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Opportunities in Distressed M&A

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Opportunities in Distressed M&A

The Covid-19 pandemic is likely to give rise to a wave of distressed companies looking for buyers or investors; with depressed valuations and significant pockets of cash available to investors, there are likely to be many M&A opportunities that might be classed as "distressed M&A". This article considers the opportunities for investors with a degree of appetite for risk, the issues investors in a Covid-19 recovery environment might face, and how the sophisticated buyer might address some of them.

Even before the coronavirus pandemic sent shockwaves through global economies, warnings had been sounding that the ten year bull run would come to an end, and a long-awaited slowdown would occur, with a number of sectors then already showing signs of stress. Any doubts about a deep recession can now be cast aside as share prices have been tumbling and businesses making drastic cuts and reorganising. Whilst many companies have acted quickly to preserve cash and to ensure they have liquidity for the foreseeable future, there remains a high level of uncertainty as to the speed at which recovery may happen.

Even companies that have been able to draw on bank, government or shareholder support in recent weeks will need to re-assess their position and many are likely to come under considerable pressure in the coming months - particularly those with already high levels of debt or those operating in industry sectors likely to continue to feel the effects of the slump in demand for the foreseeable future. The impact of government stimulus packages ceasing is also a major issue. This sets the scene for financial investors and sovereign wealth funds, as well as stronger trade buyers, to enter the market and acquire distressed companies, and there are already signs that they are starting to become active.

This article considers the opportunities for investors prepared to engage in distressed M&A in the Covid-19 recovery phase and beyond and the issues they might face, as well as how the sophisticated buyer might address some of the risks of transacting in this environment.

Beyond COVID-19: A Roadmap to Stability

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Distressed M&A and the Covid-19 environment

What do we mean by distressed M&A?

Distressed M&A differs considerably from non-distressed or "traditional" M&A as we are referring to the acquisition of assets, shares or businesses where the seller or indeed the company itself being acquired is in financial distress: at one end of the spectrum, the company concerned may have some breathing space or be in early discussions with its lenders based on its view of its own cash needs going forward; towards the other end, the company could be in negotiations concerning a restructuring process or in a formal insolvency proceeding.

Distressed M&A in a Covid-19 environment

Whilst share prices have rebounded somewhat following the initial crash, there is still significant volatility as markets react to the steady flow of news and government responses to the crisis and this, together with the uncertainty as to corporate earnings, means that there remains a gap between valuation expectations of buyers and sellers but also extreme difficulty in making robust and defensible valuations.

The pressure on boards to file for bankruptcy has been reduced somewhat by changes in legislation - the UK, Germany or Australia, for example, where temporary relief from the requirement to file for insolvency to avoid personal liability for wrongful or insolvent trading has been granted allowing time for stakeholders to triage the situation outside of formal insolvency proceedings. With the actions many companies have been taking to shore up their balance sheets, to restructure and to preserve cash, we are not yet at the tipping point at which we will see a sudden rise in distressed M&A situations but that is expected to change. When that tipping point is reached will vary across different sectors.

The conditions are also potentially different to the aftermath of the global financial crisis because swift government action on a global scale has meant that the banking system is still (largely) intact and is expected to remain so. Further, private equity, hedge funds and other investors, including sovereign wealth funds, have record levels of dry powder that can be deployed into buying or investing into distressed assets, including through private investments into public equities (PIPE's).

Read more about private investments into public equities (PIPE's) in our recent article "PIPEs Unblocked, Finally?"

We will also likely see the stronger trade buyers emerging - those companies with strong market positions or balance sheets seeking to capitalise on suppressed share prices of competitors or competitors facing financial distress not just in the most challenged sectors, such as retail, transport, energy, construction, hospitality and leisure but also potentially in technology and healthcare, as well as Fintech. The oil & gas industry was already suffering as a result of the reduced oil price, over-supply and a Russian/OPEC dispute, and many companies in the sector, and the companies servicing them, were already saddled with significant debt with a mounting challenge as to how to refinance it. There will also be other sectors that will be subject to stress - "non-core" infrastructure assets, for example, may have exposure to the effects of the pandemic. In short, there will be very few sectors that are immune to the crisis.

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Takata Corporation in the in the highly contested and extraordinarily complex chapter 11 cases of TK Holdings Inc., et al.

- **Winner:** Cross Border Turnaround of the Year, Annual Turnaround Atlas Awards 2019.

GSK's transformational joint venture with Pfizer's Consumer Healthcare business, with combined sales of approximately USD 12.7 billion

Advising the non-debtor international affiliates of **Westinghouse**, as co-counsel, in connection with the chapter 11 cases of Westinghouse Electric Corporation LLC and its subsidiaries.

