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STRATEGIES FOR PRIVATE EQUITY INVESTING IN A DISTRESSED ENVIRONMENT

To Our Clients and Friends:

"In a crisis, be aware of the danger--but recognize the opportunity." – John F. Kennedy. As the tragic and unprecedented consequences of the COVID-19 pandemic have demonstrated, we are certainly experiencing a crisis.

For private equity funds, the current environment—while providing unprecedented challenges for many portfolio companies—will also provide some unique investment opportunities to acquire both distressed assets and assets of distressed sellers.

In a distressed context, there are four principal strategies to achieve ownership:

- a negotiated distressed sale conducted outside of a formal insolvency process,
- a negotiated sale through a pre-packaged insolvency procedure, such as a scheme of arrangement,
- a purchase out of a judicial insolvency process, such as a scheme of arrangement, administration or liquidation, and
- a loan to own strategic purchase of debt with a view to obtaining control.

This article discusses these strategies below, and introduces the key issues, opportunities and obstacles associated with each of them.

Negotiated Deals

The path of a negotiated distressed acquisition will, in large part, necessarily be determined by the extent of the distress. For example, the company's ability to meet impending debt service obligations, its compliance with financial covenants and other debt financing obligations, liquidity and whether the company is actually or about to become insolvent, will all impact the timing and nature of the transaction. The more the process is rushed to meet fixed deadlines, the less likely potential investors will be able to conduct full due diligence, although key risks still need to be assessed such as termination rights on a change of control for material contracts.

The identity of the distressed parties is also obviously critical -- is it the seller which is distressed, the target or both? Where the seller is in financial distress, the lack of typical warranty protection should be considered as any warranties given by the seller will likely be of little real value. In this context, both warranty and indemnity insurance and escrow arrangements should be considered. Depending on the level of distress and the distressed seller's need for liquidity, it may not, however, accept significant holdbacks through escrow arrangements.

Furthermore, in the context of a distressed seller, buyers must also consider the risk that the transaction is vulnerable to challenge as an unlawful preference, fraudulent conveyance, a transaction at an undervalue or analogous equitable challenge, depending on the jurisdiction. In this context, where the asset has a market value, ensuring that the price paid was at least the market value and otherwise the best price reasonably obtainable by the seller for the asset at the time of the sale in the prevailing market conditions and other relevant circumstances should mitigate this risk. Methods most often used to evidence this by a seller include running a competitive sale process and/or obtaining a fairness opinion from a financial advisor. Also to the extent that there are business separation issues where the target will need transitional support and/or services from the seller, buyers again need to be mindful of this where the seller is in financial distress. This is because the seller may no longer exist to provide such support or services following the closing of the deal.

Financing acquisitions with debt in the current environment will be challenging. However, where the proceeds of the sale are insufficient to repay the target's lenders in full, they may be prepared to 'roll their debt' into a new structure where the private equity sponsor is providing additional liquidity that enhances their chances of maximizing recovery. A debt roll will usually require the consent of all of the existing lenders. However, the availability of this approach turns very much on the drafting of the relevant debt documents. There may be creative alternatives around any obstacles presented by the debt documents such as structural adjustments (where certain otherwise unanimous lender matters have a lower approval threshold) and yank-the-bank provisions (entitling the borrower to prepay or replace at par a non-consenting lender). In addition to the foregoing there may be alternative levers to pull such as the threat of a covenant strip to bring hold-outs into line. Failing this, it may be possible, subject to achieving the relevant thresholds (typically 75% or more in value and a majority in number of the lenders), to use an insolvency process such as a scheme of arrangement to compel all of the existing lenders to roll the debt into a new structure.

Pre-Packaged Insolvency Sale

A pre-packaged insolvency sale involves the target company's creditors agreeing on a plan to sell the company or its assets and then immediately filing the plan with the relevant bankruptcy court in order to implement it. The availability of pre-packaged insolvency sales and the applicable rules vary from jurisdiction to jurisdiction. However, they typically have the following characteristics:

- there is no risk of a challenge to the transaction as a preference or a transaction at an undervalue,
- it is a negotiated sale process where the sale will be pre-agreed with the administrator and any due diligence will need to be carried out before the pre-pack is implemented,
- the sale can be effected as a sale of shares or of key assets,
- there will be no transitional support or services from the seller,

- insolvency lawyers will need to be involved early in the process, and
- junior creditors may or may not be able to prevent the insolvency procedure depending on where the value breaks (that is, if the value from the sale is such that there would be insufficient proceeds to repay any class of creditors, that class will be 'out of the money' and unable to block the process – however they may seek to dispute the valuation).

