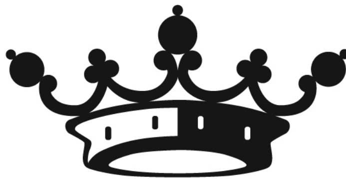
INSIDE THE MINDS

M&A Strategies for Bankruptcy and Distressed Companies

Leading Lawyers on Asset Valuation, Deal Structure, and Risk Management



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Important Tools in Distressed M&A Transactions

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Introduction

The beginning of the credit crisis in mid-2007 and other recent economic trends have increased the number of distressed companies that are seeking to sell assets as part of their plans to improve their financial condition or undergo other corporate debt restructurings. Based on recent financial data, the number of distressed companies soared from the fall of 2007 to the summer of 2008, as have the number of downgrades of corporate bonds. Companies with sound fundamentals may become available at attractive prices in the coming years, particularly compared to the sometimes-inflated valuations attached to many companies in the non-distressed market. However, buying distressed assets and companies inside or outside of bankruptcy court poses certain potential dangers and challenges that do not present themselves in the non-distressed M&A market, but also offers more significant upside opportunities for potential purchasers. To capitalize on these opportunities, buyers need to be especially focused on identifying distressed sellers and conducting the acquisition process in a manner that minimizes these dangers while maximizing these opportunities as much as possible. As more fully discussed below, the Chapter 11 process may provide both buyers and sellers with tools that will help them make the best of a distressed merger and acquisition transaction.

Practical Considerations for Buyers in Distressed M&As

Identifying a Distressed Seller and Due Diligence

Other than the filing of a bankruptcy petition, there may be other signs pointing to the fact that a company is in distress. Identifying these signs as early as possible may provide a buyer with a distinct advantage in pursuing and ultimately purchasing the distressed company or its assets.

In-depth due diligence is often the best method for discovering further details about a troubled company's financial distress. Once a buyer understands the reasons a company is struggling, it can more realistically assess the likelihood of returning the company to profitability. Note, however, that in looking for the sources of a company's distress, buyers

should avoid the common misconception that financial distress is solely caused by a company taking too much debt upon itself. Focusing too much on a company's debt levels can fool a buyer into thinking that the company's problems can be solved simply by restructuring the debt.

In reality, many different external and internal factors may cause financial distress. A company may be overleveraged or poorly managed, but that does not mean a buyer can turn things around by simply infusing capital or new management. Instead, buyers must weigh the potential for creating value to determine the corrective measures to take. Ratings downgrades of the company's debt may trigger defaults under the company's financing arrangements, limit access to commercial paper markets, and cause turmoil with a company's suppliers, who may be unwilling to continue to extend credit. An upcoming scheduled expiry of a company's credit facilities may cause the company to experience liquidity concerns and force it to take some unusual cash-preserving actions.

A company may also have undertaken a debt reduction program, including making certain asset sales or equity offerings, or certain cost reduction initiatives, such as layoffs, pursuing union concessions, and exiting from certain business lines. These may all be signals that a company is entering or about to enter into a period of financial distress, which may provide an opportunity for an astute buyer to attempt to purchase the company or its assets. An unexpected change in senior management, especially in the positions with responsibility for the company's financial matters, can be another indicator that a company is experiencing a certain level of financial distress.

The company's capital structure can also be a sign of possible forthcoming financial problems. If a company has a complex capital structure, dominated by multiple affiliates issuing multiple series of public debt with covenants limiting the granting of liens, asset sales, and other fundraising activities, this structure may potentially lead to liquidity problems down the road, as even a well-functioning company may get itself into a complex web of debt-related restrictions that it soon becomes unable to handle effectively.

The possibility of impending significant regulatory investigations or decisions regarding the company, which may trigger (or increase) class actions or stockholder derivative actions against the company, should also be considered. The more a company and its senior executives have to focus on regulatory and litigation issues as opposed to running the business of the company, the greater the chance that problems may arise regarding the business, or warning signs regarding the distress of the business may be overlooked by the people whose job it is to keep on top of these issues and potential problems.

A buyer should look very carefully at the company's products, know-how, customer and supplier relationships, market share, competition rates, production costs, industry conditions, and other intangibles. All of these areas, if not properly managed or addressed, may lead an otherwise healthy company into financial distress. If there is insufficient demand for the company's products or services, or if the company lacks a viable business model, the company's profit streams may soon begin drying up. Buyers should also try to determine how the company responds to financial distress. Even if the company once had promise, it may have invoked short-term survival strategies that irreparably damaged its long-term prospects. The company may have cut spending on research and development or marketing to generate immediate cash flow benefits for itself and its balance sheet, which will make the prospect of long-term recovery very difficult. If the company discounted prices to maintain customers, it would probably be difficult to return to the old pricing structure, again making recovery difficult. While delving into these issues is undoubtedly difficult and time-consuming work, the risk associated with overlooking or not properly considering issues of these types and magnitudes may someday mean the difference between a successful or an unsuccessful investment.

