ROUNDTABLE December 2018

DISTRESSED M&A

Too much money chasing few 'good' deals is the current distressed M&A market mantra. In many jurisdictions, strong economies and low interest rates have limited the opportunities for investors – many with substantial 'dry powder' to deploy – to purchase assets through distressed M&A. That said, drivers of distress can be cyclical, structural or situational and, despite fewer distressed scenarios, opportunistic trade buyers with plenty of ammunition in their war chests remain on the lookout for 'bolt-on' stressed companies. ■

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FW: What do you consider to be the main trends and developments to have dominated the distressed M&A market over the past 12 months or so?

Chow: Too much money chasing too few 'good' deals continues to dominate the distressed M&A market. In terms of industry, distressed retail continued to dominate the North American distressed markets, resulting in some significant distressed M&A transactions such as Toys R Us Canada, Performance Sports Group, Rockport and Nine West. After a banner year for distressed M&A in the North American oil and gas sector in 2016, there was a noticeable drop in 2017 and continued softness in 2018. However, as stabilising oil prices are threatened by concerns about oversupply, we may see another round of distressed oil and gas M&A transactions. In Canada, we also continued to see distressed businesses being acquired by way of debt-to-equity conversions as evidenced by recent examples such as Concordia International and Banro Gold, with several other distressed prospects in the imminent pipeline.

Watson: Fund clients have seen an increase in opportunities – and plenty of competition for them – although asset quality has been variable. Covenant-lite loans are perhaps playing their part. Action is often only taken late in the day, in the absence of earlier triggers, with a sales process pursued as an option of last resort against the backdrop of an urgent liquidity need requiring the consent of many stakeholders or an insolvent wind-down as the only alternative. Processes are being run on an accelerated basis, which is liable to lead to deeper discounts – some trade buyers are unwilling or unable to move quickly enough and purchasers typically seek a reduction in price to reflect the heightened risk posed by more limited diligence opportunities. Of course, this can present opportunities for those who are more nimble and sophisticated. Pre-pack administrations continue to be used as the delivery mechanism in many cases.

Tilley: Distressed M&A will always be opportunistic for funds and strategic for trade buyers and nothing over the past 12 months has changed that much. Funds have plenty of ammunition in their war chests and many trade buyers have strengthened their balance sheets ready to move when opportunities arise. But low interest rates and banks' reluctance to force insolvency triggers have made lack of supply of opportunity, rather than investor demand, the dominant factor. The depreciation of sterling in 2016 sparked some foreign interest in UK assets but not in areas of uncertainty where supply chains or markets could be affected by an adverse outcome of the UK's EU exit negotiations. Otherwise, it is pretty much business as usual, with trade buyers looking for 'bolt-on' stressed companies through share purchase or pre-packs where they have the knowledge to fix, rather than broaden their business models, while funds continue to look to pick up assets from distress.

Durrer: The distressed M&A market has continued to be dominated by the huge amount of private capital that remains available to assist stressed and distressed companies to avoid restructuring and liquidation. Although interest rates have continued to rise at a steady pace, spurred by the Fed's policies to stave off inflation, rising interest rates have, to date, not yet slowed private capital investment and lending. The reality, however, is that such an eventuality is inevitable, and we are likely to see our first real, normal down-cycle in almost 20 years, commence sometime in the next 24 months.

Weinberger: A strong economy and persistent low interest rates have limited the number of distressed situations in the market. As a result, investors, many of which have substantial 'dry powder' to deploy, are presented with fewer opportunities to purchase assets through distressed M&A. That said, the stable economy and low interest rates have energised broader M&A activity, and, consequently, companies experiencing distress have been able to pursue distressed M&A transactions that would not otherwise be possible in a more subdued M&A environment. Given the aforementioned economic tailwinds, and competitive M&A environment, potential acquirers have been more willing to engage in distressed processes. This willingness on the part of potential buyers has empowered creditors to believe that they can get 'bailed out' by potential strategic buyers and distressed investors, who are willing to deploy capital to purchase distressed companies. Smaller companies have benefited most from the increased interest in distressed M&A, as these smaller companies tend to have fewer strategic options than larger companies.

FW: What are some of the key drivers of distress in today's business world? Do any sectors or industries appear particularly susceptible?

Watson: Drivers of distress can be cyclical, structural or situational, and often overlap. Macroeconomic headwinds include reduced consumer and government spending as a result of austerity politics, rising oil prices, increases in business rates and the minimum wage, adverse forex movements impacting on importers and borrowers of dollar-denominated debt alike, and the long shadow of Brexit. Structural factors also have an impact, perhaps the most significant being the change in consumer preferences from 'bricks to clicks', with the rise of internet shopping and food delivery putting pressure on retailers and restaurateurs who fail to move with the times. Finally, distress can be event-driven, for example the discovery of accounting irregularities, such as Steinhoff, or the knock-on effect of a major client, such as Carillion, or supplier itself becoming insolvent. Susceptible sectors include those reliant on discretionary consumer spending, such as retail, leisure and casual dining, construction, shipping, aviation and healthcare.

