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Distressed Company Investing in the COVID-19 Environment

Given the numerous opportunities across a broad range of industries that will arise for investments in distressed companies or their assets, this article will focus on the unique dynamics of navigating this universe and highlight some potential pitfalls for the unwary.

By Patrick M. Birney and Leslie J. Levinson | Published in the *New York Law Journal* | June 8, 2020

How quickly things can change: From an environment of confident growth, record-low unemployment, and a booming stock market coupled with a low interest rate environment, deal making was poised to continue through the 2020 presidential election, and beyond. That was yesterday's news. With the onslaught of the COVID-19 pandemic, the jobless rate has grown into the teens and recessionary indicators are displacing economic growth. In turn, many formerly healthy companies have seen revenues evaporate, cash reserves dwindle, and valuations impaired. Bankruptcy and restructuring professionals are already engaged in a new wave of activity spurred by the pandemic. Given the numerous opportunities across a broad range of industries that will arise for investments in distressed companies or their assets, this article will focus on the unique dynamics of navigating this universe and highlight some potential pitfalls for the unwary.

Identifying the Distressed Company. Opportunities for investments in distressed assets attributable to the COVID-19 pandemic are arising from a variety of sources, including reduction in publicly traded company equity values and the related cash needs of such companies, payment and covenant defaults in credit facilities, regulatory pressures, and general operational difficulties. As pandemic-related conditions persist, existing business models may simply be unsustainable. Investors experienced in identifying how to deal with these varied circumstances, as well as possessing the resources to fund these opportunities through previously established or new funds dedicated to distressed opportunities, will likely be the successful acquirers in this new paradigm.

Special Due Diligence Issues in COVID-19 Distressed Companies. While investment and acquisition opportunities in the COVID-19 environment abound, due diligence takes on an enhanced importance, particularly in areas where the diligence playbook for the issue is outdated. One such area of focus may be supply chain disruptions. With many industries dependent on a seamless flow of products from a globally interconnected supply chain, disruptions in this flow arising from the pandemic

will need to be addressed and evaluated, and solutions explored. Investors will need to determine if the problems are transitory or systemic and evaluate the alternative supplies that exist to replace breaks in the supply chain. Another area may be post-closing capital requirements. Will investors need to continue to prop up the target's working capital, and how will that capital be made available? Are the issues more in the nature of short-term collection of receivables; can payables be extended or prioritized for payment? Valuable client and vendor contracts must be analyzed. Are certain contracts at risk for termination by impossibility of performance or otherwise, and how quickly can such agreements at risk be replaced, if at all? Have fault-lines in labor and employment issues arisen through the pandemic? If so, can they be addressed in the short term? Of course, key diligence will surround whether financial and operational weaknesses attributable to the pandemic can be overcome to make the target valuable and profitable following investor intervention. Zeroing in on these COVID-19-related key issues in diligence and bringing the right resources to address them quickly and effectively will make a favorable outcome more likely for the distressed company investor.

The Advantages/Disadvantages of Acquiring a Company Affected by COVID-19 in Out-of-Court Transactions. The hallmarks of an out of court transaction are that the business entity is in distress, it needs to sell, and must close the deal as quickly as possible. Although not without its own perils, the likely deal of choice in an out-of-court transaction will be an asset sale, in which the investor pays fair value for the target's assets and certain expressly-assumed liabilities, and specifically disclaims responsibility for all liabilities that were not assumed.

Acquiring assets outside of a bankruptcy or receivership proceeding will reduce acquisition-related transaction costs, as well as in some instances decrease the likelihood the assets will be lost to a strategic competitor in a court-sanctioned auction process. However, without a court order authorizing a transfer of the assets free and clear of all liens, claims and interests, the savings born from reduced transaction costs or reduced purchase price must be weighed against potential post-closing creditors' claims and attendant litigation costs related to those claims, especially with the prospect of limited indemnifications and a target's unwillingness or inability to make customary representations and warranties. In addition to the more novel diligence issues described above, the prudent buyer must also focus on issues related to the universe of potential creditor claims against the target, with special emphasis on those claims that could impact the assets to be transferred.

