TÖRNGREN MAGNELL

Stockholm, 27 April 2020

”Distressed M&A”

– Törngren Magnell on M&A challenges in Corona times

Introduction

Icy Corona winds are sweeping through the formerly frothy Swedish M&A market of 2017-2019. With few exceptions, the Seller-friendly auction processes of the past few years have all but ceased in anticipation of a more stable business environment. M&A deals are still being done, to be sure, but they may look completely different from what we have been used to.

In this article we look at some of the trends in the current distressed climate and the legal challenges (and opportunities) they bring.

Restructuring and in-house sales processes (or sometimes fire sales!)

Financial stresses often force managers to confront the reality that, while the core business may be sound and worthy of management resources, some of company’s other activities can only be seen as ancillary. Such non-core business, in the stark light of the current downturn, may be not only a drain of capital and management resources, but potentially so onerous as to jeopardize the very survival of the core business. In such case, divesting the non-core business may be the only option. By controlling the sales process, the seller is best placed to package and properly separate the non-core business from other operations.

Buyers of a such a business need to take care to manage the (elevated) risks involved in the acquisition:

- Possible insolvency claw-back

If the seller, in spite of the sale, succumbs to insolvency after the transaction, it is likely that the receiver will review the terms carefully (i.e. for transactions voidable because they were made at an undervalue or unlawfully preferred one group of creditors over another). If the receiver concludes that creditors were prejudiced by the transaction and that it contributed to the insolvency, the transaction may be called into question and be subject to claw-backs.

Claw-backs (which depend on a court ruling) could potentially entail that the buyer is forced to “return” acquired business assets and that investments made by the buyer in the business after the acquisition may be lost. This might result in the buyer obtaining claims against the seller (e.g. for repayment of the price and possibly also for compensation for investments) but these are likely to have little value as they rank equally with other unsecured creditors in the seller's bankruptcy estate.

In order to manage and minimize this risk, the buyer should ensure, as far as possible through

its own investigations of the seller's financial situation, that the transaction does not involve or contribute to the insolvency of the seller or that the transaction can otherwise be criticized. It is also important that contracts are drafted in such a way as to minimize claw-back risks.

- No warranties

A distressed seller is likely to sell on the basis of no warranties or very limited warranty cover only. And the value of any warranties given must be discounted for the solvency risk of the seller.

The buyer must therefore rely more heavily on its own due diligence (even more than in the case of a "normal" transaction). This may prove to be a challenge given the rapid pace of distressed transactions (see below).

Whilst it can be more challenging to find warranty insurance cover for situations with a distressed seller, we have seen some insurance markets willing to consider providing limited coverage even in these situations. Buyers would do well to explore the possibilities that insurance solutions can offer.

- Conditions to closing

If the transaction must be cleared by competition authorities (or completion for other reasons is subject to other conditions), completion will be left hanging until the condition has been fulfilled.

If the seller is declared bankrupt after signing the contract but before closing, completion of the transaction will be subject to the receiver deciding to carry out the transaction.

Given the buyer's strong interest in carrying out the transaction once the contract has been signed, and taking into account the costs that the buyer has incurred in carrying out the transaction, there is a clear risk that a receiver will realize that there is scope to achieve better terms and therefore attempt to renegotiate the transaction.

- High transaction tempo

While a traditional M&A process is normally handled over a period of three to four months from the distribution of marketing materials until the deal is completed, transactions in a distressed environment must be executed much faster, from a matter of days to a few weeks, depending on complexity and circumstances.

This not only places particularly high demands on the responsiveness and availability of the parties involved in the process, but also on financial and legal advisers having sufficient experience to help make the right decisions under pressure.

- Legal title and delivery of assets

Where the seller is in default or otherwise vulnerable to an insolvency situation, it is important that the buyer ensures that the assets that are the subject of the acquisition have been removed from the seller's possession before (or at the latest in connection with) the payment of the purchase price. Should bankruptcy occur after the buyer has paid but before the buyer has taken possession of the assets, there is risk that the buyer will not actually be able to take control of the assets and gain unencumbered title.

Discharge of security

If the seller is in breach of its covenants to financing banks, the bank's security rights may have crystalized and it may hold pledges or other security on the seller's assets, such as shares in subsidiaries. Vested security entails that the bank has the right to sell pledged assets and to be repaid from the proceeds. In such transactions, in addition to the above, it is important to consider the following:

- Since the bank is selling in the name of the borrower under a power of attorney granted by the borrower, a buyer must carefully check the pledge agreement and other documentation relating to the bank's authority to execute the transaction.
- In reviewing the pledge agreement and related documentation, it is also important for the buyer to examine whether the bank's right to sell the pledged assets is conditional or limited and to what extent any conditions are satisfied, or limitations apply.
- Since the bank is selling the pledged assets under a power of attorney as described above, it will not be able to give customary representations and warranties.
- As the borrower is unlikely to be cooperative in a forced sale, due diligence is likely to be severely limited. It usually only comprises information available to the bank.
- It is common for companies to cross-guarantee commitments and collateral for the obligations of other group companies vis-à-vis banks. It is therefore crucial that the bank agrees to release the target company from any other obligations. A buyer should also confirm that the sale of the target company in the context of a forced sale effectively extinguishes any claims and other requirements that the borrower or its affiliates might have against the target company. This helps create a firewall against any subsequent claims from other members of the borrower's group or their receivers in bankruptcy.

