Purchasing distressed companies: how to use the US bankruptcy system to your advantage

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Financially distressed and over-leveraged companies create great investment opportunities. For a party interested in acquiring the assets of such a company, whether the sale occurs inside or outside the bankruptcy context will present different advantages and disadvantages.

Sales outside bankruptcy are generally less expensive and time-consuming than those in bankruptcy and will not expose the purchaser to the same degree of formal competition for the assets. However, this type of sale may create certain concerns for the potential purchaser. For example, if the sale proceeds are insufficient to pay the distressed seller's creditors in full, will the buyer face future exposure to these creditors? In addition, will the sale itself be subject to later challenge or avoidance?

In contrast, sales that occur in a bankruptcy setting offer purchasers greater post-sale legal protection from the seller's creditors and from related concerns. Thus, such sales, in particular pursuant to Section 363 of the Bankruptcy Code (known as a '363 sale'), have become particularly popular in recent years. In a 363 sale the purchaser and the Chapter 11 debtor (as seller) generally enter into a proposed purchase agreement that is subject to both higher and better offers from third parties, typically following a court-approved auction process and ultimately bankruptcy court approval following a hearing on notice to all the debtor's creditors and other parties in interest. Bankruptcy sales may also be carried out under a Chapter 11 reorganisation plan, as discussed below.

The proposed purchaser should be in a better position to obtain the target company's assets free of pre-sale liabilities and obligations that the purchaser has not elected to assume if it exercises appropriate care throughout the bankruptcy process, including:

- negotiating a sale agreement that provides the purchaser with certain downside protections such as a break-up fee and/or an expense reimbursement, whereby it would receive at least some level of monetary compensation from the seller in the event that it were ultimately outbid or the proposed sale fell through, in exchange for serving as the initial lead bidder (or 'stalking horse'); and
- proposing a comprehensive order of the bankruptcy court approving the sale.

Thus, a purchase consummated through the bankruptcy process should help to ensure that the buyer receives the benefit of its bargain, enhancing the attractiveness of distressed investments. Accordingly, a 363 sale proves to be the most attractive option available to buy the assets of a distressed company in many situations.

This chapter compares the pros and cons of purchases of assets of distressed companies made outside bankruptcy to those made in the context of a bankruptcy case, illuminating the benefits that can be derived from the latter. It then discusses different structures for bankruptcy sales, including 363 sales and sales consummated pursuant to a reorganisation plan under

Chapter 11 of the Bankruptcy Code (plan sales). It concludes by discussing specific ways to enhance the likelihood of success of a particular bankruptcy sale for the proposed purchaser.

Sales outside bankruptcy

In most situations, as long as other applicable laws are complied with and the seller satisfies its fiduciary duties and contractual obligations, parties are free to consummate a sale outside the bankruptcy process. In addition, even where a sale is later challenged under governing state law (eg, as an avoidable fraudulent conveyance), generally the parties need show only that fair value was exchanged. Accordingly, such a sale may generally proceed without judicial oversight or extensive creditor or shareholder scrutiny.

For these reasons, sales consummated outside bankruptcy offer several potential advantages over bankruptcy sales. First, non-bankruptcy sales are generally quicker and less expensive, since both the legal and other costs associated with a bankruptcy and the delays inherent in the bankruptcy court auction process are avoided. Similarly, non-bankruptcy sales may be more likely to preserve the company's relationships with its customers and vendors, especially given the likely enhanced speed of the sale, as well as the reduced potential disruption to the seller's business that a bankruptcy filing may cause.

Second, the purchaser in a non-bankruptcy sale faces less competition because such sales are not generally subject to the common requirements in bankruptcy of a formal auction or that the sale be subject to higher and better offers. In addition, non-bankruptcy sales are subject to less public or creditor scrutiny and are not overseen by a bankruptcy judge, giving the seller and the purchaser greater flexibility. Thus, the purchaser has a greater ability to lock up the transaction or enter into no-shop agreements with the target company, offering the purchaser greater short-term certainty.