Tilley: The global economy has been buoyant in 2018 but there are signs of weakening, as the US interest rate rises take dollar exchange rates with it. A strengthening dollar has some regional effect in those emerging markets with

dollar-denominated loans, or the perennial problem economies, Argentina, Turkey and some South East Asian countries. Stock markets worldwide are reining back in what is considered by many as a correction but could be more serious. More worrying for the global economy are the disruptions to trade patterns caused by US government policies and the supply countries' counter-reactions. This has an impact not only in countries such as China but in the US itself where tariff increases on imported steel and aluminium impact manufacturing costs and manufacturers' profit margins, particularly in the auto manufacturing sector. Uncertainties in Europe surrounding potential legislation affecting diesel engine cars is also affecting manufacturers.

Durrer: Notwithstanding the robust US economy, there are sectors that remain vulnerable to distress. The retail sector figures prominently among them. Toys R Us and Sears are among the latest casualties of the 'Amazon effect'. Even though Amazon has acquired Whole Foods and is beginning to open showcase stores featuring new products and cutting-edge technology, traditional brick-and-mortar strategies continue to flail in the face of the dominance of Amazon's saturation and Walmart's logistical advantage. Another industry that is in crisis is big pharma. The opioid litigation threat is devouring the industry from the inside out, and it will get much worse before a solution arises.

Weinberger: Both macroeconomic and microeconomic factors contribute to distress. As one would expect in a strong economy, recent distress has tended to be company- or industry-specific, resulting from technological developments, changing consumer preferences or other micro factors. Retail is the prime example: the sector has experienced a multi-year period of distress due to shifting consumer preferences, with customers migrating to online shopping and away from brick-and-mortar stores, as well as unsustainable levels of leverage throughout the sector. Looking forward, there is significant concern regarding the impact of recent tariffs on certain sectors, particularly manufacturing and agriculture. Long-term tariffs could significantly affect certain companies' cost structures and profitability, resulting from an inability to pass on cost increases. Of late, this, taken along with rising interest rates, has created general uncertainty and fears of a broader market decline.

Chow: Disruptions and the resulting displacements caused by technological innovation and market forces are some of the key drivers of distress today. Increased borrowing costs will impair the ability of highly leveraged businesses to make much-needed capital investments and improvements to remain competitive in the digital economy. Retail continues to struggle to adapt to dramatic shifts in consumer buying habits and the 'Amazon effect'. Rising interest rates and inflation will continue to exert pressures on discretionary consumer spending, exacerbating the retail hurt. Similarly, the automotive sector is also poised to experience significant distress, as it is particularly susceptible to significant technological disruption and a retraction in consumer spending. The trickle down or ripple effect also threatens to disrupt secondary industries. For example, the shuttering of traditional brick-and-mortar stores not only threatens the real estate sector but the resulting lower volumes, competition and resulting tighter margins also threaten to disrupt the transportation and logistics sector.

FW: How would you characterise the current appetite of distressed investors? What are the advantages – and potential disadvantages – of participating in this market?

Tilley: Distressed investors are highly active both in looking for portfolios of non-performing loans (NPLs) or single ticket deals. The NPL market has been with us since 2009, and has moved from country to country and from sector to sector. It remains close to €1 trillion in Europe and is only slowly being reduced. Funds were first attracted into the consumer debt and the domestic and commercial real estate sectors, which were easier both to evaluate and to manage disposals and collections. Ireland and the UK were first in line, followed by other West European markets such as Germany, Holland and Scandinavia. The focus moved to Spain and Eastern Europe and is now firmly on Greece, Italy and Cyprus. Challenges exist in local legislation, much of which is changing and is untested, and in difficulties in accessing clear information for valuation purposes. This is especially so

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for corporate NPLs where the challenges and opportunities are now most apparent. Data rooms are often very sketchy. The advantages are clear once an investor can identify a viable business to turn around and a management team to achieve it.

THE ECONOMIC OUTLOOK SUGGESTS THAT OPPORTUNITIES SHOULD ONLY INCREASE IN THE COMING YEARS. HOWEVER, PARTICIPANTS NEED TO BE NIMBLE, SHREWD AND PROPERLY ADVISED.

JAMES WATSON
Kirkland & Ellis International LLP

Chow: In the current distressed market with low supply and high demand, competition for 'good' investments is fierce. In the distressed market, investors can pick up valuable assets with turnaround upside at a significantly lower price and more quickly than they would in a 'traditional' M&A structure. Distressed M&A is typically conducted on an 'as is, where is' basis, with limited representations, warranties and recourse, within compressed timeliness and subject to due diligence limitations. Although the purchase price reflects the 'as is, where is' nature of the deal, the distressed investor will need to be comfortable moving quickly within very short timelines and accepting the risks that are inherent in doing so. In the current competitive market, this means that distressed investors may have to be prepared to bear more risk to be successful in a competitive bidding process for good opportunities.

