerns.

Before offering a letter of intent or signing a purchase agreement, a prospective buyer should be aware of significant new and increased risks relating to the pandemic and look for ways to evaluate and mitigate those risks.

Continuing Uncertainty: The pandemic is continuing, as is uncertainty about when the economy, business sectors and individual companies will stabilize and begin to grow again.

Heightened Due Diligence Review: Thorough due diligence on the target and its industry is more important than ever, especially as to the following matters that have been or may be affected by the pandemic:

- *Financial:* Evaluate the existing and projected pandemic impacts on revenues of the target in the Second Quarter and beyond. Consider whether the bases for the target's revenue projections remain valid or need to be reforecast.
- *Supply Chain:* Consider the ongoing effect of the pandemic on vendors' ability to remain in business and to timely fulfill orders for raw materials, component parts or services. Look into any exclusive supply contracts that will remain in effect and the ability to cover with alternative supply sources in the event the vendor is unable to perform.
- *Market and Customer Issues:* Evaluate current and projected demand for the target's products or services, the concentration of customers, and whether any significant customers are delinquent in paying invoices or demanding discounts.
- *COVID-Related Opportunities:* If demand for the target's products is weak, can manufacturing lines be temporarily repurposed for products with high current demand, such as personal protective equipment (PPE)?
- *Workforce Issues:* Can the acquired business operate profitably with a reduced workforce, or with employees working remotely?
- *Capacity Restrictions and Closure Orders:* Consider the effect of existing and potential restrictions on on-site capacity (employees and/or customers) and existing or potential mandated business closures.
- *PPE and Social Distancing at Facilities:* Evaluate needs of the business for PPE for its employees, the ability to maintain social distancing and other recommended or mandated requirements at the target's plants and offices.

Special Concerns with Troubled Companies: It is especially important to identify and mitigate the following risks posed by the purchase of a troubled company .

- *Trade Debt, Employee Liabilities, Litigation and Liens:* Cash-strapped companies may have significant delinquent trade debt owing to vendors, unpaid wage claims, underfunded pension plan, profit sharing and other liabilities to employees, litigation and judgments, new lien filings, and assets of the business that may be in the possession of another party and subject to a possessory lien.
- *Insolvency and Fraudulent Transfer Risk:* With the assistance of attorneys and financial advisors, consider whether the target or seller is (or may become) insolvent. Transactions with insolvent companies outside of a bankruptcy present significant risk that the

transaction could be deemed a fraudulent transfer or fraudulent conveyance, which could result in a possible unwinding of the transaction if a claim is brought by unpaid creditors of the target.

- *When to Insist on a Bankruptcy:* If the target's financial condition significantly deteriorates, consider whether it is safer to require the target to go through a bankruptcy proceeding, where a sale or restructuring can occur while stripping liens and claims of creditors.

Strong Documents and Recourse:

- Representation and warranty insurance and strong indemnification escrows may be more important than ever.
- In many cases, the seller's representations and warranties, pre-closing covenants, indemnification obligations, holdbacks or escrows, and conditions precedent to closing may need to be substantially enhanced.

Financing Concerns:

- *Acquisition Financing:* Financing remains available for financially stable companies and good transactions. However, lenders are taking a more cautious approach, requiring more intrusive due diligence, lower leverage, higher margins, and the ability to walk away from commitments for material adverse changes. It is important to negotiate a financing contingency enabling the buyer to walk away from the deal in the event it is unable to obtain acquisition financing on acceptable terms.
- *Financial Covenants:* Buyers will need to consider the impact of the purchased business on the buyers' existing financial covenants with lenders and liquidity needs.

Walk Rights: A buyer should negotiate for the ability to terminate the deal upon a material adverse change in the target (including its financial condition and prospects) and for COVID-19-specific reasons. With reduced competition for deals, sellers have less ability to fight this or to demand significant break-up fees.

CARES Act Loans:

- *PPP Loans:* Targets that applied for or took out Paycheck Protection Program (PPP) loans present unique risks and challenges, especially if the closing is to occur before the lender and Small Business Administration determine the amount of the loan to be forgiven. Many PPP promissory notes we have reviewed provide that a default occurs (and the maturity of the loan can be accelerated) if a borrower merges with or is acquired by another company. Buyers need to be prepared to demand that closing occur after the forgiveness determination (with the remaining loan paid at or before closing) or hold back or escrow sufficient funds to pay the loan (with accrued interest) in full.
  In addition, the target and its owners could potentially face significant additional liability if PPP loan proceeds were used for non-permitted purposes or if the target made false certifications in

its loan application or forgiveness application (including as to eligibility and need).
Finally, if either the buyer or target received a PPP loan and the other claimed the Employee Retention Tax Credit under the CARES Act, the party claiming the credit may lose the credit and have to pay additional taxes, interest, and penalties.

- _Main Street Lending Program Loans:_ A company that took out a Main Street Lending Program loan is subject to certain executive compensation limits for a year after the loan is paid off. As a result, it may be beneficial to consider an asset purchase transaction rather than an equity purchase or merger transaction.

[1] *See, e.g.*, Willis Towers Watson, *COVID-19 Drags Q2 North America M&A Deals to Lowest Level in Over a Decade*, July 7, 2020, published in Globe Newswire (https://tinyurl.com/y39qzuwq); Bloomberg Law, *Virus Upends $87 Billion of Deals in Sign of Corporate Fears*, June 29, 2020 (https://tinyurl.com/yygv8fzn).
