There are a myriad of differences between selling distressed and healthy companies. Irrespective of the situation, most sellers are highly motivated to maximize value. In a distressed situation, however, external parties can dictate the timing of a sale and dramatically influence its outcome. Selling a distressed company is unique; the path is paved with pitfalls. There are several actions management can take to maximize enterprise value and the ultimate outcome for all stakeholders.

Distressed Company Attributes
For purposes of this article, distressed companies are approaching, or in, the zone of insolvency. These companies are troubled, but have not slipped into the more severe arenas of bankruptcy or receivership. Attributes for distressed companies can include any or all of the following:

- Difficulty in paying obligations as they become due in the normal course of business
- Limited or no credit availability
- Lack of ability to refinance existing debt
- Covenant violations with lenders
- Erosion of enterprise value and bonds trading at junk pricing
- Liabilities exceeding assets

Management Responsibilities
As the company approaches the zone of insolvency, both management and the Board of Directors assume greater operational and fiduciary responsibilities to all creditors of the company. Management must develop clear strategies to deal with the liquidity crisis and address the objectives of each stakeholder. Examples of viable strategies can include turning around the company, downsizing and reducing debt, divesting a product line, subsidiary, or other select assets, refinancing existing debt, acquiring a competitor, or selling the entire company. Oftentimes, the company pursues parallel paths such as implementing an operational turnaround and pursing the sale option.

Profit Improvement Initiatives
There is an old saying that states “If you find yourself in a hole, the first thing to do is stop digging!” It is critical for management to make immediate changes in their business to generate near-term cash availability and to maximize proceeds from the disposition of all or part of the business assets. Profit improvement actions demonstrate management’s vision of profitability, buy time and options with creditors, and increase enterprise value. While non-distressed companies will also benefit from profit improvement initiatives, they are imperative for distressed companies, enabling management to better control the company’s destiny.

The minimum profit improvement goal is positive cash flow from operations after payment of debt service obligations. Profit improvements should address all aspects of
the business including sales and marketing, operations, administrative, financial, and cash flow/working capital management. Even if identified improvements are not fully implemented, certain buyers will reflect credible profit improvements in their purchase price.

**Sales Process**
Utilization of a well-run sale process is crucial to a successful outcome and robust valuation. Overall, these steps include preparing the company for sale, completing an Information Memorandum, preparing a Buyers List, assembling the Data Room for buyer’s due diligence, negotiating and executing a Letter of Intent, preparing the definitive purchase agreement, and executing the contract. Each step in the process has unique aspects in distressed situations.

**Preparing the Company for Sale**
Insufficiently preparing the company for sale is a frequent management mistake in both distressed and non-distressed situations. Arguably one of the most important aspects is the development of a believable “story” and strategy to present to the market in both the Information Memorandum and subsequent management presentations. The “story” articulates a clear explanation of the company’s missteps, remedies taken, company value drivers, and potential synergies for the buyer. It must be believable and include buyer-specific customization based upon an overall strategy. For example, an industry buyer may need the company’s facility; a financial buyer may want an acquisition strategy.

Other necessary preparation includes critical tasks such as “cleaning up” the financial statements. Each line on the balance sheet should be supported with accurate and justifiable subsidiary schedules or analyses. Additionally, many companies complete physical inventories to ensure maximum accuracy in the quantities and valuation. Waiting until the buyer’s due diligence to discover balance sheet inaccuracies will likely result in suboptimal negotiating results.

**Information Memorandum**
There are some critical differences between a distressed and non-distressed company’s Information Memorandum. A distressed company’s memorandum must be prepared much quicker due to the overall urgency in the process. This is especially true if the company is burning cash. Another difference is to potentially focus the buyer on Adjusted Contribution Margin which shows the incremental profit contributed assuming products are moved to the buyer’s facility. Another key difference is focusing the buyer on the present and future, not the past. For example, an important strategy is to direct the buyer to use an adjusted run-rate for purposes of defining cash flows. Adjustments are based upon one-time or non-recurring items, including those identified but not yet implemented. By focusing on adjusted run-rate data, the buyer can quickly assess cash flows of the company on an ongoing basis after full implementation of profit improvement initiatives without unduly penalizing the seller for past missteps.


**Buyers List**
Developing the distressed seller’s Buyer’s List is similar to a non-distressed seller, but entails some critical nuances. The objective of a robust auction process is similar in both circumstances and all viable buyers are considered whether strategic or financial, domestic or international. Generally in a distressed sale, however, buyers must have the financial wherewithal to consummate an all-cash transaction. While most financial buyers do not pursue distressed companies, there is a community of private equity funds dedicated to distressed situations.

**Buyer Due Diligence**
Proper communications are critical in all distressed situations with the type of communication dependent upon the type of stakeholder. Potential buyers must have accurate and consistent communication in order to have a fair process. To facilitate buyer communications, a “Data Room” is used to accumulate pertinent information for potential buyers to review either before or after they make a purchase offer.

**Buyer Negotiations**
The seller should not negotiate in a way that gives the impression that a deal must be completed with a particular buyer. This is a key challenge for the seller in a distressed situation. Rather than selling from a position of vulnerability, sellers should negotiate with a sense of urgency while understanding their best fallback alternative if a particular transaction is not completed. Ideally, this is achieved by negotiating with multiple buyers simultaneously. Good negotiators lead buyers to a strong purchase price through knowing the buyer’s business and synergistic opportunities. These synergies become an integral part of the presentation of the seller’s business strategy to the buyer.

**Valuation**
Unlike a non-distressed situation, the secured lender’s calculation of liquidation value may determine the likely disposition strategy and timing. Banks will use appraisals of real estate, fixed assets, inventory and other assets as a basis of an orderly liquidation or forced-sale valuation. This liquidation calculation becomes the senior lender’s strategy that minimizes implementation risk and is the “worse case” scenario. Offers generally must exceed this liquidation value or secured lenders will be inclined to take the “sure thing” rather than risk a discount on their debt as a result of the company sale. A well-run sale process should generate results significantly beyond this floor value if there is strong potential value.

**Speed to Close**
In a distressed sale, the seller generally wants to close quickly due to liquidity constraints. Secured banks are also motivated for a quick close since cash used to fund operations will reduce their collateral position. This highlights the need for the company to improve profitability so management has the ability to better control its destiny. Timing considerations also have implications on due diligence calendars and preparation of a definitive purchase agreement. One technique frequently utilized in a distressed situation is preparing the definitive agreement concurrent with the buyer’s due diligence. Some buyers prefer to piecemeal the process with due diligence completed first, thereby
limiting their legal costs for the definitive agreement. However, buyers experienced in purchasing distressed companies understand the need for speed and the inherent risks with a slow close including potentially losing both customers and suppliers, or the filing of an involuntary proceeding.

**Deal structure**
Distressed sale deal structures have some significant differences compared to sales of healthy companies. Often assets are sold “as is, where is” because the seller has inadequate resources to cover representations and warranties in the purchase agreement. There are also significant limits on the Material Adverse Change (MAC) clause in the contract. Simply due to the nature of a distressed company, a MAC could almost be expected. Finally, there is limited or no provision for a buyer’s financing contingency in the contract.

**Conclusion**
There are numerous differences between a distressed and non-distressed company sale. In both situations, management wants to successfully control their company’s destiny. Selling a distressed company, however, is inherently more complex. Knowing and addressing those complexities and pitfalls will define the ultimate success or failure of the company sale and the proceeds for stakeholders.