- **Winner:** Private Equity Acquisition & Turnaround of the Year, Annual Turnaround Atlas A

“A distressed M&A process tends to be an imperfect one - characterised by a compressed timetable, limited information available to a buyer and invariably more limited contractual protection for buyers. As such buyers need to be well prepared, with experienced advisers, and they must be ready to act (and react) quickly.”

What does a distressed M&A sales process look like?

The type of sale process will be determined by the level of stress a company finds itself under and, in particular, whether the transaction is conducted under a formal insolvency process or not. A company that is not subject to the imminent threat of insolvency may have sufficient breathing space to run a "traditional" auction process for relevant assets or put itself up for sale.

This may also be the best time for traditional buyers to enter the fray - while the business' key employees, customers and suppliers remain in place and supportive, for example; this is critical because as the breathing space runs out, the business and its reputation may start to become permanently damaged and the company will start to spiral towards insolvency. This can start to happen once news of the sale process or of the company's financial situation becomes more widely known - a particular problem for listed companies that must keep the market updated with developments affecting the company.

In distressed sales, the price will not always be enough to repay all of the company's debt in full. Whilst a lender will usually be able to accelerate a loan where the company concerned is in breach of the covenants in the facility agreement, experience from the global financial crisis suggests that creditors will often achieve a better return if they support an orderly restructuring of the company's debts than if they push the company into a formal insolvency. They will commonly enter into a standstill agreement with the company - buying precious time to preserve the business and goodwill of the company and hold off insolvency, but speed is of the essence. Any sales process for a company in this position is likely to be lender-led - particularly so where the company has various classes of financial creditors with different types of debt. The dynamics of such a sale become more complex, in part because lenders may not have the same incentives to maximise the price at which assets are sold as the seller's directors or indeed an insolvency practitioner (if one has been appointed), who will usually be under a duty to obtain the best price it can for the assets. A lender, by contrast, will be more concerned about obtaining enough to repay the debt owed to it and may be more risk averse.

Any sale process will generally involve an auction process but due to the time constraints that often apply, the marketing of the assets may be more limited than in conventional M&A.

These sale processes are typically characterised by a number of tactics, such as credit-bidding - where a secured lender is permitted to bid for and purchase its collateral using the debtor's outstanding debt as payment, or the introduction of a "stalking horse" bidder, a common feature of US bankruptcy sales, where a party is invited into the process - often secured with a break fee

and with early access to information - in a court-approved auction under section 363 of the US Bankruptcy Code. The stalking horse then makes a bid for the assets, which when made public, sets the minimum price for the bankruptcy court-approved "363 sale" that follows. Both of these can be powerful tools in the hands of financial investors - providing them with significant leverage but equally can be attractive to a seller who has the certainty of a bid at a fixed or quantifiable price.

An investor need not simply look at acquiring the shares of a distressed company. Where value breaks in the debt, another option may be to purchase the debt, which will often trade at a significant discount to its face value.

A number of investors use this "loan-to-own" strategy to gain control of the company, because owning the debt and being one of a distressed company's stakeholders with whom the company's directors will be working closely gives them access to information and influence which together confer a significant tactical advantage in negotiations to acquire the assets. There is an increasing volume of dry powder available for deployment in loan-to-own situations and that trend will continue.

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Due diligence and valuation issues

One of the characteristics of a distressed M&A transaction for buyers is the "as is, where is" nature of the transaction. There is often little time for full due diligence and/or limited access to or availability of due diligence materials. It is rare for there to be any vendor due diligence, meaning that buyers do not get a head-start on the diligence process and will likely incur increased costs as they must diligence the target assets themselves. Coupled with a tight timetable, this means buyers and their advisers must focus their attention on the critical issues and more material risks.

The Covid-19 recovery period will likely only add to the challenges the distressed buyer will face as opportunities for site visits and access to physical documents and people will remain limited. It may be that in the case of the more light touch administrations, where some of the key management of the distressed businesses have been retained, buyers will have greater access to management.

The areas of focus for buyer due diligence should not differ to any material extent from a traditional M&A process: for example, a buyer will want to ensure that assets are being acquired free of any encumbrances, that change of control consents or retention of title clauses in material contracts have been identified, that it knows which employees may be transferred automatically by operation of law (e.g. TUPE in the UK or equivalent in Europe) and that the risk that pensions liabilities or successor liabilities under environmental law could transfer or attach to the assets being acquired have been assessed. Certain issues such as supply chain integrity, which has been highlighted as a result of the pandemic, will now also play a larger part in any diligence process.