Legal Issues Involved in Distressed Transactions

Several categories of legal issues may be involved in purchasing the equity or assets of a distressed company. Set forth below is a discussion of several of these issues.

Fiduciary Duties

Both the seller and the buyer must be cognizant of the fiduciary duties involved in undertaking the distressed transaction. Under Delaware law, which governs most corporations, directors owe to the corporation the primary duties of "care" and "loyalty." The duty of care requires that directors exercise the degree of care that ordinarily careful and prudent people would use in similar circumstances. The duty of loyalty obligates directors to act in good faith in the best interests of the corporation and its stockholders, and to refrain from engaging in activities that would provide such directors with an improper personal benefit from their relationship with the corporation. The duty of loyalty also prohibits self-dealing and usurpation of corporate opportunities by directors.

In the discharge of their fiduciary duties, directors generally have the benefit of the "business judgment rule," a presumption that in making a business decision, the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action they took was in the best interests of the corporation. A director's business judgment will generally be respected, and will not be second-guessed by the courts. In a lawsuit challenging the director's conduct, the burden will be on the party challenging the decision to establish facts rebutting the presumption underlying the business judgment rule. The justification for the business judgment rule is that without it, people would not be willing to serve as directors or take appropriate risks for the benefit of the corporation.

There are, however, circumstances in which directors are not entitled to the presumption afforded by the business judgment rule. For example, when a director has a personal interest in a matter, implicating the duty of loyalty, the director loses the benefit of this presumption, and the director's conduct is measured by a much stricter standard—"entire" or "intrinsic" fairness to the corporation. In a lawsuit challenging the director's conduct, the burden of proof in these cases rests upon the director to show that his or her conduct satisfies the "entire" fairness test (which focuses on the fairness of both the transaction's price and the process of the transaction).

The duties of directors of a solvent corporation run to the corporation, which is to be managed for the benefit of its stockholders. No fiduciary duties are owed to creditors of a solvent corporation, as confirmed recently by the Delaware Supreme Court. In *North American Catholic Educational Programming Foundation Inc. v. Gheewalla*, 2007 WL 1453705 (Del. May 18, 2007), the court stated that in the context of a solvent corporation, directors owe their fiduciary obligations to the corporation and its stockholders. While stockholders rely on directors acting as fiduciaries to protect their interests, creditors are afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law, and other sources of creditor rights. Generally, directors do not owe creditors duties beyond the relevant contractual terms.

Until recently, many believed that the duties of directors shifted as a corporation neared insolvency. It was generally thought that entering the so-called "zone of insolvency" was a triggering event for changing a director's duties, and that it might even strip directors of the protection of the business judgment rule. In *Gheewalla*, the Delaware Supreme Court set forth the current state of Delaware law regarding this issue. The Delaware Supreme Court stated that the duties of directors, and the beneficiaries of such duties, do not change as insolvency of the corporation becomes more likely—i.e., the Delaware Supreme Court held that the "zone of insolvency" theory has no legal significance. Therefore, no direct claim for breach of fiduciary duties may be asserted by the creditors of a solvent corporation, even one that is operating in the "zone of insolvency." When a solvent corporation is navigating in the "zone of insolvency," the focus for Delaware directors does not change—directors must continue to discharge their fiduciary duties to the corporation and its stockholders by exercising their business judgment in the best interests of the corporation for the benefit of its stockholders.

The Delaware Supreme Court in *Gheewalla* firmly rejected those previous decisions that implied that there might be some ill-defined moment as a corporation nears (but had not yet reached) insolvency when the scales tipped and the fiduciary duties of directors expanded to include creditors,

along with stockholders. The court reasoned that a lack of a bright-line test (i.e., that fiduciary duties apply to creditors only after the corporation actually becomes insolvent) may lead to uncertainty on the part of directors that might constrain them from making necessary decisions for fear that their judgment might be second-guessed as having been motivated by a desire to serve the wrong constituency or the corporation.

Once a corporation actually becomes insolvent, however, the duty of directors expands—requiring directors to direct the affairs of the corporation to maximize its value for the benefit of all of its stakeholders. When a corporation is solvent, those stakeholders are the corporation's stockholders, and when the corporation is insolvent, its creditors take the place of the stockholders as the residual beneficiaries of any increase in the value of the corporation. The primary object of the directors' duties remains the same, however—directors owe their duties to the corporation. When a corporation becomes insolvent, directors can pursue value-maximizing strategies, while recognizing that the corporation's creditors have become its residual claimants, and the advancement of their best interests has become the corporation's and its directors' principal objective. This follows logically from the conceptual premise that directors primarily owe fiduciary duties to the corporation itself, and only secondarily to the indirect beneficiaries of their work.

