

DUE DILIGENCE IN THE FINANCE OF ASSET ACQUISITIONS

Economic pressures are causing much smaller business to close, and in connection with such closures, some asset acquisition activity has begun to develop. Keeping in mind that such businesses are stressed, it has become even more important to take a careful look at the books and records of the target company. While bank customers are seeing opportunities in the acquisitions, it has often fallen upon the bank officer to conduct the detailed analysis of the assets being purchased, the nature of the interests in the assets, and the potential pitfalls involved.

It is of the utmost importance to balance several considerations. First, the Bank does not want to be a “guarantor” of the viability of any asset purchase. Second, the Bank does not necessarily want to substitute its judgment as to certain business matter for that of the experienced customer. But most importantly, the Bank wants to get paid, and a careful look at the condition of the assets and the contracts under which the assets are to be operated can enable a Lender avoid financing a losing proposition, and in the long run, do the Borrower a favor as well.

The Bank’s Role in Due Diligence

The Bank is a second opinion on the advisability of the acquisition. Note the subjective terms, “opinion” and “advisability.” Nothing in the Bank’s duties include the obligation to catch errors in the procedure used by the customer in its review. Nothing requires the Bank to do the customer’s job. Nothing in this process makes the Bank a partner. But the Bank does want to be assured of a cash flow sufficient to meet debt service requirements, and the Bank does want to assure itself of the unimpeded access to assets for the repayment of principal in the event cash flow is inadequate. To meet these requirements, the officer should review, at a minimum, the items discussed in this article. Most importantly, the Bank should be given independent access to the Seller’s books and records in connection with the review. Items prepared by or delivered by the customer are helpful, but the Bank officer is ultimately responsible for accuracy of information as provided by the Seller, so on site due diligence is essential.

Conducting the Review

The following will set out an approach to reviewing the assets to be purchased. Keep in mind that this discussion only refers to an asset purchase, which in theory does not require the review of Seller company debt and claims as may be required under a merger, but recent successor liability statutes applicable to certain takes and claims are eroding some of the protections customarily assumed in a asset sale, so keep that in mind in connection with the review of these issues¹. Basically, the review will be based upon the legal status of the party conveying the assets, and a careful review of each of the Assets to be conveyed.

¹ The reader may wish to refer to the “Hidden Liens” discussion in our October, 2009 newsletter for some discussion of successor liability statutes (available on our website at www.baskinmccarroll.com).

ORGANIZATION. In order for the Seller to properly convey assets, most jurisdictions require that the Seller be an organization in good standing (though often this may be remedied after the fact or by ratification). However, where a notice of dissolution has been properly filed, the distributions of assets may be deemed part of the “winding up” of the company business, and if there has been no activity on the part of the Seller for some time, a dissolution procedure may be employed to support the power of the Seller to convey. Otherwise, the fact that the organization is not in good standing may often mean that taxes of some nature (including franchise and excise taxes) may not be current, and that the title to the asset being purchased is encumbered by a state tax lien. Also, though highly rare, a charter or bylaw provisions may prohibit the type of conveyance or the action being taken with respect to the sale. Finally, there may be an issue as to the proper authority for the conveyance of substantially all of the assets of the company, and the proper party to do so. With this in mind, the officer should review:

1. The Seller's Articles of Incorporation or Formation
2. The Seller's Bylaws or Operating Agreement
3. The Seller’s resolutions with respect to the sale, and the means by which they were adopted (taking care to observe proper voting requirements, and the inclusion of all stockholders appearing in the ledger)
4. the Seller’s Certificate of Good Standing from the Secretary of State of the state where the Seller is incorporated (and qualification to do business, if selling the assets located in another jurisdiction, and assumed name qualifications, if applicable).

PROPERTIES. Different types of properties being sold require different due diligence approaches.

Real Property Where the assets include the sale of real property, especially in the event of franchise sales or multi-location retail businesses, the rights to operate at the different locations is essential to maintaining the customer base, and these physical locations must be preserved. Where the properties are owned in fee, the usual requirements of a real estate loan, primarily title work, is a requirement. Where leases are involved many of the same issues as required in connection with the assignment of contract rights discussed below arise. In any case, assurances of the Seller’s right to the undisturbed possession of the premises from which business is operated for the term of the loan is essential, and must be confirmed by the Bank Officer. But even more importantly for the safe harbor provisions of CERCLA and RCRA, the issues of environmental protection and land use arise with respect to the past and future use of the real estate asset. In approaching the real estate acquisition, the Bank Officer should acquire and review:

1. A schedule of the Borrower's business locations.
2. Copies of all real estate leases, deeds, mortgages, title policies, surveys, zoning approvals, variances or use permits

3. Environmental audits, if any, for each property leased by the Borrower, including the following:
 - a. A listing of hazardous substances used in the Borrower's operations
 - b. A description of the Borrower's disposal methods.
 - c. A list of environmental permits and licenses.
 - d. Copies of all correspondence, notices and files related to EPA, state, or local regulatory agencies.
 - e. A list identifying and describing any environmental litigation or investigations.
 - f. A list identifying and describing any known superfund exposure. and
 - g. A list identifying and describing any contingent environmental liabilities or continuing indemnification obligations.

Tangible Personal Property. Although there is not general recording system for the conveyance of personalty, it is susceptible to a greater number of liens and charges, and must be carefully examined both from a structural aspect and a title aspect. For example, unrecorded judgment liens can be a lien on personalty in some jurisdictions while not on realty. Also, many tax impositions may apply to personalty only. UCC-11 searches become important, and if the sale includes inventory, the nature of claims for labor law wage federal and the tax consequences to the Seller and its other assets should be considered. Always acquire and review:

1. A schedule of fixed assets and the locations thereof.
2. All U.C.C. filings.
3. All leases of equipment.
4. A schedule of sales and purchases of major capital equipment during last three years.