Weinberger: As a result of the strong economy and an abundance of asset managers sitting on substantial un-invested capital – including distressed or alternative capital managers along with more traditional non-distressed investors looking for value in an otherwise overheating market – there is currently an imbalance between investor appetite and the number of distressed opportunities available. Said differently, there appear to be numerous distressed investors chasing only a few deals. The relative scarcity of distressed deals and the large number of distressed investors has likely propped up prices for distressed assets, consistent with many other asset classes in today's market. The obvious disadvantage in such a market is that a distressed investor clamouring to deploy its investors' capital may be tempted to pay a higher price for an asset than fundamentals would justify. Creditors, on the other hand, can often get higher, if not full, recoveries by selling distressed assets in the current 'hot' M&A environment.

Watson: Considerable quantities of dry powder in the hands of a multitude of institutional investors, coupled with a limited supply of compelling opportunities, makes for a competitive marketplace. The appetite for investment in the distressed space is certainly there, though this is tempered by a perception of valuations occasionally becoming frothy and recognition of the need for continued discipline with respect to deployment. The key advantage of participating in the market is that it presents an opportunity to acquire attractive assets at a discount to their fundamental value. The economic outlook also suggests that opportunities should only increase in the coming years. However, participants need to be nimble, shrewd and properly advised. The abridged opportunity to conduct diligence, on both the business and the management team, and limited scope for meaningful representations and warranties in the documents, presents real downside risk. Successful turnarounds can also be expensive and time-consuming.

Durrer: Distressed investors are being very careful about when they are deploying their capital. Many have chosen to wait on the sidelines until a true down-cycle takes hold so as to capture better yields and stiff competition. Investors that are participating today must have a competitive advantage in the form of better analytics or access to information or experts on a basis that is better than their competitors.

FW: Have any recent, high-profile distressed M&A transactions caught your eye? What lessons can we draw from how the process was conducted?

Weinberger: Tintri is a recent example of a distressed M&A transaction that faced several of the challenges that we often see. Tintri is a cloud computing company, and was the third-fastest company to go from IPO to bankruptcy. One lesson the Tintri situation highlights is the importance of retaining key employees. Once Tintri entered financial distress, competitors actively lured away the company's most valuable employees. These employees were naturally concerned about their employment security and fled to safety. This dynamic created problems for potential buyers, as it made diligence more difficult due to the loss of institutional knowledge. Companies should be as open as possible with employees early in the process and attempt to design ways to incentivise critical employees to remain with the company throughout a sale or restructuring process. The Tintri process also clearly illustrated the importance of securing

a stalking-horse bid in order to foster competitive tension and maximise value.

Watson: UK retailers have dominated the headlines this year, often for their use of company voluntary arrangements (CVAs) to shed lease liabilities, for example Prezzo, Homebase and Toys R Us, but also, and not always mutually exclusively, for their involvement in 'pre-pack' administration sales. Examples include the sale of American Golf to Endless, certain Coast assets to Karen Millen and, notably, the sale of House of Fraser and Evans Cycles to Sports Direct. These are a useful reminder of the utility of the tool as a means of rescuing distressed businesses, or parts of them, in circumstances where directors' duties mean they may not be comfortable with 'pressing the button' themselves, though the sale of Homebase to Hilco demonstrates they are not the only option. They also show how, like a CVA, a pre-pack administration can be an alternative mechanism to leave behind non-viable leases.

Chow: The sale of Toys R Us Canada had several unique aspects. The sale of TRU Canada on going concern, standalone basis, was approved by both the US and Canadian bankruptcy courts and was effected through a share sale by the US parent rather than through the more common asset sale structure. The share purchase agreement contained a release of the US parent and to ensure that amounts were not distributed to the US parent on account of its equity interest prior to the claims of TRU Canada's prefiling creditors being paid or addressed on a consensual basis, the share purchase agreement created an equity reserve, that was available to creditors of TRU Canada if TRU Canada failed to pay any prefilings claims.

Durrer: The Westinghouse transaction was truly remarkable for a number of reasons. First, it began as a freefall Chapter 11 involving two large nuclear power plant construction projects in dire danger of a shutdown. Freefalls are the exception these days, rather than the rule. Ultimately, the case was resolved by confirmation of a consensual plan of reorganisation two days short of its anniversary. Over $8bn of debt was resolved, and the Westinghouse business was successfully sold to Brookfield. Unsecured creditors, other than affiliated claims, are estimated to have been paid in full. Surprisingly, over the course of just under one year, only a few hours were ever spent in court in front of the judge. Most of the issues in the case were resolved consensually, without the involvement of the court. Another interesting feature was that claims trading, either at or near par, was a catalyst for the global settlement.