However, pricing and allocating the risks that are identified in due diligence may require creativity: completion accounts are rarely attractive to sellers in a distressed M&A sale, because of the uncertainty over the consideration that may be paid, and the consequent delays, if there is any dispute between the parties, and fixed price consideration is the norm. However, where it is difficult to evaluate the quantum or likelihood of a risk arising buyers may consider placing a sum into escrow to be used as security should the risk crystallise - with the payment being released to the seller (or former creditors) if the risk does not crystallise within an agreed timeframe.

For the reasons set out below, warranty protection is unlikely to be on offer unless a W&I insurance policy is purchased.

Structuring the transaction

Typically, a buyer will want to structure an acquisition as an asset sale because it can pick and choose the assets that it wishes to acquire and can leave behind liabilities, including unknown or contingent liabilities. A "hive-down" or "carve-out" of the assets into a newco, and the purchase of the shares in the newco, may also be attractive to the buyer.

These structures also remove some of the due diligence burden from the buyer as its focus can be on the assets and rights it wants to acquire, their free transferability and the absence of liens or other encumbrances over them. The tension between buyers and sellers is clear because selling the shares in a company is usually faster to achieve, the documentation commensurately simpler and the tax treatment usually more favourable to the seller, whereas in an asset sale - particularly so in a complicated carve-out - the seller must identify each and every asset and may need to seek consents to assign or transfer those assets. Similarly, it may not be attractive to leave behind all of the liabilities of the business. Tax tends not to be a primary driver however in distressed sales because either the price being paid for the assets does not give rise to a chargeable gain or because losses may be available to shield any gain.

Both buyers and sellers will need to be mindful of insolvency laws when looking at structuring. Common to the insolvency regimes in most countries is the risk that a transaction can be unwound and assets "clawed back" if they are transferred at an undervalue (or are a fraudulent conveyance in the US parlance) in the period preceding a company becoming insolvent or entering into a formal insolvency process. Directors of a distressed company will be concerned about this as they could face personal liability. Buyers may wish to acquire the assets from an insolvency practitioner or through a formal insolvency process in order to eliminate the risk of a transaction being challenged by creditors after the transaction has taken place should the

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Pre-packaged administrations (or "pre-packs") are an often used way to mitigate claw-back risk as they involve the transaction being negotiated with the insolvency practitioner, who is waiting in the wings pending a formal appointment, and who then signs the sale agreement immediately upon or shortly after being formally appointed. In addition to mitigating claw-back risk, this process carries the additional benefit of speed and usually the preservation of the business as a going concern. Similar processes exist in other countries, such as the "section 363 sale" process used in the US. Bear in mind however, that involving courts or insolvency practitioners carries with it additional issues. A transaction is likely to need to satisfy a new participant in the transactions - namely the court or insolvency practitioner - that the transaction is lawful and/or consistent with their duties. In the case of a pre-pack, this involves the administrator complying with Statement of Insolvency Practice 16 which places obligations on the administrator to make disclosures to creditors, including of the reasons for the pre-pack and the steps taken to arrive at the purchase price.

Finally, when it comes to structuring, in any sale process a seller will usually be seeking maximum deal certainty, and this is particularly the case in a distressed situation as a looming insolvency is a catalyst to a swift process with no or limited scope for a buyer to back out once a deal has been signed. This will apply to many aspects of the deal documentation - from eliminating MAC termination rights to limiting the scope of "gap covenants" and no or limited repetition of warranties (if indeed any are given). Ensuring that the business has access to funding throughout any pre-closing period will also be essential and buyers may also be called upon to provide that interim funding.

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Warranty protection and W&I insurance

Another feature of distressed M&A transactions is that buyers do not typically get warranties from sellers; moreover, if the company is in a formal insolvency process, administrators do not give warranties. Even where warranties can be obtained, there is often going to be doubt about whether the seller will be able to stand behind the warranties if a claim arises.

Interaction with management - provided they retain the confidence of existing stakeholders - can assist buyers in getting more meaningful due diligence materials and a deeper understanding of the business. Where the sale or restructuring provides for management incentivisation, management may even be prepared to give warranties in such a situation (but subject to appropriate limitations on liability) although this is probably the exception rather than the rule.

