Distressed M&A and Downsizing: Opportunities and Pitfalls

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First Panel: The State of Distressed M&A

Moderator: Lynn Harrison III

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Presenting on the State of Distressed M&A

Lynn Harrison
Partner, New York

Audrey Molina
Partner, Paris

John Nelson Chrisman
Partner, Dallas

Dr. Arne Friel
Partner, Berlin

Derek McCombe
Partner, Glasgow

Cristian Fischetti
Partner, Milan

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United States

Speaker: John Nelson Chrisman

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General Market Climate for Distressed M&A in the United States

- US M&A Market Hot. Total number of deals less but value sky high – First half of 2021, saw deals worth US$1.4t (up from US$345b in H1 2020) – almost double the average seen in the five years prior to the pandemic (US$784b)
- Flood of bankruptcies didn't really happen (due to Government intervention) and distressed M&A below market expectations
- However, the number of companies rated B- or lower with a negative outlook by S&P Global is increasing, a signal that distressed companies are out there and may soon look to transact
- SPACs likely to drive market in the next 18 months

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Acquisition Structures in the US

Out of Court

- Asset sales outside bankruptcy court
  - Freedom to structure; Less parties; pick and choose assets & liabilities
  - Less certainty on free & clear of encumbrances; fraudulent conveyance
  - Flexible timetable

In Court

- 363 of the Bankruptcy Code
  - Notice to interested parties and court approval of sale
  - Highest and Best sale – court approved auction
  - 60-90 days
- Chapter 11 Plan of Reorganization (usually for shares instead of assets)
  - Drafting and renegotiating plan, creditor votes, approval by court
  - 2-4 months – driving preapproved plans

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Primary liabilities of directors (Delaware Law)

- Outside of bankruptcy, state law determines directors' duties and liabilities save in respect of securities transactions and disclosure under U.S. federal securities law (Securities Act and Exchange Act)
- Directors owe their duties to the shareholders as a whole when the company is solvent and to the stakeholders as a whole when the company is insolvent. In rare circumstances, a creditor of an insolvent company may assert, on a derivative basis, breach of fiduciary duty claims the company may have against its directors
- Whether the company is solvent or insolvent, directors have the protection of the business judgment rule. Under the business judgment rule, directors are generally insulated from liability for business decisions that were made on an informed basis, in good faith and in the honest belief that the action was taken in the best interests of the company. As the directors' duties are those of loyalty and care, a director will be liable only for conduct that was self-interested, in bad faith or without due care (bearing in mind the significant deference to directors' judgment afforded by the business judgment rule) and resulted in loss of value for the company
- Subject to certain exceptions, directors generally are not personally liable for a company's failure to make timely payments to its creditors and may cause the company to delay payments to creditors if doing so is, as a matter of their business judgment, in the best interests of the company. Directors may favor particular creditors if doing so is, as a matter of their business judgment, in the best interests of the company (subject to certain exceptions)
- A company is not required to file for bankruptcy upon becoming insolvent and a company may file for bankruptcy protection even if it is not insolvent. However, directors may face liability for breach of fiduciary duty if they fail to take appropriate protective action, such as a bankruptcy filing, in the face of creditor enforcement actions such as foreclosure on significant company assets
- Breach of fiduciary claims under state law may be asserted in bankruptcy for the benefit of the creditors of the company.
- Under the laws of certain states, officers and directors may be personally, and even criminally, liable for the failure to pay wages and benefits.

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Recent Developments and Trends in the US

- Rep & Warranty Insurance (synthetic RWI)
- Foreign control issues (under CFIUS)
- Difficulties in due diligence exacerbated
- Timetable for out of court deals - short beyond belief – may drive anti-embarrassment provisions
- Debt for equity and loan to own

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United Kingdom

Speaker: Derek McCombe

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General Market Climate for Distressed M&A in the UK

- One of the surprising features of the pandemic, given the damage it has caused to businesses in many sectors, is how little M&A activity we have seen so far involving distressed or insolvent businesses
- Significant Governmental financial support for corporates – low interest loans, furlough scheme, HMRC
- Suspension / relaxation of certain insolvency principals - winding up petitions, wrongful trading by directors
- Banks are well capitalised and have issued Government guaranteed loans and so are taking less enforcement action
- Distressed / insolvent sales have, so far, frequently been pre-planned or inevitable
- Financial support being phased out and so an increased level of distressed M&A is anticipated as companies face increasing liquidity issues.

