

Issues to Consider in Buying or Selling a Distressed Company

Companies under financial pressures may consider one of their options as selling their business. At the same time, buyers may find opportunities in acquiring a distressed companies at a discount. The sale of a distressed company raises a number of competing issues for buyers and sellers. A brief mention of some of the issues to consider in buying or selling a distressed business are included below.

- *Valuation*: Obviously, the seller will want the highest price it can get, while the buyer will want to negotiate for the lowest price it can obtain. Both the buyer and seller would be well served in obtaining an independent valuation of the business, if possible, before proceeding.
- *Debt*: Distressed companies are usually distressed because of their debt burden. Thus, the buyer will need to ascertain how much long term debt the selling company has (which would include capital leases) as well as what contractual obligations must remain in place for the distressed company to continue to operate. The buyer should engage a financial advisor (such as an accounting firm) to do a financial due diligence. The buyer will also need to conduct UCC searches and, if real property is involved, title searches.
- *Asset Sale vs. Stock Sale*: In order to minimize its exposure to unwanted liabilities, the buyer will want to structure the transaction as a purchase of assets. However, if the selling company is a C corporation, an asset sale will expose the owners of the selling company to double taxation and thus, in such a situation, the buyer and seller will be at odds on how to structure the transaction. There may be ways to structure the transaction tax-efficiently, and you will need to discuss this with your legal and tax advisors.
- *Purchase Agreement Issues*: The sale of a distressed company will involve unique questions for the Purchase Agreement. For example, the buyer will want extensive representations and warranties, while the seller may want to sell the assets “as is, where is, with all faults.” The buyer will also want to make sure it gets good indemnification from the sellers for any breaches of the representations or warranties. However, in the sale of a distressed company, the sellers may not have the financial ability to satisfy any post-closing indemnification. The buyer may thus want to “hold-back” or escrow a portion of the purchase price for a certain period of time (maybe 1 to 2 years) to provide a fund to satisfy the seller’s indemnification obligations. On the other hand, the seller will want to limit its post-closing indemnification obligations by negotiating both time and dollar caps on the indemnification.
- *Employment and Non-Competition Agreements*. The owners of a business may want to sell in order to alleviate themselves of the financial burden of the business, but they might want to continue being employed. Thus, the owners may want to negotiate a good, long-term employment agreement with the buyer. For some distressed companies, the purchase price for the business may in fact be minimal, with the upside to the sellers coming in the form of employment agreements with the buyer. The buyer will also want to protect itself from the owners of the selling company competing with it, and thus the parties will negotiate the terms of a non-competition agreement. The sellers may want to consider “carve-outs” from the non-competition agreement that would make it clear for them to continue to earn a living post-closing.

- *Bankruptcy Purchases:* Buying assets through a bankruptcy proceeding offers added benefits to the buyer. Under the Bankruptcy Code, buyers can purchase assets “free and clear” of liens and interests. However, because any such sale must involve the bankruptcy court and obtaining consents of secured creditors, the sale may proceed slowly. In addition, the debtor in bankruptcy usually uses a “stalking horse” procedure to try to obtain the highest bid, and thus there may be competition among buyers. Furthermore, while the assets are sold free and clear of liens, they are also sold “as is,” and so there generally is no post-closing indemnification from the sellers.

We hope this newsletter has been helpful. If you are thinking about selling your business or buying a business, we can provide the experienced mergers and acquisition assistance you need.