Specifically, an analysis of the distressed target's books and records, as well as lien, judgment and pending litigation searches, should arm the buyer with critical information related to liabilities that need to be addressed or satisfied at the time of closing to ensure that the assets are free of liens and other claims. If significant secured and unsecured claims exist, or the purchase price will not wholly satisfy the secured debt, or both, the buyer must implement strategies to address these claims to minimize

post-closing disruptions. Planning examples include: (1) a consensual secured-party carveout that allocates a percentage of sale proceeds to general unsecured creditors; (2) the subsequent satisfaction of unsecured claims through an escrow agent and claims administration process; and (3) agreements with critical seller vendors that forgive or reduce existing claims in exchange for promises of future work. Although these steps can be challenging outside of a court-sanctioned sale process, they may be among the few available avenues to buy creditor peace and reduce post-closing disruptions.

An associated risk arising from an out-of-court acquisition of distressed assets is the risk that the transaction is subsequently challenged as a fraudulent transfer, under the Uniform Voidable Transactions Act or §548 of the Bankruptcy Code. A carefully tailored sale process that encompasses the disbursement mechanism described above, can minimize, but certainly not eliminate, fraudulent transfer risk. Additional protections can be obtained through the sale process. For example, if the distressed target is contemplating the sale of all, or substantially all, of its assets, a prudent buyer should possess objective evidence that it paid fair value for the target's assets, presuming the assets were purchased in a private sale and were not subject to a sale process resulting in higher and better offers. Alternatively, if the distressed target has fully shopped the assets, including employing an investment banker with industry knowledge and appropriate contacts, to orchestrate a robust sale process, the buyer can take comfort that there will be a strong record supporting the purchase price.

Acquiring Distressed Assets in Bankruptcy—Does COVID-19 Change the Landscape? COVID-19 has significantly changed the landscape related to the acquisition of distressed assets in the context of a petition filed under the Bankruptcy Code—some advantageous to the distressed investor, and some not. First, on March 27, 2020, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) was enacted and became law. Section 1113 of the CARES Act addresses changes to the Bankruptcy Code, which automatically sunset on March 27, 2021.

Regarding distressed-investing opportunities, these changes include an increase in the maximum debt threshold for a debtor to qualify under the newly-minted small business provisions of Subchapter V of Chapter 11 of the Bankruptcy Code (SBRA). Under the CARES Act, the maximum debt threshold for a distressed target to qualify as a small business debtor increased from approximately $2.7 million to $7.5 million. In turn, the SBRA has adopted certain substantive and procedural provisions that reduce the time and expense of the distressed entity's time in bankruptcy. Together, these provisions will provide more distressed entities an opportunity to access the bankruptcy courts. Some of these distressed businesses will successfully reorganize, while others may not. The unsuccessful will provide distressed investors with an increased universe of opportunities to purchase target assets with the free and clear protections afforded by a court order.

If the last 45 days are indicative, COVID-19 also will likely inundate the bankruptcy courts with an unprecedented volume of both commercial and consumer filings. It is premature to forecast how the number of new cases will impact the timely administration of the bankruptcy courts' dockets, but there is certainty that the proliferation of new cases will impact the speed with which distressed asset deals will be marketed and sold in bankruptcy.

Conclusion

In the new COVID-19 environment, opportunities to acquire distressed companies are likely to continue to increase, but with a different range of issues and solutions needed than those encountered in prior downturns. Careful evaluation of the underlying circumstances and strategies to address them, as well as utilizing the proper structure to acquire the distressed assets, will be paramount in this climate.

Leslie J. Levinson *is a partner in Robinson & Cole's distressed and special situations team, co-chairs the transactional health law group and is also a member of the business transactions group.* **Patrick M. Birney** *is a partner in the firm's distressed and special situations team, co-chairs the bankruptcy and reorganizations group and is also a member of the business litigation group.*

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