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Key Considerations from the Seller and Buyer Perspective in the UK

Seller Considerations	Buyer's Perspective
Directors' duties / wrongful trading Determining likely value Risk of review The need for speed Form of consideration Conditions to completion Limited recourse – W&I insurance Directors' conflicts	Reduced price Availability of cash Transaction Structure – share purchase, business and asset purchase or insolvent acquisition (including through pre-pack administrations) TUPE - employee protections Limited recourse – W&I insurance

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France

Speaker: Audrey Molina

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General Market Climate for Distressed M&A in France

- In France, the measures put in place by the government because of the crisis have blocked a lot of opportunities/targets in distressed M&A, whether in out of court transactions or in insolvency proceedings. However, the difficulties in supply will likely change the game.
- The targets are mainly companies which do not obtain additional financial support from their shareholders or/and their banks in the sector the most impacted by the pandemic such as travel, hospitality and leisure.

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Transaction Structures in place in France

- **Out-of-court**

  To minimize the risk of claims in connection with the sale of a fragile business to a third party acquirer not having a substantial financial basis or a serious project, the seller may consider selling under preventive proceeding, i.e., further to the appointment of an *ad hoc Mandataire* or a conciliator by the President of the court under a confidential proceeding, with the aim of verifying that the project is serious under the Court's supervision

- **Insolvency proceeding**

  Prepack sale and sale plan (sale of assets and activity without the debts)

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Liabilities and Duties of Directors in France

- When the company is insolvent (i.e., it is unable to pay its debts as it becomes due out of available assets, treasury test), the directors have the legal obligation to file for bankruptcy within 45 days

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Germany

Speaker: Arne Friel

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Distressed M&A in Germany

- General Market Conditions for Distressed M&A / Impact of the Pandemic
  - The M&A market is still a sellers' market
  - Distressed transactions for more complex targets provide opportunities
  - Distressed M&As below expectations but climbing
  - Limited impact of pandemic
- Applicable Acquisition Structures
  - Out of court transactions (backed-up by restructuring opinions)
  - Traditional in court transactions: asset deal following special rules
  - Share deals by insolvency plan (without consent of shareholders)
- Primary Liabilities of Directors and Officers in Distressed M&A Context
  - Filing obligation with strict personal liability under civil and criminal law
- Recent Developments and Trends
  - Implementation of a restructuring plan as a new tool for restructurings involving only selected creditors (e.g., finance creditors)

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Italy

Speaker: Cristian Fischetti

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General Market Climate for Distressed M&A in Italy

- Despite the negative impact of COVID-19, in 2020 the M&A market held up to the impact
- Fears of an outbreak of bankruptcy proceedings have been significantly mitigated by several emergency measures
- 2021 registered a significant increase in M&A distressed transactions targeting hotel and leisure facilities
- The sale and purchase of the receivables of the financial creditors *vis-à-vis* target companies is significantly increasing in distressed deals (in particular, unlikely-to-pay exposures)

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Overview of the Pandemic Impact in Italy

- **Value Contraction**: the epidemiological emergency generally slowed down transactions driving a contraction both in terms of deals and overall counter value (€34.5 billion compared to €52.4 billion in 2019)
- **2020 Rebounding**: indeed, data from the 4th quarter of 2020 revealed a deal-making rebounding
- **Deals**: in the first 9 months of 2021, over 800 deals were closed in Italy (+30% against to over 600 in September 2020) for approximately €1 billion, compared to €29 billion last year (+144%)

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Structural Changes in Italy

- **Due diligence importance:** the pandemic increased the importance of the due diligence process regarding target companies (with particular attention paid to key areas such as employment, health and safety, governmental and financial resources, financing)
- **Warranties indemnities and insurance:** as W&I are being used as strategic risk management tools to cover the investments, W&I insurers may request exclusions related to business interruption
- **MAC Clauses:** new breach coverage now generally includes exclusions related to pandemic events

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Primary Liabilities and Duties of Directors in Italy

- **Temporary suspension of recapitalization duties:** the Italian government set out a temporary suspension of the recapitalization provisions (from 8 April 2020 to 31 December 2020). As a consequence, during the same period the winding up of a company due to the reduction below the legal minimum did not apply
- **Sound management**: such temporary suspension does not affect the duties of the management to prevent and manage the distress and the insolvency. Therefore, the directors must promptly assess if the company is facing a distressed situation and eventually consider activating any relevant proceedings aimed at overcoming the crisis

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Recent Developments and Trends in Italy

- As the government starts to phase out support, SMEs may face liquidity challenges
- The postponement of the new Italian insolvency code should facilitate the restructuring and distressed M&A transactions
- Traditional investors may enter transaction involving distressed assets
- Transactions concerning the transfer of receivables may significantly increase in the upcoming years (SMEs may dominate bad loan portfolios)
- PNRR (*Piano Nazionale di Ripresa e Resilienza*): the EU recovery fund may support new investments.

