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Distressed M&A – Opportunities and Risks

by **Ruairí Mulrean, Paul Dineen, Richard Curran, Marco Hickey**

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As many companies continue to suffer economic hardship due to the ongoing COVID-19 pandemic, it is likely that mergers and acquisitions of companies and assets in distress will feature as a significant proportion of overall M&A transactions in Ireland during the coming months.

Companies with otherwise good businesses may find that the slowdown in the economy and the absence of credit or other forms of funding (Distressed Companies) will mean that they are running out of cash and quickly facing an uncertain future. These Distressed Companies might be the recipients of opportunistic approaches from more secure trade competitors or find that they are forced into insolvency and therefore liquidation, examinership or receivership.

For those secure businesses with current high levels of liquidity, the acquisition of a Distressed Company or its underlying assets (Distressed Assets) can represent an attractive acquisition opportunity, as company and asset valuations will be considerably lower when in distress (Distressed Acquisitions). Nevertheless, prospective buyers and sellers need to be aware that the fundamentals of a Distressed Acquisition differ from those of a traditional acquisition of shares or assets.

In this article we outline some high-level considerations that prospective buyers and sellers should consider if contemplating a Distressed Acquisition.

Key Considerations in Distressed Acquisitions

1. Deal Structure

The principle of caveat emptor (let the buyer beware) applies to any transaction involving the acquisition of shares or assets whether they are distressed or not. If the Distressed Company has some breathing room and is not under an imminent threat of insolvency, then it may be possible to structure the transaction in the same way as a transaction with a financially healthy company, i.e. by way of a share or asset purchase backed by due diligence and the usual warranties and other contractual protections.

However, in practice, these transactions are often completed quickly leaving limited scope for due diligence and the negotiation of warranties.

When considering whether to opt for a share purchase or an asset purchase the difference is often described as follows:

- A share purchase will involve the buyer purchasing the company inclusive of any legacy debts but where stamp duty will typically be 1% of the value of the shares.
- An asset purchase will allow the buyer to “cherry pick” Distressed Assets, which can be purchased free of most legacy debts, but where stamp duty will typically be 7.5% of the value of the stampable assets transferring.

Therefore, from a risk perspective, a Distressed Asset purchase may be a more favourable option for a buyer when considering the structuring of a Distressed Acquisition.

However, and in addition to the above, a buyer will also need to be wary of the nature of the financial difficulty faced by the Distressed Company being sold or selling the assets. In particular, it will need to assess the scope and nature of the financial liabilities being left behind and ensure there is no residual claim over the assets or against the company in question, such as bank debt which may be secured on the assets, as well as preferential creditors such as the Revenue Commissioners or employees who may have a claim over the assets of an insolvent company. See further below under 'Other Potential Risk Factors'.

If the Distressed Company is in liquidation or receivership, then the transaction can only be structured as a purchase of the Distressed Assets. If the Distressed Company is in examinership, it would be possible for a buyer to acquire the Distressed Company or to purchase the Distressed Assets from the examiner.

2. Timelines

Time is generally of the essence when purchasing a Distressed Company or Distressed Assets due to the continuing diminution in values, erosion of goodwill and likely demands from creditors. As such, negotiations will need to be concluded quickly and much more efficiently than might happen when purchasing a financial healthy company or a non-distressed asset base.

If purchasing Distressed Assets from an examiner, then the examiner will want to conclude negotiations quickly in order to include details of the proposed deal in the scheme of arrangement that the examiner has to present to the relevant Court within the 150-day statutory time-limit (previously 100 days).

Similarly, if purchasing Distressed Assets from a liquidator or receiver they too will want to conclude the sale quickly if asset values continue to depreciate in order to obtain the best price for the creditors.

3. Exclusivity

If a Distressed Company has yet to enter into a formal insolvency procedure, it will still be under the control of its existing directors. Therefore, the agreement of a short period of exclusivity with the Distressed Company might still be possible.

If a Distressed Company is in liquidation or receivership, the liquidator or receiver would usually be unwilling to commit to a period of exclusivity, as to do so could undermine his/her duty to realise the Distressed Assets for the best price possible unless extra consideration is offered.

If a Distressed Company is in examinership, given the tight timeframe for completion of the examinership, it is unlikely that an examiner would agree to anything more than a very short period of exclusivity with a prospective buyer.

4. Due Diligence

As Distressed Acquisitions are generally time sensitive, access to information and documents can be limited, meaning that a full and complete due diligence exercise may not be possible. In this instance, the scope of any due diligence conducted should be limited to areas of material importance such as the reasons that caused the company or assets to become distressed. Additionally, with some level of COVID-19 related travel and social distancing measures likely to be in place for the foreseeable future a buyer should consider what level of onsite physical inspections of documents and assets is required and how much of the diligence to be undertaken is capable of being conducted online/virtually.