Nonetheless, sales of a distressed company's assets outside bankruptcy have several significant disadvantages, especially for the purchaser. First, the likelihood that the purchaser could become responsible for the liabilities and obligations of the target company is much greater than in a bankruptcy sale. While the purchaser can, in the sale contract, purport to leave liabilities behind and to obtain indemnification and other rights against the seller, such rights may prove illusory without a comprehensive bankruptcy court order expressly approving the sale free and clear of such liabilities and obligations, particularly given that the seller may lack any remaining material assets following the sale.

Second, if the seller enters bankruptcy after the parties execute a purchase agreement but before they consummate the sale, the purchase agreement may be subject to rejection by the seller or by a bankruptcy trustee overseeing the debtor's estate, likely leaving the purchaser with only an unsecured claim for any resulting damages. Under those circumstances, the purchaser could receive little or no compensation for the time and expense it has incurred in connection with the sale. More troublingly, the agreement may still be enforceable by the seller or its bankruptcy trustee against the purchaser, but now under circumstances or in an environment in which the purchaser may no longer be comfortable going forward.

Finally, and of particular note, is the risk that the target company may file for bankruptcy protection after the sale has closed. In that event, there is a substantial risk that the seller's creditors or a bankruptcy trustee could seek to avoid the sale as a fraudulent conveyance on the grounds that the seller was insolvent, or rendered insolvent thereby, and that the purchase price did not constitute fair or reasonably equivalent value. The remedy in such circumstances can be the unwinding of the transaction or requiring the purchaser to pay additional consideration as damages. The more successful the acquired company becomes, the more vulnerable to a post-sale attack it will be.

Bankruptcy sales

Bankruptcy court transactions offer many advantages to both seller and buyer. For the debtor, filing a bankruptcy petition automatically stays the collection of pre-petition accounts and litigation. In addition, subsequent to the filing debt payments are deferred and are subject to compromise, enabling the debtor to continue its operations while in bankruptcy. Moreover, the Bankruptcy Code bestows powers on the debtor that it would not possess outside bankruptcy. For example, the debtor may reject unfavourable unexpired leases and executory contracts and assume and assign favourable ones to a purchaser, subject to curing any payment defaults, even if (with some limited exceptions) the terms of such contracts purport to restrict assignment. The most substantial benefit to the purchaser in a bankruptcy sale is that the

purchaser may buy the debtor's assets free and clear of most liens, claims and encumbrances, greatly limiting the purchaser's exposure to future successor liability and other claims.

Bankruptcy transactions, like out-of-court transactions, do have certain disadvantages. For example, in the case of 363 sales the bankruptcy court is required to hold a hearing (following public notice and typically an auction) to determine whether the purchase price being paid is the highest and best offer for the assets under the circumstances. In addition, the very possibility of an auction limits the purchaser's ability to lock up the transaction in a manner that would generally be possible outside bankruptcy (although the purchaser can negotiate for certain protections to compensate it in the event of a successful overbid by another party).

An additional disadvantage of a bankruptcy sale is that for certain businesses, bankruptcy can generate negative publicity and adversely affect performance, thereby decreasing the value of the assets in question. In addition, the debtor's decisions in its operations and business are subject to increased scrutiny during the bankruptcy process. Further, the bankruptcy court can occasionally become an open forum for dissent by creditors that are unhappy with the debtor or its circumstances, including providing a ready platform for opposing the proposed sale. Thus, even if it is the winning bidder, the proposed purchaser may be forced to raise its offer, either to defeat competing bidders or to allay objections to the sale by the debtor's major creditor constituencies.

Sales under Section 363 of the Bankruptcy Code

The most common type of bankruptcy sale is a 363 sale. Section 363 of the Bankruptcy Code permits a debtor to sell substantially all of its assets independent of a reorganisation plan, provided that it adheres to certain procedures (including a bidding process, an auction and a sale hearing) and provides parties in interest with adequate notice and an opportunity to be heard and to object to any aspect of the proposed sale.