"Pre-pack" proceedings

Sometimes, a seller is clearly not going to make it through a financial crisis and bankruptcy is a foregone conclusion. To help limit the loss of value that results from bankruptcy, many legal systems – but not Sweden's – have a statutory procedure whereby the assets of a crisis-hit company can be packaged for sale prior to the opening of insolvency proceedings, with the help of an "administrator" or official receiver (appointed by a court in some jurisdictions). The procedure, usually referred to as "pre-pack", normally involves a pre-approved sale immediately after the formal insolvency proceedings have been opened.

The starting point for carrying out such a procedure is that it must be possible to sell the business as a "going concern", which can bring about a higher value and thus enhance the return to creditors, reduce the negative impact of bankruptcy proceedings on the business and help save jobs, compared with the sale of the business by the bankruptcy estate, and which often entails that the assets are not (or cannot be) sold as a cohesive pool.

Although there is no statutory framework for pre-pack sales in Sweden, it is possible to achieve a similar result within the framework of Swedish bankruptcy law. This essentially involves the following steps:

- The seller begins preparation for the sale of a business and enters into negotiations with potential buyers to obtain indicative bids.
- The company's key stakeholders, such as landlords, banks, key customers and suppliers who will primarily be affected by a sale, are involved early in the sales process to win support for the rapid sale of the business.

- The seller and interested parties contact a prospective receiver and report on the company's financial situation, as well as the financial outcomes of the proposed transaction vs a traditional insolvency sales process.
- Once a final acquisition candidate has been selected, the seller negotiates a purchase agreement with the terms of the transfer of the business.
- The execution of the transaction is conditional on the seller being declared bankrupt and the receiver approving the transaction by acceding to the transfer agreements.
- The seller is declared bankrupt and the receiver is appointed. It is worth pointing out that the district court, after hearing the supervisory authority, must approve the proposed receiver. If a receiver other than the one proposed by the seller is appointed, this would likely delay the sale under the prepared plan, since it can only be executed once the appointed receiver has been able to familiarize him- or herself with the financial situation and the sales process carried out.
- Once the seller is declared bankrupt, the transaction is completed by the bankruptcy estate as soon as possible thereafter.

One advantage of a pre-pack for the buyer is that the transaction is carried out in agreement with the receiver, which removes the concern about the transaction being unwound. Another important advantage is that the business can continue to operate without the disruption that normally accompanies a formal bankruptcy. Especially in terms of communication, it is a great advantage in relation to employees, customers, suppliers and other stakeholders to be able to announce the buyer's takeover of the business and its intention to continue operations immediately following the declaration of bankruptcy.

For the receiver, it is important that the he or she can get comfortable concluding that the pre-pack outcome is more advantageous for creditors compared to a traditional bankruptcy auction, by obtaining detailed modelling on the financial terms of the transaction . If it emerges after a sale that a traditional liquidation auction of the business would have delivered greater value and a better outcome for creditors, the receiver risks criticism and, in the worst case, liability for damages suffered by aggrieved creditors. It is therefore absolutely crucial for the sales process to be well-prepared and executed in a well-structured and professional manner with the help of experienced financial and legal advisors, so that the receiver feels comfortable to proceed quickly with the “pre-pack” transaction once appointed, and can subsequently account for his or her assessments and defend the transaction.

One of the most successful recent examples of the application of an unofficial pre-pack procedure in Sweden is the sale of Ving group to Petter Stordalen/Strawberry Equities, Altor and TDR Capital in autumn 2019, where Törngren Magnell advised the Ving group and its previous owner Thomas Cook. The pre-pack procedure was a prerequisite for the implementation of the deal, mainly because a central part of the business involved an airline, which meant that a bankruptcy would entail an interruption in the business which in effect would prevent a continuation of the business after the bankruptcy.

Törngren Magnell – Extensive M&A and insolvency expertise

Törngren Magnell has extensive experience in the sale and purchase of companies and businesses, both in the context of traditional auction processes and distressed M&A. Our senior lawyers have extensive experience in bankruptcies, liquidation, reconstructions and other insolvency situations. We are uniquely situated to advise the boards of companies under financial strain, particularly now in the Corona crisis, to take the decisive action necessary to deal with these situations.