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Second Panel: Downsizing Your Operations

Moderator: Nora Wouters

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Presenting on Downsizing Your Operations: Legal Implications and Considerations

Nora Wouters
Partner, Brussels

Frank Lenzen
Partner, Frankfurt

Katell Déniel-Allioux
Partner, Paris

Dr. Christoph Papenheim
Partner, Frankfurt

Olivier Genevois
Partner, Paris

Krijn Hoogenboezem
Partner, Amsterdam

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Presenting on Downsizing Your Operations: Legal Implications and Considerations

Eugenie Nunes
Partner, Amsterdam

Lee P. Whidden
Partner, New York

Ian Fox
Partner, London

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United Kingdom

Speaker: Ian Fox

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Downsizing Your Operations - UK

- Substantial downsizing has been necessary in certain sectors (i.e., retail, hospitality, travel and leisure)
- Temporary suspension of certain Directors' and Officers' liabilities has now been now lifted, causing pressure to act without delay
- D&O insurance is now harder to get, and much more expensive
- Employee furloughs are now ending, leading to redundancies in some sectors, and severe staff shortages in others
- These impacts are exacerbated by Brexit – shortages of low cost staff, truck drivers, etc.

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Downsizing Your Operations - UK

- Supply chain disruptions are causing stress across many sectors, eg petrol stations
- Likely increases in interest rates will cause further distress to leveraged businesses and consumers
- Energy sector crunch is causing market wide disruption, testing system protections for competition and consumers
- UK is heavily committed to green measures as host of COP26

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Downsizing Your Operations - UK

- UK has a wide range of flexible restructuring tools and expert insolvency Judges
- 2020 introduction of Restructuring Plans, including Ch 11- style cross class cram down is still being tested
- RPs, Schemes of Arrangement and Company Voluntary Arrangements are now being widely used, especially in retail, leisure and aviation
- Many more are now being challenged in the Courts, which are becoming much more interventionist
- Cross border recognition issues have yet to be tested post Brexit

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France

Speakers: Katell Déniel-Allioux and Olivier Genevois

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Director and/or officer liabilities in case of insolvency proceedings

- If the French entity is insolvent, the legal representative of the French entity has strict obligations to declare the situation to the relevant Court to open a reorganization proceeding; this occurs when there might be a disconnect between the local manager and the shareholder, notably when the French subsidiary is loss making for years and is constantly financed by its shareholder
- The Court may hold the managers personally liable for all or part of the assets' shortfall. It may be an action before the civil or commercial courts called action for excess liabilities over assets or a criminal action. In case of a civil proceeding, the Court may hold the managers liable for all or part of the assets' shortfall.
- Shareholders or a parent company's responsibilities could be engaged in case of *de facto* management or under certain circumstances lack of financial support

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Director and/or officer liabilities in case of restructuring/sale of a company *in bonis* (share or asset deal)

- In case of sale - necessity to find a potential purchaser with a serious, realistic and sufficiently funded project to avoid any future liabilities if the purchaser becomes insolvent
- In case of acquisition - need to limit liabilities/costs linked to the acquisition

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Lessons learned from previous transactions

- Proper estimate of the financial situation and evaluation of the assets of the entity in distressed situations to determine the relevant process of acquisition/des-investment (including the means of the other entities of the Group in France)
- Involvement sooner rather than later of the local management/public accountant to avoid over reactions (official right of alert of the public accountant notably) in case of cash transfer/preparation acts between the local entity and any other entity of the Group
- In case of sale, the proper process to be adopted to evaluate the financial health of the candidate and use of tools to validate the choice to avoid/limit further actions of the employees transferred against the seller

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Risks and Legal Implications

- In case of acquisition: to be liable for any non-identified risks (asbestos/environmental issues, occupational diseases including the rate of future social contributions, etc.) but could be covered by proper M&A process/restructuring tools
- Consultation of the employees' representatives of the French-based entity concerned ("SEC") may be required *prior* to the acquisition or the assets/share deal. Any preparatory act (including at the Group level) could represent an impediment of the SEC's rights and as such impact process in France (criminal liability for employer/shareholder – impact on labour authorities' authorizations)
- Risk of litigations by former employees (collective dismissals)/employees transferred if the purchaser is not solvent and/or failed to run the business acquired within a reasonable period of time after the acquisition