In evaluating competing bids at an auction, the debtor may consider not only the price offered, but also whether the competing bidder can consummate the transaction in the same anticipated time period as the initial proposed purchaser. In addition, a bidder with committed financing and necessary regulatory approvals will possess a clear advantage over other bidders. Similarly, the debtor will also consider whether it would be preferable to break up the assets through sales to multiple acquirers in order to determine whether the overall consideration that could be realised in that manner exceeds that offered by the proposed stalking horse for all the assets in a single purchase.

Although there are certain disadvantages to 363 sales, by virtue of the capacity to limit pre-sale liabilities from following the purchaser, a 363 sale often proves to be the most desirable option for the purchase of the assets of a distressed company. Advantages from the buyer's perspective include the relative speed at which such sales can occur (as least as compared to plan sales) and the avoidance of complicated restructuring issues involved in the plan process. Moreover, the purchaser may agree to act as the initial bidder (referred to as a 'stalking horse'), entitling it to certain downside protections if it is outbid at the subsequent auction.

Disadvantages include the delay and attendant costs and burdens of the auction process (as compared to sales outside bankruptcy), as well as the risk that the purchaser's initial offer may be topped by higher and better offers.

However, under certain circumstances the debtor may be able to consummate a sale without undertaking a formal auction process. For example, if the debtor's cash flow or other operational situation is particularly dire, it may attempt (typically with the consent of its major creditors) to convince the court that it is necessary to approve the sale to the proposed purchaser as quickly as possible and without a future auction, before the debtor runs out of money and is forced to close its doors. Sometimes the debtor has already conducted an extensive auction process (in some instances with the assistance of an investment banker or similar professional) before signing an agreement with the proposed purchaser, and may be able to convince the court that any future competitive bidding through an additional court-approved auction is not warranted or likely to achieve a substantially greater purchase price.

In addition, if the proposed buyer has sufficient leverage (eg, because the debtor needs to consummate a sale quickly, there are few other anticipated interested buyers or the buyer is offering a high purchase price) it may inform the debtor that it is interested in acquiring the assets only if the debtor agrees not to conduct a formal auction. Of course, not only would that kind of buyer have to forgo the opportunity to obtain a break-up fee or other bidding

protection, but these efforts are also more vulnerable to a creditor challenge than an auction sale.

These potential non-auction scenarios are possible only in fairly unique circumstances. Moreover, a third party may still emerge at or prior to the sale hearing and attempt to make a competing bid. If the debtor (and its creditors) agree to accept that belated third-party bid, or are compelled to do so by the court, the initial proposed purchaser would have limited recourse.

Stalking-horse status

The availability and enforceability of exclusivity or no-shop clauses in the bankruptcy sale context are limited because the debtor has a duty to maximise the value of its assets for the benefit of its creditors by exposing the assets to as many competing bidders as possible. Nonetheless, a prospective buyer may agree to act as a stalking horse by signing a purchase agreement, subject to the approval of the bankruptcy court and to higher and better bids at an auction. In general, the bankruptcy court will consider granting stalking-horse status to a proposed purchaser on an expedited basis (typically within a few weeks of the parties signing the purchase agreement and the debtor filing an appropriate motion in the bankruptcy court), thus guaranteeing early in the sale process that the purchaser/stalking horse will either acquire the assets of the company if not outbid at the auction or be compensated for its costs and efforts if it is outbid.

In particular, a stalking horse should insist that the debtor obtain court approval of a break-up fee and an expense reimbursement, which have become common features in 363 sales. Such fees are usually around three per cent of the proposed consideration and are generally payable from the proceeds that the seller receives from the sale to another bidder. However, depending on the level of interest of other potential purchasers, the stalking horse may be able to negotiate better terms on these and other items. Thus, the more leverage a purchaser has, the greater protections it can obtain, including, in some cases, granting the break-up and reimbursement fees priority over other post-petition claims.

Thus, attaining stalking-horse status offers several distinct advantages that increase the likelihood that the initial proposed purchaser will emerge as the successful acquirer of the assets, regardless of whether a formal competitive auction actually ensues. Initially, before it will anoint a particular proposed purchaser as the stalking horse, the seller must be satisfied that such party will have the wherewithal and applicable regulatory approvals to consummate the transaction within the contemplated time period. Any party making a competing bid has the burden of overcoming any 'bird in the hand' feelings that the seller may have, as it must demonstrate that it is at least as capable as the stalking horse (if not more so) of closing the deal in a manageable timeframe.