Tilley: In the UK, the House of Fraser acquisition by the owner of Sports Direct has been strongly reported. What started out as a CVA to force landlords into significant concessions in both rent reductions and release of obligations in shop closures, degenerated into an unplanned pre-pack administration. The use of a CVA in the first place was contentious because the CVA does not confer the right to terminate leasehold obligations but is a vehicle for persuading landlords for concessions under the threat of worse terms in insolvency. It was a method used with success in other recent high street retailer rescues, but because of the number of properties and the scale of demands, it was opposed by landlords who warned off other suitors and investors, and thus triggered insolvency and a pre-pack administration. With little time for proper planning by the buyer, impaired unsecured suppliers, concession operators and employees became hostile to the acquisition and hampered a smooth transition. This is still playing out with clear lessons for ambitious debtor plans and the disruption of poorly planned acquisitions.

FW: What particular challenges does the distressed M&A process generally involve, compared to 'traditional' M&A? For example, what considerations need to be made when structuring and financing this type of deal?

Watson: Timetables and risk allocation are the most important differences with a distressed process, and both amount to more risk for the buyer. Processes are often accelerated and access to information and management may be less fulsome, meaning the quality and quantity of due diligence is likely to be lower than usual. Representations and warranties, which might otherwise be relied upon to 'fill in the gaps' and offer downside protection, may also be pared back, particularly on any sale by an insolvency officeholder. Pricing is therefore critical in reflecting the risk assumed by the buyer. Structurally,

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an insolvency officeholder in particular will want to see a fully funded offer and is likely to demand that the price is fully, or substantially, payable in cash on completion. The risks around funding any immediate new money need and the insolvency mechanism used to deliver the assets will also need to be carefully evaluated.

Chow: The two biggest challenges for distressed investors are the 'as is, where is' nature of the transaction, with limited representations and warranties and recourse and the significant compressed time frames upon which diligence, negotiation and completion of the transaction is conducted compared to 'traditional' M&A. The more information a distressed investor knows before the formal sale process commences about the distressed business and industry and the legal process in which the distressed assets are being acquired, particularly if within formal insolvency processes that cross borders, the more it will be able to move quickly and better position itself for a successful bid. Those processes, including the availability of vesting orders, may be able to offset many of the challenges of limited diligence and recourse. Distressed investors may offer additional consideration or other accommodation to the distressed seller in exchange for additional representations and warranties or recourse rights.

Durrer: Distressed M&A differs in several ways from 'traditional' M&A. First, distressed transactions move at a much faster pace than traditional ones, often due to external factors, such as scarce liquidity, looming maturities or pending defaults. Second, as a consequence of the speed of such transactions, due diligence is often truncated and must therefore be prioritised. Accordingly, to manage risks associated with less than ideal due diligence, deal structures tend toward asset purchases as opposed to outright acquisition. Nonetheless, as transactions tend to be more global, asset purchases are occasionally not available due to local law restrictions.

"DISTRESSED M&A IS MORE COMPLICATED THAN TRADITIONAL M&A. IT IS MUCH HARDER TO GAIN A GOOD UNDERSTANDING OF THE BUSINESS AND ANY INSOLVENCY PROCESS CAN BE UNPREDICTABLE."

ALAN TILLEY
BM&T LLP

Tilley: Often the target is close to insolvency and the buyer needs to move quickly to avoid triggering a reputation-damaging insolvency and manage stakeholders in the process. Consideration must be given whether to buy the company as a going concern avoiding insolvency and with limited due diligence, with all its liabilities and possible undisclosed claims, or to buy assets and assume selected liabilities such as critical vendors, either pre- or post-insolvency in a pre-planned or a pre-pack process. In some cases, the acquirer may choose to buy secured loans at a discount and use the security rights to gain control of the company, so-called 'loan to own'. Distressed M&A is more complicated than traditional M&A. It is much harder to gain a good understanding of the business and any insolvency process can be unpredictable.

Weinberger: In addition to facing unique legal considerations, companies undertaking a distressed M&A transaction contend with operational challenges that rarely arise in healthy M&A processes. Among the most significant challenges are retaining key employees, managing relationships with key suppliers, and operating within very limited time frames, often due to dwindling liquidity or pressure from lenders. Retention of key employees is critical not only to maintaining steady operations during a tumultuous period but also to facilitating an effective diligence process for buyers within a condensed time frame. Mere rumours of potential missed payroll, filing of bankruptcy or a sale of the company can send essential personnel racing for the exits. Employees are not the only ones who scramble for safety during periods of distress. Key suppliers, which must fight to recover cents on the dollar in a Chapter 11 filing, often shut off trade support as soon as the word 'bankruptcy' is first uttered. The elimination of trade support often severely disrupts supply chains, and – as we saw in Toys R Us – the disruption of the supply chain can often push a company teetering on the brink into filing for bankruptcy.

FW: What strategies and methodologies should be employed to value distressed companies, identify and manage potential risks, and lay the groundwork for maximising return on investment down the line?