In a share purchase, any change of control provisions or restrictive covenants on changes of ownership included in key contracts or lending/security arrangements should be identified.

In an asset purchase, any security held against the Distressed Assets should be identified and released on or before completion. Key contracts and leases attaching to the Distressed Assets should be reviewed to establish if any restrictions on assignment are contained within.

Ultimately, the risks associated with this lower level of diligence should be adequately captured in the acquisition price.

5. Warranty Protection

One of the primary differences between a Distressed Acquisition and that of a traditional acquisition is that buyers will not usually secure any warranties, or at best limited warranties, from the sellers as to the condition of the business or Distressed Assets. Even if such warranties are given, due to the distressed nature of the transaction, it will be questionable whether or not the sellers can stand over the warranties if a claim arises.

The non-warranty standard in Distressed Acquisitions applies to an even greater extent if the Distressed Acquisition involves a purchase from a liquidator, examiner or receiver as these insolvency practitioners will not provide any form of warranty cover. They will also propose the contractual terms of purchase with little or no scope for amendment, including the exclusion of liability on their part together with an indemnity from the buyer as against any third party claims that might arise in connection with the Distressed Acquisition.

As is the case with the level of risk associated with the limited amount of due diligence conducted in a Distressed Acquisition, the unavailability of warranties and other contractual covers is often offset by the benefit of acquiring the Distressed Company or Distressed Assets at a good price. Therefore, buyers will often be happy to assume the risk given the distressed discount.

To mitigate against the risks related to the lack of warranties, the purchase of a warranty and indemnity (W&I) insurance policy might be a consideration for a buyer. It should be noted that W&I insurance providers generally tend to refuse to underwrite against risks that have not been the subject of a thorough due diligence and disclosure exercise. Despite this commonly adopted approach, the W&I insurance industry is market-driven and a recent innovation in this industry is that W&I insurers have developed a fully synthetic W&I policy whereby the seller does not give any warranties to the buyer. Instead the buyer agrees a suite of warranties with the W&I insurer and they are encapsulated in a W&I policy. Such a policy will cost more than a traditional policy, but it might be useful as a method of protection if the sale price is right.

6. Merger Control

Similar to the merger control regimes in other jurisdictions, the Irish merger control regime provides for what is known as the “failing firm defence” for Distressed Acquisitions: If certain conditions are met, then the Distressed Acquisition will not be subject to the same level of merger control scrutiny than that of a traditional acquisition even if completion of the Distressed Acquisition will result in a substantial lessoning of competition.

However, it should be noted that the “failing firm defence” has rarely been invoked in this jurisdiction due to the restrictive nature of the conditions that must be met before the Irish Competition and Consumer Protection Commission (CCPC) will accept the “failing firm defence” as a justification for deviating from standard merger control rules.

Therefore, the parties to a Distressed Acquisition and their advisers should be cognisant that if the financial thresholds for a mandatory merger approval notification to the CCPC are met then unless the conditions of the “failing firm defence” can be satisfied, the Distressed Acquisition will be subject to normal levels of merger control scrutiny and timelines, which should be taken account of when considering the viability of a Distressed Acquisition.

7. Other Potential Risk Factors

If the transaction is structured as a purchase of Distressed Assets from a Distressed Company that is not facing an imminent threat of insolvency, but the company has a liquidator appointed to it during the course of the transaction or soon after closing, then the liquidator, or any creditor or contributory of the Distressed Company can apply to the High Court to challenge the transaction on the grounds that it was a fraudulent transfer.

If the application is successful, the Distressed Assets will be "clawed-back" for realisation by the liquidator. The High Court shall have regard to the rights of persons "who have bona fide and for value acquired an interest in the property" the subject of the application.

Our Experience

Embarking on a Distressed Acquisition creates a different set of challenges and risks for a buyer than those associated with a traditional acquisition. At LK Shields we have a wealth of experience and expertise in advising and navigating clients through the legalities and possible risks attaching to all forms of acquisitions. If you are contemplating a Distressed Acquisition as a potential investment opportunity or to expand your corporate footprint, we would be very happy to discuss the fundamentals of such an acquisition with you.

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About the Authors

Ruairí Mulrean
Partner

Ruairí practises in the areas of corporate law, mergers and acquisitions, corporate restructuring and insolvency.
T: + 353 1 638 5844 **E:** rmulrean@lkshields.ie

Paul Dineen
Associate Solicitor

Paul is an Associate Solicitor with experience in a wide range of corporate and commercial matters including mergers and acquisitions.
T: +353 1 638 5897 **E:** pdineen@lkshields.ie

Richard Curran
Partner

Richard has extensive experience in corporate finance transactions.
T: + 353 1 637 1514 **E:** rcurran@lkshields.ie

Marco Hickey
Partner

Recognised as a Leading Individual for EU and Competition by Legal 500 2020.
T: + 353 1 637 1522 **E:** mhickey@lkshields.ie