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Dealmaking in a Distressed Environment

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Editor's Note: David A. Katz is a partner at Wachtell, Lipton, Rosen & Katz specializing in the areas of mergers and acquisitions and complex securities transactions. This post is based on the introduction of a Wachtell Litpon publication, titled "Dealmaking in a Distressed Environment;" the full publication is available here.

The topic of this outline is mergers and acquisitions where the target company is "distressed." Distress for these purposes generally means that a company is having difficulty dealing with its liabilities—whether in making required payments on borrowed money, obtaining or paying down trade credit, addressing debt covenant breaches, or raising additional debt to address funding needs.

Distressed companies can represent attractive acquisition targets. Their stock and their debt often trade at prices reflecting the difficulties they face, and they may be under pressure to sell assets or securities quickly to raise capital or pay down debt. Accordingly, prospective acquirors may have an opportunity to acquire attractive assets or securities at a discount. This outline considers how best to acquire a distressed company from every possible point of entry, whether that consists of buying existing or newly-issued stock, merging with the target, buying assets, or buying existing debt in the hope that it converts into ownership.

Some modestly distressed companies require a mere "band-aid" (such as a temporary waiver of a financial maintenance covenant when the macroeconomy has led to a temporary decline in earnings, but the company is able to meet all of its obligations as they come due). Others require "major surgery" (as where the company is fundamentally over-levered and must radically reduce debt).

Before discussing the law and practice of distressed acquisitions, we undertake a review of corporate responses to debt crises. Each response can represent an entry point for a would-be acquiror, and a basic understanding of how companies first respond to distress is necessary for an acquiror. Part I.A of this outline therefore considers the fundamentals of forbearance agreements, waivers and amendments of bank and bond debt, the mildest of corporate responses to distress. When the measures described in Part I.A are unavailing, a non-bankruptcy solution may still be available if the financially distressed company takes other measures, which are covered in Part I.B. These often involve a dilution or change in the equityholders' control of the distressed company or its assets, and thus may provide opportunities for a potential investor to acquire interests in, assets from, or ownership of, the distressed company. Examples include sales of assets, PIPE investments, rights offerings, debt repurchases or restructurings, exchange offers, and foreclosure sales. Dealing with a company in this stage, however, entails numerous risks for an investor. Part I.B, therefore, highlights potential benefits and risks of working with a distressed company on the verge of bankruptcy, as well as some methods that can be used to avoid these risks and capture those benefits.

Out-of-court transactions like those described in Part I.B tend to be less costly and time-consuming than in-court transactions, but they often require shareholder approval or creditor consensus—and non-consenting parties typically cannot be bound against their will to changes in their fundamental rights (e.g., a reduction of principal or interest on or an extension of maturity of an obligation owed to a creditor).

By contrast, a transaction executed pursuant to the United States Bankruptcy Code can bind non-consenting parties and does not require shareholder approval. Therefore, in-court solutions are often imperative for firms experiencing acute distress.

Hybrid approaches such as "prepackaged" and "pre-negotiated" reorganization plans are discussed in Part II of this outline. These plans are appropriate for troubled companies with sufficient lead time before they are in acute distress to engage in out-of-court bargaining prior to offering in-court solutions. They tend to result in cheaper, faster, less confrontational bankruptcies with less collateral damage (less impact on trade credit terms, less risk of outright loss of suppliers, less reputational harm with customers, fewer employee defections, etc.). Sometimes the mere fact that a borrower is prepared to file bankruptcy brings dissenting creditors into line and makes a fully out-of-court solution possible.

Part III of this outline considers acquisitions of companies in and through bankruptcy. Asset sales in bankruptcy—addressed in Part III.A—may be consummated pursuant to section 363 of the Bankruptcy Code on an expedited basis. Such sales (commonly referred to as "363 sales") had traditionally been disfavored where the assets to be sold constituted a significant portion of a bankrupt company's business and time was not of the essence. This general rule has frayed as several large debtors have been allowed to sell substantially all of their assets despite having a lengthy liquidity runway, and major 363 sales are now quite common. Another alternative is the acquisition of a bankrupt company, or a significant portion thereof, by either creditors or outside investors through implementation of a reorganization plan, which is addressed in Part III.B.

Part IV of this outline addresses specific considerations regarding trading in claims against distressed companies. Claims trading can be a strategy for obtaining control (e.g., by buying claims that will receive ownership of the restructured company under a plan of reorganization or that can be used as consideration in a 363 sale) or an investment opportunity for the trader with a shorter-term horizon. For either class of investor, trading claims is fraught with risks and opportunities that generally do not exist for acquirors of claims against non-distressed companies.

Regardless of an investor's ultimate point of entry, it will not surprise the reader that we believe a good first step when considering a transaction with a distressed company is to hire counsel familiar with the process. Counsel will be able to review all relevant documentation, verify that collateral has been properly secured and perfected (or not), expose vulnerabilities, find opportunities, and safeguard against undue risk.

The full publication is available here.