Notwithstanding the Delaware Supreme Court's decision in *Gheewalla*, a recent Delaware bankruptcy court decision has breathed new life into the "zone of insolvency" theory. The case, *George L. Miller v. McCown De Leeuw & Co. (In re The Brown Schools)*, 386 B.R. 37 (Bankr. D. Del. April 24, 2008), involved a private equity firm's efforts, over a number of years, to restructure the firm's investment in one of its portfolio companies. These efforts eventually failed, and the portfolio company filed for liquidation under Chapter 7 of the Bankruptcy Code. The trustee appointed in the company's Chapter 7 case asserted causes of action against the private equity firm, certain of its affiliates, and its board designees based, in large measure, on the "zone of insolvency" theory—i.e., that the private equity firm only engaged in transactions that prolonged the life of the portfolio

company in order to recover on its own investment, to the detriment of the other creditors of the portfolio company.

It should be noted, however, that in *Brown Schools*, the Delaware bankruptcy court reintroduced the "zone of insolvency" theory only in the context of an alleged breach of the duty of loyalty by the directors of the portfolio company (among other causes of action), and clarified that while an independent cause of action under the "zone of insolvency" theory would not be sustained by the Delaware courts, the use of the "zone of insolvency" theory as a component of or as a measure of damages for another cause of action may be allowed to proceed under Delaware law.
In *Brown Schools*, the bankruptcy trustee asserted causes of action against the defendants for breach of the duty of loyalty, corporate waste, and civil conspiracy. The defendants objected, contending that the trustee's claims were based on the "zone of insolvency" theory—that the defendants wrongfully prolonged the debtors' existence, which, under Delaware law, could not serve as a basis of liability. The bankruptcy court refused to dismiss the causes of action, holding that the trustee's claims for breach of the duty of loyalty properly alleged, among other things, that the defendants prolonged the life of the company for the benefit of the defendants, and to the detriment of the debtors and their creditors.

In addition, the bankruptcy court ruled that the "zone of insolvency" theory may be applicable with regard to damages calculation. The trustee alleged that the defendants' actions increased the insolvency of the debtors by, and sought damages of, as much as $22 million. The defendants objected, arguing that the damage calculation improperly applied the "zone of insolvency" theory. The bankruptcy court disagreed. The court stated that the "zone of insolvency" theory, while it could not be used by a plaintiff as an independent cause of action against a defendant, could be used as a basis for calculating damages for a viable cause of action brought by a plaintiff against a defendant—such as breach of the fiduciary duty of loyalty.

It is important to note that while *Brown Schools* may portend a revival of the "zone of insolvency" theory as both a component of a conventional cause of action and a measure of damages, it does so only in the context of a

motion to dismiss. The decision not to dismiss the cause of action based, in part, on the "zone of insolvency" theory, does not mean that the court will find that the alleged facts are correct or sufficient to ultimately sustain the asserted causes of action against the defendants.

For practical purposes, since it is hard, in fact, to pinpoint the exact moment of "insolvency," directors should take care, when a corporation is experiencing hard times, to begin to take into account the interests of creditors and other stakeholders of the corporation, even if directors do not owe any formal duties to those parties until insolvency of the corporation actually occurs. Notwithstanding the above discussion, it can be argued that the "zone of insolvency" theory exists whether courts recognize it or not, because of the uncertainty in calculating the precise moment of a corporation's insolvency. A prudent and well-advised board of directors will therefore consider the effect of their actions on creditors and other stakeholders of the corporation—and not just stockholders—well before a court would recognize a formal duty for them to do so. Directors' focus should always remain on maximizing the value of the corporation, with decisions arrived at after appropriate deliberation and upon sufficient information and professional advice.

Successor Liability

Acquisitions of distressed businesses are generally structured as asset purchases, with the buyer attempting to avoid assuming as many liabilities associated with the distressed business as possible. As a general matter, buyers of assets are not liable for any liabilities of the seller. However, a number of important exceptions require consideration in connection with acquisitions of distressed companies.

The buyer will have successor liability if it expressly or impliedly agrees to assume the liabilities of the seller under an asset purchase agreement. The asset purchase agreement in any distressed M&A transaction should very carefully establish what liabilities are being excluded from the purchase and what liabilities are being assumed by the buyer. Even a carefully drafted

purchase agreement, however, will not absolutely limit successor liability due to the various doctrines described below.

The buyer will also have successor liability if, through the transaction, the buyer is deemed to have engaged in a "de facto merger" with the seller. The most critical factor implicating the "de facto merger" exception is whether the stockholders of the buyer are the same as the stockholders of the seller. Generally, four elements must be present in order for a court to invoke the "de facto merger" exception:

- There must be a continuation of the enterprise of the seller (e.g., through a continuity of management, personnel, physical location, assets, and general business operations)
- There must be a continuity of stockholders such that the stockholders of the seller become stockholders of the buyer
- The seller must cease its ordinary business operations, liquidate, and dissolve as soon as possible
- The buyer must assume those liabilities and obligations of the seller ordinarily necessary for the uninterrupted continuation of normal business operations of the seller.

