



# Distressed M&A

An overview

September 2020



Freshfields Bruckhaus Deringer

# Setting the scene

**Driven by the Coronavirus pandemic, companies are facing increased financial difficulty and many will look to divest certain assets or subsidiaries, or be forced into sales as part of insolvency proceedings.**

**This is presenting opportunities for purchasers as they enter a new market, or expand their existing business or portfolio – for an attractively low price.**

M&A in this field is not without risk and requires planning and knowledge of the way that the purchase of a distressed asset or the purchase of a business from a seller facing distress differs from 'normal' M&A.

## **Preparation is key**

In the following pages we set out the key considerations for purchasers looking to capitalise on distressed opportunities – answering the questions:

- **What are the different stages of distress and what are the risks of engaging at each stage?**
- **How does 'distressed' M&A differ from 'normal' M&A?**
- **What should a purchaser consider in a 'distressed' M&A situation?**
- **What will the seller be considering?**
- **What are my next steps?**

# The spectrum of distress

**'Normal' M&A  
where seller is  
facing  
challenging  
headwinds**

**Distressed  
M&A outside  
an insolvency  
process**

**Insolvency**

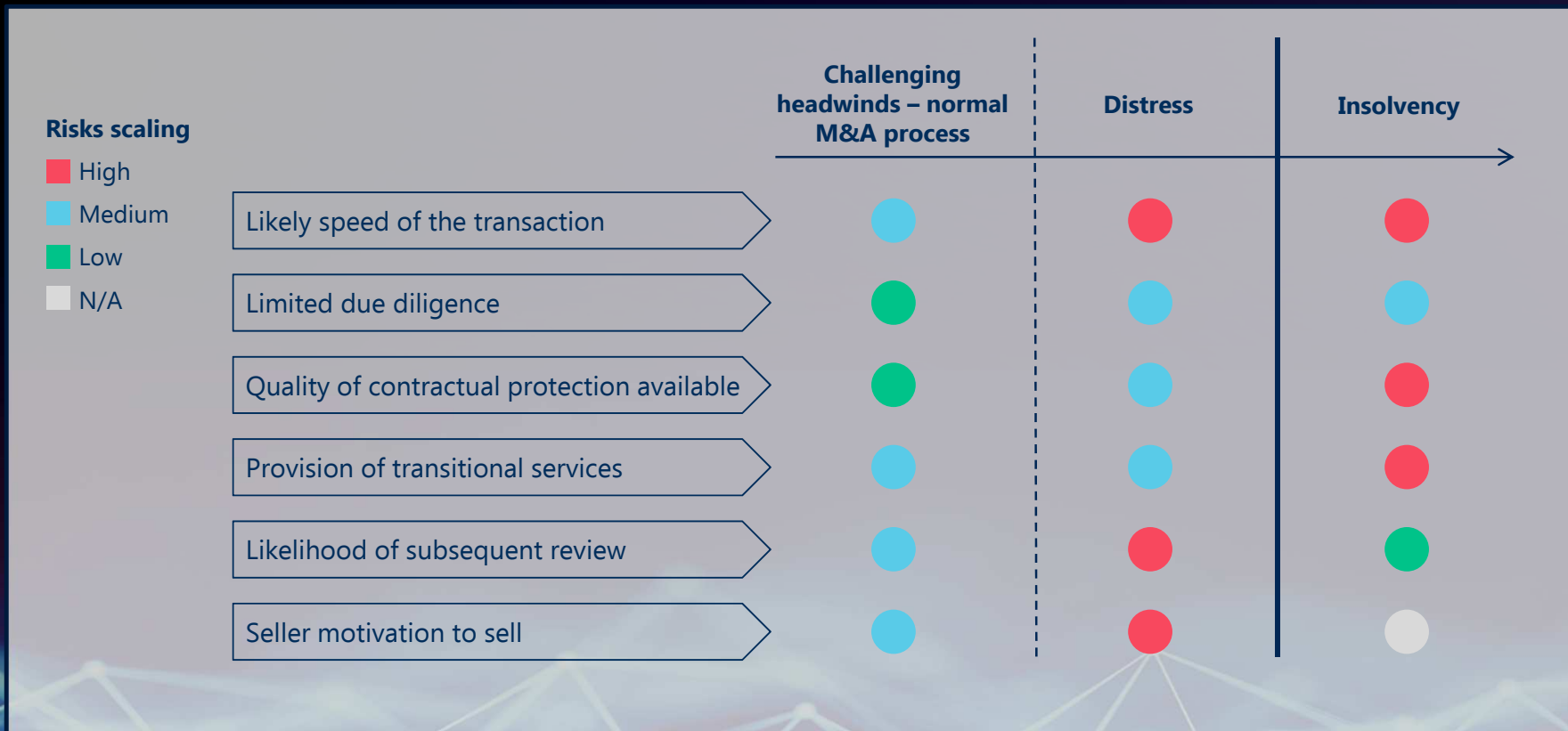
- No formal distress
- Works more like a 'traditional' M&A deal, though may come with added complexity
- Seller may be considering other transactions in parallel to M&A, eg debt refinancing/capital raise

