COVID-19: DISTRESSED M&A IN THE ERA OF A PANDEMIC - PART 1, EYES WIDE OPEN

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INTRODUCTION

COVID-19 and the ensuing economic turmoil are continuing to adversely impact businesses worldwide. As a result, in the months ahead, thousands of companies either will be unable to survive on a stand-alone basis or will conclude they are better positioned if they merge with a stronger partner. For strategic buyers, private equity firms, and other investors, these financially distressed companies can represent favorable acquisition opportunities (e.g., reduced valuations, reduced competition from bidders that are not comfortable with distressed targets, cost synergies, the ability to fill in missing product lines or geographic territories).

However, acquiring a financially distressed company is very different (and often more challenging) than acquiring a financially healthy company in a normal M&A process.[1] In light of the different process and risks involved, buyers should approach distressed M&A opportunities with their “eyes wide open.”

This article is the first in a series by K&L Gates attorneys regarding distressed M&A. This introduction focuses on the unique aspects of acquiring distressed companies (as compared to acquiring financially healthy companies). Part 2 (coming shortly) will address COVID-19 ramifications for distressed M&A – e.g., antitrust/competition, economic uncertainty, government loans, representation and warranty insurance (RWI), tax. Future parts will address other distressed M&A topics relevant to the current market, such as transaction structure, contractual protection, avoidance of liabilities, and cross-border deals.

UNIQUE ASPECTS OF DISTRESSED M&A PROCESS

Reduced Timeframe

Generally, the negotiation timeline will be accelerated due to the deteriorating financial situation of the target, creditor demands, and the potential near-term loss of significant business relationships (customers, employees, suppliers, etc.).

Due Diligence Challenges

As discussed more fully below, specific pressures will alter a normal due diligence process in a distressed M&A transaction.

Risk of Challenge/Litigation

A distressed company typically leads to a depressed valuation. In the context of an M&A deal, lenders, other creditors, and/or equity holders may not receive full value on their debts or investments. As a result, a buyer faces the risk that the sale process or the terms of the sale will be challenged by creditors, equity holders, or trustees, either during the sale process or after closing. Through structure and drafting, these risks can be mitigated (as will be discussed in an upcoming article in this series), but usually not completely erased.

Statutory Requirements and Formalities

There are statutory requirements and market-driven formalities for distressed sales, particularly in judicial proceedings, that may be necessary to consummate the deal and, even if not mandated, should be adhered to in order to best protect the parties.

Overbid Risk and Diminished Exclusivity

Boards of directors, trustees, assignees, and receivers have statutory and fiduciary duties to maximize the value of the company's assets, market the assets, and subject offers to higher and better bids. While an initial bidder – the “stalking horse” –may be able to obtain deal protections (minimum overbid amounts, break-up fees, etc.), there may be limited or no exclusivity and in many cases a full auction process.

More Parties Involved

In addition to the usual buyer/seller negotiations, there is greater need to coordinate with lenders, lienholders, landlords, suppliers, customers, employees, etc. so that the acquired business remains viable post-closing. There may also be third-party consents required for items such as lien releases. More parties means more complexity, and communications must often be carefully managed and coordinated by the target company.

Purchase Agreement

In order to address the matters above as well as to account for the typically reduced recourse against sellers, the purchase agreement in a distressed M&A deal often looks quite different from a purchase agreement for a financially healthy target. We will address this point in greater detail in one of the upcoming articles in this series.

Antitrust/Competition

One piece of good news: a bidder for a distressed business may be able to avail itself of the “failing firm” defense.[2]

UNIQUE ASPECTS OF DISTRESSED M&A DUE DILIGENCE

Distressed M&A requires a different diligence approach than a “normal” M&A process.

A bidder should perform due diligence on whatever conditions are causing the distress. While this may be obvious as being COVID-19 in the current environment, a bidder will want to dig deeper as to the nature, extent, and likely duration of the COVID-19 causation based on the target company's individual situation, as well as whether or not there are contributing causes unrelated to COVID-19.

The target's lack of liquidity and resulting need to conserve cash leads to additional risk and compressed timeframes. For example, the liquidity issues may cause the target to defer investment in capital expenditure projects, maintenance of facilities and equipment, improvements to its IT infrastructure, or employee hiring. Just as the target is feeling the pressure of the financial distress, the same may be true for the target's employees, suppliers, and customers. The target may experience employee departures and disruptions with important suppliers or customers who may also become financially distressed. Many vendors may be requiring payment in cash up front, further damaging the target's liquidity, and if the target is cash strapped to the point of failing to meet payroll or purchase materials for completion of contracts, a lengthy diligence process may contribute to further losses in operations and overall value.

In addition to all of the normal M&A diligence inquiries and the distressed M&A issues above, there are several other diligence challenges that apply in most distressed M&A processes.

Reduced Timeframe

As more fully discussed above, the timeframe for diligence may be significantly reduced from a normal M&A transaction.

Reduced Scope

Diligence is often limited in scope and incomplete. The target may be leanly staffed due to constrained financial resources, and the target may have experienced key departures, as employees jump from the sinking ship. Oftentimes, distressed sales are managed by third parties (foreclosing senior creditors, restructuring advisors, receivers, assignees, etc.) who do not have full sets of records or the in-depth knowledge that an operator would have in nonstressed situations. The company's records may be incomplete and/or disorganized (with little time to clean up), which combined with the other factors above, makes full and complete diligence challenging.

Reduced Visibility into Target's Finances

The target's accounting/finance team may be preoccupied with liquidity problems. The damage of financial stress to the operational business may not show up immediately, and the true financial picture is often worse than advertised. The distressed nature of the business often continues to trend downward and may spiral quickly.

CONCLUSION

Strategic buyers and private equity funds will see opportunities to invest in attractive companies in need of capital. A distressed sale process is not for the faint of heart, but in a radically changed M&A landscape, the distressed market has great potential. Buyers looking to acquire distressed businesses in the COVID-19 world can best position themselves now by educating themselves on the process, engaging experienced advisors, securing cash financing, and preparing for an expedited sale process.

FOR MORE INFORMATION

Please be on the lookout for the next article in our Distressed M&A series, which will be coming out shortly. This series of articles is written by a number of attorneys from K&L Gates' cross-disciplinary distressed M&A team, including attorneys from our M&A, bankruptcy/insolvency/restructuring/insolvency, antitrust/competition, RWI, and COVID-19 practice groups. While the primary authors are U.S.-based, most of the commentary above applies internationally. Our global distressed M&A team, with attorneys in Asia, Australia, Europe, Middle East, North America and South America, stands ready to assist you.

FOOTNOTES

[1] For more on M&A in the wake of COVID-19, see COVID-19: Implications on M&A Transactions.

[2] For more on the “failing firm” defense, see COVID-19: Will Today's COVID-19 Distressed Businesses Become

Tomorrow's Antitrust-Cured Acquisition Targets?

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