



Distressed M&A – Navigating through the Challenges

Distressed transactions carry several additional risks and associated considerations. We will address these in a series of articles, this being the first in the series.

Introduction

Distressed Mergers and Acquisitions (M&A) differ considerably from non-distressed and more “traditional” M&A. Distressed M&A constitutes a strategically complex and difficult discipline within corporate acquisitions, addressing situations where a company encounters financial difficulties.

This article series will investigate the key aspects of distressed M&A transactions, providing insights into the legal and business challenges which company owners, buyers, and sellers may encounter in the process.

Understanding Distressed M&A

Distressed M&A comes into play when a company deals with financial or operational challenges, such as impending insolvency, liquidity constraints, or substantial debt burdens.

Rather than the company starting formal restructuring proceedings, or, even worse, filing for bankruptcy and going into administration, distressed M&A aims to save all or parts of the company by selling to or securing financing from third parties.

The transaction is structured to facilitate recovery or an orderly wind-down of some or all of the company's activities.

What triggers financial Distress for Companies?

Given the complex interplay of factors affecting a company's financial well-being, it is essential to explore the key contributors to financial distress. Broader macroeconomic forces, such as economic slowdowns, downturns, or market saturation, can be a precursor to financial distress. Geopolitical tensions, exemplified by events like the armed conflict between Russia and Ukraine, and unforeseen humanitarian crises, such as the Covid-19 pandemic, can exert significant financial pressure on any company.

Financial distress can, however, also be rooted in microeconomic factors that warrant closer examination. Poor strategic decisions by the company's management team, the inability to adapt to market disruptions, instances of unethical practices among key leadership, or extensive principal-agent conflicts may, occasionally, also be early indicators of impending financial distress.

It is therefore imperative to understand both the macro and microeconomic factors influencing the company's financial situation.

Structure

Timing, deliverability, and structuring play vital roles in distressed M&A processes. Nevertheless, it is important to emphasize that time is a crucial factor and essential for a successful transaction.

The approach may involve a solvent transaction (share sale) or necessitate an asset-based strategy optionally through an insolvency process, including formal restructuring or bankruptcy. Despite potential time constraints, determining the need for an insolvency process is not always initially evident and may require a deeper analysis of the business, identifying the assets in the distressed company and determining if the business idea is strong enough to be transferred to the new company or a buyer. However, buyers often prefer completing the deal on a solvent basis in order to safeguard reputation and company interests.

When a company's balance sheet is overshadowed by its debt commitments, buyers typically opt for structuring a distressed acquisition as an asset deal to minimize risk and offload liabilities.

Structure

Liquidation of Companies

Before winding up a distressed company, it is important to identify when and where things went wrong. This makes it easier to assess the business idea and to conclude whether or not the business will be able to be transferred to a new company.

There are three models for winding up companies, including:

- 1) Pre-transfer: The healthy part of the business is sold and transferred out of the company, and the proceeds are used to pay creditors. Guarantees may be provided in this case. The company will subsequently go into administration, and the trustee of the bankruptcy estate will review the transactions to determine if the transactions are challengeable and reversible. It is therefore important that the foundation of the transaction is an official appraisal report from an independent and reputable firm to ensure that the assets are sold at the correct price.
- 2) Reconstruction: The company's management sells the assets, with the appointed reconstructor overseeing the process to ensure that the creditors are treated appropriately.
- 3) Bankruptcy: The trustee sells and administers the estate, taking over management of the company. The trustee's responsibility is to wind up the company in a way that is most beneficial to the creditors.

We will elaborate on all of the above-mentioned models in future articles within this series.

Themes that will be explored

In the upcoming articles, we will delve into specific themes such as due diligence in distressed M&A, warranties, W&I issues, and insolvency procedures, including asset transfer.

Continuing with this article series, we will further explore the strategies and best practices that can assist organizations in navigating the challenges of the process and ensure a successful outcome.

Our Remarks

Distressed M&A has numerous legal implications and considerations, encompassing the management of debt obligations, safeguarding shareholder rights, and negotiating warranties and representations.

Consequently, it is imperative to engage legal counsel as early in the process as feasible. This enhances the likelihood of the company surviving and returning to a financially solvent trajectory.

At Moalem Weitemeyer, we have a team of experienced lawyers well-equipped to advise on distressed M&A processes. The team goes beyond the core requirements of restructuring and corporate specialists, including experts in associated considerations that may impact both the structure and implementation of a distressed transaction. These considerations encompass bankruptcy, insolvency procedures, due diligence, tax and regulatory issues, and board considerations. It is imperative that these additional factors are identified and addressed as a priority.

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If you have any questions or require further information regarding any of the above, please do not hesitate to contact us.

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