Certain federal and state statutes can also override the intention of the parties in an asset transaction regarding successor liability. If the seller has existing federal labor and employment claims, environmental claims, and/or product liability tort claims, a buyer must be especially cautious since these claims can have their own "successor" liability standard.

Agreements in Distressed M&As

Preliminary Agreements

Care should be taken before entering into any agreements in relation to a distressed M&A transaction. Typically, there are several forms of

preliminary agreements the buyer may desire to enter into early in the process of a distressed M&A transaction. These agreements include confidentiality agreements, standstill agreements, and exclusivity agreements.

Regarding confidentiality agreements, buyers should try to avoid provisions whereby the buyer agrees not to disclose the existence of discussions regarding the transaction or the terms of a proposed transaction to any third party. In a distressed M&A situation, a buyer should closely consider whether it should agree to such a provision, in order to allow itself to preserve the ability and flexibility to promote the distressed transactions to the seller's creditors and perhaps collaborate with other bidders regarding the potential transaction.

Sellers often seek to have a potential buyer enter into a standstill agreement early in the transaction process in order to curb the ability of the buyer to purchase claims against the seller, which may give the buyer a point of leverage in negotiations with the seller. Buyers generally disfavor entering into such agreements since, without a claim, a buyer may not have standing to object to the sale process in the bankruptcy court if it ends up having an issue with how the sale process was run. If a buyer does end up agreeing to a standstill, it should require, at a minimum, that a "most-favored nation" provision be included, which would loosen the standstill and other restrictions related thereto to the extent they are loosened for others involved as potential buyers in the transaction. This will discourage the seller from offering special arrangements to favored buyers, such as insiders.

A buyer should also be wary of capitulating to the seller's point of view regarding any issue in exchange for the seller agreeing to enter into an exclusivity agreement with the buyer. Exclusivity arrangements are of uncertain value in the distressed setting because they are contrary to a fundamental objective of the bankruptcy process—obtaining the highest and best offer for the assets to maximize the proceeds available for creditors. As a result, although these agreements may be useful for optical or strategic purposes, buyers should not assume they are enforceable

without bankruptcy court approval (which will often be difficult to get, since it would require a showing to the court that entering into an exclusivity agreement was not contrary to a basic tenet of the bankruptcy process).

Purchase Agreement

The purchase agreement for a Chapter 11 sale is typically quite similar to a non-bankruptcy purchase agreement, with the following exceptions:

- There will usually be detailed provisions describing the bankruptcy process, including the proposed bidding procedures.
- The consideration being paid may be unusual. It may include claims against the seller or equity in the business being purchased. In addition, since the comparison of offers will turn primarily on the value offered, buyers should make sure the purchase agreement spells out each element of consideration, including items such as the value of assumed liabilities, severance, or similar costs saved by the buyer's continued employment of employees associated with the purchased business and the avoidance of shutdown costs.
- The agreement will include a process for the designation, assumption, and assignment of contracts, and should include mechanisms for the determination and payment of cure costs. In many cases, the agreement is predicated on estimates of cure costs, and will specify what happens if a cure cost is ultimately determined to exceed the estimate.
- There will likely be fewer representations and warranties (e.g., due organization, capitalization, authorization, etc.) and limited post-closing indemnification for breaches of those representations and warranties.
- There may be fewer post-closing covenants (e.g., transition services, tax matters, etc.) from the seller. This will depend on the seller's prospects post-closing, and its ability (and

desire) to retain the assets and contracts needed to perform these services, or willingness to attempt to require the assignee of those assets or contracts to perform these services.

- There may be fewer conditions to closing, because in most cases, the Bankruptcy Code nullifies things like stockholder consent and third party contract consents.
- Care should be exercised regarding the tax, environmental, and product liability sections of the purchase agreement. These areas may pose particular challenges due to the risk of successor liability, as discussed above.
- The agreement will be governed by the federal bankruptcy laws, in addition to the appropriate state laws, and the parties will submit to the bankruptcy court's jurisdiction for the resolution of disputes.

Acquiring Assets Pursuant to a 363 Sale in the Bankruptcy Context

A "363 Sale" commonly refers to a sale of material assets by a bankruptcy debtor outside the context of a confirmed plan of reorganization. A 363 Sale gets its name from Section 363 of the Bankruptcy Code (11 U.S.C. § 363), which governs the sale and use of the property of a debtor. Section 363 provides that a debtor may use or sell assets within the ordinary course of business without bankruptcy court approval. Thus, a debtor may continue to sell inventory in the ordinary course of business without prior approval from the bankruptcy court. For any use or sale of assets outside of the ordinary course of business, however, Section 363 requires prior bankruptcy court approval. As an M&A transaction by its very nature is outside the ordinary course of business, such transactions require prior bankruptcy court approval.

