CORPORATE
COVID-19 IN ASIA

# Coronavirus: Private equity investing in a distressed environment

Gibson Dunn partners shed light on the various paths for turning acquisition opportunities into closed deals

For private equity funds, the current Covid-19 pandemic – while providing unprecedented challenges for many portfolio companies – will also present some unique investment opportunities to invest in distressed businesses.

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 as a path to obtaining control.

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

1 MINUTE READ

**The Covid-19 pandemic has resulted in severe economic dislocation in Asia and worldwide. In this article, Gibson Dunn lawyers examine various strategies that investors may employ to assist companies in distress, and at the same time deploy capital smartly to make opportunistic investments in this time of crisis.**

## Negotiated deals

A negotiated distressed acquisition is exactly what it sounds like: a freely negotiated acquisition that requires the agreement of all stakeholders. It is typically characterised by the entire process remaining outside any statutory insolvency procedure. The course of a negotiated distressed acquisition is largely 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 solvency, will impact the timing and nature of the transaction.

The identity of the distressed parties is critical -- is it the seller which is distressed, the target, or both? Where the seller is in financial distress, the ability to diligence the target can be problematic because of timing

**In the loan-to-own context, understanding the capital structure of the target company and the terms of its debt financing is critical**

pressures or want of access. Beyond diligence, the lack of typical warranty protection should be considered, as any warranties given by the seller will likely be of little real value, therefore, both warranty and indemnity insurance and escrow arrangements should be considered. A further question is whether transitional support and/or service arrangements are required from the seller. Buyers should be mindful of this point because the seller may no longer exist to provide such support or services following the closing of the deal.

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. 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, taking into account 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.

Financing acquisitions with debt in the current environment will be challenging. However, if proceeds of the sale are insufficient to repay the target's lenders, they may be prepared to 'roll their debt' into a new structure when the private equity sponsor is providing additional liquidity. A debt roll usually requires the consent of all of the existing lenders. However, the availability of this approach depends on the drafting of the relevant debt documents. There may be creative alternatives to 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, there may be alternative approaches such as the threat of a covenant strip to bring holdouts into line.

## Prepackaged insolvency sale

A prepackaged insolvency sale involves the target company's creditors agreeing on a plan to sell the company or its assets, then immediately filing the plan with the relevant bankruptcy court to implement it. Such a process can often be used as an alternative to a negotiated deal as – subject to obtaining the relevant thresholds – it is possible to cram down holdout creditors who could block a negotiated deal. The availability of pre-packaged insolvency sales and the applicable rules vary from jurisdiction to jurisdiction. However, they typically have the following characteristics:

- no risk of a challenge to the transaction as a preference or a transaction at an undervalue;
- a negotiated sale process that is pre-agreed with the administrator, and any due diligence will need to be carried out before the prepack is implemented;
- the sale can take the form of a sale of shares or of key assets;
- no transitional support or services from the seller is required;
- insolvency lawyers are 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.

Timing for the process will depend on the rules for the relevant insolvency procedure. As such, a critical threshold question is whether the company has sufficient liquidity during this process or is able to obtain additional financing.

It is also worth noting that recently, some governments (including the UK and Australia) have proposed temporary changes to insolvency-related legislation to allow, among other things, directors of a company to continue trading without incurring liability for wrongful/insolvent trading. If adopted, these modifications would reduce pressure on directors to sell assets or the whole company to address a downturn in the company's performance or liquidity. This may, in turn, slow down discussions with creditors and private equity investors about pursuing a prepackaged insolvency sale or other approach.

## 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 prepackaged sale, the applicable rules and procedures vary by 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.

**While the circumstances occasioned by the Covid-19 virus have resulted in crisis, the crisis may give rise to opportunities**

## Loan-to-own

Loan-to-own strategies involve investors acquiring the 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

**Lenders in the same class of debt frequently have different interests**

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 is typically 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 is critical to identifying a strategy for obtaining desired levels of equity through the financing documents. This is the case 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 need to identify the 'fulcrum credit': 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 – which is important because lenders in the same class of debt frequently have different interests. For example, an original lender who funded the loan at par will have a 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. Similarly, the interests of lenders will vary if they are hedging counterparties with the debtor, or if they are creditors at another level of the capital structure. For example, if value breaks in the senior debt, a lender with a small position in the senior debt may want to try to block 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.

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, but the methods are tried and tested. The key points investors must keep in mind when determining the path most likely to succeed include but are not limited to:

- 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
- the scope of the transaction and whether liabilities are comprehensively resolved.

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