

BANKRUPTCY AND INSOLVENCY

The risk of buying a distressed business can bring great rewards

Conservative and risk-averse purchasers would do better to pay the higher upfront costs of a healthy business, but the purchase of a distressed business can be profitable for those willing to take the risk.

By Gary Lifman

If any of your clients are interested in running their own businesses, they've probably considered the traditional routes of either starting their own or buying an existing profitable company. However, one avenue that people sometimes fail to consider is the option of buying a distressed business. While each option presents its own risks and rewards, buying a distressed business can offer many opportunities for the right person — as long as they have the right professional team in place.

Know your client

The first step is to make sure your client has the mettle to play in the distressed business game. The ideal buyer needs to be a "doer" who is comfortable getting his or her hands dirty. Many distressed businesses have lost market share, key employees, credibility, customers and suppliers. To get the business back on the path to prosperity, new owners must be compassionately ruthless, being prepared to do what it takes — including firing staff or restructuring. While it can be a long and sometimes painful process, the

person with the right constitution can often reap the glory of a successful venture down the road.

It can be easier to accomplish these tasks if the purchaser is in a related industry. In addition to ensuring an optimal transfer of knowledge, this allows the business to more easily integrate into the existing one. Industry-specific expertise also comes into play after the deal closes. While a newly acquired healthy company can be effectively managed by focusing on the status quo, distressed businesses require additional attention. Investors must plan for the company's near-term survival and longer-term recovery.

Know the ins and outs

The process of purchasing a distressed business is very different than that of simply buying an existing healthy one. There are many avoidable pitfalls that you and your client should keep in mind:

- Assets are usually purchased through an insolvency proceeding (receivership, *Bankruptcy and Insolvency Act* or CCAA restructuring) and as such are sold on an "as is, where is" basis.

These types of transactions happen very quickly. While the purchase of a healthy business can take months, distressed business sales are often completed in just a few weeks.

- While due diligence should always be done by a purchaser, the representations and warranties normally provided simply do not apply in a distressed business transaction. If the business has gone through a restructuring or insolvency process, there will be no hidden liabilities, which means due diligence will rest more on the asset side of the balance sheet. The due diligence process should also consider how the assets can be leveraged by a purchaser applying his or her expertise and financial resources as the business moves forward.

- Insolvency is a highly specialized area that demands the deft legal touch of experienced practitioners with a focused skill set. It pays to recognize that an insolvency-specific professional team made up of experienced legal, financial, tax and valuation advisers can more quickly identify and exploit the opportunities

inherent in this type of transaction.

Finding the hidden gem

The real key to successfully navigating the acquisition of distressed firms extends beyond simply knowing the ins and outs of these unique transactions. Relationships within the insolvency community play a significant role. All the players know each other, either personally or by reputation. By involving experienced practitioners right from the start, lawyers and their clients can gain an inside track to many transactions.

To advise clients eager to buy these diamonds in the rough, it makes sense to start the process with insolvency professionals. Look for firms with both corporate finance and restructuring groups that can help identify and work through the whole acquisition process to ensure the right skills are available at each stage. Have trustees help identify synergistic buyers and sellers. By working with specialists who have established practices in the insolvency community, you have a better chance of tapping into these hidden opportunities on behalf of your clients and ensuring a smoother process if the transaction proceeds at an accelerated pace.

On the plus side

Despite the risks, distressed companies present some compelling financial advantages over more traditional investment choices. Beyond the reduced asking price, companies that have gone through a restructuring have been cleansed of all debt and related regulatory obligations.

In addition, business buyers of conventional, non-distressed com-



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panies typically pay a multiple of earnings, which includes goodwill. If the business fails, they may be able to recoup only the break-up value. Buyers of distressed companies typically only pay the break-up value thereby limiting their downside risk should the company fail.

Ultimately, distressed businesses are not for everyone. Conservative and risk-averse purchasers would do better to pay the higher upfront costs of a healthy business. But with greater risk comes the potential for greater reward. Those with the stomach for it can, and do, succeed from one man's loss.

Gary Lifman is a partner with Toronto-based A. Farber & Partners Inc., which has provided expert advice in the areas of insolvency and restructuring for over 25 years. Other specialty services provided by the Farber Group include forensic accounting, fraud investigations, corporate finance, turnarounds and CFO resources.