

# COVID-19

## How to participate in a distressed M&A environment

May 2020

Thank you for attending our recent seminar on **How to participate in a distressed M&A environment**. As a takeaway, please find below some key considerations to keep in mind as you move forward through the various stages. Should you have any questions, please do not hesitate to contact a member of the team below.

### Key considerations

#### Restructuring and Insolvency

- Engage your team early, and make sure an insolvency professional is on that team. An insolvency lawyer is not always going to recommend a court process, but they will have expertise in ways to structure a deal that may make the outcome more attractive to a buyer or seller client.
- Find ways to control the process. From the seller's side, that means try to use a debtor-in-possession process. From the buyer's side, there are many potential avenues, including buying legacy debt, providing interim financing, being the stalking horse bidder, and entering into a restructuring support agreement or other agreement to bind the buyer to transact with you.

#### M&A

- From the seller's side, remember that process is key to discharge your fiduciary obligations in a change of control scenario. This may include taking early steps to establish an independent committee, retain financial and legal advisors, canvass the market, engage with your key stakeholders and continue to actively monitor and evaluate the situation.
- Engaging your team early will provide purchasers with the dexterity and efficiency needed to move or pivot quickly and carefully in a distressed M&A environment.
- Due diligence preparedness will be key to speed and efficiency. Sellers should understand what the due diligence "pressure points" may be and consider whether any steps can be taken ahead of time to address potential gating issues.
- Purchasers should not underestimate the importance of due diligence to evaluate the real performance of the target, review up-to-date information, uncover potential upsides and other benefits, and navigate and quantify risks.

## Tax considerations

Two primary sets of tax considerations in the sale or purchase of a distressed company are (1) the deductibility of the target's tax losses post-acquisition, and (2) the application of the debt forgiveness rules to any required debt restructuring.

### Tax Loss Considerations

- **Loss Deductibility:** When a company undergoes a change of control or other "loss restriction event", its ability to deduct its tax losses from future income becomes restricted. Following a loss restriction event, a company can only deduct its non-capital losses from the business that gave rise to the losses or a similar business (the "same or similar business" rule), provided that the business that gave rise to the losses continued to be carried on from the time the losses arose. Accordingly, purchasers of distressed corporations with existing loss pools need to carefully consider whether the target's business ceased to be carried on, and whether the continued business of the target is sufficiently similar to the purchaser's business to enable its losses to be deducted against the income of the purchaser's business following a business consolidation. In rare cases, it may be possible to structure an acquisition, so as not to result in a loss-restriction event.
- **Bankruptcy and Creditor Protection:** When a company declares bankruptcy and receives an absolute order of discharge, its tax losses are no longer available to be carried forward and deducted against future income. However, the losses of a company under creditor protection that has not received such an order may still be able to be deducted from future income, subject to the above same or similar business test.
- **Loss "Consolidation":** In some circumstances, purchasers may be able to acquire a company with and "shift" the losses another related company without undergoing a business consolidation. This approach will generally take longer to utilize all the losses, but will still allow a purchaser to utilize the losses in another business while the acquired business is nurtured back or restructured to profitability.

### Debt Restructuring Considerations

- **Debt Forgiveness:** When a company undergoes a debt restructuring process (including accounts payable), the debt restructuring may give rise to "debt forgiveness" under the Income Tax Act. If the restructuring results in the company being deemed to realize a "forgiven amount", this amount will first be mandatorily applied to reduce its tax loss pools, and then on an elective basis, to reduce its undepreciated capital cost (UCC) pools of its depreciable property, resource pools and adjusted cost base of its capital property. One half of any remaining balance of the forgiven amounts is included in the company's taxable income. Purchasers will need to consider whether the debt forgiveness rules will reduce the value of various tax attributes of a target, or result in taxable income – and whether it might be beneficial to preserve tax pools that can be deducted from future income at a rate of 100% at the cost of recognizing a current income inclusion at a rate of 50%. In some cases, it may be possible and beneficial to convert non-capital tax loss pools into elective UCC pools or realize latent capital losses prior to a debt restructuring – in order to maximize the current deductions available after the application of the debt forgiveness rules.
- **Intercompany Debts:** Careful planning can be undertaken to ensure that certain intercompany debts of a target will not result in a "forgiven amount" under the debt forgiveness rules.
- **Account Receivables:** Purchasers should consider whether various account receivables of a distressed target can be converted into losses through the application of the doubtful and bad debt rules in the Income Tax Act.
- **US Denominated Debt:** Purchaser should consider whether a foreign currency gain or loss may arise on a restructuring of a target debt denominated in US dollars (or other foreign currency).

## Key contacts:

### M&A



**Nicole Bacsalmasi**  
Partner, Calgary  
D +1 403 268 6854  
nicole.bacsalmasi@dentons.com



**Alex Farcas**  
Partner, Toronto  
D +1 416 863 4515  
alex.farcas@dentons.com



**Scott Rozansky**  
Partner, Montréal  
D +1 514 878 5866  
scott.rozansky@dentons.com

### Restructuring and Insolvency



**Tevia Jeffries**  
Partner, Vancouver  
D +1 604 691 6427  
tevia.jeffries@dentons.com



**David W. Mann, Q.C.**  
Partner, Calgary  
D +1 403 268 7097  
david.mann@dentons.com

### Tax



**Ron Dueck**  
Partner, Vancouver  
D +1 604 443 7106  
ron.dueck@dentons.com

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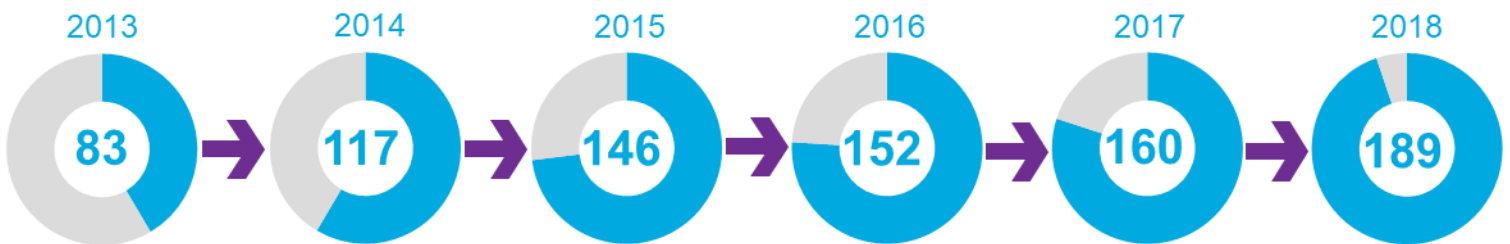


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