Weinberger: When evaluating distressed investment opportunities, investors must balance taking a sober view of the company's current operating position difficulties and market position with the potential value that could be unlocked by properly recapitalising the firm, allowing operations to normalise and re-evaluating

strategic alternatives after the company has been restored to full health. While distressed M&A is typically conducted within a short time frame, intensive due diligence is crucial. Investors should diagnose both the macro and idiosyncratic causes of distress, carefully review financial statements and, particularly in a bankruptcy process, fully evaluate the effect the filing has had on key customer, employee and supplier relationships. The results of this intensive due diligence must then be incorporated into a valuation framework. Because distressed situations face unique challenges, and in some instances earn negative earnings before interest, tax, depreciation and amortisation (EBITDA), investors must be creative when performing a valuation analysis – a simple multiple analysis may not suffice.

Durrer: Whenever one values distressed companies, one must start by evaluating the core reasons behind the company's failure. If it failed because of flawed management, what business plan can new management execute on a reasonable timetable? If too much leverage is the reason for the failure, what can the company accomplish under appropriate leverage? What is the appropriate leverage compared to EBITDA or the asset base? What are the headwinds and tailwinds facing the company? In the case of a transparent or prolonged insolvency process, what is the possibility for breakage – loss of customers or revenue sources?

Tilley: Conventional valuation metrics for profitable companies, such as profit multiples, are not applicable. Asset valuations are certainly useful if there is real estate and industrial machinery. But an acquirer should understand how the acquisition affects his own business valuation by possibly diluting his own value and should have a clear idea of an exit, either for success, or recovery in insolvency as a backstop if the business fails to respond to turnaround. Ideally, an acquirer should have a clear plan and enough information to prepare a post-acquisition business plan with forecast cash generation. Working capital considerations such as possible hostage demands from critical vendors, restructuring costs and possible defections of key employees all mean the total cash outlay may be several times the initial purchase price. This all needs to be factored in to calculate if an acceptable internal rate of return or cash pay back is possible.

Chow: Diligence and having a good understanding of how and why the distressed target became distressed is critical to determining value and potential upside on a distressed investment and to identifying and managing potential risks and laying the groundwork for maximising return on investment in the future. Otherwise, the acquirer will fall into the same traps as the distressed seller. The key stakeholders of the seller are likely to be the same after the business is acquired. Therefore, understanding key relationships and identifying and retaining individuals within the target who have those relationships with suppliers and customers are also important to maintaining goodwill. Key stakeholders could also prove to be beneficial as key allies of an acquirer's bid.

Watson: A bidder should conduct a typical going concern valuation, on the basis of comparable companies and transactions, as well as on a discounted cash flow basis, adjusted for any sensitivities identified in diligence. A suitable discount will then need to be applied to reflect the distressed situation, including any immediate and projected new money need, and specific risks. It is also advisable to value the business on a liquidation basis to produce an estimated outcome statement showing the low-case value if downside risks materialise; 'hard assets' are likely to be key to downside protection. If the target has a 'backable' management team, they are likely to have a firm view on both risks and opportunities. In tandem, sector experts can assist in sense-checking management's views and providing their own, informed perspective. As with any M&A transaction, having a clear and fully considered exit strategy at the outset is crucial.

FW: Could you provide an insight into some of the legal aspects and issues that typically arise in distressed transactions? How might such issues affect the way agreements are drafted?

Durrer: The most important elements of a distressed transaction are certainty of price and closing. Issues that may affect price, such as adjustments, holdbacks, indemnities, representations and warranties, are all abhorred, curtailed

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> Blake, Cassels & Graydon LLP

or outright rejected by targets. Elements that affect closing, including conditions precedent, potential defaults and so on, will likely face resistance along the way. Ultimately, the push-pull of these negotiations is resolved in much the same way as any ordinary M&A transaction: essentially, who has the leverage? In distressed transactions, however, an additional element of leverage is that the target often faces a lack of time and flexibility. Of course, competition can provide relief from such pressures.

Tilley: Any merger or acquisition is a major event for any company and should only be undertaken with competent legal advisers being informed at every step. Share or asset purchase, solvent or insolvent, assets and liabilities to acquire or avoid, pension liabilities and employee obligations under the Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE) relations are some of the major issues to consider. In any closing documentation, adequate consideration should be given to representations and warranties. The list varies according to the method. Share purchases are easier to document but carry greater risk of acquiring unrecorded or contingent liabilities. A salutary point should be that poorly documented and planned acquisitions are a major contributor to subsequent corporate failure.

Watson: When a business is in the zone of insolvency, the directors may be unwilling to accept the risks associated with selling assets at a price which leaves stakeholders unpaid. A pre-pack administration may, therefore, need to be used as a delivery mechanism. Administration SPAs are quite different to normal SPAs – administrators will sell assets on an ‘as is, where is’ basis, without meaningful representations and warranties, so caveat emptor. It is also critical to check termination rights in key contracts and leases to assess whether the administration entitles the counterparty to terminate. A purchaser may need to push for elements of the purchase price to be payable only if key assets can be transferred. The presence of a defined benefit pension scheme, that will not be transferring to the purchaser group, is also a red flag that will need full consideration.

