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Rewards and Risks for Distressed Strategic Middle Market M&A

During the bull market that followed the recovery from the 2008 financial crisis, we saw robust and sustained merger and acquisition (M&A) activity. Acquisitive companies pursued target businesses with strong balance sheets and bright growth prospects. Acquirers and targets became accustomed to broad rules of the road that guided M&A valuation, structure and process and informed transaction risk and reward. The coronavirus pandemic and its resulting economic dislocation will upend many of those rules.

Due to the pandemic, thousands of businesses are, or will be, unable to survive on their own and may seek to sell or partner with stronger companies. For prepared strategic acquirers with strong balance sheets, these financially distressed businesses present a unique opportunity to purchase valuable assets at reduced valuations. Acquiring distressed businesses, however, is very different from the M&A process typical of the past bull market.

Below highlights risks buyers face in acquiring distressed assets, describes why typical M&A protections may prove insufficient and outlines alternate strategies that are effective in mitigating such risks.

Risks to Buyers of Distressed Assets

In a typical asset sale, the purchase agreement between buyer and seller will specify the seller's assets that the buyer will acquire and the seller's liabilities that the buyer will assume. As a general rule, so long as the buyer expressly disclaims any intent to assume other liabilities and pays fair value for the assets, the buyer avoids taking on any liabilities of seller that are not expressly assumed. Those liabilities remain with seller. For transactions involving distressed assets, this often-used construct and the related protections may be compromised by the heightened risk of successor liability.

The Bottom Line

Buyers acquiring distressed assets should remain mindful of transactional risks unique in distressed contexts. Such buyers should not rely solely on typical M&A risk mitigation tactics in structuring and negotiating a deal, and instead should consider the ways that they can reduce exposure to the various threats through the means described in this alert.

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Successor Liability

Successor liability is a state law doctrine that undermines the general rule that a buyer in an asset sale can choose which liabilities it will assume and which liabilities the seller will retain.

In a nutshell, successor liability may result in a buyer being deemed the “successor” to the seller’s business despite explicit provisions to the contrary in the purchase agreement. The risk of successor liability is heightened in transactions involving distressed assets due to the concepts of fraudulent transfer or conveyance and *de facto* merger.

Fraudulent Transfers

In its most recognizable form, a fraudulent transfer occurs when a seller transfers property with the intent of reducing amounts that may be recovered by its creditors.

However, a fraudulent transfer may also exist when a seller fails to receive “adequate consideration” for the assets sold and when the seller is insolvent, becomes insolvent as a result of the transfer or is left with insufficient assets relative to the unsold business. When this occurs, the creditors of the seller have a potential fraudulent transfer claim against the buyer, regardless of whether the seller had any fraudulent or wrongful intent.

A successful fraudulent transfer claim may invalidate the sale — forcing the buyer to convey the acquired assets, or an equivalent monetary value, to the creditor. A creditor may also seek other recourse against the buyer. All of this exposes the buyer to risks that it did not agree to assume in the purchase agreement, including risks stemming from liabilities that the buyer and the seller expressly agreed would be retained by the seller.

Determining whether the consideration paid for acquired assets is “adequate” is inherently subjective. When acquiring distressed assets, buyers must tread with particular care because of the discounted valuations that make such assets attractive in the first place.

De Facto Mergers

Despite a transaction being structured as an asset sale, a court, in certain circumstances, will determine that the acquisition amounted to a merger and deem it a “*de facto* merger.” Whether an asset sale is a *de facto* merger varies by state. The traditional factors considered in determining whether an asset purchase amounted to a merger are:

- Continuity of personnel, physical location, assets and general business operations;
- Continuity of ownership;

- >> The seller ceasing operations, liquidating and dissolving as soon as legally and practically possible; and
- >> The buyer assuming those obligations of the seller that are ordinarily necessary for the seller to conduct its business uninterrupted.

De facto mergers are more likely to be found in connection with distressed asset sales because courts will often delve deeper into these transactions to determine if the sale was really a means for the sellers to walk away from the liabilities facing an insolvent or near insolvent company.

Typical M&A Risk Mitigation Strategies Likely To Fall Short

Classic strategies used by buyers to mitigate risk in an asset sale may prove ineffective or impractical in a distressed asset purchase. In most distressed transactions, the usual array of contractual protections, such as representations, warranties and indemnities have limited, if any, practical utility. In addition, there is a reduced willingness and availability for post-closing recourse in distressed transactions. Even if post-closing recourse is allowed, it may have little, if any, practical value.

Contractual Protections

Representations and warranties and indemnities form the classic contractual protections for a buyer. The value of these protections is ultimately tied to the creditworthiness of the party that stands behind them. When a seller is insolvent, or near insolvent, these contractual protections are ineffective.

Post-Closing Recourse

Typical asset deals provide for post-closing recourse for a breach of representation and warranties and indemnified losses. In distressed transactions, sellers may take the position that the discounted valuation takes into account the enhanced risks. Applying that position, the buyer is already compensated for such risks by the discounted valuation.

Buyers will often hold-back or place in escrow some portion of the purchase price to collateralize its protections under the purchase agreement. Because valuations for distressed assets are discounted, there are limited funds available for hold-back or escrow. Representation and warranty insurance, which has steadily become more common in middle market transactions, may be cost prohibitive or unavailable in distressed transactions.

Strategies to Successfully Mitigate Risk

Given that typical M&A risk mitigation strategies often fall short when dealing with distressed assets, buyers need to adapt their M&A approach to address the different risks presented when acquiring

such assets and utilize the tools available to manage such risks.