Another factor serving to entrench the stalking horse is that it will likely have more time to conduct its due diligence with respect to the assets than any other party. Typically, other potential bidders will begin their due diligence only once the court has already approved the stalking horse. Not only will such other bidders have less time, they will also have to undertake such due diligence at the same time as all other potential bidders, in contrast to the stalking horse, which in all likelihood had sole access to the debtor's management and books and records before it executed the purchase agreement. Similarly, only the stalking horse will be reimbursed for its time and expenses if it is not the winning bidder, thereby disincentivising other parties from entering into the process by requiring them to bear their own due diligence and related expenses if they fail to win at the auction.

Furthermore, the stalking horse has the ability to establish both the terms of the sale transaction against which other parties are required to bid (by drafting the sale agreement that will provide the baseline for all other competing bids) and the procedures that other parties must follow in making competing bids. The stalking horse can seek to affect the auction by imposing objective standards (eg, creditworthiness) or other requirements (eg, an earnest-money deposit or a minimum initial overbid) on other potential bidders; it also may seek to restrict the amount of time that other parties have to conduct their diligence and make a competing bid – all of which may serve as formidable barriers to entering the auction process. Moreover, the break-up fee provides the stalking horse with a competitive advantage because it requires that any competing bidder cover such amount, plus a premium, thereby effectively increasing the minimum purchase price for any other bidder by at least the amount of the break-up fee and any minimum initial overbid (or alternatively effectively enabling the stalking horse to credit bid the amount of the break-up fee when competing against any other bidder).

For these and related reasons, securing stalking-horse status will substantially increase a purchaser's ability to emerge as the successful bidder of the debtor's assets.

Sales through a Chapter 11 reorganisation plan

Although a great majority of sales that occur in bankruptcy are 363 sales, plan sales are also a viable method to buy the assets of a distressed company. However, plan sales are more complicated and generally take longer than 363 sales. A reorganisation plan may be implemented only after the debtor's disclosure statement (which provides creditors with adequate information concerning the proposed plan to enable them to vote) has been approved by the bankruptcy court and distributed to the debtor's creditors and shareholders for voting. A bankruptcy court will confirm a reorganisation plan only once the debtor has satisfied all the Bankruptcy Code's requirements – in particular, that the plan:

- is "feasible";
- is in the "best interest of creditors"; and
- either is approved by the requisite majority of parties voting in the impaired classes or complies with the cram-down requirements of Section 1129(b) of the Bankruptcy Code.

For the plan to be crammed down on dissenting creditors, it must both be "fair and equitable" and not "discriminate unfairly", and at least one class of impaired creditors must have voted to accept the plan. All these requirements are in addition to those necessary for the approval of the sale itself.

A pre-packaged or pre-arranged bankruptcy may also be attractive to a potential buyer of a company. A pre-packaged plan involves the negotiation of a reorganisation plan and the solicitation of votes prior to a bankruptcy filing, whereas a pre-arranged plan involves the negotiation of a plan pre-bankruptcy, but not the solicitation of votes until after the bankruptcy filing.

There are certain advantages to a plan sale. In particular, where the debtor's major creditors all strongly support the proposed sale, a plan sale may avoid the auction process and thus may be able to protect the purchaser's downside risk. Moreover, a plan sale can be structured with greater flexibility and can offer added protection for the purchaser and other parties in the form of injunctions and exculpation provisions contained in the proposed plan that are not always available in a 363 sale. In addition, by virtue of the plan confirmation process and all the protections afforded therein, creditors should have a greater comfort level with the overall transaction as, unlike a 363 sale (where the sole determination is which entity will purchase the assets and for what price), they will know what consideration they will actually be receiving from the debtor on account of their claims.

