

Restructurings and Distressed Investing — Planning the Perfect Exit

Investors must address several key issues at the outset of a restructuring to smooth the path to a successful realisation of their investment

The classic image of a restructuring situation is of the critically ill patient struggling to survive. All efforts are focussed on right-sizing the balance sheet to save the company from total collapse. However, this over-arching priority can divert attention from the equally important goal of preserving value within the business. Ultimately, the goal of any investor in a distressed situation is to realise a suitable return. In the same way as an investor should plan how to preserve value, they should pay equal attention to planning how to realise that value through a post-restructuring exit. The challenge is to retain the discipline to do so whilst implementing a holistic restructuring under the pressure of a potential insolvency.

Timing

The key to planning any exit is to establish the desired time horizon for realising the investment. Investors must be realistic as to what is achievable. The ability to exit quickly will often come at a cost and should be balanced against the need to place the business on a sound footing for long enough to resolve the issues that have brought it to its current position. Without doubt the short-term distressed investor will be focussed on the liquidity of its investment above all else. The longer-term investor should undertake a more complex assessment:

- What are the real exit timing goals, both best and worst case scenarios?
- Are the timing goals driven by investment targets or firmer back-stop dates such as financing restrictions or life-of-fund limitations?
- Does the exit timing take into consideration exit-transaction execution periods which will be subject to market or other risks?
- Are all investors' timing goals aligned?
- What is the preferred exit route? Is there tolerance for a partial exit (for example via a private placement, IPO or joint venture) or is a full exit the only attractive option?
- In the case of a private sale, who are the likely purchasers?

Investment structure

The ability to control the timing of any exit will turn, in many cases, on the investment structure adopted at the time of the restructuring. In all but those situations in which the investor has sole control of the business, the distressed investor must consider the extent to which it will be able to impose its wishes and timetable on other investors and whether its freedom to manoeuvre will be limited. A full understanding of these dynamics will be critical to the timing and nature of the exit and the control that the investor can exert. Key considerations in any investment or shareholders' agreement and/or company constitution documenting the overall restructuring package should include:

- Board appointment rights
- Minority protections, including any reserved matters/veto rights
- Tag along and drag along rights
- The ability to deal with any deadlock scenarios
- Pre-exit process provisions such as a right to request an amendment to the capital structure and prior consent from co-investors to any re-financing or recapitalisation

Beyond the pure legal considerations, in order to plan and effectively facilitate the ultimate exit, any distressed investor should consider carefully the nature and goals of its co-investors. Do they share the same goals and target or are there likely to be differences of opinion? Even where the same goals and targets are shared by the co-investor(s), consideration must be given to what scope exists for ownership rights to change hands during the life of the investment. The distressed investment situation is often an evolving one. Co-investors may exit and/or introduce a third party with conflicting interests; common interest groups can be formed and can break-up rapidly. Considering how this fluidity may impact the investor is crucial as matters develop over time. Changing positions can create both risks and opportunities and hand unexpected influence to relatively minor players within the capital structure such as through minority veto rights.

Convertible or exchangeable shares, warrants and other share subscription rights can present particular risks in this regard, as they may afford unexpected value or influence to the holders upon exercise. When considering the investment structure at the time of the restructuring, investors should consider precisely what the capital structure will look like when all such securities are unwound and how this structure sits with an investor's exit timetable. Often unanticipated or unintended powers can fall to the holders of such securities impacting other investors' influence or returns.

Clearing the barriers to exit

Each distressed business will face its own challenges and difficulties. Addressing those issues so that the business is able to operate on a secure footing will, in most cases, be a pre-requisite to a profitable exit. Identifying the major hurdles and conducting appropriate due diligence is crucial to developing a viable strategy to resolve the critical concerns and implement an effective and timely exit plan. The common issues to address include:

Due diligence – business and operational issues

Clearly, any number of business and operational challenges will have contributed to a distressed business's difficulties. Unpicking what went wrong and how to fix it may take many months or even longer. Nonetheless, a firm understanding of the challenges facing the business will afford investors a far

greater opportunity to develop a coherent turnaround and exit strategy and an understanding of the costs involved.

The pressures of a potential restructuring or insolvency will inevitably limit the time available to investors to conduct — or for management to participate in — appropriate due diligence. Investors and management should consider how much time is genuinely available to conduct due diligence, to develop a realistic understanding of the level of comfort such due diligence will provide and to establish whether the due diligence that can be conducted is adequate to allow the investor to develop a robust turnaround and exit strategy.

Long tail liabilities

In certain situations, the financial stress of the company may be a direct result of significant long tail liabilities. These could arise from, for example, significant litigation, regulatory investigations and fines, pension scheme liabilities or environmental exposure. Negative macroeconomic conditions may both impact the value of the business directly and increase these long tail liabilities. Specialists should assess these liabilities in order to quantify the extent of the exposure and the approach to containing them. Any failure to do so may impact the investor's ability to exit at an attractive valuation.

