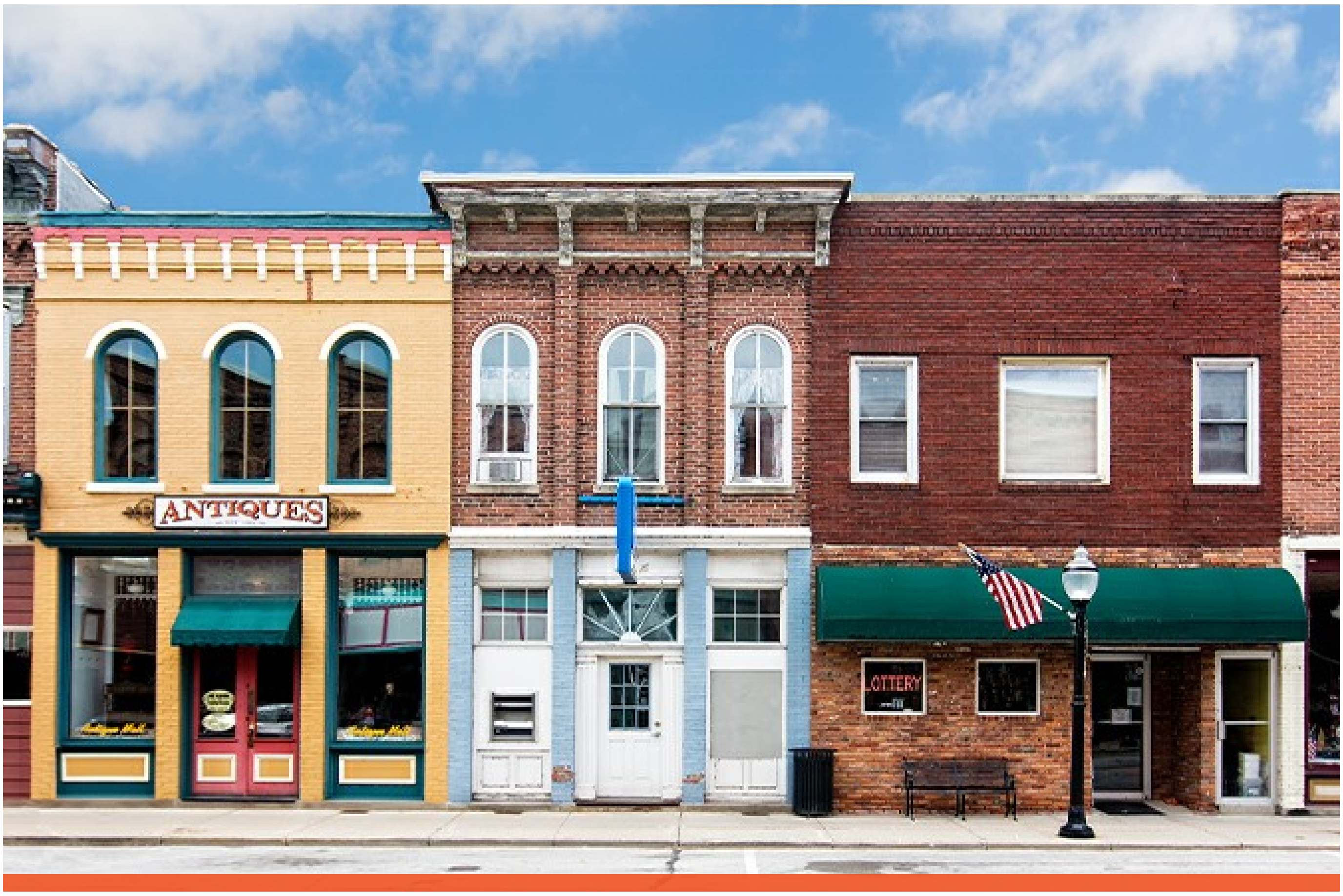
Distressed businesses on sale: Consider opportunities and risks, Crain's Chicago Business



Christal L. Contini, Marc J. Carmel | Monday, November 7, 2022

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While the United States has experienced a strong economy for most of the past decade, companies and investors that purchased businesses have been focused on improving upon already successful businesses. As the economy slows and businesses suffer from persistent inflation, higher interest rates, supply chain issues, labor shortages, and the end of pandemic-related assistance (among other factors), many companies facing distress are going to be looking for buyers or new investors. Private equity firms and businesses with access to capital are able to purchase distressed businesses at a discount with the opportunity to restructure their targets into successful businesses as a new platform or to enhance their current operations (as an add-on, bold-on, or tuck-in acquisition). But these situations also pose unique challenges that must be considered.