On the other hand, disadvantages include:

- the level of uncertainty involved as to whether the proposed plan will be found to satisfy all the statutory requirements for confirmation; and
- the requirement that the debtor pay all administrative and priority claims in full, potentially increasing the overall cost to the purchaser.

Similarly, the debtor must obtain the requisite level of votes from the debtor's creditors to approve the plan providing for the sale. In a 363 sale outside a plan, all the purchaser has to concern itself with is that it has provided the highest and best bid and that the debtor has satisfied the generally lower standards and burdens for achieving court approval for the sale.

Limiting the purchaser's post-sale liability

A properly drafted sale order can serve to insulate the purchaser from most successor and other claims stemming from pre-sale liabilities. First and foremost, the sale order should contain clear and broad language eliminating (or drastically limiting) any successor liability or any other pre-sale liability, and it should expressly enjoin any party in interest (including government entities) from asserting any such liabilities or liens against the purchaser or the assets in question following the sale.

Moreover, the order should provide for the retention of the bankruptcy court's exclusive jurisdiction to enforce the order (including enforcing the injunction provisions described above) and to hear any disputes related thereto or any efforts by the debtor's creditors to assert their liens or claims against the purchaser or its assets. The sale order should also require that any future reorganisation plan incorporate the sale transaction and preclude any deviations from the terms of the transaction without the consent of the purchaser.

The order should also contain specific findings that:

- the notice of the bidding procedures, auction and sale hearing was proper, adequate and sufficient;

- the transaction was not fraudulent;
- the consideration provided by the purchaser was fair and served to maximise the value of the assets for the benefit of the debtor's estate and creditors;
- the sale is exempt from any transfer or related taxes under Section 1146 of the Bankruptcy Code (although this finding has come under greater scrutiny recently, especially where a debtor has not yet filed a proposed plan at the time of the sale hearing);
- the transaction was negotiated at arm's length and with full disclosure to all relevant parties;
- the purchaser is not a successor to the debtor;
- the sale is not a *de facto* merger and the purchaser's business is not a mere continuation of the debtor's business;
- the sale transaction does not constitute a *sub rosa* reorganisation plan;
- the purchase was made in good faith;
- the sale price was not controlled by an agreement among potential bidders at the sale; and
- no other liabilities are being assumed by the purchaser other than those expressly identified.

If such an order is entered and proper notice is given, it will be very difficult for a creditor of the seller that received actual or constructive notice of the sale to challenge the terms of the sale order and proceed against the purchaser or the purchased assets with respect to liabilities or obligations of the target company. In particular, if the sale order is not stayed by an objecting party pending its appeal, a reversal of such order does not affect the validity of the sale, granting the purchaser even more protection that is not available in other sales contexts.

Notice requirements

To protect the rights of both the purchaser and the debtor's creditors, notice should be given to the most widespread and diverse audience possible under the circumstances. Extensive notice, providing parties with the opportunity to object to the sale or to certain aspects of it, helps to ensure that the sale order and/or other agreements related to the sale are enforceable to the fullest extent possible under the law. The parties should pay particular attention to providing notice to all relevant taxing and other governmental or regulatory authorities (eg, environmental authorities). To protect the parties from oversight and carelessness, notice should also be published in a reputable national newspaper.

Conclusion

Sales under Section 363 offer several protections and advantages that purchasers of assets of financially distressed companies should consider when they decide to buy such assets. Although bankruptcy sales can generally be more expensive and more complicated than non-bankruptcy sales, in many instances the benefits (especially to the purchaser) in the form of added protection and security can outweigh the extra costs and delay.

For example, by obtaining stalking-horse status the purchaser can be guaranteed the right either to purchase the assets free and clear of liens, claims and encumbrances if it is the successful bidder at the auction, or at least to be compensated for its costs and efforts if it is outbid at the auction. Proper attention to negotiating and drafting the sale agreement, the bidding procedures, the proposed bidding procedures order and the proposed sale order can further protect the purchaser by preventing many challenges to the sale and allowing the purchaser to insulate itself from many types of liability, thereby enabling it to achieve the benefits of ownership while being shielded to the greatest extent possible from the seller's pre-sale obligations.