

8.5.5.e: Key Considerations In Distressed M&A Transactions

20 February 2009

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The good news with respect to the mergers and acquisitions market is that in spite of terrible economic conditions there are still opportunities, particularly for the acquisition of "distressed" companies. The bad news, of course, is that M&A activity declined significantly in 2008. Mergerstat reports year to date deal value for U.S. and U.S. cross-border transactions at \$887.2 billion (as of December 9, 2008), a 33% decline over 2007. To put those statistics into perspective, 2008 will represent the fifth largest year over year decline in deal value in the last 25 years - 1990, 2001, 2002 and 1991 saw greater percentage declines (51%, 46%, 35% and 34% respectively).

The bottom line is that it has been an extremely difficult year for the M&A market for a variety of reasons and the market is unlikely to improve dramatically anytime soon. A primary factor for the reduced deal activity is the debt market liquidity crisis which has posed a significant obstacle for financial and strategic buyers to obtain debt financing for transactions on reasonable terms and conditions. Additionally, public company buyers are hindered from using their publicly-traded securities as deal consideration due to the significant recent market declines.

On a more positive note, the following market conditions should contribute to increased deal activity in spite of the lack of credit availability:

- private equity firms and hedge funds recently raised record amounts of cash and are poised to take advantage of good valuations for target companies;
- foreign acquirers will be attracted to U.S. targets by the weak U.S. dollar; and
- distressed companies will be attractive targets for both strategic and financial buyers.

Distressed M&A Overview

One result of the credit crisis is that operationally sound companies are finding it difficult to refinance their existing debt or access additional debt financing on reasonable terms that has historically been fairly easy to obtain. In this environment, many companies who otherwise would be able to continue to operate may find themselves in positions of financial distress and

facing bankruptcy, which will likely lead to the next wave of corporate debt restructurings. As such, there will be many opportunities for financial and strategic buyers to purchase assets at significantly discounted prices.

Acquiring assets from distressed companies, inside or outside of bankruptcy, poses certain pitfalls and challenges for buyers and sellers that don't exist when buying assets from a solvent company. Some of the key considerations that buyers and sellers should analyze prior to consummating a transaction outside of the bankruptcy court are described below.

Key Considerations for Buyers

- **Fraudulent transfer claims.** The primary risk buyers of distressed assets need to be mindful of is the potential for the transaction to be unwound after the fact as a constructive "fraudulent transfer." Of course, any such transaction might be unwound if it involved actual fraudulent intent, as well. But a constructive "fraudulent transfer" can result in the same unwinding if a seller (1) is insolvent at the time of the sale or becomes insolvent as a result of the sale, and (2) the consideration paid for the assets is less than the "reasonably equivalent value." All of the relevant facts of a particular transaction will be analyzed to determine whether a transaction constitutes a fraudulent transfer, and there is no objective test that guarantees whether such a claim will be successful or not. Furthermore, fraudulent transfer claims can be asserted by creditors months or even years after a transaction is closed. If a creditor is successful in its claim, the buyer would be forced to return the purchased assets or the value thereof to the seller, and would be left with nothing but an unsecured claim for a return of the purchase price, which is generally worth mere pennies on the dollar. Therefore, it is imperative for a buyer acquiring assets at a discount from a seller that is insolvent, or may become insolvent, to evaluate whether the purchase price is of a reasonably equivalent value based on a variety of factors, including the marketability of the assets at the time of the sale and the level of interest, if any, from other potential buyers. An arms length third party appraisal is the best way to protect against a fraudulent transfer claim. However, if the necessary timing for the transaction does not allow for a third party appraisal, or if the assets are purchased at a significant discount, a third party appraisal may not be a viable option.
- **Successor liability claims.** Acquisitions of both financially healthy and financially distressed companies pose some risk of successor liability, though the risk is greater when the seller may not continue as a sustainable business. Generally in asset transactions the acquiring company is not liable for the debts or liabilities of the selling company simply because of the buyer's succession to the ownership of the purchased assets and absent a specific assumption of such liabilities as part of the agreement. There are a number of exceptions to this general rule, however, and under certain legal theories purchasers of assets can sometimes be held liable as a successor for certain environmental, products liability, tax, employee benefits and labor and employment claims. Creditors of the insolvent seller have a greater incentive to look elsewhere to satisfy the seller's unpaid debts, and consequently may choose to pursue successor liability claims against a purchaser. Furthermore, an insolvent seller is not in a position to stand behind its indemnification obligations to the purchaser for breaches of

representations and warranties made in the purchase agreement. Unless the seller's stockholders are jointly or severally responsible for the indemnification obligations of the seller, the indemnification protection for the buyer from the insolvent seller is practically worthless. Consequently, buyers of distressed companies should diligently investigate the areas of the seller's business that could expose the buyer to potential successor liability claims.

Key Considerations for Sellers

- Fiduciary duties of directors. Although distressed companies may desire to quickly sell assets to avoid becoming insolvent or going into bankruptcy, the distressed nature of the seller's business requires its board of directors to carefully analyze its fiduciary duties prior to consummating a sale transaction. Directors of a solvent corporation have fiduciary duties of care and loyalty running solely to the corporation and its stockholders. Until recently, the prevailing commentary and cases considering Delaware law suggested that such fiduciary duties shifted from the stockholders to the company's creditors as the company neared insolvency. In that context boards were routinely advised that the triggering event for the shift in fiduciary duties was when the corporation entered the "zone of insolvency." The challenge for boards under the traditional "zone of insolvency" standard was to try to determine the point at which the company actually entered the zone. Recent cases in Delaware have rejected the notion that duties of directors shift as insolvency becomes progressively more likely, and simply provide that a director's fiduciary duties do not shift from a corporation's stockholders to its creditors until the precise moment in time when the corporation becomes insolvent (See *North American Catholic Educational Programming Foundation, Inc. v. Gheewalla*, 930 A.2d 92 (2007) and *Trenwick America Litigation Trust v. Ernst & Young*, 906 A.2d 168 (2006)). Once a debtor is actually insolvent, creditors in many jurisdictions may be able to assert claims against the debtor as well as its officers and directors.

While the elimination in Delaware courts of the zone of insolvency concept appears on its face to simplify the determination of when fiduciary duties shift to the creditors, there is likely to be little practical effect on decision-making because of the complexity in calculating when actual insolvency occurs. Under U.S. law, there are at least three tests for determining when a corporation is insolvent: (1) when a corporation is unable to pay its debts as they become due; (2) when the liabilities exceed the reasonable value of the assets; and (3) when a transaction results in a corporation with unreasonably small capital with which to conduct its ongoing business. Each of the above tests has subjective components which makes the precise calculation of the moment of insolvency difficult. Therefore, a prudent board of a troubled company must be mindful of the effects their actions may have on creditors as well as stockholders.

Conclusions and Observations

The number of M&A transactions involving acquisitions of troubled companies is likely going to increase dramatically. Financial and strategic buyers will exploit distressed companies financing needs which will result in substantially reduced asset values. While there are a number of options

for structuring such acquisitions both in and out of bankruptcy, each with its own advantages and disadvantages, this article has highlighted a few of the more significant concerns for buyers and sellers in the acquisition of assets from a distressed company outside of the bankruptcy court process. Since most out of court asset transactions involving troubled companies occur on an accelerated schedule, all parties should proceed with caution and with the appropriate guidance to avoid the additional pitfalls involved in distressed company transactions.

First published in the Orange County Business Journal on 1/19/09.

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