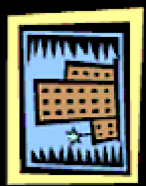
CLARK WILSON LLP
BC's Law Firm for Business



Business Matters

SLOWING ECONOMY AND TIGHTER LENDING STANDARDS PRESENTS OPPORTUNITIES AND CHALLENGES

BUYING AND SELLING FINANCIALLY DISTRESSED BUSINESSES

By Shauna Towriss

Newspaper headlines have recently declared that Canada has managed to avoid a technical recession, but there is no doubt that 2008 has seen a slowing of the Canadian economy and recent world-wide financial turmoil likely means that 2009 will not be much better. After years of fast-paced growth and ready access to financing on favourable terms, experts are predicting that the effect of the global "credit crisis" will materialize in Canada and B.C. in the form of an increased number of M & A transactions involving financially distressed targets. Specifically, as a result of banks tightening their lending standards and credit spreads and reducing their exposure in certain industries, over-leveraged companies may begin to find it challenging to secure credit on manageable terms. These and other financial constraints may threaten enterprise viability and make insolvency an unfortunate reality for such companies.

During past economic downturns, complicated restructurings and liquidations were par for the course. However, the current indicators are that distressed sales will become the preferred deal structure for addressing the problems facing financially troubled companies. Distressed M & A transactions involve the management-led sale of a financially troubled company as a going concern. The exact structure of the transaction may take a variety of forms, but the primary consideration for both the distressed company and any potential acquiror will be timing. An early and focussed strategy is critical not only for a distressed business to maximize recovery value but also for potential acquirors to gain advantage over other bidders. Given the importance of timing, it is crucial for both parties to understand the key factors set out below when considering the purchase and sale of a financially distressed enterprise.

Understanding the Distressed Company's Situation and Assessing Value

The first step in any distressed purchase and sale transaction is to assess the financially troubled company's situation and to determine how long it will be able to continue operating as a viable business. Distressed companies typically find themselves in a broken balance sheet scenario or a cash burn situation. Potential acquirors are usually most interested in the former, because the company is generating cash flow but suffering from being over-leveraged. This usually means that the purchase and sale can be closed quickly and in a fairly straightforward manner. Although timeliness is still essential, this situation is usually more time-flexible with respect to completing the transaction than is the case where there is a cash burn issue. When the distressed company is bleeding cash, in order to maintain the business as a going concern and to create the breathing room necessary to complete a sale transaction with a potential acquiror, the existing management or corporate recovery team must focus on stabilizing operations, conserving cash and communicating with all key stakeholders.

Of course, while liquidation is an option for a financially troubled company, it is typically the sale of all or portions of the business as a going concern that will maximize value for all constituents – particularly where shutting down and liquidating the business could give rise to costly contingent liabilities (i.e. pension obligations etc.).

Setting Expectations and Communicating with Key Constituents

By definition, distressed companies produce infighting and competition for leverage among the various stakeholders groups, each of which is seeking to maximize its recovery value in any sale of the distressed business. However, the expedited time frame of a typical distressed sale, the divergent views among the stakeholder groups regarding how to maximize value and the substantial influence some stakeholders will wield over the structure of any final deal means that the management of the distressed company must determine key stakeholders and assess their viewpoints as early on in the process as possible. Opening dialogue among the interested parties early on will make it possible to manage expectations of the key stakeholders and to optimize outcomes. Such key stakeholders may include the company's employees, customers, landlords, trade creditors, senior and junior lenders, bondholders, shareholders and directors/management.

Management of a financially troubled company should be also mindful that in certain instances, creditor cooperation may be essential where the company is burdened by large or complicated debts, while in other cases, customer or trade creditor cooperation may prove critical where a particular customer base or industry segment is important to maintaining business value. In a distressed sale, management and existing shareholders will likely lose their current level control, so those involved in structuring a distressed sale should be prepared for difficult conversations and negotiations with those stakeholders.

