Moalem Weitemeyer

ARTICLE

DISTRESSED M&A – ASSET TRANSFER: A LIFELINE FOR DISTRESSED COMPANIES

Distressed transactions carry several additional risks and associated considerations. These will be addressed in a series of articles. This is the second article in the series.

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Introduction

Saving a distressed company as a business owner does not necessitate a traditional M&A transaction, reconstruction, or worse, bankruptcy.

An alternative strategy can be to establish a new entity with the specific purpose of acquiring parts or the entirety of the company's viable, profit-generating assets. However, the parties may be susceptible to potential liability claims if done incorrectly.

This article is the second in a short series on distressed M&A. The article will exclusively focus on asset transfer before a formal restructuring period (pre-transfer) and thus does not focus on the formal process involving reconstruction and bankruptcy.

When should a Company make use of distressed M&A?

Companies are exposed to risks on a daily basis that could cause or put them at risk for potential bankruptcy. This might be due to a sudden liquidity shortfall, an overreliance on a singular customer or market, an unfavorable outcome to a lawsuit, or inadequate financial management. In each of these distinct cases, however, the income-generating assets are unaffected and still hold value, despite the company being financially distressed.

In such circumstances, it may be possible to sustain operations by either setting up a newly formed legal entity with the purpose of buying the income-generating part of the business or transferring/in-kind contribute the healthy part of the business to a 100% owned subsidiary, with the aim of making the subsidiary viable and/or sellable at a later stage to the benefit of the creditors and shareholders. This would offer the company a second chance of succeeding, seeing as the old debt remains with the old legal company. Such a transfer is known as an asset sale or asset transaction.

It is important to note that when assets are transferred and not contributed in-kind the buyers must pay for the assets on the same terms as an independent third party-owned company, as the transaction may otherwise be subject to reversal.

It also gives the owner a possibility of exclusively buying the financially sound assets and diversifying away from the assets that resulted in the distressed situation in the first place. The company's creditors would most likely scrutinize the sale since it would be between related parties and they would ensure that the sale is considered the creditors' interest, including securing the highest purchase price for the assets. It is important to note that if the assets are not sold at the market price, and are not accompanied by an independent appraisal report, the distressed company, which will later go bankrupt, can file for a reversal of the transaction. It is therefore crucial to ensure that the assets are sold on market terms to avoid potential legal conflicts in the newly formed entity.

While it is understandably unfavorable news for the company's creditors if a business sells its assets, it is better in the long run for the creditors that the assets are sold on favorable terms before a bankruptcy occur rather than having to submit their claim in the bankruptcy estate and thereby not being guaranteed full payment, since a sale before bankruptcy proceeding can among other things ensure a higher purchase price for the assets.

Asset Transfer

An agreement to acquire the business asset from the distressed company typically outlines the transfer of various assets, including accounts receivable, intellectual property, inventory, and operational equipment.

Employees

The acquisition often involves entering into new employment contracts with a significant number of employees, ensuring job retention and maintaining operational continuity. It also meets potential estate requirements, protecting against priority claims from laid-off employees. When addressing the planning for future operations, it is crucial to consider the relationship with employees, including who should be offered employment and on what terms.

This will be discussed in more detail in later articles.

Secured creditors

Banks and debt providers with a security interest in company assets may have security in real estate, inventory, and other assets. It is crucial to negotiate with secured creditors so that the new entity can assume some or all the debt owed to them, reducing the need for capital to purchase the asset, since the purchase price will include the debt transfer.

Payment

When it comes to pricing and payment, the buyer must pay the market value for the assets, and preferably in cash. Deferred payment or assumption of debt is likely to result in an unequal treatment of creditors, consequently posing the risk of preferential treatment of creditors and the possibility of reversal of the transaction in a later bankruptcy process. Ultimately, this could also lead to management liability, as it is the management that has endorsed the transfer.