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Best practices and tactics

- Many decisions under French law may lead to criminal actions taken by third parties
- Before deciding, you need to anticipate and know what you can/you cannot do. It is recommended to involve your local counsel as soon as possible and decide what you want to do after having understood the local legal constraints
- In certain circumstances, you will need to conduct a sale process even if your initial decision is to shut your operation down
- Involving your local managers is not an option, you need to trust them or to dismiss them and replace them (but then be careful and check whether they are both managers and employees)
- Never act as a de facto manager and never give instructions to your local managers
- Do not present your decision to downsize operations as a final decision but as a proposal or a contemplated step, still under review
- Do not forget your suppliers (notice period to terminate contracts)
- Environmental matters need to be tackled well in advance (baseline)

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Germany

Speakers: Frank Lenzen and Christoph Papenheim

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Downsizing Your Operations – Employment Laws Germany

- **Individual Employment Laws**
  - Protection against unfair dismissal laws – what does "redundancy" legally mean
  - Severance entitlements? Legal framework / practice in Germany
  - Special rules in the context of insolvency proceedings
  - Transfer of business as an option for downsizing operations
- **Collective Labor Laws**
  - Involvement of works council and union
  - Negotiation of collective agreements, particularly social plan
  - Timelines
  - Lessons learned and best practices

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Netherlands

Speakers: Eugenie Nunes and Krijn Hoogenboezem

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Downsizing Your Operations - Netherlands

From an Employment Perspective

- Rights of Works Councils
- Rights of Unions
- Transfer of Undertaking
- Restructuring, reorganisation and dismissal

Through Insolvency Proceedings

- Bankruptcy sales exempt from TUPE
- Pre-pack
- Dutch scheme

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United States

Speaker: Lee Whidden

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Downsizing Workforce - US

- U.S. Federal Worker Adjustment and Retraining Notification Act ("WARN Act") applicable to employers with 100 or more full time employees and requires at least 60 days' notice before a "plant closing" or "mass layoff"
- Employees will be covered if they are terminated or laid off for more than six months or if their regular hours are reduced by more than 50%
- The act is triggered by the number of affected employees at a single site that results in a loss of at least 50 full-time employees during a 30-day period; OR
- Mass layoffs that result in loss of at least 50 full-time employees during a 30-day period affecting 33% or more of active employees or loss of 500 employees during a 30-day period
  - **Penalties**: Back pay and benefits for each day of the violation up to 60 days along with civil penalties
- Seller is responsible for WARN notice up to and including the effective date of the sale--purchaser responsibility thereafter
- After the effective date of the sale, any employee of the seller is considered an employee of the purchaser
  - **Liabilities:** Parent companies and private equity investors have been found liable if they are considered a single employer

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Downsizing Workforce - US

- Depends on the degree of common control - courts look to degree of independence between a parent and subsidiary, common ownership, common officers and directors, dependency of operations, use of same employees or same personnel policies
- Exceptions To Federal WARN Act:
  - Unforeseeable business circumstances
    - Employer must have actively been seeking financing or refinancing and must have taken specific actions to obtain the financing; financing, if obtained could have avoided shutdown; notice would have precluded getting the financing.
  - Faltering Business
    - Condition outside employer's control - loss of major contract or supplier; inability to foresee or protect business losses from such conditions
  - Natural Disaster
    - Floods, earthquakes - direct result for layoff

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Downsizing Workforce - US

- Several States have their own version of WARN Acts that require notice in addition to the US Warn Act and may have different requirements and more severe penalties than the federal statute;
  - E.g.: NY Mass layoffs involving 25 or more full-time employees (if the 25 or more employees make up at least 33% of all the employees at the site) Mass layoffs involving 250 or more full-time employees
  - 90 days' written notice to employees as well as various government entities required
- WARN Act applicable in and out of Bankruptcy--Failure to Give Notice During Bankruptcy May Result in Administrative Claims
- Collective bargaining agreements (CBAs) CBAs may have notice and severance provisions
- Bankruptcy Code permits rejection of CBAs after good faith bargaining
- Employer is required to meet with employee representative and must demonstrate that meetings and substantive discussions took place and if such rejection or modification of the CBA

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Thank you!

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