Warranty and indemnity (W&I) insurance policies have become very common in M&A transactions but underwriters have typically not been prepared to offer coverage at all, or certainly not extensive coverage, where there has not been a customary due diligence and disclosure process. However, a new feature of the W&I market is the fully "synthetic" policy, where the insured interacts directly with the insurer and no warranties are given by the seller or administrator. Instead, a package of warranties are agreed between the buyer and the insurer - which can be very attractive to the sellers or to an administrator as it becomes the buyer's issue and need not involve them. However, these policies come at a price - they are typically more expensive than a traditional W&I policy. The other limitation is that the insurers will nonetheless expect there to be due diligence undertaken on the assets being acquired and so affording buyers an opportunity to carry out due diligence will be necessary in auction process if it is anticipated that they may seek insurance.

The W&I insurance market is demand driven, however, and we expect to see competition drive down pricing and an increase in product offerings and terms tailored to what the market is demanding. So, for example, whereas blanket Covid-19 exclusions were common at the beginning of the pandemic, insurers are started to be more pragmatic and entertain more bespoke exclusions.

Anti-embarassment provisions

It is common for sellers to include an "anti-embarrassment" clause in the sale documentation: a requirement that the buyer makes an additional payment for the sale assets if certain trigger events occur - usually the sale of the assets or a substantial part of them within a period after the distressed sale, typically between one and three years after closing of the sale.

They are particularly common where there has been a pre-pack sale by an administrator in which the business has only been subject to a relatively limited marketing exercise or where the business or assets have been acquired following a restructuring and where certain creditors have been forced to accept less than the face value of their debt.

Whilst it is generally the case that a business is likely to be sold at something of a discount to the "market value" to reflect the distressed nature of the sale and the lack of contractual protection a buyer might receive, this discount may be greater in the Covid-19 recovery phase where there could be limited visibility on when demand may return, and as to what the "new normal" will look like. An anti-embarrassment clause will also give the seller some of the upside that a buyer might otherwise have if it were to flip the business within a short time after the original sale. The intention is not, however, to stop the buyer from benefiting from turning around the acquired business but with some of the difficulties referred to above with settling on valuation and of pricing risk, there might be scope for a lower up-front price and an enhanced anti-embarrassment payment or a longer time period during which the clause applies. An obvious alternative may be a debt-for-equity swap, and this could be particularly attractive where there may be greater confidence in the recoverability of the company's business.

Regulatory issues in distressed M&A

Foreign investment screening

Acquiring assets, or even assuming control or ownership by enforcing security upon default, may well be a triggering event for foreign investment regulatory authorities where the new owner is ultimately foreign owned.

Prior to Covid-19, there was a clear path towards "de-globalisation" with rising national protectionism and calls for stronger screening of foreign investment throughout the world. The increasing scrutiny from CIFIUS and FIRB in the US and Australia respectively were already getting attention before Covid-19 but the coronavirus pandemic has prompted the governments in a number of countries to take an even more stringent approach - notably in Europe and Canada. For example, in March 2020, the European Commission published guidelines to EU Member States calling on them to adopt or strenuously enforce their foreign investment screening mechanisms to protect sensitive assets from foreign takeover during the crisis. Whilst many cross-border transactions will still have a high likelihood of being approved, those in a number of sectors - and not just those where national security may be at issue - may encounter greater scrutiny and face a prolonged approval process.

Baker McKenzie has a range of tools to assist buyers and investors assess the global regulatory landscape, including its Foreign Investment Review Evaluation or "FIRE" platform.

Antitrust

In the context of distressed M&A and with the likelihood of sector consolidation as stronger players buy weaker players or weaker players look to survive through mergers, competition law will also be a key consideration for many deals.

In cases of extreme financial distress, the viability of the distressed business may not allow for a lengthy antitrust review process and a number of countries have a "failing firm" concept in their merger control rules, allowing for the parties, for example, to seek a derogation or waiver from the requirement to wait for merger control clearance before the transaction closes. Whether or not a derogation is necessary will depend upon the jurisdictions involved and whether the rules in the relevant jurisdiction impose mandatory or "suspensory" merger filings, i.e. it is a requirement that the deal cannot close unless the requisite approval is given or the applicable waiting period has expired (so called "standstill obligations").

This is the case under the EU merger control rules but not the UK where, the requirement to notify the transaction is voluntary. The European Commission can, for example, grant a derogation from the standstill obligations (but not the requirement for approval) where such obligations would endanger the viability of one of the parties and the transaction would not lead to irreversible harm to competition. Whilst they relatively rare, situations where it may be possible to obtain a derogation include where the target is in acute financial distress.

