FINANCIER WORLDWIDE corporatefinanceintelligence

DISTRESSED INVESTING

Distressed M&A – knowing how and when to buy assets

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In the midst of a tightening credit market, rising default rates, an imminent recession, and a weakened US dollar, investors worldwide are capitalising on a host of emerging investment opportunities, including acquiring the assets of a troubled company both inside and outside of bankruptcy. The trend in Chapter 11 cases has been an increasing volume of streamlined court approved asset sales under section 363 of the US Bankruptcy Code. These sales are optimally pre-negotiated prior to a bankruptcy filing and include special bid protections designed to protect the proposed buyer. The sale is then processed through a bankruptcy to cleanse the desired assets from unwanted liabilities and contracts. Indeed, the section 363 process can be a powerful tool for the distressed investor who knows how to use it properly.

From a potential buyer's perspective, there are numerous advantages associated with the strategic acquisition of a bankrupt company's assets, including (i) speed; (ii) acquiring assets free and clear of any creditor claim or interest; (iii) shedding undesired contracts and assets; (iv) causing the debtor/seller to 'assume and assign' desirable contracts, even those that may contain anti-assignment clauses; (v) protecting the buyer from certain successor liability claims; and (vi) obtaining fair value for the assets, thereby protecting the buyer's officers and directors from future undervaluation claims.

The prospective buyer also benefits from bid protections, including agreed upon bid procedures sanctioned by the bankruptcy court, and in certain instances, lock-up arrangements, reasonable break up fees, and expense reimbursement for a stalking horse bidder. From the debtor/seller's perspective, it is optimal to have a stalking horse bidder to set the base price for the assets as it prevents low ball offers and ensures the stalking horse bidder's commitment to buy the assets if there are no higher and better offers.

Still, there are drawbacks to buying through a section 363 sale process. In order to ensure that a debtor/seller obtains the highest and best price for its assets, and as a means of maximising recoveries to creditors, the bidding process is usually open to competitive bidding, thereby exposing prospective buyers, who might ordinarily have acquired such assets privately through a bilateral agreement, to market competition. In addition, certain types of liabilities, such as certain environmental claims, may not be fully cleansed by a section 363 sale. Finally, a bankruptcy court may impose specific limitations on pre-negotiated bid protections if they are deemed too onerous to allow fair bidding.

Given these complex dynamics, a host of financial players, including private equity funds, hedge funds, and market competitors need to carefully weigh the benefits and risks of participating in a privately negotiated out of court acquisition versus a section 363 sale.

The overall process

In a classic 363 sale scenario with a stalking horse bidder, the prospective buyer enters into an asset purchase agreement with the debtor and makes its bid subject to pre-agreed bid procedures subject to bankruptcy court approval. The stalking horse bidder will normally negotiate various bid protections, having already committed significant time and effort to performing due diligence and finalising the agreement. These protections generally include a combination of (i) a break-up fee between 1 and 5 percent of the sale price; (ii) expense reimbursement up to a negotiated cap; (iii) minimum increments for competitive overbids; (iv) qualification and deposit requirements for competing bidders; (v) strict deadlines for competing bids; and (vi) dates for the run-off auction, final court approval, and closing.

The stalking horse might also, in appropriate circumstances, couple a section 363 asset purchase agreement with debtor in possession financing using a separate closing or transition operating agreement which would be subject to bankruptcy court approval. Ultimately, these ancillary agreements may enhance the prospective buyer's ability to emerge as the successful bidder. In the case of debtor in possession financing, restrictions can be placed on the terms and default triggers may allow the lender/prospective buyer to foreclose or credit-bid its loan.

Once a deal has been pre-negotiated by the parties and the debtor/seller has filed for bankruptcy, debtor's counsel will file for the court's approval a motion approving, among other things, bid procedures for the debtor's assets, certain bid protections, and the scheduling of the sale and notice thereof. Under the Bankruptcy Code, in order to approve a section 363 sale, a bankruptcy court is required to find that (i) there is a sound business purpose underlying the sale; (ii) accurate and reasonable notice has been provided; (iii) a fair and reasonable purchase price has been paid, and (iv) the sale was the result of arms length negotiations and made in good faith.

