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Distressed M&A Solutions

The current Coronavirus crisis is opening up opportunities for competitors as well as investors to purchase businesses in financial distress. While such businesses may be often acquired on advantageous terms, these transactions can also entail various significant legal risks.

Once a potential buyer has decided to acquire a business in distress, or parts thereof, the first step is to determine the best deal structure for the acquisition of the desired assets. In practice, the most commonly used structures to complete such acquisitions are either the share deal or the asset deal. Popular variations of the asset deal include the pre-packaged deal and the hive-down. We examine the risks of these popular formats in turn:

The Share Deal

To start with, the purchase of a business may be effected by simply acquiring all of the shares in the target company operating the business (a so-called «share deal»). The share deal is thereby most often simpler than the asset deal (see hereinafter). In a share deal, the buyer acquires from the shareholders of the target company all of the shares in the target company and, thus, indirectly, the entire business operated by the target company, i.e. all of the assets and all of the liabilities of the target company (whether they are known or not). The fact that the buyer also acquires all liabilities of the target company – which can be substantial in case of a company in distress – makes the share deal often less appealing to interested buyers.

The Asset Deal

The acquisition of a business or parts thereof may also be effected by means of a purchase of the assets of the target company (a so-called «asset deal»). With an assets deal, the buyer may in principle choose the assets of the target company it wishes to acquire from the target company, without necessarily being obliged to acquire or take on any liabilities from the respective target company. One should note, however, that where the buyer wishes also to acquire the existing contractual relationships that the target company holds with third parties (for example, its customers), the transfer/acquisition of such contracts requires the consent of those respective third parties; which, as a consequence, entails a certain degree of uncertainty to whether such third parties will consent to the substitution of the target company by the buyer as party to the respective agreements.

Considering the above, a buyer may, in principle, avoid taking on uncertain or unknown liabilities from the target company by opting for an asset deal structure instead of a share deal structure. One important exception to this applies to employment relationships. If the buyer acquires a business (or parts thereof) and not just single assets, the employees of the respective business (or the respective part of the business) are also transferred by law to the buyer along with the respective business; and, by law, the buyer becomes liable together with the target company for the outstanding wage claims of the respective employees.

Finally, in an assets deal, the target company – as owner of its assets – is the seller of the assets. This in turn harbours the pending risk that such sales become subject to avoidance actions under the Federal Act on Debt Collection and Bankruptcy (SchKG) in subsequent bankruptcy proceedings over the target company. Such actions allow the

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bankruptcy estate, respectively the creditors, once the target company has entered into bankruptcy proceedings, to challenge prior transactions in court (including asset deals), by which the target company has sold assets to third parties below market value, or which are conceived to be fraudulent conveyances. If such a challenge is sustained by the competent court, the assets sold are returned to the bankruptcy estate and the buyer is left, in respect of the purchase price paid for the assets, as an unsecured creditor of the company in bankruptcy.

The Pre-Packaged Deal

The risks of having to take over employees, of being liable for outstanding wage claims and of losing the acquired assets following any potential bankruptcy proceedings, may be addressed by a so-called «pre-packaged deal».

The pre-packaged deal – in contrast to the «regular» asset deal – requires first of all that the target company (i.e. the seller in financial distress) enters into composition proceedings according to Art. 293 et seq. of the Federal Act on Debt Collection and Bankruptcy (comparable to the U.S. chapter 11 proceedings). For companies in financial distress, the composition proceedings represent an alternative to the regular bankruptcy proceedings. These latter proceedings usually result in the immediate suspension of all business activities of the company in distress and are aimed at the liquidation of the company in distress. The composition proceedings, on the other hand, are intended to allow the company in distress (under the supervision of the bankruptcy court) to be restructured or to be liquidated slowly, while maintaining its value as a going concern. In contrast to the regular bankruptcy proceedings, the board of directors and the management of the company remain in most cases responsible for managing the company, but usually under the supervision of a court-appointed trustee. The requirements for commencing the composition proceedings and granting the preliminary stay are relatively straightforward in the initial phase and have been temporarily further reduced by the COVID-19 Decree. In principle, the composition proceedings are commenced and the provisory stay is granted initially if a reorganisation of the company or an agreement with the creditors on the reorganisation or liquidation of the company in distress does not appear to be obviously hopeless.

In the case of a pre-packaged deal, the target company, before it files to commence the composition proceedings, will need to:

a) prepare a restructuring plan to be presented to the bankruptcy court, which provides for the sale of the business or parts thereof (with or without employees) to the buyer; or
b) sign a sale agreement with the buyer relating to the sale of the business or parts thereof (with or without employees), where the completion of the sale agreement is made subject to the bankruptcy court's approval in the composition proceedings.

Thereafter, the target company in distress will apply for the composition proceedings and, if approved by the bankruptcy court, enter into those composition proceedings. In the course of those composition proceedings, the sale transaction (i.e. the sale agreement) is presented to the bankruptcy court for approval.

If the bankruptcy court approves the sale agreement, the sale and transfer of the respective assets to the buyer can no longer be subject to any avoidance actions and, therefore, may not be challenged in subsequent bankruptcy proceedings over the target company should the composition proceedings fail. Furthermore, where the bankruptcy court so approves the sale of a business, the buyer ceases to be liable for any outstanding wage claims, and the employment relationships do not transfer automatically to the buyer. In the experience of the authors, a decision of the bankruptcy court may be expected within a reasonable time period.

The «Hive Down»

As a further variation of the assets deal, under a hive down, the target company firstly transfers parts of its business to a subsidiary within the framework of a restructuring; and then the shares in that subsidiary to the buyer (effecting an indirect transfer of the target business assets). Although this type of restructuring may take some time, the target company itself is often in a better position to transfer its assets to a subsidiary, as many agreements allow the transfer of assets (such as contracts) internally to a subsidiary, but not to an external third party. The sale of the shares in the subsidiary may also be subject to avoidance actions in following bankruptcy proceedings over the target company. Such risk may be addressed again by pursuing a pre-packaged deal.

Conclusion

In each individual case, the appropriate legal structure for the acquisition of the respective business, i.e. the target assets, must be examined carefully by the interested buyer. The decision on the ideal deal structure is always based on a cost-benefit as well as a commercially-minded risk analysis.

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