M&A considerations and opportunities when looking at insolvent targets

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The COVID-19 global pandemic has impacted nearly all business types. The majority of businesses have suffered impaired supply and demand dynamics with very little warning and almost no time for businesses to prepare for the resulting downturn. The unfortunate result of this is that an increasingly high number of businesses are finding themselves insolvent or facing insolvency and, in many cases, shareholders will be looking at M&A as a way to extract themselves from the situation. The increase in distressed companies provides a number of opportunities to investors to purchase assets with value at discounted pricing.

As an investor when should you act in an insolvent situation?

A key objective for the investor in a distressed asset is to close the transaction prior to the target entering into a formal insolvency process.

Pre-insolvency process

Prior to the target going formally into insolvency, it will still be controlled by its current shareholders and therefore there is more scope for a buyer to obtain a full suite of representations, warranties, and indemnities. In addition, many shareholder-founders are keen to avoid the stigma attached to them having founded an insolvent company and as a result may be willing to agree to sell the target at a lower price than it would otherwise have been sold, although note the duties of directors and managers explained below to ensure they are not selling assets at an undervalue. A founder will typically also be more willing to co-operate with the due diligence process, although this will be subject to the severity of the distressed nature and the time available to close the transaction.

The major risk to the investor in relation to distressed M&A pre-insolvency is that the past actions of the target could be challenged by creditors. This risk can be mitigated by only purchasing the assets of the distressed company rather than the shares or carrying out due diligence in respect of such transactions and obtaining appropriate warranty and indemnity coverage. However, even with this, protection claims from third parties is not the preferred way to start operating a company.

Pre-pack

The UAE does not specifically provide for ‘pre-pack’ but there is no reason why the debtor could not attempt to undertake an expedited dual process with a buyer and simultaneously with creditors to come up with a restructuring plan that involves an orderly sale with the consent of the creditors before filing a PCP under the UAE Bankruptcy law. The benefits to all parties are that the business of the company can be acquired as a going concern.

And, since pre-packs are asset sales, most of the liabilities can be left behind to be settled by the purchase price. In addition, the transaction is less likely to be challenged as it would have the advantage of creditor consent. In addition, due diligence (albeit likely to be on an accelerated timetable) can be carried out during the negotiation process and therefore the investor can familiarise itself with the business and assess the risks of the investment. On the downside, it is unlikely that any warranties or indemnities will be provided (or would have much realistic value if provided) and therefore little downside protection if the business and assets are not as the investor expected. Due diligence is nevertheless essential in a pre-pack transaction.

Flexibility for a pre-pack arrangement would certainly be greater under the DIFC and ADGM regime. But no matter which regime is applicable, the 'must haves' for an opportunistic buyer of assets from a distressed business are going to be an experienced and sophisticated advisory team that can assist in running dual track discussions with the creditors on the one hand and the distressed business on the other hand.

M&A in a formal insolvency process

A transaction negotiated with a liquidator will usually mean acquiring the assets or shares free from any encumbrances. In addition, after the formal insolvency process has been entered into the target would have the benefit of a moratorium from further claims from creditors. However, the administrator/liquidator are unlikely to assist with any more than essential due diligence and the administrators will not provide warranty or indemnity to the investor and therefore the investor could be going into the transaction blind with no form of contractual recourse.

Considerations for sellers and investors

Personal liability

Directors and managers of distressed companies need to ensure that they are acting within the laws of the jurisdiction that the company is incorporated in to ensure they are not found personally liable for their actions. In the UAE (excluding the DIFC or ADGM) directors and general managers may be found criminally liable for a number of matters including if they:

- sell assets at an undervalue to delay the suspension of debt payments or declare the company bankrupt;
- hide company property from creditors; or
- pay a creditor to the detriment of others.

In the context of an asset sale, managers/directors will need to ensure that they obtain an appropriate price for the assets being sold to ensure they do not fall foul of the insolvency laws and risk incurring personal criminal liability.

In the context of a share sale the investor will need to satisfy itself that any directors it appoints to replace the exiting investors do not automatically inherit the potential criminal liabilities of previous directors.

Existing contracts

It is likely that any financing documents and material customer or supplier agreements will have provisions relating to the consequences of the company becoming insolvent. These may include automatic termination of the relevant agreement, acceleration of any loan facilities and call options over assets or shares owned by the company being automatically exercisable. Any seller will need to consider and potentially disclose to the buyer the risk of these provisions being relied upon by the counterparty and the consequences of any such reliance. The buyer will need to satisfy itself that no such provisions have been or could be triggered in a way which could impact the buyer being able to acquire the assets it needs to operate the business.

Asset sale or share sale?

Whether to buy the assets of a distressed asset or the shares is a key consideration. In an asset deal, the investor would buy the assets of the distressed company leaving the liabilities behind. The insolvency practitioner or the distressed company would then distribute the purchase price to the creditors, with secured creditors being paid first and any balance being distributed amongst the unsecured creditors.

A share purchase is generally considered the riskiest way to acquire a distressed business. In a share deal the liabilities of the business will be acquired and need to be dealt with by the buyer. In the case of a share acquisition the buyer will also need to consider any local laws in relation to liabilities of directors or general managers for the actions of the company, particularly if the company has been trading insolvently.

In the case of either an asset purchase or a share purchase, the buyer will need to satisfy itself that all assets necessary for use in the business are owned by the company selling the assets or the company of which it is buying the shares. It is very common in group scenarios for assets to be owned by other entities, particularly in respect of intellectual property rights which are often held by a holding company.

A combination of both a share sale and an asset sale is where the seller transfers assets to a new company within the seller's group and the new company is then sold to the investor, this is known as a "hive down". The benefit of this approach is that it overcomes a number of issues related to an asset sale, as the new company will only own those assets transferred to it and liabilities can be left behind, the buyer's due diligence can be limited to the assets transferred and that the assets have been transferred correctly. The number of third party consents required for the transfer of assets by the seller to the new company may also be less than would be required on the transfer of assets to the buyer as some assets or contracts may allow for assignment or transfer intra-group without the consent of this parties. Dependent on the jurisdiction of the seller there may also be an opportunity for the seller to retain the losses and set these off against future years for taxation purposes. The down-side to a hive down is that it takes longer as, in practice, it requires the completion of two separate transactions; an intra-group asset sale followed by a share sale and as discussed below time is a key consideration in any distressed M&A scenario.

Other key considerations

Time

Time is a major consideration in any distressed M&A situation. Due diligence and negotiation of transaction documents will always take time, which is something the distressed target may not be able to provide as the target's financial distress worsens. It is becoming common for the potential buyers to provide bridge loans whilst negotiating the transaction. However, injecting funds into an already distressed company prior to owning it carries with it a high level of risk. In addition, the longer a company is trading in a distressed situation the likelihood is that the number of its liabilities will be increasing and therefore the number of creditors who may object to the transaction would also increase.

Therefore, there is a careful balancing act to be carried out for any buyer; between weighing up the balance of being satisfied with the due diligence carried out and not worsening the situation of the company.

Price

It is common for the purchase of distressed assets to be at a lower price than the target is actually worth. A way that a seller can protect itself in such an event is to negotiate an anti-embarrassment clause to procure that if the buyer sells on the asset shortly after purchasing it from the seller, the seller is entitled to a percentage of the uplift.

Conclusion

Acquiring or selling distressed assets adds another layer of complexity to any M&A transaction. There are a number of matters to be considered and weighed up for both the investor and the seller.

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