Distressed M&A in the Corona crisis II – Acquisition before or during insolvency proceedings?

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The corona crisis has recently brought M&A activity almost to a standstill. With our series of articles 'Distressed M&A in the Corona crisis' we want to promote further M&A activity. The crisis only changes the rules of the game - and we want to shed more light on these changed rules for you.

Opportunities for buyers and sellers

Distressed situations offer opportunities for buyers and sellers. The opportunities for buyers are obvious, valuations come under pressure and buyers get the opportunity to acquire a company at a low purchase price.

The sale of non-core businesses in the crisis may help the seller for various reasons: the sale initially creates liquidity and reduces the cost burden caused by a possibly loss-making business. At the same time, the sale allows the seller to focus on his core business, which is supported by the newly created liquidity.

In times of crisis, however, an M&A transaction can above all offer win-win opportunities for both buyer and seller, e.g. in critical supply chains. The distress of a supplier brings considerable risks for the customer. It is therefore in the customer's own interest to help stabilize the supplier. The acquisition of parts of the supplier's business by the customer can help the supplier to navigate through the crisis and stabilize the long term supply of the customer.

The rules of the game for transactions in a crisis vary, depending on the stage at which the transaction takes place. And the crisis would not be a crisis if the transaction could be carried out completely without risk. It is crucial to understand the risks and to minimize them with available structuring possibilities.

Acquisition before insolvency

The implementation of a transaction prior to insolvency has the significant advantage that the buyer and seller themselves control the M&A process. Once a target becomes insolvent, an insolvency administrator usually takes control, and in any case, creditors are given a decisive say. From the buyer's point of view, this phase before insolvency also offers the advantage that the seller can grant him exclusivity, thus reducing the risk of frustrated opportunity costs shortly before completion if another buyer's bid is awarded the contract.

The main advantage of the acquisition via an asset deal out of insolvency (see below) is that the purchaser can acquire the business free of debt. With an asset deal out of insolvency, the purchaser acquires only the assets necessary for the business with fixed and current assets, rights, contracts and employees – old liabilities are settled by the insolvency administrator.

A transaction before insolvency does not offer this advantage. With a share deal, the buyer acquires the legal entity with its entire balance sheet, including all liabilities. And even with an asset deal before insolvency, not all liabilities can be cut off: while the buyer is generally only liable for liabilities which he expressly assumes, liabilities to employees are transferred by virtue of law according to § 613a German Civil Code, the buyer is liable for tax liabilities according to § 75 German Tax Code and finally, the buyer is liable according to § 25 German Commercial Code, provided that the buyer continues to operate the business under the 'old' company name and does not exclude liability by means of a corresponding entry in the commercial register.

If the seller falls into insolvency after implementation, there are special risks under insolvency law. If the transaction has not yet been completed at the time of insolvency and the parties have not yet completely fulfilled their performance obligations, § 103 German Insolvency Code allows the insolvency administrator to refuse further performance of the transaction. This always involves a special risk for buyers if they have made advance payments, e.g. if they have made a down payment on the purchase price to support liquidity in the crisis. We will shortly publish a further article in this series on the possibilities of implementing transactions in such a way that risks arising from the choice of performance are minimized.

But even if the transaction has been fully completed, the insolvency further jeopardizes the transaction: German insolvency law offers the insolvency administrator various rights to challenge the transaction, all of which are aimed at the reversal of legal transactions that are disadvantageous to creditors. This risk, too, can be mitigated to a large extent, and we will also be looking at this topic in a further article in this series soon.

From the insolvency law's point of view, however, not only the adminstrator's right to refuse the contract performance and the cancellation rights are detrimental for the buyer, the insolvency of the seller can also devalue secondary claims of the buyer. From the M&A buyer's point of view, this is particularly relevant for guarantee and indemnity claims, which transform to mere insolvency claims after the insolvency of the seller and are only fulfilled with the insolvency quota.

In this respect, a thorough due diligence is of particular importance. However, due diligence can never replace the seller's guarantee liability, as the guarantees always back the assumptions on which the due diligence is based. Although the buyer can check contracts for legal and other risks, he always needs at least the guarantee that all (material) contracts have been disclosed.

Here, an instrument that you also know from 'normal' transactions is of particular importance: Warranty and Indemnity Insurance, in short W&I Insurance. If the buyer takes out a W&I insurance for the seller's warranties, the insurance is liable in the event of a warranty, and the seller's default is no longer a risk.

The range of products offered by W&I providers for transactions in the run-up to insolvency is broad: even risks of avoidance under insolvency law can be insured. If the appropriateness is proven by a valuation report or a fairness opinion, insurers assume the risk that a court will assess the transaction differently in the event of rescission.

Last but not least: the implementation of the transaction has the very significant advantage that the target is not yet afflicted with the stigma of insolvency. If the company only goes bankrupt, the business may be permanently damaged by business interruptions, customers jump ship and the (usually best) employees are the first to leave the sinking ship.

With this and our other contributions in this series, we would like to promote transactions before insolvency despite a corporate crisis. The risks are manageable and can be mitigated by legal measures. The damage that is often inflicted on a company in insolvency is often much greater than the savings made due to a possibly (even) lower purchase price.

Acquisition from insolvency

Admittedly, the acquisition from insolvency also has its appeal. Above all, the separation of business assets and liabilities, which is possible with the transferred restructuring, can be sufficient in itself to restructure the company.

In contrast to an asset deal before insolvency, employee and tax liabilities are not transferred to the purchaser. While the legislator has legally standardized this for tax liabilities in § 75 para. 2 AO, this also applies to liabilities to employees which were established before the opening of insolvency proceedings. The background to this case law of the German federal court is that employees should not be placed in a better position than all other creditors.

Another major advantage is of course the possible selection of the assets necessary for operation (cherry picking), which is possible with the transferred remediation; any company land polluted with environmental damage is simply not acquired. Such a selection is also possible for the employees: the purchaser can make a selection of the employees to be taken over ('Olympic team' according to the purchaser concept), the insolvency administrator transfers the remaining employees to a so-called employment and qualification company.

In addition to the already mentioned significant adverse effects of insolvency on business operations, the acquisition of the company from the insolvency administrator has the further disadvantage from an M&A point of view that insolvency administrators generally do not provide any guarantees in the context of the sale, with the exception of the guarantee of ownership of the assets sold. With the guarantee liability, the insolvency administrator would establish so-called mass liabilities, for which he would be personally liable. As shown, the disadvantage of a lack of operational guarantees cannot be offset by careful due diligence, as this also requires the provision of guarantees.

And now the crux of the matter: this risk cannot be covered by W&I insurance in the same way as before insolvency. For every W&I insurance, as a rule, a primary guarantor is required; his liability can be limited to 1 Euro, but according to general legal principles only up to the limit of the intentional liability. This intentional liability threatening the primary guarantor is sufficient for the W&I insurer to bear the liability risk for breaches of warranty through no fault of his own or through negligence. However, the insolvency administrator is no longer the primary guarantor.

And we still have a workaround for this as well: the guarantees can – also limited to 1 Euro – also be given by the management of the target company, who can thus make an important contribution to enable the buyer to take out the S&E insurance, provide sufficient comfort for the transaction and give the company, the employees and themselves a future.

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