- With covenants in debt documents at risk, creditors may be more active in the process
- Cash flow and credit issues will typically make the seller want to move quickly
- Deals involve risks for purchasers (esp. claw-back)

- Liquidator, administrator, receiver or foreign insolvency officeholder, leaving the seller with limited input on the deal
- Creditors, on the other hand, may be in the driving seat

# Risks and rewards across the spectrum of distress

Various aspects of risk in the deal will vary depending on the level of distress of the seller or target and type of process.



# Distressed M&A: purchaser considerations

## 1 Prepare to move at pace

Likely speed of the transaction:

- Processes often move at a faster pace than 'normal' M&A
- The seller may need to move at a fast pace due to limited liquidity, looming maturities or pending defaults
- Often, the level of distress of the seller will reflect the speed with which the transaction needs to take place

## 2 Focus due diligence on key areas of upside and risk

Limited due diligence:

- As a consequence of the speed of processes, the due diligence process is often truncated
- The seller is unlikely to provide an information memorandum and may provide only limited sale information
- Information from previous sale processes, capital raises or other transactions may be repurposed but may be out of date
- Purchasers should focus their due diligence on the key areas of the target's business which will allow them to sensibly assess potential upside and risk

## 3 Be ready to adapt and manage contractual risk in different ways

Quality of contractual protection:

- It may be difficult for a purchaser to negotiate 'standard' contractual protections (eg leakage covenants, closing accounts adjustments or wrong pockets provisions)
- If the purchaser is able to negotiate such protections, there is a risk that the seller will be unable to stand behind them
- Usual structural protections around consideration (eg earn outs) may not work in 'distressed' M&A processes if the seller or target is in urgent need of the sale proceeds
- Often, the level of distress of the seller or target will reflect the speed with which the transaction needs to take place

# Distressed M&A: purchaser considerations

## 4 Understand independence and/or interdependence of the target

Provision of transitional services:

- If the target business is unable to stand alone following the transaction, purchasers will need to consider what services it will need in order to continue to operate - and who is capable of providing those services
- This can be problematic where the only supplier is the seller's group but is easier if it is a commodity or another commercial provider
- In a sale following a formal insolvency process, there will not be a transitional services agreement, so the target business must be capable of standing alone or acquiring services from third parties.

## 5 Know your litigation risks and relevant local regimes

Likelihood of subsequent review:

- If a seller enters into an insolvency process after a sale, the insolvency officeholder may seek to set the deal aside
- Specialist local law advice is vital in order to understand the rules that may apply and to mitigate risk

## 6 Who is the real seller?

Seller motivation to sell:

- The seller's motivation to sell will increase in line with its or the target's level of distress
- Purchasers will want to be sure of who they are in fact negotiating with as there may be various stakeholders involved (eg shareholders and creditors) which may impact on deal timing and priorities

# Seller priorities

1

## Speed

- Will seller be focused on speed and certainty of execution, over outright price?
- Who is advising the seller and the target – separate advisers?

2

## Certainty

- Deal certainty will be very important
- Any conditions will make the offer less attractive
- What can a purchaser do to mitigate antitrust risk?

3

## Consideration

- What type of consideration will be most attractive?
- Immediate cash v deferred cash, pay a deposit at signing and/or provide temporary liquidity?
- Certainty of financing will give seller comfort

4

## Value

- Initial price may be reduced if matters are discovered during diligence. Risk to be priced in given limited opportunity for contractual protection
- Consider negotiating tactics and timing of price drops if necessary
- Anti-embarrassment factor

5

## Management

- Incentivised to do deal?
- Directors' duties
- Likely no value in their equity share plans
- Consider cash bonuses
- Consider how to ensure they focus on dealing with operational issues

# Wider considerations

## Foreign investment (*FI*) controls

We have seen a general tightening of FI rules around the world in the past few years and Covid-19 is resulting in a further ratcheting up of protective measures against foreign investments.