Effective strategies for obtaining desirable assets

Section 363 of the Bankruptcy Code allows a bankruptcy trustee or debtor in possession to sell the debtor's assets "free and clear of any interest in such property." In most cases, creditor claims and interests are paid out of the sale proceeds and do not follow the prospective buyer. Broadly speaking, in a section 363 sale, liens attach to proceeds after the sale but are extinguished against the asset being sold if (i) applicable non-bankruptcy law permits the sale free and clear of such interest (ii) the lien holder consents; (iii) the price of the assets being sold is greater than the value of all liens; (iv) the lien is in bona fide dispute; or (v) the lien holder could be compelled to accept money to satisfy its interest.

The prospective buyer can shed undesired contracts and cause the debtor/seller to assume and assign desirable ones. As a precondition to acquiring a contract, the payment defaults will need to be cured or renegotiated consensually with the contract counterparty and the prospective buyer will need to provide adequate ▸▸

assurance of future performance, such as proof that it is financially capable of performing the contract terms going forward. The Bankruptcy Code does not, however, obviate the need to obtain government approval for the sale of regulated entities such as a licensed banking business. Nor can debtor/sellers necessarily assign every type of contract – in particular, those contracts where applicable non-bankruptcy law excuses the contract counterparty from accepting performance from an assignee (commonly implicated in intellectual property and personal services contracts).

Out of court negotiations – the appropriate timing of acquiring assets

Depending on a prospective buyer's appetite for risk and its knowledge of the relevant market or industry, an out of court acquisition strategy can yield several benefits. But there are risks: first, given the nature of a company in distress and the mounting difficulties it faces, more often than not, the state of its books and records will present challenges to a buyer who seeks to understand, within a relatively short timeframe, a true picture of the company's liabilities. Prospective buyers, therefore, assume some risk that that there may be unknown liabilities associated with a company on the brink of bankruptcy. Second, it is fairly uncommon in these circumstances, or in this tightening credit market, for a buyer to obtain a solvent entity or personal guarantee to protect against such unknown risks. Similarly, a buyer would not be well advised to rely on any indemnity from a cash-strapped company.

Nevertheless, it may make sense to acquire distressed assets as quickly as possible through an out of court arrangement in the event that a prospective buyer becomes aware of the potential sale of assets before its market competitor. If, for example, a buyer is looking to corner the market on a highly sought after piece of technology, such a buyer might be willing to bear some risk and/or pay a premium. In addition to buying the or marketable asset(s), these premiums can include hiring the company's employees and covering its operating expenses through closing, all the while restricting the seller's ability to shop the deal.

Obviously, a seller's top priority is to obtain the highest price it can for its assets, but in the context of a company running out of cash, there may be limited time and resources to fully market the assets or to obtain an appraisal or fairness opinion. In addition, there are significant expenses associated with filing a bankruptcy case and formally engaging in the 363 sale process – costs that the buyer or seller may be unwilling or unable to pay.

Depending on the parties' goals, a privately negotiated sale can be less disruptive to the company to the extent that customers, employees, and vendors may not be involved, as their interests would otherwise be implicated in a bankruptcy case. Given these potential advantages, paying a premium to participate in a private deal and avoid a bankruptcy auction could make sound business sense. Buyers who make this decision, however, should do so knowing they will be unable to reap the benefits of the section 363 protections mentioned above.

Final thought

Buyers of distressed assets should not overlook the section 363 sale option as a powerful tool to help manage the sale process, obtain the assets they want, and manage their downside risk. Although there will necessarily be upfront costs, a prospective buyer's commitment is, to a large extent, controllable. For many financial players looking at complicated distressed companies and taking all factors into account, the benefits to all parties in a section 363 sale scenario may outweigh the alternative of buying the assets in a private sale. ■

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