Although consummation of a sale through a confirmed plan of reorganization has certain benefits, confirmation of a plan of reorganization can be procedurally and substantively cumbersome, introducing both delay and execution risk to a contemplated M&A transaction. 363 Sales, by comparison, may be implemented by motion of the debtor to the

bankruptcy court—a process that is dramatically less cumbersome than confirmation of a plan—and may be approved by the bankruptcy court even if no creditors support the proposed transaction. As a consequence, buyers and debtors often prefer 363 Sales over sales consummated through a plan of reorganization. Indeed, in certain circumstances, debtors have been forced to abandon attempts to implement an asset sale through a confirmed plan of reorganization and instead substantially pursued a 363 Sale, due to the inability to satisfy the procedural and substantive hurdles necessary for confirming a plan.

Typically, a 363 Sale will involve some form of public auction. While technically not prohibited, completely private sales where material assets are not exposed to an open marketing process are rare and require the debtor to overcome significant evidentiary hurdles. In a private sale, the debtor will be required to prove to the bankruptcy court that it is receiving fair value for the assets, usually through expert valuation testimony. In a public auction, however, fair market value may be presumed, provided the marketing and auction process was adequate. From a practical standpoint, stakeholders, who are often inherently skeptical of whether the last dollar possible has been obtained, will likely oppose any attempt to implement an M&A transaction that does not involve some level of public marketing and exposure. For these reasons, private sales are rarely undertaken.

The Auction Process

Most bankruptcy auctions typically involve two phases—the private marketing phase, during which a debtor seeks to obtain a "stalking horse" bid (or the first favorable bid obtained by the debtor that the debtor will use to set the base price for the assets), and a public marketing phase, during which the debtor exposes the stalking horse bid to topping bids. On occasion, either because of timing concerns or because a stalking horse bid was not obtainable, a debtor will seek to proceed at an open auction with no stalking horse bid in the hope that by exposing the assets to public auction, the debtor will be able to generate interest from prospective suitors.

The private marketing phase is substantially similar to the marketing of an asset outside of bankruptcy—financial advisers will prepare teasers and solicit interests from a wide range of strategic and financial prospective suitors; offering memorandums will be prepared and distributed once confidentiality agreements are signed; and access to management and confidential due diligence will be provided to those prospective bidders who have demonstrated sufficient interest in the asset, typically through letters of intent or expressions of interest, thus warranting advancement to the next phase. Depending upon the level of interest expressed, a successful marketing process will lead to the selection of one or more bidders with which to negotiate definitive documentation with respect to the transaction. The goal for the debtor should be to complete the private marketing phase with a definitive agreement fully executed by a stalking horse bidder that has little to no contingencies.

A prospective buyer who wants to purchase the assets must first determine whether it wants to be the stalking horse bidder in the auction process. As an initial matter, because the asset will ultimately be exposed to public competitive bidding, there is the possibility that the stalking horse bidder will overpay, and could have paid less if it had waited for the public auction to commence. Further, pursuit of becoming a stalking horse bidder can require substantial time and resources with no assurance of success. Often the stalking horse bidder can be compensated for its time and expenses through a break-up fee, discussed more fully below, but if there are several parties with aspirations of becoming the stalking horse bidder these monetary incentives will likely diminish. Furthermore, even after undertaking exhaustive due diligence, the stalking horse bidder may find that that the assets are sold to a different bidder.

Nevertheless, unless its intent is to "bottom fish," for those buyers that are determined to purchase the assets and are willing to expend the time and resources on necessary due diligence, the objective should be to become the stalking horse bidder. Perhaps most important, the stalking horse bidder controls the terms of the transaction, including the final form of the asset purchase agreement which will serve as the baseline from which all other prospective bidders are required to work when formulating their bids.

Prospective bidders will be discouraged from deviating substantially from the terms and conditions set forth in the stalking horse bidder's asset purchase agreement. Rather, they will be encouraged to make as few modifications as possible, if any, to the form agreement agreed upon by the debtor and the stalking horse bidder.

Another advantage that a buyer obtains when it serves as the stalking horse bidder is that it has substantial leverage in crafting the bidding procedures for the auction. Most stalking horse bidders will require the debtor to file a motion promptly following execution of the definitive asset purchase agreement seeking approval of bidding protections and the procedures that must be followed by other prospective bidders when participating in the auction. Approval of the transaction is reserved until after the auction process is complete. The winning bidder and the debtor must return to the bankruptcy court to seek its blessing of the transaction.

The stalking horse bidder can require, as a term of its commitment, that certain bid procedures be utilized. For instance, the stalking horse bidder may ask that the auction be fast-tracked, thereby limiting the ability of other prospective bidders to conduct effective and meaningful due diligence. The stalking horse bidder may also demand that the bidding procedures provide for hefty incremental bids with a view toward discouraging prospective bidders from engaging in a bidding frenzy. A stalking horse bidder can also require that any prospective bidders be required to submit a good faith deposit of a significant sum. Effectively, what the foregoing accomplishes is to allow the stalking horse bidder to utilize the form asset purchase agreement and the bidding procedures to thin the pool of bidders and make it more likely that it will be able to purchase the assets at the price and on the terms that it initially negotiated with the debtor.

