Key issues to consider when undertaking distressed M&A

The COVID-19 outbreak has had a significant impact on global markets in an extremely short period of time. It has caused an unprecedented reduction in both supply and demand and, notwithstanding extensive government and central bank actions, the ultimate and enduring impact of the pandemic will not be known for some time. What is clear is that, with businesses around the world facing significant and unprecedented challenges, opportunities will exist for those with the resources and risk appetite to conduct M&A involving targets or sellers in financial distress.

This note aims to provide insight into distressed M&A transactions for those who may be less familiar with the way in which they have developed over the last decade, and considers how buyers and sellers may adapt to take advantage of opportunities arising from the unique global trading environment we are currently experiencing.

Deal types

A distressed environment impacts both the way in which deals are done and the structures that are used to implement them. We are likely to see an increase in the use of:

Business and asset sales: Generally, on a global basis, share deals are significantly more common than business and asset sales, at least within the mainstream corporate finance market. DLA Piper's annual Global M&A Intelligence Report, the most comprehensive of its kind, shows that around 80% of deals surveyed in the last five years were share sales.

However, in the wake of the coronavirus crisis we are likely to see a material increase in the use of business and asset sales. When conducting distressed M&A, buyers are often in a stronger negotiating position, have less time to conduct due diligence and, most critically, are transacting with one or more parties on the sell side that may not be able to meet any warranty or indemnity claims in the future. From a seller's perspective, tax is one of the key reasons to use a share sale, but this is often much less of a factor in a distressed environment where valuations are subdued and gains are less likely (and to the extent that they arise there are often sufficient losses available to shield them). As a result, buyers frequently seek to pick and choose the assets they want to acquire and, subject to certain exceptions1, leave behind as much in the way of liabilities as possible, including unknown and contingent liabilities.

Business and asset transactions can range from the acquisition of an entire multi-country business as a going concern to the acquisition of one division, a single category of assets or specific individual assets only. Although there are clear advantages for buyers from a liability perspective in being able to pick and choose exactly what to acquire, business and asset transfers can be more complex to implement than share deals – for example, it is more common for third-party consents to be required when transferring assets such as leases, commercial contracts, permits and licenses, which means these transactions can take longer to complete and have more execution risk than a straightforward share purchase. Understanding the risk around consents is even more important when government departments, regulators and consenting parties may be resource constrained, meaning consents may take longer to obtain.

Accelerated M&A (AMA): In an environment where a business has only days before running out of cash, every hour counts in order to preserve value. Also, for sellers with an urgent need to realise cash proceeds or to consolidate business activities, transaction speed and certainty may be material commercial drivers. The flip side of this, of course, is likely to be a lower selling price. This may be a particular problem for publicly listed sellers, who will need to justify the trade-off between speed/certainty and value. Sellers can, to some extent, mitigate this by seeking to negotiate anti embarrassment provisions which would apply in the event of a quick flip of the target business by the buyer for a significantly inflated price, but whether a buyer will accept this will depend on the relative negotiating strength of the parties.

Consequently, where a target or seller is in financial distress, an AMA process may be needed. A truncated auction can be used to drive competitive tension, to achieve the best possible price while reducing delays. Since an AMA process takes place over a much shorter time period, the list of bidders is likely to be limited to those who are used to transacting quickly and have the experience to manage a limited due diligence process and no significant warranties or indemnities in relation to the target business.

Due to the speed at which the parties need to transact, most AMA is undertaken by way of share sales (because of the relative simplicity of the transaction documents and the reduced requirement for third party consents). A share sale may also be particularly appealing where the target business has significant assets or is operating across multiple jurisdictions, where opting for an asset sale would require multiple transfers and compliance with numerous local formalities. Usually, the main downside to a share sale from a buyer's perspective is that all of the liabilities of the target company, known and unknown, will be acquired. This tends to mean either enhanced due diligence – which may be unpalatable given time pressures – or a lower purchase price. In an AMA process, understanding and pricing the risk associated with the target's liabilities and undertaking pre-closing conversations with major creditors are key.

Debt for equity and loan to own transactions: Where there is an expectation that a borrower's business will likely recover in the medium to long term, lenders may recognise that short term cash and debt serviceability issues may suit back ended upside structures such as debt for equity swaps (being a reduction in bank debt in return for the lender acquiring a material equity holding, and usually involving a significant dilution of existing shareholders). The principle goes that if value breaks in the debt then the risk (and therefore the price of forbearance and write down of debt in support of the borrower) should be reflected in the lender's ultimate return.

Coercive (and even consensual) debt for equity swaps will need careful contingency pre-planning and strategic guidance from legal and financial advisors, particularly in complex multi-stakeholder situations.

An extension of this is investors specifically buying into distressed debt to gain control of a business. In distressed situations, debt can often be bought and sold at a material discount to face value, and acquiring investors often find themselves in a strong position. There is increasing willingness on the part of institutional lenders to consider exit from problematic situations via sales of debt in the secondary market, even where there may have been a historic relationship with the sponsor or borrower. This is due to a number of factors including (but not limited to):

- risk weighted capital pressures; and
- lack of internal resource, experience and flexibility required to craft a speedy response to restructuring situations (e.g. by providing emergency liquidity).