The timing for the process will depend on the rules for the relevant insolvency procedure. As such, an important threshold question is whether the company either has sufficient liquidity during this process or is able to obtain additional financing.

It is also worth noting that some governments (including the United Kingdom and Australia) have in the last week proposed temporary changes to certain relevant insolvency related laws to allow, among other things, directors of a company to continue trading without incurring liability for wrongful/insolvent trading. If adopted, these modifications would presumably lessen the urgency directors in such jurisdictions may feel to sell assets or the whole company to address a downturn in the company's performance or liquidity. This may, in turn, slow down any discussions with creditors and private equity investors about pursuing a pre-packaged insolvency sale or other alternative.

Fire Sale

Where a company is already in a formal insolvency process, there may be an opportunity to purchase the assets from the relevant provisional liquidator or similar insolvency professional. Insolvency procedures are generally seen as value destructive to the business as key contracts will typically automatically terminate and goodwill is eroded. As with a pre-packaged sale, the applicable rules and procedures vary from jurisdiction to jurisdiction. There is no risk of challenge to the transaction as a preference or a transaction at an undervalue. Timing will often be driven by the pace of value deterioration of the business.

Loan to Own

Loan to own strategies involve investors acquiring secured debt of the target at a discount to par with a plan to convert the debt to equity either consensually, through a security enforcement (if all stakeholders agree), or through a formal insolvency procedure which binds all creditors and removes any risk of a challenge to the transaction as a preference or transaction at an undervalue. There will be essentially no diligence in these transactions other than publicly available information and information which has been provided to the lenders under the financing documents.

In the loan to own context, understanding the capital structure of the target company and the terms of its debt financing, including the rights of each class of creditors, is critical to identifying a clear path to obtain the desired level of equity interest through the financing documents. This is so regardless of whether there will be a security enforcement or formal insolvency procedure. Key items in this analysis include voting thresholds, the terms of any intercreditor agreement and who can direct enforcement and the rights to release the claims of other creditors under guarantees and security.

Prior to acquiring the secured debt of a target company, loan to own investors will have formed a view as to what constitutes the 'fulcrum credit'. The 'fulcrum credit' is the amount and type of debt most likely to be converted into equity through the process. Such investors will frequently seek to acquire -- either alone or together with investors pursuing similar strategies -- a blocking stake in the fulcrum credit so that its vote is required to be obtained in connection with any decisions to be made under the financing documentation. They will also want to understand the creditor composition. Understanding the creditor composition is important because lenders in the same class of debt frequently have different interests. For example, a lender who was an original lender and made the loan at par will have a very different view on what would be a positive outcome compared to a lender who acquired the debt in the secondary market at a deep discount to par, say, 20 cents on the dollar. Similarly, the interests of lenders will vary if they are hedging counterparties with the debtor or they also have debt at other levels of the capital structure. For example, where the value breaks in the senior debt (i.e., there is insufficient value to repay the senior lenders in full), a lender with a small position in the senior debt may want to try to block an enforcement of the debt security if it has a much larger position in a junior class of the debt which is 'out of the money' in the hope that the business will improve over time.

The timing of loan to own transactions is very much deal specific.

Conclusion

While the circumstances occasioned by the COVID-19 virus have resulted in crisis, the crisis may give rise to opportunities to assist ailing businesses through the distressed investment and acquisition frameworks described above. The issues raised in any distressed acquisition are myriad and complex. However, the methods used are tried and tested. The key points investors must keep in mind when determining the path most likely to succeed include, among other things, the following:

-control of process;

-timing and extent of remaining business liquidity;

-structure of financing, composition of creditors and detailed terms;

-structure of proposed investment, whether statutory or asset sale;

-publicity and public perception; and

-scope of transaction and whether liabilities are comprehensively resolved.

As such, investors would do well to communicate with counsel early in the process to assist in analyzing the best path forward.

Gibson Dunn's lawyers are available to assist with any questions you may have regarding developments related to the COVID-19 pandemic. For additional information, please contact any *member of the firm's Coronavirus (COVID-19) Response Team, the Gibson Dunn lawyer with whom you usually work in the firm's Global Finance or Private Equity practice groups, or the authors in Hong Kong:*

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