Advising Boards on M&A Transactions in Times of Distress

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Welcome

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On the
Agenda

Part I: Starting the Process

Part II: Duties of the Board and Best Practices

Part III: Alternative Processes and Transactions

Part IV: Special Considerations in Distressed Situations

Part V: Questions?

Part I
Starting the Process

Starting the Process: Getting There and Key Players

- companies may be pushed into “distressed” situations by a number of factors, but generally:
  - ongoing deterioration of macro-business (i.e. commodity prices, pandemic) or company-specific matters, coupled with:
  - inability to meet ongoing debt service obligations or pending maturities, without obvious source of liquidity to satisfy lenders or other creditors
- earlier-stage solutions didn’t provide solution:
  - quiet or public sale/M&A process failed to yield bids determined to be adequate by Board, based on current equity value
  - capital and debt markets, private investors, unavailable or “unreasonable” terms
- as options decline, typical corporate strategic and M&A dynamics shift, including a number of new faces…..

Starting the Process: Getting There and Key Players

- historical relationship banker joined by “special loans” bankers and their advisors
- external corporate legal counsel adds restructuring counsel to working group
- traditional external financial advisors often supplemented with (or replaced by) specialized restructuring and workout advisors (no bank conflicts)
- other creditors or shareholders become more vocal and emboldened
  - second-tier debt often the “swing vote”, may also retain legal and financial advisors
  - depending on severity of situation, shareholders may take activist role
- complexity (and cost) of getting the deal done just increased exponentially

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Part II
Duties of the Board and Best Practices

Overview of Fiduciary Duties

- in Canada, duties of loyalty and care always apply:
  - act honestly and in good faith with a view to the best interests of the corporation (*loyalty*)
  - exercise the care, diligence and skill that a reasonably prudent person would exercise n comparable circumstances (*care*)
- "business judgement rule" provides protection to directors:
  - if prudent and reasonable decision are made on an informed basis in light of applicable circumstances
  - courts are reluctant to second-guess directors in corporate decision-making
- duty owed to the corporation requires consideration of all stakeholders (shareholders, creditors, employees, other external) (*BCE, 2008)*
- Issue: how is this viewed as a corporation enters the "zone" or "vicinity" of insolvency?

Duties in the “Vicinity” of Insolvency

- “spectrum” of “best interests of the corporation” will shift towards creditors vs. shareholders
  - heightened consideration of impact on creditors given increased claims to value of corporation vs. limited potential return to shareholders
- conflicts of interest between duties to “corporation” (creditors) and shareholders become amplified
  - D&O often are (or represent) significant shareholders with compensation tied to equity
  - requires full disclosure of conflicts to the Board (shareholdings alone not problematic, subject to materiality/quantum)
    - must be satisfied as to independence of each director, management and advisors
  - special committees often used for both independence and efficiency
    - separate Board counsel and, depending on situation, financial advisors often retained

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Duties in the "Vicinity" of Insolvency

- Best practices to avoid potential claims or liabilities:
  - hire and rely on independent legal and financial advisors to provide informed advice
  - stay informed through regular detailed updates, including with respect to transactions (or "non-transactions") that may hinder creditor recovery or provide preferential payments
    - understand cash flows, triggers in key debt and commercial agreements, and consequence of alternative legal processes
  - meet *in camera* without conflicted parties present
  - keep good board minutes and "board books"
- Risk of oppression action/remedy looms:
  - very broad remedy available in Canada to almost any stakeholder, including creditors, shareholders or other affected persons
  - based on the reasonable expectation of stakeholders (back to "spectrum of duties" discussion)

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Part III
Alternative Processes and Transactions

