M&A considerations for companies in financial distress

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This is part three of a series focusing on current M&A trends, opportunities and challenges

The COVID-19 global pandemic has impacted virtually all industries, most of which have experienced the consequences of reduced demand, shuttered operations, supply chain disruptions and the like. Unlike previous economic downturns, where there was a certain amount of lead time to prepare for the leaner times to come, the speed at which the pandemic hit the Canadian economy left very little time for businesses to react. Many businesses, including those with sound underlying operations, are in some form of financial distress, which can include being unable to meet obligations as they come due, breaching covenants with major creditors, or being unable to obtain new financing or refinance existing obligations.

Time is not on your side

So far in 2020, the availability of governmental assistance has supported businesses during the early part of the pandemic. This has not eliminated the financial distress many companies are facing, but has blunted the immediate negative affects of the pandemic. However, as government stimulus is phased out and business returns to "normal," companies experiencing problems may find they are accelerating quickly. Lenders who to date have largely amended or extended credit facilities may find themselves under pressure to take action in respect of defaulting borrowers. As financial distress increases, the options available decrease. Restructuring becomes more difficult and liquidation becomes more likely.

Time is never your friend when you are financially distressed. It is, therefore, critical for corporate boards and management to know the signs of insolvency and proactively consider opportunities and options for their business as signs of insolvency begin to appear. The company's directors will have an important role in this process, and should consider forming a steering or special committee to oversee strategically the company's restructuring efforts.

Proactive steps that may be taken as the signs of insolvency appear include engaging insolvency advisors (accountants, financial advisors, chief restructuring officers and legal counsel) who, together with management, should review the company's cash flows, key commercial agreements and financing agreements. The company will want to consider what pre-emptive actions it can take to head off any impending liquidity problems before they occur, such as:

- negotiating with key creditors/stakeholders (which may include negotiating forbearance agreements);
- refinancing with new debt;
- exchange offers;
- sales of redundant and non-core or perhaps even core assets;
- recapitalization with additional equity;
- loan buybacks; and
- potential mergers or divestitures of entire business divisions (*i.e.,* distressed M&A).

In parallel with these proactive steps, the company may also want to consider, and possibly simultaneously prepare for, a court-supervised restructuring under the *Bankruptcy and Insolvency Act* (BIA) or the Companies' Creditors Arrangement Act (CCAA) to access additional legal tools and powers to implement a transaction. A united, quick and efficient effort by directors and management is critical to effectively addressing the issues distressed companies face.

Communication between the company and its creditors will be important. In situations where the underlying business has strong prospects of recovery over time but currently suffers from short-term liquidity issues, lenders may consider undertaking debt for equity swaps. Lenders may be persuaded to swap debt for a material equity position, which carries with it an opportunity for greater long term return than accept a compromise of their debt and the associated costs of dealing with a defaulting borrower. The debt for equity swap will come at a cost to existing shareholders, who will usually experience a substantial dilution of their existing ownership as compensation for the additional risk of the lender taking an equity position in the company.

Wolves at your door

Companies will also need to monitor and prepare for the situation where investors buy into distressed debt to gain control of the business. In these circumstances, debt can be purchased in the secondary market at a material discount and the buyers of the debt can then put themselves in a strong negotiating position in relation to the borrower. We are beginning to see this occurring in Canada, even with chartered bank lenders and other senior lending institutions.

Over the last decade, many private investors have been able to accumulate large amounts of investment capital, which has not been deployed into investments (so called "dry powder"). As such, it can be expected that there will be a considerable amount of money available to purchase distressed debt and parties willing to undertake a "loan to own" strategy, using the purchase of a company's debt as a catalyst to restructure or recapitalize the target company. In these circumstances, the new debt holders may exploit defaults in the loans to negotiate a debt for equity swap or to acquire the lender's business or key assets through the exercise of default remedies and the enforcement of security.