Issuing a promissory note to the old company is not advisable, but if it occurs, it is crucial that it is issued on market terms. In most situations it is not possible for the newly formed entity to acquire the debt from all the creditors. Typically, debt owed to tax authorities and other public functions cannot be freely transferred between the parties. In such cases, it is important to note that the principle of equality still applies, meaning that no creditors are to be given preferential treatment.

In these situations, aggrieved creditors may file claims for damages against those who have executed the transfer, including management and participating advisors.

There are two commonly utilized options for assuming part of a company’s debt burden:

Continued security interest in assets

If a bank holds a security interest in the distressed company's assets – such as a business charge and this security interest is not subject to avoidance, an agreement can be reached with the bank to transfer the secured debt to the new entity as partial payment for the assets. However, this applies only to the extent that the debt is secured by assets. In this case, an assessment of the assets encumbered by security is essential.

Offsetting employee claims

In cases where there are employee claims, such as unpaid salary, pension payments, or vacation pay in the old company, the buying entity assumes responsibility for these employee claims for the transferred employees.

It is accepted that the buying entity offsets these obligations against the purchase price. This provides a liquidity advantage since the vacation pay obligation to the entity's employees (typically constituting the majority of the assumed employee claims) only impacts the buyer's entity as employees take their vacations, which may be long after the transfer.

Legal precedent has established that only already accrued obligations for the period preceding the transfer can be offset. Therefore, offsetting future obligations, such as the obligation to pay salary during a notice period, is not permissible, even though the buying entity inherits the employees' seniority with respect to the old employer company.

However, it should be noted that in the cases where not all employees are offered employment in the new company, there may be a significant risk of unequal treatment and favoritism towards creditors. Therefore, it is an important consideration for the buyer to also take these factors into account.

In a similar scenario where the distressed company has gone into administration, it is the Employees' Guarantee Fund that grants approval to pay off the outstanding debt, after which the new company assumes the employee obligations. This can help to ensure that the employee is not overcompensated by receiving payment for both salary during the notice period, while simultaneously entering into an agreement with the new company and thus receiving a salary during the period of suspension.

This will be further elaborated in one of the upcoming articles, which addresses the scenario where the distressed company is undergoing reconstruction or bankruptcy proceedings.

Our Remarks

An asset sale process, as outlined in this article, requires a significant amount of time and preparation. Assets need to undergo valuation, negotiations with the bank and other creditors must be made, employee obligations require calculation, and the formulation of a transfer agreement becomes imperative. This typically involves close cooperation between the creditors, legal counsel, and auditors.

Consequently, we recommend preparing well in advance of the asset transfer. This encompasses practical considerations such as establishing a new entity, opening a bank account, completing registrations (e.g., VAT register), and meticulously managing the contract portfolio to ensure a seamless transition. Engaging financial advisors with specialized expertise in negotiating with financial institutions can be of considerable benefit.

It is imperative to underscore that, irrespective of the circumstances, business owners must meticulously adhere to applicable rules and requirements governing a business transfer; failure to do so may result in compensation claims.

In conclusion, it is noteworthy that vigilant risk management, strategic adaptability, and judicious financial governance are paramount to shield against these multifaceted risks. This will fortify the company's resilience in the face of potential insolvency.

Once everything is back under control, readiness is essential. The commercial approach and management are just as crucial as the legal and financial processes. A robust commercial foundation and an effective business plan that enables a prompt and professional response contribute to ensuring trust in the company and the collaborations offered to clients, partners, and, importantly, employees in the future.

At Moalem Weitemeyer, we have a team of experienced lawyers well-prepared 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 asset transfer, insolvency procedures, bankruptcy, due diligence, tax and regulatory issues, and board considerations.

It is imperative that these additional factors are identified and addressed as a priority.

Contacts

Thomas Weitemeyer
Managing Partner
thomas.weitemeyer@moalemweitemeyer.com

Josephine Nielsen
Associate
josephine.nielsen@moalemweitemeyer.com

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