Weinberger: We have been seeing two issues frequently as of late. First, issues regarding data, especially customer data. As companies become more data intensive, issues have arisen regarding privacy, appropriate disclosure of data during the diligence process and, ultimately, the question around ownership of such data and whether it could potentially be used as collateral. We have often seen buyers become increasingly concerned with data and data security and they are continuing to look for new ways to minimise associated risks. Second, companies, particularly smaller companies with fewer lenders, are increasingly interested in entering into a distressed M&A transaction without a bankruptcy filing to avoid the associated costs and potential business disruption.

Chow: Three issues come up regularly in distressed M&A transactions in Canada. First, the ‘as is, where is’ nature of distressed M&A transactions. Second, the scope and legal effect of the court order vesting assets in the acquirer free and clear of claims and encumbrances. And third, the risk of closing before the expiry of the applicable appeal period. Typically, representations and warranties about the target business or assets are very limited, will be subject to materiality thresholds and will merge on closing, thereby limiting recourse to a pre-closing termination trigger. In those rare cases where the acquirer successfully negotiates representations and warranties that survive closing, these will typically be time limited and recourse subject to a specified dollar cap. The agreement should specify specific claims or interests that the acquirer requires to be vested out as a condition to closing, and provide for proper notice to be served on all affected parties with potential affected interests. Purchase agreements should also specify whether the acquirer is prepared to close before the expiry of the applicable appeal period.

FW: Given the aggressive time frames involved, what pressure does distressed M&A exert on the due diligence process? What steps should an acquirer take to address this issue?

Tilley: There will be time pressure to avoid insolvency or losing customer and key employee confidence, so clearly understanding the ‘end game’, the rationale for purchase, is fundamental. Too often, the excitement of the deal can drive the process rather than the logic or the hard numbers. Continuous reassessment is important. Having an independent adviser or partner acting as sounding board and playing ‘devil’s advocate’ will avoid excesses of exuberance. Identify the key deal breakers and navigate around them. If in doubt, do not do it. Deals are rarely critical. There is usually another one coming along.

Chow: Aggressive time frames exert extraordinary pressure on the due diligence process. Advance due diligence ahead of the commencement of the formal sale process can be beneficial. A sale conducted through a formal insolvency process in Canada often involves a court-approved sale process that sets out the rules, including sale process, which includes sale milestones that are subject to extension or amendment with or without court approval depending on the specific terms of the sale process. If there is DIP financing, those sale milestones usually cannot be amended without the DIP lender’s consent. Timelines may also be informed by conditions imposed by lenders, other key stakeholders and liquidity constraints. If the seller or a key stakeholder believes a particular acquirer is a bona fide potential acquirer, it may be more supportive of extending some of the timelines in order to facilitate more favourable bona fide bids.

Weinberger: Dwindling liquidity often forces companies into out-of-court distressed M&A processes. Unfortunately, management teams are sometimes unrealistically optimistic, so by the time a liquidity shortfall is identified, it is already far too late to consider devising an orderly solution. Therefore, buyers

stepping into these distressed situations often watch liquidity disappear throughout the process. Furthermore, managers of distressed businesses will be distracted by trying to retain key employees, managing vendor relationships and minimising operational disruptions, meaning that far less bandwidth will be devoted to facilitating an orderly diligence process than would be possible in a healthy process. Buyers, therefore, must enter distressed processes extremely well organised and with sharply focused due diligence request lists. Unlike a traditional M&A process where management will have the time and manpower to satisfy virtually any information request, distressed investors necessarily will need to isolate key risks and ask targeted questions to analyse and price those risks.

Watson: The timetable exerts considerable pressure, both with respect to the information itself and the time needed to analyse it. In a competitive sales process, the seller may try to push purchasers to perform less work by saying it reflects badly on their offer and suggests they cannot move fast enough. It is, therefore, very important for a purchaser to engage professional advisers early to help prepare for the process and to ensure that key information is readily available on launch. From a seller's perspective, it may be advisable to suggest to trade buyers in particular that they engage a restructuring adviser to help guide them through a process with which they may not be familiar and to manage expectations. Diligence shortcomings may be compensated by a deeper discount or bid structure which manages downside risk, for example escrow or earn-out mechanisms, but this will not always be viable.

Durrer: The best distressed investors are able to accelerate their due diligence to accommodate the time pressures of distressed transactions. They deploy advisers and analysts in earnest. They pursue exhaustive meetings with management, customers, employees and business partners in order to evaluate valuation metrics. Because of the competition for such deals, however, the deployment of resources must be balanced against the risk that the expenses of such a deployment will not be recovered.

