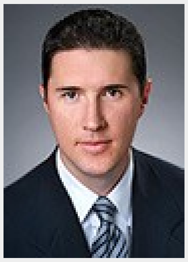
Allen Matkins Corporate and Securities

Acquiring Manufacturing Businesses in Turbulent Times



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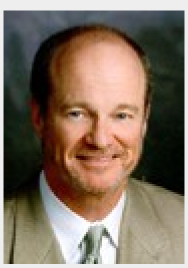

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Manufacturing businesses have been greatly impacted by the downturn in business and consumer spending and the tight credit markets. While auto and auto parts manufacturers have received the lion's share of media attention, all industry sectors are being affected. As a result, worldwide, there are numerous manufacturing businesses available for sale in all industry sectors. Investors and operators who are able to acquire these businesses at discount prices and ride-out the current recession may be able to generate large investment returns. However, recessionary markets can accentuate business weaknesses and mistakes, and investors should conduct enhanced due diligence in any potential acquisition.

This is the second part of a series of alerts identifying business and legal issues involved in purchasing businesses in the current market. If you would like to view our previous alert on *Acquiring Restaurants in Turbulent Times* click here.

The following are a number of areas requiring particular attention when acquiring a manufacturing business in a recessionary economy:

Financial Information: Scrupulous analysis of the seller's financial information and tax returns should be conducted and accountants experienced in the industry consulted, where appropriate. Acquirers should determine the cause of declines in operating results, including those resulting from the following factors: cyclical, seasonal, general economic recession, increased costs in critical materials and supplies, poor management or a loss or weakening of the seller's customer base. Acquirers also should conduct limited interviews of customers and suppliers to confirm sales figures.

New Regulations: A flurry of new laws and regulations have been proposed or adopted in the past few months. Some of these may benefit or adversely affect the current or future operations of the target.

Tax Law Changes: A number of tax law changes have been proposed, including changes to the taxing of carried interests and foreign operations.

Currency Volatility: Global operations will be impacted by the volatility in the currency markets.

Commodity Price Volatility: Commodity price volatility may adversely affect the underlying business model for the target.

Financial Condition of Major Suppliers & Customers: The financial condition of major or sole suppliers and customers should be evaluated to determine whether they are at risk to go out of business.

Banking Relations: The target may have outstanding loans and lines of credit requiring refinancing in the short-term. The target may also provide purchaser financing to its purchasers. These credit products currently may not be available to an acquirer.

Insurance Policies: The financial condition of insurers currently insuring the business should be evaluated and the terms of existing policies analyzed against what is currently available in the marketplace.

Accruals and Reserves: Claim accruals and accounts receivable reserves may be appropriate from a historical operations perspective, but not for the current market.

Stimulus Funds: The target may be able to augment its business with business opportunities that will arise from federal stimulus funds.

Management and Key Employees: The current employment market may permit the acquirer to upgrade employee talent at lower salaries. Where numerous employees may be terminated in connection with the sale, the parties will need to ensure compliance with workforce reduction laws.

Employee Benefits: A comprehensive review should be undertaken to ensure that all qualified plan requirements have been met particularly where the target has had a significant downsizing. In addition, attention should be paid to health and welfare issues, including COBRA.

The following are a number of areas requiring attention in any financial climate:

Suppliers: Trade payables should be reviewed and interviews with the seller's suppliers should be conducted to ensure uninterrupted operations following acquisition. Key and sole source suppliers of raw materials should be identified to determine potential future supply constraints and pricing pressure.

Customers: Existing customer contracts and correspondence should be reviewed and interviews with key customers should be conducted to determine when significant contracts expire and if any terminations have been threatened by customers.

Inventory: Raw materials and inventory should be counted prior to execution of the purchase agreement and appropriate provision made for adjustment to the purchase price post-closing to account for reduction beyond that contemplated by the agreed-upon business terms. The parties may need to comply with bulk sales statutes.

Contracts: Significant contracts may not be freely assignable. The acquirer will need to balance tax and liability goals inherent in an asset purchase with the ability to maintain in force contracts through an equity purchase.

Employee Issues: Historical worker's compensation premiums and claims should be reviewed to extrapolate costs going forward. Any collective bargaining agreements and past grievances with employees or vendors should also be reviewed.

Intellectual Property: Intellectual property used in the target may infringe on the rights of others or not be freely transferable to the acquirer.

Equipment: The quality and condition of existing equipment should be determined prior to sale. To the extent that the acquirer will not operate from the seller's facility, an analysis of the current condition, replacement cost and potential relocation costs will need to be conducted to determine whether relocation is cost effective.

Transition Services: To the extent that the acquirer will need the assistance of the seller for some period following the closing of the transaction (for example to transition accounting, order fulfillment or other services), the parties should agree in advance as to the level of cooperation and any required compensation. Where a down market has forced the sale of a business at less than peak pricing, the seller may not be incentivized to assist with post-closing items unless contractually obligated to do so.

Product Liability: Product warranties and historical claims should be scrutinized.

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About Allen Matkins

Allen Matkins Leck Gamble Mallory & Natsis LLP is a California law firm with more than 230 attorneys practicing out of seven offices in Los Angeles, Century City, Orange County, Del Mar Heights, San Diego, San Francisco and Walnut Creek. The firm's broad based areas of focus include corporate, real estate, construction, real estate finance, business litigation, employment and labor law, taxation, land use, bankruptcy and creditors' rights, intellectual property and environmental. more...

The acquirer should require indemnity for pre-closing activities and consider requiring the seller to purchase an insurance tail policy to cover such period.

Permits and Licensing: Manufacturers generally operate under permits and licenses issued by local, state and federal agencies. Often these permits and licenses are not freely assignable to an unaffiliated acquirer. In many cases, the process for transferring a license or obtaining a new license will dictate the timeline for acquiring the business. Depending on the complexity and bureaucracy involved, consultants often can be used to expedite the process.

Environmental: Depending on the products being produced, the plant and other facilities should be investigated and a Phase I or more in-depth assessment undertaken by environmental consultants to determine whether there has been any environmental contamination. Where there is potential liability, the acquirer should require indemnification in an amount estimated sufficient to compensate for potential damages and by a party with sufficient financial resources to cover the indemnity.

Lease: To the extent the acquirer will operate from the seller's facility, the facility lease should be carefully reviewed. Relocation of manufacturing facilities can be expensive and sometimes impossible if comparable space is not available. Alternatively, in the current market, new facilities may be available at cheaper rents allowing for negotiation or cost-effective relocation.

Tax: Tax attorneys and accountants should be consulted to determine the optimum structure for the transaction and whether any tax incentives are available. For example, businesses located in delineated Enterprise Zones in California may avail themselves of various tax credits, including credits for hiring qualified employees and credits for sales and use taxes paid for machinery.

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