With a good understanding of how to approach due diligence, the right strategies and tactics to effectuate the transaction, and experienced advisors engaged throughout the process, purchasing a distressed business can be a very successful endeavor.

The challenge of due diligence

There are reasons that the target company is distressed, and some of them create challenges with performing due diligence. One cause — or a symptom — of distress is the target's poor financial, business, and legal records. Many buyers that evaluate distressed situations become frustrated and decide not to bid when they cannot verify every number or contract as they would in a traditional, exhaustive diligence process. To avoid this problem, potential investors (whether a private equity firm or otherwise) should seek to capitalize on their extensive network by engaging industry experts, financial advisors, and legal counsel that know the market and can help assess the financial and legal risks associated with purchasing the distressed business. Successful buyers of distressed assets focus on identifying risks, pricing the identified risks, and working with specialists to reimagine the business after stripping away the liabilities and other obstacles holding the business back from being successful.

Assessing the situation and executing with the right strategies and tactics

In addition to becoming comfortable with its understanding of the business, a potential buyer focuses on ensuring that its new investment is not saddled with the distressed business's liabilities and other problems. There are a number of different formal and informal processes that the buyer can employ to address this. Distressed assets may be purchased without any formal process, or they could be purchased through an Article 9 foreclosure process, a receivership, an assignment for the benefit of creditors or other state-law process, or a federal bankruptcy process. Think of these as tools to effectuate the purchase of a distressed business, each with their own advantages and disadvantages. The right tool for the job depends on the situation. After analyzing the situation and working with advisors to consider the different legal processes available, the investor can then determine which is best to acquire the business at the best price. With proper planning, the distressed business can be acquired free and clear of most creditors' liens, claims, and other encumbrances on the assets.

There are operational and other business risks to consider before purchasing a distressed business. Distressed companies may have tenuous supplier relationships resulting from delayed payments or other issues. Likewise, customer relationships may suffer if the distressed business has not delivered as promised. Also, management and employees are likely feeling their own stress as a result of having to work for an employer in financial or operational distress. It is important for potential buyers and investors to be sensitive to these concerns. At the same time, there are opportunities to prepare an operational plan and communications strategy that proactively addresses these issues and positions the buyer or investor as the savior.

The importance of working with knowledgeable advisors

While every acquisition requires knowledgeable advisors, purchasing a distressed company requires a team of lawyers and financial advisors that understand how to navigate the legal and business issues that are specific to the world of distress, which includes confusing state laws and the federal bankruptcy code. Among the most important advice that a private equity firm or other buyer can receive from its advisors is whether the purchase of distressed assets can be accomplished without a formal process or, if not, which of the different processes is best. Most sales of distressed businesses include limited representations and warranties and no post-closing indemnification for the buyer. Additionally, the consent process for the assignment of contracts and leases with distressed acquisitions is very different from a typical, non-distressed transaction, and there are even differences among the different legal frameworks. Working with knowledgeable and experienced advisors to understand the advantages and disadvantages of each available alternative is key to a buyer maximizing the value of distressed opportunities.

Conclusion

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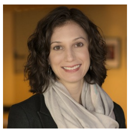
Private equity firms or businesses looking to purchase businesses that are impaired can benefit from a faltering economy by considering alternative acquisition strategies, such as purchasing distressed assets through a bankruptcy or other process at a discount. Such acquisitions are not without risk, but buyers that are able to successfully navigate the process and turn around a troubled business are able to drive significant value for their investors.



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