FW: How should parties manage the competing interests of the various groups associated with a distressed transaction? To ensure a smooth process, is it important to preserve relationships with key stakeholders?

Weinberger: Carefully managing the relationships with, and between, key stakeholders is essential in a distressed M&A transaction because, unlike in healthy transactions in which most stakeholders are paid-in-full or otherwise unimpaired, in distressed situations stakeholders are often required to make sacrifices. Given the fixed size of the pie, these sacrifices can lead to infighting among stakeholders which, in fact, would all potentially benefit from maximising the value of the company. Furthermore, very often various stakeholders have tools to prevent or delay the consummation of a transaction, effectively holding everyone else hostage in order to achieve a particular objective. We believe it is crucial to facilitate an open and transparent dialogue among all stakeholders and to very clearly communicate the benefits of everyone working together to achieve a common goal: maximising the value realised in a transaction.

Watson: Relevant stakeholders can include lenders, shareholders, pension trustees – and, by their side, the Pension Regulator and Pension Protection Fund – landlords, contract counterparties, employees and customers. As a general rule, preserving relationships with all relevant parties to the extent possible is valuable in terms of minimising execution, legal and investment risk. Early engagement with parties whose support is critical to the implementation of the deal and the future of the business is recommended – surprises are typically best avoided, though this may need to be weighed against deal confidentiality and other sensitivities. Conversely, it may be possible to structure a deal around a hostile stakeholder, in which case, distance may be preferable to avoid potential spoiling tactics. Overall, a well-managed and coordinated PR strategy is essential, especially for any transaction that may attract the attention of the media or politicians.

Durrer: The best way to negotiate with a range of parties with disparate interests is to understand their differing perspectives and address their motivations directly. Clear communication is always key. Rather than being aggressive or combative, parties should attempt to understand the opponent's desires, goals and needs. More often than not, common ground can be found and exploited. Relationships, once destroyed or impaired, are hard to repair. A little investment in the short term may pay a substantial dividend in the long run.

Chow: It is very important to manage and preserve relationships with the key stakeholders. Key stakeholders can often prove to be a useful ally in advancing an acquirer's bid. Those relationships can assist in the due diligence process, obtaining extensions of sale milestones and successfully negotiating amendments to or obtaining new material contracts required for the business to be successful post-sale. Those parties will also often have a voice in the court approval process. In Canada, for a sale conducted under Canada's Companies' Creditors Arrangement Act (CCAA), the CCAA provides that the court, in exercising its discretion to approve a sale, should consider, among other facts, whether the sale or disposition would be more beneficial to the creditors than a sale or disposition under a bankruptcy, the extent to which the creditors were consulted and the effects of the proposed sale or disposition on the creditors and other interested parties.

Tilley: In most cases, there is a mutual interest within stakeholders for success but not always a clear understanding or balance. Some who may have to concede most to secure anything can harbour discontent and may try to leverage their real or perceived position to derail the deal. The acquirer should have a clear understanding of stakeholder priorities identifying the

key stakeholders and ensuring that they are kept informed as far as possible during the deal and after completion to avoid defections. Kept in the dark, people fear the worst and react accordingly. Key employee retention and critical vendor management is important. But a business cannot run without customers, so customer relationships and retention are the most significant relationship to ensure acquisition success.

FW: For its part, how should a distressed company go about preparing information to maximise the chances of a successful sale? What initial preparations might prove useful?

Chow: Gathering books and records of the distressed target can be a very time consuming and difficult task. Potential acquirers want immediate access to detailed lists of assets by category and legal owner – such as owned real property, leased real property, equipment and machinery, IP rights, licences, material contracts, and so on – and complete copies of all material contracts and licences, and financial data. Often the distressed business has suffered from a loss of personnel and a loss of historical knowledge, exacerbating informational challenges. These challenges may be further aggravated given truncated due diligence timelines if the distress has been unexpected or when books and records are decentralised across divisions, jurisdictions or corporate entity. If possible, it would be beneficial to have information prepared before key employee departures.

Watson: A sales process which is not rushed, in which reliable information is readily available to bidders, and which uses credible M&A advisers should maximise value. It is therefore recommended, and consistent with the directors' duties, to kick off the process sufficiently early, including early engagement of advisers to assist. Bidders will base their offer on actuals for the last 12 months and forecast numbers for the next 12 months, so time should be spent ensuring the information for these periods is accurate and robust. The business plan behind the forecast also needs to stand up to scrutiny and demonstrate clearly the future growth that can be delivered. Identifying upside opportunities will help entice bidders. Conversely, inconsistencies in the numbers will reflect badly on management and lead bidders to demand more time to do their own work. If management is weak, look for solutions that can be presented to financial investors.

Durrer: Due diligence is always a challenge for distressed companies. More often than not, a distressed company has failed in some measure on core financial metrics and performance. As a consequence, it may lack the ability to produce reliable business records, on a timely basis, to support an M&A transaction. At a minimum, potential acquirers may simply be suspicious of the reliability of information about the target. Professionals can often help to steer and guide the provision of information consistent with the priorities of potential buyers and investors in an effort to maximise value.

