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Balancing the Risks and Benefits of Transactions Involving Distressed Companies

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Introduction

As we all know, 2008 and 2009 have presented us with an extremely challenging business environment, one which many companies were unprepared to face. Given the limited availability of credit and the difficult access to both the public and private financing markets, the sad reality is that many companies will not weather this economic storm. While there is no mystery as to why we've seen an increase in the number of transaction involving distressed companies, the risks, benefits and structuring of distressed company acquisitions remain a bit of a mystery to many, even veterans of more typical M&A transactions.

Distressed company M&A involves some risks that don't exist in a non-distressed situation and the buyer often can't avail itself of the standard contractual protections, such as indemnification provisions, it would have in a typical transaction. On the other hand, for buyers willing to accept certain risks, the current market presents interesting opportunities for acquiring businesses at prices that can be a relative bargain and, depending on how the transaction is structured, may even present the opportunity to avoid assuming more unwanted liabilities than in a non-distressed deal. Understanding the risks and benefits of distressed company M&A, and how to use structuring to achieve the right balance, will help buyers navigate down an unfamiliar road to what just might be a very beneficial transaction. For a buyer (and its lawyer), adjusting to the rules of the road in the world of distressed M&A may be the most challenging part of a transaction with an insolvent company.

Purchasing assets from an insolvent company: unique challenges

When a buyer is considering purchasing assets from an insolvent company, it must pay particular attention to avoiding the inadvertent assumption of unwanted liabilities—a much more difficult proposition in transactions with insolvent companies than in other contexts. For buyers used to purchasing assets from solvent companies, a distressed transaction may be their first introduction to the concept of "fraudulent transfer" or "fraudulent conveyance." In a nutshell, a creditor of an insolvent company may be able to invalidate a sale of the company's assets, or seek recourse against the buyer of the assets, in the event of a fraudulent transfer. The concept of fraudulent transfer appears in both the bankruptcy code and in the laws of each state; while the elements of such a claim vary depending on the jurisdiction, as a general matter if the seller does not receive reasonably equivalent value for the assets and was insolvent, became insolvent as a result of the transfer, or the remaining assets of the seller were unreasonably small in relation to the business, then creditors will have a basis for a fraudulent transfer claim. Such a claim raises the possibility that the buyer will have to satisfy liabilities to creditors that it did not agree to assume—and may have in fact expressly provided were to remain with the seller—in the transaction. Similarly, the buyer may be subjected to additional, un-bargained for, liabilities through claims brought against the buyer on a successor liability theory. By case law and, in some instances, by statute, buyers that are "successors" to the business are deemed to have assumed certain liabilities, regardless of any assertions to the contrary in the purchase agreement. Liabilities for taxes, product liabilities, environmental and employee claims are the most fertile ground for successor liability claims.

At the same time, it is typical to have only a relatively limited ability to be made whole for unwanted liabilities through provisions in the purchase agreement. It is uncommon for the purchaser of assets out of bankruptcy, for example, to receive any significant representations and warranties, let alone any post-closing recourse; even in structures that fall short of a bankruptcy, representations and warranties, as well as post-closing recourse, are more limited than transactions involving healthy companies. A mixture of factors contribute to this, among others: the limited resources that a troubled company has to devote to negotiating a typical merger agreement—which would often run about sixty pages long—and preparing the related disclosure schedule; the buyer's desire to quickly close the transaction before the employee and customer bases completely disintegrate and the value of the transaction is lost; a discounted purchase price; and, given the discounted purchase price, the

relatively small amount reasonably available for escrow and indemnification.

As a result, diligence becomes of paramount importance. It is far preferable to avoid "buying" liabilities by discovering them in advance through diligence than to discover them following closing and have only limited recourse against the insolvent seller. Buyers should consider going beyond its usual diligence and obtaining a third party valuation of the assets being acquired, seeking releases and waivers from third parties who might have claims against the seller and employing deal mechanisms more directly involving the seller's creditors, such as an assignment for the benefit of creditors (also referred to as an "ABC") or a "friendly" foreclosure, discussed briefly below, which may provide some incremental protection against unwanted liabilities and claims of fraudulent transfer. But while the distressed company does present some unique challenges, it also offers a unique opportunity—the opportunity to use the bankruptcy process to more definitively leave unwanted liabilities behind.

The opportunity of bankruptcy protection: a "363 sale"

"Chapter 11" bankruptcies are well known, if not well understood, as a mechanism by which an insolvent company may develop, pursuant to the bankruptcy laws and subject to the confirmation of the bankruptcy court, a plan of reorganization which would allow the company to restructure its debts and contractual arrangements with its lenders, customers, suppliers, vendors, etc., ideally with the goal of emerging from bankruptcy as a viable business. Lesser known in the popular lexicon but more common in practice are "363 sales," a reference to a section in the bankruptcy code allowing an insolvent company to sell assets, often through an auction, with the sale blessed by the bankruptcy court. From the buyer's perspective, 363 sales offer many of the same benefits as a Chapter 11 plan, but achieved more expeditiously and at a lower cost. First and foremost among the benefits of a 363 sale is that, with only limited exception, assets are transferred to the buyer free and clear of liens and encumbrances and free from creditor and successor liability claims. 363 sales give buyers significant protection against unwanted liabilities, although there have been some conflicting court decisions on the degree to which the buyer will have such protection. In some instances, courts have imposed successor liability even for sales occurring through a bankruptcy process, but that is the exception rather than the rule. Other benefits include the ability to assume certain contracts even if they contain anti-assignment provisions (provided that defaults are cured), a shortening of the waiting period required under the antitrust laws and the fact that no approval of the transaction by the seller's stockholder is required.