A regulatory strategy

Taking the time to understand the rules and political sensitivities in each country, and then to identify a clear regulatory strategy, with appropriate messaging and communication with the relevant governmental authorities and regulators from early on in the M&A process is advisable as a means to assess the viability of options that might be available to a buyer and the likely timescales for decisions. This will be particularly important in the Covid-19 recovery phase. Early consideration of the likely remedies that might be offered up in advance to secure clearances and approvals is also recommended.

Foreign Investment Review Evaluation Tool

Baker McKenzie has a range of tools to assist buyers and investors assess the global regulatory landscape, including its Foreign Investment Review Evaluation **"FIRE"** tool.

FIRE is a Baker McKenzie analysis platform which answers 49 detailed questions on foreign investment review regimes in 20 jurisdictions with more countries being added soon including India, China, Russia and Korea. It is updated in real time, provides depth and legal certainty, and to our knowledge is the only product of its kind on the market.

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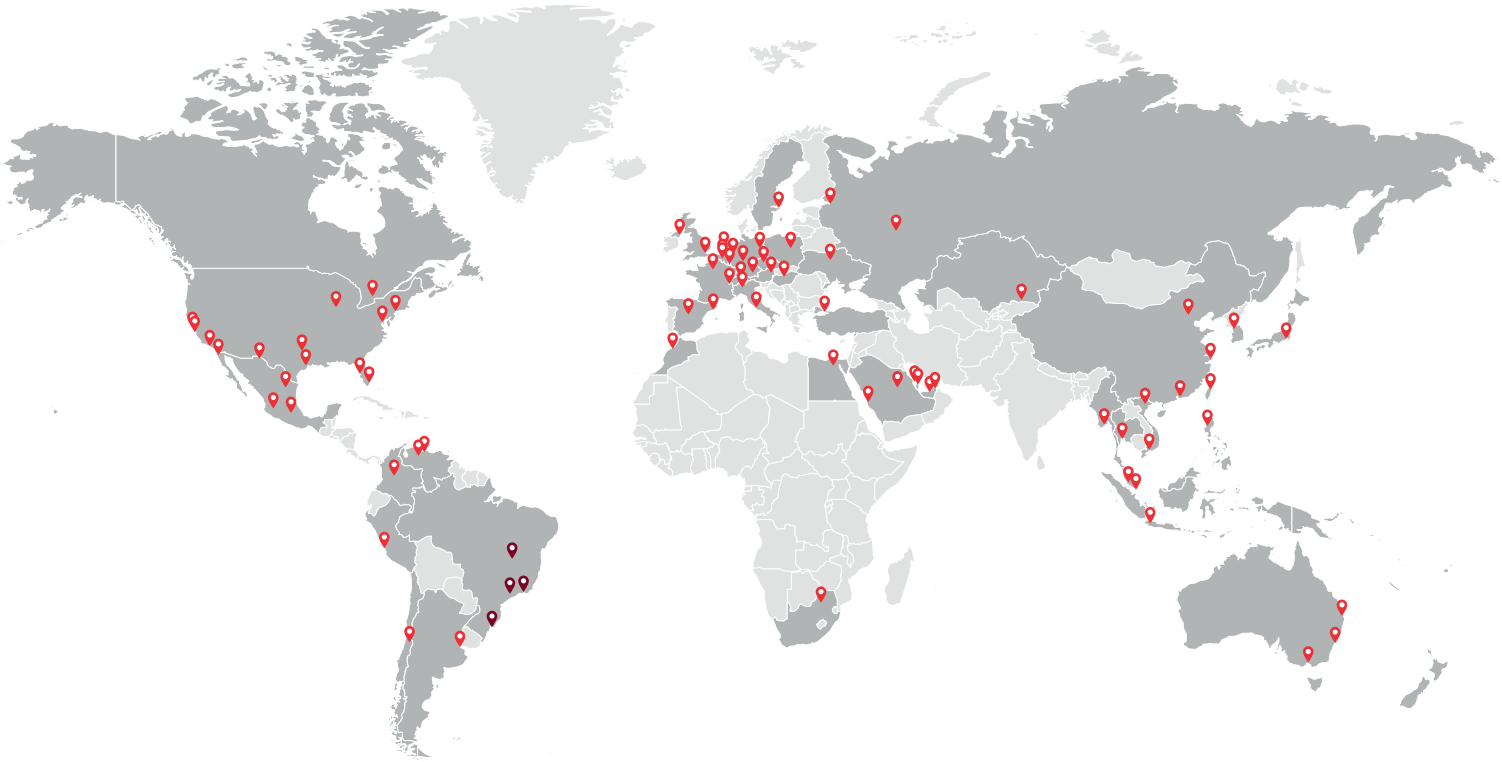

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