These tools include:

- Placing a heightened emphasis on the due diligence process (especially with respect to areas of the acquired business potentially impacted by COVID-19);
- Discovering and "buying" or addressing liabilities in advance;
- Obtaining a third party valuation;
- Taking steps to clearly differentiate the buying entity from the selling entity; and
- Negotiating releases from creditors with material claims against the seller.

Due Diligence

Due diligence is paramount in distressed acquisitions. Seller representations and warranties traditionally work to compliment a buyer's diligence. As compared to typical transactions, representations and warranties are often curtailed in an acquisition of distressed assets. Moreover, as discussed above, typical post-closing recourse (including in respect of seller-retained liabilities) is limited in such transactions. As a result, if the buyer can identify liabilities or risks in advance, then appropriate action may be taken to proactively address such risks (such as a reduction to purchase price or an agreed settlement with creditors).

Due Diligence Related to COVID-19

In the wake of COVID-19, a buyer must conduct comprehensive due diligence on aspects of the business it previously may have not focused on. As a result of the pandemic, the IRS and many state taxing authorities have deferred traditional tax filing and payment deadlines. A buyer should determine whether the seller has deferred any tax filings and payments and whether these deferred filings and payments, if now due, have been made. A buyer should also review the contractual force majeure rights available to counterparties to the seller's contracts to determine whether the pandemic will excuse partial or complete non-performance.

Additionally, to the extent the seller received a Paycheck Protection Program loan, the buyer should assess whether:

- The seller was entitled to the loan based on the criteria and guidance provided by the Coronavirus Aid, Relief and Economic Security Act (the CARES Act) and the Small Business Administration (SBA);

- The loan proceeds were used in compliance with the purposes set forth by the CARES Act and the SBA; and
- The seller will be entitled to loan forgiveness and, if so, in what amount.

Reducing the Likelihood of a Fraudulent Conveyance Claim

1. Third Party Valuation of Purchased Assets: Failure to pay adequate or equivalent consideration for purchased assets is a key component of a successful fraudulent conveyance claim. Obtaining an independent third party valuation that supports the purchase price as adequate or equivalent relative to the purchased assets can be instrumental in discouraging and defeating a potential fraudulent conveyance claim.
2. Seller Survival: To further mitigate the chance of a successful fraudulent conveyance claim, the seller entity should remain in existence following the sale. In addition, the seller's shareholders should not receive sale proceeds while obligations to the seller's shareholders remain outstanding. Accordingly, the seller should not distribute sale proceeds to its shareholders until settlements arrangements have been reached with its creditors.

Differentiate the Buyer from the Seller

In an effort to defeat a finding of a "*de facto* merger" buyers should consider:

- Clearly announcing the new ownership and that such ownership is by an entity that is entirely different and separate from the seller;
- Changing the name of the business and, if possible, changing at least some of the officers;
- Relocating the headquarters of the business;
- Properly incentivizing management for their future services without favoring their unsecured claims relative to those of other creditors; and
- Ensuring, to the extent possible, that the seller does not dissolve following the closing of the acquisition.

Negotiate Releases with Third Parties

It is highly likely that an insolvent or near insolvent seller will be subject to claims from third parties. A buyer should attempt to identify all third party creditor claims against the seller and negotiate with these creditors directly in an effort to compromise and settle any viable claims such creditors may have.

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One method to help ensure that obligations to creditors are satisfied is to maintain a fund of amounts otherwise payable to a seller to discharge obligations to creditors. Once the seller obtains a release from such creditors, any portions of the fund not paid to such creditors may be released to the seller.

Alternative Transaction Structures

An assignment for the benefit of creditors, "friendly foreclosures" with secured creditors and 363 Sales under Chapter 11 of the US Bankruptcy Code serve as alternatives to a distressed asset sale.

Assignment for the Benefit of Creditors (ABC)

ABC is a state law doctrine whereby an entity in debt voluntarily transfers all of its assets to a trustee who holds the assets in trust for liquidation and distribution to creditors. In an ABC, the trustee divests the business's assets and ensures that creditor obligations are paid to the extent possible.

Depending on the state, an ABC may be less expensive and more expedient than a Chapter 7 bankruptcy and may provide the trustee with more flexibility in determining the priority of payments to be made. Yet, an ABC lacks many of the protections afforded by U.S. Bankruptcy Code, including discharge from liability to creditors, an automatic stay from creditor collection activities and the right of the purchaser to acquire the creditor's assets free and clear of liens.

In addition, an ABC is generally not an effective method to reorganize a business (unlike a Chapter 11 bankruptcy). Rather, ABCs are used to wind down a business by selling or liquidating it.

"Friendly Foreclosures"

A "friendly foreclosure" is a process whereby a senior, secured creditor will foreclose its liens and convey its collateral (i.e. the assets of the business) to a buyer of the business pursuant to Article 9 of the UCC. To effectuate this, the buyer, lender and debtor must work in concerted effort.

363 Sales

A 363 Sale under Chapter 11 is a process by which a debtor markets its assets to potential purchasers and choses one bidder to function as a stalking horse bidder. The debtor will enter into a tentative asset purchase agreement with the stalking horse bidder, which will be filed with the court and made available for other bidders to submit a superior bid.

While this process can protect the buyer against a fraudulent conveyance claims, the auction associated with a 363 Sale can inflate the monetary value of the seller's assets. This process is also time consuming and the buyer runs the risk of the purchased assets depreciating in value during the course of the sale process.

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For More Information

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