A 363 sale is often pre-negotiated. That is, before any filing is made with the bankruptcy court, the seller and the buyer enter into a negotiated asset purchase agreement (or APA) to then be submitted to the bankruptcy court for approval. On the most superficial level, the APA is similar to what a buyer sees in the context of any other asset purchase. It provides for a list of particular assets to be purchased, liabilities to be assumed, liabilities to remain with the seller and for a specified purchase price. The APA would contain representations and warranties, pre-closing covenants, closing conditions, and termination rights. Within these high-level categories of provisions, however, there will be substantial deviation from the provisions contained in an APA involving a solvent company. As previously discussed, the representations and warranties will be very basic and limited. Pre-closing covenants will focus less on limitations on the seller's operations between signing and closing and more on the bankruptcy process itself. Closing conditions and termination rights will be limited and fairly seller favorable. In fact, buyers new to 363 sales may be surprised to learn that the APA in a 363 sale is ultimately not binding on the seller until it is approved by the bankruptcy court. That approval can come only after a notice and an opportunity for an auction process during which creditors may challenge the terms of the proposed transaction and the seller must actively seek out other bidders for the assets.

A 363 sale APA thus explicitly puts the buyer in the position of being the "stalking horse bidder" for the seller's efforts to obtain a higher price for its assets in a public auction. It is common for the stalking horse bidder to receive a break-up fee if it is not the winning bidder in consideration for playing this role. Of course, the appropriate amount for such a fee is going to be hotly contested, because any fee that the buyer receives would come out of the total proceeds that are available to the creditors. Potential buyers must consider whether the risk of the public bankruptcy auction is worth the protection a bankruptcy process can provide or whether a privately negotiated transaction not subject to approval by the bankruptcy court might be more desirable; if a bankruptcy process is deemed more advantageous, potential buyers must decide whether it is better to be the stalking horse or to participate as a third party bidder in the later auction. Each case will differ depending on the competitive landscape for the assets, the types of liabilities that may arise, the number of potential creditors and claimants involved, and the importance to the buyer of securing the assets.

Downsides to a 363 sale

While a 363 sale can be completed more efficiently than a Chapter 11 plan, it nonetheless can be more time consuming than a typical asset purchase or other structures such as the ABC, the friendly foreclosure or

other variants of the same. It also exposes the buyer to the risk of being outbid at auction for the assets it desires to acquire. The auction process alone can be time-consuming, and in the interim the seller could experience a loss of employees and customers—and much of the value that the buyer is hoping to attain in purchasing the company could be quickly eroded. In addition, while the stalking horse buyer may negotiate an APA that provides for, among other things, a limited time period in which the bankruptcy process and the auction must occur, that certain requirements must be satisfied for a third party to submit a "qualified" bid in the auction, the minimum amount by which third parties must "overbid" the stalking horse and each other and, of course, the amount of the breakup fee if the stalking horse is not the winning bidder, the bankruptcy court must approve those provisions. While experienced legal counsel can guide the client towards what is a generally accepted range for such provisions, ultimately the bankruptcy court has the final word on these matters.

Alternative structures

Where circumstances warrant a greater degree of structural (as opposed to contractual) protection against fraudulent transfer and successor liability claims than a typical APA provides, but in a shorter time frame with less risk of third party bidders than a 363 sale provides, an ABC or friendly foreclosure may provide the right balance between the buyer's competing concerns. In an ABC, the seller assigns its assets to a third party (the assignee) who is then responsible for selling the assets and distributing the proceeds to the seller's creditors (net of the assignee's fee). ABCs are governed by state law and vary significantly from state to state. Depending on a given state's law, an ABC may or may not be an option. In addition, the fact that an ABC typically requires stockholder approval may also rule out an ABC as an option. While nothing provides absolute protection from a fraudulent transfer allegation, because an ABC involves a sale of the assets by an independent third party fiduciary, the purchase of assets through an ABC may reduce the risk that a creditor will view the sale process as having been unfair or inadequate and bring a fraudulent transfer claim.

In a friendly foreclosure, the secured creditor and the seller agree that the secured creditor will foreclose on the assets and then use its power as secured creditor to transfer title to the assets to a buyer. While the buyer should expect the secured creditor to seek to sell the assets on a purely "as-is, where-is" basis with little in the way of representations and warranties or indemnity, the structure may provide incremental protection against claims made by unsecured creditors and third parties asserting successor liability by virtue of the formal state law foreclosure process.

Final point: dealing with changed circumstances

When evaluating acquiring a distressed company, buyers should be prepared for surprises. Most likely, in the course of due diligence, the liabilities will turn out to be greater than initially thought, accounts receivable will be more difficult to collect than represented and issues surrounding employees will be thornier than anticipated. This is sufficiently common in distressed company deals that while it should not necessarily be cause for undue alarm, it may well be cause for rethinking how the transaction should be structured. Where it may have initially seemed that the seller was more "troubled" than "distressed" and the buyer was willing to proceed with a more traditional stock purchase agreement, changed circumstances may lead to a conclusion that in fact a 363 sale or friendly foreclosure may better balance the competing risks and benefits. Ultimately, the buyer's goals in terms of price, liabilities, timing, avoiding competing bids, keeping the employee and customer bases intact, etc. will all have to be taken into account. It is important for a buyer to remain flexible, to preserve its ability to revise the proposed structure to take its diligence into account and to keep its eye on the ball in terms of what it wants to achieve. One of the most important roles the buyer's lawyer plays in a distressed company deal is structuring the transaction to appropriately balance the risks and the benefits in a manner that best achieves the client's business goals.

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