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Key Characteristics of Distressed M&A in Malaysia

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A distressed merger and acquisition ("**M&A**") is essentially a sub-category of a conventional M&A, which involves sales of shares or assets of companies that are in financial turmoil and these companies are being placed under administration, receivership and/or liquidation. Due to the unprecedented Covid-19 pandemic, distressed M&A transactions have become more common in recent years with companies in financial and operational distress looking to dispose of their assets to better manage high illiquidity as well as reducing over-indebtedness risk. With the increase in distressed M&A activity in recent years, this article seeks to outline the key characteristics of distressed M&A transactions in Malaysia.

Structure

Often, given the uncertainty of the distressed company's actual value, contingent liabilities and the risk of subsequent insolvency proceedings, a distressed M&A would often involve the sale of business or assets by the distressed company as opposed to a transaction involving the equity interest in the said company. The potential purchaser has the discretion to select or cherry pick assets of the distressed company, thereby reducing the risk of the purchaser inheriting liabilities associated with the entire company.

From the seller's perspective, the seller may consider restructuring its business to make the sale more attractive, as an example, the jewel assets may be hived down to a new special purpose vehicle that has no historical liabilities thus making it appealing to potential purchasers which could drive up the value. The drawback in this is that such restructuring may delay the proposed transaction and delay the capital injection required by the seller. Additionally, such restructuring would also typically need the buy in of the shareholders and the creditors, as, given the state of the company, they may not be cooperative in providing their approvals.

Due Diligence

Like any other conventional M&A transaction, due diligence is an integral aspect in a distressed M&A transaction to be undertaken by the purchaser before the acquisition of distressed company's

assets. Given the time-pressured nature of distressed M&A transactions, the timeframe to complete the due diligence exercise is often truncated and also the data and documents that are available for due diligence purposes are typically incomplete and sometimes unavailable for review by the purchaser as the seller of such distressed asset is usually an appointed administrator, liquidator or receiver and manager with limited knowledge of the operations of the company. Furthermore, as there is also some urgency to recoup losses or to plug the liquidity gap, only motivated purchasers are courted by the seller. All these factors combined usually results in restricting the purchaser's ability to conduct a thorough due diligence. In this case, the due diligence exercise would be curtailed by prioritizing the material information which is matters of importance to the buyer such as financial matters, legal aspects and key employees in the company. Having said that, this material information would nonetheless depend on the type of business being acquired as well as the risk appetite of the potential purchaser.

Representation & Warranties

Another key characteristic of a distressed M&A transactions would be that it is usually on a "as is, where is" basis with the purchaser having fewer contractual protections, notably with regards to the representation and warranties over the assets and the distressed company. This is due to the inherent risks involved in a distressed M&A transaction; the seller (especially if it is an appointed administrator, liquidator or receiver and manager) would be reluctant or unable to provide extensive warranties and representations about the company's financial health given the uncertainties in quantifying the financial impact of the outcome of any disputes or contingent liabilities. Also, in a situation where the distressed company is in administration, receivership or liquidation, the purchaser is also expected to provide an indemnity to the appointed administrator, liquidator or receiver and manager (in addition to the seller company) from any liabilities arising thereafter due to the breach or non-compliance of the terms of the agreement by the purchaser in connection with the sales. Another point to note is that it is typical to have clauses within the agreement which expressly state that

the appointed administrator, liquidator or receiver and manager assume no personal liability of whatsoever nature with regards to sales and under any documents created pursuant to the sales as well as any breach by the seller company of all or any of its obligations under the sales. In addition to this, it will also be made clear that in the event the court orders the removal of the appointed administrator, liquidator or receiver and manager, the purchaser shall have no claim, action, allegation or demand of whatsoever nature against these appointed personnel including their employees, agents and/or the firm arising from such removal. This is mainly to provide protection due to the limited knowledge these appointed personnel have over the distressed company and the fact that the sales will be made on an "as is, where is" basis.

Nevertheless, given the nature of distressed M&A which typically involves a relatively low number of interested bidders coupled with the fact that the administrator, receiver and manager or liquidator are under a duty to recoup money to service the outstanding debts as opposed to the typical M&A transactions whereby the stakeholders would be seeking the maximum sale price, distressed M&A may offer greater opportunities to potential purchasers to acquire the assets at a discounted value. The paradigm example of how the purchaser can obtain discounted pricing for company shares within distressed M&A transactions is perhaps Tune Air Sdn Bhd's acquisition of a majority stake in Air Asia from DRB-HICOM Berhad at a nominal value but included an assumption of certain debt related to Air Asia.