With respect to monetary incentives, a debtor will normally induce the stalking horse bidder to make an initial bid by compensating it for the time and expenses incurred with respect to the formulation of the initial bid. Such incentives include, among others, a break-up fee if the debtor accepts a higher offer from a third party bidder, and reimbursement for certain expenses, including due diligence expenses. Break-up fees vary depending

on the size of the transaction, but typically range from one to 3 percent of the transaction size. These fees compensate the stalking horse bidder for participating in the upside of the auction should the assets be sold to a third party at a certain price, and they may discourage prospective bidders from participating in the auction by increasing the amount of the initial upset price. Other prospective bidders will be required to not only match the bid of the stalking horse bidder but also increase their bid by an amount in excess of the break-up fee, thereby allowing the debtor to pay the break-up fee and still provide a return to the debtor's bankruptcy estate in excess of what the stalking horse bidder originally proposed.

One protection that a stalking horse bidder often negotiates for which has little practical utility is a "no shop" provision, which prohibits the debtor from actively seeking to enter into discussions or negotiations with other potential bidders. These provisions usually contain a fiduciary out, permitting the debtors to negotiate with any prospective bidders that approach the debtor. Anytime there is a public auction, the bidding procedures, in accordance with the mandates of the Bankruptcy Code, will require or at least permit that notice of the auction be given not only to all parties in interest in the case, including all creditors and equity holders, but also to any entity who may be thought to have an interest in acquiring the asset, through direct service of the pleadings and sometimes through publication notice. Effectively, the prospective bidders will be informed of their ability to contact the debtor and commence negotiations, thereby eliminating any perceived advantage associated with the "no shop" provision. Further, courts disfavor "no shop" provisions because they leave the court with the impression that the debtor has limited its fiduciary duty to maximize the value of the estate for the benefit of the creditors, by failing to market the assets to all potential bidders.

In determining whether to approve the transaction, the bankruptcy court will employ a business judgment analysis and require the debtor to establish that a sound business justification exists for the sale of these assets. Courts look to various factors to determine whether to approve the transaction, including whether (i) a sound business reason exists for the proposed transaction; (ii) fair and reasonable consideration is being provided; and (iii)

the transaction has been proposed and negotiated in good faith. At the sale hearing, the debtor should be prepared to provide sufficient evidentiary support establishing the reasons for selling these assets; the manner in which management came to the decision; and how the assets were marketed. Normally, a bankruptcy court will not upset the auction process by refusing to approve the winning bid. The bankruptcy court may presume that a fair market value was established through the auction process, provided the court concludes the process was conducted appropriately. Any challengers will have the burden of rebutting these presumptions and demonstrating that the price received by the debtor is grossly inadequate or that the auction process was materially flawed.

A prospective buyer should be aware of the fact that even where the auction is officially over and all that is pending is confirmation of the sale, bankruptcy courts have exercised their discretion to consider higher bids from other parties at the confirmation hearing, though such occurrences are a rare event.

Purchasing Assets Free of Liens or Interests

Section 363(f) of the Bankruptcy Code permits the bankruptcy court to authorize a sale of assets free of "any interest" that an entity has in the debtor's assets. The term "interest" is generally thought to encompass liens, encumbrances, and claims. However, it is still unsettled whether an acquirer can purchase assets through a 363 Sale free and clear of successor liability claims.

Reduced Litigation Risk

By purchasing assets through a 363 Sale, as opposed to buying assets from a distressed company outside of the bankruptcy context, the risk of subsequent litigation is drastically reduced. Outside of bankruptcy, a risk of subsequent litigation exists where the acquirer purchases assets from an insolvent seller. If the seller subsequently files for bankruptcy, the acquirer runs the risk of being sued, as the seller's bankruptcy estate may seek to recover these assets for the benefit of all of its creditors through a

fraudulent conveyance action, as set forth above. An acquirer is susceptible to being sued by the debtor (or a trustee) for a fraudulent transfer for up to six years after the transaction is completed, depending on whether the debtor seeks to avoid the transaction under state or federal law.

For a debtor to avoid the transaction as a constructive fraudulent conveyance, the debtor needs to show that the debtor received less than a reasonably equivalent value in exchange for the assets and was insolvent. In the bankruptcy context, the definition of insolvency is broad, and in addition to a balance sheet test or determination of insolvency, if the debtor was not generally paying its debts as they became due, it can take into account whether the debtor was adequately capitalized. With respect to the "inadequacy of capital" prong, the bankruptcy court is given the benefit of hindsight after the target failed. Ultimately, a bankruptcy court may determine that the debtor was insolvent at the time of the transaction even where the buyer understands the debtor to be solvent from a balance sheet perspective.

The consequences to the acquirer if it is on the losing side of a fraudulent conveyance action can be severe. Under most circumstances, the acquirer's exposure is the difference between the price paid for the assets and the fair market value of the assets at the time of transfer. However, if the acquirer was determined to have lacked the requisite good faith in the transaction, the acquirer may be required to surrender the property or cash equal to the value of the property, and only receive a general unsecured claim against the debtor equal to the amount paid.