Alternative Processes: “Normal” M&A Deal

“Traditional” corporate M&A deals not involving restructuring

- often a “one last shot” opportunity to avoid restructuring and payout or preserve equity value in ongoing entity (although maybe not at a premium)
  - under certain statutes (ABCA), M&A deal can also “arrange” and payout creditors in addition to equityholders
- bargaining power shifts heavily to Buyer given Target’s lack of alternatives
  - if creditors are being compromised or arranged at less than 100% realization, creditors may supplant Target as key party to negotiate with Buyer
- substantial asset sale(s) sometimes alternative “last chance” to continue corporate entity and preserve shareholder value
  - adequacy of creditor coverage from sale proceeds and viability of ongoing entity must be weighed against benefits of more formal restructuring
  - shareholder approval required for sale of “all or substantially all” of the assets

Alternative Processes: Restructuring Options

"Distressed" corporate M&A arranging note or other debt

- *Tervita Corp, Re,* 2016 ABQB 662
  - The use of the CBCA restructuring rules in cases of near-insolvency can give rise to risks of manipulation and unfair dealing among affected parties, and these arrangements must be scrutinized carefully to ensure that the rights of all interested parties are respected. While the opposing parties are entitled to a fair hearing on the issues, that right must be balanced with the interests of all stakeholders in a complex reorganization.

Advantages

- Structuring flexibility
- Minimal court oversight
- Possible to obtain a US law securities exemption for issuance of securities
- Limited stay of proceedings available in certain circumstances (CBCA only)
- Allows for restructuring both equity and debt claims
- Perceived to be less negative stigma than proceedings using the CCAA

Disadvantages

- Unlike CCAA arrangement proceedings, the CBCA does not provide for:
  - Sales process
  - Court-ordered charges
  - Court-appointed officer (i.e. monitor)
  - Broad stay of proceedings
  - Broad body of case law on classification for voting purposes
  - Arrangement of trade debt

Alternative Processes: Restructuring Options

CCAA Sale Process

- Court presiding over CCAA or BIA proposal proceedings has the statutory jurisdiction to authorize asset sales outside the ordinary course of business “free and clear of any security, charge or other restriction”
- Court should consider:
  - whether sale process was reasonable and approved by court-appointed monitor
  - whether monitor believes disposition is more beneficial than liquidation through bankruptcy
  - the extent to which creditors were consulted
  - whether the consideration received by the debtor is reasonable

Part IV

Special Considerations in Distressed Situations

M&A Deals in Distressed Times

Time is not on your side

- creditors can run out of patience as options fall away, and deadlines can creep up quickly
- unlike shareholders, creditors are not motivated by long-term value growth potential – rather to preserve and realize maximum value now
- be prepared and understand alternatives and outcomes well in advance
  - understand benefits and drawbacks of asset sales vs. refinancings vs. restructurings vs. recapitalization vs. outright corporate sale or merger, including under CCAA or BIA, and impact on all stakeholders the time required for a “traditional” M&A shop process (public or private) may not be available in distressed times and my further erode value and options

M&A Deals in Distressed Times

Focus is on deal certainty:

- MAC clause: ensure any known or possible Target-specific events are carved out
- ability to comply with interim covenants: “carry on business in ordinary course, [consistent with past practice]” may not apply in traditional sense to Target in circumstances (*L Brands, Cineplex, Maps Hotels*)
- avoid uncertain/hair-trigger closing conditions: Target shareholder dissent rights, third party consents (including Buyers lenders, debt levels, etc..)
- break fees: only payable if a better deal comes along (or potentially serious breach of deal execution covenants); more potential creditor value erosion

Other Considerations in Distressed Situations

Other Considerations:

- *D&O Insurance*: review coverage in light of potential restructuring, and purchase tail
- *Ensure Payments Up-to-Date:* ensure wages are paid and CRA remittances are made to avoid personal liability
- *D&O Resignations*: understand appropriate timing and consequences
- *D&O Disclosure*: if insolvency proceedings are commenced or creditors are compromised in plan of arrangement (with one year look-back), 10 year trailing disclosure in AIF, proxy circular
- *Company Public Disclosure*: ensure public disclosure is balanced and neither over-optimistic nor prematurely pessimistic; people are trading on current news
- *Insider Trading*: ensure insider blackouts are in place; can also impact ability or timing of grants of incentive awards if material undisclosed information exists

Do you have any questions?

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