Distressed M&A as a response

Where the company chooses to explore the potential for mergers or divestitures of the entire company or of significant business divisions, the company should be aware that distressed M&A contains many elements different from traditional M&A. When a company finds itself in financial distress, in our experience, the initial reaction of directors and management is to first look to more "traditional" ways to solve this problem and maximize value for their stakeholders. In particular, public companies want to avoid the stigma associated with a formal insolvency process and look to find a solution that can be completed outside of formal insolvency proceedings.

Companies will often first look to undertake a sale through a public auction process or, more typically in Canada, through a private market check, undertaken with the assistance of financial advisors. Unfortunately, these traditional processes can often produce unsatisfactory results as they typically take several months to work through the process – which is more time than a distressed company has at its disposal to canvass the market and complete a transaction. Furthermore, potential purchasers will be aware of the company's financial distress through their due diligence review and may be concerned that transactions conducted when the target company is in the zone of insolvency could face challenges by creditors who view a transfer of assets as being conducted in a manner and at a price which is unfavourable to creditors' interests. After factoring in these risks, bidding participants in these processes often submit bids at values the target company's board of directors and management find hard to accept. As a result, these more traditional processes can often result in no transaction. Given the passage of time, this can leave the company in more dire circumstances.

Where there is buyer interest in completing a transaction but insolvency-related concerns cloud the process, a company may wish to consider a "pre-pack" restructuring. This alternative may be particularly attractive in those circumstances where the company has undertaken a recent strategic process or has independent evidence of value of the company's business or of particular assets. In a pre-pack deal, the company and the buyer negotiate a transaction prior to commencing insolvency proceedings. The sale is completed shortly after commencing a formal insolvency proceeding under the BIA or the CCAA.

The advantages of a pre-pack transaction are that the negotiations between the parties can occur outside of the formal insolvency process, with the business being acquired on a going concern basis. The transaction can be completed with less due diligence on the buyer's part, as the business or assets will transfer to the buyer under a vesting order from the court, free of liabilities and encumbrances (other than permitted encumbrances). Additionally, given the vesting order from the court under the BIA/CCAA process, it is less likely creditors will challenge the transaction.

Another option is for distressed M&A to occur within a court-supervised process under the CCAA, without a pre-packaged buyer. Under this process, the company can attempt to sell its assets or business in a manner similar to a conventional M&A process, but on an accelerated timeline. Together with the company's court-appointed monitor, the company will develop marketing materials and open up a data room for interested and qualified participants. Initial deadlines for binding or non-binding bids will be set and, depending on the process chosen, the company may negotiate with the winning bidder or undergo a second round of bidding with select bidders from the initial round. Bids may be received for all of the business or discrete assets.

Depending on the form of transaction ultimately agreed to, where the assets and business of the company are sold *en bloc*, the business can continue as a going concern under new ownership. The timelines for these processes are typically much shorter than for traditional M&A processes. The involvement of the court helps in completing the transaction, as the court order approving the sale can solve for many obstacles that could derail a transaction via a traditional M&A process.

For example, due diligence processes can be reduced and the negotiation of extensive representations, warranties and indemnity provisions typical in the usual transaction agreement can be replaced by the vesting order of the court, where the transfer of the assets or business is completed free and clear of liabilities and encumbrances. Additionally, shareholder approval requirements – which in a public company context can take up to 60 days to receive – can be avoided through the CCAA process. Similarly, the CCAA provides a venue to deal with third party and creditor claims which can be addressed outside of the M&A transaction, allowing the buyer to complete its acquisition and leaving the creditors' claims to be dealt with separately by the company through the court-supervised insolvency process.

Conclusion

As we are now into a second wave of COVID-19, and with a global recession lurking in the wings, businesses and their directors and managers are well advised to critically assess the financial condition of their business over the short term and the longer term. Where required, businesses should begin taking proactive steps in response, some of which may involve distressed M&A in one form or another.

If you have questions about mergers and acquisitions in this challenging time, get in touch with your BLG lawyer or either of the key contacts listed below.

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