Financing structure

Financial restructuring of the business often provides part of the solution to distressed scenarios. Ensuring that the company's financial structure — in particular its debt finance arrangements, including its working capital facilities — provides the appropriate flexibility will be key to smoothing the path to exit. The most common pitfalls are to be found in change in control covenants that effectively prevent the disposal of the investor's interest, in whole or in part, absent creditor consent. Restrictions on disposals by the company may present similar obstacles. Obtaining creditor consent will clearly become a greater challenge when considering multiple creditor facilities or publicly traded debt securities. Naturally, a borrower or investor will never be able to obtain full flexibility to execute whatever exit plan it chooses. However, investors should carefully consider likely exit alternatives, so that, subject to negotiation, those alternatives can be implemented within the terms of the relevant financing agreements. Retaining flexibility so that the existing financing arrangements are "portable" and can be transferred to the new owners of the business provides an obvious advantage.

Management team

Investors should identify the management team that will guide the business on its path to recovery. Will the existing management team be replaced entirely or would retaining all or at least some of the team members be prudent? Will the restructuring plan involve a creditor-turned-shareholder acquiring a seat on the board? What are the costs involved in removing and/or replacing individuals? Investors should also carefully consider whether the right team is in place for the appropriate stage of the company's rehabilitation. The individuals needed to negotiate with creditors and bring the business back from the brink of insolvency may not necessarily be the right people to implement a longer term turnaround strategy. Similarly, succession planning should be considered, as the turnaround team may not be the right group to continue the growth of the business once it has returned to a more stable footing and is ready for the next growth stage. Putting in place the right individuals to commence and lead that next stage will likely contribute to the exit valuation.

Investors should also consider the team that will execute the exit. The transaction will require a detailed knowledge of the company to drive the due diligence process and to prepare transaction documentation (e.g., any information memorandum or prospectus). Cost-cutting initiatives may mean that the company is

left with only a lean central management team and additional resources may be required if the appropriate individuals have not been retained.

Management incentives

Investors should consider how management will be appropriately incentivised through the turnaround process and should ensure that management's interests are suitably aligned with the investor and the overall exit timetable. In a distressed situation it is likely that existing management's incentive package will have little or no value. As a result, if any of the existing team is to be retained, appropriate amendments may be required to their incentive package. The issuance of securities to management may require the consent of a wide group of investors if dilutive of their holdings. Management may not be willing to accept ordinary equity if it holds little value. An investor may look to structures including equity/performance ratchets for management, in order to closely tie management's realisation to the performance targets of the business following the restructuring. The individual managers' tax positions should be considered at an early stage as this may have some impact, for example, on the group's corporate structure (including structuring issues to give certain managers the benefit of entrepreneur's relief).

Corporate structure

Although a business may be able to operate under its existing corporate structure through the turnaround process, it is likely the business will require some form of pre-sale or pre-IPO reorganisation. Such reorganisation could be as simple as inserting a new "listco" at the top of the group structure. Ensuring that investors retain appropriate powers and flexibility to take such steps is advisable (as noted above). More complex groups may require more fundamental restructurings prior to an exit in order to deal with investments at different levels of the capital structure and tax issues. Although identifying every issue at the time of the initial investment or restructuring may not be possible, investors should develop a broad understanding of what may be required and, more importantly, understand whose consent will be needed.

Tax

Tax considerations to ensure an efficient structure for realising value will always be key to any exit. Often, surprisingly little attention is paid to the tax planning of an exit at the time of the restructuring. While understandable, given the competing priorities at that time, tax concerns will frequently drive a need for greater complexity in the exit structure — particularly given that other interested parties, (including the company, the investors and management) — may not have tax positions that are aligned. As discussed above, if a more complex pre-exit restructuring is necessary, this complexity may hand unwanted influence to those whose consent is required.

Negative publicity

Ultimately, the reputation of any company that has approached or gone through a restructuring will be tainted to a certain degree. Key to a successful exit, particularly via the public markets, will be rebuilding the company's reputation. Although financial and operational success will go a long way towards achieving this, altering the market's perception of a failed company is a long term task. The work to achieve this, including developing a clear internal and external communication strategy, should start well before the exit is contemplated in earnest.

Final words...

No two restructuring investment opportunities are the same. In many cases the issues highlighted above will apply to a greater or lesser degree. Other considerations particular to the relevant business and/or the investor(s) may have a greater bearing than any of the above concerns. The ultimate goal of any investor

in a restructuring situation is to generate a suitable return. In order to do so, however, not only must the underlying business perform but the exit route to realise that return must be effective. Investors must plan both of these aspects of distressed investing at the outset. And therein lies the key message; for in the case of exiting a restructuring situation, the old maxim applies more so than ever: “marry in haste, repent at leisure.”

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

[James Inness](#)

james.inness@lw.com
+44.20.7710.3019
London

[John Houghton](#)

john.houghton@lw.com
+44.20.7710.1847
London

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