**CONTACT US FOR A REPORT  
SUMMARISING FI CONTROLS ACROSS A  
NUMBER OF KEY JURISDICTIONS**

## Merger control

Covid-19 is having an impact on merger control in addition to causing delays to transaction reviews; deals are now being reviewed against the backdrop of significant economic distress and are becoming increasingly politicised.

## Access to financing

It will be vital for purchasers to be able to show their ability to make funds available at completion, particularly if competing against bidders with ready access to capital/financing.

## Alternative deal structures

Whilst carve-outs will continue to be popular deal structures, purchasers are increasingly considering private investments in public equity (*PIPEs*) as a way to acquire discounted equity and asset deals as a way to structurally insulate themselves from certain risks.

## W&I insurance

Depending on the bargaining-power between seller and purchaser, it is possible that purchasers may be able to negotiate sell-side W&I policies, in particular to address the deficiencies in due diligence. It should also be noted that insurers have started to specifically exclude pandemic-related losses from their policy coverage as COVID-19 is a known risk.

## Auction dynamics in the time of Covid-19

The universe of affected stakeholders that are critical to the deal is diverse on a distressed deal. It is paramount to speak to the right people: creditors, sponsors, key customers and suppliers, (key) employees, CRO and receivers (if any) all need to be on board.



# Purchaser preparation

Purchasers should prepare in advance so that they can move quickly and make the most of any potential opportunities

## Identify opportunities

### Build network

Banks  
Advisors  
Financial investors

### Monitor

Market notifications  
Restructuring and trade press

## Demonstrate your seriousness

Indication early competitive price, but prevent being 'shopped around'

Show path to accelerated execution

Engage with seller to understand any objectives beyond value

## Show understanding of distressed M&A

### Acknowledge and accommodate:

Transaction speed  
Limits to contractual protection  
Due diligence limitations  
Agenda of officeholder (if any)

Make it clear to seller (and all your advisers) you are focused on targeted DD

Line up W&I insurance

## Manage stakeholders

### Engage early with Management / CRO

Key customers and suppliers  
(Fulcrum) Creditors  
Sell-side FA  
Officeholder

## Secure financing

### Line up financing

### Accommodate certain funds requirements

Down-payment  
Bank guarantee  
Hard commitment letters / ILAs

## Show sophisticated approach to transaction documents

### Know the market practice

Don't request what the seller cannot accept

Focus on the key aspects










Limit personal liability risk of management and officeholder

Don't underestimate the complexity



# Country considerations

# Jurisdictions matter

										Notes
Clawback risk	Y	Y	Y	(Y)	Y	Y	N	Y	o	o High risk, but all distressed M&A done in-court anyway
Preventive framework	Y	N	N	Y	Y	Y	Y	o	N	o Refinancing agreement with limited scope
Cramdown possible	Y	N	N	Y	N	o	o	o	N	o NL: Only unsecured creditors in certain cases; ES: Certain creditors excluded; IT: Only banks and intermediaries
Obligatory filing*	o	Y	Y	Y	Y	Y	o	Y	N	o No obligatory filing, but wrongful trading risk for management
Pre-pack	Y	N	N	o	Y	o	Y	Y	Y	o BE: No case law available; IT: Possible, but require auction and are therefore intricate
Key:	UK	Germany (DE)	Austria (AT)	Belgium (BE)	France (FR)	Italy (IT)	Netherlands (NL)	Spain (ES)	USA	* Currently suspended in many jurisdictions because of COVID-19 pandemic

## Key considerations: United Kingdom



- Schemes of arrangement and Company Voluntary Arrangements (CVA) are often-used tools to avoid insolvency and allow cram-down – the newly introduced Restructuring Plan is intended to achieve the same goals, but unlike schemes/CVAs allows cram-down of equity
- Pre-packs possible. New legislation allows for pre-insolvency moratorium
- No filing requirement, but risk of wrongful trading (new legislation has proposed it be suspended during pandemic)
- Independent officeholders
- No conditionality and no reps on insolvency deals
- No foreign investment control tightening (yet)
- Clawback risk, but manageable

## Key considerations: Germany



- No out-of-insolvency cram-down (yet)
- Optional debtor-in-possession proceedings enable management to retain control in insolvency
- In-court transactions enable cherry-picking of assets and contracts
- Insolvency proceedings enable asset deals or acquisition of restructured debtor by way of insolvency plan
- Filing requirement can be disruptive in pre-insolvency situations
- Robust, but sophisticated and commercial receivers (individuals)
- In-court deals require creditor approval
- Positive liquidity effect through state picking up 3 months' salaries