Contract Rights and Intangibles. Benefits accruing under contracts can usually be divided into two groups. First are the vendor contracts which provide the services necessary to conduct the business using the acquired assets. These may be direct as in the case of raw material supply contracts, or indirect, such as plant maintenance or security. A very important subgroup is the employee and professional contracts, if those are in fact to be transferred. The other group of contracts will be the revenue producing contracts, or those under which the business makes its money. In both cases, the more important the contract (e.g. raw materials

supplies, major customers) the more important an estoppel certificate or other evidence of the willingness of the contract partner to continue the relationship becomes to the eventual ability of the Purchaser to repay the loan. Some basic contracts to consider are:

1. subsidiary, partnership, or joint venture relationships and obligations,
2. contracts between the Company and any officers, directors, 5-percent shareholders or affiliates
3. loan agreements, bank financing arrangements, line of credit, or promissory notes to which the Company is a party.
- 4, security agreements, mortgages, indentures, collateral pledges, and similar agreements.
5. guaranties to which the Company is a party.
6. installment sale agreements.
7. distribution agreements, sales representative agreements, marketing agreements, and supply agreements.
8. contracts, and closing transcripts from any mergers, acquisitions, or divestitures within last five years.
9. options and stock purchase agreements involving interests in other companies.
10. standard quote, purchase order, invoice and warranty forms.
11. nondisclosure or noncompetition agreements to which the Company is a party.
12. supply or service agreements.
13. schedule of unfilled orders.
14. current advertising programs, marketing plans and budgets, and printed marketing materials.
15. employee list including positions, current salaries, salaries and bonuses paid during last three years, and years of service.
- 16 consulting, nondisclosure, nonsolicitation or noncompetition agreements between the Company and any of its employees.
17. all employee benefits and holiday, vacation, and sick leave policies.

- 18 Summary plan descriptions of qualified and non-qualified retirement plans.
- 19 collective bargaining agreements, if any.
20. worker's compensation claim history and unemployment insurance claims history.
21. all stock option and stock purchase plans and a schedule of grants thereunder.

Intellectual Property Rights. If a particular or unique product is to be manufactured or replicated with the acquired assets, the rights of the Seller in and to the product should be protected by the appropriate intellectual property rights. This may not just include a patent or other transferred asset. It may also include a license or non-exclusive right to manufacture or distribute. While the exclusive patent is the most simple and protective of the competitive rights being purchased, distribution and manufacturing rights may afford the same type of competitive advantage, but the agreements under which these rights are exercised must be carefully scrutinized. At a minimum, where applicable, the Loan Officer should request:

1. A schedule of domestic and foreign patents and patent applications.
2. A schedule of trademark and trade names.
3. A schedule of copyrights.
4. A description of important technical know-how.
5. A description of methods used to protect trade secrets and know-how.
6. Any "work for hire" agreements.
7. A schedule and copies of all consulting agreements, agreements regarding inventions, and licenses or assignments of intellectual property to or from the Company.
8. Any patent clearance documents.
9. A schedule and summary of any claims or threatened claims by or against the Company regarding intellectual property.
- 10 A schedule of all software licenses used by the Borrower in its operations

OTHER ASSETS

Licenses and Permits. The rights given the Purchaser borrower to conduct business using the acquired assets is often dependent of business licenses and other privileges granted by local governmental authorities. These are almost universally not transferrable, but the terms under which new licenses and permits must be obtained should be known prior to the

disbursement of funds, and care needs to be made to see that the business does in fact have the necessary licensure for its operations. Some permits, such as building, pool, boiler or other structural matters are in fact transferred with the physical asset so permitted, and need not be renewed. Other business engaged in heavily regulated activities (alcohol, petroleum, dry cleaning, gambling and others) will require a great deal of time in making certain the regulating authorities are aware and in agreement with the transfer². Because the type of license is unique to the operation of the Borrower, a listing is not practical, but the Loan Officer should request copies of all governmental permits being used in the business, and especially those relating to the use of hazardous or heavily regulated activities.

Taxes, Litigation and Professional Support. While a review of the financial records of the Borrower will show most of the current issues affecting a business, there are some items which may have a future affect o the business which have yet to appear on the bottom line. One of the most effective ways to look into the possibility of future issues is to review any litigation files and insurance claims which may affect future operations. Some of the more important things to request are:

1. A schedule of all pending litigation.
2. A description of any threatened litigation.
3. Copies of insurance policies possibly providing coverage as to pending or threatened litigation.
4. Documents relating to any injunctions, consent decrees, or settlements to which the Company is a party.
5. A list of unsatisfied judgments.
6. A schedule and copies of the Company's general liability, personal and real property, product liability, errors and omissions, key-man, directors and officers, worker's compensation, and other insurance.
7. A schedule of the Company's insurance claims history for past three years.
8. A schedule of all law firms, accounting firms, consulting firms, and similar professionals engaged by the Company during past five years.
9. Copies of all articles and press releases relating to the Company within the past three years.

² Indeed, some businesses not normally thought of as heavily regulated can be a surprise. In Memphis, for example, at one time the sale of a hotel property could require the recommendation of the Office of Planning and Development, in an effort intended to curb hourly-rental hotels.

Of course, the foregoing is meant to be a general approach to any business. The review of a retail establishment is much different from that of a manufacturing and distribution operation, and similarly for service businesses. However, following the outline above should give one some insight to the Borrower's business, which the Loan Officer must often know as well as the Borrower.