Credit Bidding

An acquirer in pursuit of a debtor's assets may also consider purchasing a material position in the capital structure of the debtor, whether or not the debtor's debt is trading below the acquirer's perceived fair valuation. By taking a position in the debtor's secured debt, an acquirer can seek to purchase assets through a 363 Sale without the infusion of fresh capital. Section 363(k) of the Bankruptcy Code permits a secured claim holder to bid at a 363 Sale and, if it is successful, offset its claim against the purchase

price of the assets. Thus, if an acquirer has taken a position in the debtor's secured debt, it may bid at the 363 Sale for any assets subject to its security interest, and offset its claim against the purchase price.

Purchasing a material position in the capital structure has other advantages besides merely giving the acquirer an ability to credit bid. Besides giving the acquirer a proverbial "seat at the table" to potentially influence any negotiations that take place in the bankruptcy proceeding, the acquirer may lower its acquisition costs by realizing on a perceived discount in the trading value of the debt, or mitigating the investment cost required to pursue the asset in the event that the acquirer does not become the stalking horse bidder in a later 363 Sale through the creation of a competitive environment that leads to a greater return on its debt position.

Acquiring a Business Pursuant to a Confirmed Chapter 11 Plan

Another means by which a party can acquire a business is through a plan of reorganization, or a Chapter 11 reorganization plan. An acquisition through a confirmed plan may be by choice, or dictated by the facts and circumstances of the bankruptcy case. In certain situations, the acquirer has no choice but to proceed with the acquisition through a plan of reorganization, such as an investment that requires a stock acquisition. This typically occurs where the debtor has valuable licensing rights, or other contractual obligations of significant benefit, that are not assignable to third parties. This strategy is equivalent to providing an equity sponsorship where the old equity is cancelled and new equity is issued to the acquirer under the plan of reorganization. Asset transactions are also possible through a confirmed plan of reorganization.

An acquisition through a confirmed plan can be distinctly different from a 363 Sale. Although the debtor is usually the proponent under a plan of reorganization, subject to certain limitations, a plan may be proposed by parties other than the debtor and confirmed without debtor support, providing the opportunity to pursue the acquisition in a hostile-like manner. The 363 Sale process can commence only upon motion of the debtor,

which means that the debtor must be in agreement with the terms and conditions of the sale.

One drawback to purchasing assets through a plan of reorganization is that getting the plan confirmed can be a lengthy and expensive process. The proponent is first required to file the plan and disclosure statement with the bankruptcy court. A disclosure statement is akin to an offering memorandum, and provides claimants and equity interest holders of the debtor with sufficient information regarding the distributions each will receive under the plan; when such distributions will be made; and describes any contingencies to the distribution, if any. Before the plan of reorganization can even be solicited (i.e., distributed to creditors for a vote), the disclosure statement must be approved by the bankruptcy court. In determining whether to approve the disclosure statement, the bankruptcy court must be satisfied that the disclosure statement contains "adequate information" sufficient to enable claimants and equity holders to make an informed judgment about the plan. Parties may object to the disclosure statement, either because the disclosure statement does not adequately describe the provisions of the plan, or because the plan cannot be confirmed because it does not comply with the relevant provisions of the Bankruptcy Code.

Once the bankruptcy court approves the disclosure statement, it will be sent (along with the plan and ballots) to the creditors and equity interest holders of the company to solicit their votes. The bankruptcy court order approving the disclosure statement will set a deadline for parties to vote and for parties to object to the confirmation of the plan, as well as a date for a hearing where the bankruptcy court will determine if the plan meets the confirmation requirements of the Bankruptcy Code. Generally, parties are given between one to two months to consider, vote on, or object to the plan.

Aside from the lengthy confirmation process, unlike a 363 Sale where the bankruptcy court can approve the sale of material assets (including substantially all of the debtor's assets) over the objection of every single creditor, an acquisition through a confirmed plan requires at least minimal

support from creditors—otherwise, the plan or reorganization will not be confirmed. Thus, the plan process can be potentially derailed, as other stakeholders are provided with an opportunity to oppose confirmation of the plan.

There are distinct advantages to acquiring a business through a plan of reorganization. Although acquisitions through a plan of reorganization are often exposed to a public auction process, because of the additional creditor protections (i.e., confirmation requirements) provided for under Section 1129 of the Bankruptcy Code, and the inherent evidentiary burden present in any plan confirmation setting, exposing a transaction to competitive bidding is not as universal. In fact, it is not unheard of for a sale through a plan of reorganization to not become exposed to competitive bidding.

Several other benefits can be reaped by an acquirer when proceeding with an acquisition through a plan of reorganization. These benefits are discussed below.