## Key considerations: Austria



- Preventive framework available, but hardly used (a new law is currently being prepared)
- Mandatory filing within 60 days of (cash flow or balance sheet) insolvency; extended to 120 days if the cash-flow insolvency is caused by a natural disaster, i.e., a pandemic
- In-court deals likely to require creditor and court approval
- Receiver likely to carry out real auction
- Options to avoid TUPE in insolvency deals
- Foreign investment control tightening upcoming
- Claw-back risk in subsequent insolvency, but manageable

## Key considerations: Belgium



- Valuations mostly based on liquidation asset values
- Judicial reorganisation outside of insolvency possible with cram-down of minority creditors and cleansing of security for asset deal (court approval needed)
- W&I insurance uncommon on all distressed deal types
- Mandatory filing in case of cash flow insolvency
- Possibility to pick employees on in-court deals
- Only limited clawback risk (bona fide deal)
- COVID-19 moratorium: no enforcement, no involuntary bankruptcy, no termination of agreements, suspension of filing

## Key considerations: France



- Variety of preventive frameworks available (views of court-appointed official key)
- Management-led safeguard and rehabilitation proceedings (DIP) prevalent
- Mandatory filing in case of cash flow insolvency
- Buyer can limit number of assumed employees and select “jobs” to be taken over
- Bank guarantee or cash collateral required on insolvency deals
- Foreign investment control being intensified



## Key considerations: Italy



- Variety of various pre-insolvency restructuring frameworks (certified recovery plan, restructuring agreement, standstill agreement, "blank request") available; eliminate clawback risk
- Frequently used composition proceedings concordato preventivo (managed, but not led by court)
- In-court deals require auction/"stalking horse" bid
- Mandatory filing upon cash flow insolvency
- Pre-packs possible, but the need to implement an auction in insolvency makes pre-packed deals pretty difficult
- 10% deposit required for participation in in-court auction
- W&I insurance not a common feature

## Key considerations: The Netherlands



- Pre-pack culture with “silent administrator” and “silent supervising judge” to prepare deal, which is executed promptly after filing. Low clawback risk
- Out-of-court “suspension of payment” state available, but typically followed by insolvency to use in-court restructuring tools. Higher clawback risk
- “Scheme of arrangement” type process about to be implemented
- TUPE does not apply on in-court deals
- Court approval needed for (pre-packed) insolvency deals
- W&I insurance not a common feature

## Key considerations: Spain



- Out-of-court refinancing agreements can be used to amend the terms (establishing more favourable conditions for the debtor) or extend the maturity of a company's debt; if certain requirements are met, no claw-back risk
- Company's obligation to file within two months of cash-flow insolvency only, but suspended until end of 2020 under COVID-19 legislation
- Pre-pack possible if 20% of debt, subject to other criteria
- Pre-packs typically on "normal" terms
- Relatively long claw-back period (acts carried out within the two years before the insolvency declaration might be rescinded)
- Insolvency still seen as tarnishing reputation
- Foreign investment control tightened (now from 10%)

## Key considerations: USA



- The vast majority of distressed M&A deals done in Chapter 11 proceedings to avoid clawback risk as a court will approve the transaction
- Processes and deals in Chapter 11 are public and transparent
- “Section 363 sale process”
  - “Stalking horse” bid used to shop for bids
  - If higher bids made, live auction
  - “Stalking horse” has first-mover advantage and wins approx. 70% of auctions
- “Sale through Plan of Reorganisation and Plan Funding”
  - No auction required, but could occur
  - Can take several months
  - Creditor solicitation of the plan is required

## Key considerations: MENA

- A variety of insolvency processes exist across the MENA jurisdictions – however, they are largely untried and untested and rarely ever used in practice. Accordingly, consensual transactions are advisable and usually necessary to manage execution risk
- Timescales relating to such processes (including distressed sales) tend to be prohibitively long and the corresponding cost implications and uncertainty of outcome does not help either
- Clawback risk generally exists – the vulnerability periods vary across jurisdictions and can range from 6 months to no limit at all, where a transaction prejudices creditors
- At-will employment is common so redundancies and transfer of employment issues are rare
- Asset sales are often used, particularly where there is a concern around the true extent of the liabilities of a distressed company

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