Conducting a Successful Sale Process

Another important factor in successful distressed sale transactions is running the right sale process. Maximizing realizable value for all stakeholders, including the potential acquiror, means that management of the distressed company must consider all available information and stakeholder interests. The due diligence process will be important on both sides of the transaction, but distressed businesses should be aware that permitting too many interested parties to "kick the tires" of the company may consume too much of management's valuable time. Focus and speed are essential to both the marketing and the buyer due diligence processes. The distressed company and its turnaround team should ensure that requisite regulatory approvals are obtained and that legal and tax advisors are in place early on to advise on the appropriate process and deal structure. Among other things, both the distressed company and the potential acquiror will need to consider the extent of liquidity in the business, the nature and terms of financial contracts and the willingness of senior secured lenders to support any ultimate deal. The parties must also focus on structuring the transaction to maximize value, including value to be gleaned from potential tax losses and adhering to a fair transparent sales process that will withstand stakeholder challenges.

Unique Considerations for the Selling Company and Potential Acquirors

The Distressed Company

Strategy is key for sellers of a distressed company. With very little time or negotiating leverage, the focus must be on maximizing value and generating sufficient interest from potential acquirors in order to be able to actualize that value. Management must make a thorough assessment of the distressed company's circumstances and a variety of strategic alternatives must be considered, from reducing the number of employees and selling off non-core assets to restructuring existing equity and helping acquirors realize tax advantageous deal structures. Compiling relevant documents into a comprehensive due diligence package will also assist the turnaround team to hit the ground running when potential acquirors come knocking.

Additionally, as noted above, management should not waste time entertaining potential acquirors who are not serious about getting a deal done. This will be a decision for management to make, but conflicts of interest, financial capacity and reputability of any potential acquiror will be key considerations for management and the company's legal and tax advisors.

Potential Acquirors

Potential acquirors will want to maximize their negotiating leverage over the financially distressed company to limit risk and obtain a favourable purchase price, but even a strong negotiating position will not avoid the inherent challenges of an accelerated deal time frame and a truncated due diligence process. These two challenges mean that (a) the potential acquiror has less time than in a regular acquisition to assess the distressed business and its risks and opportunities and (b) the distressed sale will likely occur on an "as is, where is" basis. However, there are a number of risk management strategies, such as holdbacks and certain court orders and other processes that the potential acquiror and its legal and tax advisors can utilize to reduce risk.

Conclusion

With credit markets reverting to a point where lenders are seeking more conservative risk/reward equations, the availability of affordable credit or refinancing opportunities for overleveraged companies is going to be restricted. Some companies may become financially distressed and be forced to seek strategic alternatives such as restructurings and distressed sales of their business. Of course, if done effectively, this gives stakeholders an opportunity to rescue some value, while at the same time providing a fruitful opportunity for potential acquirors who can afford to act quickly and assume some risk.

With parties operating with imperfect information and within constrained time frames, the success of any approach will depend on the creativity, experience, speed and pragmatism of the parties structuring the distressed M & A deal. Some stakeholders will have no choice but to 'take a haircut' and accept less than full value for their interest in the distressed company. Nevertheless, with strategic and timely decisions by both the sellers of the distressed company and the potential acquiror, the parties may be able to rescue a significant amount of the value of the company, thereby preserving the goodwill and the enterprise value of the company, and likely creating greater value for stakeholders than would have been achieved in a liquidation scenario.

How Can We Help?

Whether you are a distressed company, or a potential acquiror of a distressed company, our **M & A Group** is ready to advise and guide you through the challenges and opportunities associated with distressed purchase and sale transactions. Contact **Aaron Singer** at 604.643.3108 or **Shauna Towriss** at 604.891.7749 to find out more about how Clark Wilson can help you craft your plan and strategy in a timely and creative manner.

Shauna Towriss
604.891.7749
skt@cwilson.com

This article was originally published in the September 2008 edition of Clark Wilson LLP's Business Matters *newsletter*, available at: www.cwilson.com/newsletters/bmatters/bm-sep08.htm