Tilley: Firstly, maximise the number of potential buyers with an information memorandum that is positive without being misleading, is short and highlights the upside potential as well as explaining the underlying reasons the business is in distress. Have a detailed data room prepared, normally electronic, with all corporate information, historic numbers and details of assets, liabilities, pension plans, organisation charts and employee details. With time being critical, easy access to good quality data is important. Buyers of distressed businesses will want to focus on risks and their mitigation, so make sure data to help that analysis is available. A rapid process will also need access to management and any other key people, so ensure nobody has holidays or trips planned that will make them unavailable for meetings with potential buyers. Lining up your advisers and briefing them is another task to be done as soon as possible.

Weinberger: Given some of the challenges, the first step in preparing for a successful sale is hiring experienced advisers, with relevant industry expertise and with whom the company's senior executives are comfortable working. Advisers help drive the process forward, including with preparing key documents, drafting investor presentations and assisting the company with crafting its story. Understanding what buyers typically require, and proactively sharing such information in a digestible format, is key to keeping the process efficient and on track. It is also essential to retain and properly incentivise key employees from the beginning of the process, as these individuals hold crucial institutional knowledge and possess the expertise to answer detailed questions from potential investors.

FW: What are your predictions for the distressed M&A market over the coming months? Are there reasons to expect an increase in activity?

Durrer: Professionals debate whether the down-cycle will occur in the next 12, 18 or 24 months. No one debates that it will come, however. This next cycle will probably be more traditional than in recent years. Recent turnarounds have been driven by quick sales, liquidations and pre-packs. During the next cycle, we will likely see more freefall cases. 2017 had a number of such transactions, and this may have been the tip of the iceberg approaching through the fog.

Weinberger: For a variety of reasons, there is speculation that an economic downturn is on the horizon, and many market participants view it as not a matter of if, but when market conditions deteriorate. Increased distressed activity could be caused either by an economic downturn or by continued rising interest rates, making refinancing more difficult and increasing the rate on variable-rate debt. It is not entirely clear that an economic downturn that creates distress results in more distressed M&A. Although more distressed situations will arise, there is typically less capital available for M&A, valuations decline and buyers become reluctant to transact. As a result,

stakeholders in distressed situations may look to non-M&A alternatives to restructure the company's obligations, such as debt-to-equity conversions, changing cash to PIK interest and pushing out debt maturities to give businesses more time and liquidity to withstand a downturn until a better market environment is reached for a sale or other liquidity event.

Tilley: Economic downturns, rapid technological change, sudden interest rate rises and uncertainty are harbingers of increased distress. Corporates are most exposed to this but there can be winners and losers. Some have become overleveraged as recent lending has been loose and covenant-lite. In distress, the market leaders gain ground and the laggards become prey. The current uncertainties in the global and UK markets certainly are leaning towards revenue, activity level and margin pressures. Market-leading trade buyers will see opportunities. Funds still have plenty of liquidity and are primed to deal. It is doubtful that we are looking at a 2008-style recession as banks have stronger balance sheets than previously. However, it does not take a great fall in activity to tip smaller, less well managed and funded companies over the edge. The circumstances look poised for a market correction and an increase in distressed M&A.

Chow: Geopolitical disruptions, looming trade wars, rising borrowing costs and continued technological disruptions threaten to converge to create a perfect storm for an economic downturn. The US Federal Reserve has raised its interest rate three times already this year and the Bank of Canada has raised rates five times since the summer of 2017. In each case, more hikes are anticipated in the foreseeable future. Meaningful rate hikes increase debt service obligations of businesses, which will give rise to or aggravate liquidity constraints for already-distressed or overleveraged businesses. That will make it make more difficult and expensive for businesses with maturing debt obligations to refinance, including trillions of dollars of US bond debt set to mature in the next few years. The impact of higher interest rates will also be felt on consumer spending. With each successive rate hike, we move one step closer to the 'tipping' point for consumers who have accumulated significant amounts of debt in the 'cheap' money environment.

Watson: As the old adage goes, restructuring lawyers have predicted 10 of the last three recessions. However, consensus view seems to be that 2019 will see an economic slowdown before a 2020 recession in the UK, and certain other countries, and a corresponding uptick in potential distressed opportunities in that period. Though credit markets remain relatively buoyant, allowing some companies to refinance their way out of trouble, multiple headwinds, including Brexit uncertainty and disruption, a rising interest rate environment in the UK, but little room to cut rates again if the economy trends downward, and the cost pressures alluded to above, suggest many businesses will struggle. One other point to watch in future – the proposed new requirement on directors of a holding company to consider the interests of the stakeholders of a financially distressed subsidiary when it is sold, presenting new legal issues for sellers to grapple with. ■

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