A historic benign economic environment has led to alternative capital providers raising billions of dollars' worth of "dry powder" in the search for opportunities to restructure and/or recapitalise businesses and has substantially closed the bid-ask spread in the secondary market for debt.

We are therefore anticipating increasing volumes in debt trading activity in the sponsor backed leveraged mid-market and large cap market where debt-equity swaps and loan to own strategies may be a legitimate part of rehabilitation of debt burdened businesses.

The rights of acquiring investors as creditors give them visibility of the borrower's business and, at a time when management are obliged to work closely with creditors2, the balance of power can shift dramatically towards acquiring investors who have the flexibility to write down debt in return for control and/or enhanced recovery through equity.

Sponsors and owners may effectively become disenfranchised by "special situations" investors if the sponsor or owner is not part of the solution and is, given the stress in the business, out of the money. Investors may look for defaults in financing which provide commercial leverage to negotiate a debt for equity swap, or compel such a transaction through an enforcement of their security or other creditor rights. Where large and/or complex capital structures are involved, in certain jurisdictions debt for equity swaps can be implemented by means of a court-sanctioned process in which the consent of the existing owner or other out of the money creditors is not required (valuation is therefore key), and other creditor holdouts may be crammed into accepting the restructuring. New owners seeking to avoid such a scenario will need to structure shareholder arrangements carefully and may also look to provide liquidity to the group against a restructured balance sheet.

So called "loan to own" strategies can be reactive (e.g. an incumbent situation where institutional lenders see no option but to take control of the business themselves) or activist (where investors will look for weaknesses in financial structures and buy into the debt, using their leverage to effect a distressed acquisition of the borrower itself).

Timing of transactions

A key issue in distressed M&A is whether the transaction happens inside or outside a formal insolvency process. There are advantages and disadvantages of each, which are considered below.

‘Solvent’ transactions: While the impact of entering a formal insolvency process will vary business to business and country to country, the parties may want to avoid any stigma which might be associated with a formal process. However, this needs to be balanced against the risks associated with acquiring either the equity of a distressed company or the business and assets of a company in distress.

Acquiring a business and assets outside of a formal insolvency process means that a buyer is exposed to the risk of the transaction being subsequently challenged by creditors of the seller if they consider the value of the transaction to be too low. Acquiring the equity in a distressed company also carries risk for the buyer, as past actions and transactions of the distressed company could be challenged, particularly if the target company's management succumbed to pressures from lenders and other creditors and acted without proper consideration or in breach of contracts or regulations. Ideally, antecedent transactions would be identified through the due diligence process and any potential issues dealt with prior to the acquisition, and the buyer would also secure appropriate contractual protection in the form of warranties and indemnities. However, given there is often a burning platform, there may be a significantly reduced timeline in which to conduct due diligence, and the seller may not have sufficient funds to meet warranty or indemnity claims owed to a buyer following the acquisition. The focus is therefore often on price.

In a transaction where incumbent lenders are to remain in place post-completion, the buyer may wish to engage with them early in the process to negotiate discounts and/or leniencies by virtue of the proposed rescue plan.

Transactions negotiated pre-insolvency to occur through an insolvency process (Pre-packaged / Chapter 11 sales): Another way to acquire a business or assets from a company which is facing severe financial difficulties is through a pre-pack administration/Chapter 11 structure. These structures allow for negotiations regarding the sale to take place prior to the seller entering into a formal insolvency process but with the sale being effected immediately upon, or shortly after, the entry by the seller into such a process. Warranties and indemnities from the seller are unlikely, so due diligence needs to be a key buyer concern.

There are several advantages to the buyer, including:

- acquiring the benefit of the business and its assets whilst leaving most of the burden/liabilities behind;
- the speed and flexibility that come from dealing with a seller that is not subject to a formal insolvency process, allowing for the sale of the business as a going concern with as little disruption and loss of value as possible (and resulting in a better outcome overall for creditors than if the business simply ceased to trade); and
- more comfort/certainty, as the transaction is less likely to be challenged where it takes place during an insolvency process.

See DLA Piper obtains approval of first coronavirus-impacted bankruptcy sale for an example of how such a sale can work.

Carve-out sales: Depending on the urgency of the transaction, as an alternative to either a pure asset or share deal a seller may transfer (or “hive-out”) assets it wishes to sell to a new company which is then sold to the buyer. For example, a franchisee operator may transfer specific locations to a new entity, which is then sold in a share sale. The harder it is to effect a clean hive out of the relevant business, in a way that allows it to stand on its own two feet, the less likely it will be that such a structure is viable.

If the circumstances permit, this structure could yield the best result for both the buyer and the seller. It can assist the seller in realising a greater value for the assets being sold and the buyer is more likely to be able to complete due diligence on a clean entity with speed and be comfortable with what it is acquiring.

A carve-out can be used effectively for a planned disposal of a free-standing non core business or assets. The more ties the carved-out operation has to the business being retained, the harder it will be to make it work. Understanding the complexities of the hive out will be key for a buyer, including whether the transfer of assets to the new company is free and clear of liens/charges, whether any third party consents are required, any tax consequences that might arise and identifying any liabilities that will follow the assets.