Exemption from Transfer Taxes

If an acquirer expects that it will incur significant transfer taxes (e.g., state or local taxes incurred upon the transfer of real or personal property) in the purchase of the debtor's assets, then acquiring these assets through a Chapter 11 plan would be the preferable route, rather than through a pre-plan 363 Sale. This is because Section 1146(a) of the Bankruptcy Code provides an exemption that was intended to encourage and facilitate bankruptcy asset sales. Specifically, this section exempts parties from paying stamp taxes or similar transfer taxes on assets sold pursuant to a confirmed Chapter 11 plan. Until recently, there was considerable disagreement over whether Section 1146(a)'s exemption applied to pre-confirmation transfers, or sales pursuant to Section 363 of the Bankruptcy Code. In June 2008, the United States Supreme Court in *Florida Dept. of Revenue v. Piccadilly Cafeterias Inc.*, 128 S.Ct. 2326, No. 07-312, 2008 WL 2404077 (U.S. June 16, 2008), settled this issue when it held that the exemption on transfer taxes

contained in Section 1146(a) applies only to transfers of assets made pursuant to a confirmed plan.

Exemption from Securities Registration Requirements

While Section 1145 is typically relevant in a stand-alone plan context, it has been used in conjunction with the acquisition of a business to permit an initial public offering of the acquirer's stock without the necessity of filing a registration statement with the Securities and Exchange Commission. Section 1145 of the Bankruptcy Code exempts parties in a Chapter 11 bankruptcy case from federal securities registration requirements, as well as any state or local securities registration requirements. Specifically, section 1145(a) of the Bankruptcy Code provides an exemption from the registration requirements where securities (including warrants, options, and rights) of the reorganized debtor, or the debtor's successor, are exchanged for pre-bankruptcy claims against interests in the debtor pursuant to a confirmed Chapter 11 plan.

Releases and Injunctions

The acquirer can often obtain broad releases and injunctions as part of the plan of reorganization that otherwise would be unavailable in the 363 Sale context. Such releases and injunctions go beyond Section 363(f) of the Bankruptcy Code, including releases and injunctions against successor liability. The plan can also make use of sections of the Bankruptcy Code that specifically authorize the bankruptcy court to enter a sweeping injunction, or channeling injunction, which prohibits certain bankruptcy claimants from pursuing their claims after confirmation if the claimant is to be paid in whole or in part by a trust created through a qualifying plan of reorganization. These sorts of injunctions are typically found in asbestos and mass tort cases.

Another example of a broad release is third party releases. For example, a plan can provide for an injunction preventing any creditor or equity security holder from asserting any claim against an acquirer. These sorts of injunctions are rare and only allowed upon a showing of exceptional

circumstances and the satisfaction of certain factors including, among others, the debtor's reorganization will have little chance at success without the injunction and a substantial majority of the creditors agree to the injunction. However, such injunctions are not unheard of, and should at least be contemplated in connection with any acquisition.
Ultimately, the availability of these releases depends on the facts and circumstances presented.

Taking a Position in the Capital Structure to Facilitate an Acquisition

As an alternative to directly purchasing the assets of the debtor, an acquirer may want to consider buying and holding either unsecured or secured claims of the debtor through the reorganization process in an attempt to convert those claims into equity of the newly reorganized debtor. For instance, an acquirer may buy a controlling position in the "fulcrum class" of claims, or employ a "loan to own" strategy.

The strategy of buying into the "fulcrum class" is implemented by first identifying the fulcrum class of claims—the class of claims where the equity of the debtor will be distributed when the reorganization is complete. A "loan to own" strategy is implemented by an acquirer extending credit pre-bankruptcy to the debtor or acquiring the secured debt of the debtor, either before it enters bankruptcy or after the bankruptcy filing, with a view toward converting its debt into a controlling equity position. Similarly, an acquirer can explore a "DIP to own" strategy, whereby the acquirer bridges the debtor's liquidity needs at the commencement of a Chapter 11 case through court ordered debtor-in-possession (DIP) financing with a view toward acquiring the debtor's equity through the bankruptcy process.

Such DIP financing should require a quick sale of the debtor's assets, and provide that the acquirer will serve as the stalking horse bidder in the transaction. The acquirer can also use its position as DIP lender to negotiate a plan of reorganization that would convert its debt to equity. One benefit to the acquirer, as DIP lender, is the ability to obtain a senior position in the debtor's capital structure while wading through the plan process, thereby reducing execution risk. The acquirer can also negotiate its

ability to exercise its remedies under the loan agreements in the event of default by the debtor during the bankruptcy proceeding. The acquirer can take comfort in the fact that these remedies will be approved by the bankruptcy court prior to any extension of credit. This situation is unique to a DIP lender, in that if the acquirer was merely a prepetition (i.e., pre-bankruptcy) secured creditor, it would be precluded from enforcing its rights under the loan documents as a result of the automatic stay imposed by the Bankruptcy Code.

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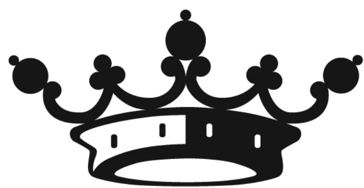

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