Regulatory Concern

It is often that the sales in distressed M&A transactions are expected to be conducted swiftly in order for the seller to receive the purchase price and to alleviate the debt-ridden company and hence the truncated due diligence exercise. However, despite the potential simplification of the due diligence process, the timing to complete the sales also hinges on the potential regulatory restrictions, such as in the context of sales of land where the title deed imposes the requirement to obtain state authority consent prior to the transfer or in the context of existing licences or contracts awarded by the regulators which requires consent for change of ownership. Also, if the sale transaction involves a foreign

purchaser, depending on the nature of the sale, consent from the relevant regulators may need to be sought. In these cases, additional timing to complete the sale would need to be taken into account by the potential purchaser given that consent to be sought would typically take up to weeks or months. To manage this, any regulatory engagement should be done from the onset. In some circumstances, the sale of significant assets may be a compelling reason to grant such approval if the purchaser is seen as a white knight.

Financing by the Purchaser

Yet another distinguishing feature of distressed M&A transactions in Malaysia is the potential challenge that may be faced by the purchaser to raise financing for the acquisition of a distressed asset given the bankability of the assets from the financiers' perspective, such as availability of sufficient assets to be used as security for the loan, ability of the assets to generate cashflows to service the loan interest and principal payments and the track record of the purchaser in managing the asset after the acquisition. Having said that, it is to be noted that a purchaser's ability to secure financing is also predicated on their own financial capacity as well as having other assets to be pledged to the bank as security for the loan. In this case, a purchaser with strong sponsor support will typically be viewed favourably by the banks in the loan granting process. Having said that, other than seeking financing from the conventional financial institutions, purchasers may also consider other means to raise funds such as from private equity firms.

Valuation

The valuation of a distressed company is also often complex in nature given the fast-changing conditions of the market and the continued operations of the company. The seller would be pressured to maintain the value of the company and its assets or enhance it whilst the purchaser would want to obtain the best value of what it considers to be a risky asset. That said, there needs to be some level of certainty at which the sale can be transacted.

The two most common mechanisms are the completion accounts mechanism and the locked box mechanism. The completion account mechanism is often known as the conventional approach whereby parties

would agree on a preliminary purchase price in the sale and purchase agreement. Thereafter, post completion the preliminary purchase price can be adjusted upwards or downwards based on completion accounts on the basis that the true value on completion would be calculated then. The formula in which such adjustments can be made is often the subject of a lot of negotiations. Increasingly though, given that the gap between signing the sale and purchase agreement and completion is usually short for a sale of distressed assets, the locked box mechanism has become more popular. A locked box mechanism affords both parties certainty as parties would agree to a fixed price usually using company's most recent financial statements prepared as close to the completion as possible. Thereafter, there are no post completion adjustments. To ensure that the value of the company remains intact, the purchaser will include several provisions in the sale and purchase agreement to prevent leakages.

Potential Clawback

When it comes to dealing in the acquisition of distressed assets by the purchaser, another common conundrum is that such transaction is always accompanied by the risk of potential clawback whereby interested parties such as creditors (secured and unsecured alike) or shareholders may challenge the acquisition of the distressed asset based on undue preference where, for instance, such an acquisition at an undervalued consideration favours a certain purchaser. If an undue preference claim is successfully raised, the distressed M&A transaction can be declared void such that the transfer of assets would be reversed, therefore enabling "claw back" under the Malaysian Companies Act 2016. To avoid this and specifically for transactions that are sizeable in nature and which may involve multiple creditors, it is worthwhile to consider a court sanctioned route. The Malaysian Companies Act 2016 provides for several types of corporate rescue mechanisms which is beyond the ambit of this article, however, it is worth noting that court sanctioned schemes such as the scheme of arrangement pursuant to section 366 of the Malaysian Companies Act 2016 would afford some degree of comfort and protection for future claims and should be considered together with the proposed sale.

As an example, the case of *Francis a/l Augustine Pereira v Dataran Mantin Sdn Bhd & 6 others* involved a scheme of arrangement to acquire a luxury condominium project which was owned by Mico Vionic Sdn Bhd ("**Mico Vionic**"), a wholly-owned subsidiary of Dataran Mantin Sdn Bhd ("**Dataran Mantin**"), for the purposes of completing the abandoned project and fulfilling the debt of some of the project's creditors. One of the claims raised by the appellant was that the scheme gave rise to undue preference. The Federal Court dismissed this undue preference claim on the basis that the project in question was not owned by the company facing liquidation, Dataran Mantin, but rather, by Mico Vionic. Hence, the Federal Court did not invalidate the acquisition of the condominium project as part of the scheme of arrangement and therefore clawback was not successful.

Conclusion

Distressed M&A transactions are inherently complex by nature, and would offer a distinct array of opportunities and challenges for sellers and purchasers alike, such as the purchaser having to grapple with limited due diligence and lack of representation and warranties, obtaining financing and potential clawback challenges from interested parties but in any event with the right risk appetite there are opportunities to acquire the assets or business at a great discounted value. Finally, a successful distressed M&A transaction more often than not requires the involvement of the right parties with the purchaser who is familiar with the nature of the asset and able to match the asking price by the seller and with a solid business plan to maximise the value of the assets post completion.

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