Additionally, it will be important to ensure that any carve-out is undertaken in a way that protects both the seller and the buyer in the event of any current or future insolvency of the seller. For example, the carve out should consider distribution restrictions, transactions at an undervalue and directors duties (in each case where applicable in the relevant jurisdictions). Failure to comply with any of these frameworks could have serious implications for the directors involved and may result in the hive-out being unwound in the event of a future appointment of administrators (which could, in certain circumstances, mean that the buyer does not get good title to some or all of the assets it contracted to acquire).

Insolvent transactions: It is still possible to acquire businesses and companies once they have entered a formal insolvency process, through a sale conducted by the bankruptcy administrator, insolvency practitioner or, in the case of the US, a debtor-in-possession and its advisors. This may be preferable for a buyer in a number of respects, including the ability to obtain assets free and clear of liens, claims and encumbrances; the ability to negotiate and consummate the sale under the protection of the insolvency process, which will include a stay or moratorium on creditor action; and court approval of the sale. However, the downside of such acquisitions from the buyer's perspective is that, absent certain exceptions, the buyer may not be able to obtain any warranty or indemnity protection from the insolvency practitioner as seller. These transactions often take place under duress meaning less time for due diligence, so a buyer needs to carefully factor this and the lack of contractual protection from the seller into its price.

Key transaction issues

For some sellers, transaction certainty and an ability to realise proceeds quickly may be more important than price. Whilst this may lead to good opportunities to acquire targets at a discount, buyers should be mindful of various issues which may arise in the context of their transaction. Some laws and regulations contain special provisions for businesses in distress but many do not, meaning that the full rigour of the relevant law or regulation must still be complied with notwithstanding the short timeframe in which these transactions take place. This can lead to a need for short-term bridge financing to fund the target during a process, which may come from the buyer itself.

Anti-trust: Anti-trust may be a key consideration for buyers, whether specialist distressed funds or trade companies looking to acquire competitors or parts of their supply chain. Where the acquisition meets the merger filing thresholds in any jurisdiction (which vary from country to country but typically depend on global and local turnover and/or market shares and/or assets), pre-clearance by one or more anti-trust authority around the world may be required or recommended. In some cases, merger filings are simple formalities, but where the acquisition risks reducing the level of competition in the market (e.g. trade deals that may lead to increased market shares for the buyer), this can be a complex and lengthy process. Anti-trust approvals therefore need to be considered at the outset to ensure that expectations regarding the deal structure, timing and execution risks are managed from the outset. If anti-trust approvals are required, the resulting (and potentially lengthy) gap between signing and closing will put increased pressure on contractual provisions that apply during this time, such as material adverse change/effect rights, funding of the target and any other interim covenants that govern the way in which the seller can/should manage the target business during the gap period, all in circumstances where there is a looming insolvency situation.

Due diligence: In a distressed transaction, buyers may be required to undertake limited due diligence in a shortened timeframe. Further, both buyer and seller may have limited resources to devote to due diligence in the current environment, and accessing paper records and government officials and performing on site diligence (whether environmental or otherwise) in jurisdictions instituting orders to stay at home may prove challenging. Buyers need to engage experienced advisers who are able to quickly distill the issues, focus on the pertinent points and prioritise the most material risks.

Warranties, indemnities and insurance: Typically, sellers may be less willing to provide warranty and indemnity protection in a distressed scenario and, indeed, they may be less able to stand behind such warranties and indemnities, if given. Historically, W&I insurance has not frequently been available in distressed M&A situations, as insurers usually want to see that a fulsome due diligence exercise has been undertaken before providing coverage. It is, however, possible for certain insurers to agree a package of warranties in advance based on a pre-agreed level of due diligence. This provides certainty for the buyer as to the level of protection it is going to get in the transaction documents. Many W&I insurers are now starting to consider offering synthetic W&I policies in distressed M&A scenarios, where no warranties are given by sellers or administrators. We expect to see significant innovation in this regard in the coming months.

Anti-embarrassment: As accelerated sales processes inevitably impact pricing, sellers may wish to consider anti embarrassment provisions to protect against a quick flip of the business by the buyer for a significantly inflated price.

Concluding remarks

Undertaking M&A transactions in a distressed market means buyers and sellers have even more to consider than in a typical M&A transaction, and significantly less time to do so. Parties need good advisers who understand their business objectives, can respond quickly and who have the experience to advise on how best to structure transactions in these uncertain times.

Should you wish to discuss the issues raised in this alert, please contact your usual DLA Piper contact or one of the partners listed below.

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Article originally appeared here.

1 Where a business is sold as a going concern, the most notable exception, applicable in many jurisdictions, is the transfer of employees (and their associated liabilities) by operation of law. If real estate assets are sold, liabilities *associated with environmental remediation may transfer, and in some jurisdictions tax and unfunded pensions liabilities are also an issue.*

2 In times of financial distress, dialogue between a borrower's management team and its creditors increases. Management need to seek the continuing support of creditors, and management's duties as directors shift away from shareholders and towards the interests of creditors.